Grant Thornton

# Economic Newsletter

## Third quarter - October 2018

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# Quarterly commentary

**Despite all the noise (Italy, Trump's trade policy, emerging markets, etc.), the global economy's reflation process continues** and will become more and more evident. Long-term interest rates are therefore going to have to move upwards significantly. In terms of other issues, although we still think that the tightening of global financial conditions can take place in an orderly manner, the fact that overheating risks in the US continue to edge up increases the likelihood that we will experience volatility in the markets.

**The US continues to grow well above potential and to create jobs at rates that more than double what is sustainable in the medium-term. In a context of zero spare capacity** (or even a positive output gap), it is quite likely that price and wage pressures will continue to rise (with regards the latter, we expect October to be affected by an unfavourable base effect and for this to be followed by year-on-year growth rates of over 3% by the end of the year).

**The Fed continues to adopt a very cautious attitude, slowly raising rates and accepting the likelihood of some overshooting of its inflation target.** As wage and price pressures become more evident, we believe the Fed's dovish attitude will eventually translate into an appreciable increase in long-term rates in the US, particularly in the longer end of the curve.

**A move to higher long-term rates will probably also be helped by the FED's progressive upward revision of estimates of the so-called neutral rate,** the famous r*. This did in fact already happen, very incipiently, at the September meeting of the US monetary authority.

**In the euro area, the reduction in spare capacity is still going very well** (the unemployment rate is dropping very quickly and job vacancies are at maximum levels), against a backdrop of better wage performance and better inflation expectations.

**Without anyone seemingly paying much attention, the price of crude oil continues to rise.** This will tend to sustain general inflation rates over the coming months. At the same time, the euro's recent weakness will also favour inflation in Europe.

**As things stand, we foresee a clearly bullish path for core inflation over the coming quarters, which should lead the ECB to be more explicit about the future path of interest rates.** This will, in turn, likely lead to a significant (perhaps larger than the US) rebound in long-term rates in the not so distant future.

**Even in Japan, which seemed doomed to live in permanent deflation, there are increasingly obvious signs of a recovery in prices and wages.**

**China, for its part, is only slowing very gently.** Private consumption remains strong and, furthermore, the authorities have already shown their willingness to support economic activity through greater investment in infrastructure and reasonable credit growth, especially for SMEs. In this context, we believe that the risk of an abrupt slowdown in the Chinese economy, particularly in the short-term, remains very low.

**Elsewhere in the emerging world, and excluding a relatively small group of poor performing countries, not only are there no signs of a slowdown, but also the opposite is happening:** India managed to grow above 8% in Q2; Vietnam, Malaysia and Thailand are also in good shape; Indonesia, despite all the noise surrounding its currency, continues to grow above 5%; the main risk in the Philippines is overheating and not loss of economic momentum; Colombia is recovering rapidly in a context of more expensive oil; Chile also presents good numbers; Peru has accelerated significantly against a backdrop of controlled inflation; the whole of Eastern Europe is growing solidly with very low levels of unemployment and with rising wages, etc.

**Generally speaking, we see no serious reasons to expect a significant global shock within the emerging markets. What is certain however is if the American economy were to overheat (as seems increasingly likely), then disruptive scenarios are conceivable:** financing in dollars could tighten significantly, obviously harming liquidity and probably global economic activity also. The main reason for this disruptive scenario would come from the United States itself however, with the potential excessive raising of long-term interest rates.

# United States

## The US economy is in good shape, with overheating risks on the rise

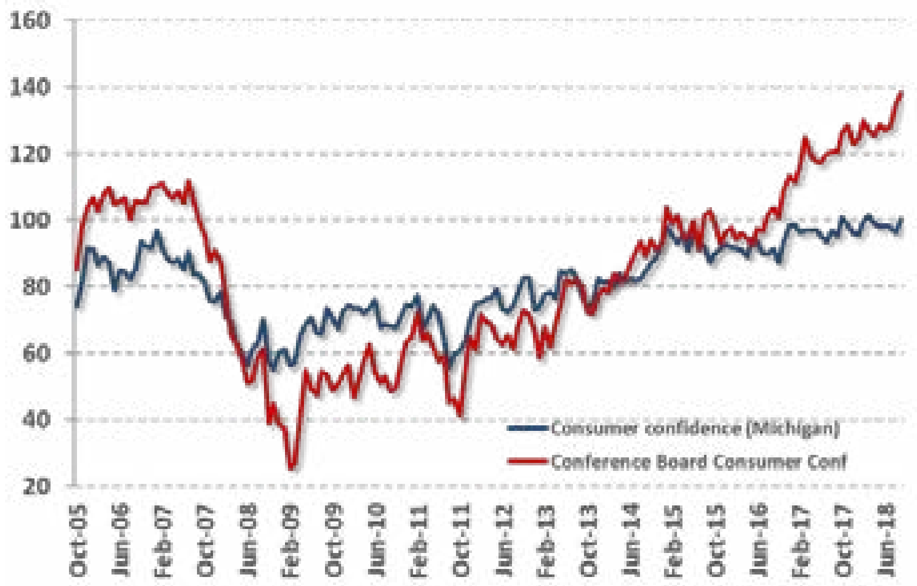
**Recent macro data continue to be very strong: annualized GDP growth was north of 4% in Q2 and we expect a similar rate for Q3.** If this is confirmed as we expect, growth in the US would have averaged at over 3% for four consecutive quarters for the first time in this economic expansion. More importantly yet, there is no reason to expect a loss of momentum going forward.

**Given the fact that fiscal policy has turned clearly procyclical,** and leaving aside the possibility of a global trade war (something that we consider quite unlikely)**, the main risk for the US economy going forward is not sudden slowdown, but rather significant overheating.**

**Private consumption is looking very good:** consumers' balance sheets are healthy; disposable income is growing at solid rates; the labour market is in excellent shape; sentiment indicators are very strong, etc.

**Corporate investment has been growing at solid rates for some time now and there is good reason to be optimistic about the future.** The recovery in oil prices is leading to increased 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 purely by resorting to unused capacity and they are therefore increasing capital expenditure at a significant pace. The recovery in investment is also good news for productivity (and potential growth). In fact it is quite encouraging to see that productivity growth has already shown signs of improvement during the past 12 months, a process that should gain speed going forward given the tightness of the labour market.

Consumer confidence is very strong




Source: Bloomberg, Alinea Global

**Even though house prices have increased a lot in recent years (and this moderates housing demand), solid underlying fundamentals should continue to support the real estate sector** in a context of relatively strong household formation rates, progressively accelerating wages and low inventories of unsold homes.

**Although a stronger dollar is bad news for US exports, we believe that the US currency hasn't appreciated enough to be a serious drag.** Moreover, we should also bear in mind that the recovery in oil prices is leading to a significant increase in energy exports, something that looks set to hold going forward.

**If we look at 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, and even more so when the unemployment rate is already below the values compatible with full employment. With this in mind, it would be normal to expect employment growth to drop and wages to accelerate further going forward (more on the latter below).

**All in all, we expect economic growth to continue clearly above potential in the coming quarters.** In fact, as already stated, we believe that overheating risks are building and will increase further in coming quarters provided financial conditions remain as accommodative as they are now.

Manufacturing and non-manufacturing ISM


Source: Bloomberg, Alinea Global

# Inflation will continue to edge up with tariffs adding further pressure on prices

**Core CPI has recovered from the negative surprises seen during the first part of 2017 and YoY rates are already at levels compatible with the FED's inflation target.**

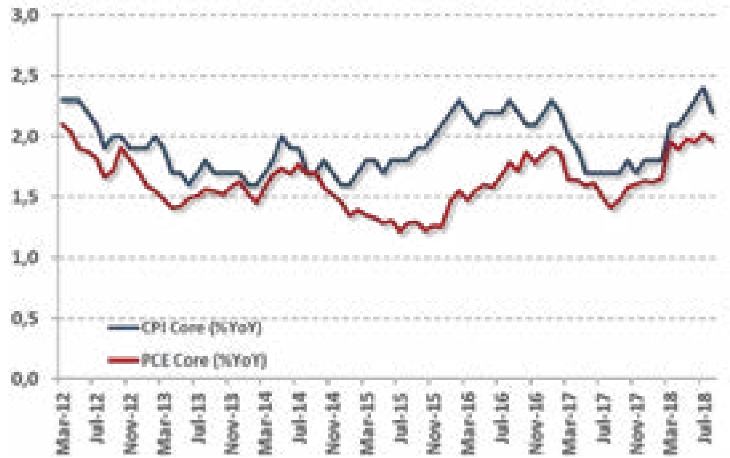
**Moreover, the outlook for core prices is fairly positive in our view:** with growth above potential, a positive output gap, and inflation expectations relatively well-anchored (even creeping a little higher in recent times), the most probable scenario going forward is for core inflation to edge progressively higher in the coming quarters.

**The risk of a significant inflation surprise going forward is on the up unless monetary conditions begin to tighten soon:** the unemployment rate is already very low; demand growth is outstripping supply growth; and a highly procyclical fiscal stance will create further demand pressures.

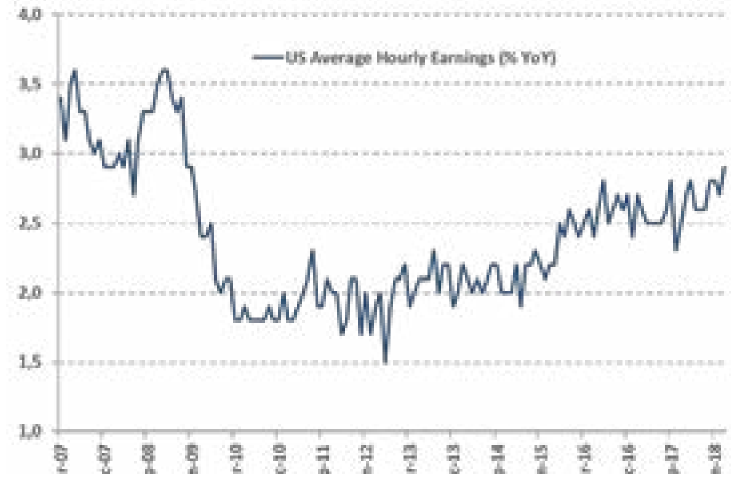
**At the same time, as tariffs restrict supply in a context of rapid demand growth, the main impact will probably be greater inflationary pressure.** It is important to note that economic sentiment indicators remain upbeat and therefore show that aggregate demand is not significantly affected by the noise surrounding Trump's trade policy.

**Meanwhile, labour market tightness should continue to favour progressively higher wage growth.** It is actually quite encouraging to see that wages have accelerated more clearly in recent months. Going forward, we believe we are more likely to see positive surprises in wage growth than in inflation, where expectations remain anchored around the FED's 2% target.

Core CPI should continue to head higher in coming months




Wages are clearly picking up




Source: Bloomberg, Alinea Global

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

**As the economy is looking fairly good, financial conditions are very accommodative, fiscal policy is clearly pro-cyclical and wages are accelerating, it was no surprise that the Fed raised interest rates again** at its September meeting and that another hike is likely in December. It was also interesting to see the US monetary authority revising its estimate of the neutral rate modestly higher (we actually think that further upward movements in this important variable are to be expected in the coming quarters).

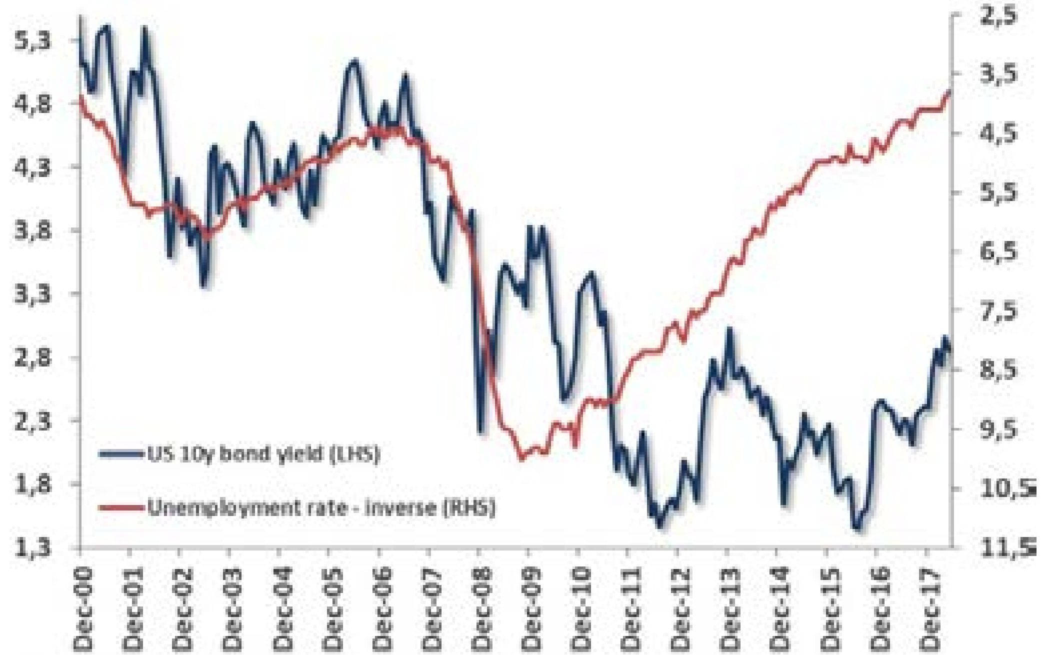
**Having said this, the Fed continues to signal only gradual interest rate increases going forward, even if this risks inflation overshooting** the 2% target for a significant period of time.

**With the Fed remaining so cautious about raising rates, the risk of falling behind the curve is clearly edging higher.** Under normal circumstances, this would have lead to an increase in the term premium and therefore to a steeper yield curve, especially in the 10-30y maturity range. Most market participants still believe that inflation will never seriously rise, no matter how hot the economy becomes, so the yield curve remains incredibly flat.

**We are fairly fearful that monetary conditions will remain too accommodative for too long a time** and this will put the US economy at risk of overheating. If this does indeed prove to be the case, inflation will inevitably overshoot the 2% target by a significantly higher amount than even the Fed (let alone the markets) are currently expecting.

**In our opinion, it is becoming increasingly clear that the US economy needs long-term rates to increase significantly in order to contain the risk of overheating.** The longer long-term rates stay this low, the greater the risk of overheating and the higher these same rates will need to rise later on, potentially creating a difficult scenario for risk assets going forward.

Long-term rates still far too low




Source: Bloomberg, Alinea Global

# European Union

## The deceleration seen so far this year will probably be temporary

**Economic activity was weaker than expected during the first part of 2018, but this should be put into context.** Firstly, growth continued to be clearly above potential. Secondly, the deceleration seen during this period was mostly due to temporary factors (bad weather, strikes, high incidence of the flu in countries like Germany, adjustments in the car industry due to changes in emissions tests, etc.).

**Looking ahead it is important to remember that significant tailwinds continue to help the Eurozone's economic expansion:** extremely accommodative monetary conditions; somewhat expansionary tax policies; a somewhat weaker euro compared to the dollar; price-competitiveness adjustments among countries in the periphery during the crisis, etc.

**As this is the case, and provided the noise around trade, Italy and Brexit remains under control (as we think it), there is good reason to remain positive about the Eurozone's economy going forward:** the unemployment rate is dropping fairly quickly and the labour market continues to show strength; sentiment indicators are still at quite high levels; PMIs never fell to worrying levels and have actually shown some signs of recovery in recent times; credit to households and non-financial corporations has picked up again; capacity utilization levels are quite high and this is obviously good news for corporate investment going forward, etc.

**Admittedly, it will be difficult for growth to hit the very strong rates seen during the second half of last year again. This is not due to lack of demand however, rather it is a sign that supply is having a harder time coping with fairly robust domestic demand.** In fact, the very same reason that justifies a little more cautiousness surrounding European economic growth in the future should also lead us to expect increasingly higher wage and price pressures in the Eurozone going forward (in fact both wage growth and inflation have sent more positive signals in recent times).

Economic sentiment: still very solid levels


Source: Bloomberg, Alinea Global

# Despite the noise around Italy, prospects still look good

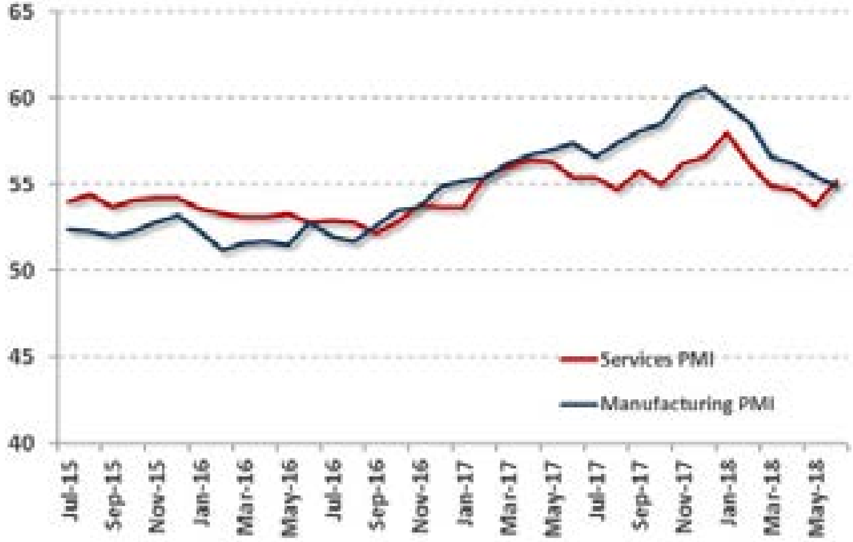
**The new Italian government continues to create noise: the budgetary deficit foreseen for 2019 (2.4%) is clearly too high and won't be accepted by the European Commission.**

**Having said this, we think that highly disruptive scenarios will be avoided:** other countries in the periphery are in significantly better shape than they were some years ago and we believe, therefore, that the risk of Italy influencing other countries remains relatively low.

**It is quite possible that negotiations around Brexit will continue to create unrest in the coming months. At the same time, it is also hard to see Brexit creating significant headwinds for growth in the Eurozone in the short-term.**

**Generally speaking, and without underestimating the risks, we think that the most likely scenario going forward is for the Eurozone to continue to grow clearly above potential, allowing for a relatively rapid reduction in spare capacity** (incidentally, it is also good to remember that spare capacity levels in the Eurozone are no longer huge).

PMIs still at healthy levels




Source: Bloomberg, Alinea Global

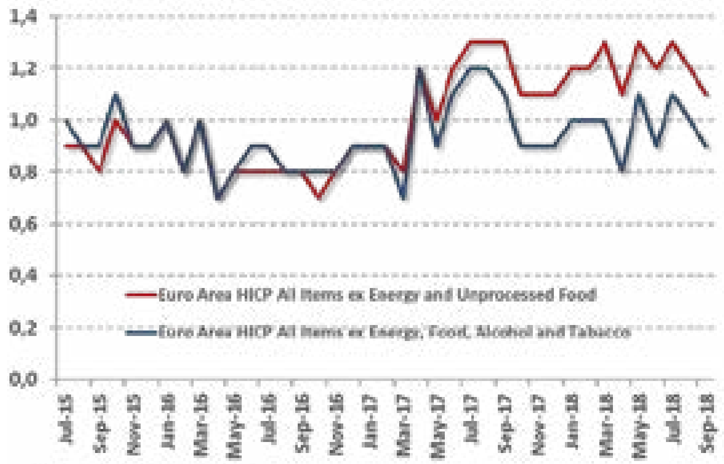
# Better prospects for core inflation and wages: the ECB confirms the end of the QE programme

**The favourable macro environment should lead to a gradual acceleration in core prices.** We consider it quite likely that inflation, excluding fresh food and energy, will reach YoY rates close to 1.5% by December.

**Four main factors help explain why we remain fairly upbeat about core prices going forward.** First, we continue to see growth clearly above potential and therefore expect the output gap to close quite rapidly (the unemployment rate will fall below 8% in the near future and the vacancy rate is already at record levels). Second, and in relation to point one, there are already signs of wage acceleration in many countries. Third, the euro's recent depreciation will help push the cost of goods higher going forward. Finally, due to higher energy prices, headline inflation is now around 2%. Considering the much improved shape of Europe's labour market and the fact that collective bargaining in our continent has a significant backward looking component, second round effects in the form of higher wages and core prices are to be expected in the coming months.

**As it stands, it was no surprise that at its September meeting the ECB decided to confirm the end of the QE programme in December.** It was also good to see Draghi sending some important messages at the press conference. He said that, contrary to what many people are saying, there are also upside risks to growth in the Eurozone going forward, namely a somewhat more expansionary fiscal policy in several countries and, more importantly, an increasingly apparent underlying strength in the Eurozone's economy. He also mentioned that the ECB expects core inflation to edge higher during the rest of 2018 and going into 2019 and he stressed the fact that wages have been accelerating. Finally, he also reiterated that the ECB continues to grow more confident about Europe's inflation outlook. Taking all this into account we believe that forward rates are currently far too low and that the ECB will probably make use of forward guidance to help term premia better reflect the scenario of inflation converging to the 2% objective.

Core inflation should edge higher going forward




Inflation expectations have improved


Source: Bloomberg, Alinea Global

# United Kingdom

## The economy is holding up relatively well, despite all the noise around Brexit

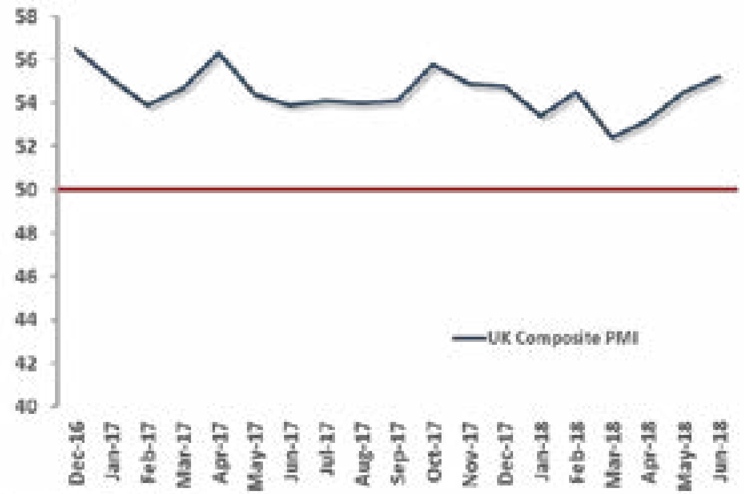
**Even though it is very difficult to imagine quite what form Brexit will take, we believe the likelihood of very disruptive scenarios in the short-term is quite low.**

**Short-term macro data have regained momentum recently and prospects look reasonably good.** The weak pound should continue to boost both exports and the manufacturing sector. Moreover, and partially to compensate for the negative effect of Brexit on sentiment, levels of spare capacity are so low that British companies are being forced to invest to cope with demand growth. What about private consumption? It is clear that this important variable has also been negatively affected by uncertainty around Brexit and also by imported inflation. At the same time however, in a context of full employment we should be relatively optimistic about wages going forward, something that in turn should help private consumption in the coming quarters. Encouragingly, signs of positive momentum in wage growth are increasingly apparent.

**Given the very low levels of spare capacity and the more positive signals coming from both wages and domestic price pressures, we think the BOE will continue to raise interest rates in the coming quarters.**

**From a medium-term perspective, it is clear that the long-term negative effects of Brexit on the UK could end up being quite significant:** the UK will probably lose full access to one of the biggest markets in the world; London will lose 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. It would therefore be a very positive move if the British government were finally to decide to keep the UK in as close a relationship as possible with the EU.

Latest economic data are moderately positive




Source: Bloomberg, Alinea Global

# Spain

## Despite some slowing down, Spain's economy continues to look good going forward

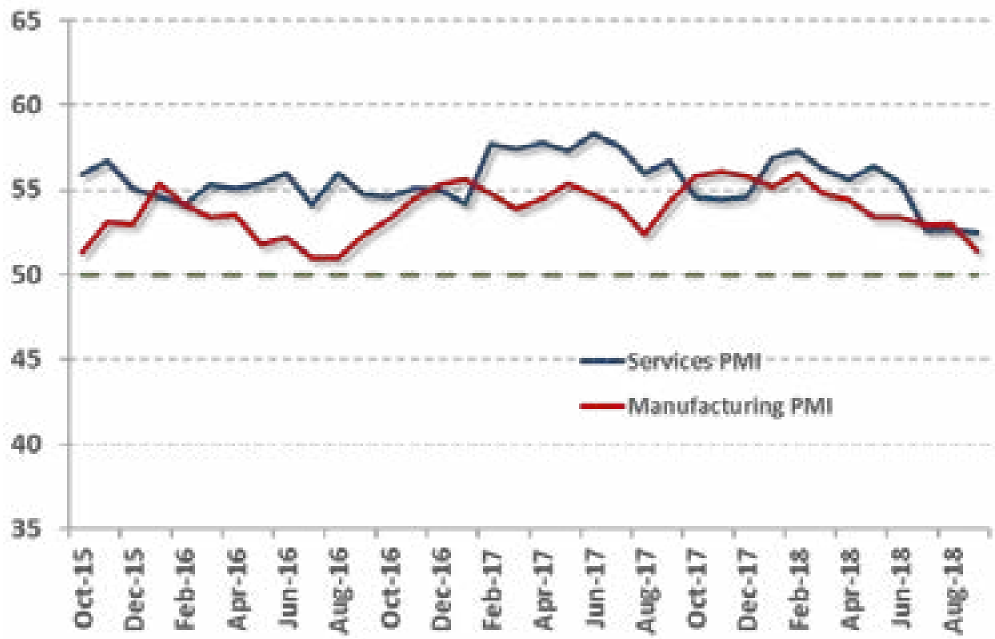
**Recent macro data point to a certain slowing down in economic activity in Spain,** but growth rates remain healthy (around 2.5% YoY). As was to be expected, the tourist industry has been unable to maintain the spectacular growth rates seen in previous years.

**Going forward, and provided the situation in Catalonia remains under control (clearly the most probable scenario), we believe the Spanish economy will continue to benefit from a number of important tailwinds:** significant price competitiveness gains made during the crisis; a much improved balance sheet situation for both families and companies; a global economy that is in very good shape; still very low interest rates; a fiscal policy that will turn mildly expansionary.

**Going forward, we therefore expect growth to remain clearly above potential and spare capacity to continue to drop fairly quickly.** This in turn will put upward pressures on wages (this is already taking place and will be further aided by second round effects of higher oil prices on wages, given the backward looking nature of collective bargaining in Spain).

**As this short-term macroeconomic scenario plays out, core prices seem poised to edge progressively higher in the coming quarters.**

Manufacturing and non-manufacturing PMI




Source: Bloomberg, Alinea Global

# High debt and low potential growth - still Spain's medium-term challenges

**Given this relatively upbeat short-term macro outlook, it would be a huge mistake if the government failed to use the current tailwinds to boldly address the significant structural challenges still facing the Spanish economy** (low potential growth, an ageing population, increased inequality, and significant levels of external debt).

**It is particularly important for Spain to comply with the requirements of the Stability and Growth Pact and to ensure the long-term sustainability of its public finances.** Regrettably, recent news regarding fiscal policy has been somewhat worrisome. On the one hand, there is too much talk about the need to increase pensions at least in line with inflation, but there is too little talk about how this will be financed (this is a very costly proposition considering the ageing population and the fact that the average pension in Spain is actually quite high when compared to the average wage). On the other hand, fiscal policy has become expansionary when perhaps it would have been a better idea to increase the pace of deficit correction (especially taking into account the current strength of the Spanish economy and the fact that public debt is actually quite high, at around 100% of GDP).

Core inflation should edge progressively higher


Source: Bloomberg, Alinea Global

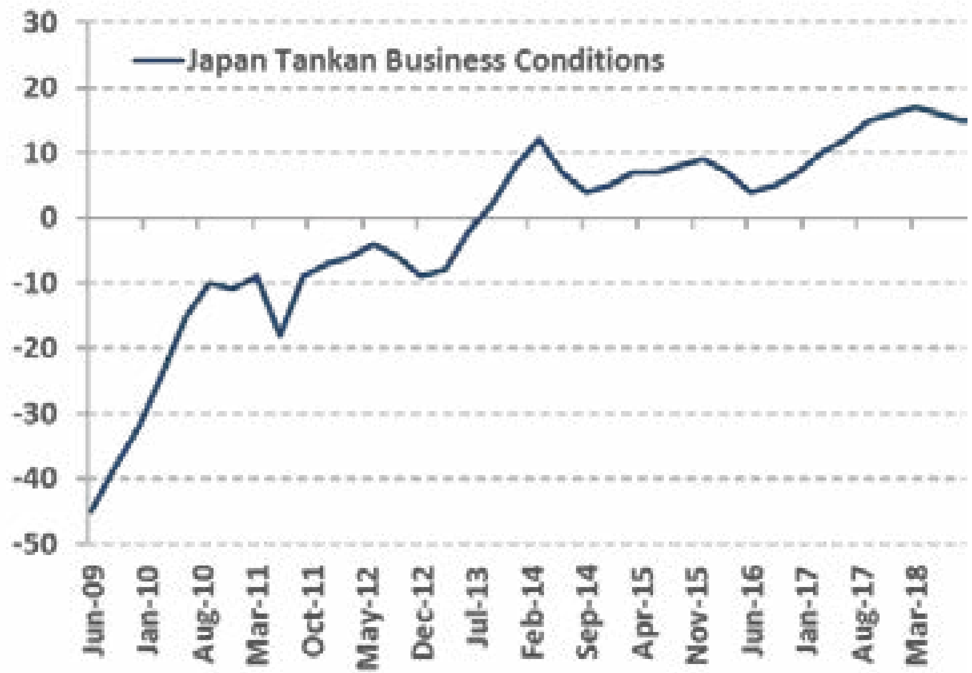
# Japan

## Japan grows above potential and the prospects going

**Trying to figure out how the Japanese economy is doing in the very short-term is no easy task.** On the one hand, the quality of short-term data is far from optimal (in fact the government was recently forced to implement a plan to improve them). On the other hand, and more importantly, 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 the country's population is decreasing, there is hardly any immigration and there is therefore a very low level of potential growth (probably around 0.75-1% a year). It is therefore understandable for the Japanese economy to alternate quarters of positive growth with quarters of negative growth, and even more so in the current environment of very low levels of spare capacity.

**Having said this Japan managed to grow significantly above potential in Q2 and recent macro data have been mostly positive:** sentiment indicators are at healthy levels; corporate investment is sending encouraging signs in a context of increasing capacity constraints; exports and industrial production are both 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 very well. At the same time, wages are beginning to pick up more significantly against a backdrop of very low unemployment 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; whilst this has helped keep wage growth in check, it will naturally become less of a factor going forward since a lot of progress has already been made in this area; on the other hand it is true that immigration could continue to help expand the labour force in Japan thereby easing pressure on wages). Somewhat stronger wage growth is of course excellent news for Japanese private consumption going forward.

Positive outlook in the medium-term




Source: Bloomberg, Alinea Global

# Economic fundamentals point to progressively higher inflation and wage growth

**Although the 2% inflation objective is still far out of reach, a tight labour market** (the unemployment rate is 2.4% and the jobs/applicants ratio is very high at 1.63) **in a context of above-potential growth should put further upward pressures on wages and then on inflation going forward** (some positive signs have already been emerging on both fronts in recent months).

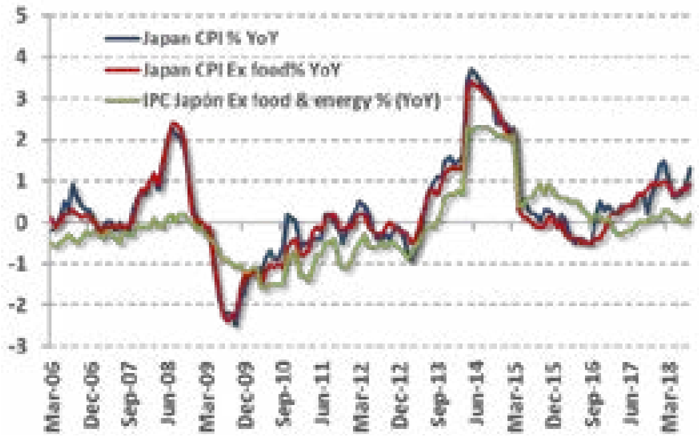
**The BOJ continues to implement its yield curve control policy,** trying to make sure that 10y yields stay reasonably close to 0% and having committed to allowing inflation to overshoot the 2% target for a considerable period of time. Since August, the 10 year yield has been allowed to fluctuate 20bp around the 0% target to allow for more trading activity in the debt markets.

**At the same time, the government has said that a primary surplus will only be achieved in 2027 meaning that fiscal policy will remain accommodative,** thereby helping create further inflationary pressures over the coming quarters.

**Beyond creating inflation, perhaps the most important challenge for Japan going forward is the need to increase potential growth.** And, for this to happen, the country has to make more progress in the field of structural reform. Three elements seem especially important in this respect: the labour market should be reformed in order to reduce duality among formal and informal workers; immigration should be fostered (some progress is already being made in this field); and conditions for FDI should be further improved (as it drives productivity). **Looking further ahead, it will also be crucial for the government to ensure a sustainable path for the country's public debt.**

A positive output gap points to higher wages and prices


Prices are already showing some positive signs




Source: Bloomberg, Alinea Global

# Emerging countries - China

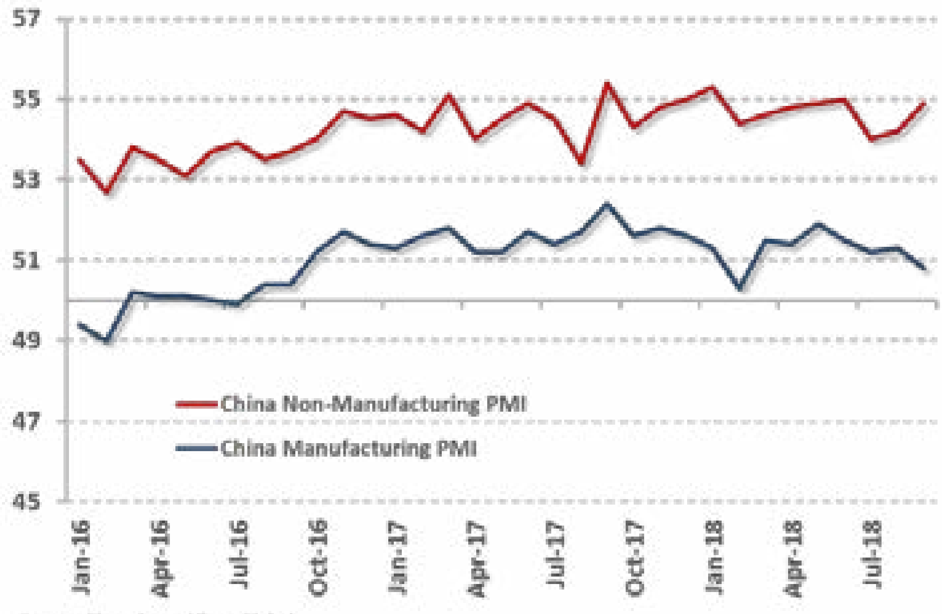
## Even if US tariffs do pose a threat, the risk of a hard landing is very low

**Despite the talk of a trade war, the Chinese economy remains relatively solid with the most recent macro data pointing to a very mild deceleration only:** private consumption should continue to do well alongside a strong labour market, increases in wages and high consumer confidence levels (even though household debt has been growing, it has started from very low levels; moreover, net wealth continues to be solid); exports remain healthy; both the services sector and the most technologically advanced segments of the manufacturing sector look strong; China has already made significant progress in relation to industry sectors affected by overcapacity issues and this reduces downward pressures on activity going forward; the fact that inflation is still quite low (despite recent increases) creates room for manoeuvre by the PBOC; fiscal policy is becoming more expansionary.

**China's economic strength increases the country's ability to confront the risk of a trade war with the US.** Having said this, we continue to believe that China's trade policy will be guided by two basic principles. Firstly, the authorities will respond to tariffs set by Trump, but will avoid giving the impression that they want to escalate the conflict. Secondly, as it is in the country's best interest to do so at its current stage of economic development, China will continue to adopt measures aimed at reducing trade barriers (in September, for example, a broad reduction in tariffs was announced), at increasing protection around intellectual property rights and at promoting a more level playing field for foreign companies operating in the country.

**As a result of the risks arising from a potential trade war with the US, we believe that, going forward, the Chinese authorities will put even more emphasis than before on finding the right balance between reducing financial risk and ensuring sufficient economic momentum.** Measures adopted recently aimed at moderately easing financial conditions and at increasing the pace of infrastructure investment are good examples of this.

The economy continues to do well




Source: Bloomberg, Alinea Global

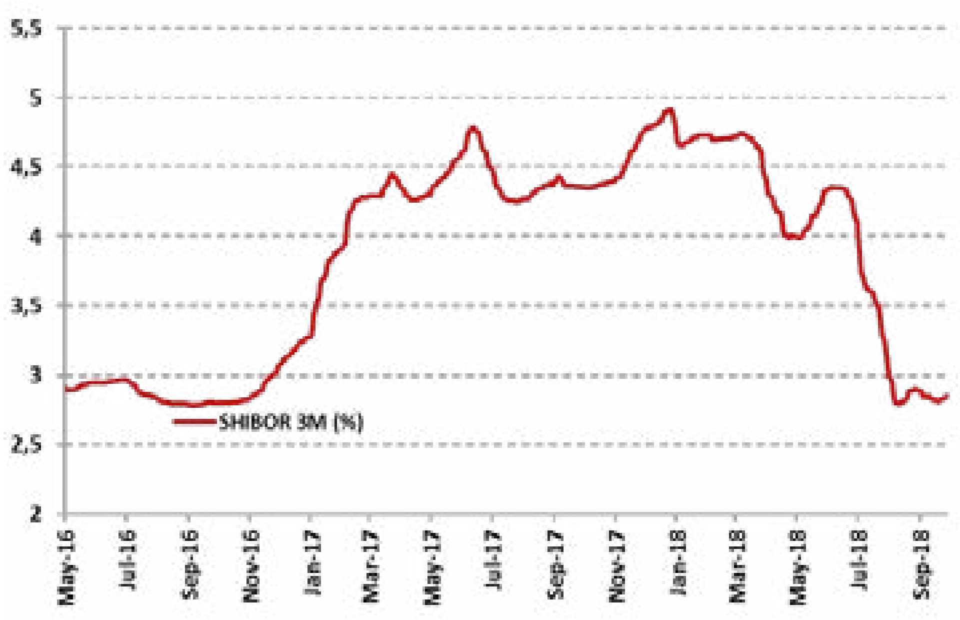
# A moderately weaker yuan due to noise around US trade policy

**Given the noise around US trade policy, the Chinese authorities have allowed the yuan to depreciate slightly against the dollar for some months.** Following a moderate depreciation, something that will probably have a positive impact on Chinese exports, China has recently decided to introduce measures aimed at stabilizing the currency.

**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.

**It is also good to know that China has sufficient room for manoeuvre in terms of the balance sheet to allow for a smooth deleveraging process (this process is actually more advanced than many had thought it would be at this stage). We therefore believe that a credit crunch scenario is quite unlikely:** we should remember that China is a net creditor to the rest of the world. Moreover, debt growth has slowed down significantly in recent times, while measures aimed at facilitating the sale or securitization of bad loans seem to be progressing well (this should help banks reduce their exposure to this kind of asset). At the same time, the authorities have continued to curb shadow banking activities.

Financial conditions a little more accommodative again



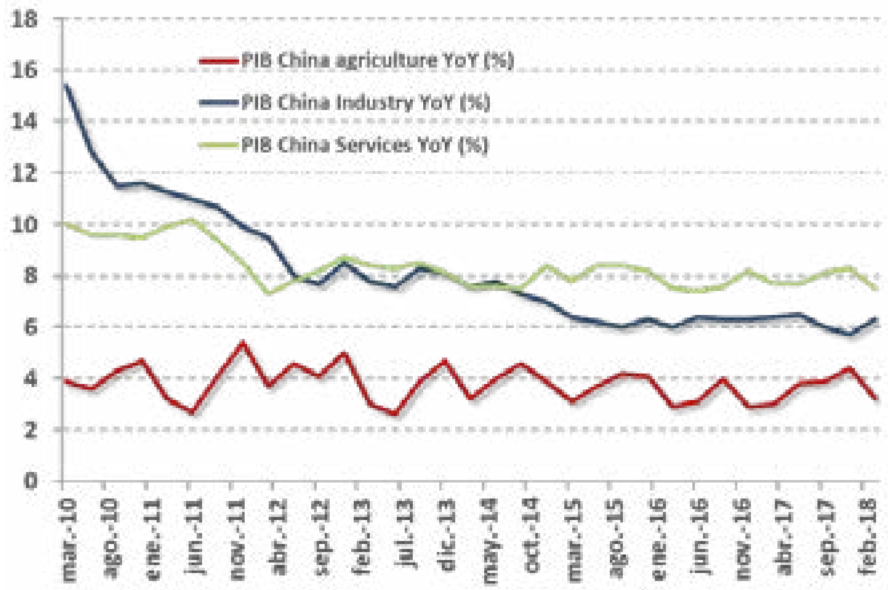

Source: Bloomberg, Alinea Global

# Further opening of Chinese markets and better IP protection will be needed

**The country is making some progress in the process of modernizing its growth model and this is also a positive step.** On the demand side, consumption continues to gain in importance. 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 good to see progress being made in some other areas: the economy's energy intensity is being reduced; corporate leverage is decreasing somewhat; and technological progress is being promoted (R&D investment reached 2.15% of GDP in 2017).

**Having said all this, and taking into account the pressure also coming from the US, it is of course crucial that the authorities continue to work hard in order to further reduce financial risk, make progress in the field of structural reform and open up Chinese markets more clearly to international competition:** excess capacity in some traditional sectors should continue to be reduced; credit growth needs to be further curbed; a real-estate bubble must be avoided; the playing field for foreign companies and private companies more generally should be improved (tariffs should be reduced, restrictions to FDI should be curbed and intellectual property rights should be better protected). At the same time, and in order to help potential growth, investment in human capital should be further encouraged.

Services continue to gain importance




Source: Bloomberg, Alinea Global

# Emerging countries - India

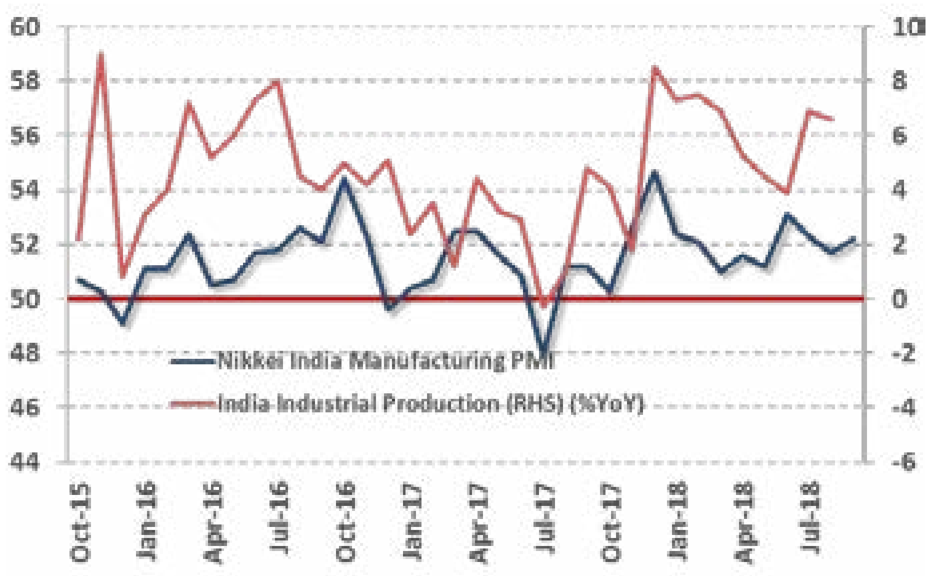
## Despite the noise in financial markets, the economy continues to do well

**Despite the noise in financial markets, India managed to grow above 8% in Q2 and the economy seems poised to continue to do well going forward:** private consumption remains resilient; exports and manufacturing production are benefiting from a strong global economy (and will also be pushed higher by a weaker rupee); both the services and the rural sectors are strong; credit growth has picked up, etc. Moreover, and after a prolonged period of sluggishness due to low capacity utilization 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 over the last 2 years, together with the recent rise in capacity utilization, seems to be proving helpful in this respect). On a more negative note, India is obviously affected by the rise in the price of oil, but we believe that more expensive energy won't be enough to derail the expansion (it is good to see that the current account deficit clearly remained below 3% in Q2).

**On the fiscal front,** and considering the relatively high budgetary deficits (especially at the state level), it is important for the government to continue to strike the right balance between boosting growth, facing social challenges and ensuring a sustainable path for public debt in the medium and long-term. In a context of higher oil prices a cautious fiscal policy will also help keep the current account deficit under control. It is therefore positive to see that the government remains fully committed to meeting the 3.3% deficit target for this fiscal year.

**The RBI increased rates again in August and we believe it will maintain a neutral stance going forward.** First, as already stated, the economy is looking better (and is progressively closing the output gap). Second, fiscal policy has turned mildly expansionary. Third, core inflation remains clearly above the 4% target. Four, inflation expectations continue to be quite high. And five, the weak rupee could put upward pressures on prices going forward.

Volatile PMIs, but positive underlying momentum




Source: Bloomberg, Alinea Global

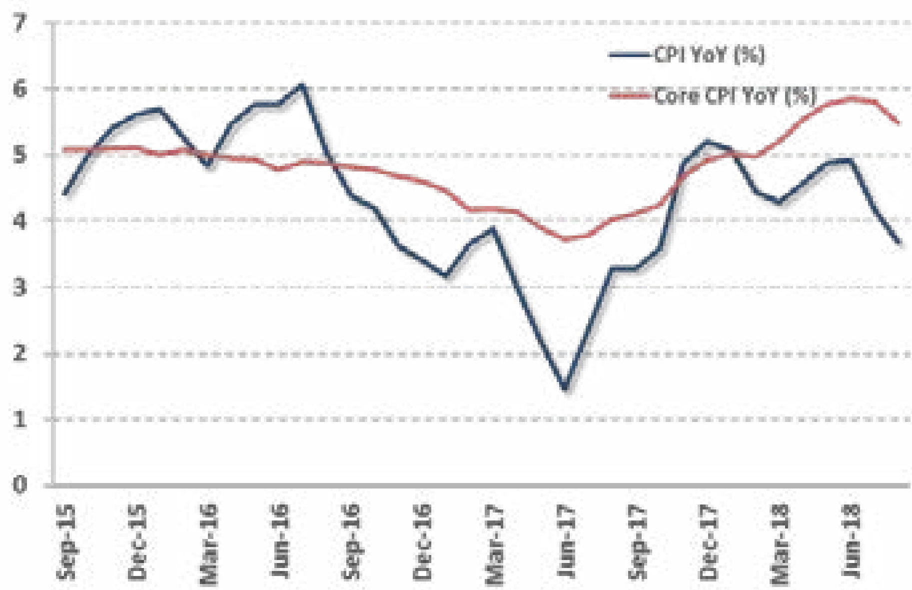
# The government continues to make progress in the field of structural reform

**As far as reforms are concerned it is certainly good news to see that significant progress has been made in the process of recapitalizing government-owned banks** (mergers have also been announced during the last few weeks). This is an important step towards stabilising the financial system and improving the transmission of monetary policy. More generally, the central government continuing to promote competition among states is helping create reform momentum all over the country.

**The fact that the RBI is using its acquired powers to force lenders to write-down NPLs should also be welcomed.** Moreover, efforts made to further develop the market for corporate bonds will also tend to have a positive effect on private investment.

**Going forward, further steps will be needed, particularly in the following areas: governance structures in state-o**wned banks need to be further improved (and the supervisory power of the RBI over these banks should be increased) to reduce fraud; defaults in the shadow banking sector should be monitored and sufficient liquidity should be ensured so as to avoid potential systemic risks (there was one such case in September); non-financial corporations (especially in certain sectors) should reduce leverage; 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 these funds could flow to the real economy in a more efficient way); the labour market and agricultural industry regulations should be further improved; land reform should be boldly pursued since it would help reduce the significant obstacles that infrastructure investment in India still faces; FDI flows should be further liberalized (it is encouraging to see that some positive steps have been taken in this direction recently).

Core inflation still above 5%




Source: Bloomberg, Alinea Global

# Emerging countries - Brazil

## Uncertainties surrounding the coming elections are clearly negative

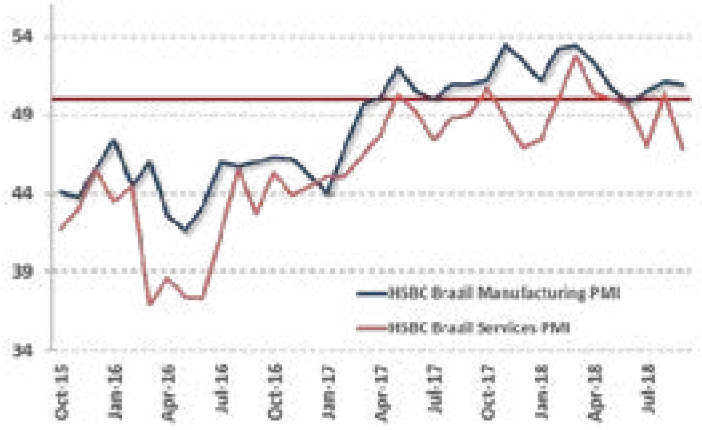
**In the medium-term Brazil's economic future will be dictated by two main factors.** On the one hand, macroeconomic stability (both fiscal and so far as inflation is concerned) should be ensured, so that the high financing costs traditionally faced by the country can be sustainably reduced. On the other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

**The results of the forthcoming elections in October therefore become crucial.** The country desperately needs the new government formed post elections to remain committed to economic reform and (at least to some degree) to fiscal austerity.

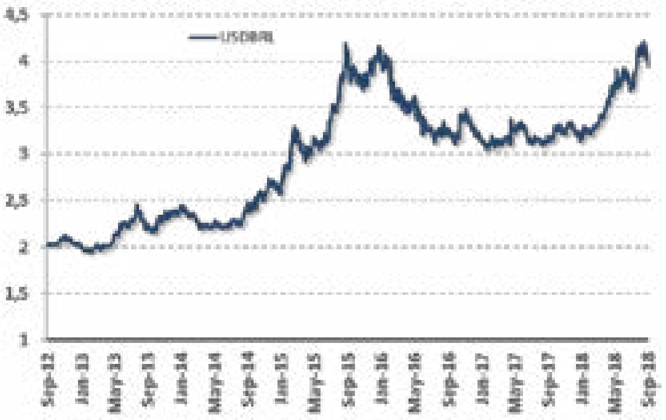
**There are two particularly relevant issues regarding reforms pending implementation following the elections:**

- Firstly, the pension system must be made sustainable (Brazil's budgetary position is quite challenging and a reform of the pension system would help significantly improve fiscal credibility with minor, if any, impact on short-term economic growth.
- Secondly, further structural reforms are needed to promote private investments in infrastructure, reduce red tape, simplify the tax system, improve financial regulations; ensure the autonomy of the central bank, etc.

Economic activity regains some momentum




The relatively weak real still helps




Source: Bloomberg, Alinea Global

# The real's depreciation and the recent rise in financing costs show the need to preserve credibility

**By reducing inflationary pressures, together with improvements in inflation expectations and high levels of spare capacity, the central bank has been able to cut interest rates fairly quickly.** This in turn has had positive effects on economic activity.

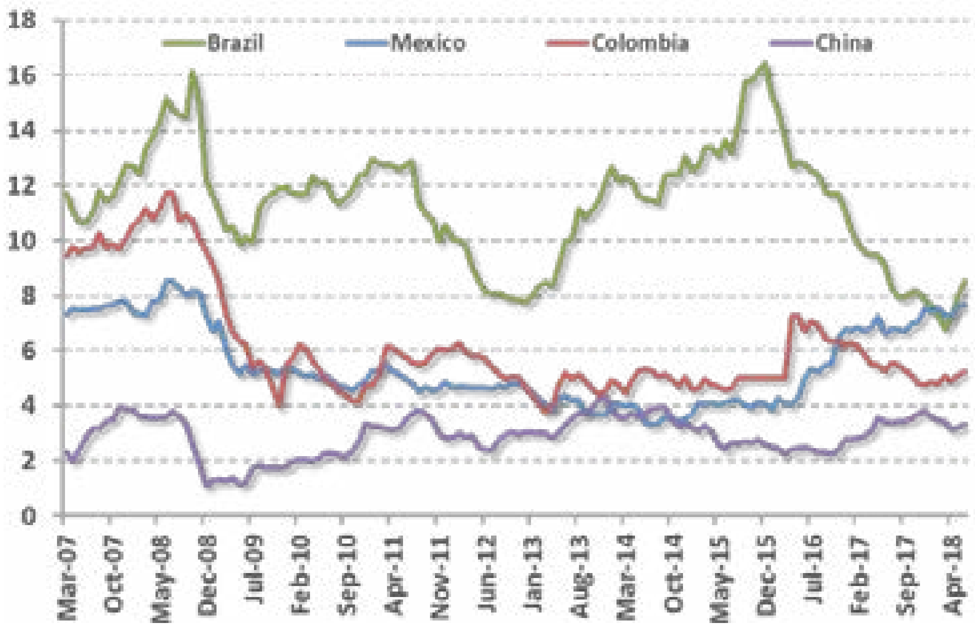
**More recently though, uncertainties around the country's political situation coupled with doubts created by the normalization of monetary policy in the US have exerted downward pressure** on both the real and economic activity.

**The good news for Brazil (at least in the short-term) is that this more uncertain environment (both for the country itself and for emerging economies more generally) sits in a context of fairly low inflation** (even if this variable has edged higher in the most recent period because of the real's depreciation and higher energy prices) **and relatively well anchored inflation expectations.** This, alongside a considerable output gap, means that the central bank does not have to change rates aggressively in response to short-term exchange rate movements (in September, rates were kept the same for the fourth consecutive time).

**We actually think that interest rates will remain constant going forward** provided the level of noise remains under control. In this context we wouldn't be surprised if the recent improvement in macro data holds, at least in the short-term.

**As previously stated however, the long-term outlook for Brazil will only strengthen if the country continues to pursue a path of structural reform, to fight against corruption and to ensure fiscal consolidation** (including, of course, the pension system reform). It is clear that the country's future depends on what kind of government triumphs at this year's elections.

Financing costs have come down quite a bit




Source: Bloomberg, Alinea Global

# Emerging countries - Russia

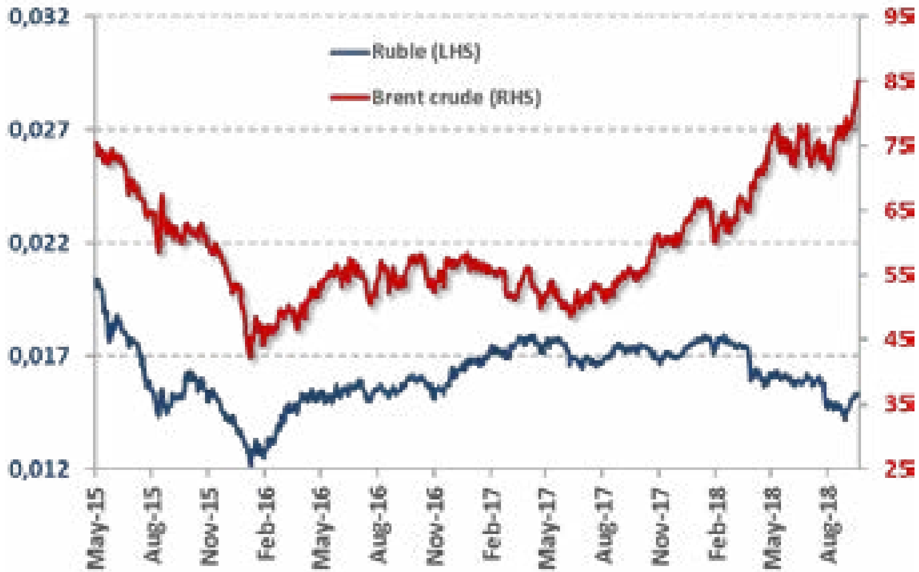
## Economic prospects look reasonably good, international sanctions are a problem

**Russia faces significant medium-term challenges:** the Russian economy's lack of diversification and its excessive reliance on commodities is a source of concern, dampening potential growth and increasing exposure to price fluctuations; corruption levels are high and the institutional framework is weak. Moreover, although positive steps have been taken by the central bank to clean up the banking sector, it is probably not over yet.

**After two consecutive weak quarters GDP growth picked up a little in Q2 (1.9% YoY) and, provided sanctions don't escalate much further, prospects going forward also look reasonably good:** the economy clearly benefits from the recovery in oil prices; 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 performing better. Generally speaking, the economy seems poised to expand at rates of around 2% YoY going forward.

**Thanks to the outstanding job of Governor Nabiullina the central bank has gained significant credibility in recent years** and this has made it possible for the monetary authority to progressively reduce interest rates as inflation has dropped significantly. In September however the monetary authority decided to raise rates moderately, by 25bp. We think this move was adequate and could be explained by several factors: monetary policy normalization in the US is having a negative effect on capital flows towards emerging markets and has been putting downward pressure on the rouble (the weakness of the latter has been further magnified by the threat of new economic sanctions); indirect tax increases expected for 2019 (together again with the weaker rouble and with rapidly increasing wages) could have an impact on inflation over the coming months; inflation expectations are still above target and have actually increased recently.

The recovery in oil prices is helping Russia




Source: Bloomberg, Alinea Global

# Russia's fiscal caution is a positive factor going forward

**The government's cautious stance as far as fiscal policy is concerned is a positive move** and creates some room for manoeuvre when concentrating efforts where they are most needed: infrastructure investment, human capital development and improvements to the healthcare system.

**It is also good to see that the government has finally been able to pass the pension system reform.** This reform is unpopular (Putin was forced to water down some of the measures aimed at increasing the retirement age for women in August), but it was badly needed to ensure the sustainability of the system.

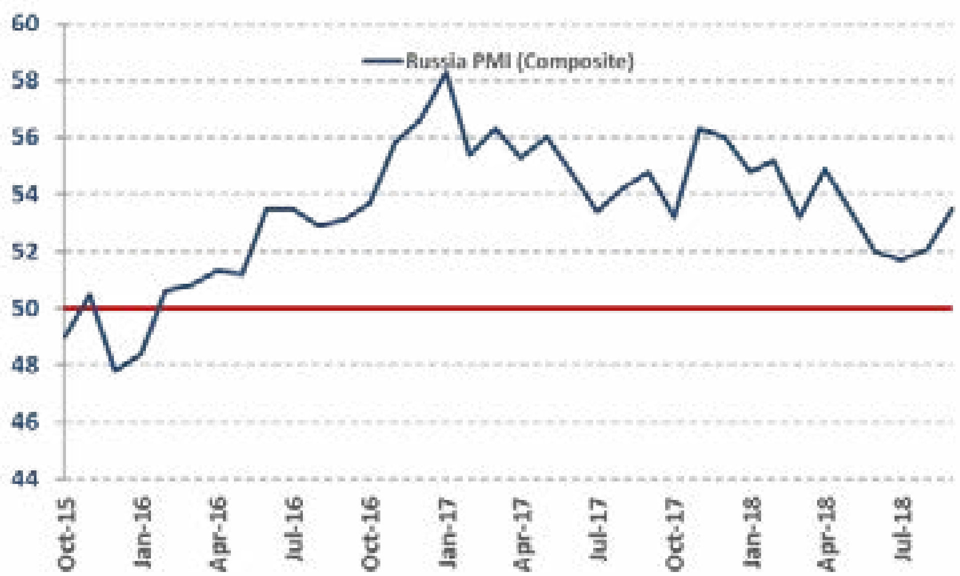
**Looking further ahead, Russia needs to make progress in three major areas:**

**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 complicated situation given the difficulties in the Ukraine and the hacking accusations).

**The government must also undertake ambitious structural reforms aimed at increasing potential growth and reducing its reliance on oil.**

**It would also be a positive move if the central bank continued its efforts to clean the balance sheets of financial institutions,** a process that is already quite advanced (at the same time, as Moody's has recently said, it is important for the central bank to avoid holding bank shares for too long since this could create conflicts of interest with its supervisory responsibilities).

Economic activity appears to be steady going forward




Source: Bloomberg, Alinea Global

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