Monthly Economic Newsletter
March 2018

Economics & Regulation Services of Grant Thornton

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Monthly Outlook

Up until the Summer of 2016 it was mostly negative views about the world economy that dominated market sentiment: many thought that the Chinese economy was going to decelerate abruptly sooner rather than later; the US economy seemed poised to enter recession because of the problems related to the energy sector; Brexit was seen as the first step that would end up leading to the collapse of the European Union; secular stagnation seemed to be the name of the game, meaning that the global economy appeared to be stuck in an equilibrium of very low growth and with aggregate demand remaining structurally weak and unable to create any kind of inflationary pressure…

But after that date everything began to look a little more upbeat: the world economy started to accelerate more clearly; the global cycle became more synchronized; international trade gained significant dynamism…

When the market decided to turn more optimistic it was just reflecting what was increasingly obvious: one just needed to look at macro data to conclude that the world was doing much better than many had been saying.

Accordingly, the market decided to leave the so called secular stagnation theory behind and embraced a new mantra: the (eternal) goldilocks economy. What this new "theory" basically says is that we are (yet again) in a new normal in which the world economy is able to grow at solid rates without ever generating any kind of inflationary pressure.

If this goldilocks scenario were to be possible it would obviously be something marvellous for everybody: risky assets need to go up because the economy is doing so well; and safe assets (specially long-term government bonds) should also increase in value because central banks will never be forced to increase interest rates in any significant way.

Regrettably the view that the world can permanently grow above potential without generating any kind of wage and/or price pressures is contrary to common sense and also against a very basic economic "law": the so-called scarcity principle. How does this scarcity principle apply to the current situation of the global economy? In at least two different yet complementary ways. On the one hand when an economy (in this case a planet) grows above potential, production factors (yes, labour too) become less easily available and this tends to put upward pressures on wages at some point in time.

The recent behaviour of salaries in the US, clearly pointing upward, together with the wage deal brokered in Germany by the biggest labour union (IG Metal), meaning labour compensation will grow close to 4% this year and next in this latter country, are good examples of what might lie ahead of us.

It is also very interesting to see in this respect what is going on in Eastern Europe, with many countries experiencing a situation in which unemployment is going clearly down while salaries are already growing at quite dynamic annual rates.

As far as prices are concerned it is also true that, as demand growth puts increasing pressure on supply, prices of goods and services will tend to rise, eventually. When one sees how consumer prices have behaved in the US of late it is difficult not to conclude that price pressures are becoming increasingly apparent (it is actually even more interesting to see how some components of the ISMs, backlogs of orders and delivery times in particular, are showing signs that demand growth is clearly overwhelming the ability of supply to respond without creating prices pressures).

Some will say that, by expecting wage and prices pressures to go up as global spare capacity disappears, we are overlooking some structural factors that are nowadays playing a significant role in creating sustained deflationary pressures in the world economy. What about the Amazon effect, robotization and technological progress? People asking these kinds of questions do have a point. It is quite obvious that companies like Amazon (by increasing competition, by enhancing the efficiency of distribution and by giving clients more information about prices) tend to put downward pressures on prices. And pretty much the same happens with things like robotization and technological progress, since they tend to significantly reduce production costs, with obvious effects on the way companies set their prices.

So what would be our answer to this kind of reasoning? First, we would say that it is important to bear in mind that neither has technological progress started today nor is the Amazon effect something entirely new in the history of mankind. With respect to the latter, for example, there are studies that show that the deflationary impact of the so-called Walmart effect in the nineties was actually bigger than the one Amazon is creating today (and back then nobody thought that central banks had lost their ability to create moderate inflation on a sustained basis). With respect to technological progress it should be enough to say that it started centuries ago (the Industrial Revolution back in the 18th century). In fact recent years have been characterized not by rapid productivity growth rates but rather the opposite (with productivity growth of course being the main way in which technological progress shows up in economic data).

Second, and no matter how optimistic one might be on the impact of these structural factors in curbing prices pressures, nobody should expect a situation in which these factors completely and permanently eliminate the effects of the already mentioned scarcity principle to be sustainable in the long term. As demand growth outpaces growth in supply and labour becomes increasingly scarce (and both things are already happening in an increasing number of countries) price and wage pressures are almost inevitable (even if not always immediate, specially after a very serious economic crisis like the Great Recession).

In the rest of this monthly commentary we will briefly go through a number of factors (beyond those already referred to above) that lead us to think that the market will progressively forget about the goldilocks economy and will rather come to conclude that a moderate global reflation scenario is far more likely.

Moreover we also think that people will end up accepting the fact that inflation risks are actually tilted to the upside, with the US in particular facing increasing overheating risks:

During 2017 several temporary factors exerted downward pressures on core CPI in the US (telecommunication prices were possibly the best known example of this). But, because of their very temporary nature, those factors will come out of the equation in the coming months and this will manifest itself in higher YoY core CPI rates going forward.

If the oil price remains around current levels this will generate a significantly positive base effect that will push headline inflation higher in the coming months (the base effect created by energy prices will be especially big around June).

Moreover the dollar's weakness will also tend to generate inflationary pressures during 2018.

And, of course, fiscal policy in the US is set to become very expansionary and procyclical. This is obviously unwarranted and will contribute to excessive aggregate demand growth and, therefore, to further upward pressures on both wages and prices.

Although we still believe that the Fed will continue to act prudently by raising interest rates only gradually, the fact that fiscal policy has become so irresponsible in the US will make the life of the US monetary authority clearly tougher going forward. As things stand right now it seems quite likely that the Fed will be forced to progressively adopt a more hawkish tone, in order to fight inflationary pressures and also in order to prevent the dollar from depreciating too much (the fact that the trade deficit is quite high and that US public debt is on an unsustainable path are obviously negatives for the dollar).

Even if significant positive inflationary surprises are not to be expected in the Euro Area (at least in the very short term) it is becoming increasingly clear that the ECB has come to accept that the macro situation in our continent is a very positive one and that this forces the institution to progressively change its monetary stance. The end of the QE programme will very possibly be announced before June and we also think that the forward guidance regarding interest rates will need to be adapted. We do not think it is reasonable to expect the ECB to keep interest rates in negative territory deep into 2019 when it is quite clear that, by then, the unemployment rate in Europe will very possibly be below its long-term equilibrium level.

Labour is becoming increasingly scarce and this is forcing firms around the world to increase investment and to look for efficiency gains. This will very possibly lead to an acceleration in productivity, which in turn will tend to exert upward pressures on r*. At the same time risk aversion is clearly going down and this also calls for somewhat higher equilibrium real rates.

All in all, it is difficult to think that the move from a situation in which the market discounts an eternal Goldilocks scenario to another in which we begin to talk about reflation or even overheating risks will not have relevant effects on long-term rates. We prefer to think that the upward movements of long-term rates that we have seen in recent weeks are just the start of a movement which, perhaps with ups and downs, will bring us to long-term interest rates considerably higher than the ones that currently exist in the market.

United States

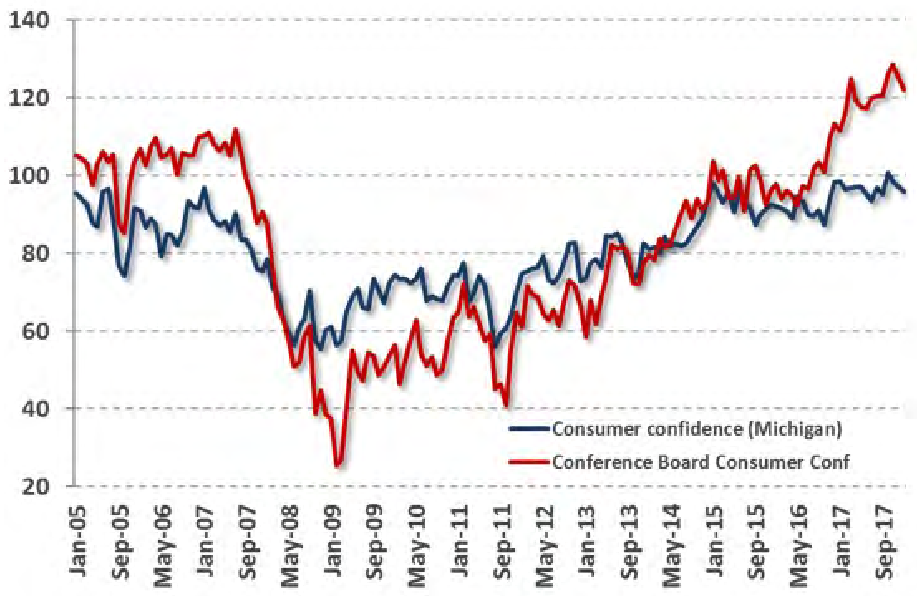
The US economy has accelerated significantly: overheating risks may be increasing

The US economy continues to growth at rates clearly above potential. Moreover fundamentals look solid and this makes us optimistic about the behaviour of the economy during 2018. It is true that growth in Q4 of 2017 came in a little below 3% annualized (2.6%) but this was due to big negative contributions from both trade (due to a large increase in imports) and inventories. More significantly underlying internal demand showed significant strength, growing above 4% annualized during the quarter.

Private consumption is looking good going forward: Consumers' balance sheets are healthy; disposable income is growing at solid rates; the labour market is in a very good shape; sentiment indicators are very strong…

Corporate investment has been improving quite significantly in recent times. On the one hand the recovery in oil prices is leading to an increase in investments in the energy sector. More importantly, after years of expansion, companies in most sectors are no longer in a position to serve increasing demand just by resorting to unused capacity and are therefore increasing capital expenditure at a significant pace. Going forward there are good reasons to expect the pick-up in corporate investments to become entrenched: with the economy already at full employment and with salaries progressively gaining traction, it would be only natural for growth to become more capital intense in the coming quarters.

Consumer confidence at very healthy levels



Source: Bloomberg, Alinea Global

The recovery in investment is also good news for the behaviour of productivity (and potential growth). In fact it is quite encouraging to see that productivity growth has already improved fairly significantly in the recent period.

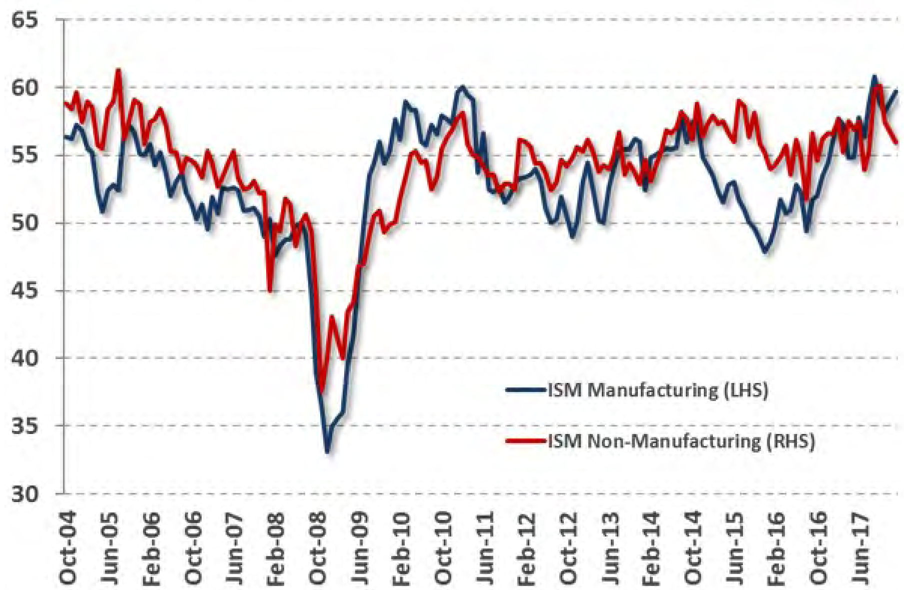
The real estate sector is showing increasing momentum and still has significant room for further expansion, in a context of relatively strong household formation rates and very low inventories of unsold homes.

The depreciation of the dollar and the signs of improvement in the global economy should also help exports going forward. Moreover the recovery in oil prices is already leading to a significant increase of energy exports, something that looks set to continue in the coming quarters.

All in all, and even before taking into account the expansionary effects coming from a fiscal policy that has turned significantly procyclical, **we expect economic growth to continue to be clearly above potential in the coming quarters.** In fact we believe that overheating risks are increasing and will increase further in coming quarters provided financial conditions remain as accommodative as they are now.

When we look to the labour market the situation is also quite positive: the US economy continues to create new jobs at rates that still more than double the numbers needed to absorb the increase in supply coming from population growth. Job growth is therefore still too strong to be sustainable in the medium term, even more so if one considers that the unemployment rate is already below the values compatible with full employment.

Manufacturing and non-manufacturing ISM



Source: Bloomberg, Alinea Global

More upside inflationary surprises in the near future are to be expected

Core CPI has recovered in recent months and this confirms in our view that the negative surprises seen during some months in 2017 were mostly due to temporary factors.

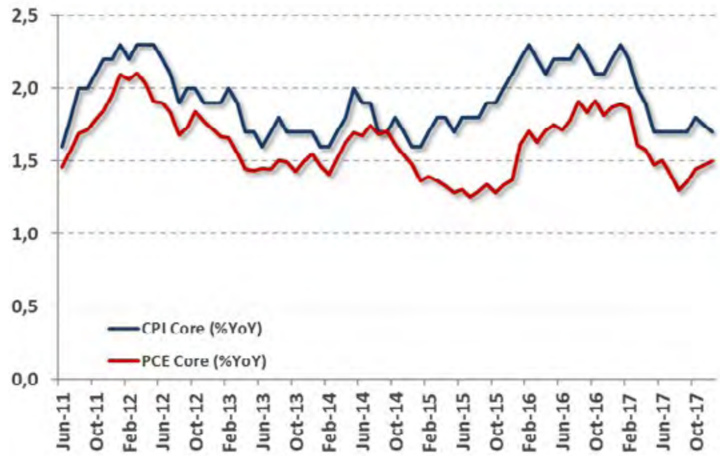
The outlook for core prices is clearly positive in our view: with growth above potential, an already closed output gap, and inflation expectations relatively well-anchored, the most probable scenario going forward will entail core inflation inching progressively higher in the coming months.

The upward movement in core inflation could be more abrupt than many are currently expecting: beyond the cyclical factors already alluded to the fact that dollar has tended to depreciate in the last 12 months (together with the fact that from March communication prices will stop biasing YoY inflation downwards in the coming months) will also help to push prices going forward.

The tax reform and the significant increases in public expenditure approved by the Congress and the Senate for this fiscal year and for next fiscal year as well will also have an expansionary effect on aggregate demand and are therefore a further reason to expect positive inflation surprises going forward.

Meanwhile, the tightness in the labour market should continue to favour progressively higher wage growth. It is actually quite encouraging to see that wages have clearly accelerated in the last couple of months, a process that looks set to continue during 2018.

Core CPI should continue to head higher in coming months



Wages are beginning to pick up more clearly

Source: Bloomberg, Alinea Global

The Fed should continue to increase rates if it wants to avoid overheating risks

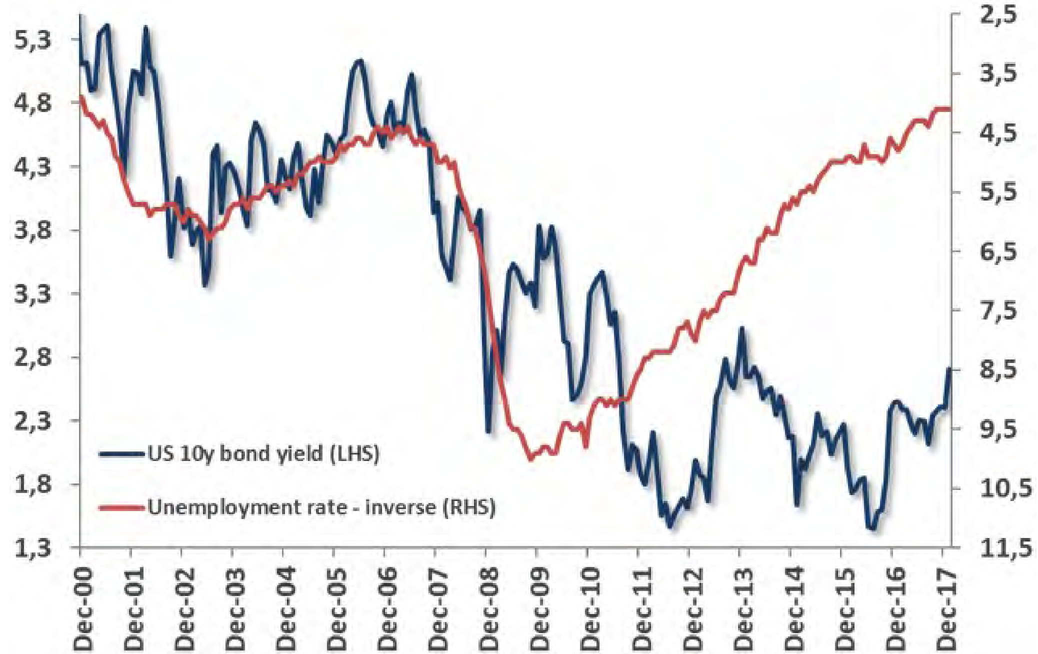
Given the fact that the economy is looking pretty good, financial conditions are very accommodative and inflation is expected to edge higher this year it was only natural to see the Fed further emphasising that it intends to continue to raise interest rates.

It is also potentially significant that the Fed is beginning to talk about revising its estimates for the so called neutral rate (r*). We actually believe that there are good reasons to thing that the r* should be revised higher going forward: the economy has accelerated in the last few quarters and it is now growing at rates around 3%, clearly above potential; the fiscal policy has turned significantly expansionary and procyclical; the dollar is weak; there are also signs that the levels of risk aversion are coming down; the global economy is doing great… Moreover productivity should trend higher in the coming quarters (corporate investment is growing strongly, in part because labour is becoming increasingly scarce) and this will put upward pressure on both potential growth and the neutral level of interest rates.

If the Fed, as we believe it will, acts in this manner (increasing rates progressively but at the same time avoiding falling too much behind the curve) inflation should edge higher but should not excessively overshoot the 2% target. If, on the other hand, the Fed ends up proving too cautious and delays further interest rates increases we believe that the risk of overheating in the US economy would become quite significant.

Of course, should the US economy end up overheating (and with growing risks for financial stability), then the Fed would be forced to raise rates in a much more aggressive manner: the actual rate should clearly be above neutral to contain inflationary pressures.

Long-term rates still far too low



Source: Bloomberg, Alinea Global

European Union

The Eurozone's economy continues to do really well

Significant tailwinds continue to help Eurozone's recovery: still low oil prices; extremely low long-term interest rates; a financial sector more willing to lend to the real economy; the private sector has reduced leverage very significantly; very significant price-competitiveness improvement among countries in the periphery; the Euro still not aa serious obstacle despite its recent appreciation…

Accordingly, the Eurozone's economy has been growing significantly above potential for quite some time (2.5% YoY in Q3) and, given most recent macro data, seems poised to continue to do well going forward: the unemployment rate is going down fairly quickly; sentiment indicators at very high levels; the PMIs look really good; high levels of use of productive capacity; dynamic exports…

It is especially reassuring to see that Europe's expansion has now reached each and every country in the area and it builds on the strength of both external and internal demand, with corporate investment also giving very positive signals.

The case of Germany is specially interesting, with economic activity remaining very strong in a context of an already positive output gap.

France appears to be clearly benefiting from an improved political situation, in a context in which macro data had been quite strong for some time now (strong PMIs, sentiment indicators at relatively upbeat levels, positive job growth, investment also sending positive signals…). In this context it is difficult not to be relatively optimistic about France going forward, even more so if one considers that Macron will continue to be able to advance his economic reform efforts.

Economic sentiment: very solid levels

Source: Bloomberg, Alinea Global

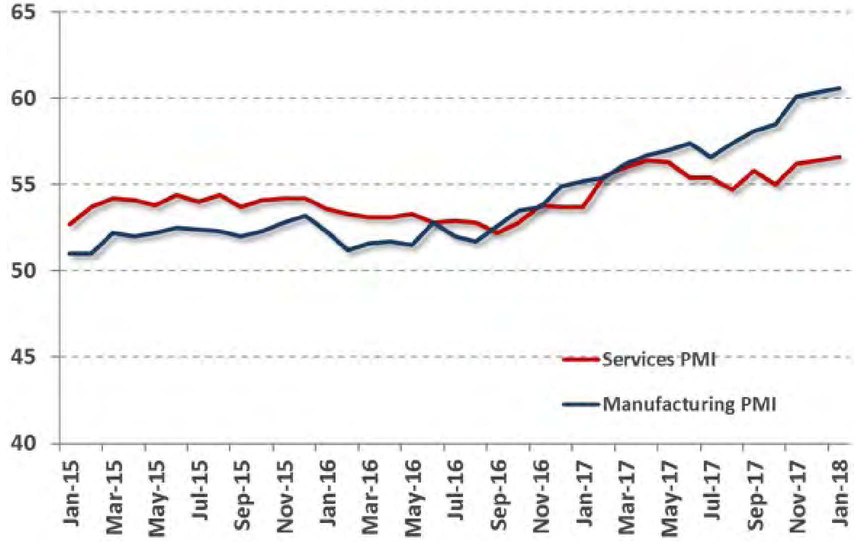
The Eurozone's economy continues to do really well

Even the Italian economy has been clearly picking up in recent quarters, with GDP surprising to the upside and with both the PMIs and the sentiment indicators also doing quite well. This improved macroeconomic outlook is also being accompanied by a more stable political situation and a stronger position of the banking sector. And the decision by S&P to upgrade Italy's public debt helps to improve sentiment as well.

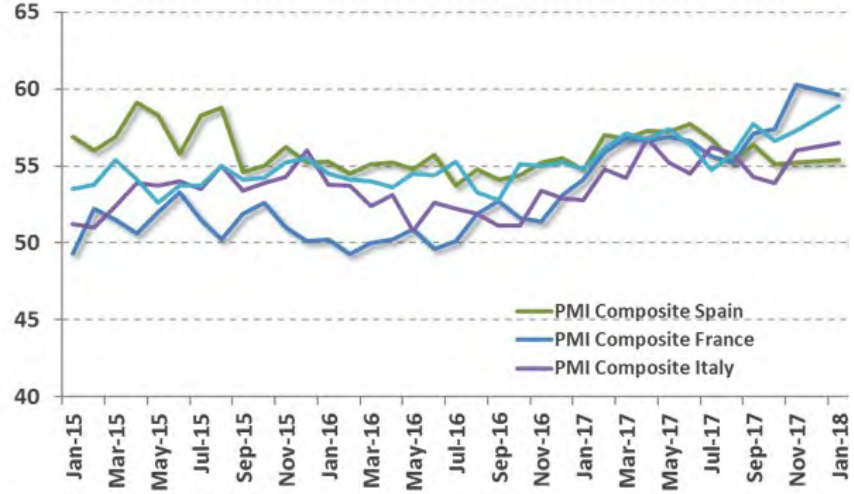
Against this quite favourable macroeconomic situation in the Euro area it is quite possible that negotiations around Brexit will continue to create noise in the coming months. In any case, even here the recent news has been relatively promising: there is already an agreement to commence trade negotiations and everything points to there being a sufficiently lengthy transitional period to avoid abrupt situations.

We believe though that the most probable scenario going forward is for Brexit to have only a moderate impact on growth outside the UK. First because the fact that the macro is looking quite good now and populism has been losing steam has considerably increased the degree of optimism about the future of the European project. Second because is has become increasingly apparent that is the UK the one that could lose the most in the face of a poorly negotiated Brexit: for countries remaining in the EU the negative impact from a more difficult trade with the UK could be partially compensated by the fact that, in the future, some of the investments that now take place in the UK will move to EU member countries, as international companies try to ensure access to the single market.

PMIs at very healthy levels and pointing higher again



The European recovery continues to broaden



Source: Bloomberg, Alinea Global

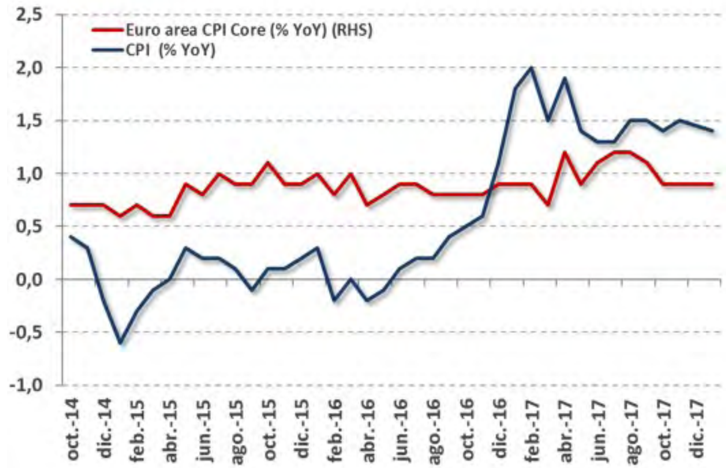
Core inflation should edge higher: the ECB could become a little more hawkish soon

The favourable macro environment should lead to a progressive acceleration of core prices in the coming months, provided the euro does not appreciate too much. Although it is true that there is still spare capacity in the Euro area, this situation will not last forever: the unemployment rate is coming down fairly quickly and could reach levels clearly below 8% by the end of this year (this is a significant number since it is below the average for this variable in the period before the crisis and therefore a fairly good approximation of structural unemployment in the area). In this context we also expect wages to progressively accelerate going forward (some encouraging signals have already become increasingly apparent in a number of countries).

In the case of Germany further progress in core prices should take place sooner and more rapidly than in the rest of the Euro area. First, growth prospects are specially positive in that country. Second, and more important, because this favourable scenario of growth above potential will continue to take place within a context of very low unemployment, and salaries that are starting to show signs of acceleration.

Being all this so we believe that there are reason to expect the ECB tu turn progressively more hawkish in the coming months. The monetary authority is becoming more confident with the macro outlook and this should lead to a decision not to continue the QE programme after September. As far as interest rates is concerned we will have to wait a little longer but could also end up being increased sooner than the market expects, provided of course the euro stops appreciating.

Core inflation should edge higher going forward



Inflation expectations have improved

Source: Bloomberg, Alinea Global

Spain

Unless the crisis with Catalonia spins out of control, prospects for Spain continue to look good

The constitutional crisis in Catalonia, if it lingers for too long, is poised to have a very negative impact on growth in that region, with Spain as a whole also possibly feeling some (even if much milder) downward pressure.

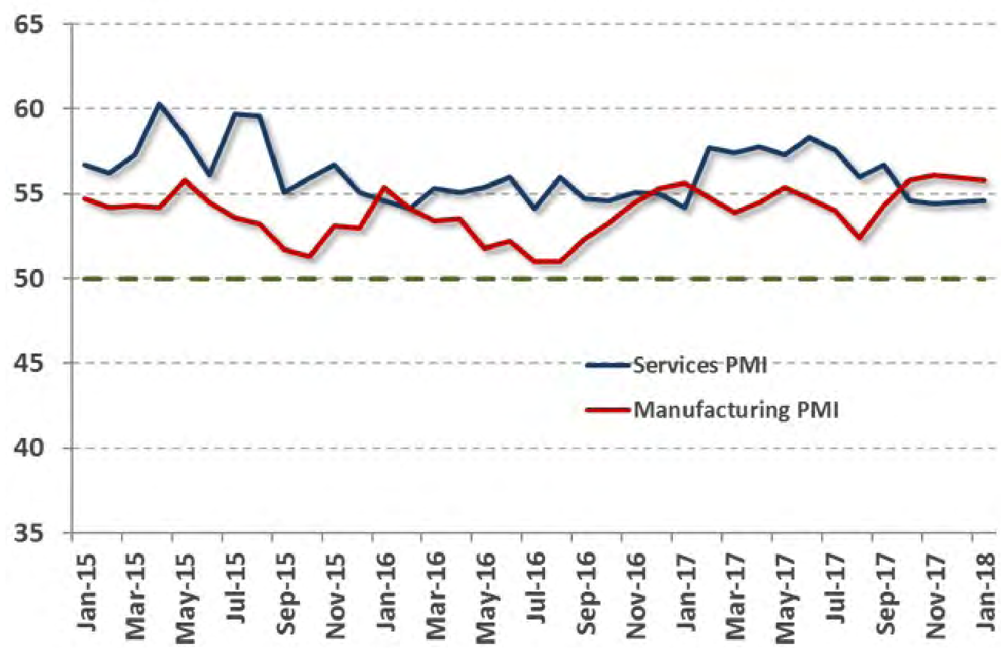
But we believe that the situation will remain under control and that the Spanish economy will continue to benefit from significant tailwinds: significant price competitiveness gains made during the crisis; a much improved balance sheet situation in both families and businesses; a global economy that is in very good shape; and extraordinarily low interest rates. The recent rating upgrade by Fitch is not accidental but rather reflects these significant strengths.

Recent macro data remain rather positive and point only to a very mild deceleration of economic activity: job growth continues to be solid; confidence indicators are at healthy levels and edging even higher; the PMIs are also doing well; exports have been quite strong; both the industrial and the services sector remain in pretty good shape; and, at least outside Catalonia, prospects for tourism and real estate continue to look encouraging.

Goring forward, and provided the situation in Catalonia doesn't spiral out of control, we think economic activity will remain strong, with rates of growth that could be close to 3% in 2018.

As this scenario unfolds, spare capacity (even if still high) will tend to go down fairly quickly in the coming quarters.

Manufacturing and non-manufacturing PMI



Source: Bloomberg, Alinea Global

Political noise, high debt and low potential, still among Spain's medium term challenges

In turn, this relatively swift reduction of spare capacity should gradually allow certain acceleration of both prices as well as salaries.

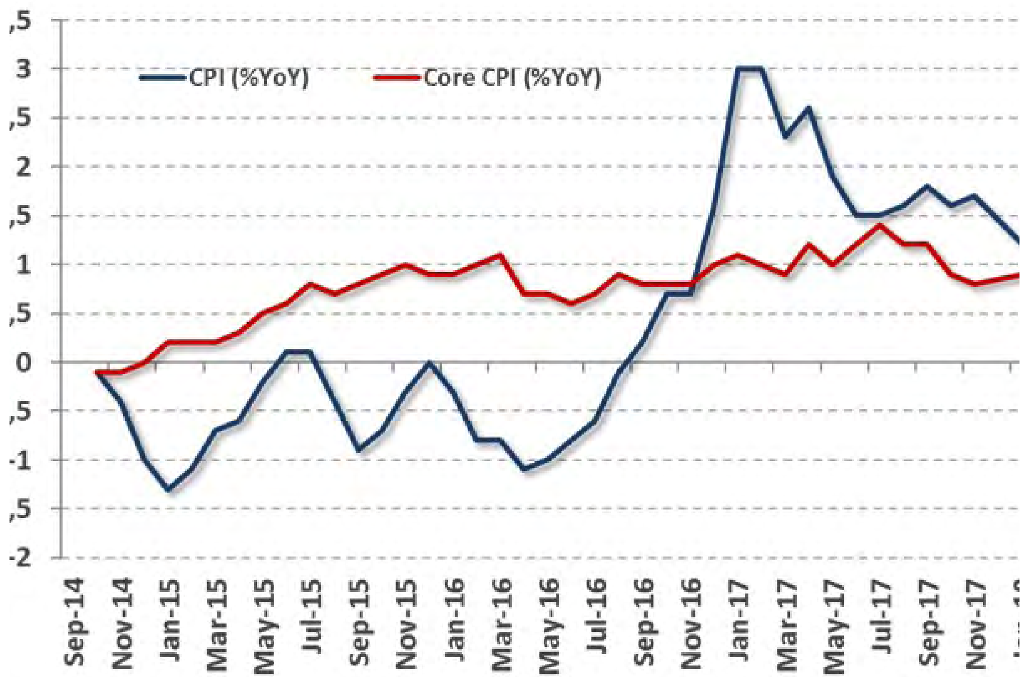
Within this cyclical panorama clearly favourable for Spain, one of the risks we run is overlooking the important long-term challenges that our economy still has to face. We still need to introduce measures to increase our low growth potential (promotion of human capital; driving technological innovation; increase competition in certain sectors…); keep our high external debt under control: and mitigate the probably excessive increase that has occurred in issues of inequality.

As regards fiscal policy, the country needs to take seriously its compliance with the public deficit targets.

In this sense it is undoubtedly positive that, apparently, budgetary execution in 2017 behaved better than initially expected.

From a political point of view, and even more so after the results of the elections, it is not impossible that the situation in Catalonia ends up creating some kind of noise among financial participants. At the same time though we tend to think that the worse is over: the fact that so many businesses have decided to leave Catalonia will tend to force political parties seeking independence to do so through negotiation rather than unilaterally.

Core inflation should edge higher little by little



Source: Bloomberg, Alinea Global

United Kingdom

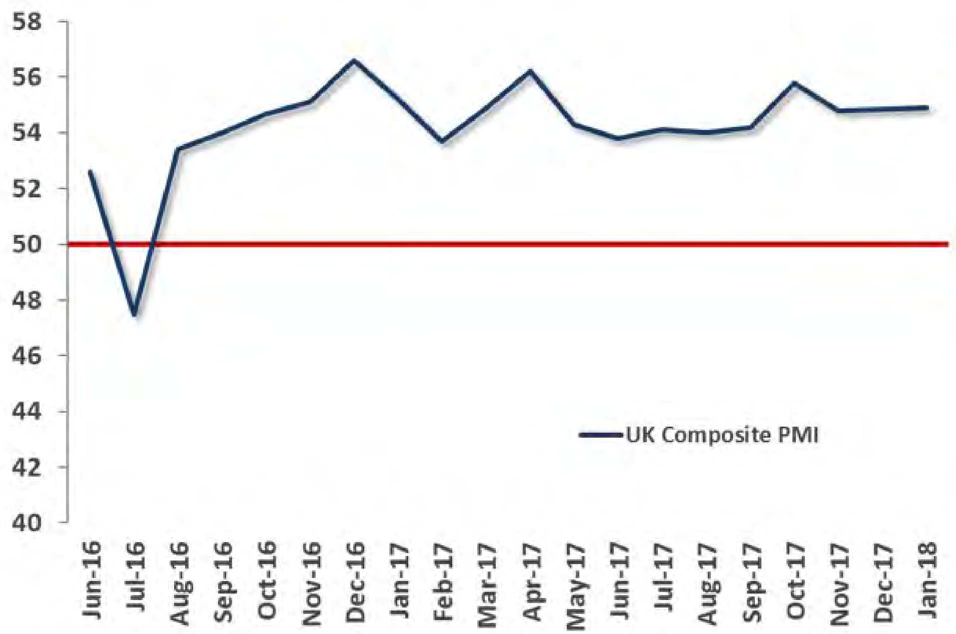
The negotiations around Brexit have shown some positive momentum of late

In the short term the probability that some kind of transitory arrangement is reached is quite high and this of course reduces the risk of immediate negative outcomes. At the same time it is clear that the long-term negative effects of Brexit for the UK continue to be significant: the UK will probably lose full access to one of the biggest markets in the world; London will probably loose part of its appeal as a global financial centre; and Britain will no longer be as attractive as it traditionally has been as a destination for highly-skilled migrants…

Short-term macro data is not looking too bad, even if it is true that the country is failing to fully benefit from the significant improvement of the global economy. On the negative side, and given the high levels of uncertainty about the future, it is difficult to be very optimistic about the prospects for corporate investment. On the positive side the pound's weakness should continue to boost both exports and the manufacturing sector going forward, while fiscal policy is set to turn mildly expansionary in 2018. What about private consumption? It is clear that this important variable is negatively affected by uncertainty and also by the increase in imported inflation. But, at the same time, in a context of an already closed output gap, one should be relatively optimistic about the behavior of wages going forward, something that in turn should help to avoid a significant deterioration in private consumption in the coming quarters. Encouragingly signs of positive momentum in wage growth are becoming increasingly apparent in recent macro data.

Given the more positive macro outlook and the fact that spare capacity in the UK is very low the BOE revised up its growth and inflation forecasts and announces at its February meeting and said that interest rates are set to rise more quickly than initially expected.

Latest economic data have surprised to the upside



Source: Bloomberg, Alinea Global

Japan

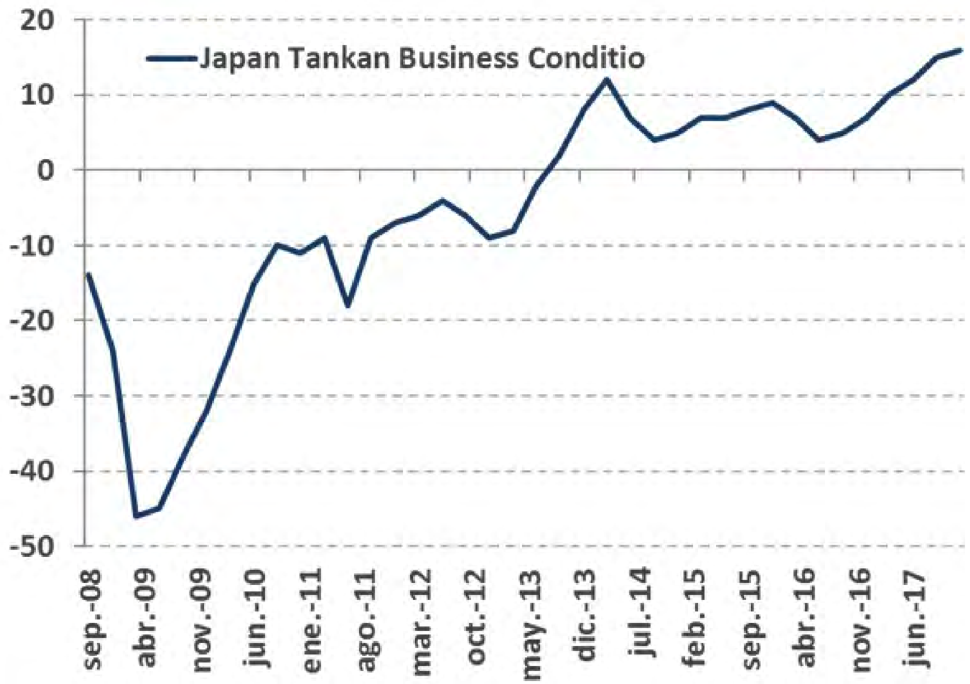
Japan continues to grow above potential and spare capacity is gone

Trying to figure out how the Japanese economy is doing in the short term is no easy task. On the one hand because the quality of short-term data is far from optimal (in fact, the government is trying to improve the way some statistics are compiled). On the other hand, and more importantly, because when people talk about Japan they normally fail to properly distinguish between cyclical and structural factors. The first thing to remember when analysing Japan is that this is a country whose population is going down and that has therefore a very low level of potential growth (probably not higher than an annual 0.75%). Being this so it is only normal for the Japanese economy to alternate quarters of positive growth with others in which growth turns negative, even more so in the current environment of very low levels of spare capacity.

GDP growth during Q4 was weaker than expected but this was mostly due to a negative contribution coming from inventories.

The macroeconomic situation in Japan is actually looking very good. First, GDP has grown for 8 consecutive quarters and with an average clearly above potential. Second, most recent economic indicators continue to be upbeat from a medium term perspective (sentiment indicators and the PMIs are healthy levels; corporate investment is sending encouraging signs; private consumption is regaining momentum; exports are in good shape; credit appears to be picking up; the prospects for the construction sector are also optimistic, in part because of investments ahead of the 2020 Tokyo Olympics; tourism is doing really well…) Third, wages are beginning to pick up, in a context of a very low unemployment rate and strong demand for workers by Japanese companies (for the past 2-3 years Japan has been successful in bringing more women to the labour force; while this has helped to keep wage growth in check it will naturally tend to become less of a factor going forward since a lot of progress in this area has already been done).

Positive outlook in the medium-term



Source: Bloomberg, Alinea Global

Economic fundamentals point to progressively higher inflation and wage growth

A tight labour market (the unemployment rate is 2.4% and the jobs/applicants ratio is very high, 1.59; the output gap is already positive) **in a context of above-potential growth should put further upward pressures on wages and then on inflation going forward** (some positive signs are already emerging on both fronts).

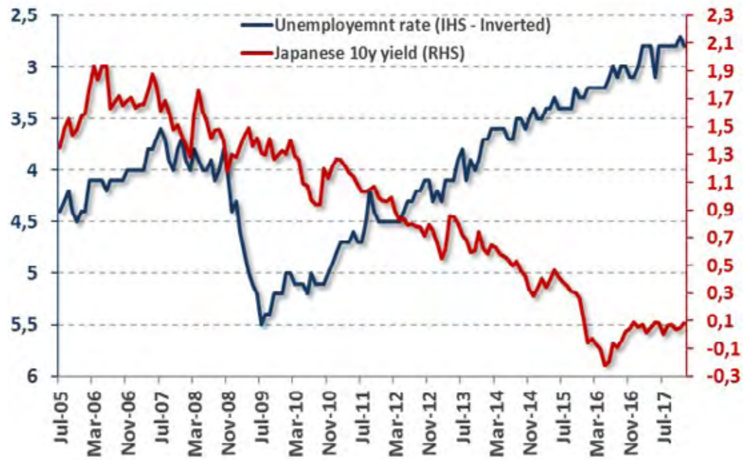
The BOJ continues to implement its yield curve control policy, trying to make sure that 10y yields stay reasonably close to 0% (in January it offered again to buy an unlimited amount of bonds at a fixed rate) and having committed to allowing inflation to overshoot the 2% target for a considerable period of time.

At the same time the government has said that a primary surplus will only be achieved in 2027 and this means that fiscal policy will remain accommodative, thereby helping to create further inflationary pressures during the current year.

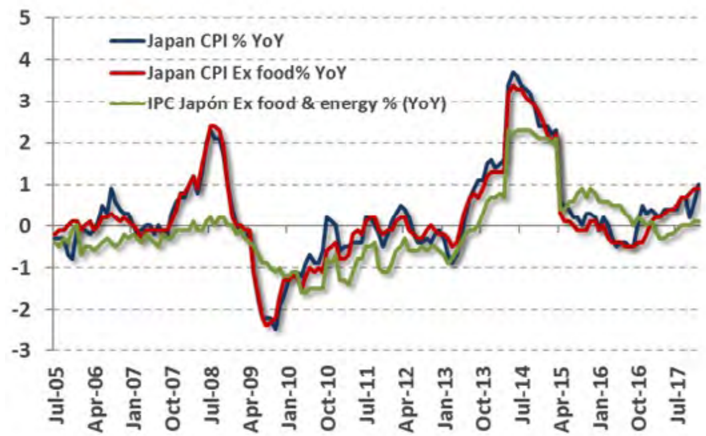
Beyond creating inflation perhaps the most important challenge for Japan going forward is the need to increase potential growth. And, for this to be possible immigration should be fostered (some progress is already being made in this field) and duality in the job market must be reduced. Additional measures also need to be taken to encourage direct foreign investment in Japan, to drive productivity growth.

Looking further ahead it will also be crucial for the government not to lose credibility when it comes to guaranteeing a sustainable path for the country's public debt.

Low output gap levels point to higher wages and prices



CPI should do better going forward



Source: Bloomberg, Alinea Global

Emerging countries - China

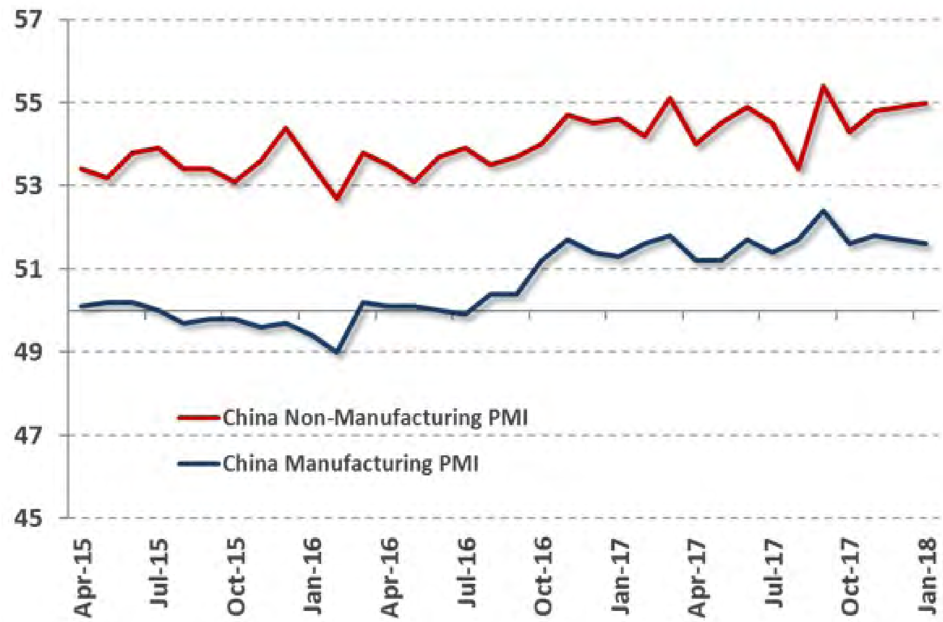
The government curbs financial risk while trying to maintain sufficient economic momentum

The Chinese economy continues to surprise to the upside and this allow authorities to continue to focus on controlling financial risks and improving the quality of growth. Authorities have introduced measures aimed at improving financial supervision and regulation; curbing shadow banking growth; promoting equity financing; reducing excess capacity in some industries; curbing fraudulent use of PPPs as a way to hide public deficits at local government level (in part as compensation for this and in order to reduce revenue pressures the central government has said it will help local authorities by partially covering the costs of certain public services); reducing emissions; promoting FDI in China; and containing the expansion of the real estate sector. Moreover, the PBOC has also moderately tightened liquidity conditions in the money market in order to reduce incentives to conduct highly leveraged purchases of financial assets.

Considering this, and after gaining pace last year, it is logical to expect the economy to moderately decelerate during 2018.

At the same time we believe that the risks of a hard landing in the Chinese economy remain quite low and that in fact upside risks seem to be becoming more likely in recent times. Private consumption is doing well, in a context of a strong labor market, increases in wages and high consumer confidence levels; exports should continue to benefit from the strength of the global economy; monetary policy will remain neutral; fiscal policy is set to remain a little expansionary… Going forward we think that both infrastructure investment and the real state sector will tend to decelerate but we also think that this process will be at least partially compensated by rapid progress in high-tech manufacturing and reduced downward pressures coming from the adjustment in industry sectors affected by overcapacity issues (the reason for this being that some progress has already been achieved in relation to these problems in 2017.)

The economy continues to do well



Source: Bloomberg, Alinea Global

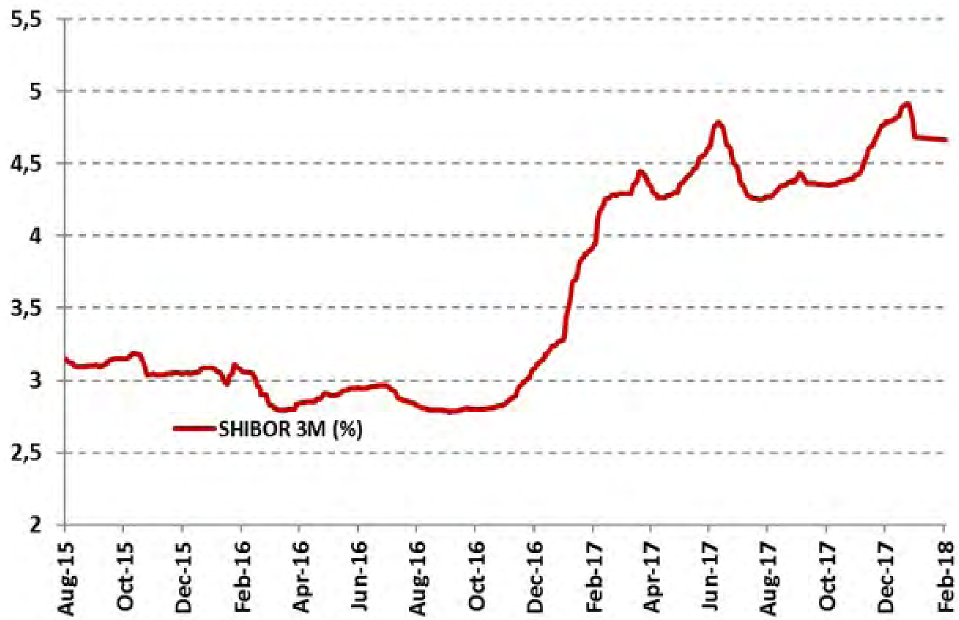
The yuan's strength eliminates a source of uncertainty and promotes capital inflows

One of the positive collateral effects of a somewhat less accommodative monetary policy is less pressure on the yuan and reduced incentives for capital outflows. Indeed, given the recent appreciation of the Chinese currency, the authorities have been eliminating in recent months some of the restrictive measures that had been previously adopted and that were aimed at curbing unjustified downward pressure on the yuan (in January, for example, the PBOC eliminated the so called "countercyclical factor", which was being used to curb depreciation pressures. At the same time China's foreign reserves have been increasing for several months in a row.

From a fundamental perspective it is actually very difficult to argue that China needs an aggressive depreciation of the yuan: Chinese exports are not losing market share in the world market in any significant way (and have actually picked up recently); moreover equilibrium exchange rate estimates by institutions such as the IMF do not point to overvaluation.

From a medium-term perspective it is good to know that China has sufficient room for manoeuver in terms of balance sheet to allow the process of deleveraging, which has already begun, to take place smoothly. Being this so we believe that a credit crunch scenario is quite unlikely. It should be remembered in this respect that, even if it is true that the growth of (gross) debt has been rapid in the last couple of years, China is a net creditor with respect to the rest of the world. Moreover measures aimed at facilitating the sale or securitization of troubled assets seems to be progressing and this should help banks to reduce their exposure to those kind of assets.

Monetary policy is less accommodative than before



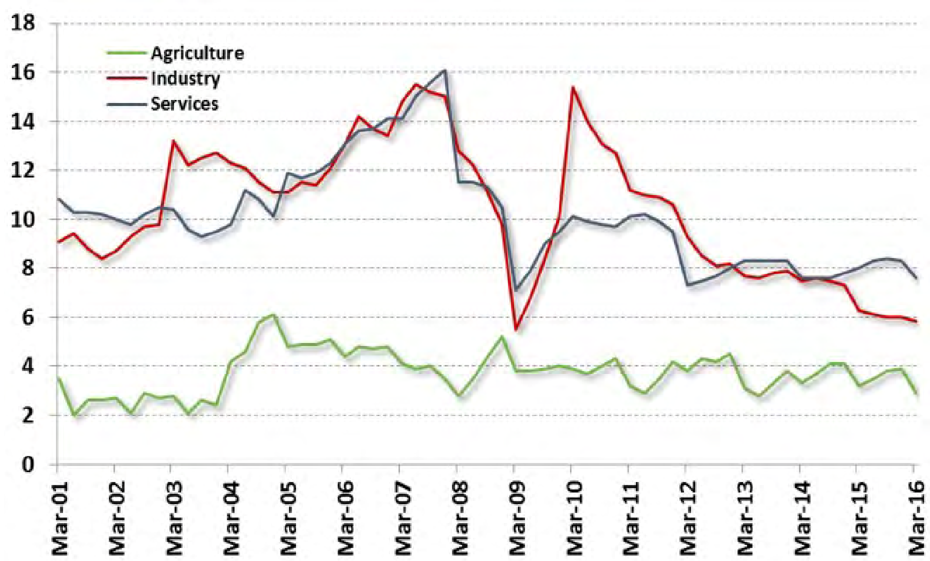
Source: Bloomberg, Alinea Global

The country continues to advance in the process of upgrading its growth model

It is also a positive thing that the country is being able to make some progress in the process of modernizing its growth model. On the demand side consumption continues to gain weight. On the supply side both the services sector and industries with relatively high technological intensity are becoming more and more dynamic. At the same time it is also good news to see progress being made in areas such as: the economy's energy intensity is being reduced (the amount of energy consumption per unit of GDP is reduced); corporate leverage is decreasing a bit; growth of the most risky parts of shadow banking is being brought under control; and technological progress is being promoted (R&D investment reached 2.15% of GDP in 2017).

Having said all this, and although China seems to be in a relatively good position to confront the significant challenges that lie ahead, it is of course crucial that the authorities continue to work hard in order to further reduce financial risk and make progress in the field of structural reform: excess capacity in some traditional sectors should continue to be reduced; credit growth needs to be further curbed; a bubble in the real estate sector must be avoided; the playing field for private companies should be improved (further easing of restrictions curbing inbound direct investment, beyond those already approved, would be helpful in this respect and would probably be well received by the US and the European Union; it is also positive that the authorities have recently decided to reduce the tariffs applied to a wide range of products); leveraged investments in financial assets should continue to be controlled; an excessive growth in household debt should be prevented (household debt is still relatively low but is growing rapidly; in November the authorities announced measures with respect to web-based micro lenders, with the objective of reducing interest rates charged to clients and better controlling credit risk)… At the same time, and in order to help potential growth, human capital development should be further enhanced.

Services continue to gain weight



Source: Bloomberg, Alinea Global

Emerging countries - India

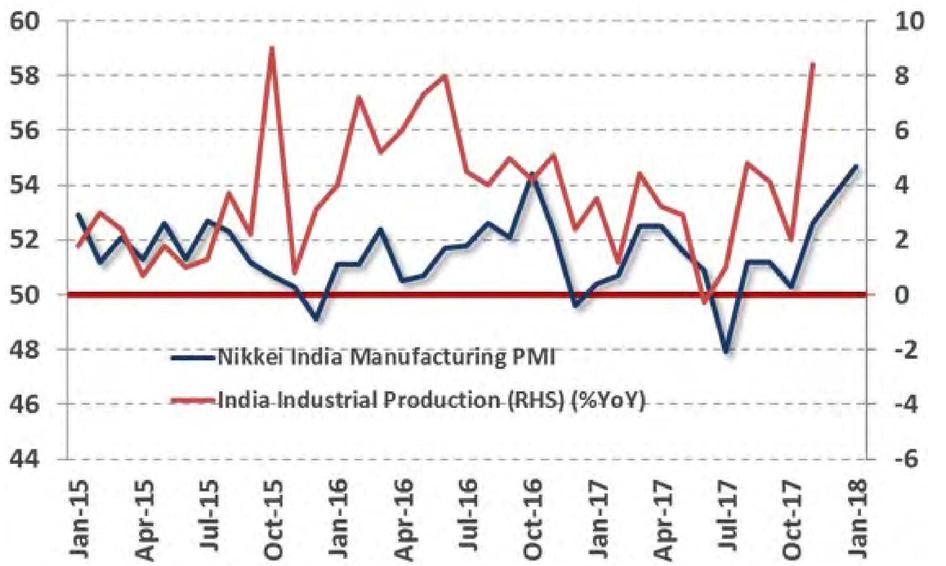
The economy seems to be re-accelerating again

India seems to have left behind the uncertainties caused by the demonetization process and the introduction of the GST (which should be clearly regarded as positive reforms from a long-term perspective). GDP growth was 7.2% YoY between October and December and prospects also look quite good. Elsewhere, prospects for upcoming quarters are reasonably positive: private consumption remains resilient; the PMIs are sending relatively positive signals; exports and industrial production are benefiting from the strength of the global economy; infrastructure investment continues to do well (and it remains a priority in the public budget); bank credit is picking up... Moreover, and after a prolonged period of sluggishness due to low capacity utilization levels and high corporate debt levels in some sectors, private investment seems to be picking up of late (the fact that the corporate sector has undergone a significant deleveraging process during the last 2 years seems to be proving helpful).

On the fiscal front, and considering the relatively high budgetary deficits (specially at states level), it is always disappointing to see deficits come in above initial targets. This has been the case of the current fiscal year and also of the next one. At the same time it should also be stressed that the deficit was actually quite close to target and in line with market participants' expectations. Moreover Moody's, when analysing the budget for next year, has said that is prudent enough and that it considers it further prove that the central government remains committed to ensuring the long term sustainability of public finances.

The RBI will probably remain prudent in the coming months. We expect interest rates to remain constant for some time and then edge progressively higher. Why? First, because, as already stated, the economy is looking better; second, because fiscal policy is set to turn mildly expansionary; and third, because inflation has been edging up of late and it is important for the central bank to remain credible in order to anchor inflation expectations.

The economy should regain momentum going forward



Source: Bloomberg, Alinea Global

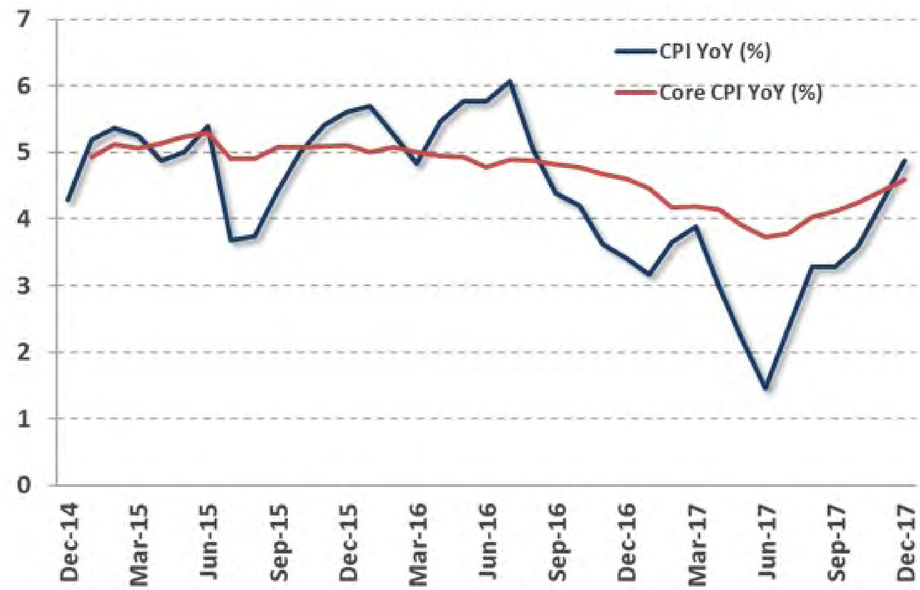
The government continues to make progress in the field of structural reform

As far as reforms are concerned it is certainly good news that the government has decided to recapitalize state banks in a more ambitious way than had previously been announced. This is an important step, which will help lend stability to the Indian financial system and improve the transmission of monetary policy in India. More generally, the fact that the central government is promoting competition among states (even through the preparation of rankings) is helping to create reform momentum that is beginning to generate encouraging results.

The fact that RBI has already begun to use its new powers that allow it to force lenders to take write downs on NPLs should also be welcomed Mo(theoretically, healthier bank balance sheets will help provide a better flow of funding towards private investment). Moreover efforts being made to further develop the market for corporate bonds will also tend to have a positive effect on private investment going forward.

Going forward, further steps would be welcome, specially in the following areas: orderly deleveraging of the most indebted corporate sectors; the tax system should be reformed in order to increase its efficiency and to generate sufficient revenue to finance infrastructure investment and social expenditure (a more credible fiscal policy would also make it possible to reduce mandatory investments by banks in public bonds, so that those funds could flow to the real economy in a more efficient way); the labour market regulation should be further improved; the same goes for the agricultural sector, as already mentioned above; the land reform should be forcefully pursued since it would help to reduce the significant obstacles that infrastructure investment in India still faces; FDI flows should be further liberalized (it is encouraging to see though that some positive steps have been taken in this direction in recent times)...

Inflation has edged up again recently



Source: Bloomberg, Alinea Global

Emerging countries - Brazil

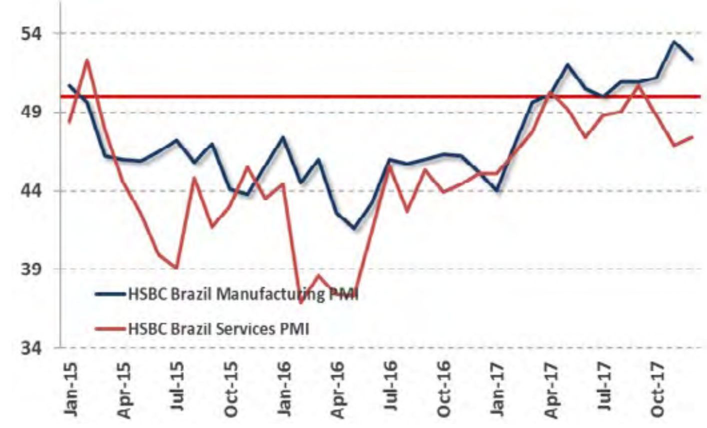
A lack of progress in pension system reforms leads to a rating downgrade

Brazil's economic future will be dictated by two main factors. On the one hand macroeconomic stability (both fiscal and as far as inflation is concerned) should be ensured, so that the high financing costs that the country has traditionally faced can be sustainably reduced. On the other hand further measures are needed aimed at increasing potential growth.

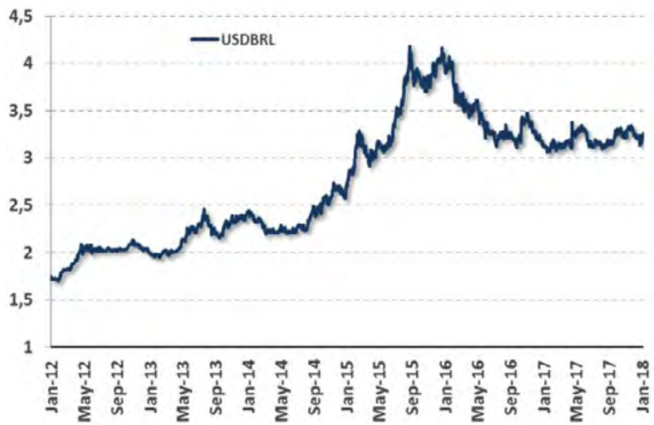
Being this so the results of the upcoming elections becomes crucial. As it has already been demonstrated that it is impossible to approve the pensions reform before the electoral process, it is now even more important to see whether or not the Brazilian people are able to elect a government firmly committed to economic reform and with fiscal responsibility.

Among the pending reforms that will need to be undertaken after the election two areas are particularly relevant: First it is crucial that the pension system be made sustainable (Brazil's budgetary position is quite challenging and a reform of the pension system would help to significantly improve fiscal credibility with minor effects, if any, on short-term economic growth; in fact S&P decided to cut Brazil's rating precisely because of the lack of progress in this field; Moody's and Fitch have also recently said that Brazil's ditching of the pension bill is bad news for the country's credit rating). Second, Brazil must continue to move forward in the field of structural reforms, aimed at improving performance in its markets; reducing red tape; improving financial regulations; simplifying the tax system; ensuring the autonomy of the central bank; etc.

Activity is showing signs of stabilization



The relatively weak real still helps



Receding inflationary pressures create further room of manoeuver for the central bank

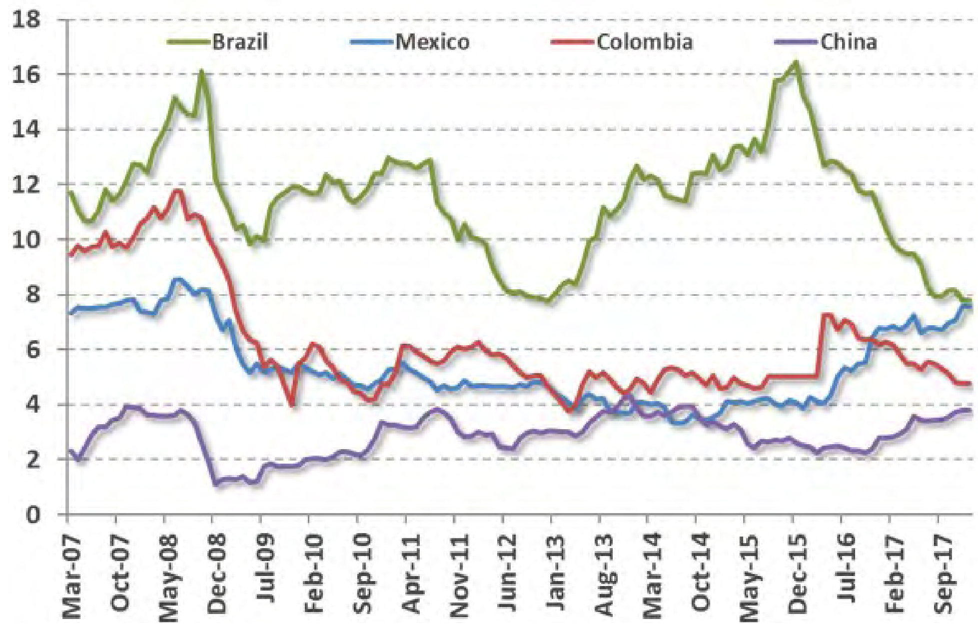
The more the country continues to advance in terms of fiscal credibility, macro stability and reforms, the lower will be the risk premium applied to the country by investors, with logically very positive effects on the structural conditions of financing the families and businesses. The fact that financing conditions have considerably improved after Rousseff left office is a clear signal that for Brazil steps in the right direction in terms of economic policy clearly pay off.

From a pure short-term perspective rapidly moderating inflationary pressures, together with improvements in inflation expectations and high levels of spare capacity, have actually allowed the central bank to reduce interest rates fairly quickly during the past few months. And, going forward, we actually expect rates **to continue to edge down.**

The positive effects of a less restrictive monetary policy have become increasingly apparent in the last few months: the unemployment rate is edging down, private consumption is looking better, industrial production is surprising to the upside and sentiment indicators and PMIs have also improved. At the same time exports continue to benefit from the Real's weakness and the strength of the global economy, while investment and credit are also sending encouraging signs. After a very hard recession Brazil might have grown at a rate of around 1% YoY in 2017, with activity progressively accelerating during the course of the year. For 2018 rates of growth of around 3% are quite plausible.

But anyway, as previously stated, recent progress will only become sustainable if the country continues to pursue the path of structural reform, fight against corruption and fiscal consolidation (including, of course, the reform of the pension system). Being this so it is clear that the country's future will greatly depend on what kind of government comes out from this year's elections.

Financing costs have come down quite a bit



Source: Bloomberg, Alinea Global

Emerging countries - Russia

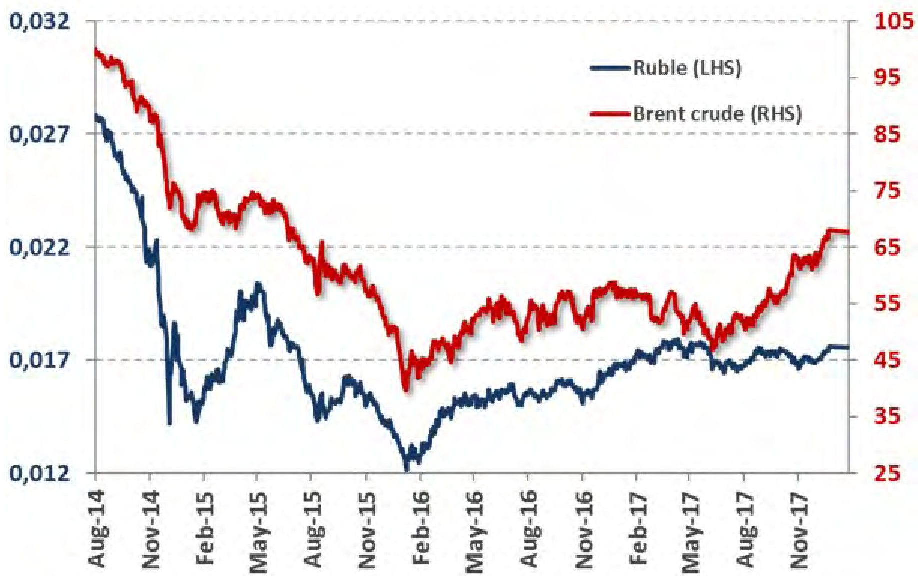
Although challenges remain, short-term prospects look reasonably good

Russia still faces significant challenges: First, the economic sanctions imposed by the Western economies continue to drag down activity. Second, the excessive dependence on raw materials is hampering the country's potential growth and increases its vulnerability through price fluctuations. Elsewhere, the restructuring of the banking sector, although extremely advanced thanks to the excellent work of the central bank, is not yet over.

But, even if it is true that the economy decelerated in the second half of last year, prospects for 2018 look reasonably good: the economy clearly benefits from the recovery in oil prices (in fact some of the deceleration last year was due to the need to freeze crude production as agreed with OPEC countries); private consumption should do well (with unemployment going down, real wages beginning to pick up and confidence levels improving; exports and private investment are sending positive signals; industrial production is also behaving better; PMIs are also pointing upwards... In general the economy seems poised to expand at rates around 2% YoY going forward.

Thanks to the outstanding job of Governor Nabiullina the central bank has gained significant credibility in issues of price stability and this has made it possible for the monetary authority to progressively reduce interest rates as inflation has come significantly down (in February rates were cut again, in this case by 25bp). Going forward we believe that rates will be moved further down (so that monetary policy ends up turning neutral). In fact, it is clear that the central bank is becoming progressively more dovish and there is a risk that rates can come down faster than initially estimated. Having said this though the fact that inflation is expected to edge a bit higher in the near future will force the central bank to remain prudent.

The recovery in oil prices is helping Russia



Source: Bloomberg, Alinea Global

Rating agencies are recognizing Russia's fiscal prudence

Moreover the fact that the government remains prudent as far as fiscal policy is also quite positive and creates some margin of manoeuvre to concentrate efforts where they are most needed: infrastructure investment, human capital development, and improvement of the healthcare system. In February S&P increased the rating of Russia's public debt and placed it in the investment grade category.

And, of course, it is also true that, in order to ensure the long term sustainability of public finances, the government will also need to thoroughly **reform the pension system** at some point.

Going forward, and apart from continuing to preserve the sustainability of public finances, Russia needs to make progress in two major areas. On the geopolitical front Russia should adopt a more collaborative stance with the western world, so that sanctions can be eased at some point in time (a situation that in any case is complicated, taking into consideration the problems in the Ukraine and the accusations of IT espionage). At the same time it is important for the government to undertake reforms targeted at improving the investment climate, to increase potential growth and reduce both the dependency on oil as well as the excessive presence of the public sector in the economy. It would also be positive if the central bank continued with its efforts to clean the balance sheets of financial institutions, a process that is anyway quite advanced already (at the same time, as Moody's has recently said, it is important for the central bank to avoid holding holding bank shares for too long since this could create conflicts of interest with it supervisory responsabilities).

Activity should behave relatively well going forward

Source: Bloomberg, Alinea Global

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