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MACROECONOMIC FORECASTS



GLOBAL GROWTH

is steady at a disappointing pace

CENTRAL BANKS

still have munitions...

THE BIG SURPRISE

is the boom in public spending



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INTRODUCTION

GLOBAL GROWTH: NO GAME PLAN OR A NEW GAME?



Low interest rates reflect the expectation of sluggish global expansion



Central banks can always go a step further as the ECB recently demonstrated



The world economy should be underpinned by growing liquidity, rising public spending and stabilising commodity prices, but at the cost of mounting debt

Mathilde Lemoine
Group Chief Economist

Global growth was unable to withstand the first hike in interest rates by the US Federal Reserve (Fed) in December (Figure 1). The resulting appreciation in the dollar has weighed on America's exports and prompted massive capital outflows from the emerging countries. In the first two months of 2016 the central bank of China was forced to spend \$128 billion of its forex reserves to prevent a disorderly depreciation of the yuan.

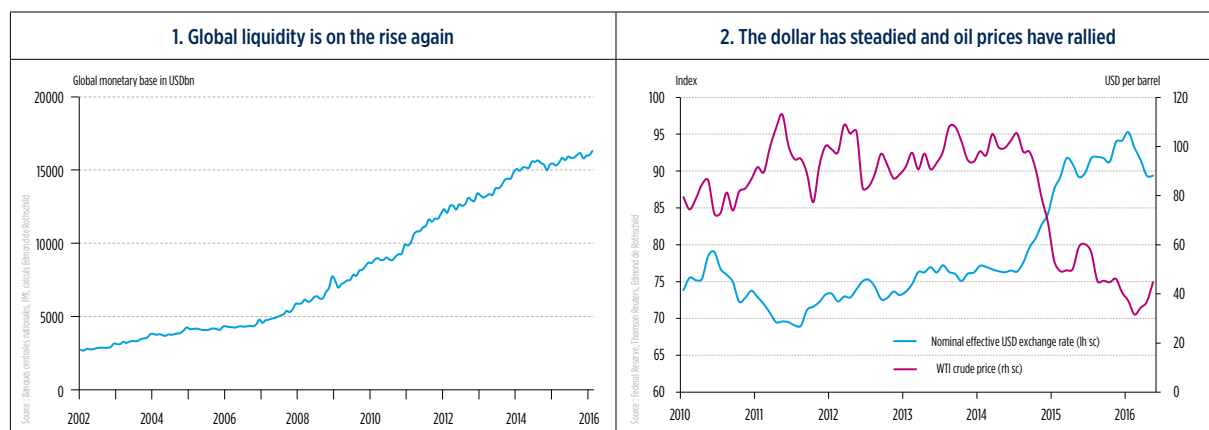
Once again, macroeconomic fundamentals proved too weak to withstand a normalisation of US monetary policy. After revising its long-term target for US interest rates downward a number of times, the Fed flip-flopped by announcing that the pace and scale of further hikes would be much smaller than expected. The European Central Bank (ECB) then surprised the markets by deciding to step up its bond purchases from EUR 60 billion to EUR 80 billion a month and, in particular, by extending the programme to include the bonds of non-financial corporations. Finally, the People's Bank of China (PBoC) injected more liquidity.

Thus, central banks have yet again ridden to the rescue of their governments. Global liquidity rose by a hefty 14% year on year in the first quarter of 2016 (Figure 1). The Bank of Japan (BoJ) moreover took the plunge by introducing negative interest rates while the ECB lowered its deposit rate further into negative territory, to -0.40%. As a consequence over 40% of the sovereign bonds issued in the Euro Zone now bear negative interest. In Germany Bund yields are now below zero on maturities up to eight years.



Thanks to these moves by central banks to shore up the global economy, the dollar steadied, capital flowed back into the emerging countries and oil prices rallied (Figure 2).

Meanwhile, after a long hiatus governments have started indulging in public spending again to boost expansion. In most of the developed countries this made a positive contribution to first-quarter GDP growth.



Negative interest rates: an act of despair or a monetary policy instrument?

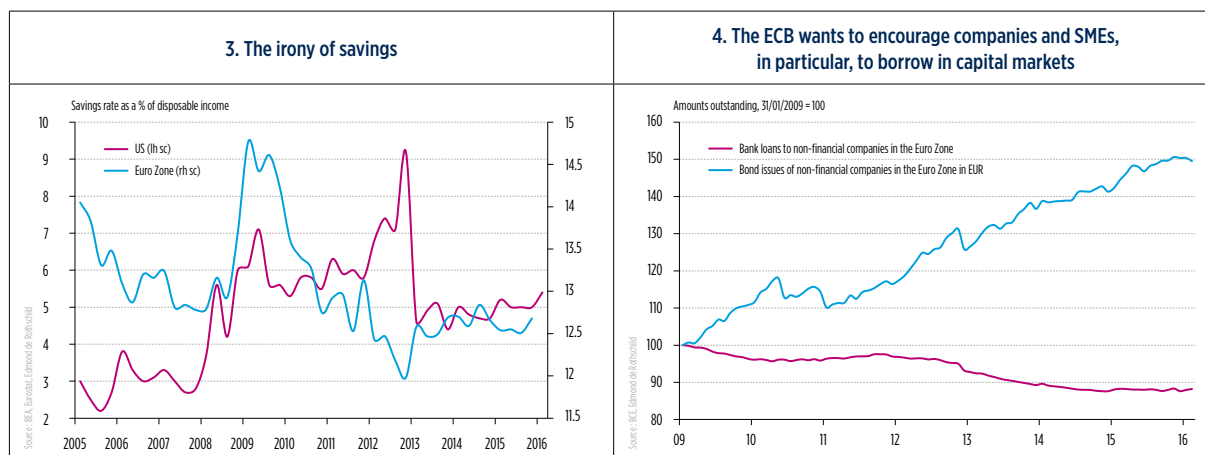
Following the lead of Sweden's Riksbank, the central banks of Denmark, Switzerland and Japan and the ECB have introduced negative interest rates one by one. Their aim is to weaken their currency relative to others and bring down real interest rates despite falling inflation. Until 2009 the mere idea of nominal interest rates on domestic deposits being below zero was inconceivable, since it means that time no longer has any value and that it pays to squander resources. In Keynesian terms, a room full of cash would be preferable to all other forms of investment.

Besides depreciating their currencies, central banks are testing this gambit to make consumers dip into their savings and spend. They also expect a pickup in business investment. The outcome is uncertain, however, as we are in uncharted territory. The zero interest rate policy was first mooted by the 19th-century German economist Silvio Gesell, a follower of Proudhon referred to by Keynes as a "strange prophet", who saw negative rates as a way to prevent money- hoarding and eliminate the rent on capital.

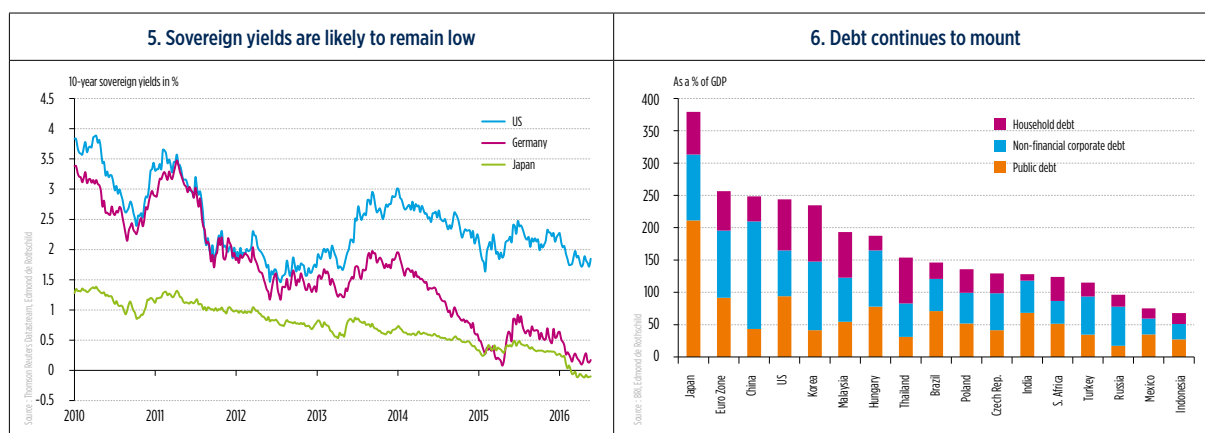
The impact of a negative cost of money on exchange rates is already starting to fade as the policy is introduced more widely. Since differentials between interest rates are narrowing, the relative changes in currencies' values are smaller. The most striking example of this was the yen's appreciation just after the BoJ announced it would start charging negative interest on a portion of commercial banks' deposits. In this case it was the prospect of capital gains on Japanese bonds and the extremely low carry cost of the yen that attracted foreign investors.

Moreover the current upswing in consumption is more the result of higher disposable incomes, thanks to the recent plunge in oil prices, than lower interest rates. Savings even continue to rise. In March America's national savings rate climbed to 5.4%, France's to 15.9% and Germany's to 9.6% (Figure 3).

To boost capital investment, the ECB is of course providing liquidity to banks but it has also had to encourage companies to borrow directly in capital markets. The fact that Eurosystem chose not to cap the amount of private debt that could be bought by the ECB should prompt SMEs in the Euro Zone to issue their own bonds. We therefore expect this segment of Euroland's debt markets to grow alongside the volume of bank loans to the corporate sector (Figure 4).



While negative interest rates are considered a monetary policy instrument by the central banks that apply them, they are also a reflection of weak GDP growth. This supports the contention that we are seeing secular stagnation (i.e. that a virtuous cycle of expansion is not kicking in) because capital investment is not profitable enough and not because of sluggish demand. For economic activity to be robust productivity has to increase, not decrease. According to the OECD its rate of growth has slowed to 6.5% in China, 1.7% in the US, 0.9% in the Euro Zone, 0.7% in Japan and 0.4% in Switzerland. This is due not only to population ageing but also to obsolescence in some segments of industry. The upshot is that, as long as governments fail to implement economic policies designed to enhance productivity, central banks have no choice but to keep taking the process of financing growth with debt a step further. Interest rates are therefore likely to remain low and debt ratios to go on escalating (Figures 5 and 6).



Mortgage business and sovereign debt are set to expand

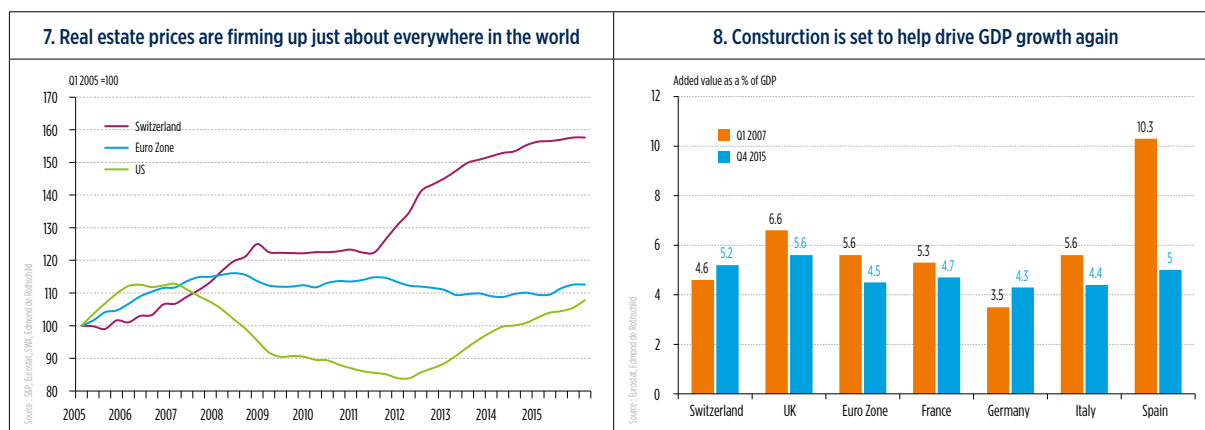
Monetary policies should help fuel economic activity worldwide in the coming quarters, particularly in the Euro Zone and China. The situation is different in the US, where on the face of it GDP growth has already reached its post-subprime cruising speed.

The recent monetary easing measures taken by the PBoC and the ECB are already providing benefits. In the Euro Zone money supply M3 has grown 5% since the beginning of the year. In China M2 is expanding at 13.6% a year, exceeding the PBoC's 13% target rate. Lending in the private sector is up more than 1% year to date in the Euro Zone after declining in 2015.

However, monetary easing is expected to benefit mortgage business and sovereign debt primarily and this could weigh on growth potential. The reason is that productivity in construction and the public sector is lower on average than in industry. As a consequence, increasing these sectors' contribution to overall GDP reduces growth potential even if it helps boost the current cycle. Moreover it increases the risk of asset bubbles.



Driven by negative interest rates and the liquidity provided to commercial banks, real-estate prices should continue to climb in the coming quarters. The Case-Schiller index, which tracks house prices in major US cities, is up 5.4% year on year. The rate is 6.2% in China, nearly 7% in Germany and 2.9% in the Euro Zone as a whole. Construction should therefore make a positive contribution to 2017 GDP (Figures 7 and 8).



Given the failure of capital investment to take off and the recent G20 discussions on budget policies, public spending has been called back from retirement and put to work. The most ardent supporters of coordinated fiscal stimulus at the global level are Japan and France, which is unsurprising as Japan's growth rates almost invariably disappoint while in the Euro Zone consumer prices were down another 0.2% in April.

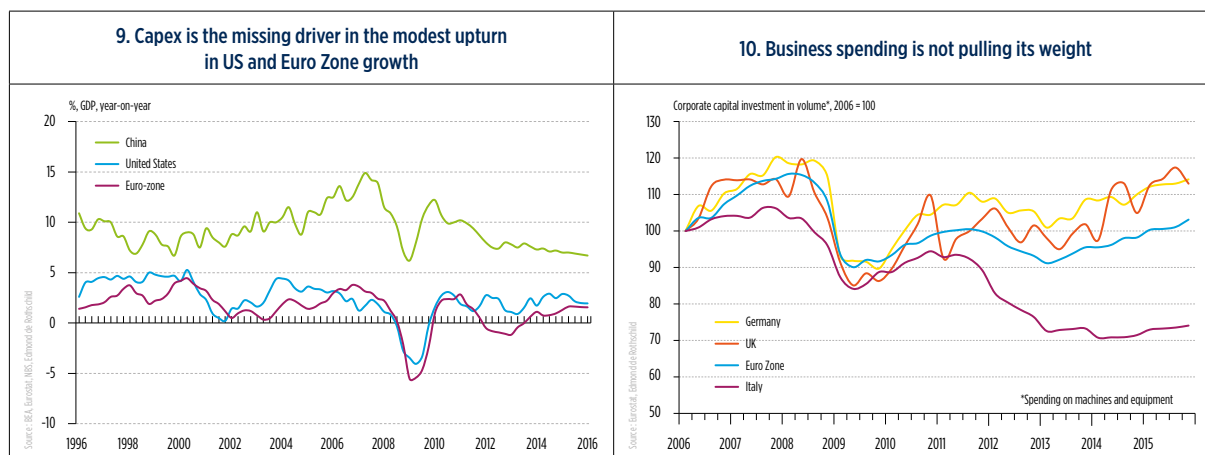
Rather than boosting productivity with policies aimed at spreading innovation and encouraging workers to adapt to economic changes, governments are resorting to old-school methods by increasing public expenditure instead.

Euroland governments are enjoying lower corporate bond yields and taking advantage of the new flexibility afforded by a reinterpretation of the Stability and Growth Pact. This allows them to put off reducing part of their structural deficit (i.e. the portion unaffected by the economic cycle). In the US the budget agreements reached at end-2015 provide for nearly USD 300 billion of infrastructure spending by 2021 and a higher general cap on federal expenditure. According to forecasts, this could add 0.3 of a percentage point to US GDP growth in both 2016 and 2017. Meanwhile, at the last National People's Congress the Chinese government announced a budget deficit equivalent to 3.0% of GDP for the current year after a shortfall of 2.3% in 2015. This largesse is due not only to increased spending on infrastructure and construction but also to reductions in the corporate tax on SMEs and the sales tax. Social security expenditure will also be higher than expected following a hike in pensions and the creation of a retraining fund for factory workers.

Corporate investment and international trade remain sluggish

Business spending is the missing driver in the modest upswing that can be observed in the US and the Euro Zone. Unlike in previous post-recession recoveries, capex has not bounded ahead to win lost ground. In the US it did not return to its pre-financial crisis level until 2014 and has risen only moderately since. In the Euro Zone spending on plant and equipment is still running 10% below its pre-crisis level (Figures 9 and 10). The pickup in lending does not mean that capex is rebooting as was illustrated by developments in the US, where the increase in loans to businesses merely triggered stock buybacks and more systematic dividend pay-outs. These practices were denounced by former Fed Chairman Ben Bernanke because of the asset bubbles they encouraged.

Capital investment is not only driven by companies' order books. It also depends on the difference between its cost and expected profitability. With this latter factor declining as forecasts of global economic growth are revised downward, central banks have no choice but to lower nominal interest rates to encourage corporate spending. Their aim is to increase the number of profitable investment projects by reducing the cost of borrowing. The problem is that, while interest rates are low due to the glut of savings set aside by ageing populations, they are still too high. This points to further monetary easing.



A lacklustre outlook... and a rising debt load

Global growth will likely edge up in the second half of 2016. But it will not be at all steady or sustainable because it will be fuelled by mounting private and public debt.

Despite this central banks' actions should ensure that the cost of money remains low. Debt is worrisome but it is also a form of insurance against falling asset prices. The higher corporate debt goes, the more devastating a drop in stockmarket values could be. The higher public debt goes, the more unbearable rising sovereign yields become. As regards the risk of an upturn in inflation expectations, this depends on the recovery in commodity prices and the resurgence of public spending. Yet long-term sovereign yields are now being shaped by unconventional monetary policies. Central banks are administering a needle. They are manipulating asset prices, prompting a misallocation of resources which itself jeopardises the chances of "price taker" companies making a profit.

In these unstable, volatile conditions, the only reliable compass we have is productivity. The countries best equipped to weather this period without too much difficulty are those whose governments are introducing reforms designed to boost innovation and its penetration by investing in training and education. The companies best equipped to respond adequately to change are those with pricing power. Adapting to the new global playing field without seeking pre-crisis points of reference is the best way to forge ahead in these virgin monetary and financial territories



OUR GROWTH FORECASTS

GDP GROWTH IN VOLUME (%)	2013	2014	2015	2016f	CONSENSUS	2017f	CONSENSUS
US	1.5	2.4	2.4	1.9	1.8	2.2	2.3
Japan	1.4	-0.1	0.6	0.7	0.5	1.3	0.5
Euro Zone	-0.2	0.9	1.5	1.7	1.5	1.1	1.6
Germany	0.4	1.6	1.4	1.6	1.6	1.2	1.6
France	0.6	0.6	1.3	1.4	1.4	0.9	1.4
Italy	-1.8	-0.3	0.6	1.1	1.0	1.1	1.2
Spain	-1.7	1.4	3.2	2.8	2.7	2.2	2.3
Portugal	-1.1	0.9	1.5	1.2	1.3	1.6	1.5
Luxembourg	4.4	4.1	4.9	3.7	3.2	4.1	3.0
Europe ex Euro Zone							
United Kingdom	2.2	2.9	2.3	1.3	1.9	1.2	2.1
Switzerland	1.8	1.9	0.9	1.1	1.2	1.2	1.6
Sweden	1.2	2.4	3.8	3.6	3.5	2.9	2.7
Israel	3.2	2.7	2.5	2.8	2.8	3.0	3.3
Emerging countries							
China	7.7	7.3	6.9	6.4	6.5	6.0	6.3
Brazil	3.0	0.1	-3.9	-4.3	-3.8	0.7	0.8
India	6.3	7.0	7.3	7.5	7.5	7.3	7.7

OUR INFLATION FORECASTS

CPI (%)	2013	2014	2015	2016f	CONSENSUS	2017f	CONSENSUS
US	1.5	1.6	0.1	1.3	1.3	2.3	2.2
Japan	0.4	2.7	0.8	0.2	0.2	0.6	1.7
Euro Zone (IPCH)	1.4	0.4	0.0	0.2	0.3	1.1	1.4
Germany	1.6	0.8	0.1	0.5	0.4	1.3	1.6
France	1.0	0.6	0.1	0.3	0.2	0.8	1.3
Italy	1.2	0.2	0.1	0.1	0.1	0.8	1.2
Spain	1.5	-0.2	-0.6	-0.1	-0.3	0.9	1.3
Portugal	0.4	-0.2	0.5	0.6	0.6	1.3	1.2
Luxembourg	1.7	0.7	0.1	0.7	1.4	1.4	2.0
Europe ex Euro Zone							
United Kingdom	2.6	1.5	0.0	0.7	0.7	1.7	1.7
Switzerland	-0.2	0.0	-1.1	-0.5	-0.5	-0.1	0.3
Sweden	0.4	0.2	0.7	0.9	0.9	1.5	1.7
Israel	1.5	0.5	-0.6	-0.3	0.0	1.2	1.4
Emerging countries							
China	2.6	2.0	1.4	2.1	2.0	2.4	2.0
Brazil	6.2	6.3	9.0	8.9	8.5	7.3	6.0
India	9.9	6.7	4.9	5.1	4.9	4.8	5.1



OUR MONETARY POLICY FORECASTS

KEY INTEREST RATES (%)	2013	2014	2015	2016f	CONSENSUS	2017f	CONSENSUS
US	0.25	0.25	0.50	1.00	0.90	1.75	1.40
Japan	0.10	0.10	0.10	-0.10	-0.10	-0.10	-0.10
Euro Zone	0.25	0.05	0.05	0.00	0.00	0.00	0.00
Europe ex Euro Zone							
United Kingdom	0.50	0.50	0.50	0.50	0.55	0.50	0.96
Switzerland	0.00	-0.25	-0.75	-1.00	-0.75	-1.00	-0.70
Sweden	0.75	0.00	-0.35	-0.50	-0.50	0.00	-0.30
Israel	1.00	0.25	0.10	0.10	0.15	0.50	0.25
Emerging countries							
China	6.00	5.60	4.35	3.85	4.05	3.35	4.10
Brazil	10.00	11.75	14.25	14.00	13.55	13.50	11.50
India	7.75	8.00	6.75	6.50	6.35	6.50	6.30

OUR EXCHANGE RATE FORECASTS

EXCHANGE RATES	2013	2014	2015	2016f	CONSENSUS	2017f	CONSENSUS
Dollar							
EUR/USD	1.37	1.20	1.08	1.08	1.12	1.04	1.12
USD/JPY	105	120	120	116	115	121	116
GBP/USD	1.66	1.56	1.47	1.35	1.48	1.39	1.52
USD/CHF	0.89	0.99	1.00	1.00	1.01	1.00	1.03
USD/CNY	6.05	6.21	6.49	6.7	6.65	6.9	6.73
Euro							
EUR/JPY	144	144	130	125	129	126	130
EUR/GBP	0.83	0.77	0.73	0.80	0.76	0.75	0.74
EUR/CHF	1.23	1.20	1.09	1.08	1.13	1.04	1.13
EUR/SEK	8.85	9.44	9.17	9.53	9.00	9.60	8.85

*Data at end of period





UNITED STATES



We expect the US economy to grow 1.9% in 2016 and 2.2% in 2017



Capital investment and foreign trade will likely make a negative contribution to overall expansion



But private consumption will remain robust and the government will increase spending

Lisa Turk

Economist, United States

The recession worries that emerged early this year have faded. While industrial production is still in negative territory, this is mainly because of the slump in the oil industry. But with energy accounting for just 2.3% of America's overall GDP, there is no threat of a knock-on effect in other sectors. We have nevertheless revised our forecasts for US growth downward, chiefly because of flagging capex and inventory drawdowns. Our revision is moderate, however, because other components of GDP such as consumption and government expenditure continue to fuel overall expansion. We expect the economy to grow 1.9% this year and 2.2% in 2017. These levels are quite close to potential growth, which has declined to 2% since the 2008 financial crisis.

We expect capital spending to fall noticeably between now and the end of 2016. The biggest drop will be seen in non-residential investment, i.e. in companies' spending on structures and equipment. This comes against a backdrop of declining production in the mining sector and stagnation in manufacturing. As a consequence capacity utilisation in industry continues to ebb and stood at 74.8% in March this year. This is 5.2 percentage points below the long-term average (80%), the level above which companies normally start investing in new plant and equipment. As long as the expected profitability of investments remains low, companies will continue to prefer buying back their own shares. Tighter credit conditions and rising wages, due to strains in the US labour market, are other obstacles that will deter executives from borrowing to finance business expansion.

Meanwhile inventories have been building up in the past two years and now stand at their highest level since 1950. This will put persistent drag on GDP growth in the coming quarters.



Foreign trade, finally, will continue to weigh on total output of goods and services as well. This will be due in part to the combined impact of dollar strength and sluggish economic activity worldwide, although these factors will be milder than they were last year. The greenback has stopped appreciating in recent months, but it will move up again somewhat between now and end-2016 as the Fed tightens while other central banks apply ultra-accommodative monetary policies. On the imports side of the equation, strong US personal expenditure will continue to drive up consumption of foreign goods. The end result will be a negative contribution to GDP growth from both sides of the trade balance.

Despite these strong headwinds, numerous other factors will enable economic activity in the US to make headway. The first of these is private consumption. Admittedly growth in retail sales is not quite as strong as anticipated, mainly because car buying has slowed down after last year's frenzy, but personal expenditure will remain the main engine of US expansion with a 2.5% increase in 2016. Spending in other sectors such as healthcare and online commerce will lead the charge. Although consumer sentiment has ebbed a bit in recent months, it remains buoyant. Since the beginning of the year 15 states have raised their minimum wage by an average of 8%. This will also have a positive impact on spending by US households, which already have the highest propensity to consume in the world.

Easier credit conditions will moreover encourage consumers to borrow to buy homes or big-ticket items. New home sales and new building permits are climbing steadily, with demand for housing outstripping supply. Residential investment will provide strong support for overall GDP growth.

As if according to a carefully laid plan, the US government is stepping up its expenditure just as the Fed tightens monetary policy. Whereas weak public spending dragged down growth between 2010 and 2014, the budget agreement reached at end-2015 will now shore up the economy. The sums being committed are large: the federal Highway Bill provides for USD 280 billion of infrastructure investment over five years (construction and maintenance of railways, roads, etc.). Compared with past programmes this one will represent an additional USD 30 billion by 2021. Other public spending will be increased by USD 80 billion over the next two years, divided equally between military and non-military outlays. Thus the ceiling created by the famous sequester on federal expenditure in 2011 has been raised. These two additional allocations will boost US GDP by 0.3%, a precious contribution that will bring overall expansion to 1.9% this year.

What is more, the US labour market is in fine fettle and should stay that way. While not many jobs are being created in industry, the number in services is impressive. The tertiary sector, which generates 68% of US GDP, is creating jobs at an average rate of 200,000 a month, far more than the 100,000 that are needed to absorb new workers entering the labour market. The unemployment rate has reached a new low of 5% and, although the participation rate is also low (it stood at 62.8% in April), this generally healthy situation should keep domestic consumption and the housing market buoyant. We expect the US jobless rate to ease further, to 4.6%, in the second half of 2016. Wages should increase as a consequence throughout the year.

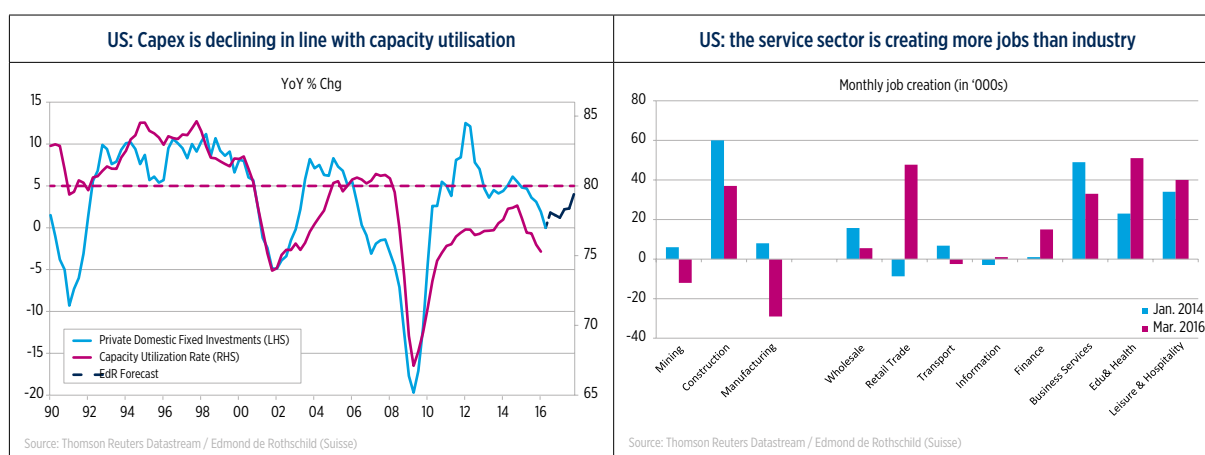
Inflation will get a leg up from the strength of job creation and consumption. Based on the assumption that oil prices will steady at an average of USD 38 a barrel, US headline inflation should range around 1% until August and then jump

2.10%

core inflation (ex food and energy prices) year on year



above 2% by end-2016. Core inflation (ex energy and food prices) is already above the Fed's 2% target rate and is set to stay in that neighbourhood. The Fed is deliberately "behind the curve", i.e. late in relation to the economic cycle, and is likely to be unfazed by the impending leap in headline inflation in the second half of the year. Taking other factors like the dollar, financial markets and the international economic environment into account, we believe the US central bank will decide to raise its federal funds rate twice this year and three times in 2017. As a consequence the 2-year Treasury yield will probably reach 1.7% by end-2016 and the 10-year yield 2.4%, resulting in a flatter interest rate curve.



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP	1.5	2.4	2.4	2.0	1.7	1.8	1.9	1.9	1.8	1.8	2.3	2.0	2.6	2.2	2.3	
GDP (% change qoq)	-	-	-	0.2	0.6	0.6	0.5	0.5	-	0.1	1.1	0.4	1.0	0.7	-	
Private consumption	1.7	2.7	3.1	2.7	2.2	2.4	2.6	2.5	2.6	2.5	2.8	2.7	3.0	2.7	2.5	
Public consumption	-2.9	-0.6	0.7	1.4	2.1	1.8	1.7	1.7	1.3	1.7	1.9	1.6	2.1	1.8	1.3	
Business investment	4.2	5.3	4.1	1.9	2.2	1.8	1.5	1.8	1.9	1.2	2.2	1.9	2.7	2.0	4.0	
Inventories (contribution)	0.0	0.0	0.2	-0.3	-0.3	-0.2	-0.2	-0.2	-	0.0	0.0	-0.1	0.1	0.0	-	
Exports	2.8	3.4	1.1	0.3	-0.3	0.8	1.2	0.5	1.0	1.3	2.6	2.3	4.0	2.5	3.3	
Imports	1.1	3.8	5.1	1.2	2.5	2.9	3.2	2.4	2.8	3.4	3.9	3.8	4.4	3.9	4.4	
Trade balance (contribution)	0.2	-0.2	-0.7	-0.2	-0.5	-0.4	-0.4	-0.3	-	-0.4	-0.3	-0.3	-0.2	-0.3	-	
Unemployment (%)	7.4	6.2	5.2	4.9	4.7	4.6	4.8	4.8	4.8	4.9	5.0	5.1	5.2	5.1	4.6	
Headline inflation	1.5	1.6	0.1	1.1	1.0	1.5	1.8	1.3	1.3	2.7	2.2	2.2	2.2	2.3	2.2	
EUR/USD rate	1.37	1.20	1.08	1.14	1.13	1.07	1.08	1.08	1.12	1.06	1.05	1.04	1.04	1.04	1.12	
Federal funds rate	0.25	0.25	0.50	0.50	0.50	0.75	1.00	1.00	0.85	1.00	1.25	1.50	1.75	1.75	1.40	
2-yr sovereign bond yield (%)	0.31	0.46	0.68	0.72	1.00	1.40	1.60	1.18	1.18	1.60	1.90	2.10	2.30	1.98	-	
10-yr sovereign bond yield(%)	2.18	2.53	2.34	1.77	2.00	2.10	2.30	2.04	2.14	2.30	2.40	2.50	2.60	2.45	-	

* Consensus forecast (NB: sovereign bond yields are averages for annual figures and period-end levels for quarterly figures)





JAPAN



Japan's GDP growth will remain below 1% in 2016, dogged by weak consumption



Another hike in the sales tax in 2017 is inconceivable as it would tip the economy back into deflation



The BoJ will take new steps to weaken the yen

Japan's economy is on the verge a fourth recession in less than six years. GDP growth was just 0.6% for all of 2015, billed as the year of the big bounce. To make matters worse, the latest quarterly tankan, or economic survey, showed that the mood among top executives in the country's leading corporations was souring. On our estimates, the Japanese economy has a potential growth rate of about 0.7% a year. The main reason why the pace has slowed so much is that the population is shrinking, by about 0.2% a year. In comparison, the population is expanding 0.5% a year in the Zone Euro and 0.9% a year in the United States. In these circumstances Japan's total output of goods and services can only grow if Japanese workers boost their low level of productivity. Unfortunately that would require sweeping reforms, including moves to modernise the labour market that the Abe government does not seem inclined to implement. Without structural reforms the benefits provided by an expansionary budget policy and an inflationary monetary policy will soon wear off and Japan will be left wallowing in the same mire that has prevented it from making much headway for over two decades.

Capital investment and consumption are also struggling. Abe recently went on record as saying that the second two-point hike in the sales tax (to 10%) would proceed as planned in April 2017, unless there was a new financial crisis or major natural disaster. He did not say whether the earthquakes that rocked the main southern island of Kyushu, on 14 and 16 April, marked the kind of "major" catastrophe that could prompt the government to review its position. Based on our own analysis, we believe that the projected increase in the consumption tax is inconceivable a year from now as it would plunge Japan back into recession and deflation. In a bid to drive up the stockmarket, by shoring up investor confidence, Prime Minister Abe prodded the civil servants' pension fund (GPIF) to



invest massively in Japanese and foreign equities. The fund has reportedly lost the equivalent of EUR 48 billion (of the EUR 1.05 trillion it manages) in one year. This news could prompt Japanese consumers to save more.

The recent earthquakes raise other questions. Besides worries of new disasters, they are stirring debate about nuclear energy and Japan's electrical power supply. Based on the advice of the Nuclear Regulation Authority the government has decided to continue operating the Sendai plant, whose two reactors are the only ones in Japan that are still functioning.

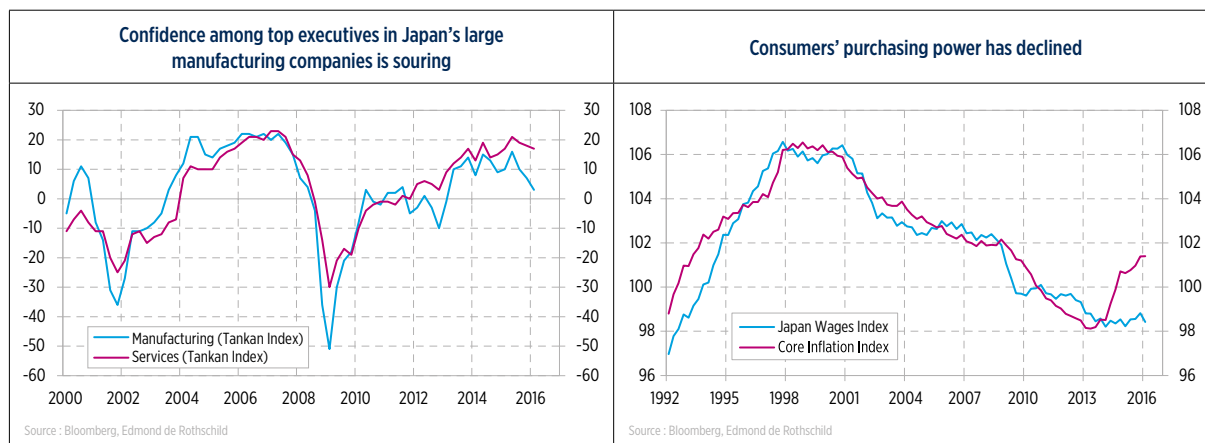
Overseas Japan's multinationals are being hurt by the yen's recent appreciation and the economic slowdown in Brazil, China and other emerging countries, where they have invested massively in recent years. China remains Japan's major trading partner, ahead of the US, buying 19% of its exports. Japanese companies are also suffering from the downturn in orders for their products in the US, most notably mining equipment. Longer term the Trans-Pacific Partnership (TPP), a colossal free-trade agreement binding 12 Pacific Rim countries (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Vietnam), will be a source of growth.

Given the economy's struggle to gather steam, the BoJ could be forced to lower its growth and inflation forecasts and, ultimately, relax its monetary policy further. For the record the BoJ already injects the yen equivalent of about \$730 billion a year via its Qualitative & Quantitative Easing (QQE). On 29 January the BoJ further decided to lower its deposit rate into negative territory. The bank's governor, Haruhiko Kuroda, said he was prepared to take additional easing measures to spur growth if inflation stayed too far below the BoJ's 2% target. In the coming months the central bank could step up its asset purchases, buy riskier assets, nudge interest rates down further or, more likely in our view, intervene more in the forex market. For the moment, however, currency dealers doubt the BoJ's ability to turn the tide and the consequence has been an upsurge of over 15% in the yen's value between December and May. The Japanese currency is now down only 30%, compared with 40% previously. Yet the BoJ's unconventional monetary policy will increasingly distort the supply-demand balance in the yen market, causing a structural depreciation in the Japanese currency.

-0.20%

is the rate at which Japan's population shrinks each year

The BoJ will probably have no other choice but to do more if it wants to stabilise the yields on Japan's sovereign bonds. The country's crushing public debt is now equivalent to more than 240% of its GDP, a record in the developed world. And it continues to swell by over 4% a year. Japan's solvency is not an issue, since its government bonds are 92% owned by Japanese citizens. But this comfortable situation is deteriorating as the average age of the population rises. The proportion of Japanese over 65 recently crossed the symbolic 25% threshold. Moreover, to maintain their standard of living, pensioners are dipping into their savings. These nest eggs have so far been made up precisely of sovereign bonds, via postal accounts. In the future, the treasury will have to turn to international investors to finance the public debt. Or, more likely, the BoJ will have to increase its bond purchases. If it does the yen will depreciate as a consequence... and the stockmarket will take off again.



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP	1.4	-0.1	0.6	0.0	0.7	0.7	1.2	0.7	0.5	1.5	1.3	1.1	1.2	1.3	0.5	
GDP (% change qoq)	-	-	-	0.4	0.3	0.4	0.1	0.3	-	0.6	0.2	0.2	0.2	0.3	-	
Private consumption	1.7	-0.9	-1.2	-0.7	0.0	0.0	1.2	0.1	-	1.2	1.3	1.1	1.1	1.2	-	
Public consumption	1.9	0.1	1.2	2.1	1.7	2.2	1.8	1.9	-	1.8	1.1	0.6	0.4	1.0	-	
Fixed-asset investment	2.6	1.1	0.2	-1.0	2.3	2.0	1.1	1.1	-	1.7	1.1	1.3	1.3	1.3	-	
Inventories (contribution)	-0.2	0.2	0.5	0.1	-0.7	-0.5	-0.2	-0.3	-	0.1	0.4	0.3	0.3	0.3	-	
Exports	1.1	8.3	2.8	-2.5	3.3	1.5	3.2	1.3	-	3.6	3.5	3.5	3.5	3.5	-	
Imports	3.0	7.2	0.3	-2.5	1.3	1.4	4.6	1.2	-	6.2	6.0	5.3	4.2	5.4	-	
Trade balance (contribution)	-0.2	0.3	0.4	-0.1	0.4	0.0	-0.1	0.1	-	-0.3	-0.3	-0.2	0.0	-0.2	-	
Industrial production	-0.6	2.1	-1.2	-2.1	0.2	1.9	2.5	0.6	-	2.4	2.6	2.1	2.5	2.4	-	
Unemployment (%)	4.0	3.6	3.4	3.3	3.2	3.2	3.2	3.2	-	3.1	3.1	3.0	3.0	3.1	-	
Headline inflation	0.4	2.7	0.8	0.0	0.0	0.2	0.4	0.2	0.2	0.8	0.6	0.5	0.6	0.6	1.7	
EUR/JPY rate	144	144	130	131	123	121	125	125	129	125	125	125	126	126	130	
USD/JPY rate	105	120	120	115	109	113	116	116	115	118	119	120	121	121	116	
BoJ overnight rate	0.10	0.10	0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	
2-yr sovereign bond yield (%)	0.10	0.07	0.01	-0.19	-0.23	-0.24	-0.27	-0.23	-	-0.26	-0.24	-0.20	-0.20	-0.23	-	
10-yr sovereign bond yield (%)	0.71	0.55	0.36	-0.04	-0.05	-0.03	0.01	-0.03	-	0.03	0.09	0.20	0.30	0.16	-	

* Consensus forecast (NB: sovereign bond yields are averages for annual figures and period-end levels for quarterly figures)





EURO ZONE



Growth should continue to be underpinned by public spending and the upturn in real estate business...



... but it could be weighed down gradually by flagging consumer spending



By preventing “lowflation”, the ECB will help bring down spreads on investment-grade corporate bonds

The Euro Zone had an excellent first quarter this year. GDP growth reached 0.5%, nearly twice the pace clocked in the last quarter of 2015. Thanks to this spurt of energy, the zone’s total output of goods and services is finally back to its pre-crisis level. It was high time. By comparison, the US economy returned to its pre-crisis level in 2011. For Eurolanders the “great recession” is now just a painful memory. Indices that track business confidence are trending upward encouragingly. But with numerous other important gauges heading south, there is still cause for concern. Eurostat’s Economic Sentiment Indicator (ESI) fell for the third straight month in March to 103 points, down from 107 three months earlier.

The recent upturn in commodity prices could weigh on private consumption, which along with capital investment was the main driver of economic activity last year. Momentum has also edged down in the labour market. If Euroland’s savings rate remains high (at end-2015 it stood at 12.7%), growth in consumer spending will probably slow.

Finally, the euro’s appreciation early this year will likely limit the strength of exports, with negative repercussions on corporate investment.

Fortunately there is scope for fiscal stimulus to take up this slack. The leeway available to national governments increased recently, thanks to a reinterpretation of the Growth and Stability Pact that has afforded greater flexibility in public spending as well as tax relief. Moreover, the Euro Zone’s aggregate debt burden has been alleviated somewhat by low interest rates. Instead of taking advantage of this situation to pay down debt, national governments are allocating more money for public expenditure. Moreover, lending in the private sector was up



almost 1% year on year in March, fuelled by the ECB's monetary policy and the implementation of the European Banking Union. Growth in mortgage business is particularly robust: in March total property loans were up nearly 3% compared with the year-earlier level. This has helped to buoy real estate prices in most of the Euro Zone countries, especially Germany.

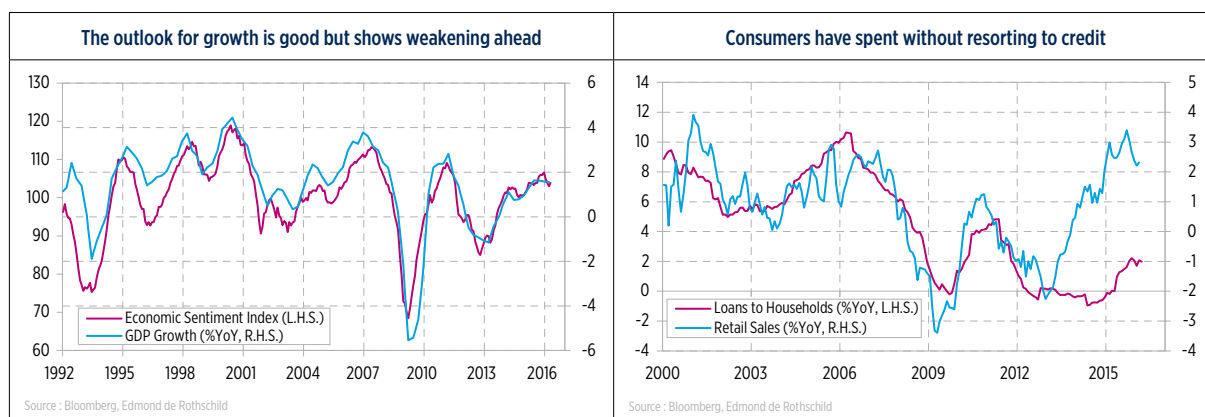
Yet the ECB continues to keep a watchful eye on the situation to prevent an onset of "lowflation" (a term used by the IMF to designate inflation which, while positive, remains weak over a protracted period). This twilight zone, bordering on deflation, is oppressive and can cause inflation expectations to stray from official targets. In the Euro Zone low inflation moreover deters peripheral countries from introducing the structural reforms they need to restore their competitiveness. Unfortunately the risk of "lowflation" is not far-fetched. The ECB's preferred indicator for tracking it, five-year inflation expectations in five years, has been falling relentlessly and now stands at just 1.4%. The Euro Zone's monetary authority cannot be satisfied with this level, especially since its economists have been constantly revising their inflation forecasts downward. Their current forecast for 2017 is 1.3%.

Nevertheless, the ECB will probably remain more "reactive" than proactive. This was the stance that its president, Mario Draghi, often adopted during the European debt crisis. He will state his determination to act so that he does not really need to take new, concrete steps. The other members of Eurosystem prefer to wait and see the impact of the measures that have already been implemented before taking the ECB's unconventional monetary policy any further. Its recent decisions to impose negative interest rates on commercial banks' deposits and increase the volume and scope of asset purchases marked a step in the right direction. The aim of reducing the interest paid on savings is to stimulate spending while the easing of credit conditions is designed to encourage demand. By taking these actions the ECB has demonstrated that central banks are not short of munitions. Its moves have been bold and gone further than consensus opinion had hoped.

The end result of the ECB's policy should be a long-term drop in yields in all segments of the European bond market. Investment-grade non-financial debt amounts to some EUR 400 billion of the total EUR 1.5 trillion issued by private corporations. This segment is therefore big enough to enable the ECB to make large-scale purchases but still small enough to narrow spreads.

0%

GDP growth since last peak
in 2008



	2016f								2017f							
% change yoy	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP	-0.2	0.9	1.5	1.5	1.6	1.9	1.9	1.7	1.5	1.5	1.3	1.0	0.8	1.1	1.6	
GDP (% qoq)	-	-	-	0.5	0.5	0.5	0.4	0.5	-	0.1	0.3	0.2	0.2	0.2	-	
Private consumption	-0.6	0.8	1.7	1.5	1.4	1.3	1.4	1.4	-	1.2	1.1	0.9	0.8	1.0	-	
Public consumption	0.2	0.8	1.3	1.6	1.6	1.5	1.4	1.5	-	1.3	1.4	1.4	1.4	1.4	-	
Business investment	-2.5	1.4	2.6	2.4	2.7	2.5	1.8	2.3	-	1.5	1.5	1.5	1.3	1.4	-	
Inventories (contribution)	0.0	0.0	-0.1	0.1	0.3	0.1	0.0	0.1	-	-0.1	-0.3	-0.3	-0.4	-0.3	-	
Exports	2.2	4.1	4.9	4.2	4.3	5.4	5.8	4.9	-	4.2	2.7	1.5	0.9	2.3	-	
Imports	1.4	4.5	5.6	5.1	5.4	5.4	5.2	5.3	-	3.7	2.2	1.1	0.4	1.8	-	
Trade balance (contribution)	0.4	0.0	-0.1	-0.2	-0.3	0.2	0.4	0.0	-	0.4	0.3	0.2	0.2	0.3	-	
Industrial production	-0.7	0.8	1.3	0.2	0.5	0.5	0.6	0.5	-	0.4	0.2	-0.2	-0.9	0.1	-	
Unemployment (%)	12.0	11.6	10.9	10.2	10.0	9.7	9.5	9.9	-	9.4	9.3	9.3	9.3	9.3	-	
Headline inflation	1.3	0.4	0.0	0.0	0.0	0.3	0.6	0.2	0.3	1.3	0.9	1.0	1.0	1.1	1.4	
IPCH inflation	1.4	0.4	0.0	0.0	0.0	0.3	0.6	0.2	0.3	1.3	0.9	1.0	1.0	1.1	1.4	
EUR/USD rate	1.37	1.20	1.08	1.14	1.13	1.07	1.08	1.08	1.12	1.06	1.05	1.04	1.04	1.04	1.12	
ECB minimum refi rate	0.25	0.05	0.05	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
ECB deposit rate	0.00	-0.20	-0.30	-0.40	-0.40	-0.40	-0.40	-0.40	-	-0.40	-0.40	-0.40	-0.40	-0.40	-	
2-yr sovereign bond yields (%)	0.14	0.05	-0.25	-0.49	-0.50	-0.45	-0.40	-0.46	-	-0.35	-0.28	-0.30	-0.30	-0.31	-	
10-yr sovereign bond yields (%)	1.63	1.24	0.54	0.15	0.26	0.33	0.42	0.29	-	0.51	0.60	0.70	0.80	0.65	-	

* Consensus forecast (NB: sovereign bond yields are averages for annual figures and period-end levels for quarterly figures)



GERMANY



Economic growth will remain a bit above 1.5% this year...



... thanks to a pickup in investment

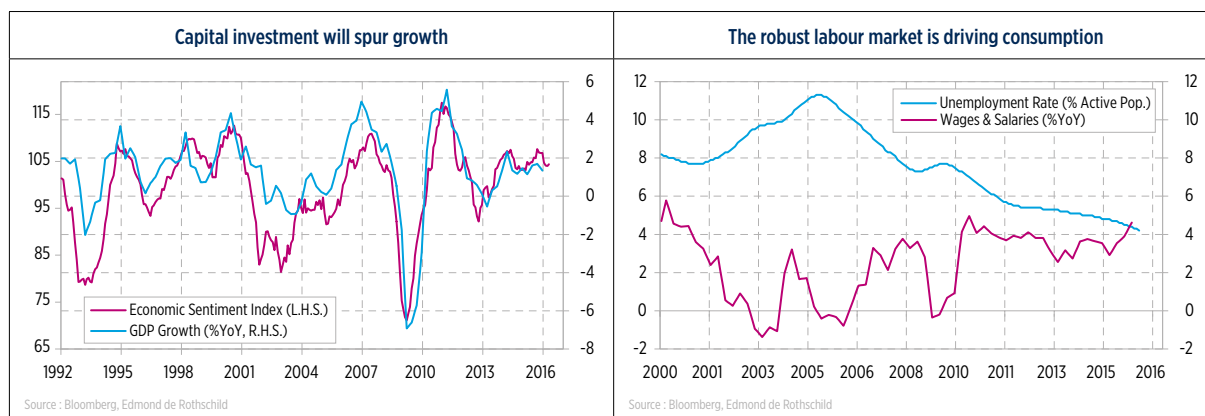


Fiscal policy is set to become more expansionary

Economic growth should remain slightly above 1.5% in 2016. Low interest rates will boost residential investment, while the robust labour market will continue to drive personal expenditure. Exports are being hurt by weak demand from the emerging markets but are benefiting from the upswing in Euroland's domestic market. Fixed-asset investment should therefore be able to accelerate as capacity utilisation rises. The gradual arrival of migrants in the labour market could trigger a slight upturn in the unemployment rate, which in March stood at a historical low (4.2%). The Merkel government's budget policy is set to become more and more expansionary as the chancellor promised at the recent EU summit. The additional spending is mainly ear-marked for infrastructure development and assistance in integrating immigrants. In the long run it is crucial that Germany encourages competition in services to reinforce innovation and investment. Meanwhile potential growth is being held back by inadequate child-care facilities and the low female participation rate in the workforce.

4.2%

Unemployment rate



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP	0.4	1.6	1.4	1.6	1.4	1.5	1.9	1.6	1.6	1.5	1.3	1.0	0.7	1.2	1.6	
GDP growth (qoq)	-	-	-	0.7	0.1	0.4	0.6	0.5	-	0.3	-0.1	0.2	0.3	0.2	-	
Personal expenditure	0.8	1.0	1.9	1.7	1.8	1.6	1.6	1.7	-	1.4	1.2	1.0	0.8	1.1	-	
Public spending	0.8	1.7	2.4	2.7	3.2	2.9	2.3	2.8	-	1.6	1.2	1.2	1.2	1.3	-	
Fixed-asset investment	-1.3	3.5	1.7	3.0	2.6	3.2	2.8	2.9	-	2.4	2.0	1.7	1.0	1.8	-	
Inventories (contribution to growth)	0.5	-0.4	-0.5	-0.2	0.0	0.1	0.1	0.0	-	0.0	0.0	-0.1	-0.2	-0.1	-	
Exports	1.8	3.9	4.8	2.5	1.9	2.3	3.9	2.6	-	4.2	4.3	4.3	4.3	4.3	-	
Imports	3.2	3.7	5.4	3.6	4.1	4.3	4.8	4.2	-	4.9	4.9	4.9	4.9	4.9	-	
Trade balance (contribution to growth)	-0.4	0.4	0.1	-0.3	-0.8	-0.7	-0.1	-0.5	-	0.0	0.0	0.0	0.0	0.0	-	
Headline inflation	1.6	0.8	0.1	0.2	0.3	0.6	0.8	0.5	0.4	1.5	1.1	1.2	1.2	1.3	1.6	

* Consensus forecast



FRANCE



Fiscal stimulus and the ECB's reflationary monetary policy will spur growth



Fixed-asset investment should continue to increase

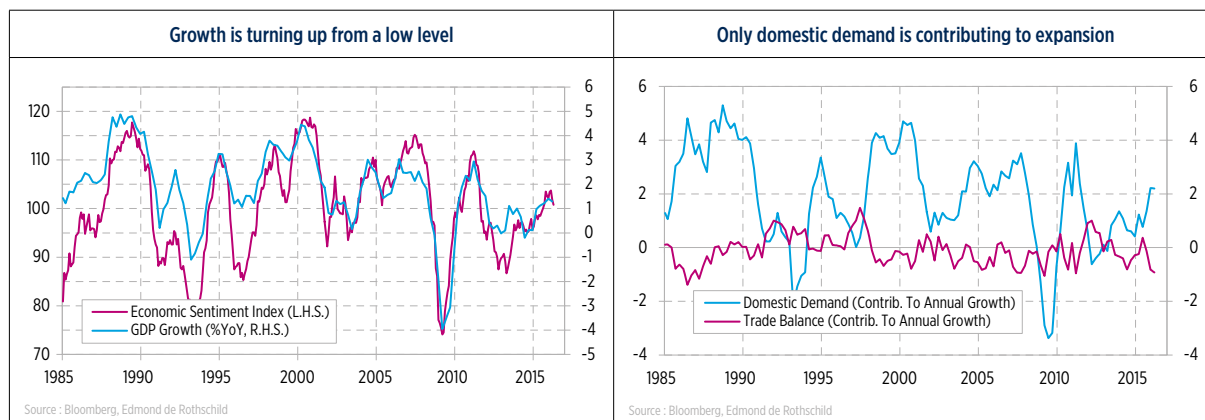


The trade balance will be hurt by the euro's recent appreciation

GDP growth is set to gain pace gradually and reach 1.4% for 2016 as a whole, spurred by increased government spending and the ECB's reflationary monetary policy. The rise in unemployment has been halted thanks to subsidised jobs in non-commercial sectors targeting young people and unskilled workers. Meanwhile there are signs of an improvement throughout the private sector. This slight pickup in activity and accelerating wage growth, however weak, will progressively put upward pressure on private consumption. Likewise, rising rents and the upturn in the business climate index will stimulate fixed-asset investment. This will also benefit from improved profit margins, which dropped to a historical low before bouncing back sharply (added value jumped 31% in Q1 16). In the end, growth will be lifted by domestic demand but dragged down by the trade balance. The euro's recent appreciation is impacting exporting companies, whose non-price competitiveness is low.

2.2%

Domestic demand's
contribution to GDP growth



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP	0.6	0.6	1.3	1.3	1.4	1.4	1.5	1.4	1.4	1.3	1.1	0.8	0.5	0.9	1.4	
GDP growth (quarterly)	-	-	-	0.5	0.2	0.3	0.4	0.4	-	0.4	-0.1	0.1	0.1	0.1	-	
Personal expenditure	0.5	0.7	1.5	1.5	1.2	1.0	1.5	1.3	-	1.3	1.2	1.0	0.9	1.1	-	
Public spending	1.5	1.2	1.4	1.7	1.4	1.2	0.9	1.3	-	0.9	0.8	0.8	0.8	0.8	-	
Fixed-asset investment	-0.8	-0.3	1.0	1.7	1.7	2.1	1.9	1.9	-	1.8	1.6	1.3	0.9	1.4	-	
Inventories (contribution to growth)	0.2	0.5	0.1	0.6	1.2	0.6	0.0	0.6	-	-0.1	-0.1	-0.3	-0.5	-0.2	-	
Exports	1.9	3.3	6.1	2.5	1.9	3.5	3.7	2.9	-	4.0	3.9	2.0	1.0	2.7	-	
Imports	2.1	4.7	6.6	5.3	5.5	4.9	3.4	4.8	-	3.4	3.7	1.5	0.5	2.3	-	
Trade balance (contribution to growth)	-0.1	-0.5	-0.3	-0.9	-1.2	-0.5	0.0	-0.6	-	0.1	0.0	0.1	0.1	0.1	-	
Headline inflation	1.0	0.6	0.1	0.0	0.0	0.4	0.6	0.3	0.2	1.1	0.6	0.7	0.7	0.8	1.3	

* Consensus forecast



ITALY



The recovery will strengthen, led by personal expenditure



Public spending will benefit from the largesse of the European Commission

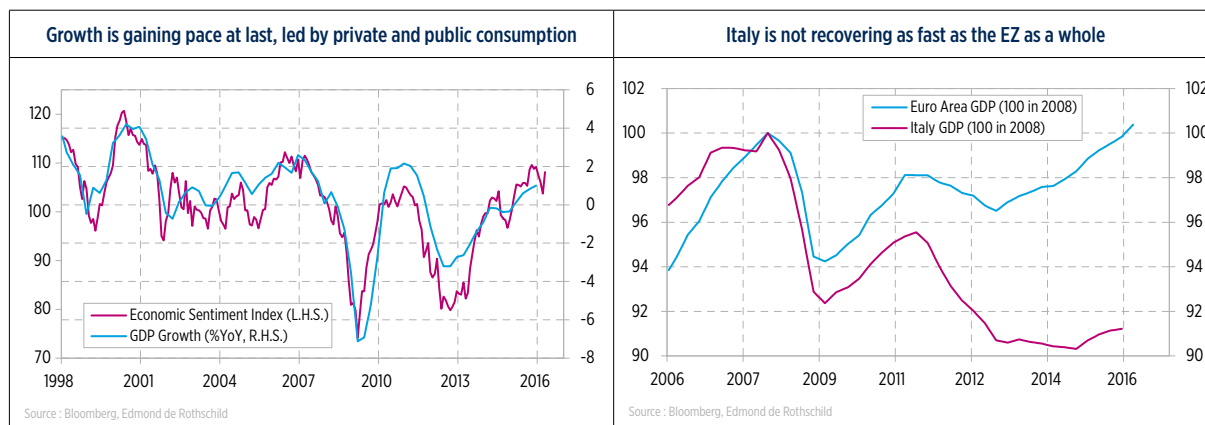


In the long run growth will run into labour market dysfunctions

GDP growth should reach 1.0% for 2016 as a whole. The unemployment rate is finally coming down, providing scope for higher disposable incomes and personal expenditure. Fixed-asset investment is struggling due to the low capacity utilisation rate and restricted credit conditions. The volume of non-performing loans remains large, slowing the recovery in bank lending. Weak foreign demand is weighing on Italy's exports, which are contributing negatively to overall GDP growth. Tax revenues will improve as the economic upswing consolidates and lower interest rates will reduce the cost of debt servicing. The government will likely take advantage of the European Commission's largesse to increase public spending and lower taxes. But if Italy wants to catch up to its fellow Euro Zone members in terms of growth potential, it will have to reform its labour market and tackle the problem of its banks' non-performing loans.

-8.6%

Delay in growth cumulated since 2008 compared to the Euro Zone



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
PIB	-1.8	-0.3	0.6	1.0	1.1	1.1	1.3	1.1	1.0	1.3	1.3	1.0	0.6	1.1	1.2	
GDP growth (quarterly)	-	-	-	0.3	0.4	0.3	0.4	0.3	-	0.3	0.4	0.0	0.0	0.2	-	
Personal expenditure	-2.4	0.6	0.9	1.5	1.5	1.3	1.3	1.4	-	1.5	1.4	1.1	0.9	1.2	-	
Public spending	-0.3	-1.0	-0.7	0.8	1.2	1.1	0.5	0.9	-	0.4	0.4	0.5	0.3	0.4	-	
Fixed-asset investment	-6.6	-3.3	0.6	1.3	1.7	1.8	1.5	1.6	-	1.7	1.8	1.0	0.5	1.2	-	
Change in inventories (contribution to growth)	0.1	0.1	0.5	0.0	0.0	-0.2	0.3	0.0	-	-0.1	-0.2	0.0	-0.1	-0.1	-	
Exports	0.9	2.9	4.1	2.1	1.6	3.5	3.0	2.5	-	3.9	4.1	2.0	1.0	2.7	-	
Imports	-2.2	3.0	5.8	3.5	3.0	3.7	3.6	3.4	-	3.7	3.6	1.8	0.9	2.5	-	
Trade balance (contribution to growth)	0.8	0.0	-0.3	-0.3	-0.3	0.0	-0.1	-0.2	-	0.2	0.2	0.1	0.1	0.1	-	
Headline inflation	1.2	0.2	0.1	0.0	0.0	0.1	0.3	0.1	0.1	1.0	0.7	0.8	0.8	0.8	1.2	

* Consensus forecast



SPAIN



Spain will remain an example, even with slowing growth



Domestic demand could remain robust

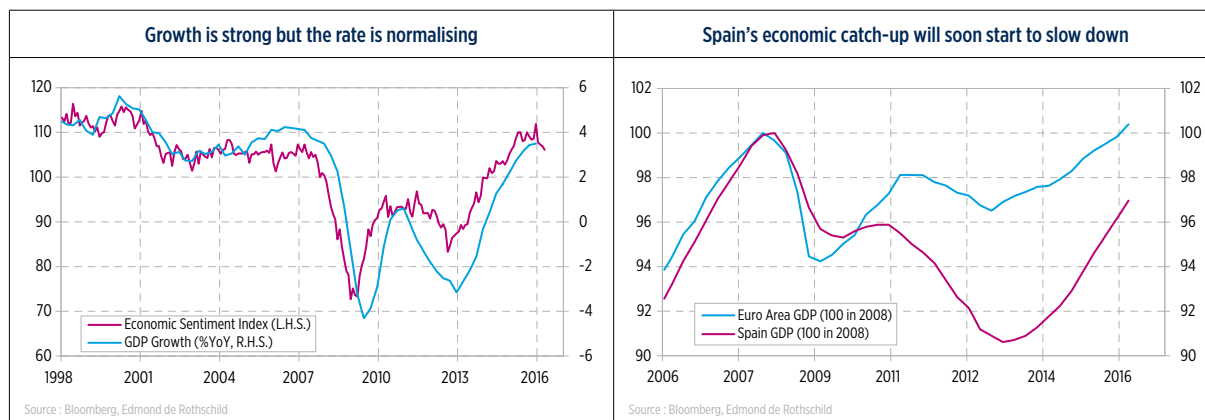


The political crisis poses the threat of a more abrupt slowdown

3.2%

GDP growth last year

The solid economic recovery seen in Spain last year ought to continue. As the positive repercussions of the weaker euro and lower commodity prices fade, GDP growth will return to normal near 2.5%. The government's expansionary fiscal policy and low interest rates will provide further support for capex, the real-estate market and personal expenditure, adding cyclical momentum to the major structural reforms implemented in recent years. This is illustrated by the Purchasing Managers Index, which has stayed above 54 points since January 2015. Since public debt remains high and growth robust, the government should go on consolidating its finances. This will be done gradually to avoid crimping economic growth. Since the 20 December 2015 election, Spain has been running without a government, an unprecedented situation since the restoration of democracy in 1975. King Felipe VI announced a poll to elect a new parliament on 26 June. This political crisis constitutes the major economic risk facing Spain at present that could cause business leaders, consumers and investors to lose confidence. But unlike with the referendum in the UK, the uncertainty will likely have a limited impact. The stakes are not the same. Household consumption and capital expenditure should not be impacted if the national savings rate increases.



% change yoy	2016f								2017f						
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*
GDP	-1.7	1.4	3.2	3.4	2.9	2.7	2.5	2.8	2.7	2.5	2.5	2.2	1.7	2.2	2.3
GDP growth (quarterly)	-	-	-	0.8	0.6	0.6	0.6	-	-	0.6	0.6	0.3	0.1	-	-
Personal expenditure	-3.1	1.2	3.1	3.4	3.2	2.8	2.6	3.0	-	2.4	2.3	2.0	1.8	2.1	-
Public spending	-2.8	0.0	2.7	2.6	1.6	1.1	0.9	1.4	-	0.8	0.8	0.8	0.8	0.8	-
Fixed-asset investment	-2.5	3.5	6.4	5.2	4.5	4.6	3.9	4.7	-	4.3	4.3	3.8	3.5	4.0	-
Change in inventories (contribution to growth)	n.a.	n.a.	n.a.	0.1	0.3	0.1	0.3	0.2	-	0.2	0.1	0.1	-0.2	0.1	-
Exports	4.3	5.1	5.4	3.7	5.4	4.3	4.4	4.9	-	4.5	4.7	2.7	1.8	3.4	-
Imports	-0.3	6.4	7.5	5.4	7.0	4.9	5.2	6.0	-	5.0	4.9	2.8	1.9	3.7	-
Trade balance (contribution to growth)	n.a.	n.a.	n.a.	-0.4	-0.4	-0.1	-0.2	-0.3	-	-0.1	0.1	0.1	0.0	0.0	-
Headline inflation	1.5	-0.2	-0.6	-0.6	-0.4	0.3	0.4	-0.1	-0.3	1.3	0.7	0.8	0.8	0.9	1.3

* Consensus forecast



PORTUGAL



Portugal's GDP is set to grow 1.2% in 2016 and 1.6% in 2017



Public spending should continue to make a positive contribution



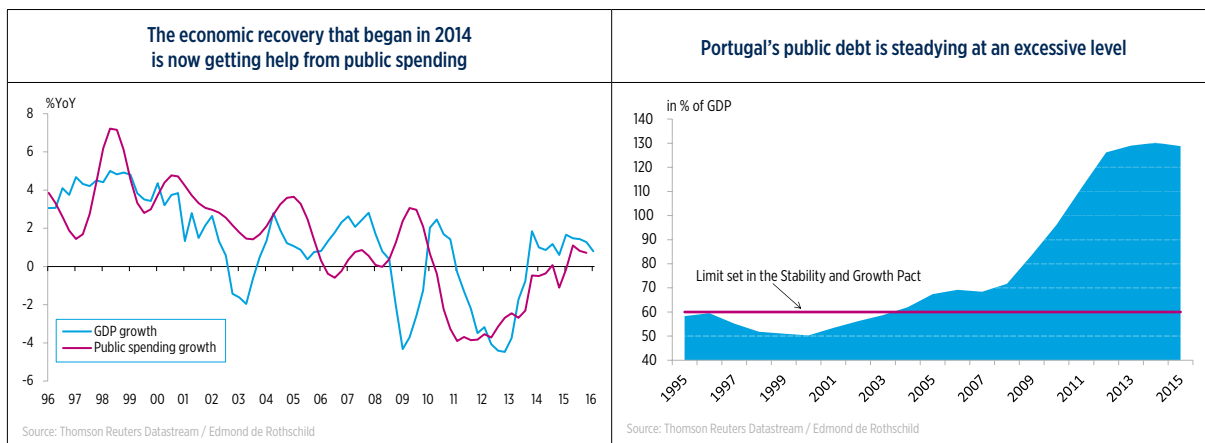
Higher potential growth will require structural reforms

Matthias van den Heuvel
Economist, Group

0.6%

Public spending rose
0.6% in 2015

The economic recovery that began in 2014 should continue but Portugal's growth rate could slow this year before picking up again. Personal expenditure, the main growth driver, will probably be hurt by high household debt (equivalent to 78% of GDP) and high unemployment (12.3% for all workers and 31% among young people in March). Capital investment, still 33% below its 2007 level, could be limited by additional deleveraging (corporate debt was equivalent to 118% of GDP at end-2015, down from 139% in 2013). Finally exports will likely be impacted by the euro's appreciation, leaving non-price competitiveness too weak. This is due to a lack of structural reforms. However, GDP growth should get a leg up from increased public spending. After dwindling every year since 2010, this was up 0.6% in 2015 and the acceleration should continue thanks to the formation of Antonio Costa's new Socialist government in November 2015. Mr Costa has stated that, despite excessive public debt (129% of GDP), he does not want to maintain the "blind austerity" policy implemented by his predecessors. His government has implemented a number of measures to help low-income workers, such as by increasing the minimum wage this year from EUR 303 to EUR 530. In 2017, fixed-asset investment will be shored up by the European Union's Structural and Investment Funds.



	2016f								2017f							
% change yoy	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP	-1.1	0.9	1.5	0.8	1.2	1.4	1.4	1.2	1.3	1.7	1.6	1.6	1.7	1.6	1.5	
Inflation	0.4	-0.2	0.5	0.5	0.4	0.6	1.0	0.6	0.6	1.5	1.3	1.2	1.3	1.3	1.2	

* Consensus forecast



LUXEMBOURG



Growth in Luxembourg is likely to slow to 3.7% in 2016 as opposed to 4.9% in 2015.



In the financial services sector, market volatility and new regulations will limit export growth.



However, positive credit conditions and a rock-solid labour market will prompt consumers to spend more. Growth will also be supported by the real-estate sector.

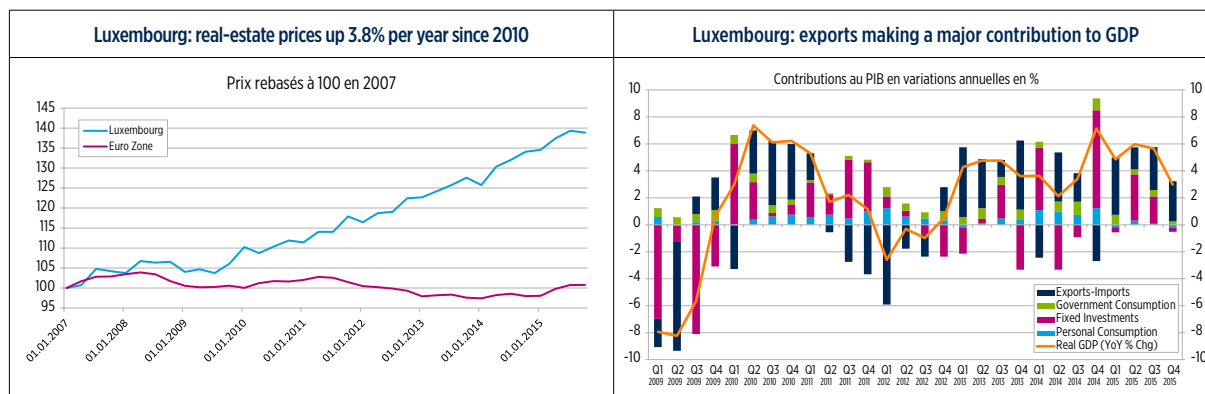
Lisa Turk
Economist, United States

Growth in Luxembourg is set to fall to only 3.7% in 2016 because of a slowdown in net exports of financial goods and services, caused by market volatility and new regulations. However, the financial sector will still be the main driver of Luxembourg's economy, accounting for 34% of GDP growth on average. Growth will also be supported by personal expenditure, which has been strong in early 2016. The outlook for consumer spending is improving because credit conditions remain favourable, oil prices are still low despite rallying recently, and the labour market is improving. The jobs market has benefited from innovative measures introduced by national employment administration ADEM, which is boosting employment among young people and women in particular.

3.80%

Average annual increase in
real-estate prices since 2010

Investment in housing is underpinned by tax incentives and will remain very strong. The mismatch between growing demand for housing and limited supply is putting serious upward pressure on real-estate prices, which have been rising at an annual average of 3.8% in the last 10 years. Household debt is rising rapidly: the authorities will have to monitor it closely and could consider macro-prudential measures.



	2016f								2017f							
% change yoy	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP growth	4.4	4.1	4.9	3.1	3.4	4.0	4.2	3.7	3.2	4.3	4.4	4.0	3.5	4.1	3.0	
Inflation	1.7	0.7	0.1	-0.1	0.5	1.0	1.2	0.7	-	1.7	1.2	1.4	1.4	1.4	2.0	

* Consensus forecast



UNITED KINGDOM

- ① **Our forecasts are clearly showing a slowdown in economic growth**
- ① **Consumer spending will decline**
- ① **Brexit-related uncertainty is having a negative impact**

Although economic growth is still higher in the UK than in the Euro Zone, the gap is now very small. In the first quarter of 2016, UK growth was close to 2%, well below the 3% achieved in 2014. Worse still, growth is clearly slowing and leading indicators are falling. Although both personal expenditure and public spending are still making positive contributions to growth, wage growth is slowing. The savings rate is at an all-time low and could rise because of uncertainty arising from the referendum about the UK's membership of the European Union. The result is that consumers will spend less and less in the next few quarters. Business investment is in freefall, and the recent decline in capacity utilisation rates means that an upturn is highly unlikely. The trade deficit hampered growth in 2015, but balance should be restored this year since the weak pound is making exporters more competitive.

Inflation remains low overall, but the underlying trend has been masked by falling energy prices in the last few years. The rally in the oil price and the decline in sterling will now start to put upward pressure on the consumer price index.

Among the risks for 2016, Brexit represents a potential political trap that should not be underestimated. The term Brexit is a contraction of "British" and "exit" and is a reference to "Grexit", which was seen as a possibility during the Greek crisis of summer 2015.

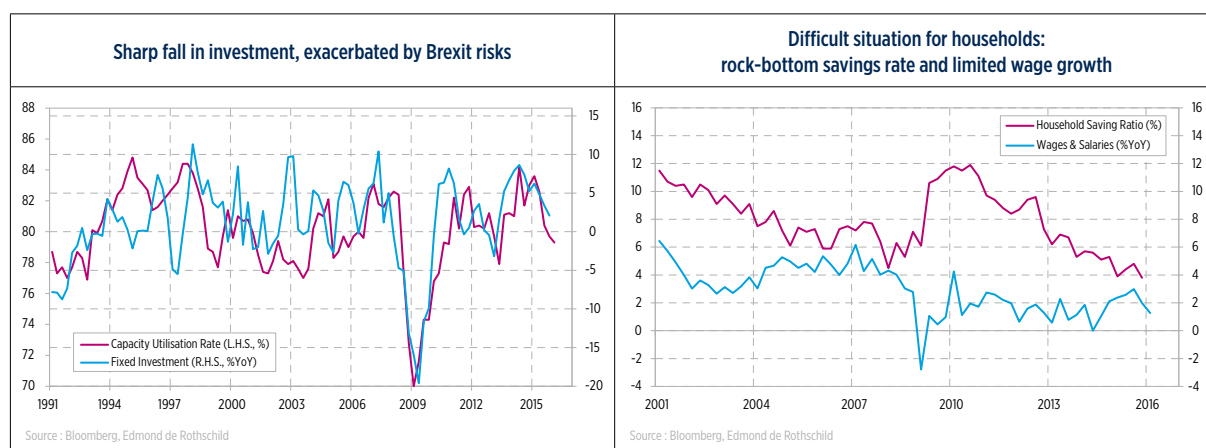
The Remain and Leave camps are currently neck-and-neck in the polls and there are still large numbers of undecided voters. On 12 June 2015 Standard & Poor's, the only rating agency that still awards the UK its coveted AAA rating, downgraded its outlook from "stable" to "negative", saying that the referendum represented a risk to the UK's growth prospects.

3.80%

Household savings rate



A Leave vote would cause capital outflows and a slump in sterling. Even if Remain wins, uncertainty will persist regarding the nature of the UK's future links with the European Union. The situation will lower the UK's long-term growth potential.



% change yoy	2016f								2017f						
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*
GDP growth	2.2	2.9	2.3	2.1	1.3	1.1	0.8	1.3	1.9	1.0	1.2	1.3	1.3	1.2	2.1
GDP growth (quarterly)	-	-	-	0.4	-0.1	0.2	0.3	0.2	-	0.6	0.1	0.2	0.3	0.3	-
Personal expenditure	1.9	2.6	2.8	2.6	2.1	2.0	1.8	2.1	-	1.5	1.5	1.5	1.7	1.5	-
Public spending	0.5	2.5	1.5	2.2	2.0	1.8	1.8	2.0	-	1.7	1.7	1.6	1.6	1.6	-
Investment	2.6	7.3	4.1	2.1	0.8	0.0	0.3	0.8	-	-0.9	-1.0	-0.5	0.4	-0.5	-
Change in inventories (contribution to growth)	0.9	0.0	-0.1	-0.7	0.1	-0.5	-0.8	-0.5	-	-0.6	-0.3	-0.3	-0.4	-0.4	-
Exports	1.2	1.2	5.1	2.9	1.4	1.8	1.6	1.9	-	1.3	1.5	1.9	2.5	1.8	-
Imports	2.8	2.4	6.3	1.8	3.0	1.1	0.1	1.5	-	-0.1	0.3	0.9	1.7	0.7	-
Trade balance (contribution to growth)	-0.5	-0.4	-0.5	0.3	-0.6	0.2	0.4	0.1	-	0.4	0.4	0.3	0.2	0.3	-
Industrial production	-0.8	1.3	1.0	-0.5	0.3	0.8	0.9	0.4	-	1.2	1.5	1.8	2.0	1.6	-
Unemployment rate (%)	7.6	6.3	5.4	5.1	5.1	5.2	5.2	5.2	-	5.3	5.3	5.3	5.2	5.3	-
Overall inflation	2.6	1.5	0.0	0.5	0.5	0.7	1.1	0.7	0.7	1.5	1.6	1.7	1.8	1.7	1.7
EUR/GBP	0.83	0.77	0.73	0.79	0.85	0.81	0.80	0.80	0.76	0.79	0.78	0.77	0.75	0.75	0.74
GBP/USD	1.66	1.56	1.47	1.44	1.33	1.32	1.35	1.35	1.48	1.34	1.35	1.36	1.39	1.39	1.52
BoE base rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.50	0.50	0.50	0.50	0.50	0.95
2-year sovereign bond yield (%)	0.38	0.68	0.54	0.44	0.60	0.80	1.10	0.74	-	1.30	1.40	1.50	1.60	1.45	-
10-yr sovereign bond yield (%)	2.34	2.51	1.82	1.42	1.80	1.90	2.00	1.78	-	2.20	2.40	2.50	2.60	2.43	-

* Consensus forecast (NB: sovereign bond yields are averages for annual figures and period-end levels for quarterly figures)



SWITZERLAND



Growth looks set to accelerate, driven by consumer spending



Deflation is not a concern because it is not the result of lower demand



The SNB could loosen monetary policy further by lowering its “exemption threshold”

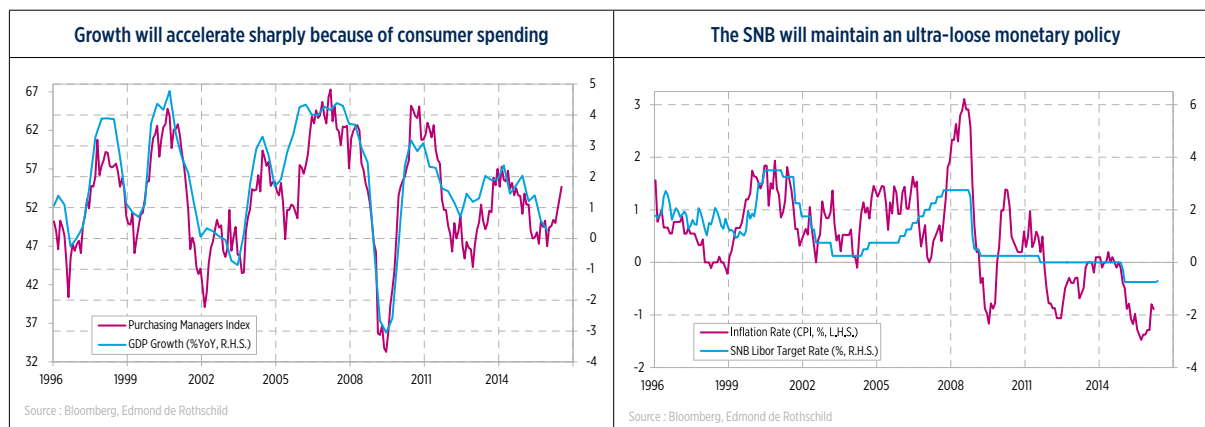
The Swiss economy avoided recession in 2015. The SNB's decision to scrap its minimum EUR/CHF exchange rate on 15 January 2015 did not have the devastating effect that some feared. Better still, confidence indexes for both purchasing managers and consumers are on a clear uptrend. They suggest that economic activity will accelerate in the next few quarters. Although the excessively strong Swiss franc is hurting competitiveness, domestic demand is strengthening. Consumers are taking advantage of their greater purchasing power by buying cheap imports. Personal expenditure should continue to accelerate. After falling in 2015, Swiss exports will rebound in 2016. Companies are adjusting to the new environment gradually, trimming jobs and margins in order to maintain market share. However, the strong franc is still a real handicap for the Swiss economy. In nominal terms and adjusted for the number of business days, Swiss exports are currently showing year-on-year growth of 2.5%. However, in real terms -i.e. adjusted for inflation- they are falling at an annual rate of 1.4%.

The consumer price index is continuing to fall, but at a slower pace because of rising energy prices but also an upturn in core inflation. Although Switzerland has seen serious deflationary pressure since 2011, it has not been caused by weak demand but by excess supply. It therefore qualifies as “good deflation”.

The lack of inflation means that the Swiss National Bank can maintain an expansionary monetary policy. It could loosen policy further if the Swiss franc were to rise too far. At the time of the G20 meeting in Shanghai, Thomas Jordan confirmed that a further rate cut could happen, and that the “exemption threshold” -currently 20 times the minimum reserve requirement for commercial banks- could be lowered.

54.7

Industrial confidence index



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP growth	1.8	1.9	0.9	0.8	0.7	1.4	1.4	1.1	1.2	1.5	1.4	1.1	1.0	1.2	1.6	
GDP growth (quarterly)	-	-	-	0.2	0.2	0.5	0.4	0.3	-	0.3	0.1	0.2	0.3	0.2	-	
Personal expenditure	2.2	1.3	1.0	1.0	1.2	1.3	1.6	1.3	-	1.6	1.5	1.3	1.2	1.4	-	
Public spending	1.3	1.3	1.7	0.4	0.9	1.4	1.5	1.1	-	1.9	1.6	1.4	1.4	1.6	-	
Investment	1.3	2.1	1.4	0.4	-0.8	-0.1	0.7	0.0	-	0.7	0.6	0.3	0.3	0.5	-	
Change in inventories (contribution to growth)	-2.5	0.7	-1.0	-0.4	1.0	1.6	1.3	0.9	-	-0.1	-0.5	-0.3	0.0	-0.2	-	
Exports	15.2	-6.9	3.1	2.2	3.4	1.3	0.3	1.8	-	2.7	3.5	3.3	2.7	3.0	-	
Imports	13.5	-8.1	2.5	1.8	5.8	3.6	2.4	3.3	-	2.6	2.9	3.3	3.1	3.0	-	
Trade balance (contribution to growth)	2.6	-0.2	0.7	0.5	-0.8	-1.1	-1.2	-0.7	-	0.4	0.8	0.5	0.1	0.4	-	
Industrial production	0.8	1.4	-2.5	1.1	1.1	2.0	2.6	1.7	-	3.3	2.8	1.8	1.9	2.5	-	
Unemployment rate (%)	3.2	3.2	3.3	3.5	3.5	3.5	3.6	3.5	-	3.6	3.6	3.5	3.5	3.6	-	
Overall inflation	-0.2	0.0	-1.1	-1.0	-0.5	-0.3	0.1	-0.5	-0.5	0.0	-0.1	-0.1	-0.1	-0.1	0.3	
EUR/CHF	1.23	1.20	1.09	1.09	1.08	1.04	1.08	1.08	1.13	1.05	1.03	1.03	1.04	1.04	1.13	
USD/CHF	0.89	0.99	1.00	0.96	0.96	0.97	1.00	1.00	1.01	0.99	0.98	0.99	1.00	1.00	1.03	
SNB sight deposit rate	0.00	-0.25	-0.75	-0.75	-0.75	-1.00	-1.00	-1.00	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-0.70	
2-year sovereign bond yield (%)	-0.03	-0.07	-0.81	-0.86	-0.90	-1.10	-1.00	-0.97	-	-1.00	-1.00	-1.00	-1.00	-1.00	-	
10-year sovereign bond yield (%)	0.88	0.68	-0.06	-0.34	-0.30	-0.30	-0.10	-0.26	-	0.00	0.10	0.15	0.30	0.14	-	

* Consensus forecast (NB: sovereign bond yields are averages for annual figures and period-end levels for quarterly figures)



SWEDEN



Sweden's GDP is set to grow by 3.6% in 2016, spurred on by domestic demand



A gradual pick-up in inflation could encourage the central bank to raise its key repo rate in 2017



Substantial overvaluation in the property market is the weightiest factor threatening Sweden's economic growth

Matthias van den Heuvel
Economist, Group

Sweden's economy lies amongst those expanding fastest within the EU, growing by 3.8% in 2015. That growth trend is underpinned by solid personal expenditure and public spending, substantial investment in housing, and rising exports. GDP is expected to continue increasing -by 3.6% in 2016 and 2.9% in 2017, spurred on by continued brisk domestic demand and a pick-up in public spending.

Productivity in Sweden is rising more quickly than for its European neighbours, leading to an increase in real disposable incomes and a contraction in unemployment. In turn, personal expenditure is rising strongly (3% in 2016). Public expenditure is also set to gain momentum as the more than 160,000 asylum seekers who arrived in 2015 are integrated.

Investment has quickened briskly in the past two years, boosted by the current property boom, but the growth rate is set to slow as high prices curtail purchasing power, which in turn will decrease the propensity to buy. The slower growth rate in respect of residential investment may be partially offset by higher investment in machinery and equipment considering that capacity utilisation has been rising steadily since 2013. In early 2016, it had reverted to 83.4% -only a whisker below its long-run average of 83.6%.

Meanwhile, growth in exports is set to ease as the krona appreciates and the economic growth rates of Sweden's main trading partners (the UK, Germany and Norway) subside.

In March 2016, inflation quickened to its highest level since 2012: 0.8% versus -0.6% in March 2014. That is still far below the 2% target, but we

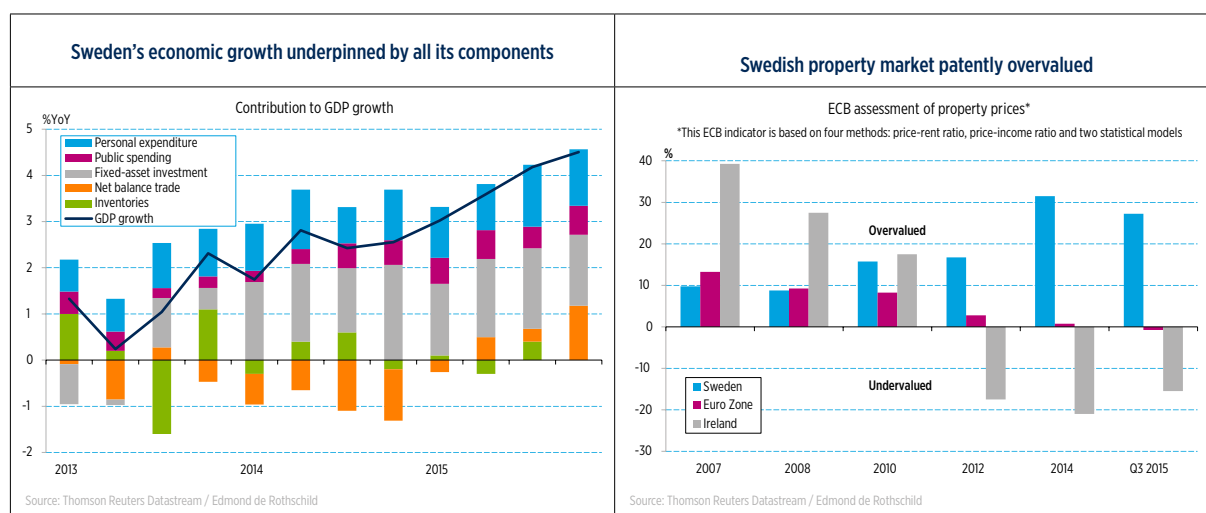
3.8%

One of Europe's fastest-growing economies in 2015



believe that inflation will continue to gather momentum as a result of continued strong domestic demand, stabilisation in energy prices and the planned increase in the carbon tax. Lastly, the Riksbank has said it will keep policy nice and loose. Correspondingly, its Executive Board has stated a readiness to intervene on the currency market if the Swedish krona surges –in order to avoid importing deflation. As a result, we expect inflation to pick up to 0.9% in 2016 and 1.5% in 2017. By the end of 2017, price appreciation and above-potential economic output are likely to make a dearer krona bearable, thereby justifying rises in the repo rate to -0.25% in Q3 2017 and 0% in Q4 2017.

On the downside, the property market casts a cloud over Sweden's growth trajectory. According to the ECB, the degree of overvaluation resembles Ireland's situation in 2007. If property prices corrected sharply, this could stunt growth as well as triggering a plunge in residential investment. However, it would also force households to reduce debt, which has expanded sharply in recent years –at a rate of 7.4% year-on-year in March 2016 versus 4.5% three years ago.



% change yoy	2016f							2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*
GDP growth	1.2	2.4	3.8	4.1	3.7	3.4	3.4	3.6	3.5	3.1	2.9	2.8	2.8	2.9	2.7
Personal expenditure	1.9	2.3	2.5	2.9	3.0	3.0	3.0	3.0	-	2.9	2.8	2.8	2.8	2.8	-
Public spending	1.3	1.5	2.2	4.1	3.8	3.7	3.3	3.7	-	2.5	2.0	1.6	1.6	1.9	-
Investment	0.6	7.6	6.9	5.5	5.0	5.0	5.0	5.1	-	4.6	4.8	4.6	4.3	4.6	-
Exports	-0.8	3.7	5.6	5.5	5.1	4.9	3.5	4.7	-	3.5	3.0	3.3	3.5	3.3	-
Imports	-0.2	6.3	5.0	5.4	5.3	4.8	3.6	4.8	-	3.7	3.5	3.6	3.6	3.6	-
Inflation	0.4	0.2	0.7	0.7	0.8	1.0	1.2	0.9	0.9	1.4	1.4	1.6	1.8	1.5	1.7
EUR/SEK	8.85	9.44	9.17	9.40	9.50	9.60	9.60	9.53	9.00	9.60	9.60	9.60	9.60	9.60	8.85
Key (repo) rate	0.75	0.00	-0.35	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.25	0.00	0.00	-0.30

* Consensus



ISRAEL



GDP growth is set to accelerate to 2.8% in 2016 and 3% in 2017...



... spurred on by higher public spending and exports



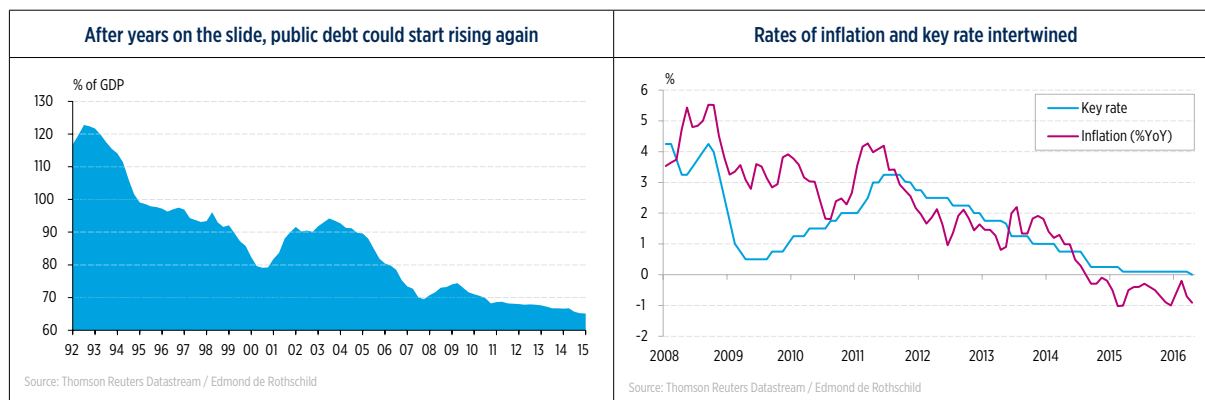
A gradual rise in inflation from the summer of 2016 would warrant a higher key rate in 2017

Matthias van den Heuvel
Economist, Group

-29%

Drop in public debt/GDP ratio
since 2004

Israel's economic growth is set to gather pace in comparison to earlier years, accelerating to 2.8% in 2016 and as much as 3% in 2017. Furthermore, the government has increased the upper limit on the fiscal deficit in 2016 from 2% to 2.9%. Its aim is to increase public expenditure after cutting the VAT rate from 18% to 17% in October 2015. It also plans to lighten corporate tax in 2016. Furthermore, exports are set to recover this year after shrinking by 3.3% in 2015 in response to sharp appreciation on the shekel (which gained 9.3% between December 2014 and July 2015) and the strike at Israel Chemicals Inc., the leading national company in this industry. However, personal expenditure is set to slow as the rise in the minimum wage, enacted in April 2015 (23.12 to 25 shekels per hour), will not be substantial enough to offset the dwindling positive effects of low interest rates, nor the gradual creep in inflation. Although prices continue to ebb (-0.7% in March 2016), we expect inflation to revert to the Bank of Israel's 1-3% target range by mid-2017 as the dampening effects of cheaper fuel prices and lower VAT dissipate. Based on the prospect of accelerating inflation, the Bank of Israel's Monetary Committee is set to start raising its key rate in the second quarter of 2017, attaining a level of 0.5% by the end of 2017.



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP growth	3.2	2.7	2.5	2.7	3.1	2.7	2.7	2.8	2.8	3.1	3.0	3.0	3.0	3.0	3.3	
Inflation	1.5	0.5	-0.6	-0.5	-0.6	-0.3	0.2	-0.3	0.0	0.7	1.0	1.3	1.5	1.2	1.4	
Key interest rate	1.00	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.15	0.10	0.25	0.25	0.50	0.50	0.25	

* Consensus forecast





EMERGING MARKETS



Emerging economies are set to continue slowing in 2016 as productivity ebbs in the face of industrial overcapacity



In our opinion, structural reforms are a sine qua non if emerging economies want to rebuild their growth models



Even so, the downtrend might level off towards the end of the year

François Léonet
Economist,
Emerging Markets

Supportive during the previous cycle, economic fundamentals are this time round working against emerging economies. Listless growth in the global economy, rock-bottom commodity prices and orthodox monetary policy in the US have together pinned back economic output in EMs. However, the downturn in these variables cannot be entirely to blame. The reality is that emerging economies have undergone a sizeable shift since the boom period between 2000 and 2008.

On the cusp of the new millennium, massive borrowing by US households kept personal spending ticking along at a high level. America therefore proved to be a lucrative market for Asian exporters. Caught up in this growth spiral were those countries that produced the raw materials for consumer goods, e.g. Brazil and Russia. This growth model was halted in its tracks in 2008 when US households – hit head on by the subprime crisis – hurried to slash their debt burdens. Deprived of their ‘natural buyers’, emerging economies, led by China, started to seek new sources of growth. This took the form of vast investment programmes, infrastructure financing schemes and other types of stimulus. The economic change of direction painfully gave rise to a two-way economic paradigm, with strong business trends in emerging economies forming a stark contrast with sluggish conditions in their developed counterparts. By 2011, the deep slump affecting developed economies had caught up with EMs, which have been in a bad way ever since.

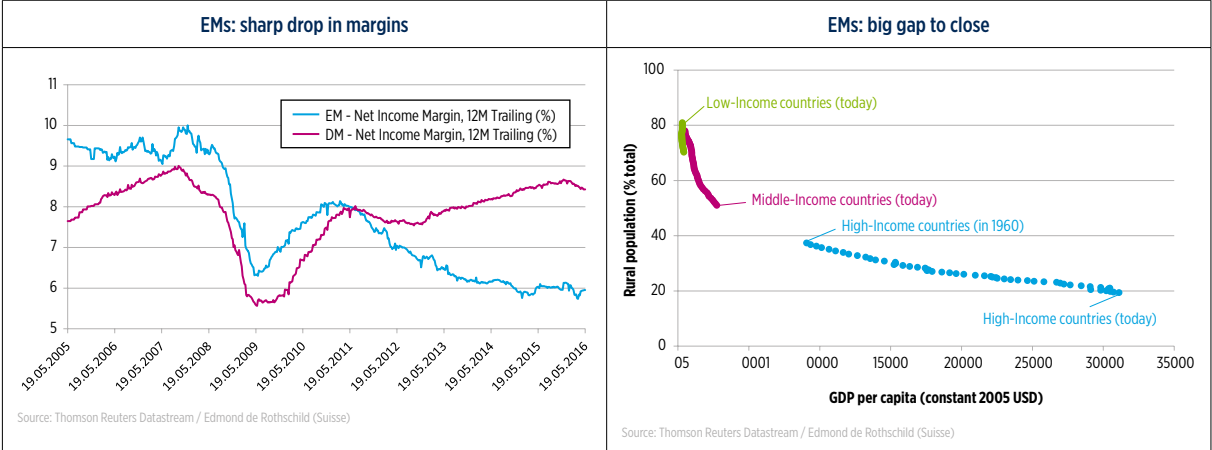
But even in their heyday, emerging economies were already experiencing a steady erosion in returns on capital. This was not a concern during times of expansion but, in recent years, has morphed into their Achilles

heel. Corporate profit margins have been shrinking relentlessly such that today they are lower than in the developed world. The main reason for margin erosion has been the rate of wage growth in emerging economies, which has outpaced productivity gains to a large extent.

As such, emerging economies are being forced to reconsider their business models and low productivity, and enact structural reforms in regard to allocation of capital and productive resources. Called on from 2010 to boost growth, credit does not seem a sustainable option for pulling the emerging world out of its ditch because so many of these countries are already carrying heavy debt burdens.

The profile of trade flows has changed in recent years. Previously, the rude health of Western consumers underpinned growth in exports from emerging economies. These days, trade has increased inside the emerging bloc. Accordingly, a business recovery in this sphere is predicated upon an upturn in EM countries themselves. The growth outlook is currently not strong enough to make this a baseline forecast. A pick-up in EM growth would first mean that business trends in China have to stabilise. Thankfully, latest figures, shown below, substantiate the prospect of a so-called soft landing.

We expect slower growth from EMs in 2016, although they will continue accounting for two-thirds of global growth -with a recovery some time in 2017.





CHINA



Economic activity set to continue cooling over the next few quarters



Fiscal and monetary intervention to keep the economy running at a brisk pace



Sources of risk concentrated mainly in real estate and lending

François Léonet
Economist,
Emerging Markets

The huge challenge facing China is to transform its growth model from an export- and investment-led economy to an economy driven by personal consumer expenditure. Growth is bound to be bumpy at times during a transition on this scale, and its success can be gauged only over the long run, rather than just a few quarters. The current adjustment in the Chinese economy towards a paradigm of more moderate growth is part of a natural process that is typical of an economy in transition and is thus set to continue. The service sector is expected to remain relatively resilient in 2016, but this will not be sufficient to absorb completely the effects of the structural slowdown in industry, which accounts for the continuing deceleration in GDP in 2016 (6.4%) and in 2017 (6.0%).

The priority for the Beijing authorities is the transition in the growth model, even if this means fuelling worrisome sources of uncertainty such as high indebtedness, the inefficiency of state-run businesses and mounting risks in the banking sector. In 2016, the Chinese government aims to achieve growth of between 6.5% and 7%, in line with its previous guidance, but above our own forecasts. In our view, it is unfortunate that the government has set a target growth figure because this leaves it with little scope in the event of a shock to growth and provides little clue as to how much progress has been made with refocusing the Chinese economy on personal expenditure.

Hard or soft landing? In the strict sense of the term, a hard landing suggests a sharp slowdown –or even a slide into recession– in an economy after a period of brisk growth. That is not where China is currently at. An endogenous shock, such as the failure of a major industrial group, banking sector stress or a debt-related crisis, would be likely to trigger a significant contraction in economic activity. For the time being, these risk factors exist but are contained.



A hard landing can also be defined as slipping to a level of growth that does not generate –or actually destroys– jobs. This leads to social unrest that could potentially destabilise the country’s political system. In China, the threshold is estimated at Gross Domestic Product (GDP) growth of around 5.5% to 6%, or below the current level of 6.7% and also below our forecast for 2016.

We anticipate a gradual slowdown in China’s GDP growth to 6.2% in the fourth quarter of 2016, and we see a soft landing as the most likely scenario. The first half of the year will be affected by a return to normal in the brokerage sector, which received an unduly large boost from margin financing transactions as the stock market stormed higher in early 2015. The credit stimulus combined with the fiscal and monetary impetus applied will partly address the persistent glut in industrial capacity, providing support for the pace of growth in the second half of the year. Investment is expected to grow by 10%, with infrastructure financing and the development of social policies garnering the bulk of it.

The official inflation target for 2016 has been set at 3.0%, but amid sluggish global demand, we forecast an inflation rate of 2.1%. Persistent deflation in producer prices (PPI) is expected as a result of surplus production capacity. The inflation in real estate prices –which is concentrated in China’s first-tier cities– will need to be watched closely.

With the official budget deficit set to widen to 3% of GDP, the authorities’ fiscal stance is resolutely accommodative. The same applies to its monetary stance, as illustrated by the anticipated expansion in money supply (M2: +13%) and lending figures, as well as the forthcoming cuts in benchmark rates and banks’ minimum reserves. Our analysis suggests that China will most likely opt for targeted fiscal measures, rather than a significant reduction in its benchmark rates as the latter often goes hand-in-hand with property price speculation and the surge in lending volumes. We anticipate two 0.25% rate cuts in 2016.

While these developments will underpin economic activity in the short term, there will be a price to pay in the form of higher long-term risks –especially credit risk. A worst-case scenario of non-performing loans– most likely highly understated by official statistics –compounding the country’s hefty debt burden cannot be ruled out altogether. That is not our baseline scenario, however. Accordingly, using infrastructure spending as a lever is an old trick that China is not supposed to be employing.

In most emerging economies, it is true to say that structural reforms are needed to revitalise production capacity bloated by years of inefficient investments. And China is no exception. The reform of state-controlled businesses (supply-side reforms) is the government’s flagship project. They are now paying a high price for past state interference, labouring in countless cases under the burden of strained finances and production models that defy basic economic common sense. These businesses must now gradually wean themselves off support from the omnipresent state and embrace the principles of the market economy. The authorities appear to have grasped the size of the task, as reflected by the cutback of 10% in steel and coal production capacity over the next few years and the creation of a \$15 billion compensation fund for affected workers.

Additionally, the restructuring of local government debt and return to more normal conditions in the real estate market, where supply exceeds demand, must continue. Attainment of these goals is crucial if China’s transition is to succeed.

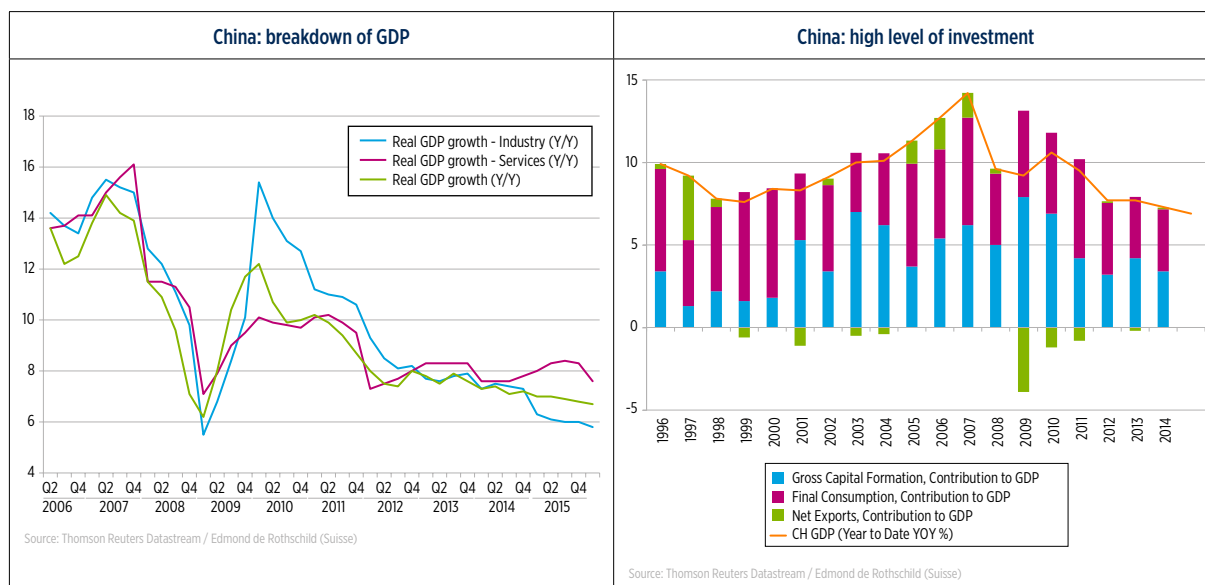
Although it has stabilised in recent months, the yuan remains exposed to the threat of downward pressure. Nonetheless, the government is likely to take decisive action in the event of massive capital outflows, which makes the scenario of a massive devaluation highly unlikely.

6.5 à 7%

Official annual growth target



The Chinese authorities are now fighting battles on several fronts –delivering a brisk rate of growth, stemming the downside pressure on equity markets and the yuan, consolidating the financial sector and preventing the failure of major industrial groups and banks. While these goals are all worth pursuing, it will be hard to achieve all of them at the same time. For example, rate cuts would provide support for the equity and real estate markets, but would undermine the yuan.



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP	7.7	7.3	6.9	6.7	6.4	6.3	6.2	6.4	6.5	6.1	6.1	6.0	5.9	6.0	6.3	
Retail sales	13.1	12.0	10.7	10.3	10.5	10.5	10.4	10.4	-	10.6	10.6	10.7	10.9	10.8	-	
Fixed asset investment	19.6	15.4	10.3	10.5	10.0	9.5	9.0	9.8	-	8.0	8.0	8.0	8.0	8.0	-	
Industrial production	9.7	8.3	6.1	6.0	6.5	6.3	6.3	6.3	-	6.0	5.9	5.9	5.5	5.8	-	
Inflation	2.6	2.0	1.4	2.1	2.0	1.8	2.2	2.1	2.0	2.5	2.5	2.3	2.2	2.4	2.0	
USD/CNY	6.05	6.21	6.49	6.60	6.70	6.80	6.80	6.7	6.65	6.80	6.80	6.90	7.00	6.9	6.73	
Benchmark rate	6.00	5.60	4.35	4.35	4.10	4.10	3.85	3.85	4.05	3.85	3.60	3.35	3.35	3.35	4.10	

* Consensus forecast



BRAZIL



No let-up in the contraction in 2016



Adoption of the fiscal measures needed to turn the Brazilian economy around complicated by the current political turmoil



Inflation set to slow, restoring the central bank's room for manoeuvre

François Léonet
Economist,
Emerging Markets

9.28%

inflation in April 2016, well
ahead of the target level

Slipping ever deeper into recession with each passing quarter (-5.9% in the fourth quarter of 2015), Brazil finds itself in a real predicament as the macroeconomic challenges it needs to tackle appear impossible to reconcile. Wage indexation and administered prices, combined with significant currency depreciation are fuelling an inflationary spiral preventing the Banco Central do Brasil from embarking on a round of monetary easing. The scope for applying a stimulus via government spending has been compromised by the rapid increase in public debt and continuous widening in the primary (-2.1%) and fiscal (-9.7%) deficits. As well as diminishing consumer and business confidence, the turmoil caused by corruption scandals engulfing the government has in many cases caused deadlock, with the requisite tax and fiscal reforms having to be adjourned or thrown out because of political disagreements.

Areas of satisfaction are few and far between in an economy traditionally driven by domestic consumption. The inflationary environment is eroding real wages and driving up debt servicing costs to record levels, thereby barring households' access to lending. In addition, households' expectations of a further turn of the tax screw have prompted them to start saving more. This weakness in sources of growth is expected to lead to a fresh GDP contraction in 2016 (-4.3% after -3.9% in 2015) prior to a recovery next year (0.7% in 2017). In a tough climate for business, investment will not provide much support (-14.3% in 2016). Depreciation in the real is likely to drive a significant improvement in Brazil's trade balance and current account from -3.3% of GDP in 2015 to -1.2% in 2016.

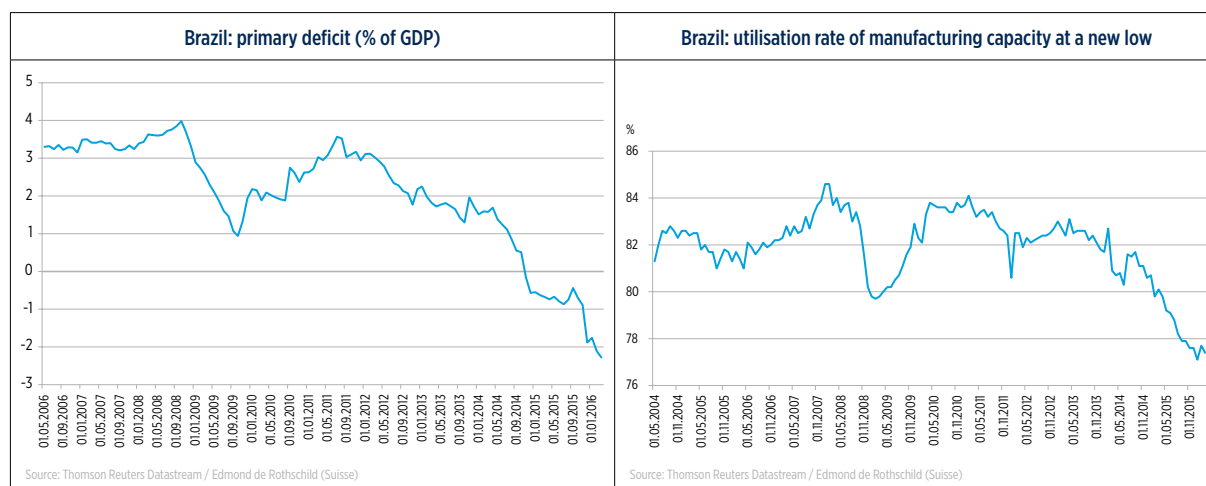
Inflation is likely to remain high, well above the 4.5% target, fuelled by automatic price indexation and the weak real (IPCA - extended national consumer price index: 8.9% in 2016). The central bank has not embarked



on a cycle of rate cuts because it wants to avoid fanning inflationary pressures. It is expected to start cutting rates in the second half of 2016.

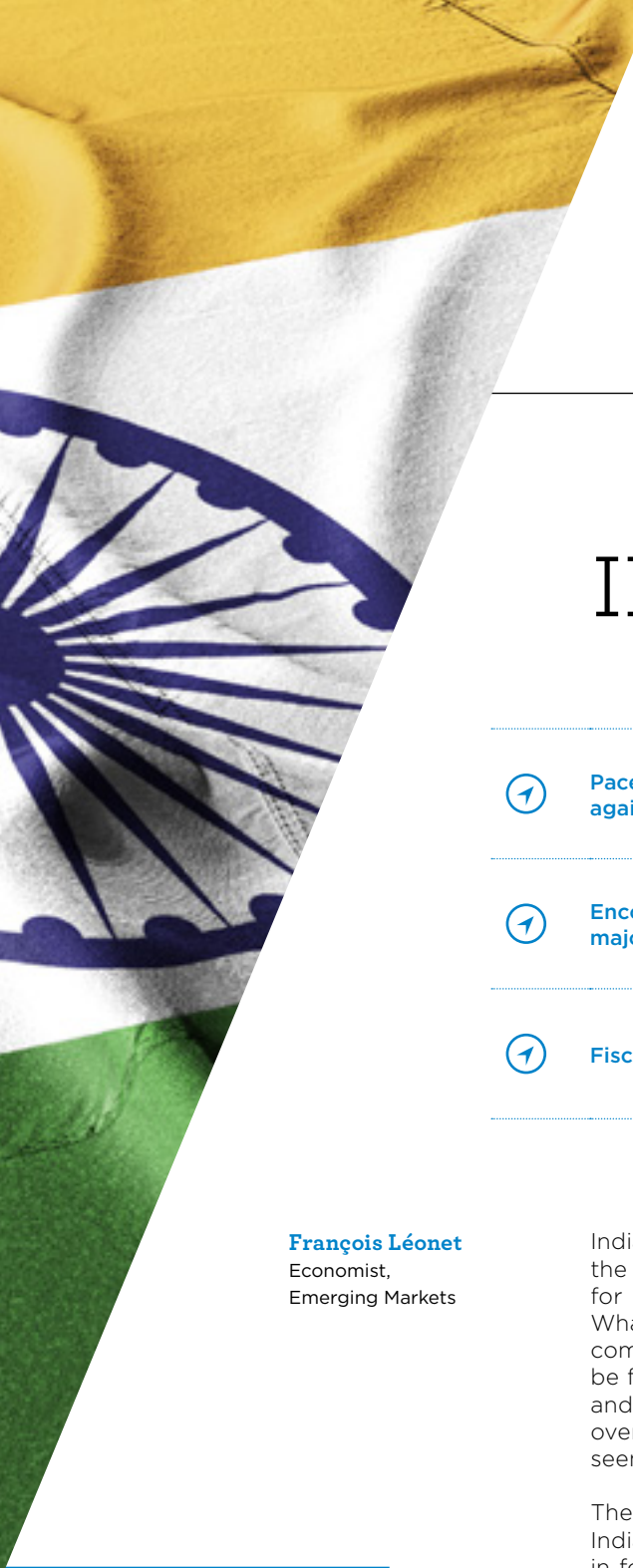
While there are countless sources of uncertainty, bright spots are much thinner on the ground and –for the most part– already taken into account by investors. Brazil’s small foreign-currency debt burden and relatively large liquidity reserves should ward off any solvency crisis that would seriously jeopardise the country’s international position. The recent stabilisation in confidence surveys may provide a crumb of comfort, but such indicators are at record lows.

While it is imperative for most emerging economies to grasp the nettle of structural reform, this is absolutely inevitable for Brazil. Years of fiscal complacency, an inflationary spiral fuelled by wage indexation, the persistent weakness of a manufacturing sector blighted by Dutch disease and untold corruption scandals have outweighed the benefits of the productivity gains achieved by a country that had grown accustomed to growth averaging 4% over the previous decade. Confirmation of Rousseff’s impeachment is no guarantee that these problems will be resolved or that the political deadlock will be overcome. 2016 will be another year of adjustment.






% change yoy	2016f							2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*
GDP	3.0	0.1	-3.9	-6.2	-5.1	-3.6	-2.5	-4.3	-3.8	0.5	0.6	0.9	0.6	0.7	0.8
Personal expenditure	3.5	1.3	-4.1	-6.3	-5.4	-4.5	-3.7	-4.9	-	-2.1	-0.7	0.1	0.8	-0.4	-
Investment	5.8	-4.4	-14.3	-19.2	-15.3	-12.8	-8.7	-14.3	-	-4.5	-1.1	0.9	1.7	-0.6	-
Inflation	6.2	6.3	9.0	10.1	9.2	8.8	8.3	8.9	8.5	7.6	7.4	7.1	7.0	7.3	6.0
Benchmark rate	10.00	11.75	14.25	14.25	14.25	14.25	14.00	14.00	13.55	14.00	13.50	13.50	13.50	13.50	11.50

* Consensus forecast



INDIA

-  **Pace of growth expected to accelerate slightly in 2016 before slowing again in 2017**
-  **Encouraging progress with structural reforms, despite the lack of a majority in the Upper House of Parliament.**
-  **Fiscal consolidation to continue over the next few years**

François Léonet
Economist,
Emerging Markets

India's statistics have undergone a methodological overhaul recently, so the utmost caution is required in any analysis. For example, indicators for the real economy paint a more mixed picture than GDP trends. Whatever the actual situation, growth trends vary from one GDP component to another. The service and consumption sectors appear to be fairly resilient, whereas trends in private investment, manufacturing and rural demand seem more mixed. Growth is expected to consolidate over the next few quarters, with 2016 set to end at levels close to those seen in 2015 (7.5%).

The significant drop in commodity prices represents a positive factor for India, which is a net energy importer and highly exposed to fluctuations in food prices. The civil service salary increases recommended by the Pay Commission are set to boost wages, with growth expected to remain relatively stable at around 5% in 2016. This level is in keeping with the Reserve Bank of India's target inflation range of +4%/-2%.

The uncertainty over the global macroeconomic environment has prompted India's monetary authorities to pursue an accommodative policy. Following a 0.75% cut in 2015, its policy is likely to remain on hold, with benchmark rates at 6.5%. Liquidity injections are also likely. Trends in the fiscal deficit need to be monitored. Receipts show a high level correlation with oil prices, which have fallen substantially in recent quarters. Fiscal discipline will be the watchword for the next few months.

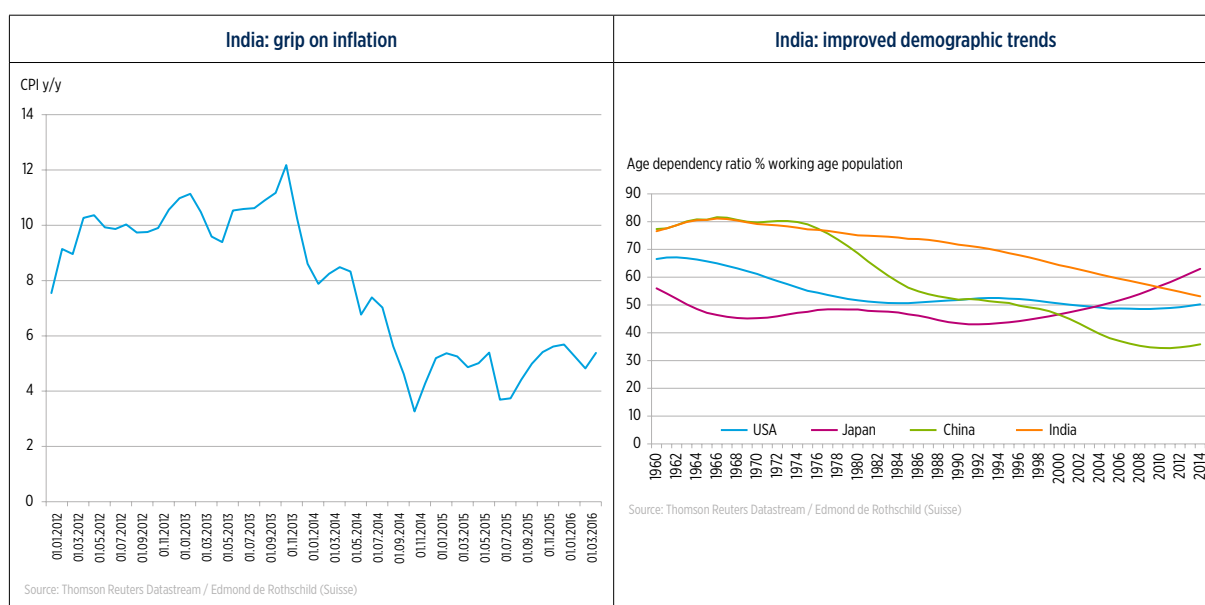
India is among the emerging economies most actively pursuing structural reforms (see the deregulation of foreign direct investments, labour market and land purchase reforms, tax on goods and services,

130th

In the Ease of doing
business rankings



etc.), although the pace of reform has slowed in recent months. Progress with improving foreign capital inflows and deregulating certain sectors of the economy augur well for the future and are likely to be followed up by other reforms, such as in the labour market.



% change yoy	2016f								2017f							
	2013	2014	2015	Q1	Q2f	Q3f	Q4f	2016f	C*	Q1f	Q2f	Q3f	Q4f	2017f	C*	
GDP	6.3	7.0	7.3	7.5	7.6	7.5	7.1	7.5	7.5	7.2	7.2	7.4	7.3	7.3	7.7	
Personal expenditure	2.4	6.4	6.6	6.5	7.3	6.6	7.3	6.9	-	6.0	5.8	6.2	6.3	6.2	-	
Investment	10.8	3.1	4.9	8.3	6.9	7.0	7.1	7.3	-	6.5	6.3	6.4	6.7	6.6	-	
Inflation	9.9	6.7	4.9	5.3	5.0	5.3	4.8	5.1	4.9	4.6	4.5	4.7	5.2	4.8	5.1	
Benchmark rate	7.75	8.00	6.75	6.75	6.75	6.75	6.50	6.50	6.35	6.50	6.50	6.50	6.50	6.50	6.30	

* Consensus forecast

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