Economic Newsletter

Fourth quarter - 2018

Economics & Regulation Services of Grant Thornton

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Quarterly commentary

Market sentiment continues to be very negative. The dominant view is that the global cycle is nearing its end and that there are significant risks that could make the situation considerably more complicated going forward.

We, however, continue to believe that there are sound reasons to expect global growth to remain healthy during 2019.

The main elements of our macro scenario for the coming quarters can be summarized as follows:

- With monetary conditions remaining lax and fiscal policies increasingly expansionary at a global level, growth in the world economy is likely to remain above potential.
- In a context of increasingly reduced spare capacity, demand that grows above supply will progressively translate into more dynamic behaviour in terms of both prices and wages (the latter, in fact, are already showing obvious signs of acceleration in many economies, starting of course with the US).
- Once this scenario becomes clearer, it is quite possible that the premium term in the risk-free rate curves will recover significantly, meaning a significant upward movement in long-term rates.

What are the possible triggers for movement such as this in the coming months?

- Although it is difficult to make short-term forecasts and we cannot rule out that some indicators will be affected in the near future by the uncertainty generated by the financial markets, we venture to mention the following elements as examples of how our reflation scenario could begin to be perceived as the most probable going forward:
- Wage acceleration in the US, which is likely to be much higher than currently discounted by the market: resurrection of the Phillips curve.
- Macro data recovery in Europe, as the negative temporary factors that have weighed down 2018 dissipate. Attention here to the data in Italy and France, where signs of recovery may become particularly evident soon (in the first case due to less uncertainty and a reduction of the risk premium and, in the second case, due to the yellow vest protests losing momentum).
- An upward trajectory of core inflation in Europe thanks to growth above potential, lower spare capacity, improved wages and the relative weakness of the euro.
- Possible trade agreement between China and the US.
- Elimination of the possibility of a no-deal Brexit.
- Sustained economic activity in emerging markets.

United States

The main risk going forward is overheating rather than abrupt slowdown

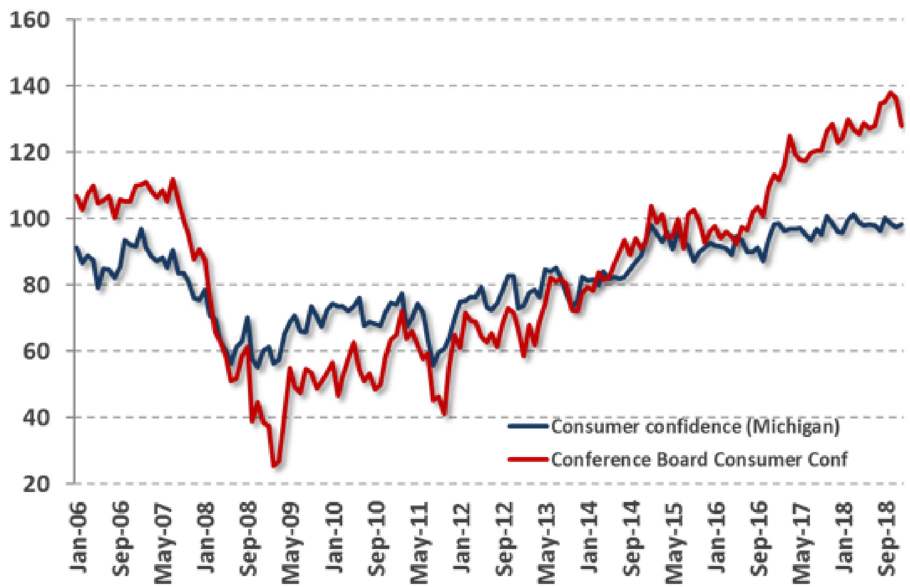
Despite the prevailing negative sentiment, the US economy is doing very well. In fact, during 2018 GDP growth reached the fastest rate seen in the current expansion. Even more importantly, because fundamentals are solid and serious imbalances are yet to be built, there are no concrete reasons to expect a worrying loss of momentum going forward.

In our view, given that the output gap is already positive, monetary conditions continue to be easy and fiscal policy will remain pro-cyclical for at least the most part of 2019, **the likelihood of overheating (rather than a sudden slowdown) is clearly greater.**

Private consumption is looking very good: Consumer balance sheets are healthy; disposable income is growing at solid rates (wages have finally begun to accelerate); the labour market is in excellent shape; sentiment indicators are strong, etc.

There are also good reasons to be positive about corporate investment going forward. After years of expansion, companies in most sectors are no longer in a position to serve increasing demand merely by resorting to unused capacity and will therefore need to increase capital expenditure at a significant pace. Many people say that corporate debt in the US is too high and will have a negative effect on private investment going forward. This need not be the case however, as rather than investing too aggressively, US companies have changed the composition of their financing structure in recent years in favour of very cheap debt. When this is the case, there is good reason to expect delinquency to remain under control, especially if we take into account that a good part of all this new debt is both long term and with fixed coupons. It would seem that US companies are in a relatively good position to face potentially higher interest rates.

Despite all the noise, consumer confidence is strong



Source: Bloomberg, Alinea Global

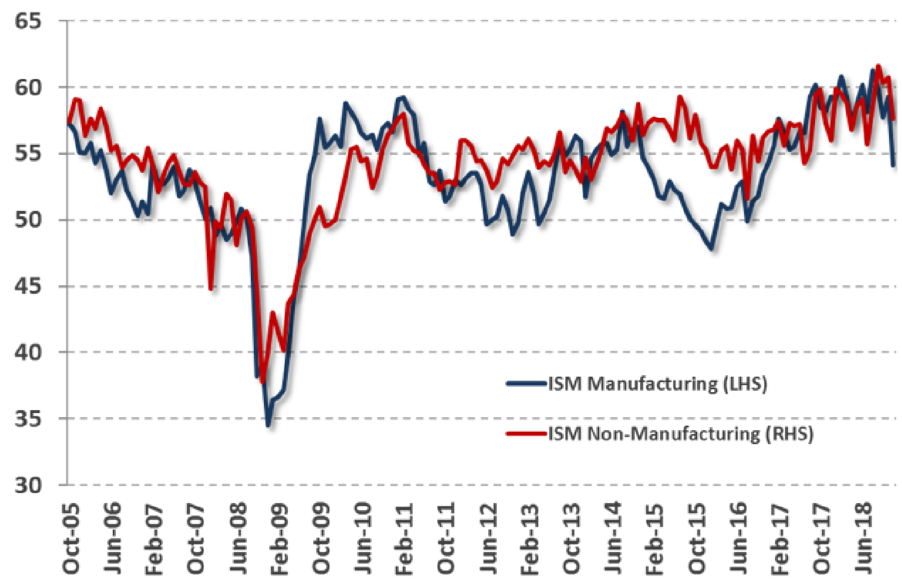
Even though house prices have increased considerably in recent years (and this of course contributes to moderate housing demand), the real estate sector will probably remain supported by solid underlying fundamentals, against a backdrop of relatively strong household formation rates, progressively accelerating wages, a very tight labour market and low inventories of unsold homes.

Despite a stronger dollar being bad news for US exports, we believe that the US currency hasn't appreciated enough to be a serious drag. Moreover it should also be noted that energy exports seem poised to continue growing at very solid rates 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 if we consider that the unemployment rate is already below equilibrium levels. Considering this, it would be logical 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 to be clearly above potential in 2019. In fact, as already stated, we believe that overheating risks are building and will increase further in the coming quarters provided that financial conditions remain as accommodative as they are now.

Manufacturing and non-manufacturing ISM



Source: Bloomberg, Alinea Global

Wages and core prices will continue to accelerate, albeit not in a linear fashion

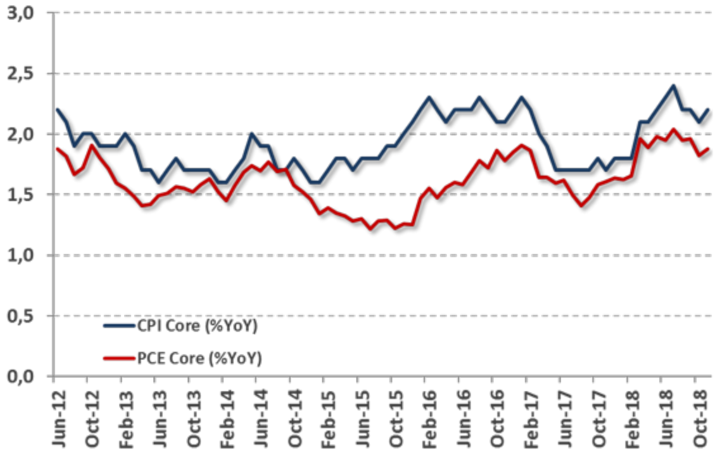
During 2018 core inflation recovered from the negative surprises seen during the first part of 2017 and YoY rates reached levels compatible with the FED's 2% inflation target.

Moreover, in our view the outlook for core prices is quite positive: with growth above potential, a positive output gap, and well-anchored inflation expectations, the most probable scenario going forward is for core inflation to edge progressively higher over the coming quarters.

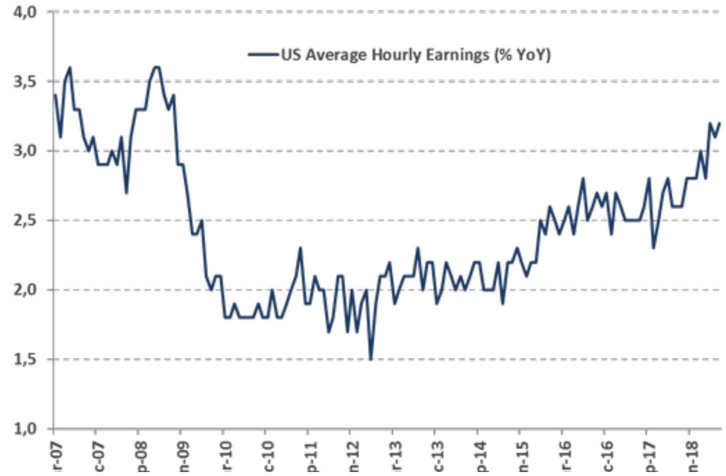
The risk of positive inflation surprises going forward is increasing, unless monetary conditions begin to tighten soon: the unemployment rate is already very low (probably too low already); demand growth is outstripping supply growth; and a highly procyclical fiscal stance has created further demand pressures.

As supply is restriced in a context of rapid demand growth, the main effect of Trump raising tariffs will probably be additional inflationary pressures. It is therefore important to note that economic sentiment indicators remain upbeat, showing that aggregate demand is not being significantly affected by noise around Trump's trade policy.
Meanwhile, tightness in the labour market should continue to favour progressively higher wage growth. It was actually quite encouraging to see that wages accelerated moderately in 2018. Going forward, with such a low unemployment rate and knowing that inflation expectations remain anchored around the FED's 2% target, we believe that positive surprises in wage growth are even more likely in the coming quarters than those related to inflation.

Core CPI is hovering near target



Wages are clearly picking up



Source: Bloomberg, Alinea Global

The Fed should continue to increase rates to avoid the risk of overheating

In our opinion, and despite pressure from Trump, the Fed was right to raise interest rates again at its December meeting: the economy is looking pretty strong, financial conditions are very accommodative, fiscal policy is clearly pro-cyclical and wages are accelerating.

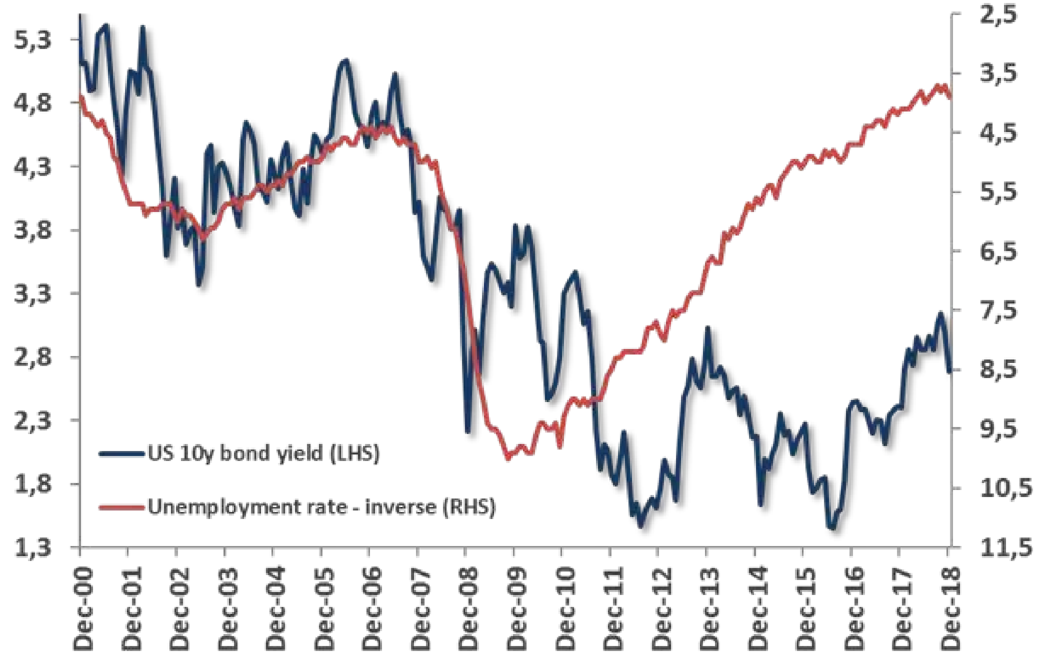
Even though the initial market reaction was negative, the Fed sent several dovish signals: further rate increases will only take place if growth remains above potential; the number of expected rises during 2019 was reduced to 2; expectations for the terminal Fed funds' rate remain very low from a historical perspective, etc. At subsequent public appearances, Powell was even more dovish, stating that the Fed will ensure expansion continues before raising rates again in 2019.

With the Fed remaining so cautious about raising rates, the risk of falling behind the curve is clearly increasing. In a normal world that should have led to an increase in the term premium. As most market participants are worried about a potential end to the global cycle however and they still believe that inflation will never seriously increase, no matter how hot the US economy becomes, the yield curve remains incredibly flat (and low).

As a result, we fear greatly that monetary conditions will remain too accommodative for too long and this will create a significant overheating risk in the US economy. Of course, and almost inevitably, if this indeed proves to be the case inflation will 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 move significantly up if the risk of overheating is to remain under control. The longer long term rates stay this low, the greater the overheating risk will become and the higher those same rates will need to rise later on, potentially breaking the correlation between bonds and equity that has prevailed in recent years.

Long-term rates still far too low



Source: Bloomberg, Alinea Global

European Union

The deceleration seen in 2018 will probably prove to be temporary

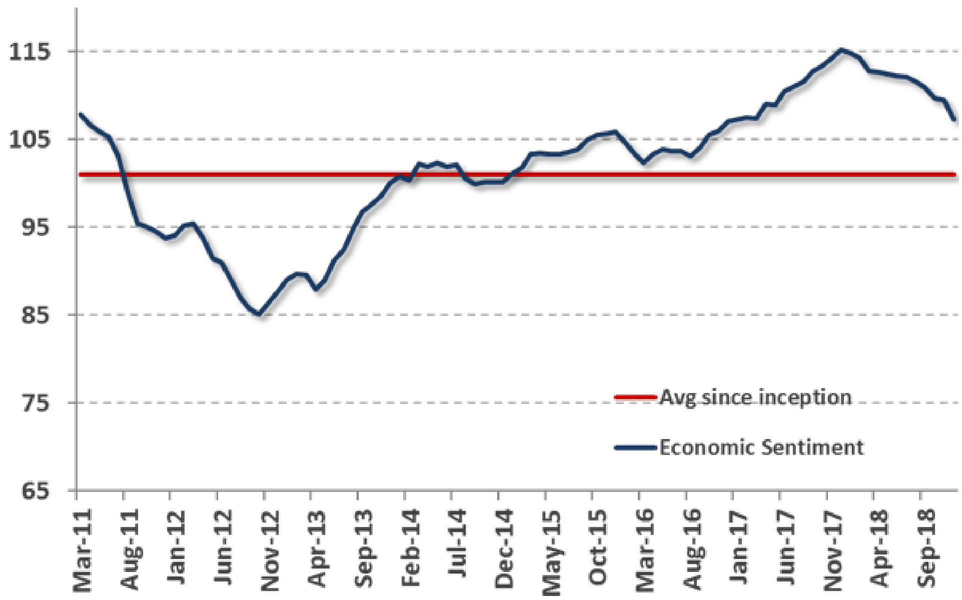
Economic activity was weaker than expected during 2018, but this needs to be put into context. Firstly, growth continued to be above potential. Secondly, the deceleration seen in this period was mostly due to temporary factors (bad weather; strikes; high incidence of flu in countries like Germany; adjustments in the car industry due to changes in emissions tests; uncertainty around Italy's fiscal plans; protests by France's yellow vests; net exports that were dragged down by the Euro's previous strength and by the crisis in Turkey, an important trading partner).

Looking ahead it is important to remember that the fundamentals underpinning the Eurozone's economic expansion remain strong: extremely accommodative monetary conditions; a financial sector more willing to lend to the real economy; a private sector that has reduced leverage very significantly; a strong labour market that together with accelerating wages is a positive factor for private consumption; high levels of capacity utilization that should push corporate investment higher in coming quarters; price-competitiveness adjustments among countries in the periphery made during the crisis; a mildly expansionary fiscal policy; a somewhat weaker Euro, etc.

This being the case, and provided the noise around global trade, Italy and Brexit remain under control (as we think will be the case), there are good reasons to believe that the Eurozone will grow significantly above potential in 2019.

We are unlikely to see growth once again reaching the very strong rates seen during the second half of 2017. This is not because of a lack of demand, rather it is the result of supply having to keep up with fairly robust domestic demand. In fact the very same reason that justifies a little more cautiousness around economic growth in the future in Europe should also lead us to expect increasingly higher wage and price pressures in the Eurozone going forward.

Economic sentiment: still very solid levels



Source: Bloomberg, Alinea Global

There are risks, but they are maybe not as serious as many people are saying

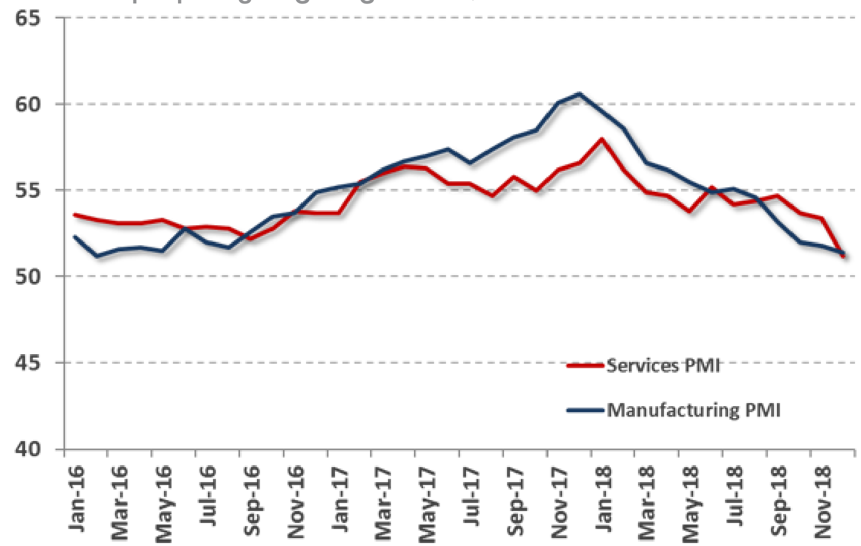
Noise regarding Italy has decreased quite significantly in recent weeks once the European Commission decided not to initiate an Excessive Deficit Procedure against the country (at least for the time being). Even though running a 2% deficit is a risky bet given Italy's high government debt burden, the deficit level is not high enough to put Italy's debt onto an unsustainable path.

In terms of Brexit, while we admit it is very difficult to say what the precise final outcome will be, we continue to believe that the likelihood of a no-deal exit (the only truly disruptive one) is actually quite low. A clear majority in Parliament are against such an outcome so, in our view, the most likely path going forward will be either that Prime Minister May's deal is agreed or Article 50 is extended to allow for a second referendum or an extension to the negotiation period.

With regards **France**, we believe that Macron will be able to find the right balance between further progress on structural reforms and measures aimed at maintaining much needed social cohesion. In Germany, meanwhile, we see no solid reasons to be worried about future political stability or the pro-European stance of the country.

All in all, and knowing of course that we can never fully dismiss certain risks, we remain positive about the Eurozone's prospects for 2019: growth above potential, relatively rapid reduction in spare capacity levels (which aren't that big anymore) and progressively higher wage and price pressures.

PMIs will propably edge higher in Q1



Source: Bloomberg, Alinea Global

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

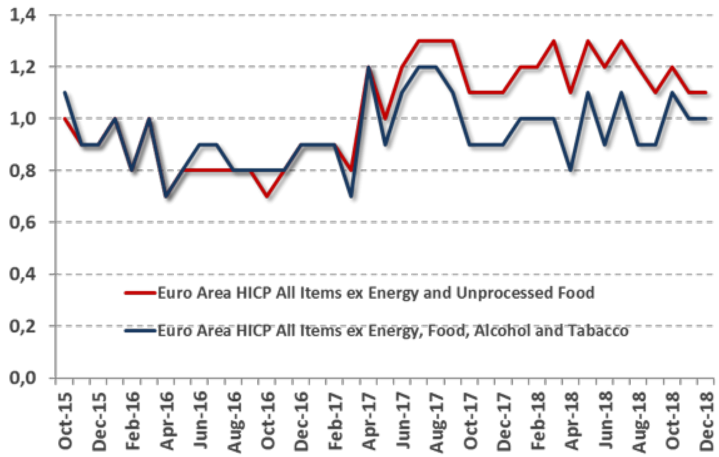
Europe's favourable macro environment should lead to a progressive acceleration of core prices.

Three main factors help explain why we remain fairly upbeat about core prices going forward. First of all, growth clearly continues to grow above potential and we therefore expect the output gap to close quite rapidly (the vacancy rate is already at record levels). Secondly, and in relation to the previous point, wages are already showing signs of acceleration in many countries. Thirdly, the Euro has depreciated in recent months and this will help push the cost of goods higher going forward.

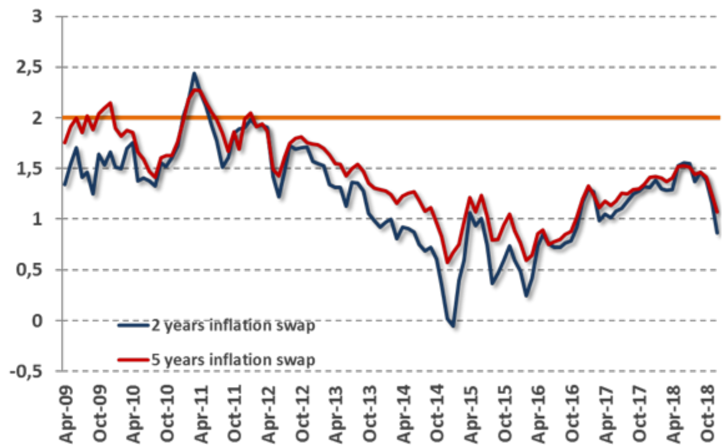
It was therefore no surprise that the ECB, at its December meeting, decided to confirm the end of the QE programme. That said, the European monetary authority continues to sound rather dovish: on the one hand, it enhanced the forward guidance by saying that it intends to continue with its reinvestment policy for an extended period of time after the first rate increase (the latter is not expected until the Summer of 2019 at the earliest); and on the other hand, the ECB insists that the Eurozone still needs very accommodative financial conditions to ensure an upward price path.

In our opinion, given the strength of internal demand and increasing evidence that the output gap is rapidly decreasing, the ECB runs the risk of falling behind the curve: maintaining highly accommodative monetary conditions for too long could (not in the short term, but possibly further down the road) lead to the risk of overheating and financial instability.

Core inflation should edge higher going forward



Inflation expectations should imporve again



Source: Bloomberg, Alinea Global

United Kingdom

Positive short term prospects once the uncertainty around Brexit clears

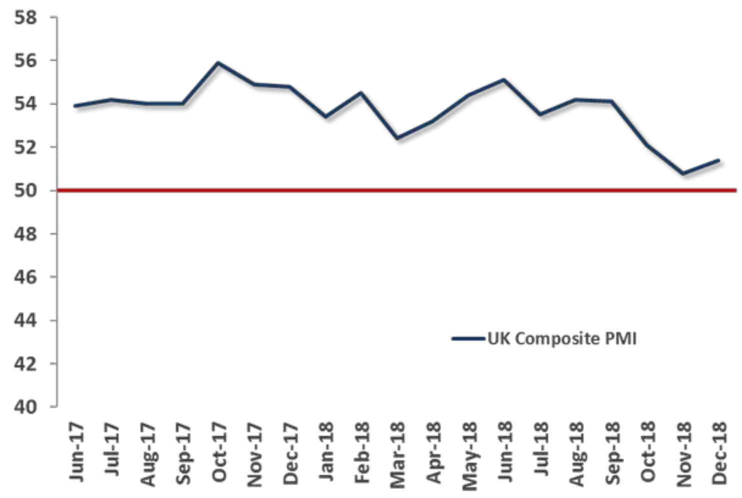
Although it is difficult to anticipate the exact outcome of Brexit, we believe that the likelihood of a no-deal is quite low: a majority of the UK parliament are clearly against this option (which is the only truly disruptive scenario in the short term).

Provided the no-deal scenario is avoided (as we expect), prospects for the British economy look reasonably good. A tight labour market should continue to push real wages higher and this is of course good news for private consumption going forward. It is also reasonable to expect corporate investment to gain momentum once the uncertainties around Brexit clear somewhat. On a more negative note, although not serious enough to affect growth, the pound will probably appreciate during 2019 and this will of course have a somewhat negative impact on net exports.

Given the very low levels of spare capacity and the more positive signals coming from both wages and domestic price pressures, we think that the BOE will probably raise interest rates gradually over the coming quarters.

Despite these positive short term forecasts, it is clear for the UK that the long term negative effects of Brexit remain: 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. Considering Britain's potential medium and long term growth, it would be a very good idea for the British government to finally decide to keep the UK as close to the EU as possible.

Latest economic data are moderately positive



Source: Bloomberg, Alinea Global

Spain

Although some risks remain, Spain's economy continues to look good going forward

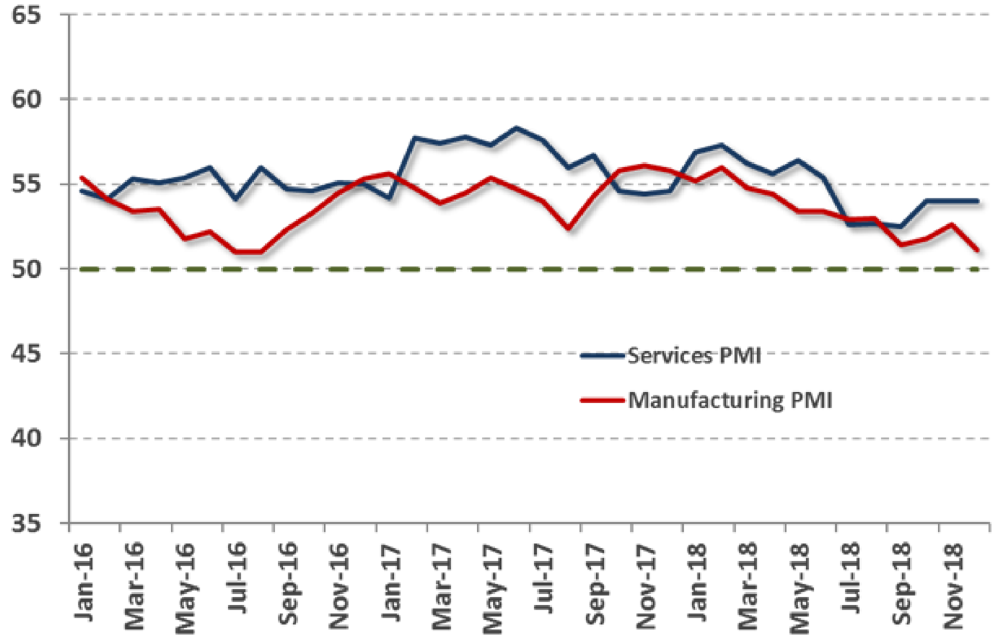
Over the first three quarters of 2018 economic activity in Spain moderated a bit but remained healthy (with GDP growing at annualized rates of around 2.5%). As was to be expected, the tourism sector was unable to maintain the spectacular growth rates seen in previous years. At the same time, an increase in crude oil prices during this period was also a negative factor for a country that produces no oil, as was a somewhat stronger Euro.

Going forward, and provided that the situation in Catalonia remains under control (clearly the most probable scenario), we believe that 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, despite all the noise, is in relatively good shape; still very low interest rates; a fiscal policy that will turn mildly expansionary, etc. Moreover, the drop in oil prices and the Euro's depreciation during the final part of 2018 will tend to push growth higher this year.

Going forward we therefore expect growth to remain clearly above potential and spare capacity to continue to decrease fairly quickly. This in turn will put upward pressures on wages (this is already happening despite the fact that unemployment is still high by international standards).

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

Manufacturing and non-manufacturing PMI



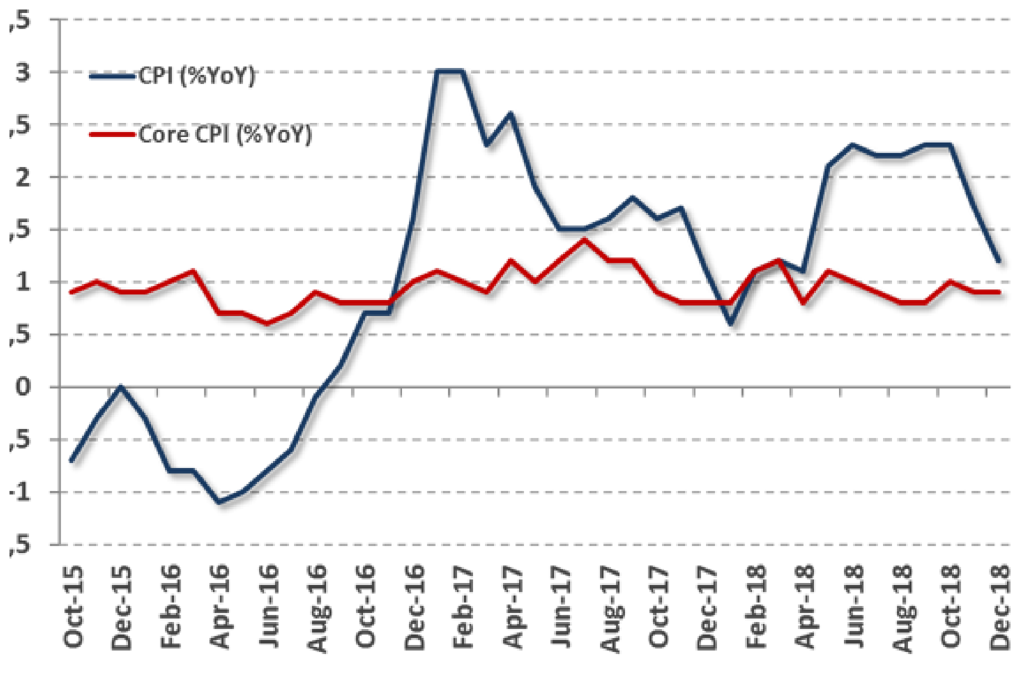
Source: Bloomberg, Alinea Global

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

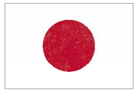
Given this relatively upbeat short term macro outlook, it would be a huge mistake if the government failed to use the current tailwinds to seriously address the significant structural challenges still faced by the Spanish economy: low potential growth (promoting human capital, fostering technological innovation, increasing competitiveness in certain industries), 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 (especially with regards the pension system). Regrettably however, recent news regarding fiscal policy has been worrisome. On the one hand, there is too much talk about the need to increase pensions at least at the same rate as inflation, but there is too little talk about how this will be financed (a very costly option taking into account the ageing population and the fact that the average pension in Spain is actually quite high 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

The Japanese economy should grow above potential forward look good

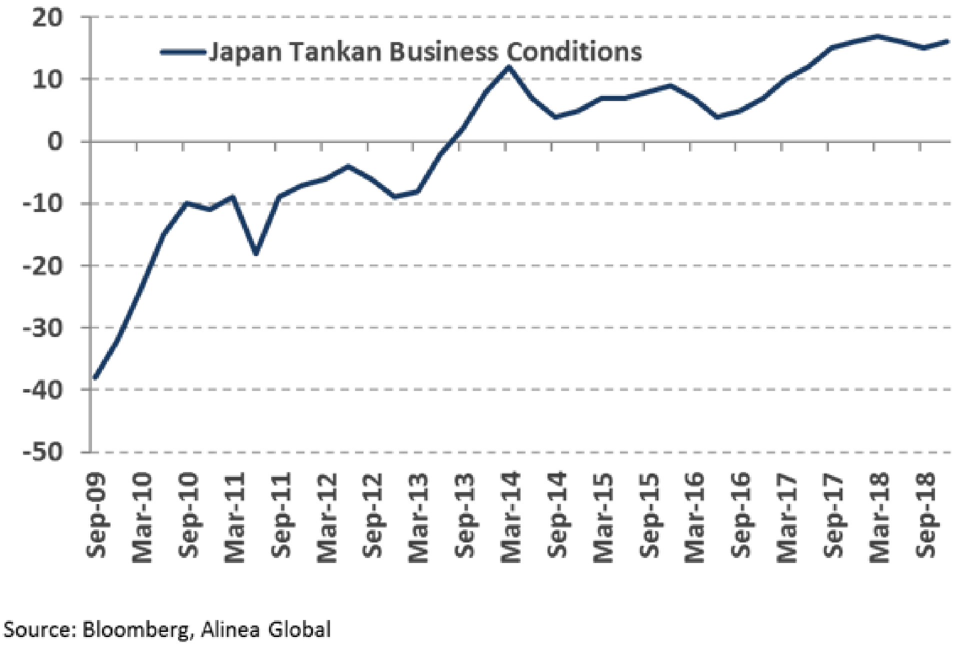
Trying to figure out how the Japanese economy is doing in the very short term is no easy task. On the one hand, the quality of short term data is far from optimal. On the other hand, and more importantly, when people talk about Japan they usually fail to properly distinguish between cyclical and structural factors. The first thing to remember when analysing Japan is that the population is decreasing and as there is almost no immigration, there is therefore a very low level of potential growth (probably no higher than 0.75-1%). It is therefore logical for the Japanese economy to alternate quarters of positive and negative growth and even more so in the current environment of very low levels of spare capacity.

Having said this, the most recent macro data have been mostly positive: sentiment indicators are at healthy levels; prospects for corporate investment look quite healthy against increasing capacity constraints; the outlook for the construction sector is also relatively positive, in part because of investments ahead of the 2020 Tokyo Olympics; tourism is doing really well; exports are holding up well despite noise surrounding trade wars. Moreover, because unemployment is so low, real wages are now going up and this should be a positive factor for private consumption.

Moreover, economic policy will continue to be growth friendly. The government has announced increases in public expenditure during 2019 and this should help compensate the potential negative effects related to the VAT increase scheduled for October.

The BOJ continues to implement its yield curve control policy, trying to ensure that 10y yields stay reasonably close to 0% (with increased flexibility) and having committed to allowing inflation to overshoot the 2% target for a considerable period of time.

Positive outlook in the medium-term



Source: Bloomberg, Alinea Global

Economic fundamentals point to progressively higher inflation and wage growth

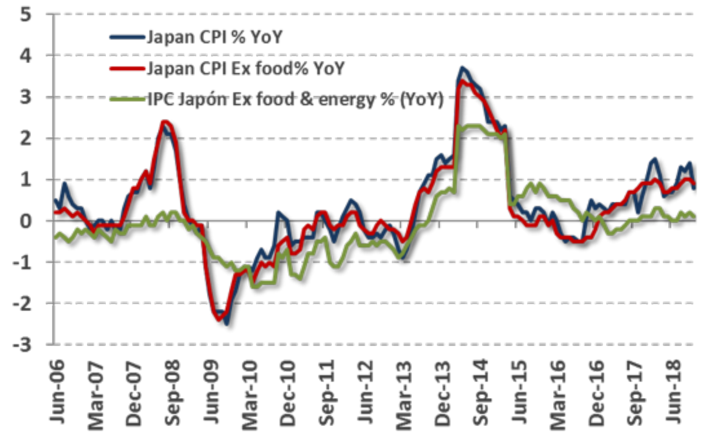
Despite the 2% inflation target still being fairly far away, a tight labour market (the unemployment rate is 2.5% and the jobs/applicants ratio is very high, 1.63) **together with above-potential growth should put further upward pressures on wages and then on inflation going forward.**

In terms of wages, it must be noted that for the past 2-3 years Japan has been successful in keeping older people active and bringing more women into the labour market; this has helped keep wage growth in check, but it will naturally become less of a factor going forward since a lot of progress in this area has already been made, especially with regards the elderly; on the other hand, and with the government introducing new measures to favour immigration, foreign workers could continue to help expand Japan's labour force, thereby easing pressures on wages.

Beyond creating inflation, Japan's most important challenge going forward is perhaps the need to increase potential growth. To achieve this the country needs to make more progress in the field of structural reform. Three elements seem particularly 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 increases competition and promotes innovation, this kind of investment can play a role in pushing up productivity growth). **Looking further ahead it will also be crucial for the government to ensure a sustainable path in terms of the country's public debt.**

A positive output gap points to higher wages and prices

Japan has left deflation behind



Source: Bloomberg, Alinea Global

Emerging countries - China

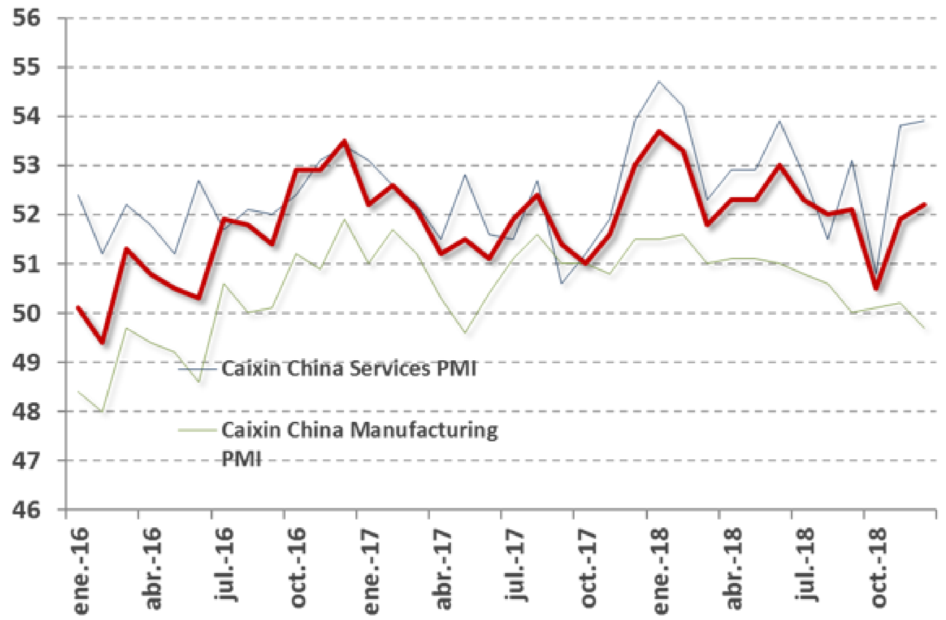
Despite all the noise, the risk of a hard landing remains low

Despite all the noise, the Chinese economy is decelerating only moderately and the risk of a hard landing remains very low going forward: private consumption has been somewhat disappointing lately but should do well going forward thanks to an increasingly strong labour market, with unemployment edging down and wages going up nicely; exports remain healthy despite noise around trade wars; the outlook for both the services sector and the most technologically advanced segments of the manufacturing sector is quite positive; China has already made significant progress in relation to industry sectors affected by overcapacity issues and this reduces downward pressures on activity going forward (in fact, investments in the manufacturing sector have sent some encouraging signals in the most recent period, thanks to the ongoing rise of capacity utilization).

Because of the risks related to a potential trade war with the US, we believe that the Chinese authorities are putting even more emphasis than before on finding the right balance between reducing financial risk and ensuring sufficient economic momentum. Measures aimed at easing financial conditions for SMEs, reducing taxes and increasing the pace of infrastructure investment are good examples. Looking ahead, and if more stimuli were to be needed, it is good to see that China still has ample room for manoeuvre in terms of both monetary and fiscal policies (the reserve requirement is high while public debt is quite low).

Our central scenario is for the US and China to reach some kind of compromise on trade issues over the coming months. The fact that Trump finally reached an agreement with Canada and Mexico, rather than killing NAFTA, shows that he is not seeking protectionism for protectionism's sake, but is rather putting pressure on other countries to gain trade concessions "for free" (although this may seem like a good strategy for the US in the short term, the potential long term impact on the USA's role as a reliable partner could be significant).

The economy is only moderately decelerating



Source: Bloomberg, Alinea Global

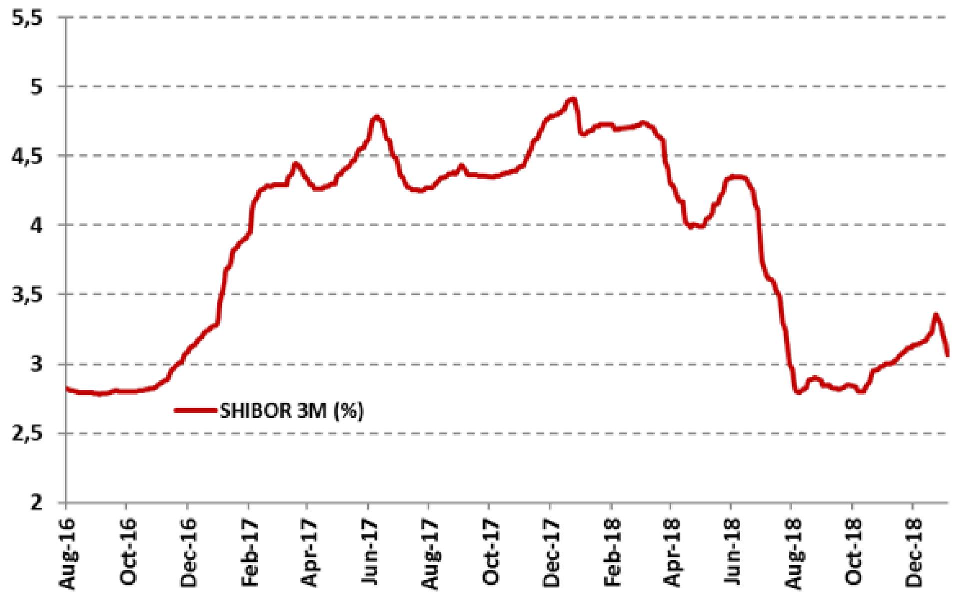
The yuan has weakened moderately due to noise around US trade policy

Given the noise around US trade policy, the Chinese authorities have allowed the yuan to depreciate somewhat against the dollar for some months. Once a moderate depreciation took place (something that will probably have a positive impact on Chinese exports), China decided to introduce measures aimed at stabilizing the currency. They have clearly been successful, at least for the time being.

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 the process of deleveraging, which is actually more advanced than many had thought it would be at this stage, to take place smoothly. 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 moderated 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 in an orderly manner). At the same time, the authorities have continued to curb shadow banking activities.

Financial conditions a little more accommodative again



Source: Bloomberg, Alinea Global

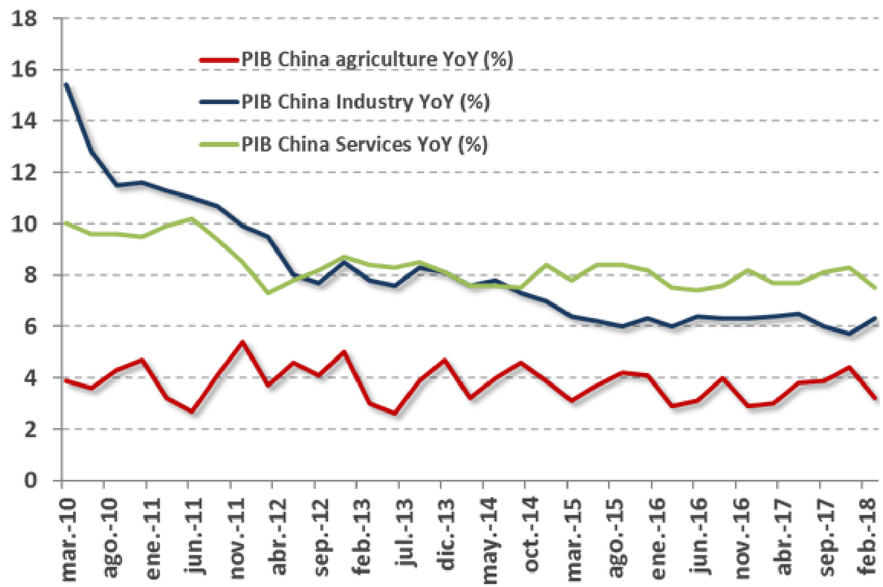
Further opening up of Chinese markets and better IP protection will be needed

It is also positive that the country is 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 some other areas: the economy's energy intensity is being reduced (the amount of energy consumption is reduced by GDP unit); 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, it is of course crucial for the authorities to continue working hard to further reduce financial risk, make progress in the field of structural reform and to open Chinese markets up 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; barriers to FDI should be lifted; and intellectual property rights should be better protected); leveraged investments in financial assets should continue to be controlled. At the same time, and in order to help potential growth, investment in human capital and research and technological innovation should be further enhanced.

In areas like intellectual property protection and fairer treatment of foreign companies, a good level of progress has been achieved in recent months due, in part, to Trump's pressure.

Services continue to gain weight



Source: Bloomberg, Alinea Global

Emerging countries - India

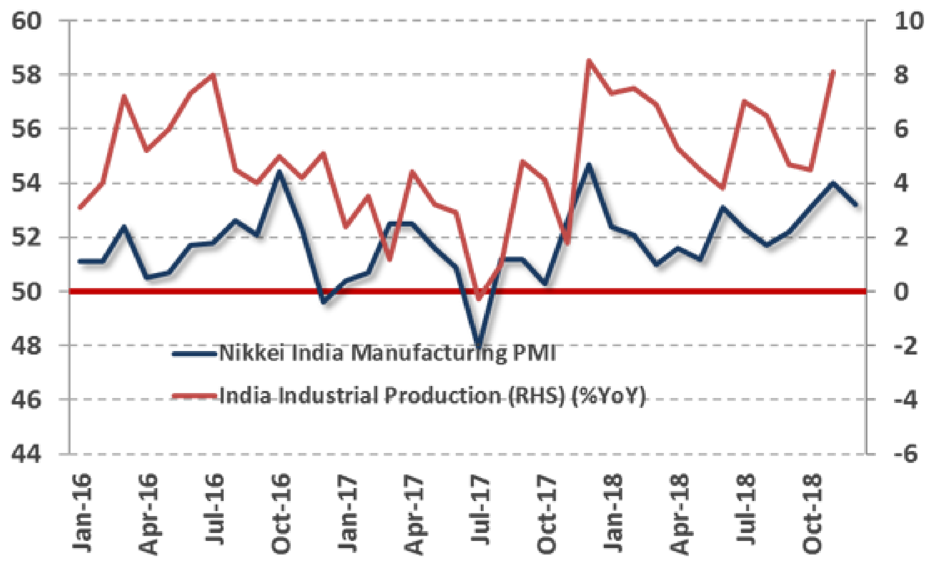
Despite all the noise, the economy continues to do well

Despite the noise in financial markets, India has shown strong rates of growth in recent quarters. Looking ahead things look reasonably good as well: private consumption remains resilient; the external sector and manufacturing production are benefiting from the strength of the global economy and a weaker rupee; infrastructure investment continues to do well; the services sector is strong; credit growth has picked up; the latest PMIs were also strong; the fall in oil prices is good news for an importing country like India. 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 the fiscal front, and considering the high budgetary deficits (especially at the state level), the government will need to strike the right balance between dealing with social challenges and ensuring a sustainable path for public debt in the medium and long term.

As far as monetary policy is concerned, the departure of Governor Patel in December (for personal reasons) is obviously far from good news, since it happened during a time of tension between the government and the RBI. We should remember that the government had been putting pressure on the central bank, seeking both a somewhat more accommodative stance on monetary policy and a more flexible treatment of public banks affected by high levels of NPLs (so that they could continue to increase credit). Looking ahead, and while it will be important to ensure that the RBI remains committed to fighting inflationary pressures against core inflation still being well above target, it is good to see that the new governor's first public declarations have been relatively encouraging.

Volatile PMIs, but positive underlying momentum



Source: Bloomberg, Alinea Global

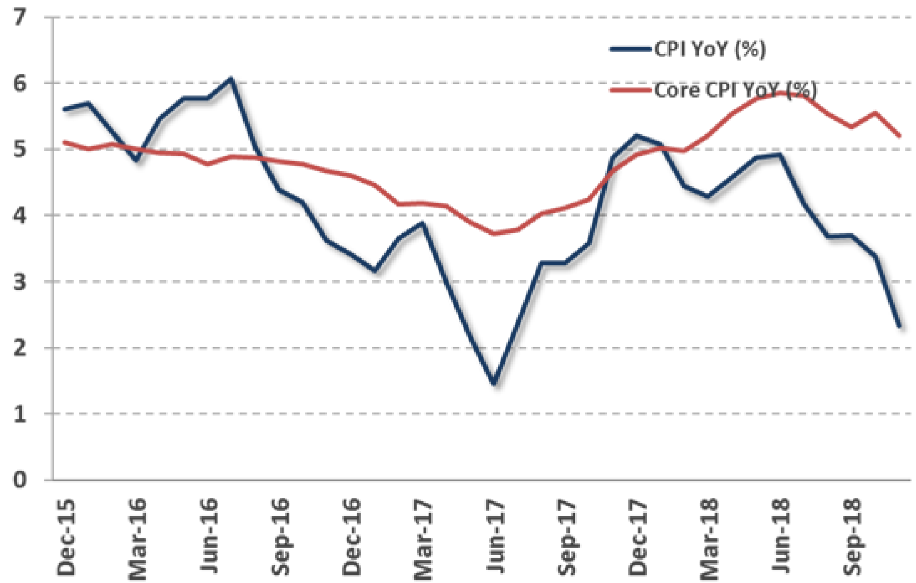
The government continues to make progress in the field of structural reform

Over the last few years, significant progress has been made in the field of structural reform. The central government has seriously promoted competition among states (including rankings) and this has clearly fostered reform momentum all over the country. Important advances (still probably partial) have also been made in reducing administrative costs, improving state-owned banks' balance sheets, increasing the efficiency of the insolvency law, and developing the market for corporate bonds, among many others.

Further steps will of course be needed, especially in the following areas: governance structures in state-owned banks need to be further improved (and supervisory power of the RBI over those banks should be increased); these state-owned banks should increase their capital levels further; defaults in the shadow banking sector should be closely monitored, while sufficient liquidity should also be ensured so as to avoid a potential credit crunch; non-financial corporations (especially in certain sectors) should further 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 those funds could flow to the real economy in a more efficient way); labour market regulation should be further improved; the same goes for the agricultural sector: land reform should be seriously pursued as 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 in recent times), improvements to education, etc.

If continued progress is made, the country seems poised to grow at attractive rates in the medium to long term given its relatively high population growth rates.

Core inflation still above 5%



Source: Bloomberg, Alinea Global

Emerging countries - Brazil

The new government is saying the right things as far as economic policy is concerned

In the medium term 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 the country has traditionally faced can be sustainably reduced.
-
- On the other hand, further measures are needed to increase potential growth.

The first positive element to be highlighted in relation to Brazil is the fact that its central bank has gained considerable credibility in recent years. This has allowed inflation expectations to be better anchored than in the past.

It is also good to see the new government sending encouraging messages in relation to its economic policy strategy: full respect for the central bank's autonomy (including the possibility of formally recognizing its independence); commitment to fiscal stability; recognition of the need to reform the pension system to make it sustainable in the medium and long term; commitment to structural reform aimed at making the Brazilian economy more flexible and competitive; recognition of the need to seriously fight corruption.

Looking ahead it will be important to see to what extent these good intentions become effective action in the form of legal reforms that are actually approved by a still significantly divided Congress.

Financing costs have come down quite a bit

Source: Bloomberg, Alinea Global

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

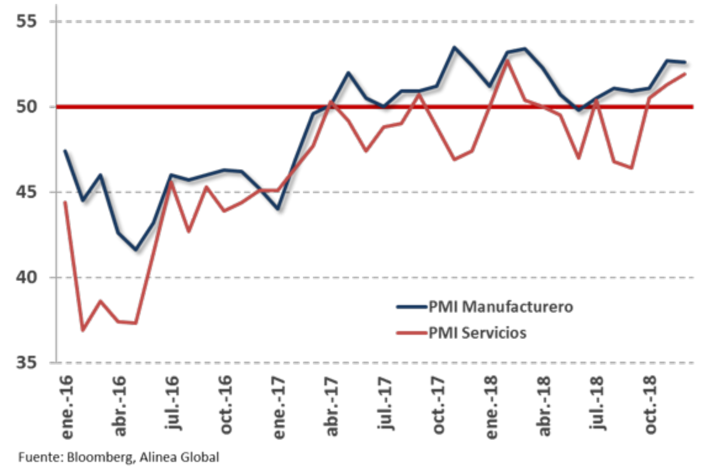
From a short term perspective the Brazilian economy showed clear signs of improvement during the latter part of 2018.

Three fundamental factors could have contributed to this. Firstly, the weak Real. Secondly, reduced price pressures, together with relatively high levels of spare capacity, allowed the central bank to bring interest rates down over the last couple of years. Thirdly, significant improvement in sentiment among both companies and households after Bolsonaro's victory at last year's election.

Those very same reasons should also act as significant tailwinds for the Brazilian economy in the coming quarters. In particular it is good to see that moderate price pressures have also contributed to an improvement in inflation expectations, something that will in turn probably enable the central bank to hold rates steady in the near future (Brazil's central bank kept interest rates constant at its December meeting and also said that its scenario for inflation had considerably improved).

In any case, as previously stated, the long term outlook for Brazil will only strengthen if the country continues to pursue the path of structural reform, the fight against corruption and fiscal consolidation (including, of course, a reform of the pension system).

Economic activity regains some momentum



The relatively weak real still helps

Source: Bloomberg, Alinea Global

Emerging countries - Russia

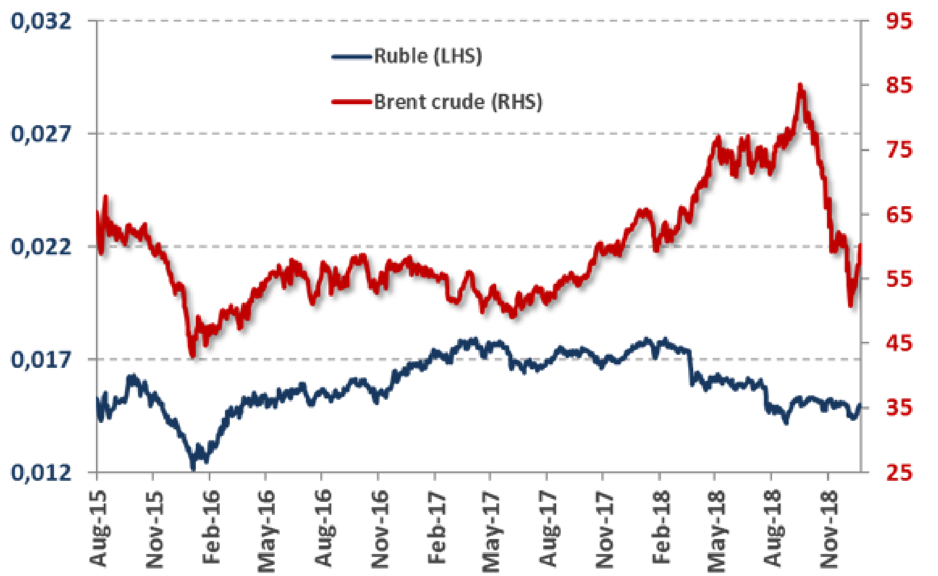
Improved macro credibility, but also institutional weakness and international sanctions

Russia faces significant medium term challenges: a lack of diversification in the Russian economy and its excessive reliance on commodities is a source of concern and helps dampen potential growth; economic sanctions imposed by western economies will continue to drag down activity (both those already in place and the threat of others); corruption levels are high, the institutional framework is weak and power is excessively concentrated in Putin. Moreover, although positive steps have already been taken by the central bank to clean up the banking sector, this work might not be over yet. In this context last year's Q3 GDP growth was again rather weak.

Provided the international sanctions do not escalate much further, prospects going forward are not that bad, at least in the short term: the price of crude oil is sustainable for the country; 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 in good shape. Generally speaking, the economy seems poised to expand at rates of around 2% YoY going forward (in line with potential). From a medium term perspective, Russia should also benefit from its commitment to macro stability and its relatively high levels of human capital.

Thanks to the outstanding job of Governor Nabiullina, the central bank has gained significant credibility in recent years. In fact the monetary authority increased interest rates in December in order to improve the anchoring of inflation expectations (they remain elevated) and as a pre-emptive move given the increase in VAT that took effect at the beginning of the year. Having said this we do not expect Russia's central bank to become a serious obstacle to growth during 2019: although rates could be hiked again once more in the coming months (inflation will probably top 5% in the coming months), Nabiullina clearly stated in December that the bank is not in the middle of a tightening cycle since the economy is not showing any kind of overheating risk.

Russia can withstansd cheaper oil



Source: Bloomberg, Alinea Global

Russia's fiscal caution is a positive factor going forward

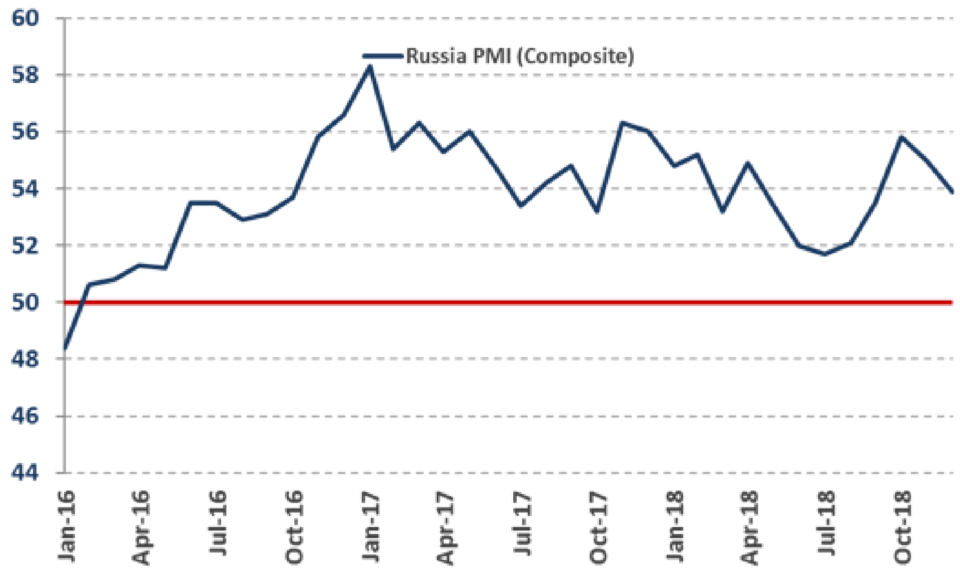
The fact that the government remains prudent as far as fiscal policy is concerned is also quite positive and creates some room for manoeuvre to concentrate efforts where they are most needed: infrastructure investment, human capital development, and improvements to the healthcare system.

It was also good to see that the government was finally able to pass the pension system reform last year. This reform was very unpopular but it was badly needed to ensure the sustainability of the system.

Looking further, 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).
- At the same time it is important for the government to conduct ambitious structural reforms to improve the investment climate, increase potential growth and reduce the country's reliance on oil.
- It would also be positive if the central bank continued with its efforts to clean the balance sheets of financial institutions, at the same time avoiding holding bank shares for too long since this could create conflicts of interest with its supervisory responsibilities.

Activity should behave relatively wll going forward



Source: Bloomberg, Alinea Global

Contact
Alvaro Sanmartín
Chief Economist at Grant Thornton and founder of Alinea Global
T. +34 91 576 39 99
Alvaro.Sanmartin@es.gt.com

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