ALLIANCEBERNSTEIN

GLOBAL ECONOMIC RESEARCH

GLOBAL MACRO OUTLOOK

OCTOBER 2018

KEY FORECAST TRENDS

+ Recent economic data indicate that global growth remains firm. But trade tension and tighter financial conditions suggest a softer period ahead.

+ While there have been some positive developments on the trade front, we very much doubt that tensions will fade quickly. Rising trade tension is a manifestation of populism that we expect to weigh on the economic and investment backdrop for some time to come.

+ Inflation still seems likely to increase, as the growth slowdown is likely to be modest and capacity use is already high. What's more, uncertainty from the trade war will weigh on supply as well as demand, adversely affecting the growth/inflation trade-off.

+ If the slowdown in growth remains gentle, developed-market central banks are likely to proceed with policy normalization—though at very different paces and with the Fed still clearly in the lead.

+ All of this points to higher bond yields, modest dollar upside (especially against the more vulnerable emerging-market currencies) and a more challenging period for risk assets.

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Wage Growth: The Dog That's Finally Starting to Bark

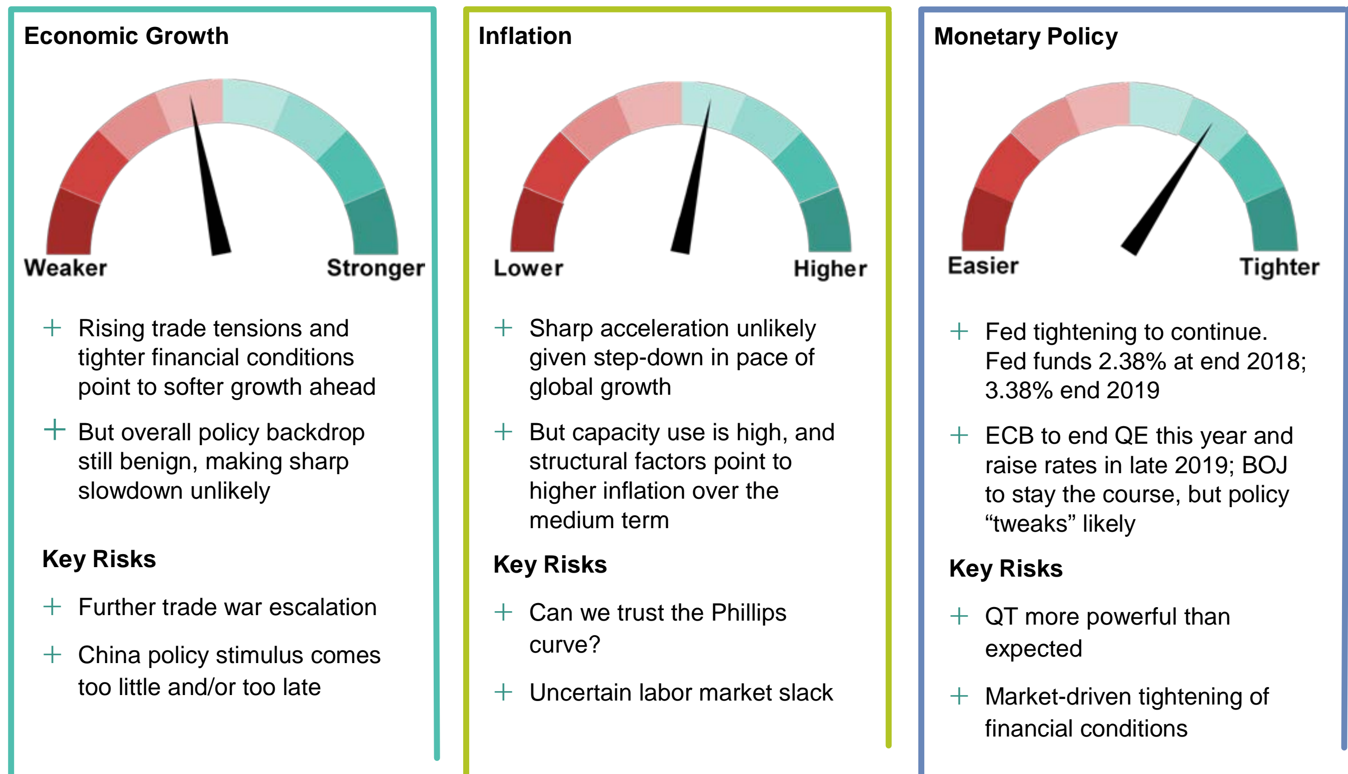
Through June 30, 2018
Source: Haver Analytics

+ One of our core views is that a combination of structural and cyclical factors will push inflation higher over coming years.

+ Until recently, supporting evidence for this view had been limited. But as unemployment continues to fall, wage growth is now starting to rise.

+ This is just the first step in the inflation process. But it's a vital one, and one that gives us confidence that we're on the right track—and that markets are underestimating the potential for inflation to rise.

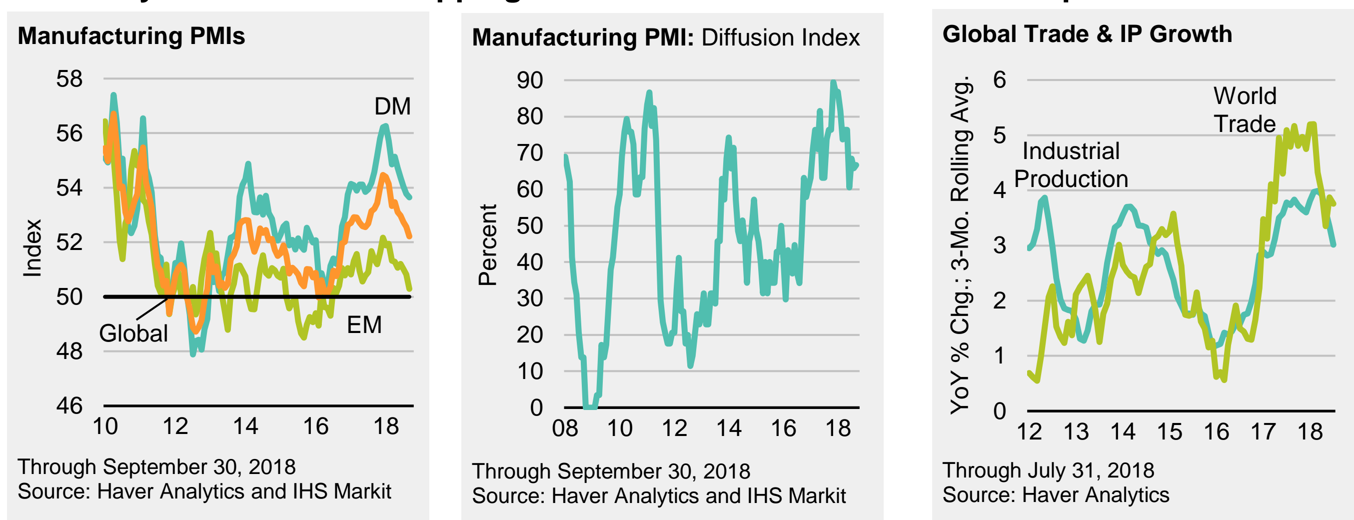
GLOBAL FORECASTS



OUTLOOK

- We reduced our bottom-up global growth forecast again for 2019, this time to 2.9%. This was a small downgrade, but it's consistent with our view that a period of slower growth lies ahead.
- We're in line with the consensus growth forecast on China at 6.3% and slightly above it on Japan (1.1% versus 1.0%). But we're below consensus on both the US (2.3% versus 2.5%) and the euro area (1.6% vs 1.8%).
- Global inflation is expected to be little changed next year as a slowdown in emerging-market (EM) inflation (4.1% versus 4.5% this year) offsets increased price pressure in developed markets (2.1% versus 1.9%).
- While the overall trend suggests tighter global monetary conditions, there are important variations to consider. The most important outlier is China, where substantial policy easing will be required over the next few quarters.

Global Cyclical Outlook: Stepping Down to a More Modest Pace of Expansion



Manufacturing PMIs — Through September 30, 2018. Source: Haver Analytics and IHS Markit

Manufacturing PMI: Diffusion Index — Through September 30, 2018. Source: Haver Analytics and IHS Markit

Global Trade & IP Growth — Through July 31, 2018. Source: Haver Analytics

GLOBAL MARKET OUTLOOK: YIELD CURVES

GLOBAL YIELDS

Global—Developed-market (DM) bond yields still expected to rise, though pace of increase now less certain

US—Solid growth, rising inflation and Fed rate hikes likely to push yields higher over the coming year

Euro Area—Bund yields still dislocated from fair value and set to rise as ECB starts to withdraw policy stimulus; recent political developments a downside risk

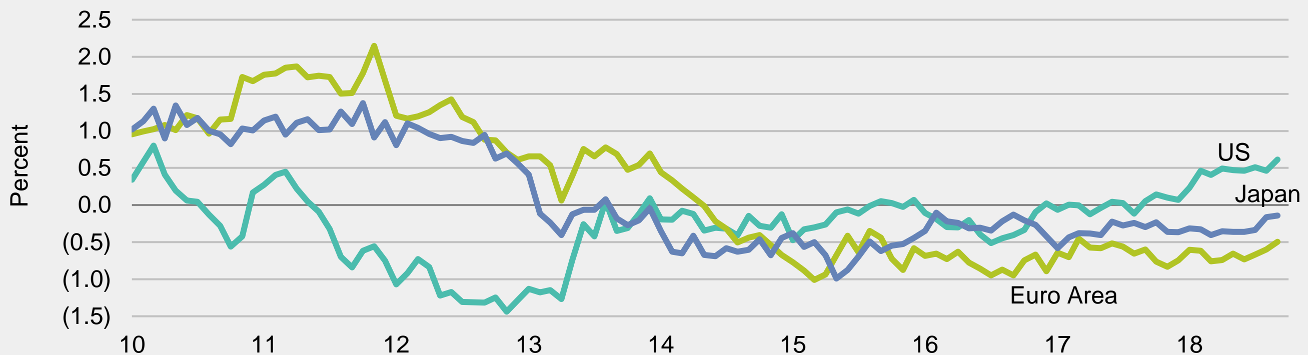
Japan—QQE-YCC policy to anchor 10-year yields close to zero, but risk of 10-year adjustment in 2019

10-Year Yields: AB vs. Consensus Year-End Forecasts (%)

	AB		Consensus	
	2018	2019	2018	2019
US	3.25	3.75	3.06	3.32
Euro Area	0.75	1.25	0.62	1.03
Japan	0.10	0.25	0.12	0.15
China	3.50	3.30	3.51	3.35

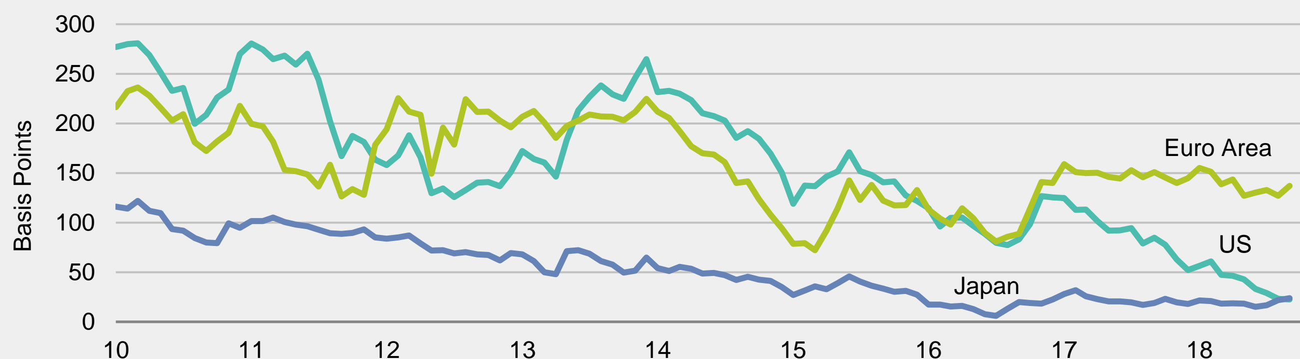
As of October 1, 2018
Source: Bloomberg and AB

Real 10-Year Bond Yields*



As of October 1, 2018
*Current 10-year bond yield less five-year/five-year forward inflation swap
Source: Bloomberg and AB

Yield Curves: 10-Year Bond Yield less Two-Year Bond Yield



As of October 1, 2018
Source: Bloomberg and AB

GLOBAL MARKET OUTLOOK: CURRENCIES

FX FORECASTS

USD—USD biased to the upside, but valuations suggest that a sharp rise from current levels is unlikely

JPY—JPY to benefit as risk-asset headwinds intensify

EUR—EUR likely to trade toward the bottom of its 1.15–1.25 trading range in coming months; politics an important downside risk (Italy, Brexit)

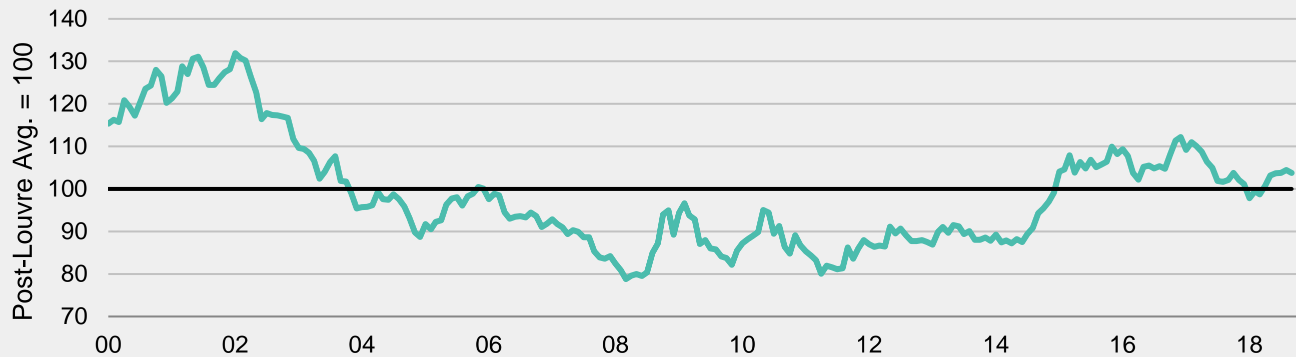
CNY—CNY already being used as a policy tool in the trade war and could fall further should tensions continue to escalate

Global FX: AB vs. Consensus Year-End Forecasts

	AB		Consensus	
	2018	**2019**	**2018**	**2019**
EUR/USD	1.15	1.15	1.16	1.23
USD/JPY	112	105	111	107
USD/CNY	7.00	7.20	6.85	6.70
EUR/GBP	0.92	0.89	0.89	0.89

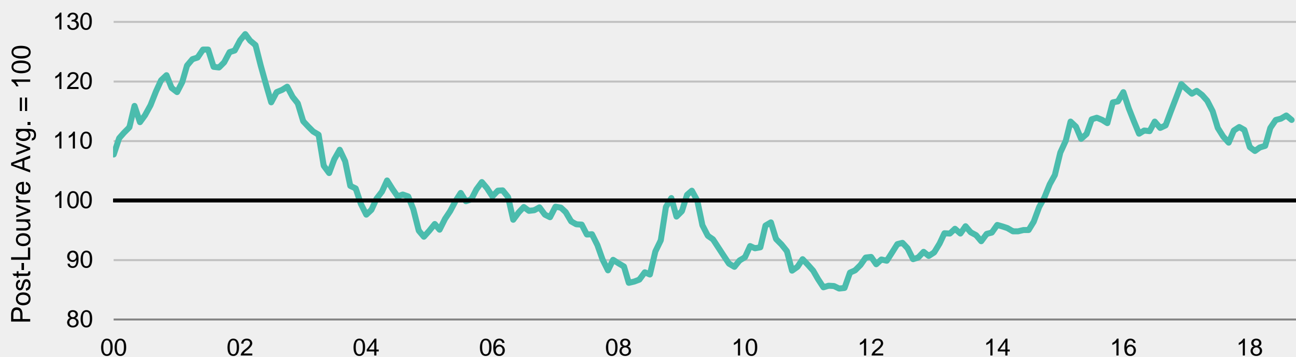
As of October 1, 2018
Source: Bloomberg and AB

Nominal USD Exchange Rate: DXY



Through October 1, 2018
Source: Bloomberg and AB

Real USD Exchange Rate



Through October 1, 2018
Source: Bloomberg and AB

US

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
US	2.5	2.3	2.3	2.5	2.38	3.38	3.25	3.75

OUTLOOK

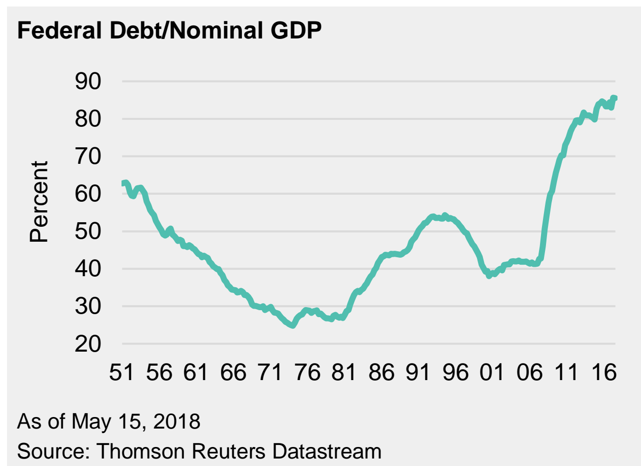
- The US economy remains strong even as the global environment has become more volatile. Trade tension dominates the headlines but has not had a significant effect on growth—and isn't likely to in the near term. It remains to be seen if longer-term business plans are disrupted by trade-related uncertainty, but our base case is that the economy continues to perform well over the medium term.
- Inflation is close to the Fed's 2.0% target on a variety of measures. The question for the rate-setting committee is how to keep it there. Rate hikes that are too rapid could slow the economy and pull inflation lower; hikes that are too slow could allow overheating and push inflation too high. We expect the Fed to persist with gradual rate hikes at quarterly intervals.
- While we expect a modest slowdown in growth in the coming quarters, persistently easy financial conditions pose upside risks to that forecast. There is no evidence of a slowdown yet apparent in the current data flow.

RISK FACTORS

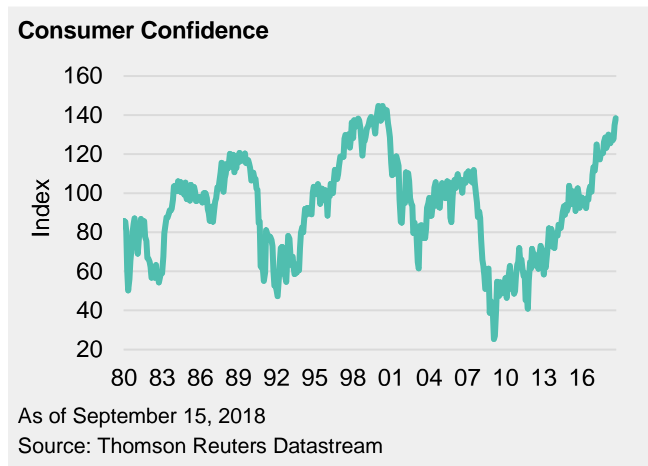
- Aside from trade tensions, the midterm election poses some risks, though they appear bigger for financial markets than for the broader economy. This probably means they will be short-lived in most of the possible electoral outcomes.
- Fiscal indiscipline remains the greatest long-term risk. Rising debt levels make government finances increasingly vulnerable to rising rates even as fiscal stimulus makes rising rates more likely.
- Trade tensions with China have yet to affect the economy materially, but the relationship between the two countries is at risk of fraying in a way that could be more disruptive than what we've seen so far.

OVERVIEW

Though the global outlook has deteriorated, the US economy is a bastion of strength. Growth remains well above trend, with unemployment at multigenerational lows and business sentiment multiple standard deviations above long-term averages. While inflation is picking up, the rate of increase remains gradual, which supports only gradual rate hikes from the Fed. It is a virtuous circle, and until something disrupts that cycle, the economy will continue to perform well. What could be disruptive? The obvious candidates are politics and trade policy. The former will come to the fore ahead of the November midterm elections and the start of the presidential election cycle thereafter. The latter remains top of mind for many but relatively insignificant to the near-term economic outlook. That can change, of course, depending on how far China and other trading partners are willing to go in taking measures to reciprocate for US tariffs. For now, however, the economic environment is benign, and we expect it to stay that way, even as a modest deceleration takes hold later this year.



As of May 15, 2018
Source: Thomson Reuters Datastream



As of September 15, 2018
Source: Thomson Reuters Datastream

Euro Area

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
Euro Area	2.1	1.6	1.8	1.8	0.00	0.25	0.75	1.50	1.15	1.15

OUTLOOK

- Although the fundamental backdrop remains sound, we expect euro-area growth to slow to 1.6% in 2019 from 2.1% this year as global trade tension weighs on exports and business investment.
- We expect headline inflation to be unchanged next year at 1.8%. Underlying inflation is also expected to pick up but remain subdued at 1.5%, from 1.2% this year.
- The European Central Bank (ECB) has announced plans to phase out its net asset purchases in December. Interest rates are likely to rise in 2019, but not until well into the second half of the year.

RISK FACTORS

- Having downgraded our growth forecast last month, we feel that risks are evenly balanced. Much will depend on further developments in the trade war.
- A disorderly resolution to Brexit negotiations is an important downside risk for many euro-area economies.
- Italian political uncertainty is an additional source of downside risk and volatility. The populist government does not plan to leave the euro and has softened its plans for fiscal loosening, but friction with its euro-area partners looks inevitable.

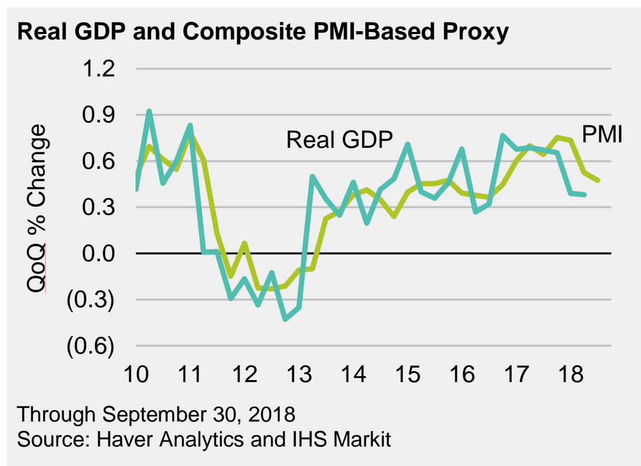
OVERVIEW

Last year the euro-area economy grew by 2.5%, its best performance since 2007 and comfortably above its potential growth rate. The growth rate was due largely to two factors: a highly supportive domestic policy mix and a mini-boom in the global trade cycle. As we move into the second half of 2018, the first of these factors remains as solid as ever but the second is not. That's partly because the global trade cycle has lost momentum. But it's also because the euro area is still quite an open economy and therefore highly exposed to the recent escalation in global-trade tensions.

While a less favorable global backdrop has led to slower growth in the opening months of 2018, recent data suggest this has now stabilized. The composite PMI was little changed at 54.2 in September, only slightly below the average for the previous six months (54.7) and consistent with annualized growth of around 2.0%, an above-trend reading for the euro area.

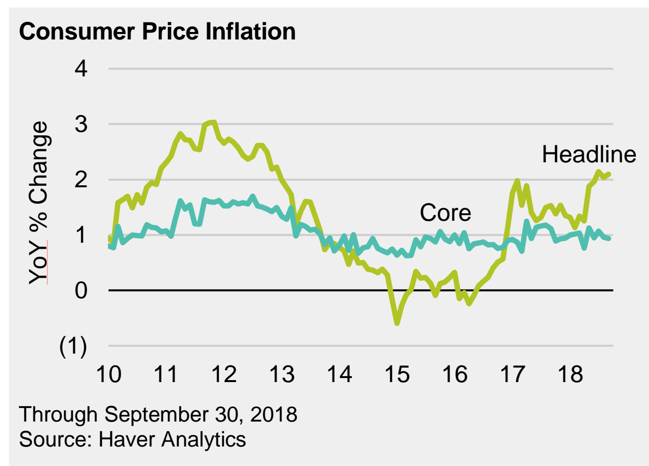
There is also growing evidence that above-trend growth and falling unemployment are feeding through to cost pressures. In the second quarter, annual growth in compensation per employee rose to 2.3%, the biggest increase since 2008 and almost a point higher than the norm between 2012 and 2016. Although core inflation remains muted at around 1.0%, this pickup in wage growth will add to the ECB's confidence that inflation is working largely as expected and that it should therefore continue with a gradual normalization of monetary policy.

Real GDP and Composite PMI-Based Proxy



Through September 30, 2018
Source: Haver Analytics and IHS Markit

Consumer Price Inflation



Through September 30, 2018
Source: Haver Analytics

Japan

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
Japan	1.3	1.1	1.0	1.3	(0.10)	0.00	0.15	0.25	112	105

OUTLOOK

+ External risks related to trade tensions and Chinese growth have increased. But we still think Japan's economy will grow by at least 1%, boosted in part by further fiscal stimulus.
+ If growth holds steady, it should lead to more concrete signs of inflation. Wage increases have started to move in the right direction, but CPI inflation remains far from the BOJ's 2% target.
+ In this environment, the BOJ will probably continue with its QQE-YCC program, designed to cap 10-year yields, in 2019, though small changes are possible.

RISK FACTORS

+ External risks have the most potential to disrupt things, either through trade channels or a sharp appreciation in the yen.

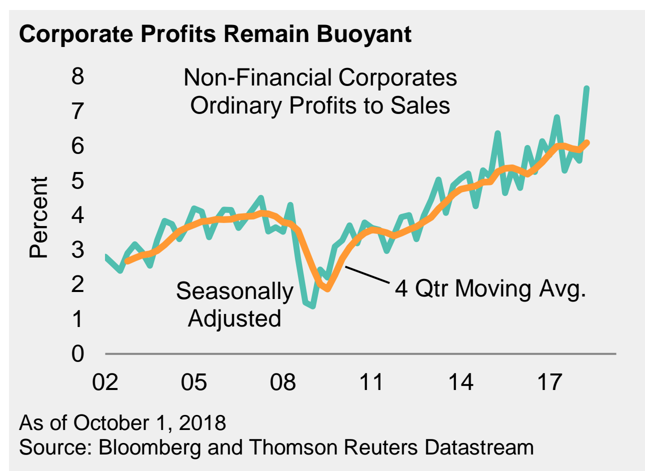
OVERVIEW

Recent Japanese data have been relatively firm. GDP rebounded in the second quarter, increasing 3.0% quarter over quarter (seasonally adjusted) after a soft first quarter, with solid capital spending a key factor. The main reasons: strong corporate profit growth and a desire to substitute capital for workers in a tight labor market. At the same time, labor tightness is now also generating a clear pickup in wage growth, which is a precondition for higher inflation.

Even so, there hasn't been enough price pressure for the BOJ to make any further adjustments to policy. It's only a couple of months since it announced its latest "tweaks" to the QQE-YCC program. Don't expect the BOJ to stop experimenting altogether, though, with YCC. We think some upward adjustment in the 10-year yield target is a plausible scenario over the next 12 to 18 months.

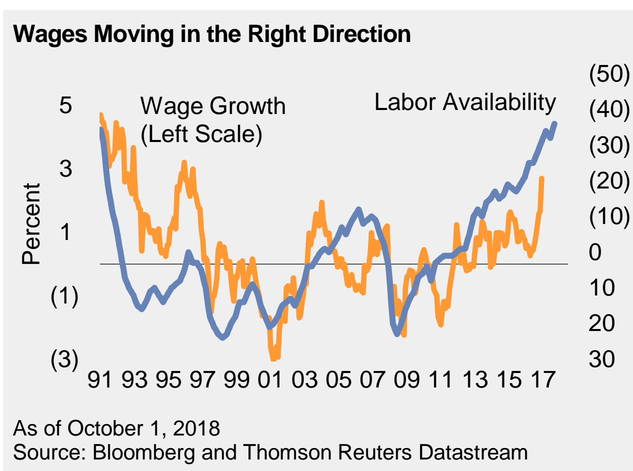
But a likely rise in the VAT in October 2019 could complicate the timing of any such adjustment. In the past, VAT hikes have had an outsize impact on GDP growth. This time around, Prime Minister Shinzo Abe will push ahead with aggressive fiscal stimulus to mitigate that risk.

Corporate Profits Remain Buoyant



As of October 1, 2018
Source: Bloomberg and Thomson Reuters Datastream

Wages Moving in the Right Direction



As of October 1, 2018
Source: Bloomberg and Thomson Reuters Datastream

China

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
China	6.5	6.3	2.3	2.3	4.35	4.35	3.50	3.30	7.00	7.20

OUTLOOK

+ We still think the Chinese economy will be a global economy stabilizer, given the ongoing capex cycle and policy easing. We see it growing by about 6.5%.
+ We expect more monetary and fiscal policy easing later this year and a move from leverage stabilization to deleveraging.
+ The RMB's ability to act as a global currency stabilizer is being eroded by interest rate differentials and rising trade tensions.

RISK FACTORS

+ A lack of timely and meaningful easing in the quarters ahead could darken the outlook for 2019.
+ Vicious circle alert: too much deleveraging in this round of the easing cycle would add further pressure for even more deleveraging in the future.
+ Prolonged and accelerated depreciation would further damage the RMB's role as a global stabilizer.

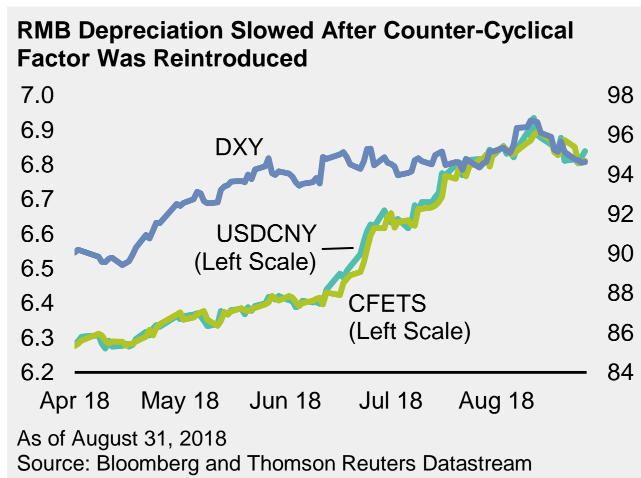
OVERVIEW

Narrowing interest-rate differentials and current account deterioration are putting downward pressure on the RMB. The move by the People's Bank of China (PBOC) to raise the FX forward risk reserve ratio and reintroduce the counter-cyclical factor may slow the pace of deprecation but won't reverse the trend. No doubt the PBOC will try to keep the RMB relatively stable by ensuring a two-way flow and periodically intervening in the market. It may gradually tighten capital controls.

We believe the most effective policy easing would be central government–led investment in key infrastructure projects, such as the accelerated 14th Five-Year Plan projects. It's possible this could lead to overstimulation, but we don't see this as a major risk. Policy measures haven't been as effective lately, mainly because there isn't much more room to add leverage. Also, the economy is becoming more consumption driven. As a result, we think the economy can only stabilize around its current level.

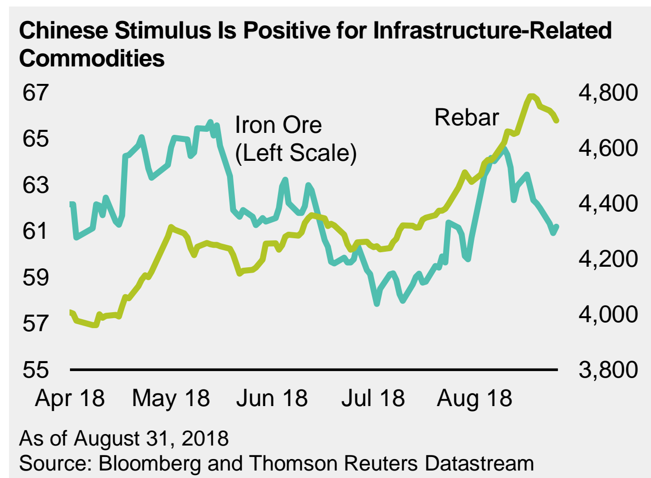
CPI inflation quietly climbed to 2.3% in August. We think there is a 5% probability that China will face stagflation in 2019, and that probability may rise further. Pressure to start importing grains is rising amid trade tension with the US. China gets most of its soybeans from Brazil, so extreme weather in Brazil would be bad news for Beijing. Also, there might be a shortfall of grain inventory in China. The possibility of a shortage, while low now, isn't something the market should neglect, as it would likely push up inflation and make it harder for the PBOC to ease policy further.

RMB Depreciation Slowed After Counter-Cyclical Factor Was Reintroduced



As of August 31, 2018
Source: Bloomberg and Thomson Reuters Datastream

Chinese Stimulus Is Positive for Infrastructure-Related Commodities



As of August 31, 2018
Source: Bloomberg and Thomson Reuters Datastream

Canada

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
Canada	2.5	2.2	2.1	2.3	1.75	2.75	2.60	3.25	1.35	1.40

OUTLOOK

- The Canadian economy continues to chug along, neither accelerating nor slowing. Canada is more vulnerable to restrictive trade policies than most countries, given its openness, so we will continue to watch trade-driven slowdowns.
- Housing markets continue to cool, which should reduce the risk of a housing-induced slowdown that could prove more disruptive than a typical business cycle event. Macroprudential measures seem to be having the desired effect.
- The Bank of Canada (BoC) did not change rates in September, but we expect a 25 b.p. rate hike in October. With inflation close to target and growth solid, gradual rate hikes are the likely path forward for the BoC.

RISK FACTOR

- US trade policy remains the biggest risk to the Canadian economy, given Canada's reliance on trade. The recently agreed framework for trade policy among the US, Canada and Mexico would appear to mitigate downside risks, but businesses may be reluctant to move forward with investment plans until the deal is formally approved.

OVERVIEW

The Canadian economy faces significant risks from the US retreat from free trade, but the good news is that Canada's starting point is solid. Growth is steady, the labor market is strong and stable, and inflation is close to target. That gives the Bank of Canada the capacity to cushion the economy against external risks as needed. In the meantime, the appropriate path of monetary policy in Canada resembles that in the US: gradual rate hikes that try to strike a balance between preventing inflation from accelerating undesirably and avoiding overtightening policy and slowing growth. Over time the trade negotiations are likely to weigh modestly on the Canadian dollar, which could offset some of the negative impacts of potential trade restrictions. More broadly, however, the longer-term outlook still depends very much on how trade negotiations play out, and that remains very much uncertain at this stage.

Australia/New Zealand

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
Australia	3.2	2.3	2.0	2.0	1.50	1.50	2.90	3.15	0.72	0.69
New Zealand	2.8	2.3	1.5	2.0	1.75	1.75	2.85	3.25	0.66	0.62

AUSTRALIA

- Business sentiment remains firm, helped by the end of the mining bust, signs of a turn in nonmining capex and exposure to public sector infrastructure spending. Hiring has been strong.
- Even so, households are under pressure. Wage growth remains at record lows, undermining income growth. House prices are clearly starting to decline. Further tightening of credit availability is likely to be a consequence of the findings of the Banking Royal Commission. And dwelling construction activity is close to a peak.
- While this tension between good and bad economic data will be difficult to resolve clearly, and with global uncertainty increasing, we now think the central bank will be on hold through the end of 2019.

NEW ZEALAND

- The outlook for New Zealand has slipped a little. Business sentiment, for example, continues to drift lower and on some metrics has started to plumb lows not seen since the global financial crisis. At the same time, net migration has peaked, and the labor market has started to soften.
- With inflation low, wage growth relatively soft, and external risks rising, the central bank will likely keep rates unchanged for an extended period.

UK

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
UK	1.4	1.5	2.6	2.1	0.75	1.25	1.75	2.25	1.25	1.30

OUTLOOK

- Recent data suggest that the economy's soft start to the year was a blip. This is particularly apparent in the new monthly GDP series from the Office for National Statistics, which shows the economy expanding by 0.6% in the three months through July. Part of the volatility of recent GDP data has been caused by construction. Indeed, if this is stripped out, the economy has expanded by either 0.3% or 0.4% for the last six quarters and looks set to do something similar in the current quarter.
- Although this represents a step down from the growth rates being achieved before the Brexit referendum, it's important to realize that the referendum result has also damaged the economy's supply potential. As a result, even relatively low rates of demand growth are likely to lead to an increase in domestic inflationary pressure. That's the reason why the Bank of England raised interest rates by 25 basis points at its August meeting and why it is likely to raise rates again in the new year—unless, of course, there is an additional hit to growth from Brexit negotiations.

RISK FACTORS

- The UK outlook continues to be heavily contingent upon the outcome of Brexit negotiations. It is increasingly clear that the government is trying to steer its way toward a soft Brexit, and this remains our central case. However, it will not be easy for the prime minister to deliver this and keep her government intact. The risk of either a hard Brexit or domestic political crisis should therefore not be dismissed.

Norway/Sweden

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
Norway	2.5	2.2	2.4	1.9	0.75	1.25	2.25	2.75	8.26	8.26
Sweden	2.7	2.3	2.0	2.0	(0.50)	0.00	0.75	1.50	9.13	8.91

NORWAY OUTLOOK

- The mainland economy grew by 2.5% year over year in the second quarter, and we expect it to grow at a similar pace over the remainder of the year. Next year, we expect growth to slow somewhat to 2.2%.
- Headline inflation rose to 3.4% in August, well above the Norges Bank's new 2.0% target. More importantly, core inflation (excluding energy and indirect tax changes) has also started to rise and now stands at 1.9%.
- The Norges Bank raised interest rates by 25 basis points at its September meeting but adjusted downwards its forecast for the future interest rate path. It now expects to raise rates at a pace of around 50 basist pints a year to just above 2.0% at the end of 2012.

RISK FACTORS

- The main risk factor for Norway is rising household debt (currently above 200% of income). The economy would also be vulnerable to a rapid decline in the oil price.

SWEDEN OUTLOOK

- Economic growth has been revised down substantially, to 2.5% in the second quarter, from an earlier estimate of 3.3%. As we had already assumed that the economy would slow markedly from the previously published estimate, we are leaving our 2019 growth forecast unchanged at 2.5% (our 2018 forecast does, however, look too optimistic).
- Core inflation was stable at 2.2% in July but was much more subdued at 1.2% excluding energy prices.
- Sveriges Riksbank has signaled that it is likely to raise interest rates by 25 basis points at either its December or February meeting. The downward revision to GDP growth and softer core inflation tilt the balance risks toward the latter.

RISK FACTOR

- High household debt and elevated house prices continue to represent a major risk to financial stability.

Asia ex Japan

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
Asia ex Japan	**6.0**	**5.8**	**2.6**	**2.7**	**4.25**	**4.38**	**4.25**	**4.22**	—	—
Hong Kong	3.0	2.8	3.0	2.6	2.50	2.50	2.40	2.40	7.85	7.85
India	7.6	7.3	4.3	4.7	6.75	7.25	8.40	8.50	73.60	74.20
Indonesia	5.3	5.1	3.2	3.7	6.00	6.50	8.40	8.60	15,100	15,500
South Korea	2.8	2.3	1.6	1.9	1.50	1.50	2.65	3.15	1,120	1,175
Thailand	4.7	4.3	1.5	2.0	1.50	2.00	3.00	3.10	33.00	33.40

OUTLOOK

+ Pressure on Asian currencies will likely remain high as long as US-China trade tension keeps escalating.
+ We expect more hawkish action rhetoric from central banks concerned about currency risk and inflation passthrough, and possibly measures designed to attract inflows and contain onshore demand for US dollars.
+ Asia's external position should remain strong compared with those of other emerging economies.

RISK FACTORS

+ Rising global yields, trade tensions and US-dollar volatility could hurt regional currencies and portfolio flows. Further continued RMB depreciation remains a key factor.
+ Higher oil prices would erode external surpluses and undermine fiscal positions.

OVERVIEW

The US decision to move ahead with another round of tariffs on US$200 billion of Chinese goods did little to improve investor risk appetite. And spillover effects from other EM currencies put further pressure on currencies in Asia, especially those in India, Indonesia and the Philippines—all countries that are running current account deficits and rely on external financing. Another key factor is the movement of the RMB, as further weakness could be another destabilizing factor for Asian currencies.

Central banks in the most vulnerable countries have sounded a more hawkish note in recent communications, which appeared to open the door to additional rate hikes and possibly other administrative measures. India is considering new incentives to attract nonresident Indians' deposit flows, Indonesia has been prioritizing public investments to contain its import bill, and the Philippines has reactivated the Currency Risk Protection Program to reduce US-dollar demand in the onshore spot market.

All in all, the measures introduced so far have been market friendly, and Asian central banks haven't been wasting FX reserves to go against the trend and defend their currencies. The pressure has come mainly from external factors rather than market doubts about the Asian policy response.

It's important to keep in mind that the fundamentals of most Asian economies are stronger than those in other EM countries. Most Asian economies are net savers with current account surpluses, limited reliance on external financing, ample foreign reserves and low fiscal deficits. The large domestic savings accumulated onshore are also likely to buffer their economies against foreign outflows and a rise in global rates.

Economically, trade tensions are starting to hurt manufacturer sentiment, as evidenced by recent declines in new export orders. As a result, the private sector may start to scale back capital expenditure plans. Export-oriented economies (South Korea, Taiwan) will likely prove most sensitive to trade tension.

Latin America

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
Latin America	**0.8**	**1.6**	**8.4**	**6.8**	**13.72**	**10.60**	**9.39**	**9.11**	**—**	**—**
Argentina	(2.0)	(0.2)	40.0	28.0	60.00	35.00	—	—	42.00	50.00
Brazil	1.5	2.3	4.0	4.1	6.50	7.75	11.60	10.90	4.00	4.05
Chile	4.0	3.9	2.9	3.0	3.00	4.00	4.95	5.05	660	670
Colombia	2.4	2.7	3.5	3.8	4.50	5.00	7.00	7.15	2,990	3,020
Mexico	2.1	2.0	4.1	4.0	7.50	7.00	8.00	8.10	19.50	20.30

OUTLOOK

+ The environment for EM assets is still challenging because of higher US interest rates, an appreciating US dollar and protectionist US trade policy. Even so, flows to dedicated EM funds were positive during the quarter.

RISK FACTORS

+ Tighter global monetary policies, heightened US protectionism, global geopolitical concerns, an appreciating US dollar and idiosyncratic political shocks in Brazil and Venezuela remain risks.

OVERVIEW

Regional economic activity has improved relative to 2017, but the recovery will be softer than expected, as Brazil's consensus growth forecasts have been revised downward and Argentina has entered what looks like a deep recession. Mexico's growth remained stable despite uncertainty associated with NAFTA negotiations and the presidential election. Output remains down sharply in Venezuela. Inflation is well above target in Argentina, while Venezuela is in hyperinflation. In the rest of the region, inflation rates remain subdued, although weakness in most regional currencies will likely generate some pass-through to domestic prices in the coming months. Consequently, that should spell the end of most monetary easing cycles across the region.

In Argentina, the announcement of a US$50 billion three-year stand-by agreement with the IMF failed to stop the slide in the peso. The central bank reacted by hiking interest rates aggressively. The authorities negotiated the frontloading of the IMF quarterly disbursements and an increase in the size of the program to assuage investors' concerns about debt rollover in the coming months. In exchange, Argentina committed to reaching a balanced primary budget in 2019 and to adopting a very tight monetary policy stance. Economic activity is decelerating rapidly, although a soft recovery could occur after the second quarter of 2019, on the back of an expected rebound in agricultural production.

In Brazil, we expect political uncertainty to remain until the second round of the presidential election takes place later in October. Former President Luiz Inácio Lula da Silva leads in the polls despite being banned from running because of corruption. Right-wing candidate Jair Bolsonaro, the poll leader when Lula is excluded, remains in the hospital after being stabbed on the campaign trail. Voters aren't likely to make strategic voting decisions until very late in the campaign, but it looks as though former São Paulo mayor Fernando Haddad (Lula's replacement) and Bolsonaro will advance to the second round.

The US, Mexico and Canada reached a preliminary agreement on a revised free trade pact. Congressional endorsement of the deal, however, will likely take place in 2019, when the makeup of the US and Mexican legislatures is likely to be different.

Eastern Europe, Middle East and Africa (EEMEA)

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
EEMEA	**2.8**	**1.8**	**6.8**	**6.2**	**10.54**	**9.70**	**10.73**	**10.04**	**—**	**—**
Hungary	3.8	3.2	2.7	3.0	0.90	1.50	3.60	3.95	250	242
Poland	4.5	3.5	2.2	2.5	1.50	1.75	3.60	4.20	4.25	4.15
Russia	1.8	1.6	3.5	4.3	7.25	6.75	8.50	8.00	70.00	65.00
South Africa	0.6	1.2	4.6	5.6	6.75	7.25	9.50	9.25	15.00	14.50
Turkey	3.0	(2.0)	16.6	15.6	24.00	22.00	20.00	18.50	7.10	6.90

OVERVIEW

+ Real GDP growth should remain strong in most of the EEMEA region in 2019, though a sharp slowdown in Turkey might knock it off its 2018 pace.
+ Most Central and Eastern European (CEE) economies are experiencing a rebound in headline CPI, which is likely to peak in mid-2019. After recent FX depreciation, Turkish headline inflation dynamics remain the most challenged, and CPI is set to peak now at around 25% in 2019.
+ Despite the CPI rebound, central banks in several CEE countries will not tighten monetary policy significantly near term.

RISK FACTORS

+ Balance-sheet normalization at DM central banks and the potential for higher core yields are risks for current account deficit countries such as Turkey and, to a lesser extent, South Africa.

OVERVIEW

The Turkish government's medium-term plan (MTP) was more form than substance. While communication and the finance minister's policy intentions became much clearer, the overall MTP is not internally consistent and therefore faces huge execution risks, in our view. Positively, the Finance Ministry's outreach to investors shows that the ministry has started to work more seriously on investor communication. This may be an indication that communication and accessibility will improve after the chaos over the past few months. An external consultancy was clearly involved in preparing the presentation, especially the ministry's restructuring and revenue measures. It would be positive if the government were to take external advice in other policy areas (such as the "bad bank") on a sustainable basis.

That said, the biggest inconsistency in the plan is the simultaneous increase in growth and the primary surplus in 2020 and 2021, considering the stage of the cycle we're in. This would make sense if the economy were able to generate strong, healthy growth that allowed the authorities to take countercyclical fiscal measures. However, with growth under substantial pressure at this point and the significant risks of a prolonged balance-sheet recession among companies (given their high leverage levels), where will this incremental boost to growth come from? The likelihood of negative growth next year, followed by near-zero growth for years after that, is very high. This environment is not conducive to running higher primary surpluses.

The implication of the above is that all the ministry's promises of revenue optimization and expenditure cuts for 2019–2021 may be scaled back quickly, and the fiscal framework may not be executed the way in which it was presented. While the finance minister promised a scaling back of investment projects, he stated that mega projects will continue as a way to support growth. If that's true, this represents very little change in Turkey's underlying growth model.

Frontier Markets

OUTLOOK

+ We expect the Nigerian (NGN) and Egyptian (EGP) currencies to drift sideways over the next six months, but the risks to rates remain to the upside.
+ Costa Rica's liquidity crisis was caused by political gridlock and policy mismanagement. If fiscal talks break down in the coming weeks, financing options will become increasingly expensive.

RISK FACTORS

+ The stability of two key frontier currencies, the one underpinned by oil (NGN) and the other largely underpinned by remittances and tourism flows (EGP), points to potential policy rather than fundamental FX anchors.
+ Global liquidity is a factor in funding ability for every country. A pullback in liquidity will further complicate Costa Rica's funding situation, as well as that of other externally vulnerable frontier markets.

OVERVIEW

The currencies of the two biggest frontier African economies have continued to drift sideways amid broad-based EMFX weakness. The NGN and the EGP went through meaningful devaluations in 2016 (the NGN lost further ground in 2017), and they are currently about 80% (NGN) and 100% (EGP) weaker against the US dollar compared to early 2016. These currency devaluations—and the resultant IMF program in Egypt's case—contributed meaningfully to rocketing foreign appetite for local debt instruments. The central banks made hay while the sun was shining, with Nigerian reserves rising from about US$25 billion in 2016 to a recent high of almost US$50 billion, while Egypt's reserves increased from US$17 billion to approximately US$45 billion over this period. But foreigners have been liquidating their local debt positions over the past few months, and the pressure is starting to show in the reserve numbers. The value of the local currency and the level of reserves are always key economic barometers in these countries, but the forthcoming elections in Nigeria (February 2019) and the fact that Nigeria's reserves are already trending lower could lead to a relatively pronounced near-term policy response (tightening) from the Central Bank of Nigeria.

Costa Rica is resorting to "emergency financing" to temporarily solve its liquidity crisis. Ongoing debates about fiscal reform have closed Costa Rica's access to the external market and have forced policymakers to close the financing gap via the domestic market—putting pressure on local yields. To contain local yields, the government chose to use an emergency measure, a three-month loan from the central bank, until longer-term financing, in both the domestic and external markets, can be secured. While the goal of the measure was to provide assurance to the market about the country's liquidity position, in reality it had the opposite effect. Investors have become increasingly concerned about Costa Rica's ability to finance itself and about the potential for a necessary fiscal reform package to be passed in the coming weeks. It will be important to watch the developments in the fiscal reform discussions: if talks break down or legal challenges emerge, we will start to become more concerned about the likelihood that the government will be able to repay the emergency loan back to the central bank in December.

	Real Growth (%)		Inflation (%)		Official Rates (%)		Long Rates (%)		FX Rates vs USD	
	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F	2018F	2019F
Global	3.1	2.9	2.9	2.9	3.27	3.44	3.44	3.71	-	-
Industrial Countries	2.2	1.9	1.9	2.1	1.23	1.78	2.03	2.53	-	-
Emerging Countries	4.7	4.5	4.7	4.2	7.20	6.55	6.24	6.00	-	-
United States	2.5	2.3	2.3	2.5	2.38	3.38	3.25	3.75	-	-
Canada	2.5	2.2	2.1	2.3	1.75	2.75	2.60	3.25	1.35	1.40
Europe	2.0	1.6	1.9	1.8	0.13	0.43	0.98	1.67	-	-
Euro Area	2.1	1.6	1.8	1.8	0.00	0.25	0.75	1.50	1.15	1.15
United Kingdom	1.4	1.5	2.6	2.1	0.75	1.25	1.75	2.25	1.25	1.30
Sweden	2.7	2.3	2.0	2.0	(0.50)	0.00	0.75	1.50	9.13	8.91
Norway	2.5	2.2	2.4	1.9	0.75	1.25	2.25	2.75	8.26	8.26
Japan	1.3	1.1	1.0	1.3	(0.10)	0.00	0.15	0.25	112	105
Australia	3.2	2.3	2.0	2.0	1.50	1.50	2.90	3.15	0.72	0.69
New Zealand	2.8	2.3	1.5	2.0	1.75	1.75	2.85	3.25	0.66	0.62
Asia ex Japan	6.0	5.8	2.6	2.7	4.25	4.38	4.25	4.22	-	-
China	6.5	6.3	2.3	2.3	4.35	4.35	3.50	3.30	7.00	7.20
Hong Kong	3.0	2.8	3.0	2.6	2.50	2.50	2.40	2.40	7.85	7.85
India	7.6	7.3	4.3	4.7	6.75	7.25	8.40	8.50	73.60	74.20
Indonesia	5.3	5.1	3.2	3.7	6.00	6.50	8.40	8.60	15,100	15,500
Korea	2.8	2.3	1.6	1.9	1.50	1.50	2.65	3.15	1,120	1,175
Thailand	4.7	4.3	1.5	2.0	1.50	2.00	3.00	3.10	33.00	33.40
Latin America	0.8	1.6	8.4	6.8	13.72	10.60	9.39	9.11	-	-
Argentina	(2.0)	(0.2)	40.0	28.0	60.00	35.00	-	-	42.00	50.00
Brazil	1.5	2.3	4.0	4.1	6.50	7.75	11.60	10.90	4.00	4.05
Chile	4.0	3.9	2.9	3.0	3.00	4.00	4.95	5.05	660	670
Colombia	2.4	2.7	3.5	3.8	4.50	5.00	7.00	7.15	2,990	3,020
Mexico	2.1	2.0	4.1	4.0	7.50	7.00	8.00	8.10	19.50	20.30
EEMEA	2.8	1.8	6.8	6.2	10.54	9.70	10.73	10.04	-	-
Hungary	3.8	3.2	2.7	3.0	0.90	1.50	3.60	3.95	250	242
Poland	4.5	3.5	2.2	2.5	1.50	1.75	3.60	4.20	4.25	4.15
Russia	1.8	1.6	3.5	4.3	7.25	6.75	8.50	8.00	70.00	65.00
South Africa	0.6	1.2	4.6	5.6	6.75	7.25	9.50	9.25	15.00	14.50
Turkey	3.0	(2.0)	16.6	15.6	24.00	22.00	20.00	18.50	7.10	6.90

Long rates are 10-year yields unless otherwise indicated.
Latin American Rates include Brazil, Chile, Colombia and Mexico
Real growth aggregates represent 48 country forecasts not all of which are shown
Blanks in Argentina are due to distorted domestic financial system so are not forecast.

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