Monthly Economic Newsletter
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Monthly Outlook

With the world economy clearly showing signs of strength, those that said that very slow growth was to remain for the foreseeable future are no longer as vocal as they used to be. Given the fact that a large number of countries are now growing significantly above potential, global trade has recovered quite considerably and that you have to try hard to find economies that are doing really badly right now, it is little wonder that the secular stagnation theory has lost much of its shine.

The so-called goldilocks economy seems to be the new game in town. Informally what this means is that financial markets are now anticipating a scenario in which the world is not only able to grow at a reasonable speed, but is also able to do so without generating any kind of inflationary pressure (not now or in the very long run).

You could say that it couldn't get any better for risk assets: their prices go up not only to reflect an upbeat macroeconomic scenario in terms of growth, but also because the discount rates used to bring future cash flows to the present remain at extremely low levels (the latter of course reflecting the fact that long-term, risk-free rates remain at rock bottom levels).

In our view, the market was short-sighted when it discounted the possibility of secular stagnation 100% and it is once again being short-sighted by thinking that this so-called goldilocks scenario is 100% likely to be the only game in town forever. For anyone willing to see, countries are not only growing above potential, but (by definition) they are also depleting spare capacity very rapidly (in fact some of the most important economies in the world already have positive output gaps).

What does this mean? It means that, contrary to what happened for many years after the global financial crisis, labour is not abundant anymore and is actually becoming scarce in very important parts of the world economy. Of course what this means is that, unless we are willing to accept that the price of a production factor (or any kind of product for that matter) has no relation whatsoever to how scarce that factor (or product) is, the most likely scenario going forward is for both wages and prices to progressively accelerate. In other words, the Phillips Curve might have been dormant until now, but it is certainly not dead.

Our central scenario continues to be one in which central banks calmly allow for a normalization of monetary policy, against a backdrop of moderate reflation in the global economy. This means that long-term nominal interest rates should edge up not only to reflect progressively higher inflation, but also to allow for moderately higher real rates (those who say that real interest rates are bound to remain extremely low forever should also admit that this means monetary policy will remain accommodative for an indefinite period of time; for us this is quite a risky proposition in terms of the context described above, with the global economy growing above potential and output gaps being rapidly eliminated).

At the same time, and even though until very recently we thought that central banks did well by remaining cautious regarding raising rates, we fear (and even more so following the October meetings, particularly with regards the ECB) that monetary authorities around the world are increasingly and rapidly falling behind the curve. What might the consequence of this be? It is by no means impossible that, if financial conditions remain this accommodative for much longer, inflation could end up significantly overshooting central banks' targets. This in turn would force the monetary authorities to increase interest rates more rapidly and more intensely than even they are currently expecting, possibly with negative implications for the global recovery in a 2-year framework.

As in our central scenario of moderate reflation, the inflation overshooting scenario would also lead to significant increases in long-term interest rates. How would both scenarios compare in terms of their implications for long-term rates? If central banks do not fall too far behind the curve (moderate reflation scenario), the upward movement in long-term rates would possibly begin sooner and would also end earlier. If, on the other hand, inflation clearly overshoots at some point, this would possibly mean that long-term rates remain low for a while but the shoot-up would be more abrupt and intense as central banks are forced to implement restrictive monetary policies.

United States

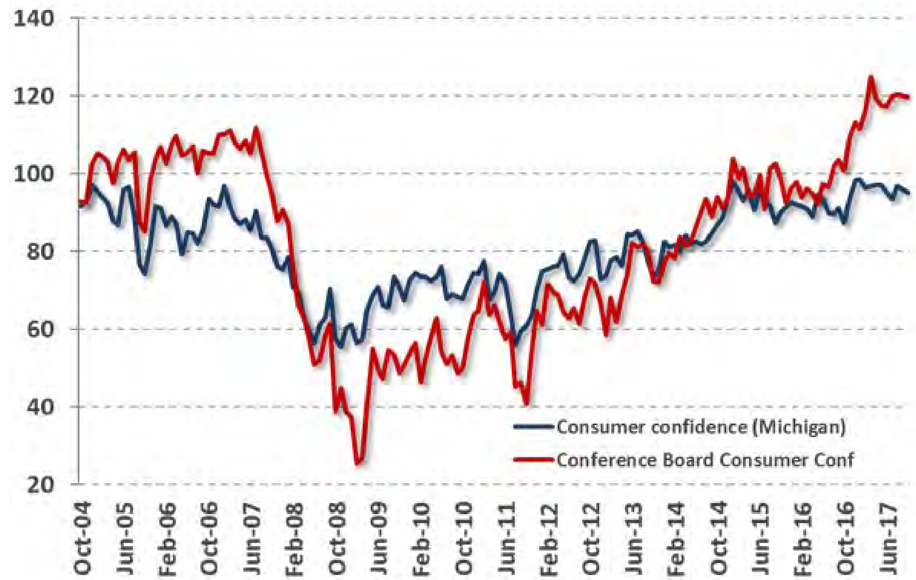
The US economy has accelerated recently and prospects look pretty good

The US economy has managed to grow at an annualized rate of around 3% for two consecutive quarters. Moreover, fundamentals look solid and this leads us to be optimistic about the economy's performance for the rest of the year and moving into 2018.

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

Corporate investment has improved quite significantly recently. On the one hand, the drag triggered by adjustments in the energy sector is now out of the equation and on the other hand, investment in equipment is also recovering as companies are no longer in a position to serve increasing demand just by resorting to unused capacity. In terms of other issues, and leaving the purely short-term to one side for a moment, the investment recovery is also good news for productivity (in fact, over the last 12 months, productivity growth has already improved quite significantly).

Consumer confidence rebounding strongly



Source: Bloomberg, Alinea Global

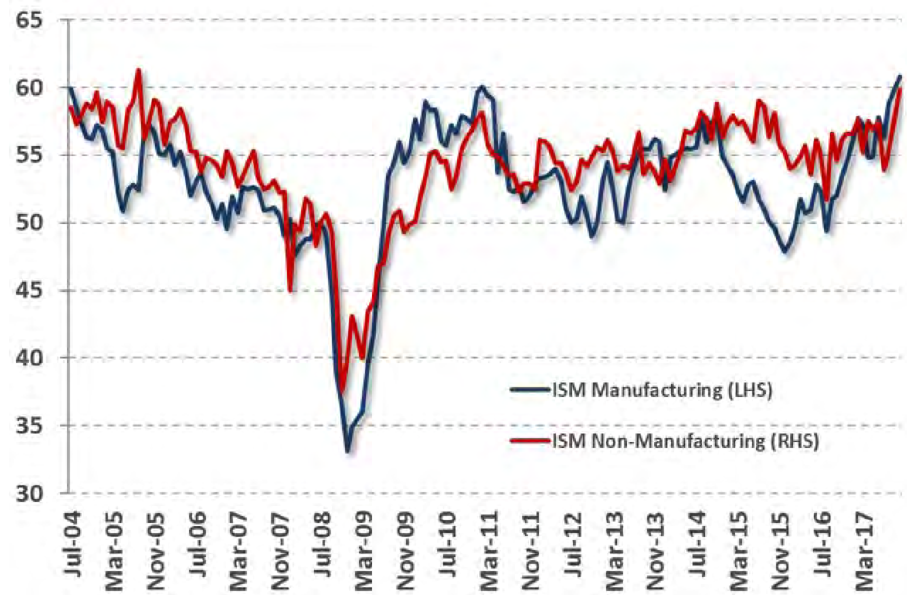
There is still significant room for further expansion in the real estate sector against a backdrop of relatively strong household formation rates and very low inventories of unsold homes. **From a purely short-term perspective,** leading indicators are already compatible with significant acceleration in this sector already in Q4.

The depreciation of the dollar and an improved global economy are also enabling the foreign sector to perform somewhat better.

All in all (and even before considering the expansionary effects of the reconstruction efforts after the hurricanes and the increasingly likely tax reform, which we will return to later), **we expect economic growth in the US to continue to be clearly above potential in the coming quarters.**

If we look at the labour market, the situation there is also 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. In fact, these developments have been so positive that it is likely that we will see job creation figures gradually dropping over the next few months.

Manufacturing and non-manufacturing ISM



Source: Bloomberg, Alinea Global

Inflationary pressures should increase going forward

Although it is admittedly true that inflation data have been relatively weak recently, we continue to believe that this is most likely due to temporary factors.

The outlook for core prices is actually quite positive in our view: with growth above potential, an already closed output gap, and inflation expectations relatively well-anchored, the most probable scenario going forward will entail core inflation inching progressively higher in the coming quarters. The considerable depreciation of the dollar over the last 12 months will also help to push prices going forward.

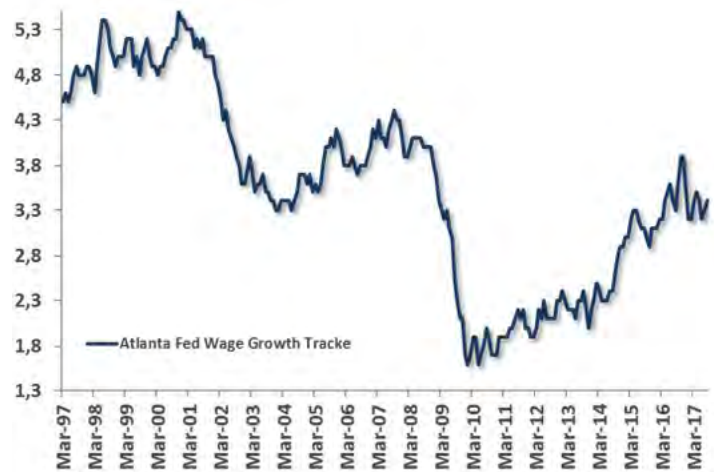
Meanwhile, a tight labour market should also lead to a gradual acceleration of wages going forward (the apparent weakness in average weekly earnings in October was mostly due to composition effects linked to the impact of the hurricanes).

In addition to all of the above, the likelihood that a significant tax cut will be approved before the end of the year has significantly increased in recent weeks. With full employment, such a reform would very likely create additional inflationary pressures going forward.

The reconstruction efforts following the hurricanes will also push up prices in the coming months. Moreover, protectionist policies and immigration curbs, although decidedly negative in terms of potential growth, would also make higher inflation all the more probable.

Core inflation is close to 2%

Wages should accelerate more clearly going forward



Source: Bloomberg, Alinea Global

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

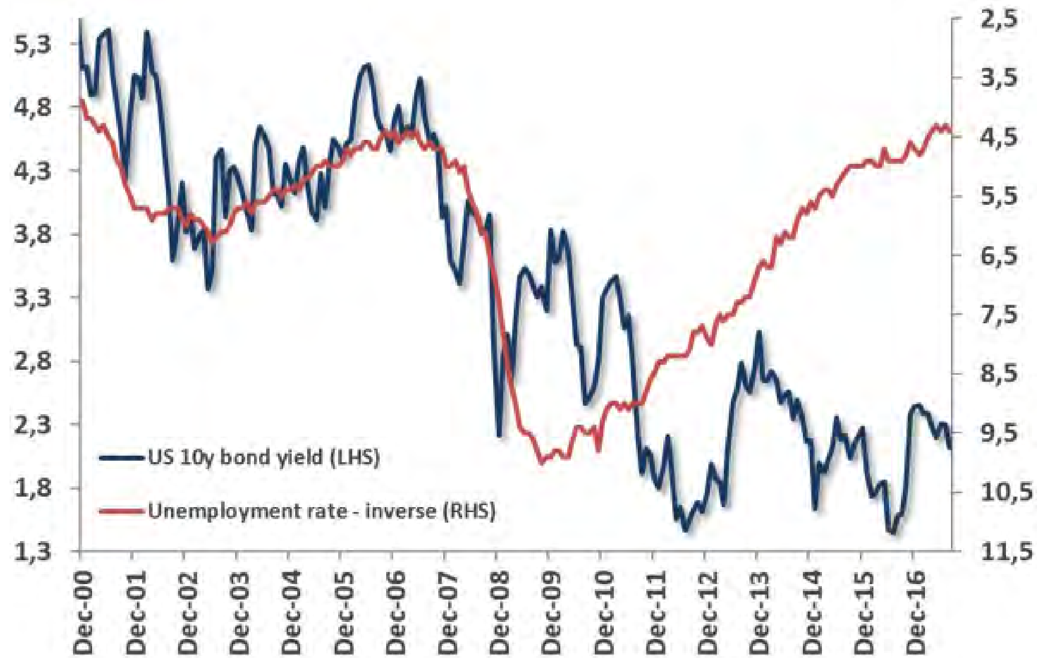
Given that the economy is looking very good and financial conditions are very accommodative, we believe that the Fed will raise interest rates in December and will continue with further gradual hikes in 2018.

At the same time, we also consider it likely that future revisions of the so-called neutral rate (r*) will be upwards rather than downwards. The economy has significantly accelerated in recent times and it is now growing at rates clearly above potential. This would seem compatible with a monetary policy stance that is probably more accommodative than currently thought. Moreover, the fact that productivity has been trending higher for several quarters puts upward pressure on both potential growth estimates and the long-term neutral interest rate.

If the Fed acts in the way we believe it will (increasing rates progressively but at the same time avoiding falling too much behind the curve), inflation should edge higher but should not excessively overshoot the 2% objective. If, on the other hand, the Fed ends up proving too cautious and delays further interest rate increases, we believe it is increasingly likely that the US economy will overheat. This could cause inflation to clearly exceed the 2% objective.

Should the US economy end up overheating, the Fed would be forced to raise rates in a much more aggressive manner, not only to compensate for higher inflation but also to force real rates high enough to make monetary policy contractionary. The increasing financial stability risks will also tend to favour a more hawkish stance by the Fed at some point in time.

Long-term rates still far too low



Source: Bloomberg, Alinea Global

European Union

The Eurozone's economy continues to do very well

Significant tailwinds continue to help the Eurozone's recovery: still low oil prices, extremely low long-term interest rates, a financial sector more willing to lend to the real economy, significantly reduced leverage in the private sector, notable price-competitiveness improvements between countries in the periphery, a somewhat more growth friendly fiscal policy, etc.

Things as they are, the Eurozone's economy has been growing significantly above potential for quite some time (2.5% YoY in Q3) and, according to the most recent macro data, seems poised to continue to do well going forward: the unemployment rate is dropping fairly quickly, sentiment indicators edge further up from already high levels, PMIs look very solid, etc.

Germany is particularly interesting with economic activity remaining very strong against an already positive output gap: the IFO is at strong levels, consumer confidence is also solid, PMIs also look very good, both industry and the real estate sector are in good shape, exports are also gaining dynamism, the unemployment rate is at record low levels, etc.

France appears to be benefiting already from an improved political situation in which macro data have actually been improving for some time now (strong PMIs, sentiment indicators at relatively upbeat levels, positive job growth, investment also sending positive signals, etc.). Generally speaking, this all points to increased activity going forward, and even more so when you consider that Macron has been able to approve a relatively ambitious labour market reform.

Economic sentiment at very solid levels

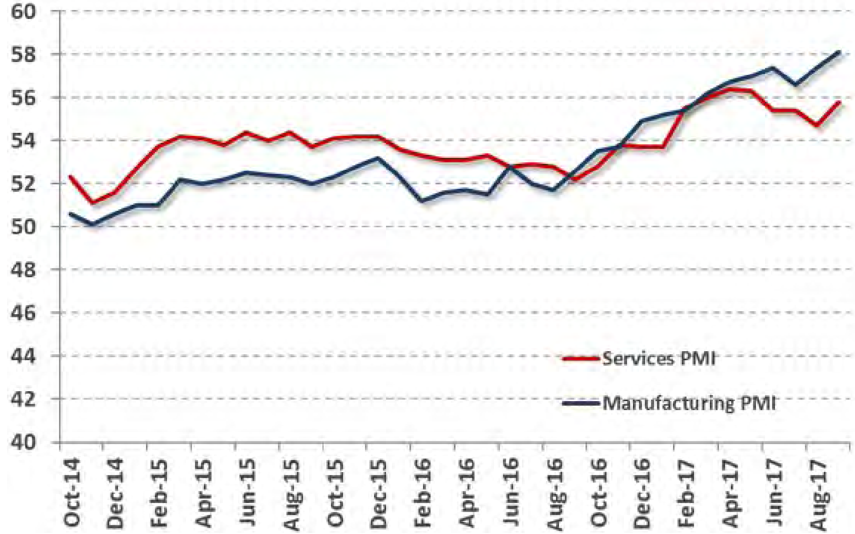
Source: Bloomberg, Alinea Global

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

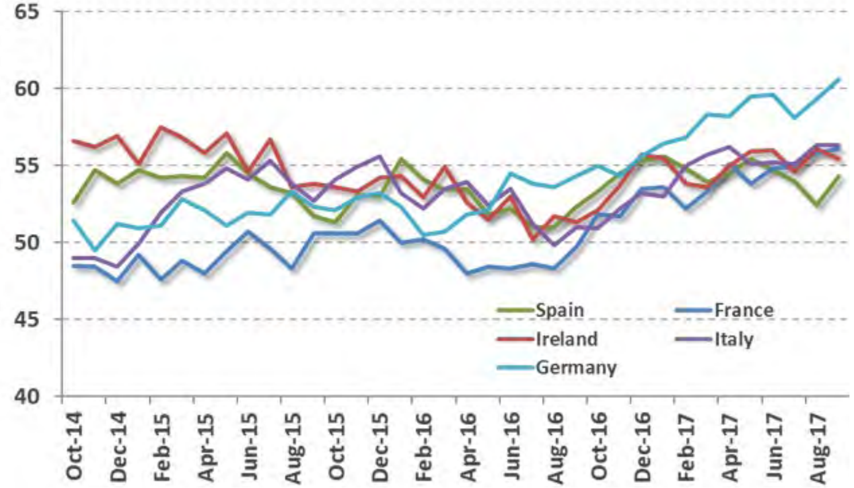
Against this quite favourable macroeconomic situation in the Euro area, it is quite likely that the Brexit negotiations will continue to create noise in the coming months.

We believe though that the most probable scenario going forward is for Brexit to have only a moderate impact on growth outside the UK. Firstly, the macro is looking quite good now and populism has been losing steam, considerably increasing the level of optimism around the future of the European project. Secondly, it has become increasingly apparent that the UK will lose the most in the event of a poorly negotiated Brexit; for countries remaining in the EU, the negative impact of a more difficult trade relationship with the UK would be partially compensated for by the fact that some of the investments that now take place in the UK will move to EU member countries in the future, as international companies try to ensure access to the single market.

PMIs at very healthy levels and pointing higher again



The European recovery continues to broaden



Source: Bloomberg, Alinea Global

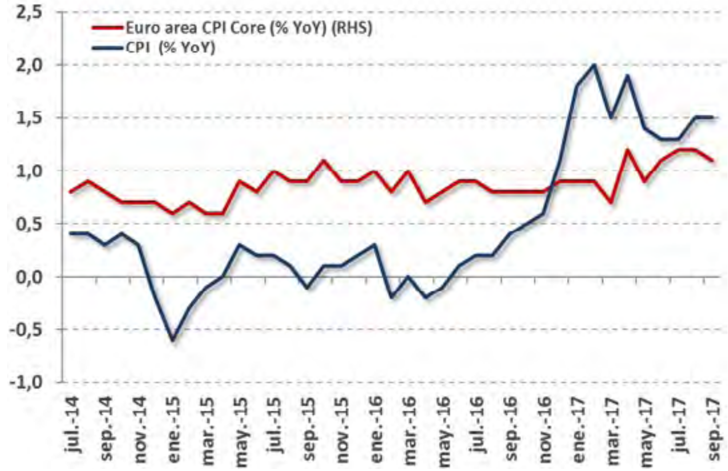
Core inflation should edge higher in the coming quarters

The favourable macro environment should lead to a gradual acceleration of core prices in the coming months, provided the euro does not appreciate too much further. Although there is still spare capacity in the Euro area, this situation will not last forever: the unemployment rate is dropping fairly quickly and could reach levels of around 8% by this time next year (this is a significant figure as it is below the average for this variable in the period before the crisis and is therefore a fairly good approximation of structural unemployment in the area). We also expect wages to gradually accelerate going forward (some encouraging signals have already become apparent).

In terms of Germany, following a negative surprise in October due to temporary factors, progress in core prices should take place sooner and more rapidly than in the rest of the Euro area. On the one hand, growth prospects are particularly positive in this country and on the other hand, this relatively dynamic growth will take place against the backdrop of a very strong labour market (the output gap is actually positive). This in turn should put additional upward pressures on both wages and prices going forward.

The ECB continues to prefer to err on the side of caution (maybe too much so). Whilst it recognises that the macroeconomic outlook has improved a lot, therefore deciding to reduce the amount of asset purchases from January 2018 onwards (it will buy 30 billion monthly, in theory until September 2018), it continues to sound as dovish as possible, so as to maximize the likelihood of core inflation continuing to point higher. This of course makes some sense, but given the strong Eurozone economy, there is an increasing risk that the ECB will end up falling significantly behind the curve.

Core inflation has improved in recent times



Inflation expectations have improved

Source: Bloomberg, Alinea Global

Spain

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

The constitutional crisis in Catalonia, if it lingers for too long, would have a very negative impact on growth in this region, potentially putting Spain's economic recovery at risk.

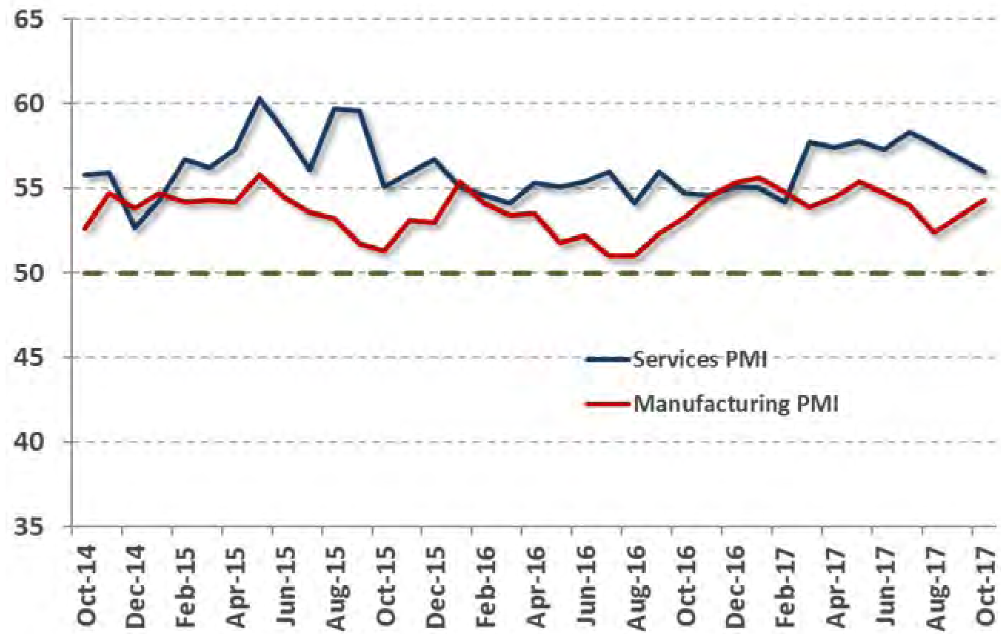
We believe however that the situation will remain under control and that the Spanish economy will continue to benefit from numerous tailwinds: significant price competitiveness gains made during the crisis, still low oil prices and extremely depressed interest rates, etc.

Although recent macro data point to a mild deceleration, they continue to be fairly positive: job growth was once again solid in September, confidence indicators are at healthy levels, PMIs are also doing well, exports have been quite strong, the services sector remains in good shape and, at least outside Catalonia, tourism and the real estate sector continue to do well.

For the rest of the year, and provided the situation in Catalonia doesn't spiral out of control, we think economic activity will remain strong with growth rates at around 3% for 2017 as a whole and 2.5% in 2018.

As this scenario unfolds, spare capacity (even though it is still high) will tend to drop fairly quickly over the coming quarters.

Manufacturing and non-manufacturing PMI



Source: Bloomberg, Alinea Global

Political noise, high debt and low potential - Spain's ongoing medium-term challenges

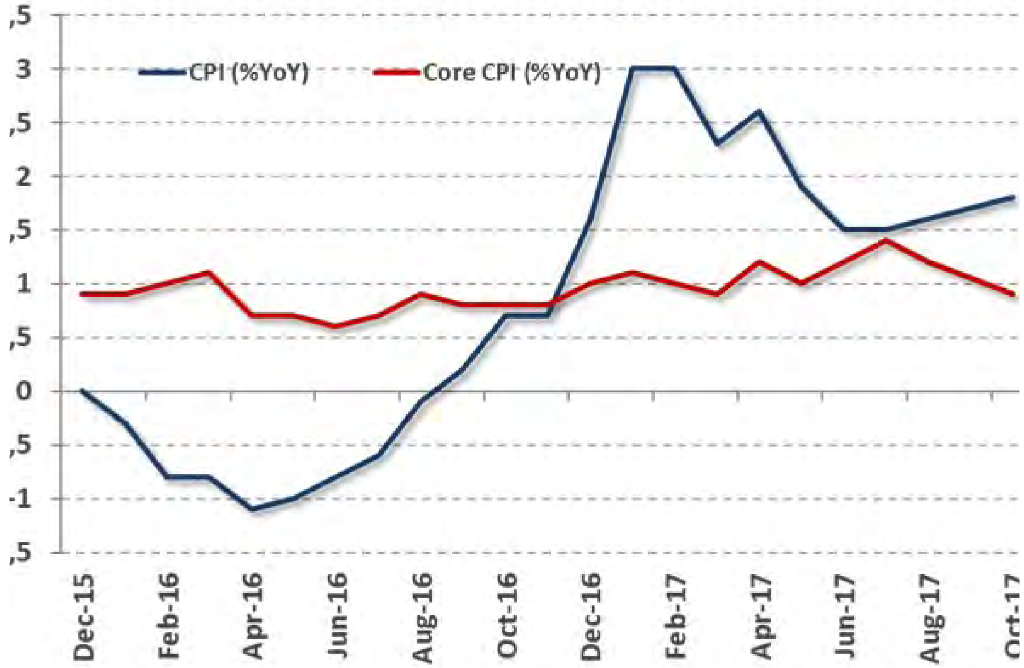
This scenario is in turn compatible with underlying inflation heading progressively higher over the coming months. As the unemployment rate continues to drop, wages should also edge somewhat higher going forward.

From a medium-term perspective, it would be great if the government could use the opportunity offered by the current tailwinds to seriously address the significant structural challenges that the Spanish economy still faces: potential low growth (promoting human capital, driving technological innovation, increasing competition in certain industries), an ageing population, increased inequality, and significant levels of external debt.

It is also important that Spain complies with the requirements of the Stability and Growth Pact in 2017 and 2018. It is undoubtedly positive that budgetary execution in the current fiscal year is going better than initially expected.

From a political perspective we cannot rule out, as already mentioned above, potential noise in the financial markets as a result of the situation in Catalonia.

Core inflation should edge gradually higher



Source: Bloomberg, Alinea Global

United Kingdom

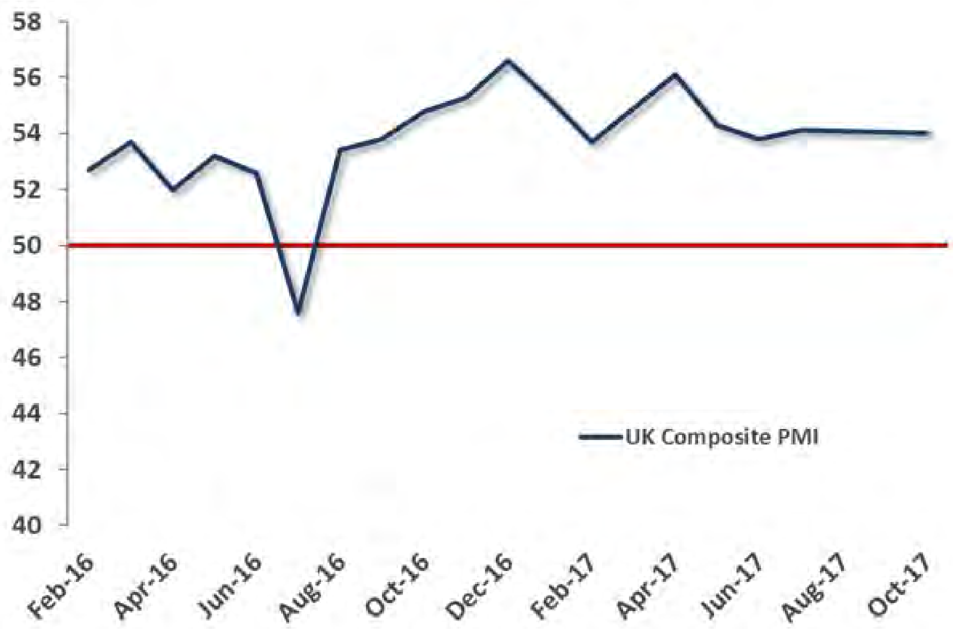
Britain's Brexit negotiating position has clearly softened

Although the Brexit negotiations are still somewhat in a rut, it is becoming increasingly clear that everybody (especially the UK) is interested in avoiding unnecessary noise (indeed the most recent negotiating position by the British government is to try to keep the UK inside the Customs Union for a period of two years beyond March 2019). Generally speaking, and even more so after May's speech in Florence, the country is increasingly aware of the significant, negative, long-term effects that a hard Brexit could entail: the country would (at least partially) lose access to one of the biggest markets in the world, London would probably lose some of its appeal as a global financial centre, the UK would no longer be as attractive as it traditionally has been as a destination for highly skilled migrants, etc.

Despite all the noise, the UK economy has maintained a certain momentum. On the negative side, and given the high levels of uncertainty regarding the future, it is hard to be overly optimistic about the prospects for corporate investment. On the positive side, the weak pound should help boost both exports and the manufacturing sector going forward. What about consumption? It is clear that this important variable is negatively affected by uncertainty and also by the increase in imported inflation. Given that the output gap has already closed and there is strong employment growth, we should be relatively optimistic about wages going forward, which in turn should help prevent significant deterioration in private consumption in the coming quarters.

The increase in inflationary pressures and the fact that the economy is doing better than expected allowed the BOE to increase interest rates at its November meeting. At the same time though, and given uncertainties surrounding Brexit, the monetary authority remains cautious when talking about the future of rates.

The economy is decelerating, but only mildly so



Source: Bloomberg, Alinea Global

Japan

Japan clearly continues to grow above potential

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 is trying to improve the way some statistics are compiled) and 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 there is hardly any immigration, resulting therefore in very low levels of growth (probably no higher than 0.75%). As this is the case, it is understandable that the Japanese economy alternates 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 all this, it is quite clear that Japan has done well in recent quarters: Firstly, GDP has grown for 6 consecutive quarters with an average that is clearly above potential. Secondly, and although it will be near on impossible to maintain the growth rates achieved in the recent past, most recent economic indicators continue to be upbeat from a medium-term perspective (sentiment indicators are at very healthy levels, corporate investment is sending encouraging signs, private consumption was relatively weak in Q3, but seems poised to recover in the current quarter, exports and industrial production seem to be in good shape, credit appears to be picking up, etc.) Thirdly, wages are beginning to pick up and there are good reasons to expect further acceleration going forward thanks to the good macroeconomic situation (and therefore healthy labour demand), an already positive output gap and considering as well that the significant progress made during the last 2-3 years in terms of women entering the labour force should lose momentum at some point (this will obviously further tighten the labour market).

Positive outlook in the medium-term

Source: Bloomberg, Alinea Global

Economic fundamentals point to progressively higher inflation and wage growth

A tight labour market accompanied by above-potential growth (the unemployment rate is 2.8% and the jobs/applicants ratio is very high, at 1.52) **should put further upward pressures on wages and then on inflation going forward** (price components in the PMIs and in the Tankan survey have actually performed better in recent times and service producer prices have also edged up somewhat of late). At the same time, and after several months of weakness, inflation expectations have also improved slightly in the most recent period.

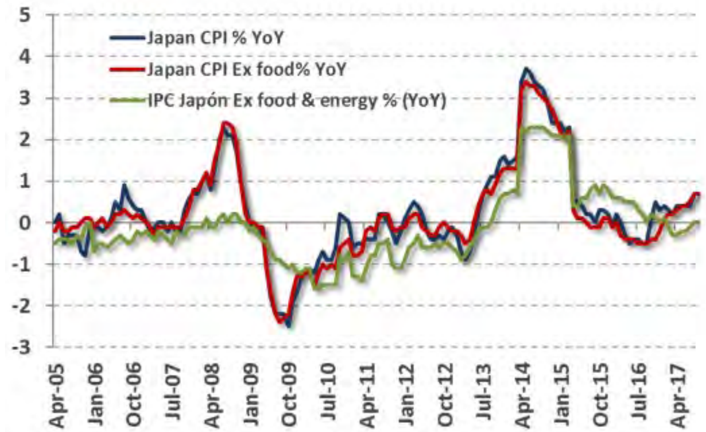
The BOJ continues to implement its yield curve control policy, trying to make sure that 10y yields stay reasonably close to 0% and committing to allowing inflation to overshoot the 2% target for a considerable period of time.

The government has also been trying to push up wages and prices: it has recently presented a set of fiscal expansionary measures that include incentives for companies to boost investment and increase salaries. Following his election victory, President Abe seems poised to push further with this type of measure.

Looking ahead, and in order to increase potential growth, it is essential that the country makes more progress in the field of structural reform, in particular with regards immigration and the labour market (in relation to the latter, a reduction of duality is a clear need for the Japanese economy). At the same time, the government should continue to improve conditions for FDI (by increasing competition and fostering innovation this kind of investment can play a role in pushing productivity growth).

Low output gap levels point to higher wages and prices

CPI should do better going forward



Source: Bloomberg, Alinea Global

Emerging countries - China

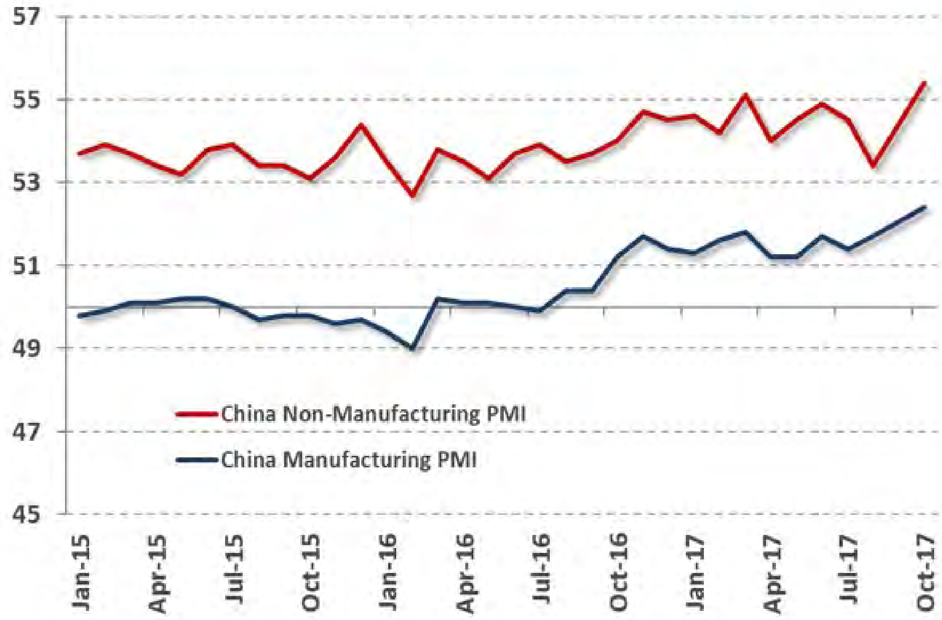
The government curbs financial risk while trying to maintain sufficient economic momentum

The positive macro situation in China has allowed the authorities to put increased emphasis on measures aimed at controlling financial risks and improving the quality of growth. Authorities have been adopting measures to improve financial supervision, to promote equity financing, to reduce excess capacity in some industries, to reduce emissions and to contain the expansion of the real estate sector. Moreover, the PBOC has also moderately tightened liquidity conditions in the money market in order to reduce incentives to conduct highly leveraged purchases of financial assets. The initial results of these policies have gradually become clear: credit growth is moderating, household debt is growing faster than corporate debt (this is good news because the balance sheet situation of households is clearly better than that of firms), and there are also signs that equity financing by companies (as opposed to debt) is also gaining some traction.

With all this in mind, it is understandable that economic growth is expected to slow down somewhat over the coming quarters.

At the same time, we believe that the risk of an abrupt deceleration in the Chinese economy remains quite low. Private consumption is doing well, whilst the labour market is strong, there is healthy disposable income growth and consumer confidence levels are high. We should also bear in mind that the authorities will continue to ensure the environment is sufficiently conducive to growth going forward. In fact, the PBOC keeps saying that it will strike a balance between favouring deleveraging and avoiding an excessive tightening of monetary conditions (the recent tax cuts aimed at promoting lending to SMEs are a good example of this). Moreover, the fact that fiscal policy is set to remain relatively expansionary, especially as far as infrastructure investment is concerned, is also good news for short-term growth.

PMIs show the economy continues to do well



Source: Bloomberg, Alinea Global

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

One of the positive collateral effects of a somewhat less accommodative monetary policy is less pressure on the yuan and reduced incentives for capital outflows. Indeed, given the recent appreciation of the Chinese currency, the authorities have decided to remove some of the restrictive measures that had previously been adopted and that were aimed at curbing unjustified downward pressure on the yuan. Moreover, China's foreign reserves have been increasing for several months in a row.

From a fundamental perspective it is actually very hard 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 (they have actually picked up somewhat recently) and equilibrium exchange rate estimates by institutions such as the IMF do not point to overvaluation.

From a medium-term perspective it is good to know that China has sufficient room for manoeuvre in terms of the balance sheet so as to allow the process of repairing banks' balance sheets to take place smoothly. We believe that a credit crunch scenario is therefore quite unlikely. We should remember that even if (gross) debt growth has been rapid in the last couple of years, China is a net creditor with respect to the rest of the world. Moreover, measures aimed at facilitating the sale or securitization of bad loans seem to be progressing and this should help banks reduce their exposure to this type of asset in an orderly manner.

Monetary policy is less accommodative than before

Source: Bloomberg, Alinea Global

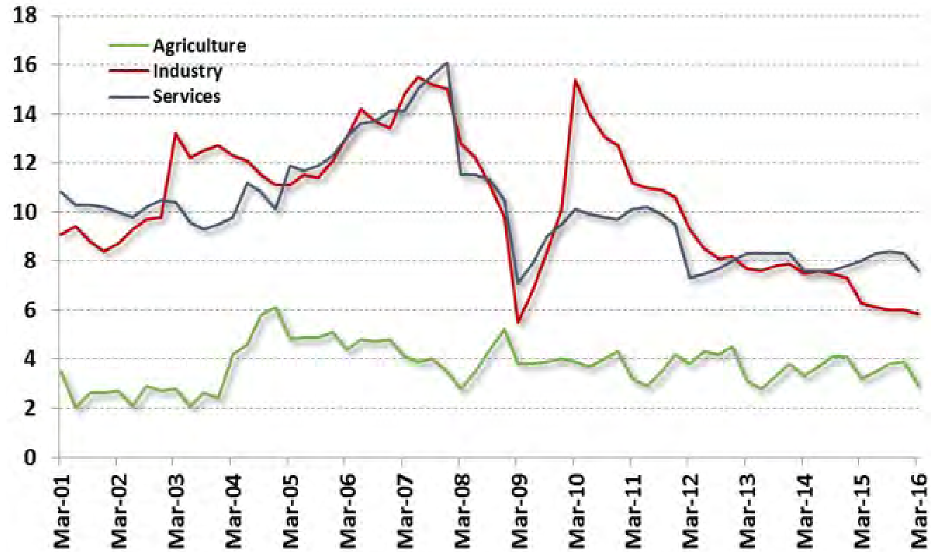
The country continues to advance in the process of upgrading its growth model

It is also a positive thing that the country is making some progress in the process of modernizing its growth model. On the demand side, consumption continues to gain weight (it was responsible for around 65% of growth during Q3). On the supply side, both the services sector and industries with relatively high technological intensity are becoming more and more dynamic. Moreover, it is good news that growth in the most risky areas of shadow banking is also being brought under control.

Having said all this, and although China seems to be in a relatively good position to tackle the significant challenges it faces, it is of course crucial that the authorities continue to work hard in order to further reduce financial risk and make progress in the field of structural reform (the last downward revision of China's rating by S&P should act as a reminder).

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 private companies should be improved (further easing of restrictions curbing inbound direct investment would be helpful and would probably be well received by the new US administration), leveraged investments in financial assets should continue to be controlled, etc. At the same time, and in order to help potential growth, the government should continue to promote research and development and human capital initiatives. It is good to see that the authorities seem to be well aware of the need to proceed along these lines.

Services continue to gain weight



Source: Bloomberg, Alinea Global

Emerging countries - India

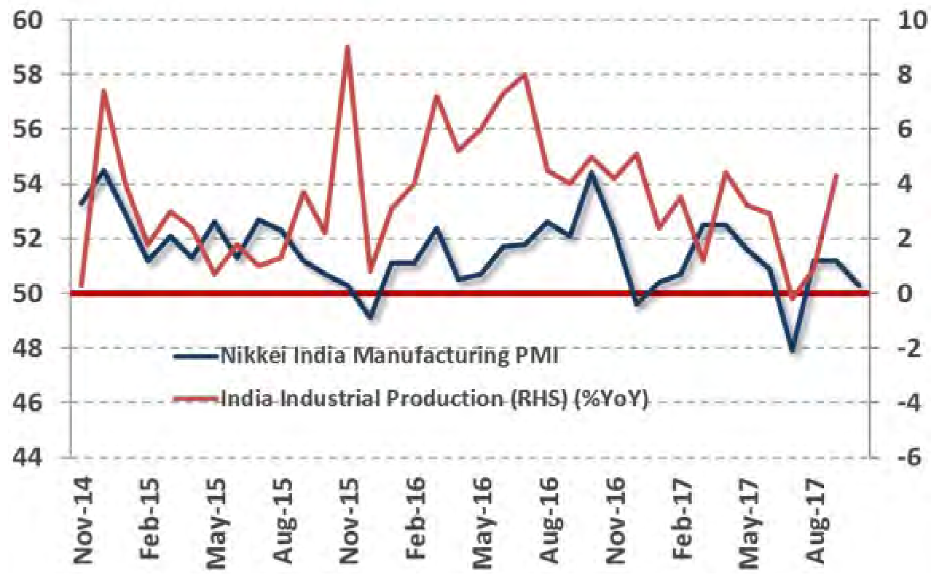
Despite short-term uncertainties, prospects for the economy look promising

Despite the uncertainties created by the demonetization process and the introduction of the GST (both are probably creating some downward pressures on economic activity in the short-term, but should clearly be regarded as positive reforms from a long-term perspective), prospects for the Indian economy look relatively promising: private consumption should remain resilient, exports continue to show positive momentum, infrastructure investment remains dynamic, etc. On a more negative note, private investment is still weak whilst capacity utilization levels are low, corporate debt is high (in certain sectors) and there are many bad loans in the banking sector.

The RBI maintained interest rates at its October meeting. Despite many people anticipating a drop in rates, we don't expect significant rate cuts going forward for several reasons. Firstly, core inflation has been relatively sticky and inflation expectations remain quite high. Secondly, food and energy prices seem poised to accelerate going forward. Thirdly, the medium-term outlook for the Indian economy is still looking good and fourthly, the most recent macroeconomic data (PMIs, auto sales, exports, etc.) are already showing signs of recovery.

On the fiscal front, and bearing in mind the relatively high budgetary deficits at a state level, it is important that the government continues to preserve the long-term sustainability of public finances. Moreover, prospects for the Indian economy look quite encouraging and it would seem that a fiscal stimulus package would be quite hard to justify from a cyclical perspective.

The economy should regain momentum going forward



Source: Bloomberg, Alinea Global

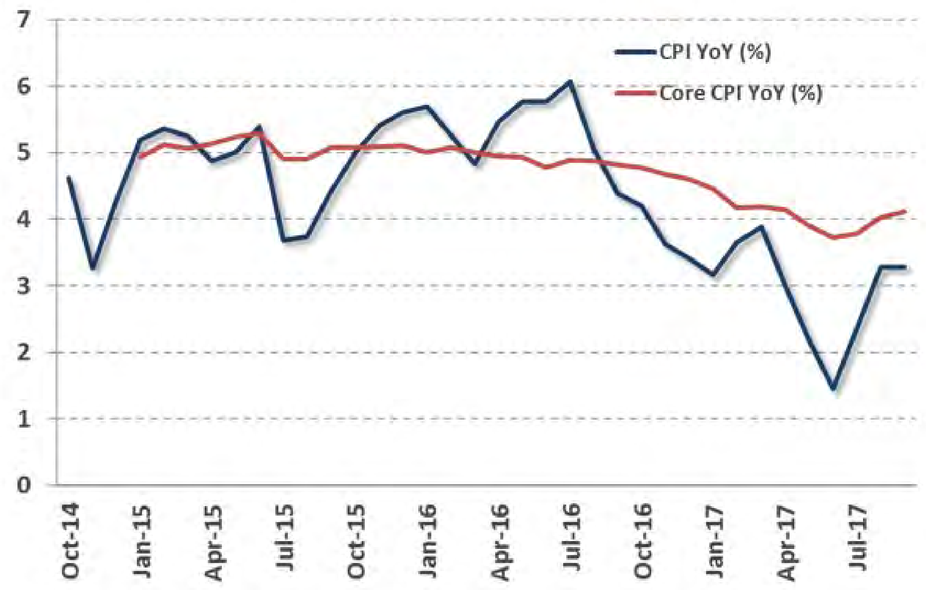
The government continues to make progress in the field of structural reform

As far as reforms are concerned, it is certainly good news that, in October, the government announced its intention to recapitalize state banks in a more ambitious way than had previously been announced (this movement, when implemented, should help improve the transmission of monetary policy in India). More generally, the central government is promoting competition between states (including rankings) and this is helping to create reform momentum all over the country.

The fact that RBI has already begun to use its new powers allowing it to force lenders to take write downs on NPLs should also be welcomed. Moreover, efforts being made to further develop the market for corporate bonds will also have a positive effect on private investment going forward.

Going forward, further steps would be welcome, particularly in the following areas: 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 those funds could flow to the real economy in a more efficient way), labour market regulation should be further improved and the same goes for the agricultural sector, as already mentioned above, land reform should be forcefully pursued since it would help reduce the significant obstacles that infrastructure investment in India still faces and FDI flows should be further liberalized, etc.

Inflation has come down notably



Source: Bloomberg, Alinea Global

Emerging countries - Brazil

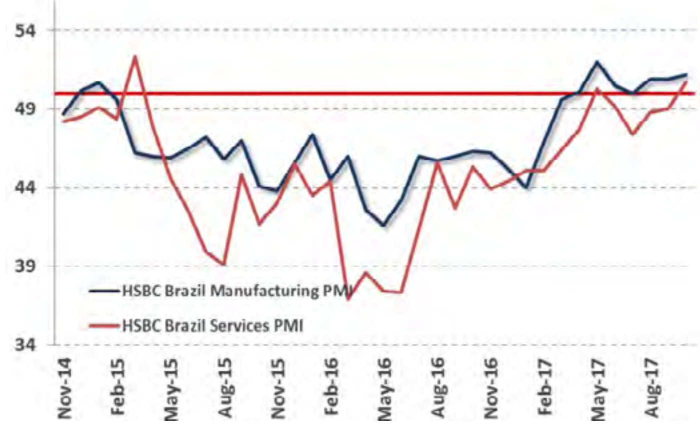
Temer's difficult political situation puts reform efforts at risk

Brazil's economic future will be dictated by two main factors. On the one hand, macroeconomic stability (both fiscal and inflation-related) should be ensured, so that the high financing costs the country has traditionally faced can be sustainably reduced and on the other hand, further measures are needed to increase potential growth and improve the economy's efficiency.

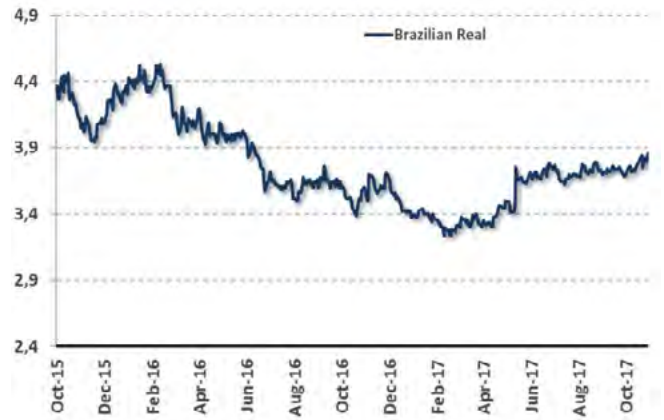
It is also very important that the government continues to make progress in the field of economic reform. In particular, it is crucial that the reform of the pension system is finally approved. At the same time the government needs to introduce additional "microeconomic" reforms aimed at promoting private investments in infrastructure, reducing red tape, simplifying the tax system, improving financial regulation and facilitating corporate debt restructuring, etc.

It is therefore bad news that Temer's position is so weak, as it could put reform efforts at risk. The government has been trying to maintain reform momentum in recent times (it has managed to approve the reform of the labour market, it has introduced further fiscal consolidation measures and it is also trying to advance privatizations and get some form of pension reform approved.) But at the same time, it is clear that Congress is becoming increasingly reluctant to support Temer's economic agenda. With elections looming next year the process of reform in Brazil will only get tougher in the near future.

Activity is showing signs of stabilizing



The weak real still helps



Source: Bloomberg, Alinea Global

Receding inflationary pressures create further room for manoeuvre for the central bank

The progress made by the government in terms of economic reform since Rousseff left office has had a considerable impact in terms of reducing the high financing costs that Brazil has traditionally been forced to accept. To make sure this continues to be the case, and to make further progress, it is crucial that the authorities continue to advance in the process of economic reform and to improve the long-term sustainability of public finances.

From a purely short-term perspective, rapidly moderating inflationary pressures, together with improvements in inflation expectations and high levels of spare capacity, have actually allowed the central bank to reduce interest rates fairly quickly during the past few months (75 bps more in October).

The positive effects of a less restrictive monetary policy have become increasingly apparent (although still tentatively) in the last few months: the unemployment rate is edging down, private consumption is looking better and sentiment indicators have also improved of late. At the same time industrial production and exports continue to benefit from the Real's weakness.

Structurally high financing costs

Source: Bloomberg, Alinea Global

Emerging countries - Russia

Although there are still challenges, things have greatly improved

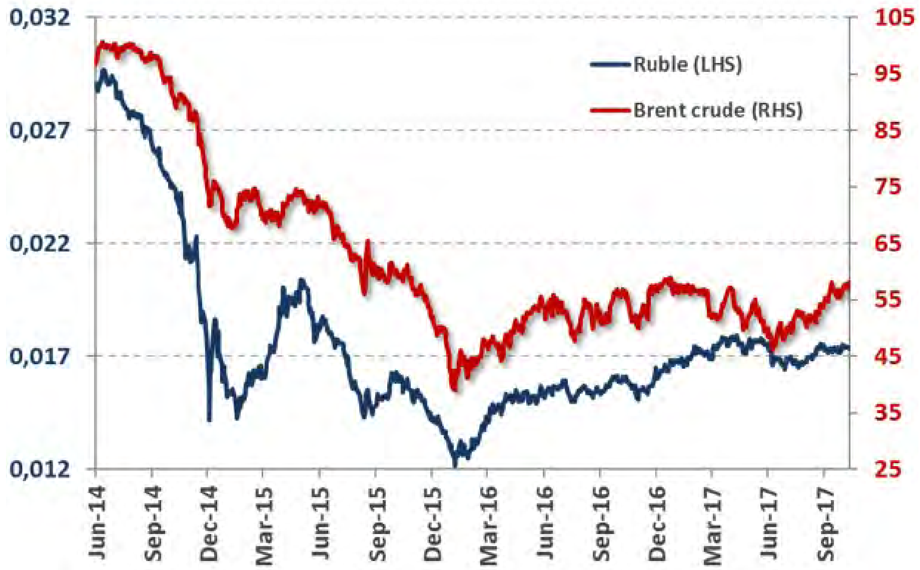
The Russian economy still faces significant challenges: the price of its main product, oil, probably won't return to the high levels seen in 2013 and the economic sanctions imposed by Western economies continue to drag down activity. Moreover, the clean-up of the banking sector is not over yet, even if positive steps have already been taken by the central bank. From a medium-term perspective, the Russian economy's lack of diversification and its excessive reliance on commodities is a source of concern and helps dampen potential growth.

The short-term macro data continue to look good: private consumption is doing better (with unemployment going down and real wages beginning to pick up) and both manufacturing production and private investment are sending positive signals.

Generally speaking, the economy appears to be expanding at rates a little above 2% YoY.

Thanks to the outstanding job done by 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 (25 bps again in October) as inflation has come down significantly. Going forward we believe that rates will edge further down (so that monetary policy ends up turning neutral), but we also expect real rates to remain relatively high, at least for a little longer, so that inflation expectations can improve a little more (also taking into account the fact that the output gap is mostly closed already).

The stabilization of oil prices should continue to help



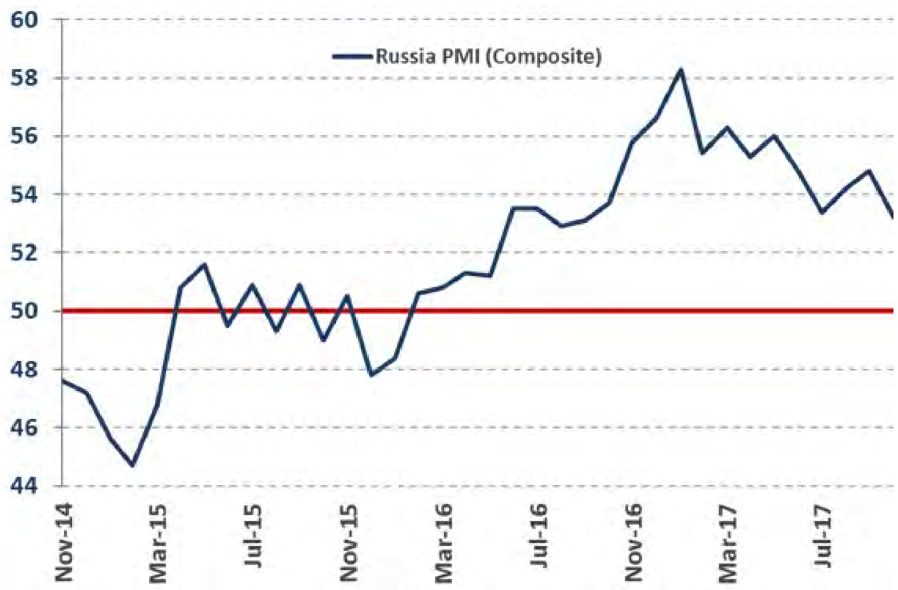
Source: Bloomberg, Alinea Global

The government remains prudent as far as fiscal policy is concerned and this further increases the central bank's room for manoeuvre to ease financial conditions going forward.

In order to ensure the medium and long-term sustainability of public finances, the government will also need to thoroughly **reform the pension system** at some point.

Going forward, and in addition to continuing to preserve the sustainability of public finances, Russia needs to make progress in two major areas: On the geopolitical front, Russia should adopt a more collaborative stance with the western world, so that sanctions can be eased at some point in time (this is a complex situation, given the tensions in the Ukraine and the hacking accusations being thrown about). At the same time, it is important for the government to make ambitious structural reforms aimed at increasing potential growth and reducing reliance on oil. It would also be good if the central bank continued its efforts to clean the balance sheets of financial institutions, a process that is already quite advanced.

Activity is showing signs of stabilization



Source: Bloomberg, Alinea Global

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