Grant Thornton

# Monthly Economic Newsletter
## October 2017

Economics & Regulation Services of Grant Thornton

Audit · Tax · Legal · Advisory

# Monthly Outlook

**With the world economy clearly showing signs of strength since the summer of 2016, those who said that very slow economic growth worldwide was the outlook 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 discounting a scenario in which the world is not only able to grow at a reasonable speed, but it 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 secular stagnation with 100% probability and it is short-sighted again now 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 scarce in key 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.

**In terms of Spain, it would be a shame if political tensions in Catalonia threatened the increasingly strong and sustainable economic recovery we are witnessing.** The authorities need to acknowledge this situation and focus their efforts on adopting measures to foster potential growth and guarantee the long-term sustainability of the country's public accounts.

Our central scenario continues to be one in which central banks progressively allow for a normalization of monetary policies, 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 that monetary policy remains 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 that monetary authorities around the world are increasingly and rapidly falling behind the curve.** What might be the consequence of this? 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 global recovery within a 2-year framework.

**Just 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 behind the curve (moderate reflation scenario), the upward movement in long-term rates would possibly begin sooner and would also tend to 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

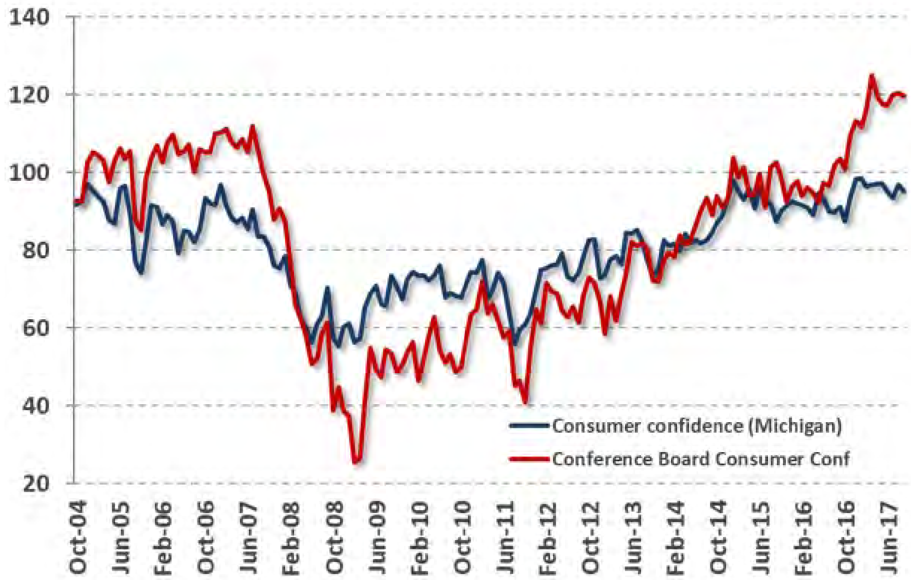
## Despite political noise, prospects for the US economy look fairly good

**The US economy managed to grow at an annualized rate of 3.1% in Q2. 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.** Hurricanes will most likely have a (moderately) negative impact on growth during Q3, but then economic activity will be pushed higher by reconstruction efforts, among other things.

**Following a relatively strong Q2, private consumption looks good going forward:** Consumers' balance sheets are healthy, disposable income is growing at solid rates, the labour market is in very good shape and sentiment indicators are very strong, etc.

**Corporate investment has improved quite significantly in recent times.** On the one hand, the drag triggered by adjustments in the energy sector is now out of the equation. 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 spare capacity. In terms of other issues, and leaving the purely short-term to one side for a moment, the investment recovery is good news going forward with regards productivity (in fact, over the last 12 months, the news surrounding productivity has been increasingly positive).

Consumer confidence rebounding strongly




Source: Bloomberg, Alinea Global

**The real estate sector still has significant room for further expansion,** against a backdrop of relatively strong household formation rates and very low inventories of unsold homes.

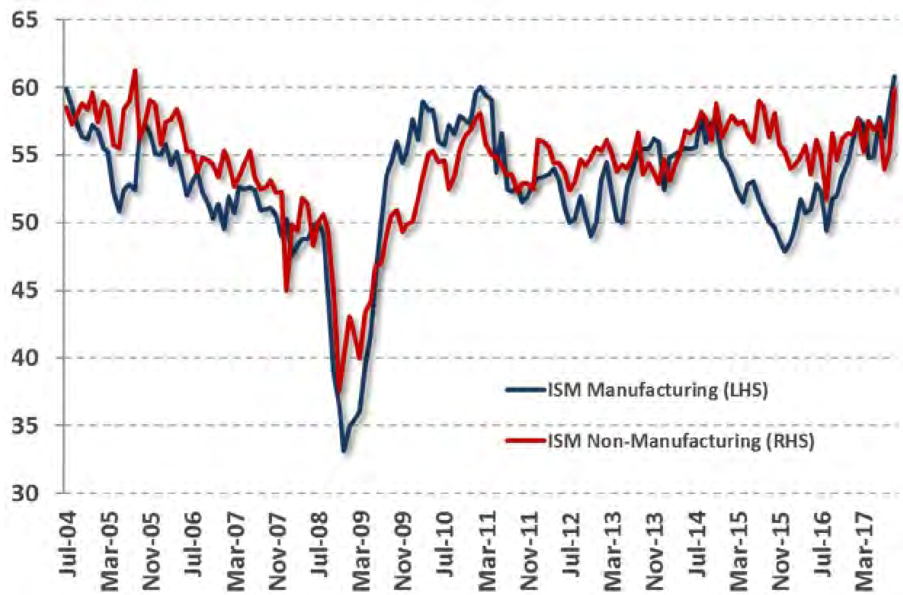
**The depreciation of the dollar and signs of improvement in the global economy are also enabling the foreign sector to perform somewhat better.**

**In general, there are no obvious disequilibria in the US real economy at the moment and this makes it quite unlikely that the economy will slow down significantly in the near future.**

**All in all we expect economic growth in 2017 to be clearly above potential** (even without taking into account the fiscal stimulus plans announced by the Trump administration).

**Looking 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. In fact, job growth has been so strong that it is highly likely that we see lower job creation rates over the coming months.

Manufacturing and non-manufacturing ISM




Source: Bloomberg, Alinea Global

# Full employment and a weak dollar will push inflationary pressures higher

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

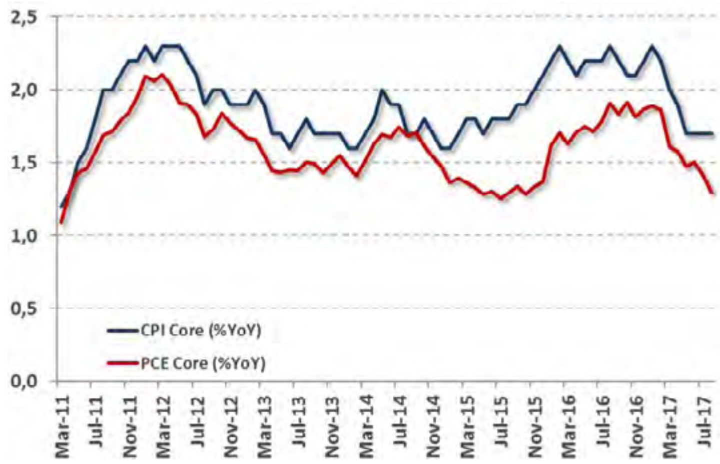
**The outlook for core prices is actually quite positive in our view:** with growth above potential, an already closed output gap, and inflation expectations relatively well-anchored, the most probable scenario going forward will entail core inflation inching progressively higher in the coming months.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

**Meanwhile, tightness in the labour market should also lead to a gradual acceleration of wages going forward.**

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

**Reconstruction work following the hurricanes will also push up prices in the coming quarters.** 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 falls due to temporary factors




Wages should accelerate more clearly going forward


Source: Bloomberg, Alinea Global

# The Fed begins to trim its balance sheet in October

**As the economy is looking good and financial conditions are very accommodative, at its September meeting the Fed announced that it would begin to trim its balance sheet in October.** It also said that it expects to raise interest rates again before the end of the year.

**At the same time however, the Fed remained very prudent,** modestly reducing its expectation for the long-term value of the Fed funds rate from 3% to 2.8%.

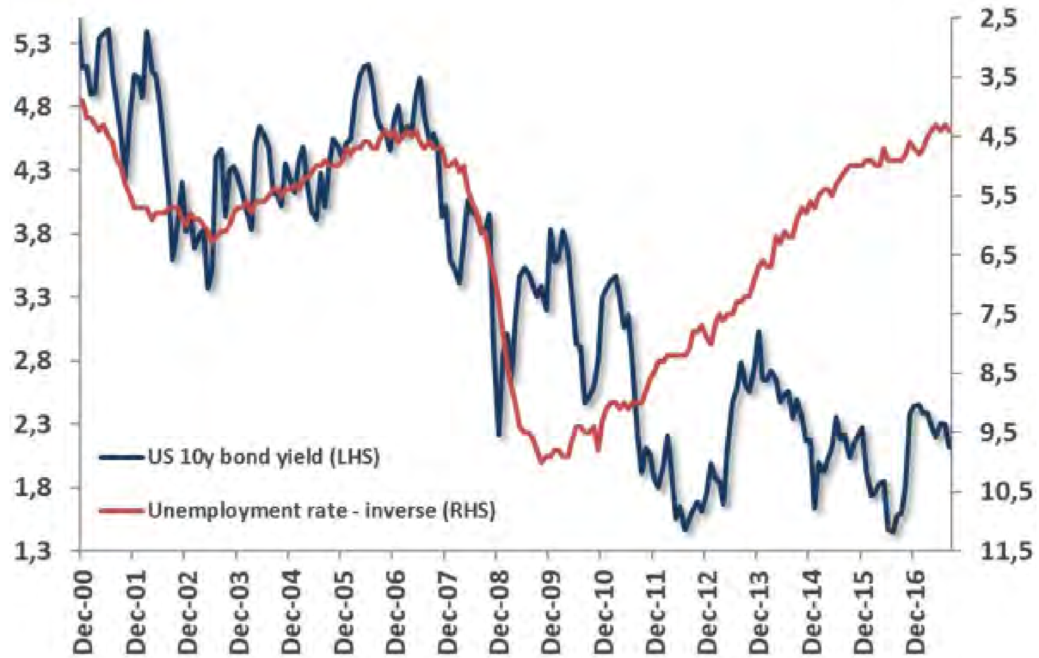
**By being so cautious we believe that the US monetary authority is running the risk of significantly overheating the US economy** (even more so if we take into account that a significant tax cut is looking increasingly likely again).

**So the scenario going forward could well be one in which the Fed falls significantly behind the curve, thereby allowing inflation to significantly overshoot the 2% inflation target.**

**If this were to happen, the Fed would then be forced to rapidly increase rates, inevitably creating the risk of significant economic deceleration (or even a recession) in the next 2 years.**

**We still believe however that the most likely scenario going forward is one in which the Fed will react to inflation edging progressively higher in the coming months.** This will probably mean that interest rates will end up going beyond the 2.8% terminal value mentioned by the Fed.

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:** extremely low long-term interest rates, a somewhat more growth friendly fiscal policy, still low oil prices, a financial sector more willing to lend to the real economy, very reduced leverage in the private sector, significant price-competitiveness improvements between countries in the periphery, the euro continuing not to be a serious problem despite its recent appreciation, etc.

**That said, the Eurozone's economy has been growing significantly above potential for quite some time and, given the most recent macro data, seems poised to continue to do well going forward:** the unemployment rate is decreasing fairly quickly, sentiment indicators edge further up from already high lev**els, PMIs look really good, etc.**

**Germany is especially interesting, with economic activity remaining very strong with 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 construction sector are in good shape, exports are also gaining dynamism, the unemployment rate is at record low levels, etc.

**France is already benefiting from an improved political situation and 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, it is difficult not to be relatively optimistic about France going forward, even more so considering that Macron has been able to approve a relatively ambitious labour market reform plan.

Economic sentiment at very solid levels

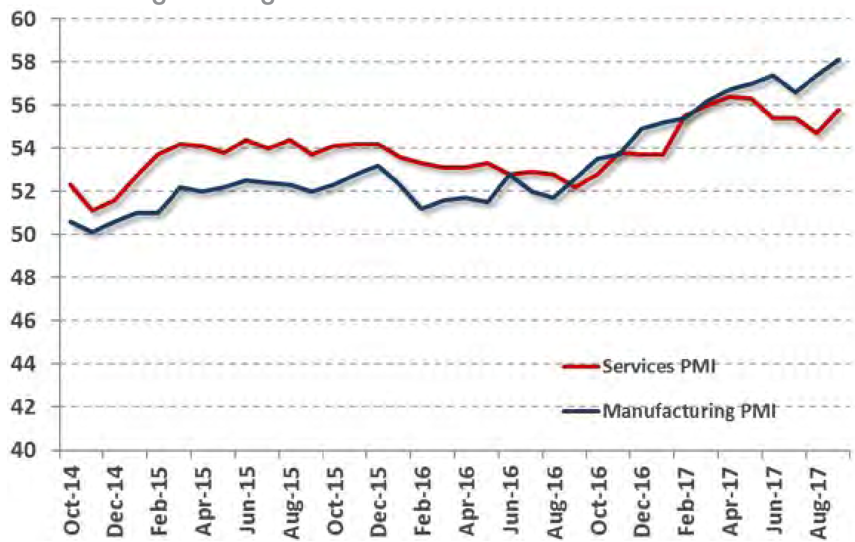

Source: Bloomberg, Alinea Global

**Even Italy seems to be improving of late:** GDP is surprising to the upside and both PMIs and sentiment indicators also doing quite well. This improved macroeconomic outlook is also accompanied by a more stable political situation and a stronger position held by the banking sector.

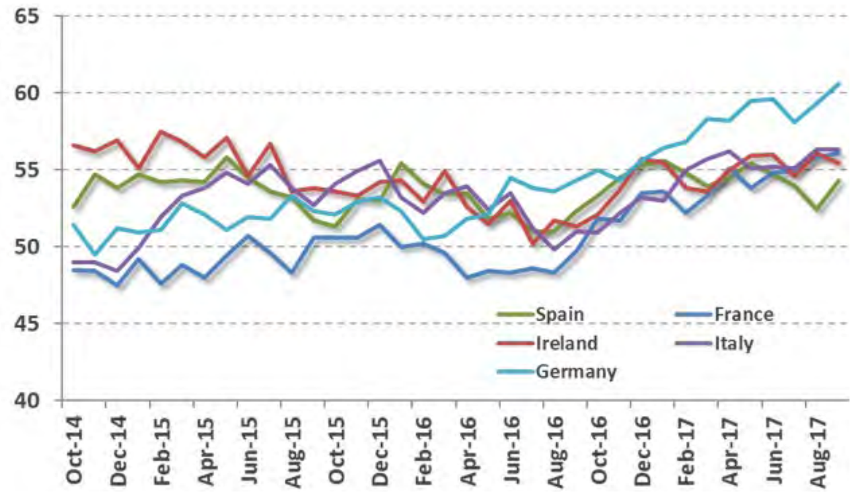
**In contrast with this quite favourable macroeconomic situation in the Euro area and despite the possibility of early elections in Italy, it is clear that negotiations around Brexit will continue to create noise in the coming months.**

**We believe however that the most probable scenario going forward is for Brexit to have only a moderate impact on growth outside the UK.** Firstly, the macroeconomic situation is looking quite good now and populism has been loosing steam, considerably increasing the level of optimism about the future of the European project. Secondly, it has become increasingly apparent that the UK will lose the most if faced with a hard Brexit. For countries remaining inside the EU, the negative impact of a more difficult trading relationship with the UK could be partially compensated for by the fact that, in the future, some of the investments that now take place in the UK (particularly in the financial sector) will move to EU member countries, as international companies try to ensure access to the single market.

PMIs at very healthy levels




The European recovery continues to broaden




Source: Bloomberg, Alinea Global

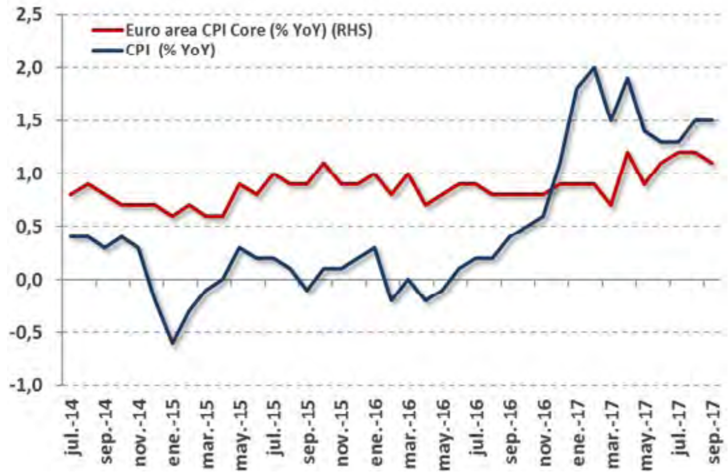
# If the euro avoids excessive appreciation, core inflation should edge higher

**The favourable macro environment is already leading to a mild acceleration in core prices, a process that looks set to continue in the coming months provided the euro does not appreciate too much further.** Although there is still considerable 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 therefore a fairly good approximation of structural unemployment in the area). Even if we consider broader measures of slack in the labour market, the output gap will probably be fully closed in around one and a half years. We also expect wages to accelerate going forward (there were already some encouraging signs in Q2).

**In Germany, 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 here. On the other hand, and more importantly, this relatively dynamic growth will take place against 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.

**As a consequence of the much improved macroeconomic outlook, at its September meeting the ECB said that it intends to take decisions on the future of QE in October.** At the same time, and given the rapid appreciation of the euro, the monetary authority also made it clear that too strong a euro would not be welcomed as it could have a dampening effect on inflationary pressures.

Core inflation has improved in recent times




Inflation expectations have improved


Source: Bloomberg, Alinea Global

# Spain

## Despite political noise surrounding Catalonia, macro data continue to do well

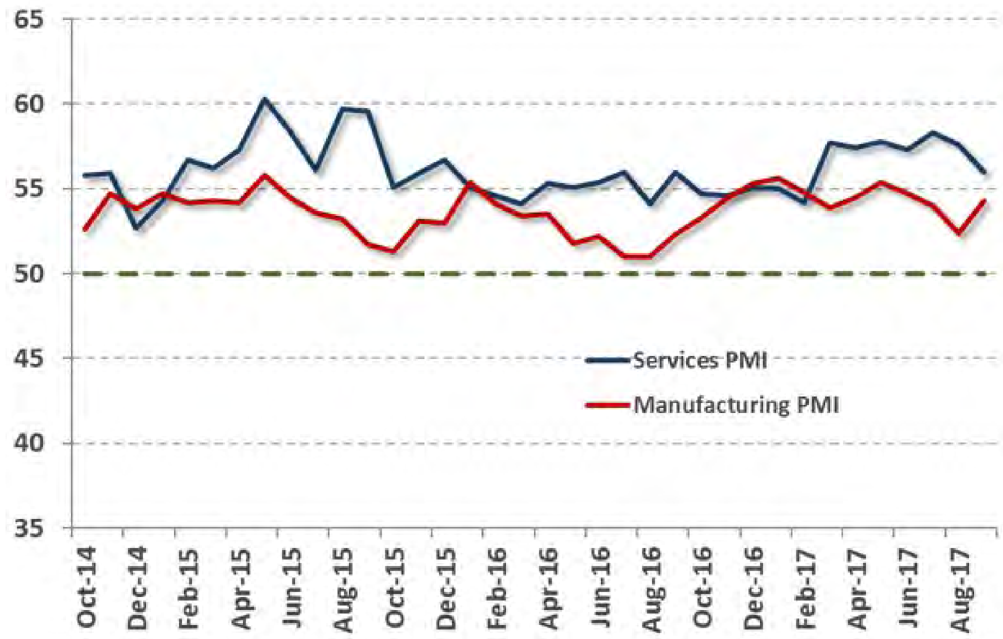
**Despite the constitutional crisis in Catalonia, Spain continues to benefit from numerous tailwinds:** significant price competitiveness gains made during the crisis, low oil prices, a weak euro, extremely low interest rates, etc.

**Even though recent macro data point to mild deceleration, they continue to be positive:** job growth was once again solid in September, confidence indicators are at healthy levels, industrial production, the services sector and exports are all in good shape, PMIs are also doing well, demand for credit continues to well, demand for credit continues to grow, tourism is doing particularly well and the real estate sector is also improving fairly quickly, etc.

**For the rest of the year, and provided the political noise around Catalonia doesn't spin out of control, we think growth will remain strong, almost surely above 3% for 2017 as a whole.** This figure is of course much higher than the current estimates of potential growth for the Spanish economy.

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

Manufacturing and non-manufacturing PMI




Source: Bloomberg, Alinea Global

# Political noise, high debt and low potential are still Spain's medium-term challenges

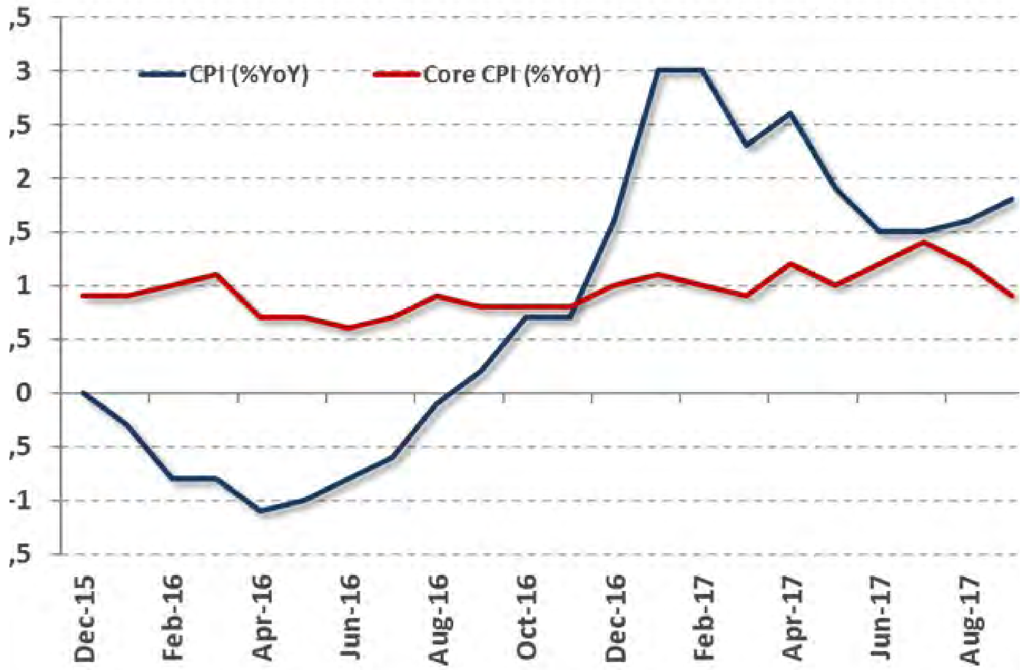
**This scenario is in turn compatible with underlying inflation heading progressively higher in the coming months.** As the unemployment rate continues to drop, wages should also tend to edge higher going forward.

**Within this clearly favourable context, it would be great if the government could use the opportunity offered by the current tailwinds to forcefully address the significant structural challenges that the Spanish economy still faces.** We still need measures to tackle low potential growth (boosting human capital, driving technological innovation, increasing competition in certain industries), to control significant external debt and to mitigate excessively increased levels of inequality.

**It is also important that Spain complies with the requirements of the Stability and Growth Pact in 2017 and 2018,** taking into account that the ECB will at some point begin to normalize its monetary policy. It is undoubtedly positive that budgetary execution in the current fiscal year is better than initially expected.

**From a political perspective, it is by no means impossible, as already mentioned above, that the situation in Catalonia ends up creating some kind of noise among financial participants.**

Core inflation should edge higher little by little




Source: Bloomberg, Alinea Global

# United Kingdom

## Britain's Brexit negotiating position has clearly softened

**In relation to Brexit, it is becoming increasingly clear that everybody, and 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 seems to be increasingly aware of the significant, negative long-term effects of a hard Brexit: the country would (at least partially) lose access to one of the biggest markets in the world, London would probably lose part 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 the uncertainty, the UK economy is maintaining a certain momentum.** On the downside, it is difficult to be overly optimistic about the prospects for corporate investment given the high levels of uncertainty about the future. Positively thinking, the weak pound is helping to boost both exports and the manufacturing sector. What about consumption? It is clear that this key variable is negatively affected by uncertainty and also by the increase in inflation. With an already closed output gap however and strong employment growth, we should be relatively optimistic about wages going forward, something that in turn should help avoid a significant deterioration in private consumption (encouragingly, the latest retail sales data have been stronger than expected).

**The increase in inflationary pressures and the fact that the economy is doing better than expected led to a significant change in tone by the BOE at its September meeting.** At present, a rise in interest rates before the end of the year looks quite likely.

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). 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 country's population is decreasing and there are therefore very low levels of potential growth (probably not higher than 0.75%). As a result, it is only normal 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.

**That said, events in recent quarters lead us to be optimistic:** Firstly, GDP has grown for 6 consecutive quarters and the average is clearly above potential. Secondly, although it will be close to impossible to maintain the rates of growth achieved recently, most recent economic indicators continue to be upbeat from a medium-term perspective (sentiment indicators are at very healthy levels, private consumption and, in particular, corporate investment are sending encouraging signs, exports and industrial production seem to be in good shape, credit appears to be picking up, etc.). And thirdly, wages are beginning to pick up (particularly in terms of temporary workers) and there is good reason to expect further acceleration going forward, thanks to the positive macroeconomic situation (and therefore healthy labour demand), an already positive output gap and considering also that significant progress made over the last 2-3 years in terms of women entering the labour force should lose momentum at some point (this will obviously tighten the labour market further).

Positive outlook in the medium-term


Source: Bloomberg, Alinea Global

# Strong action by the BOJ and better wage signs are good news for prices

**Despite the 2% inflation rate remaining distant, a tight labour market in a context of 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 behaved 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.

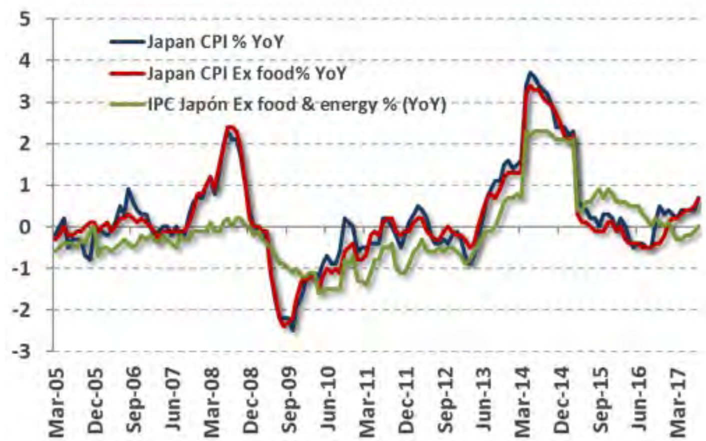
**The BOJ continues to implement its yield curve control policy,** trying to make sure that 10y yields stay reasonably close to 0% and having committed to allowing inflation to overshoot the 2% target for a considerable period of time.

**The government is also trying to push wages and prices up:** while calling snap elections President Abe has recently presented a set of fiscal expansionary measures that include incentives for companies to boost investment and increase salaries.

**In addition to inflation, and in order to increase potential growth, the country must make more progress in the field of structural reform,** in particular as far as immigration and the labour market are concerned (in relation to the latter, reduced 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

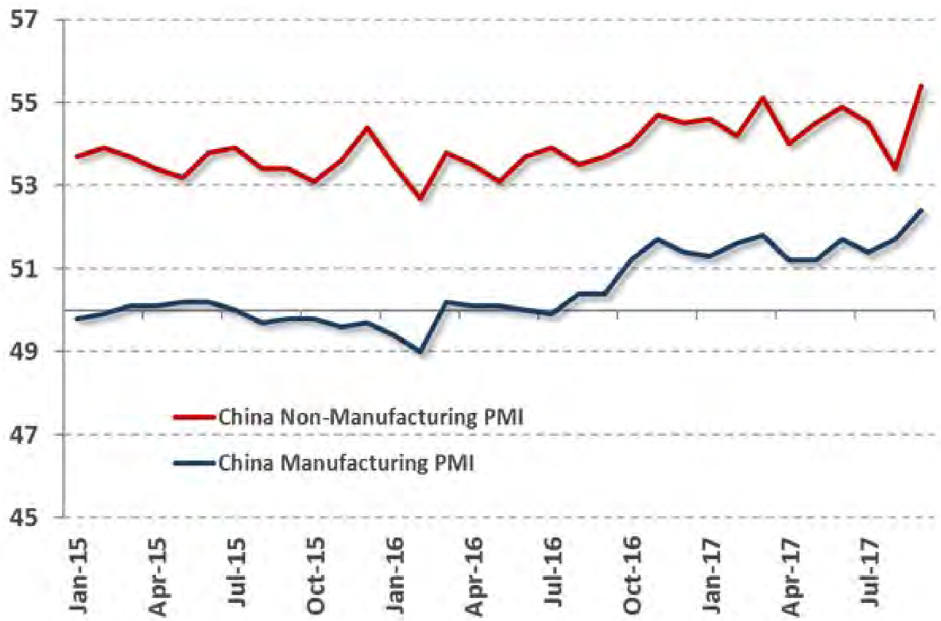
## The government curbs financial risk while trying to maintain sufficient economic momentum

**The positive macro situation in China has allowed the authorities to put increased emphasis on measures aimed at controlling financial risk.** Authorities have adopted measures aimed at improving financial supervision, promoting equity financing, reducing excess capacity in some industries and containing the expansion of the real estate sector. Moreover, the PBOC has also favoured a certain tightening of liquidity conditions in the money market in order to reduce incentives to conduct highly leveraged purchases of financial assets.

**Having said this, it would seem logical to expect a little less momentum in the economy going forward.** Moreover, having been frontloaded during 1H, public expenditure is also set to decelerate going forward. That said, up until now macro data continue to be mostly positive.

**Generally speaking, the risks of any kind of abrupt deceleration remain quite low.** Economic momentum is looking good (with private consumption doing well against a strong labour market) and the authorities will continue to ensure an environment that 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 cut in the reserve requirements for loans to SMEs is a good example: it expands credit to small businesses while at the same time improves the level playing field between traditional banks and the shadow banking system whose primary clients are precisely the SMEs). 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 eliminates a source of uncertainty and promotes capital inflows

**One of the positive collateral effects of a somewhat less accommodative monetary policy is less pressure on the yuan and reduced incentives for capital outflows.** Indeed, given the recent appreciation of the Chinese currency, the authorities have 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 has seen net capital inflow in the most recent period.

**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 worldwide in any significant way (and have actually picked up somewhat recently) and moreover, equilibrium exchange rate estimates by institutions such as the IMF do not point to undervaluation.

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

Monetary policy is becoming less accommodative


Source: Bloomberg, Alinea Global

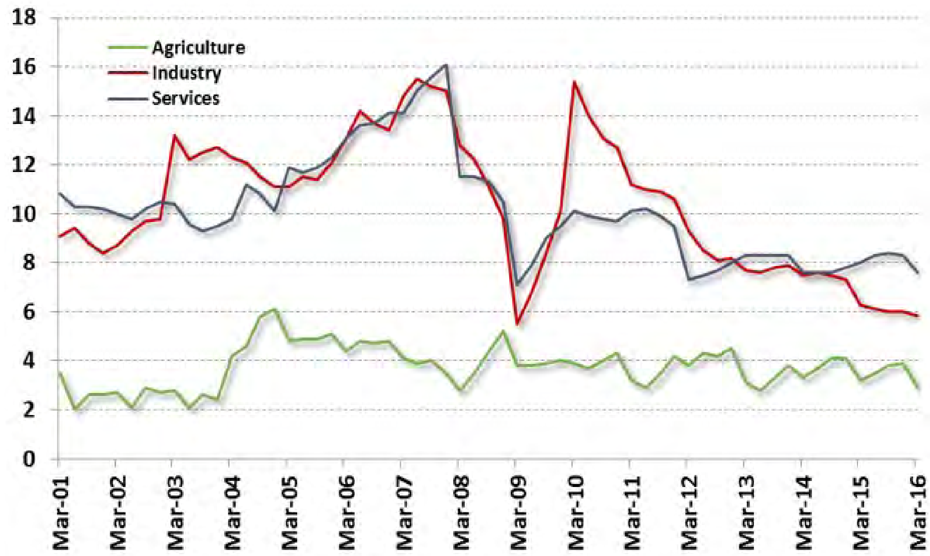
# Beyond the cyclical situation, the country continues to upgrade its growth model

**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.

**Having said all this, and although China is in a relatively good position to face the significant challenges it has ahead of it, it is of course crucial that the authorities continue to work hard (the last downward revision of China's rating by S&P should act as a reminder in this respect).**

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, leveraged investments in financial assets should be further curbed, etc. At the same time, and in order to help potential growth, the government should continue to promote research, development and human capital. It is good to see that the authorities seem to be well aware of the need to continue 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 of them are 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, with low capacity utilization levels, high corporate debt (in certain sectors) and elevated levels of bad loans in the banking sector.

**The RBI maintained interest rates at its October meeting,** arguing that the medium-term outlook for the Indian economy is still looking good and considering also the fact that core inflation remains relatively high. At the same time, food prices may well tend to accelerate in the coming months.

**On the fiscal front it is important for the government to maintain the right balance between helping economic growth and preserving the long-term sustainability of public finances.** This is of course not so easy to do, as the fiscal deficit in India is quite high, especially at state level. The introduction of a stimulus package to try to compensate for the recent economic deceleration does not look warranted, especially when accompanied by a relatively upbeat medium-term outlook.

The economy is sending better signals


Source: Bloomberg, Alinea Global

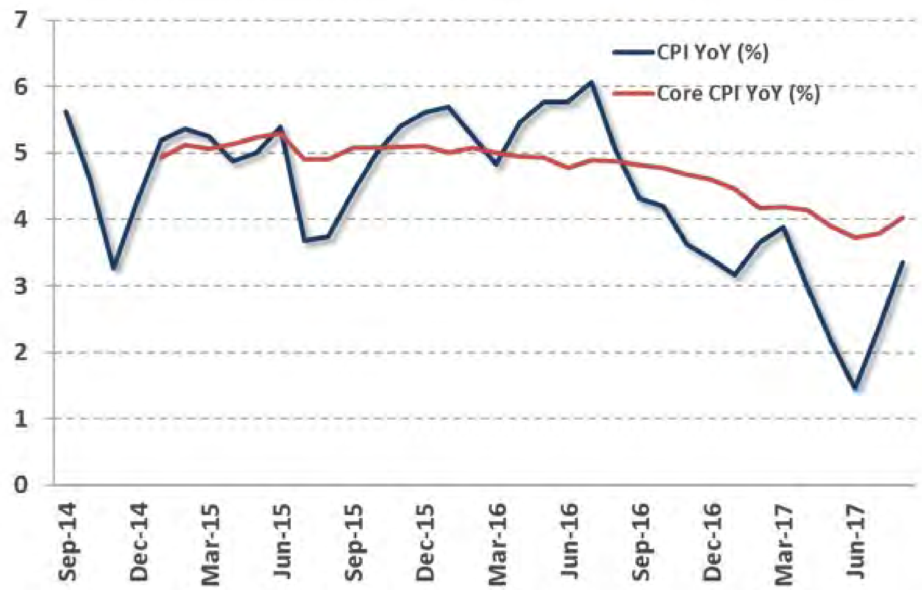
# The government continues to make progress in the field of structural reform

**In the field of structural reform,** and beyond the introduction of the GST on 1 July, the fact that the central government continues to promote competition between states (including the introduction of rankings) is proving to be an efficient way to push structural reform efforts, including those aimed at improving the investment climate. The liberalizing measures related to the agricultural sector are a step in the right direction as well.

**The RBI has already begun to use its new powers allowing it to force lenders to take write downs and this should also be welcomed** (in theory, healthier bank balances will help channel financing towards private investment). 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 progress would be welcome, particularly in the following areas:** non-financial corporations (especially in certain sectors) should reduce leverage, state banks should be restructured and further recapitalized, 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, and land reform should be forcefully pursued as it would help reduce the significant obstacles that infrastructure investment in India still faces.

Inflation has come down considerably




Source: Bloomberg, Alinea Global

# Emerging countries - Brazil

## A difficult political situation puts reform efforts at risk

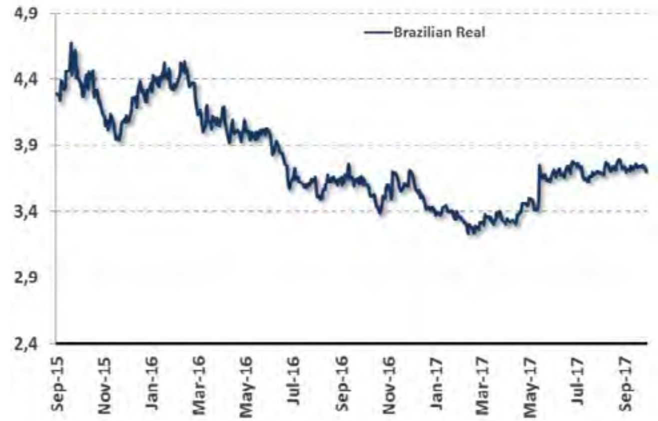
**Brazil's economic future will be dictated by two main factors.** On the one hand, macroeconomic stability (both fiscal and as far as inflation is concerned) should be ensured, so that the high financing costs the country has traditionally faced can be sustainably reduced. On the other hand, further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

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

**It is bad news that President Temer's political position is so weak, as this could put reform efforts at risk. But at the same time, it is also fair to say that the political situation is not yet catastrophic.** In recent weeks the government has managed to approve a reform of the labour market and the authorities are still trying hard to get some form of pension reform approved as soon as possible. On a more negative note, tax revenues are coming in weaker than expected and this has forced the government to raise the deficit target (even here there is some hope, as the authorities have also approved several fiscal consolidation measures together with a privatization plan which are both aimed at containing the deterioration of public finances).

Activity is showing signs of stabilizing


The weak real still helps




Source: Bloomberg, Alinea Global

# Short-term macro data continue to show improvement

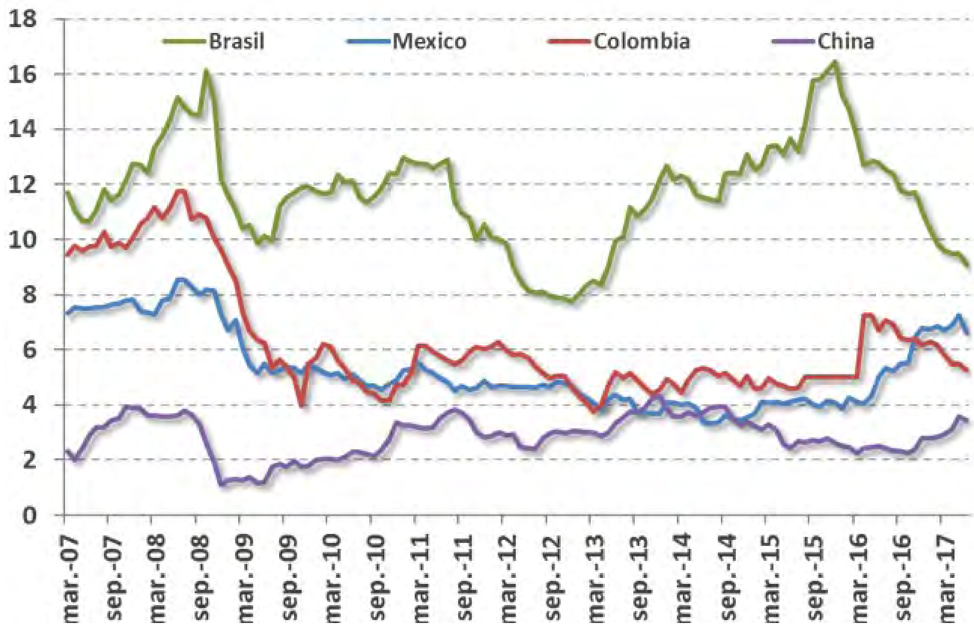
**If economic policy continues on the right path, it would actually be quite likely that Brazil entered a virtuous circle in which the central bank had room to aggressively cut interest rates, with very positive effects on both growth and employment.** In fact, the more the authorities advance in the process of economic reform and in improving the long-term sustainability of public finances, the greater the reduction in the financing costs of the Brazilian economy in the future. The recent elimination of the subsidies linked to loans made by the BNDES is clearly a step in the right direction (not only did these subsidies result in significant economic distortions, but they also brought with them significant fiscal costs).

**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 over the past few months.

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

**Looking ahead,** and after reducing rates by 100bp again in September, the central bank announced that further easing is to be expected going forward (although the size of additional rate cuts will probably be lower than those seen to date), thanks to moderating prices, improved inflation expectations and high levels of spare capacity.

Structurally high financing costs




Source: Bloomberg, Alinea Global

# Emerging countries - Russia

## Although there are still challenges, things have clearly improved

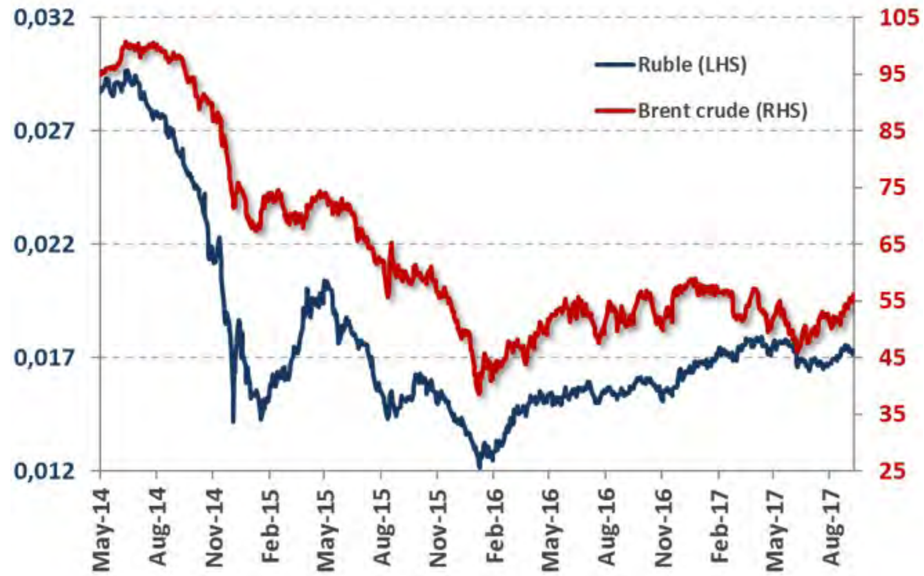
**The Russian economy faces significant challenges:** the price of its main product, oil, is still considerably lower than the levels seen in 2013 and the economic sanctions imposed by the Western economies continue to drag down activity. Moreover, although positive steps have already been taken by the central bank, the clean-up of the banking sector is not yet over. 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.

**At the same time, recent macro data confirm that the country has maintained the recovery that started in the last part of 2016.**

In fact, GDP growth came in significantly stronger than expected in the second quarter and things look good going forward as well: private consumption is improving (with unemployment dropping 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 of around 2% YoY.

**Thanks to the outstanding job of Governor Elvira 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 both inflation and inflation expectations have dropped.

The stabilization of oil prices should continue to help




Source: Bloomberg, Alinea Global

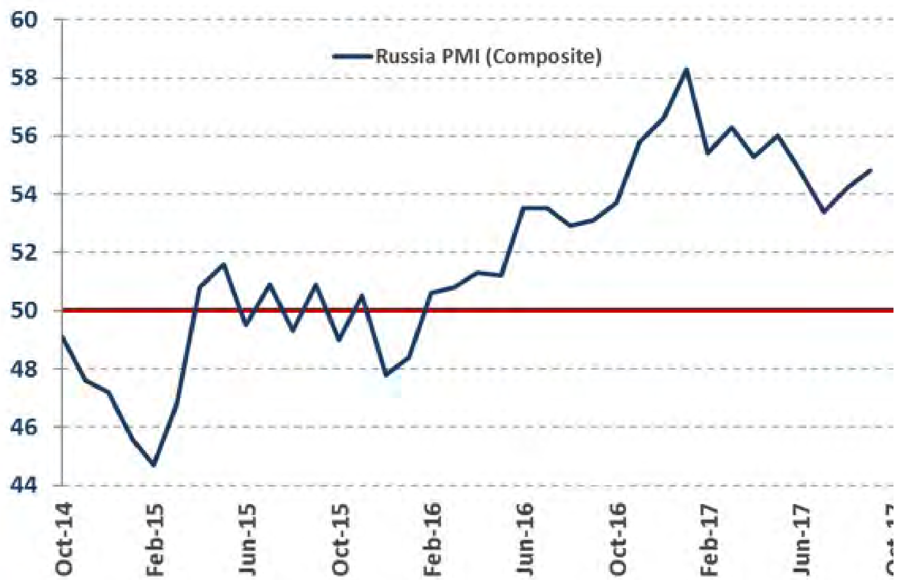
In September, interest rates were reduced again, by 50bps, and the monetary authority announced that further cuts are possible in the next couple of quarters. We believe that rates will edge further down, although we also expect real rates to remain relatively high so that inflation expectations can improve a little bit more (also taking into account the fact that the output gap is mostly closed already).

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

In order to ensure the long term sustainability of public finances, the government will also need to thoroughly reform the pension system.

**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 problems 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 improving the investment climate, increasing potential growth and reducing reliance on oil. It would also be positive if the central bank continues with 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

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

Follow us in:
www.GrantThornton.es
http://Blog.GrantThornton.es

We are 47.000 professionals in more then 130 countries working with the 70% of the Forbes Global 100.

Grant Thornton is one of the world´s leading professional services organisations.

In Spain, we are 900 professionals providing assurance, business consulting and financial, tax and legal advisory.

We help companies to unlock their potential for growth working and collaborating closely with our clients. In addition, due to their wide business vision, our experienced specialists understand and help companies to deal with the challenges that businesses face every day.

Grant Thornton
An instinct for growth™

Audit · Tax · Legal · Advisory