Macroeconomic Outlook

Research Department
September 2016

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Macroeconomic Outlook

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September 2016

Quarterly

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Please read carefully the important disclosures at the end of this publication

Global growth stable, ahead of a delicate electoral cycle

Luca Mezzomo

The global economic trends that had become apparent in the spring continued to strengthen, with signs of recovery in the emerging markets and a modest slowdown in Europe. The impact of the UK referendum was not significant. Growth will remain modest overall. The scenario is complicated by an electoral cycle that will involve various advanced economies, and by the fact that monetary policy is having less and less of an effect on aggregate demand.

Some of the fears of the previous months were allayed during the summer. There is a good chance that global growth will increase in 3Q (see fig. 2), and that manufacturing activity is picking up after the hiatus in 1H16. However, there is still not much optimism about economic developments and most 2017 growth estimates have been trimmed to a greater or lesser extent.

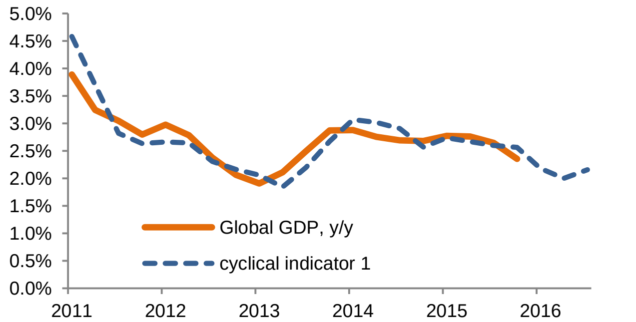
The first signs of the impact of the UK referendum are negative but not as catastrophic as many had predicted

The consequences of the UK referendum on the economy have been rather limited, and the severe crisis of confidence, on which the most catastrophic assumptions about the immediate effects were based, has not materialised. In addition, the government crisis was quickly resolved, with the new government making it abundantly clear that it was in no hurry to formalise its request to leave the EU. Financial conditions eased overall, and this was not due purely to the monetary policy measures adopted by the Bank of England. Sterling made the most striking movement, positioning itself between USD 1.29 and 1.34 and depreciating by nearly 8% in terms of the effective exchange rate. The spread between 10-year gilts and 10-year bunds fell by over 40 bps and the equities index is at higher levels now than before the referendum. The UK economy is therefore continuing smoothly along the slowing path that it had already embarked on before the referendum, and which particularly affects employment and capital spending. Exports to the UK will suffer as a result, both through weaker demand and the fall in sterling. However, other countries have not suffered repercussions via other channels, such as the financial channel.

Fig. 1 – Chinese data surprised on the upside

Fonte: Thomson Datastream Charting, CESI indexes

Fig. 2 – PMI indices forecast stabilising global growth in 3Q



NB: the cyclical indicator is based on the performance of global manufacturing and services PMIs, oil prices (with a lag of four quarters) and past performance of global GDP (lag: q-1 and q-4); Source: Intesa Sanpaolo

Outlook for emerging countries has improved, but growth was lower than expected in the US and is slowing in Europe

In the meantime, the outlook for emerging markets has improved. The situation of the major oil producers is less cause for concern after the recovery in prices consolidated at between USD 40 and 50 dollars per barrel, although without producing any sudden rises. We do not think that the OPEC countries and Russia have any intention of giving up market share in order to attempt to bring prices back to more profitable levels, partly because US production is highly responsive, and therefore the re-absorption of excess supply and the recovery in prices will be slow and modest. However, the improvements in Chinese economic data strengthened, borne out by a small recovery in exports to the Euro zone and Japan. Policies to support demand have therefore produced the desired results. Despite this, hard-to-assess risks associated with the overdependence of economic growth on investment and excess debt – and therefore doubts about the sustainability of Chinese growth – have not gone away. Moreover, the improvement in the situation of emerging countries is partly offset by opposing trends in advanced economies, which prevented global GDP from registering a significant upturn in Q2. In the US, despite the consumer spending boom, GDP growth was also surprisingly weak in the second quarter, curbed by an unfavourable inventories cycle and, to a lesser extent, by the weakness of company investment. Growth is expected to pick up in the third quarter, but the unemployment rate, which is now extremely low, indicates that the business cycle is rather mature. The Eurozone recorded a performance in line with expectations, but economic surveys worsened in the middle of the year, which could trigger a slowdown in GDP if the September/October surveys do not show the rebound we expect.

Growth is now long-established, but has not yet generated imbalances that would cast doubt on its resilience

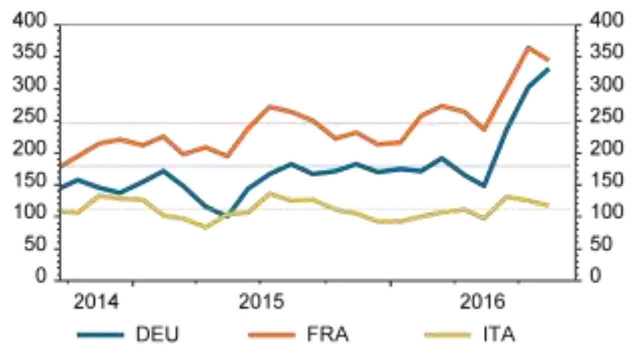
This phase of economic growth has other features apart from modest growth rates: it is long-lived and marked by low inflation rates in advanced countries, low international trade elasticity in relation to GDP growth and a low propensity to invest. The length of the expansion phase may suggest that growth is mature and could lose momentum, or even worse, give way to a recession. However, the factors that usually put an end to growth phases are still absent: there are no inflationary pressures compelling central banks to impose restrictive monetary policies; fiscal policies remain broadly neutral; and the symptoms of financial imbalance or an over-valued property market are essentially confined to China. While US non-financial companies did indeed register a fall in earnings compared with 2012-14 levels, the phenomenon came to a halt in 2Q16. Therefore, unless the Chinese financial system implodes, the growth phase still seems to have some way to go.

The caution surrounding next year's expectations is partly due to the uncertainty of political developments and the limited room for manoeuvre of economic policies.

Fig. 3 – Economic policy uncertainty at historic norm in the US…

NB: difference compared with historic average. Source: Eurostat, Datastream Charting

Fig. 4 – … but rising fast in France and Germany



Source: Eurostat, Datastream Charting

The electoral cycle in 2016-17 is surrounded with high uncertainty, which could have a negative effect on investment

Political uncertainty relates to both the US and Europe US presidential election polls show that Donald Trump still has a chance of victory. If this were to happen, it is likely that there would be a strong disconnect with respect to the economic policy and foreign policy of the previous administration, although the extent of the change, at least on the economic front, would be reduced by the need to negotiate with Congress. At the moment, the economic policy uncertainty index does not seem to reflect these risks.

In Europe, a change of government is highly likely in France, which is due to reappoint Parliament and elect a new President in 2017. In the Netherlands, the two most-represented parties in Parliament risk seeing the number of their seats halved, leading to an increase in fragmentation and strong gains made by the Eurosceptic nationalists of the Dutch Freedom

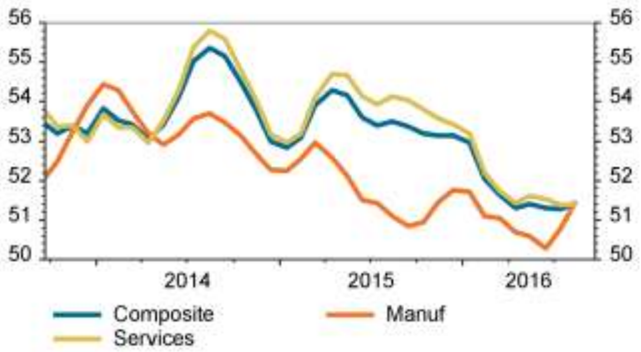
Party (*Partij voor de Vrijheid*, or PVV). In Germany, the position of Chancellor Angela Merkel has been weakened by the migrant crisis, which could erode support for the Christian Democrats in the October 2017 elections. Lastly, on 4 December 2016, Italy will vote on a big constitutional reform package; while this remains important, the event has become much less serious, now that the government's fate is no longer tied to the referendum result. The weakening of moderate governing majorities and the radicalisation of the popular vote has already driven European governments to seek refuge in the protection of national interests, making it increasingly difficult to define common policies, and this trend only seems set to become more pronounced in the next few months. This is happening at a historic time when the architecture of monetary union needs to be strengthened, acting on the structural weaknesses revealed by the 2010-12 crisis, which only the central bank's intervention prevented from leading to the collapse of the Union. Calls for action are now running up against irreconcilable opinions relating to the desirable level of risk-sharing, and the room for manoeuvre allowed by negotiations and hence the strategies for dealing with problems inherited from the past. We are fairly certain that nothing significant will happen before the new governments take office, and afterwards, there could be less favourable government agendas than there are now if the elections confirm the consensus shift to right-wing nationalism.

Monetary policies are more accommodative than expected, but this also reflects decreasing marginal effectiveness

In the first nine months of 2016, monetary policies have been more accommodative than expected, and the outlook for 2017 is going in the same direction. US monetary restriction has been suspended since the end of 2015 and only modest movements in rates are expected; new expansionary measures are forecast from the ECB and the Bank of England. The Bank of Japan will continue to implement its huge purchase programme, which has now been reformulated to aim for long-term rate stabilisation over a time horizon that goes beyond the hypothetical return of inflation to target – which belies its real purpose, i.e. solving the issue of debt sustainability. However, this is also due to the fact that the easing in financial conditions is having less of an effect on aggregate demand than expected, while financial intermediation, far from being the driver, is, at the moment, depleting much of the momentum before it reaches final demand. There is much talk of coordinated efforts between monetary policy, budgetary policy and structural reforms to kickstart growth, but many countries do not have room to manoeuvre due to the high starting levels of public debt, while other countries, such as Germany, are blocked by ideological factors. In April, the IMF revised down its GDP growth forecast by 0.2% for 2017 (calculated based on the cyclically-adjusted primary balance), largely due to Japan and peripheral Euro zone countries. 2017 budgets will probably be less restrictive than expected at the start of the year, but in any case the support to demand that could come from budgetary policies in 2017 will be virtually negligible.

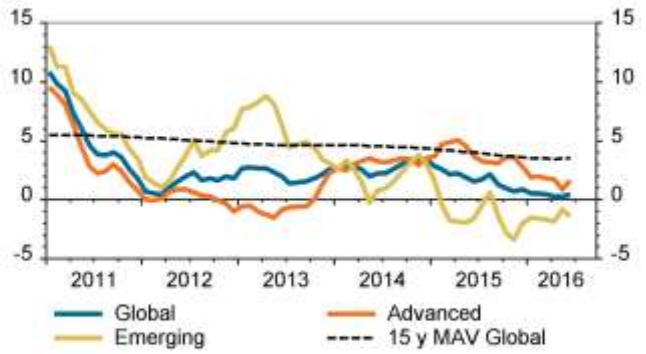
Global economic trends in 10 charts

Fig. A – Global PMIs



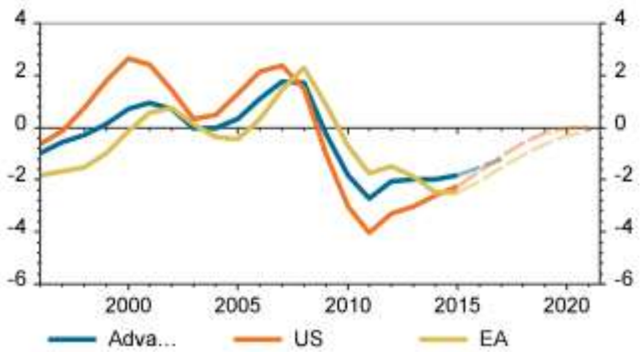
Source: Markit Economics, Thomson Reuters-Datastream Charting

Fig. B – Growth in imports, yoy



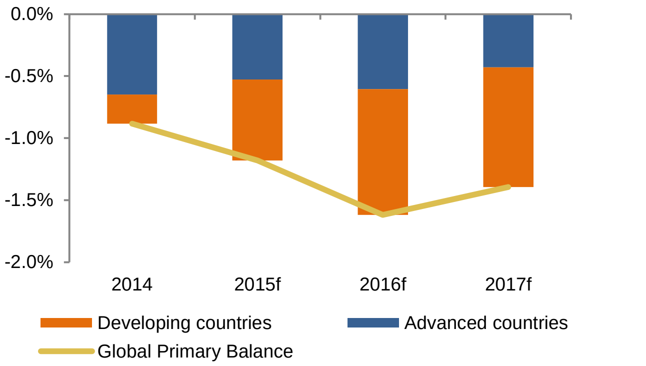
Source: CPB World Trade Monitor, Thomson Reuters-Datastream Charting

Fig. C – Output gap (IMF estimate)



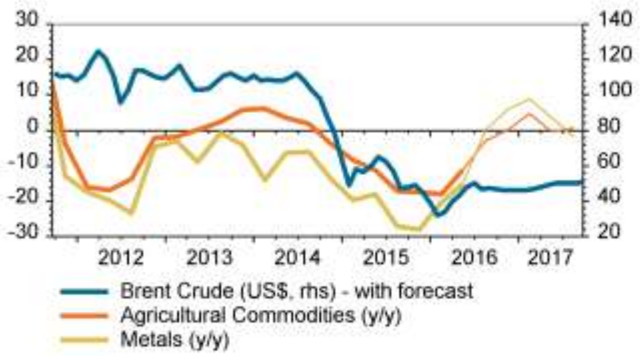
Source: Thomson Reuters-Datastream Charting and IMF

Fig. D – Public sector primary balance as a % of global GDP



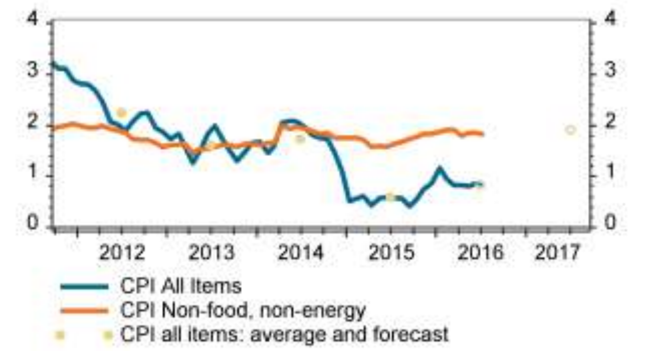
NB: based on 11 major advanced nations and 8 major emerging countries. Aggregation at current exchange rates. Source: Intesa Sanpaolo data

Fig. E – Commodity prices



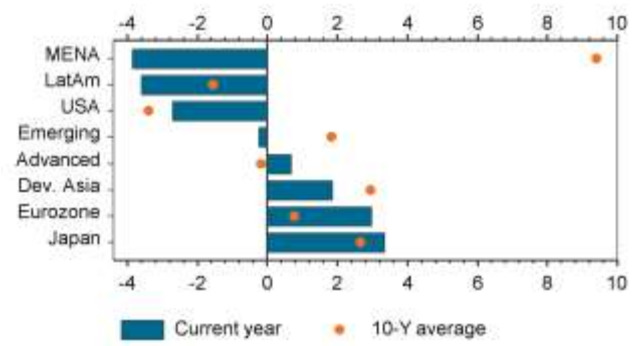
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo projections

Fig. F – Consumer price indices for OECD countries



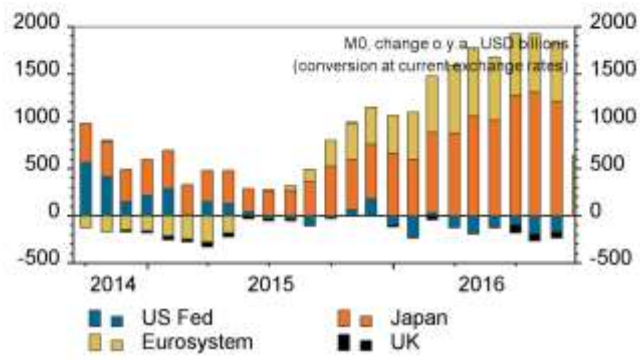
Source: OECD, Thomson Reuters-Datastream Charting

Fig. G – Balance of payments: current account balances as a % of GDP



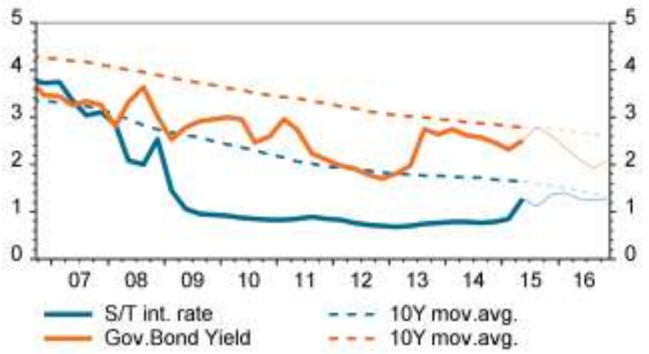
Source: IMF data and estimates, via Thomson Reuters-Datastream Charting

Fig. H – Monetary base, G3 (change, USD billion)



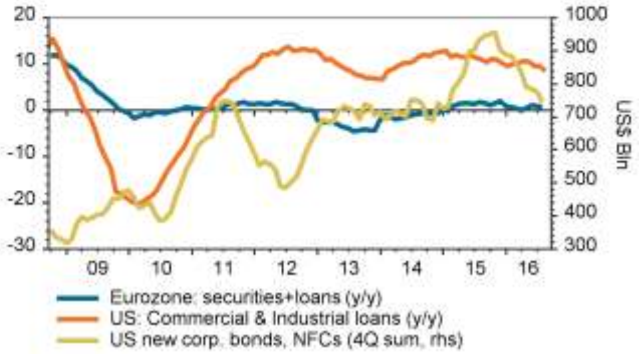
Source: Thomson Reuters-Datastream Charting, central banks and Intesa Sanpaolo estimates

Fig. I – Interest rates – global average



NB: The aggregate includes 44 advanced and emerging countries. Source: Thomson Reuters-Datastream Charting and Oxford Economics

Fig. J – Lending to non-financial companies



Source: Thomson Reuters-Datastream Charting, ECB, Federal Reserve

Tab. 1 - Economic growth by geographical region

	2013	2014	2015	2016E	2017E
US	1.7	2.4	2.6	1.4	2.2
Japan	1.4	-0.1	0.6	0.5	0.4
Euro zone	-0.2	1.1	1.9	1.5	1.3
Eastern Europe	1.7	1.6	-0.6	1.4	2.1
Latin America	2.8	0.8	-0.6	-0.2	2.1
OPEC	2.4	3.1	2.5	1.9	3.1
East Asia	6.1	8.3	5.9	5.6	5.7
Africa	3.8	3.4	3.5	2.8	3.6
World growth	3.3	3.4	3.1	3.0	3.4

Source: Intesa Sanpaolo data

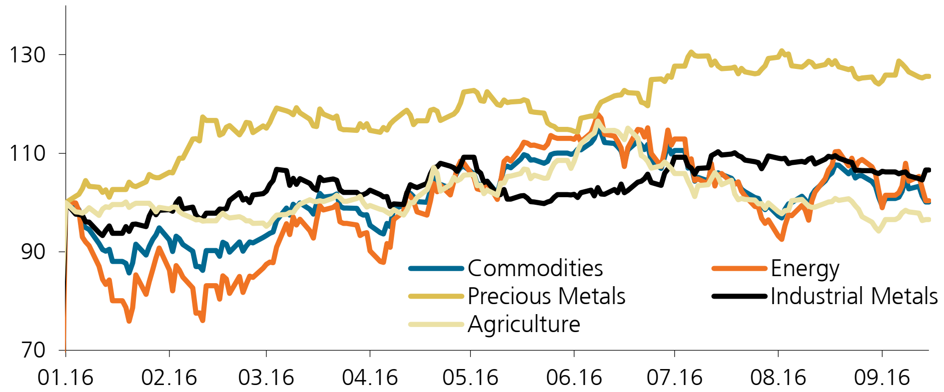
Commodities: driven by physical markets, Emerging economies and the Fed

Daniela Corsini

In the next few quarters, we think that three big themes will drive the commodities segment: changing supply and demand fundamentals, emerging market growth and US monetary policy. We expect a large dispersion in performances in the segment as for some commodities, such as oil, the deterioration in fundamentals is particularly marked, while for others, such as some industrial metals, the market balance is expected to improve..

Precious metals and industrial metals recorded a substantial price stability in the summer, while oil again demonstrated high volatility, although it remained within a wide trading range. The price of agricultural commodities fell, on account of overall positive weather conditions for harvests.

Year-to-date performance of the S&P GSCI Total Return indices (December 2015 = 100)

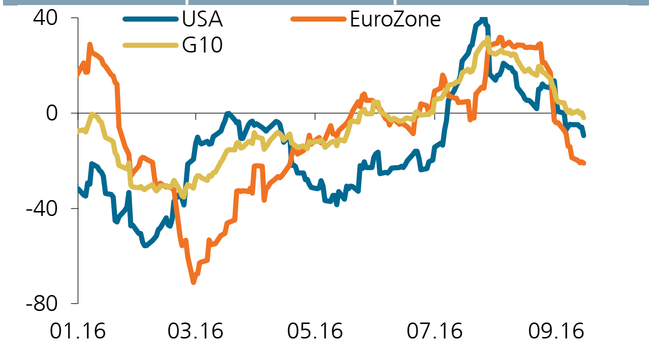


Source: Intesa Sanpaolo chart based on Bloomberg data

Macroeconomic factors have had a positive impact on commodities. On one hand, the flow of data published in emerging countries has been better than expected. Specifically, a series of generally positive data from China is fuelling a positive market sentiment towards commodities (especially industrial metals) and suggests that the monetary and fiscal policy measures implemented are providing support to economic activity. All the data published in September so far – imports, exports, industrial production, retail sales, credit market and PMI indices – have exceeded expectations. The official manufacturing PMI unexpectedly advanced to 50.4, close to its two-year highs, while the manufacturing PMI published by Caixin fell to 50.0, in line with expectations. However, for the first time since November 2014, both indices reached or exceeded the level of 50, indicating that activity is expanding. If this series of important positive data were to continue in the next few months, we could see small but significant upgrades to our growth estimates for the Asian giant, which would indicate a stabilisation of the economy and lower risks of a hard landing.

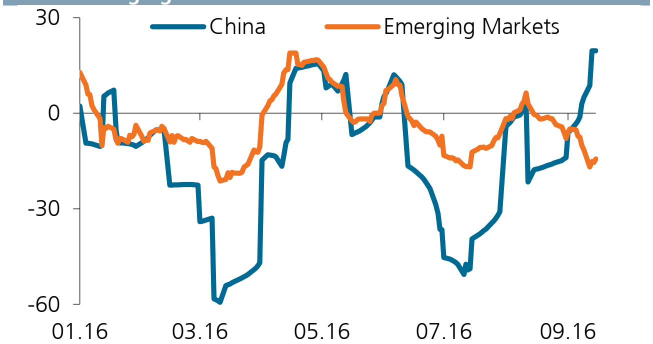
On the other hand, the flow of data published in developed countries was less positive than expected, especially in the US. Nevertheless, the market has interpreted this relative deterioration as a sign that the Fed might have further postponed its first interest rate hike. As a result, the dollar weakened, benefiting the entire commodities segment, especially gold, and at the beginning of September, the number of rises expected by the market by the end of the year fell to one. Moreover, we saw an overall easing of the main political concerns: in Europe, the impact of Brexit on the real economy is likely to be extremely limited in the short term, while in the US, the latest surveys show that the electorate is less indecisive and suggests a certain degree of continuity. An easing political risk in developed countries has triggered a moderate increase in risk appetite, which has also supported commodities.

Citi Economic Surprise Index in developed countries…



Source: Intesa Sanpaolo chart based on Bloomberg and Citigroup data

…and emerging markets

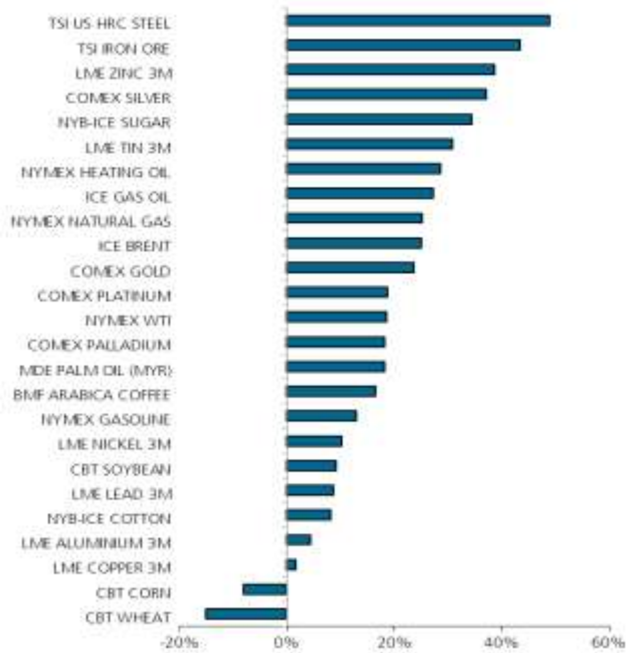


Source: Intesa Sanpaolo chart based on Bloomberg and Citigroup data

Overall, exposure to financial flows has continued to have a significant impact on commodities, fuelling volatility. This phenomenon is particularly evident for the commodities that have most caught investors' attention, and for which net long speculative positions (e.g. oil) or net short speculative positions (e.g. wheat) have reached very high levels.

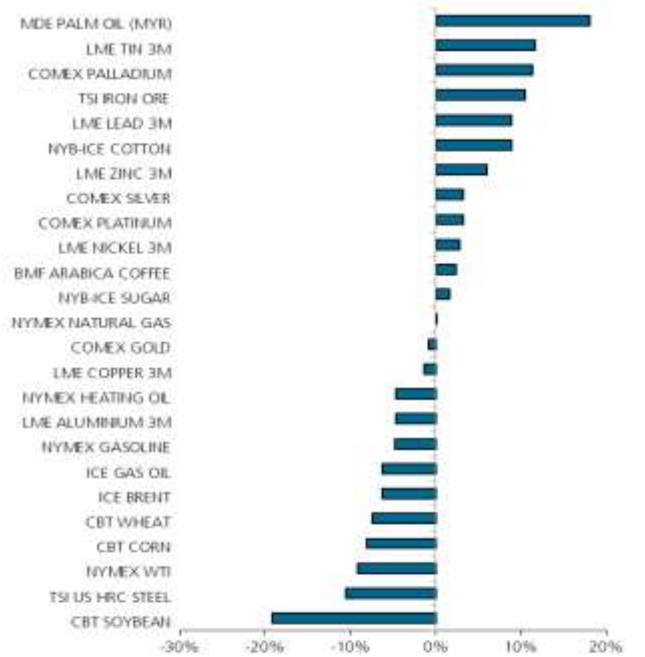
In our view, the main risk factor for the segment in the next few months is the possibility that speculative investments could be liquidated rapidly, if investors start to expect these assets to perform worse than other asset classes. This risk is especially marked for those commodities that have recorded the best year-to-date performance, such as zinc and silver, and for those that are particularly vulnerable to possible downward revisions to their estimates for supply and demand fundamentals in 2017, such as oil.

Year-to-date performance up to 27.06.2016



Source: Intesa Sanpaolo chart based on Bloomberg data

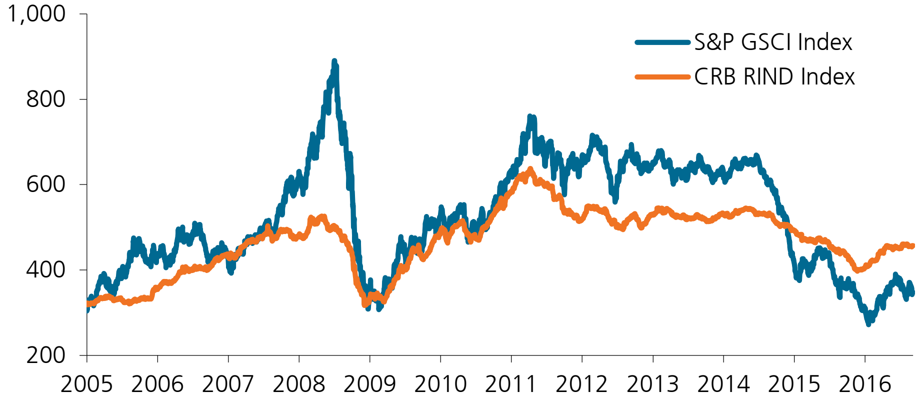
Q3 performance up to 15 September 2016



Source: Intesa Sanpaolo chart based on Bloomberg data

If we examine the price changes of a basket of some commodities that are not normally affected by purely speculative investment, e.g. the Raw Industrials Index published by the Commodity Research Bureau (CRB RIND Index), which is composed of commodities that are exposed to industrial demand but for the majority of which there are no derivatives, we see that prices have remained broadly stable during summer. In our view, this suggests that there is a considerable improvement in global demand for commodities. As a result, the stabilisation currently under way for most of the listed commodities (represented, for example, by the S&P GSCI) looks likely to be based on effectively stronger fundamentals.

Commodity indices compared: S&P GSCI and Commodity Research Bureau (CRB) Raw Industrials



Source: Intesa Sanpaolo chart based on Bloomberg data

Forecasts for the commodities universe

In the summer months, the oil price stayed within a broad trading range around an average of USD 47 for Brent and USD 45 for WTI, supported by rumours of a possible agreement between producer countries to freeze production and by optimistic forecasts stating that a rebalancing was already well under way, probably leading to a market balance in 2017. However, in September, in their latest monthly reports, the Organisation of Petroleum Exporting Countries (OPEC), the International Energy Agency (IEA) and the US Energy Information Administration (EIA) widely reviewed their forecasting scenarios, painting a picture of weaker global demand and higher non-OPEC supply than previously expected. Hence the market will not be balanced until much later than expected and the extremely high global inventories will continue to curb prices for some time to come. We therefore forecast that crude oil will stay around USD 40-50 per barrel in the next few months.

Occasional upturns will accompany expectations that the main producers may effectively implement an agreement to limit global supply. In our baseline scenario, despite the tentative signs of a greater willingness to cooperate within OPEC and the many rumours of a possible freeze on production by the main producers, we do not think it will be possible to reach an agreement before Iran increases its output up to the desired target. On the contrary, likely downward pressures will be associated with peaks in risk aversion, accompanied by a temporarily strengthening of the dollar and worries over the strength of Chinese crude imports, which we fear could surprise to the downside due to the probable slowdown in demand from independent refineries.

We think that, at the moment, the geopolitical risks are more likely to exert downwards than upwards pressure. Indeed, if the Nigerian government manages to maintain a lasting agreement with the rebels, we should see a pick-up in supply in Nigeria. In Libya, exports have been blocked for nearly two years in the main ports and, in our base scenario, we rule out a quick acceleration in the next few months. However, one of the Tripoli government's highest priorities is to steadily re-start consignments once resumed stable control of the infrastructures.

In this phase, the main precious metals markets are predominantly driven by US monetary policy decisions. Gold and silver are suffering as a result of the frequent adjustments to market expectations on the timing of the next interest rate hike. The Fed's decision to link the course of its monetary policy to trends in macroeconomic data has led to a marked increase in volatility. The markets are jittery, and speculative positions are created and liquidated quickly following surprises recorded in the US data (especially on the labour market) and in response to statements made by members of the FOMC. In our view, the first rate hike is likely to trigger inevitable but limited downwards pressure on gold and silver, which could be exacerbated by speculative flows if the Fed's tone were aggressive enough to unleash significant portfolio rebalancing. For the time being, barring any further increases in geopolitical risks or electoral surprises in developed countries, we expect that gold could trade around USD 1,330 per ounce in the last quarter of the year.

Industrial metals should make up ground in 4Q thanks to the overall improvement in supply and demand fundamentals and the apparent stabilisation of the Chinese economy currently under way. In the next few months, we would stress that the main risks to the sector are, therefore, potentially disappointing Chinese data that would re-ignite fears of a slowdown in the Asian economy, the possibility of further temporary corrections, driven by a rise in risk aversion, and the strengthening of the US dollar. In addition, zinc and nickel are most vulnerable to profit-taking. These two metals have recorded excellent year-to-date performances, accompanied by a significant accumulation of speculative positions.

As regards agricultural commodities, the summer season was positive overall for harvests. As a result, prices for the main cereals have fallen, in tandem with the deterioration in the expected supply and demand fundamentals and the recovery in speculative interest with the resulting significant accumulation of net short non-commercial positions. We expect prices to pick up moderately in 4Q but they are likely to remain well below the 1H average.

Oil: fundamentals deteriorating sharply

Global demand is growing less rapidly than expected and, in 2017, non-OPEC supply is likely to be much higher than previously estimated. As a result, the time when the market will finally return to balance seems increasingly distant. At the moment, we only see two upwards triggers that could change our scenario and lead to a significant revision of 2017 price estimates: growth in emerging countries and speculative flows towards cyclical assets.

The latest data published in the OPEC, IEA and EIA monthly reports showed a sharp change in their mood. In June, after several months of revisions to forecasts to take account of the recorded acceleration in the rebalancing process, consensus was building around expectations of a market balance by mid-2017 (EIA, IEA) or even by end-2016 (OPEC). In September, the three main forecasters highlighted global demand has been growing less quickly than expected and they were anticipating much higher non-OPEC supply than previously estimated: in 2017, IEA and OPEC even forecast that non-OPEC supply would rise by 0.4 mb/d and 0.2 mb/d respectively, while EIA continued to expect a fall of 0.2 mb/d. Furthermore, the three main forecasters expect growth in global demand to slow in 2017 (the figure is poised to shift from an annual increase of 1.4 mb/d on average in 2016 to 1.3 mb/d), with a resulting slowdown in growth of the "call on OPEC crude", i.e. the quantity of oil that group members would have to provide to balance the markets (forecast at 31.9 mb/d on average in 2016, +1.8 mb/d versus 2015, and at 33.1 mb/d in 2017, +1.2 mb/d). Consequently, the time when the market will finally return to balance seems increasingly distant: stockbuilding is likely to continue at least until mid-2017.

Supply and demand estimates published by OPEC, IEA and EIA for 2016

Estimates in September 2016 in millions of barrels	Total demand	Non-OPEC Supply	OPEC LNG supply	Call on OPEC Crude
OPEC	94.3	56.3	6.3	31.7
vs. 2015	1.2	-0.6	0.2	1.7
IEA	96.1	56.5	6.9	32.7
vs. 2015	1.4	-0.8	0.2	1.9
EIA	95.4	57.0	6.8	31.6
vs. 2015	1.5	-0.4	0.2	1.7

Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA, IEA

Supply and demand estimates published by OPEC, IEA and EIA for 2017

Estimates in September 2016 in millions of barrels	Total demand	Non-OPEC Supply	OPEC LNG supply	Call on OPEC Crude
OPEC	95.4	56.5	6.4	32.5
vs. 2015	1.2	0.2	0.1	0.8
IEA	97.4	56.8	7.0	33.7
vs. 2015	1.3	0.4	0.1	1.0
EIA	96.8	56.8	2.0	33.0
vs. 2015	1.4	-0.2	-4.8	1.4

Source: Intesa Sanpaolo chart based on data published by OPEC, US EIA, IEA

At the moment, the most optimistic forecaster, EIA, estimates that the accumulation of inventories, which is useful for assessing a supply surplus, should settle at around 0.8 mb/d on average in 2016 (from an average of 1.8 mb/d recorded in 2015) and then fall substantially to around 0.4 mb/d in 1H17. Inventories are expected to fall by 0.6 mb/d in 3Q and by 0.2 mb/d in 4Q, finally taking the market into deficit.

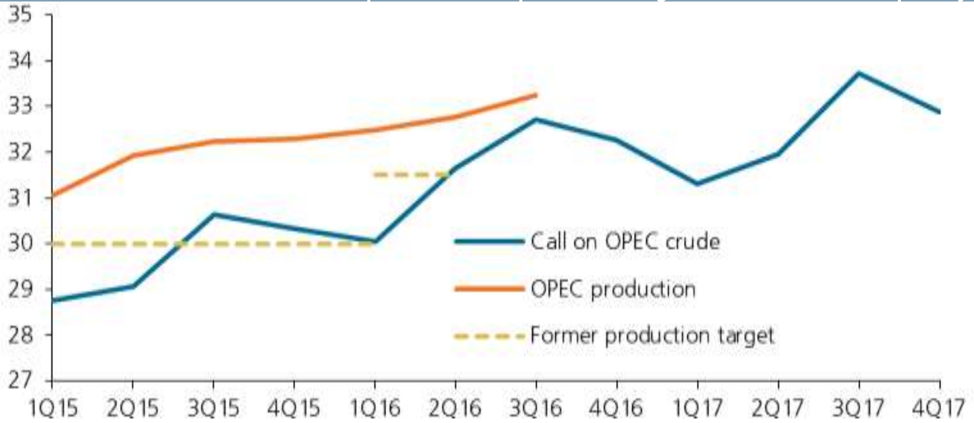
Supply and demand estimates published by US EIA

Estimates in September 2016 in mb/d	World Consumption	Non-OPEC Supply	US Supply	OPEC LNG Supply	OPEC Crude Supply	Call on OPEC crude*	Market balance**
2015	93.9	57.4	9.4	6.6	31.8	29.9	1.8
2016	95.4	57.0	8.8	6.8	32.4	31.6	0.8
Annual change	1.5	-0.4	-0.7	0.2	0.6	1.7	
2017	96.8	56.8	8.5	7.1	33.0	33.0	0.0
Annual change	1.4	-0.2	-0.3	0.3	0.5	1.4	

NB:* "Call on OPEC crude = World Consumption - Non OPEC Supply - OPEC LNG supply"; ** "Market balance = OPEC crude supply - Call on OPEC crude" Source: Intesa Sanpaolo chart on US EIA data

If we compare the average call on OPEC crude projected by the three main forecasters (33.1 mb/d) with the average OPEC production recorded in July and August (33.25 mb/d), it is clear that all debates on whether or not to freeze production are irrelevant with regard to the aims of quickly achieving market balance or shoring up prices: OPEC is already producing more than the market needs and even if production were frozen at the levels of these last few months (albeit lower than the historic low recorded this year), the market would be unable to reabsorb the extremely high levels of global stocks.

OPEC data: Call on OPEC crude, OPEC production and production target, in millions of barrels per day



Source: Intesa Sanpaolo chart based on OPEC data

Moreover, Iran, Nigeria and Libya are producing less than their production targets (by about 0.4 mb/d, 0.6 mb/d and 1.2 mb/d respectively), but they could increase supply in the next few quarters. In our baseline scenario, we rule out a stable increase of Libyan exports by the end of the year. At the time of writing, Commander Haftar's troops have seized control of the ports of Ras Lanuf and Es Sider, thereby nullifying the agreement that was so painstakingly achieved in July between the Tripoli government – recognised by the international community – and representatives of the Petroleum Facilities Guard who controlled the eastern ports. However, an agreement seems to have been reached between the National Oil Corporation (NOC) and Haftar's forces, giving way, after a two-year freeze, to the first crude oil shipments.

Our forecasts

We have had to downgrade our price scenario due to the sharp deterioration in the estimated fundamentals for 2017: if non-OPEC supply starts to rise again, global demand grows less than expected, and OPEC is already producing more than is needed to balance the markets, it is difficult to see how the extremely high global stocks could be significantly eroded.

Moreover, according to information currently available, the geopolitical risks could exert predominantly downward pressure due to the likelihood of further increases in production in Iran, Nigeria and Libya.

One large unknown that could dramatically change the estimates of when the market will become balanced is Chinese demand for imports. On one hand, Chinese fields are showing diminishing returns and hence domestic production is in structural decline. Inevitably, lower domestic demand will have to be offset by higher imports or by a reduction in inventories. On the other hand, we fear a considerable fall in the volumes required by private refineries (teapot refineries), which were authorized to import crude oil directly from abroad for the first time this year. Thanks to the contribution of these refineries, Chinese imports rose to a new record of 7.5 mb/d in 2016 and became the main driver of growth in global demand. However, on 23 August, the National Development and Reform Commission (NDRC) announced that the government will refuse applications for a licence or revoke import quotas for teapot refineries that evade taxes or falsify documents. Some analysts estimate that stricter controls could reduce Chinese imports by around 0.4-1.0 million barrels a day (mb/d), despite the support of the local government of Shandong province, where they are concentrated. In addition to more stringent tax controls, there are technical limitations (inadequate ports and oil pipeline networks, insufficient deposits) and economic difficulties, since higher crude oil prices and the introduction of higher quality standards for fuels have reduced profit margins and utilisation rates.

Given this particularly adverse scenario, we expect Brent to trade at an average of about USD 46 per barrel in 4Q16 and then rise to an average of USD 50 in 2017. According to our forecasts, WTI will trade at a discount of around USD 2, settling at an average of approximately USD 44 in 4Q16 and USD 48 in 2017.

At the moment, we only see two upwards triggers that could change our scenario and lead to a significant upward revision of 2017 price estimates:

- Emerging markets. Although rather subdued, global growth should again be driven up by emerging markets and this should directly benefit demand for commodities, including oil. Greater optimism over emerging markets could indirectly stoke risk appetite and benefit risky assets.
- Speculative flows. We have seen how investment flows have been a very powerful force this year in fuelling rallies and keeping volatility high both in western markets and in China. If expectations of a strengthening global economy were to pick up steam, we could see a shift in investment positions towards cyclical assets, perhaps triggering another sharp rise in commodity prices.

Brent and WTI: historic prices and estimates in USD/barrel

Source: Intesa Sanpaolo chart based on Bloomberg data.

Price estimates for Brent							
At 15.09.2016	3Q16	4Q16	1Q17	2Q17	2016	2017	2018
ICE BRENT	46.9	46.0	47.0	49.7	43.8	50.0	55.0
Bloomberg median	47.0	50.0	52.0	54.8	N.A.	55.5	62.0
Forward Curve	46.9	47.5	48.9	50.0	N.A.	50.3	53.1

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI							
At 15.09.2016	3Q16	4Q16	1Q17	2Q17	2016	2017	2018
NYMEX WTI	44.9	44.0	45.0	47.7	41.9	48.0	53.0
Bloomberg median	45	48.3	51.0	53.5	N.A.	54.4	61.0
Forward Curve	44.8	45.4	47.4	48.6	N.A.	48.9	51.4

Source: Intesa Sanpaolo chart based on Bloomberg data

United States: lukewarm growth, hot labour market

Giovanna Mossetti

US growth has continued to disappoint, but the economic outlook is better than it appears from the previous GDP numbers. Forecasts for the second half of the year are that it will pick up, with indicators generally positive, especially for consumption, residential building and the labour market. Residential investment is still the weakest link in this phase of the economy, and is also the main risk to the scenario, but recent signs point to a gradually less negative contribution to growth in the remainder of the year.

The **forecast for the rest of 2016 and 2017 is for moderate**, near-potential **growth**. In 2017, GDP is expected to rise by 2.2%, still driven by consumption and residential investment. The main uncertainty for the forecasts relates to **the steady-state and the scenario from 2018 onwards.** The slowdown in potential growth associated with the exceptional weakness in productivity and slowing workforce growth is accompanied by real interest rates that are well below the pre-crisis norm. There are no reliable forecasts of the **likely duration of this phase,** which, while at the moment seems anomalous, could, in fact, be the "new normal". There are differing views within the FOMC: all members recognise the uncertainty surrounding the medium-term forecasts, but some think that the recent slowdown could be temporary[1], and might be followed by a recovery in productivity, in tandem with a moderate rise in the real equilibrium rate; others, however, are more doubtful. Long-term uncertainty is one of the reasons for the Fed's extreme caution in normalising rates. With regard to the **short-term macroeconomic outlook**, the **growth scenario remains positive**, with forecasts of an upturn in 2H16 (GDP.Q3 *nowcasting* Atlanta Fed 2.9%, NY Fed 2.8%). The growth drivers remain consumption and residential investment.

Consumption and labour market indicators are in line with further moderate recovery. Growth in **real disposable income** remains solid (2.8% yoy on average in 2016), thanks to solid **labor income** and the higher purchasing power generated by the historically low level of gasoline prices. The survey of consumer expectations by the Federal Bank of New York shows that earnings growth is expected to be 2.9% over 1 year and spending growth 3.3%. The savings rate has been stable between 5.5% and 6% since 2015. Confidence is high, and **net wealth** continues to rise (the net wealth/disposable income ratio hit a new record in 2Q). **The forecast is for consumer spending growth of around 2.5-3% in 2H and 2.6% on average in 2017.**

Residential investment is expected to be on a moderate but positive path at end-2016 and in 2017. Housing starts are still increasing; there is also a shortage of houses and a sharp increase in rented accommodation and property prices in many areas. At 4.8% of GDP, residential building has doubled since the post-crisis lows and brings the sector's contribution to overall growth closer to the pre-bubble historical average. We forecast residential investment growth of 6% in 2017.

The weak component of domestic demand in 2016 has been **non-residential investment.** After shaving 1.3 percentage points off growth in 2Q, **inventories** are likely to make a positive contribution in 2H. **Fixed capital spending** was curbed by the slump in the mining sector for three consecutive quarters (fig. 3). Following the rise in the price of crude, the number of active oil rigs has been rising since May. Output from the extraction sector has been positive for three months and investment is likely to stage a reversal shortly (see fig. 4). The forecast is for a moderate increase in **total non-residential capital spending in 2H16 and 2017 of around** 3.5%.

The labour market continues to improve and is at full employment: the unemployment rate is at the equilibrium level, the numbers in work are growing by around 2% yoy, benefits are at their

[1] See, for example: Fischer, Remarks on the US economy, 08/2016; J. Yellen, Current Conditions and the Outlook for the U.S. Economy, 06/2016, J. Bullard, A New Characterization of the U.S. Macroeconomic and Monetary Policy Outlook, 06/2016, J. Powell, Recent Economic Developments, Monetary Policy Considerations and Longer-term Prospects, 06/2016, L. Brainard, The "New Normal" and What It Means for Monetary Policy, 09/2016.

lowest levels for 40 years, and wages are gradually increasing. **Further improvement will lead to a situation of increasing excess demand, with the potential risk of overheating.**

Inflation is still below the Fed's target if measured with the deflator. The core deflator has risen by a couple of tenths of a percentage point this year, but there is no clear upward trend, as in the case of core CPI. The difference between the two measures is still at maximum levels (see figs. 9-10), largely due to the definition of health, which, in the deflator includes Medicare and Medicaid services, price-controlled by Congress. We forecast that the deflator will also record, albeit with a lag, an upturn in services prices and will be **just under 2% in 2017.**

Fiscal policy is in an expansionary phase. Under existing legislation, the deficit is forecast by the CBO to be stable (3.2% in 2016 and 3.1% in 2017). The outcome of the **November elections** could lead to an increase in the deficit: **both presidential candidates have expansionary programmes** (around USD 4Trn for Trump and some USD 0.5Trn for Clinton over ten years). The last word will, however, go to Congress; it is likely that a wide Republican majority will be retained in the House and a narrow one in the Senate, which will mean that the stalemate will continue, given that the minority in the Senate will have the opportunity for filibustering. Even if there were to be a marginal Democrat majority in the Senate, Congress would still be blocked and would need to negotiate any major laws on a case-by-case basis. In the electoral campaign **the target balancing the budget is totally absent: fiscal policy will be generally expansive.**

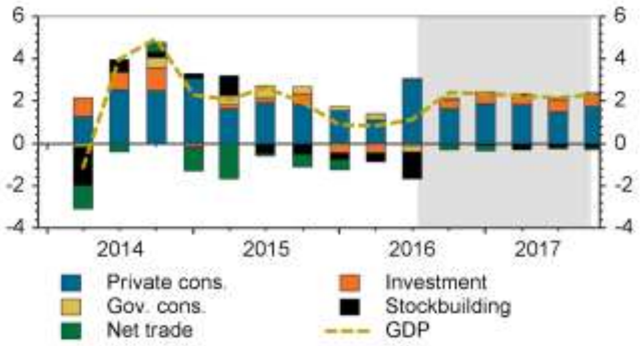
At the **FOMC meeting** in September, **rates were left unchanged** (**3 dissents**) with **indications of a likely hike by the end of the year**. "The case for a rise has strengthened but we have decided to wait for further progress towards the targets". However, an explicit assessment of the risks has re-emerged: **"the short-term risks appear to be broadly balanced"**. This is a preparatory sign of an approaching rate hike. The dot plot shows a solid consensus for a rise by the end of the year, but the path for the next few years is scattered (2017 median: 2 rises), and indicates that the Committee's message will continue to be uncertain. The only clear point seems to be the strong majority in favour of a forecast of further rises in the next few years, albeit at an uncertain pace: **the Fed's verbal guidance has become extremely unreliable.** We forecast that the **next rise will be in December and will be followed by a pause for a couple of quarters in 2017.**

Macro forecasts

	2015	2016	2017	2015	2016				2017		
				4	1	2	3	4	1	2	3
GDP (1996 US$,y/y)	2.6	1.4	2.2	1.9	1.6	1.2	1.3	1.7	2.0	2.3	2.3
q/q annual rate				0.9	0.8	1.1	2.4	2.3	2.3	2.2	2.3
Private consumption	3.2	2.6	2.6	2.3	1.6	4.4	2.4	2.7	2.6	2.2	2.5
Fixed investment - nonresid.	2.1	-0.5	3.5	-3.3	-3.4	-0.9	3.1	3.8	3.5	4.4	4.5
Fixed investment - residential	11.7	6.3	6.0	11.5	7.8	-7.7	8.2	6.2	6.2	8.1	6.9
Government consumption	1.8	0.9	0.3	1.0	1.6	-1.5	0.7	0.7	0.3	0.3	0.4
Export	0.1	-0.1	3.7	-2.7	-0.7	1.2	2.8	3.0	4.5	4.1	4.0
Import	4.6	1.1	3.6	0.7	-0.6	0.3	3.8	4.0	3.5	3.7	3.9
Stockbuilding (% contrib. to GDP)	0.2	-0.5	-0.3	-0.1	-0.1	-0.3	0.0	0.0	-0.1	-0.1	-0.1
Current account (% of GDP)	-2.6	-2.5	-2.5	-2.5	-2.7	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5
Federal Deficit (% of GDP)	-3.5	-3.8	-3.8								
Gov. Debt (% of GDP)	124.9	127.2	127.0								
CPI (y/y)	0.1	0.9	2.1	0.4	1.1	1.1	0.9	0.5	1.0	1.9	2.6
Industrial production (y/y)	0.3	-0.9	1.6	-3.4	-1.8	-0.8	1.9	1.3	1.1	2.2	2.5
Unemployment (%)	5.3	4.8	4.6	5.0	4.9	4.9	4.8	4.6	4.6	4.6	4.6
Fed Funds	0.26	0.52	1.13	0.29	0.50	0.50	0.50	0.58	0.88	1.13	1.13
Effective exch.rate (1973=100)	91.1	91.2	89.6	93.1	93.2	89.6	90.3	91.6	91.1	89.7	89.2

NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – GDP: the new normal is close to 2%

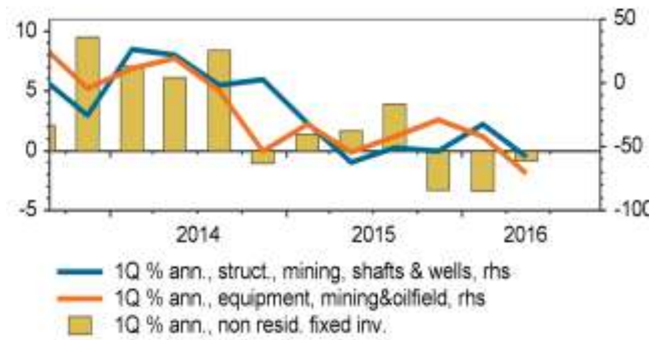


Source: Thomson Reuters-Datastream

Fig. 2 – Consumption and disposable income rising solidly

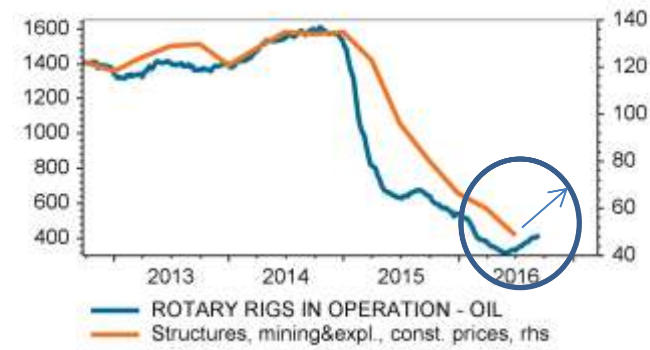
Source: Thomson Reuters-Datastream

Fig. 3 – Non-residential investment curbed by slump in mining



Source: Thomson Reuters-Datastream

Fig. 4 – Rise in the number of active oil rigs points to a reversal in mining investment

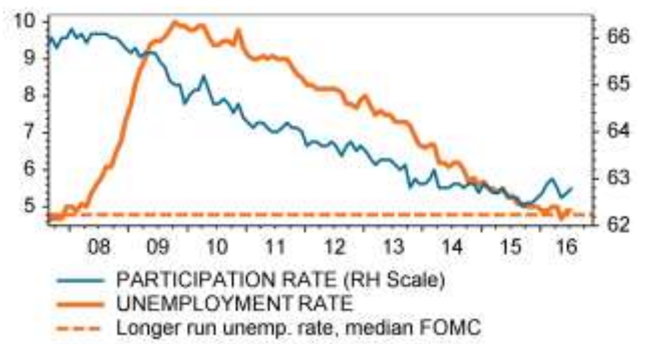


Source: Bloomberg, Thomson Reuters- Datastream

Fig. 5 – New jobs: trend is still solid

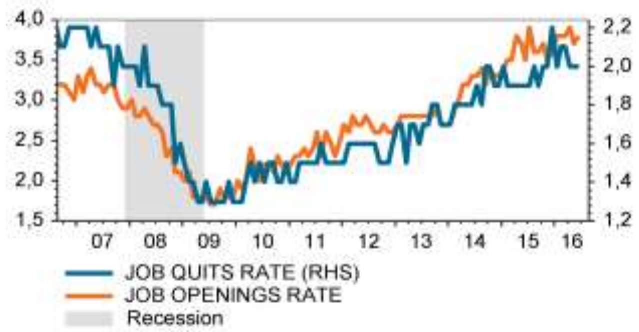
Source: Thomson Reuters-Datastream

Fig. 6 – Slack is dwindling



Source: Thomson Reuters-Datastream

Fig. 7 – Job openings and quits are indications of a labour market close to equilibrium

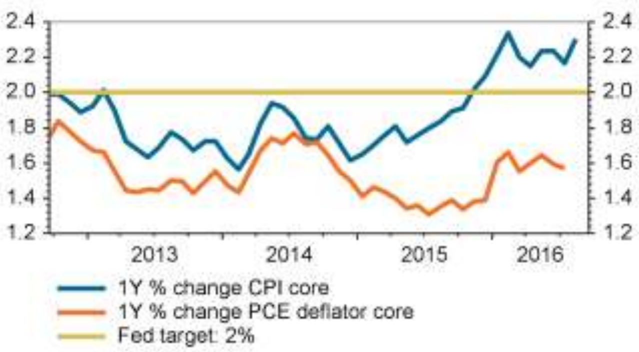


Source: Thomson Reuters-Datastream

Fig. 8 – Wages respond to labour market conditions

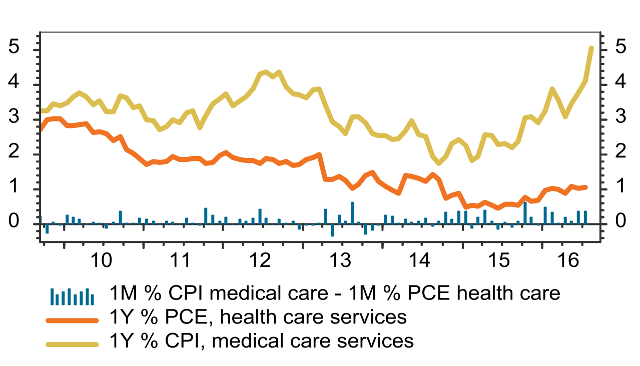
Source: Atlanta Fed, wage growth tracker

Fig. 9 – Inflation is not that far from 2%



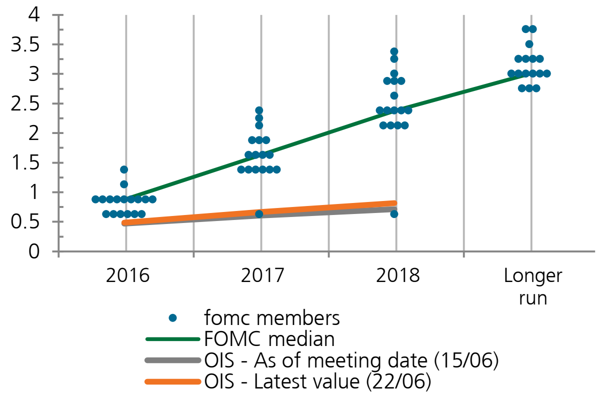
Source: Thomson Reuters-Datastream

Fig. 10 – PCE Deflator slowed by the definition of health spending



Source: Thomson Reuters-Datastream

Fig. 11 - Rate forecasts: FOMC and market still far apart



Source: Thomson Reuters-Datastream, figures at 23.06.2016

Fed macroeconomic projections – September 2016

	Median				
Variabile	2016	2017	2018	2019	Long-term
Real GDP	1.8	2.0	2.0	1.8	1.8
June forecast	2.0	2.0	2.0		2.0
Unemployment	4.8	4.6	4.5	4.6	4.8
June forecast	4.7	4.6	4.6		4.8
Consumption deflator	1.3	1.9	2.0	2.0	2.0
June forecast	1.4	1.9	2.0		2.0
Core consumption deflator	1.7	1.8	2.0	2.0	
June forecast	1.7	1.9	2.0		
NB:					
Projections of appropriate rate path					
TFed funds rate	0.6	1.1	1.9	2.6	2.9
June forecast	0.9	1.6	2.4		3.0

Source: Federal Reserve Board. GDP figures: yoy % change in 4Q

Euro Area: limited fallout from Brexit, but the recovery is slowing

Anna Maria Grimaldi

- The economic recovery in the euro area continues at a moderate pace. As we had expected, the effects of Brexit have been limited on both financial conditions and on the sentiment of both consumers and businesses. We confirm our euro area GDP growth forecasts at 1.5% in 2016 and on the decline to 1.3% in 2017. Dispersion of growth between core and peripheral countries will be less evident. In 2017 we expect a slowdown in Spain (1.6% from 3.0%) and Germany (1.4% from 1.8%), as opposed to a slight acceleration in Italy (1.0% from 0.8%) and a stabilisation in France (1.3%).
- Foreign demand addressed to the euro area will make a weaker contribution than we had estimated last June. The main driver will once again be domestic demand, fuelled by ultra-expansive financial conditions, resilient earned income, and earnings. However, private consumption, which was the main engine of growth in 2015, is likely to have peaked, as we don't think oil prices will offer any further support.
- The busy calendar of elections in the next few months adds to uncertainty. In 2016, a constitutional referendum will be held in Italy (December), as well as political elections in Austria (December) and, in all likeliness, in Spain as well (December). In 2017, general elections are scheduled in Holland (March), France (June), and Germany (August). In all these countries, with the exception of Spain, there is a risk of a further drift towards populist positions.
- Despite the numerous calls for a more active use of fiscal policy, we only expect a modest contribution from this front in 2016-17 (0.2% of GDP). The declarations of openness to a European budget and/or common spending areas such as defence, a multi-year public investment plan, or a European-scale labour insurance, are for the time being at a very preliminary stage, although they do mark a step in the right direction.
- Forecasts for a rise in euro area inflation to 1.5% in 2018 rest heavily on the trend of core prices, which should accelerate in the next few months, driven by a favourable base effect. However, starting in mid-2017, genuine upside pressures on the domestic front will be necessary. Risks are skewed to the downside.

  We believe the ECB will find itself in the position to have to do more by the end of December 2016. Monetary stimulus can only be effectively stepped up by via the PSPP, which is not so easy, given scarcity of German paper. The ECB is likely to proceed in steps, initially putting in place the less controversial changes, such as the removal of the constraints on yields and/or the purchasable shares of individual issues. A slackening of the capital keys rule would bring quite a few benefits, but rests on an entirely political decision, by no means taken for granted, and conditioned to downward revision of growth and important markets' dislocations.

Macro forecasts	2015	2016	2017	2015	2016				2017		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.9	1.5	1.3	2.0	1.7	1.6	1.5	1.4	1.2	1.2	1.3
- q/q change				0.4	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Private consumption	1.7	1.7	1.4	0.3	0.6	0.2	0.4	0.3	0.4	0.3	0.3
Fixed investment	2.9	2.3	2.3	1.4	0.4	0.0	0.7	0.6	0.6	0.6	0.6
Government consumption	1.4	1.8	1.2	0.6	0.6	0.1	0.3	0.3	0.4	0.3	0.2
Export	6.1	2.3	3.3	0.7	0.0	1.1	0.4	0.8	0.9	1.0	0.7
Import	6.1	2.8	4.4	1.4	-0.1	0.4	1.1	1.4	1.2	1.0	1.0
Stockbuilding (% contrib. to GDP)	-0.1	0.0	0.2	0.1	-0.1	-0.2	0.2	0.1	0.1	0.0	0.1
Current account (% of GDP)	3.2	3.3	2.4	3.2	3.3	3.6	3.0	3.3	2.7	2.5	2.2
Deficit (% of GDP)	-2.1	-1.9	-1.9								
Debt (% of GDP)	90.5	89.5	89.1								
CPI (y/y)	0.0	0.3	1.2	0.2	0.0	-0.1	0.3	0.8	1.3	1.4	1.2
Industrial production (y/y)	2.0	0.4	0.6	0.1	0.8	-0.3	-0.9	0.0	0.2	0.8	0.7
Unemployment (%)	10.9	10.2	9.7	10.5	10.3	10.1	10.1	10.1	9.9	9.8	9.7
3-month Euribor	-0.02	-0.26	-0.34	-0.09	-0.19	-0.26	-0.30	-0.32	-0.32	-0.35	-0.35
EUR/USD	1.11	1.11	1.14	1.10	1.10	1.13	1.12	1.09	1.11	1.14	1.15

NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Euro area growth: Andante Moderato

GDP growth in line with the trend, or just above

The Brexit effect, which was feared to trigger a tightening of financial conditions and a confidence crisis in the euro area, has proven almost imperceptible. Financial conditions have changed little compared to the beginning of June (Fig. 1). The households and businesses confidence deteriorated in the summer months, but not necessarily on the back of the outcome of the UK referendum. In August, confidence decreased in the services and retail sales sectors, both more sensitive to the trend of domestic demand than of foreign demand (Fig. 2). The composite PMI (52.9 in 3Q from 53.0) and the European Commission's economic sentiment index (104 in the summer months, from 104.3) are still at levels compatible with a stabilisation of growth in the second half of the year at the same pace as in 2Q, i.e. 0.3% q/q (Fig. 3); this quarterly rate would be compatible with year-on-year growth of 1.2%, i.e. just above potential[2]. GDP growth is expected to average 1.5% this year, and to slow to 1.3% next year, after growing by +1.9% in 2015. Thus, the Eurozone cycle is mature, as the acceleration phase should now be over; however, there are no signs of domestic imbalances large enough to justify fears of a fall back into recession.

Broadly neutral contributions from the exchange rate and from oil prices

The trend of **the effective exchange rate will weigh marginally on growth in 2017-18**, largely as a result of the appreciation recorded since May 2015 (+6%). For forecasting ends, we assume a stabilisation of the exchange rate at its recent levels, therefore with a broadly neutral impact on GDP growth. **The contribution of energy prices will change sign in the course of 2017**. After the price reductions recorded in 2015-16 (-35% and -26%, in euros) we expect a moderate increase in 2017 (+11%). The lagged effect on the trend of GDP of the drop in oil prices in 2015-16 will be offset by the expected rise in 2017, resulting in a broadly neutral impact.

The boost will come from the ECB measures already in place, and from a likely increase in stimulus

GDP growth, and in particular the recovery of demand, will continue to be supported by financial conditions that are still markedly expansive, and by a likely acceleration in credit aggregates, **thanks to an ultra-accommodative monetary policy**. The ECB still has to make purchases worth around 525 billion euros under the APP. According to ECB's estimates, the measures already in place should add 0.6% to growth in 2016-17[3]. In our baseline scenario, **we assume that the ECB will increase purchases by 80 billion euros a month until the end of June 2017**. Residual purchases would amount to around 785 billion. The stimulus effect reaped by monetary policy on euro area GDP growth could therefore prove even stronger than 0.6% next year. Furthermore, the remaining TLTRO II auctions (December 2016 and March 2017) may achieve a higher net allocation of funds than the first two operations (31 billion in June and 45.3 billion euros in September), with further stimulus effects on credit growth.

Fiscal policy will be only moderately expansionary. The flexibility allowed by Brussels, partly to handle the strong inflow of refugees, will allow a slackening of the structural balance worth 0.2% of GDP in 2016. However, it is not clear whether concessions will be made for 2017. The declarations at the Bratislava summit on an extension of the EFSI and on measures designed to support member states in fighting youth unemployment mark steps in the right direction, but are rather preliminary. However, further progress towards the introduction of a European Budget and/or common fiscal policy measures is not at all probable in the course of 2017. Despite the difficulties being faced by the Merkel government ahead of the 2017 elections, we believe Germany is highly unlikely to loosen fiscal policy more than provided for by the 2017 Budget (+0.2% surplus of GDP), as it is not by abandoning strict fiscal discipline that the CDU will win back conservative electors.

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[2] The potential rate was estimated at around 1.0% by the European Commission in its spring 2016 estimates.

[3] The impact was mentioned by Draghi in his press conference on 21 September 2016. In a speech delivered on 7 April 2016, Praet quantified the supportive effect of the measures announced between October 2014 and December 2015 at 1.5 points of GDP growth in 2015-17.

Net exports will hold growth back, but consumption and investments should support growth

The slowdown in GDP growth in the euro area in 2016-17 is largely explained by the negative contribution of net exports (-0.2% in 2016 and -0.4% in 2017), due to a cooling of global demand. The indications provided by the global PMI, and exports expectations based on national surveys, point to ongoing stagnation in goods' trade in the next few months (Fig. 4). We expect **foreign demand** directed to the euro area **to score only a modest recovery, to +2.5% in 2017 from +2.0% this year**, thanks in particular to a rebound in demand from emerging countries,. Exports to OPEC countries should make a broadly neutral contribution in 2017, after contracting this year. Exports to the advanced countries, on the other hand, could slow.

The resilience of private consumption depends on the trend of employment and on the evolution of financial conditions

The main engine of growth will once again be domestic demand, which we expect to keep increasing at a solid pace, despite a slight slowdown (1.5% in 2017 from 1.7% in 2016). Consumer spending, the true driver of the current recovery, is forecast to slow to 1.4% from 1.7% in 2015-16. **The resilience of private consumption on the forecasting horizon depends on the employment trend and on the evolution of financial conditions**. The contribution made by the drop in oil prices to the formation of disposable income will turn from markedly positive to marginally negative, in our estimates (Fig. 6). Real wages will likely slow (0.4% from +1.4% in 2015) as a result of higher inflation, and also because the latest data point to weaker growth in nominal wages (+1.0% in 2Q 2016, a low since the beginning of 2010) a trend, we expect to be confirmed going forward (1.3% in 2017 from 2.0% in 2015). Employment should continue to grow by around 1.3/1.4% between now and the end of the year, based on the indications provided by sentiment surveys, and subsequently slow to 1.2% in 2017. In any case, the recent increase in the saving rate (Fig. 8) should support consumption. The **increase of the savings rate**, despite the historic low and falling interest rates, could be a sign that households have still not entirely spent the higher income allowed by lower oil prices. However, the precautionary component may also be increasing, given the high level of uncertainty. **Investments in machinery** grew by only 0.4% q/q in 2Q 2016, after stalling at the beginning of the year. The high use of production capacity (Fig. 9), expansive credit conditions (Fig. 10), the lower cost of funding and the resilience of earnings (Fig. 11), all point to investment growth of around 0.7-0.8% q/q in the coming quarters (3.0% on average in 2017, from 2.6% this year). Our **construction spending indicator[4] points to growth of between 0.4% and 0.6% between the spring and the summer** (Fig. 12), therefore a reacceleration is likely in 3Q. The moderately expansive cycle should continue in 2017 (+1.8% from 1.5% in 2015), given the markedly supporting financial conditions and the resilience of builders sentiment.

Investments in machinery and construction to grow at the same pace as in 2016

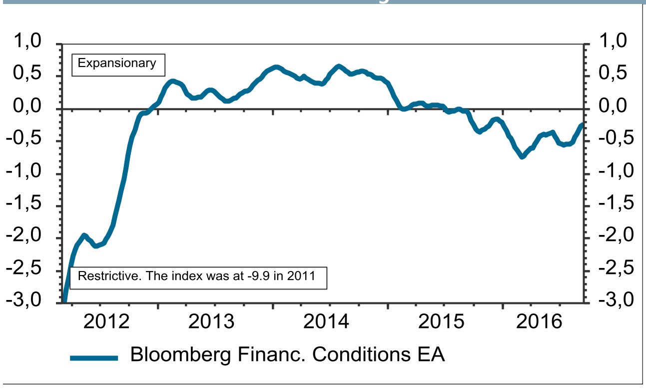
Downside risks prevail and include the intense electoral cycle in 2017.

Risks to the scenario are skewed to the downside. The chief risk is political given the busy electoral calendar in Euro this year and next. Spain is still without a government: for the time being, negotiations have stalled ahead of the administrative elections in Galicia and the Basque Country, although a third general election in a single year cannot be ruled out at this point. A repeat of the Presidential election ballot will take place in Austria in December[5], with the nationalist candidate now in the lead. Also in December, the outcome of the constitutional referendum in Italy will be known. Political elections will follow in Holland in March 2017: recent voting polls still award an advantage to the euro-sceptic populists of the PVV, in the lead with a 29% share (albeit on the decline from 35% at the beginning of August), in a highly fragmented picture that will in any case make a coalition government necessary. Presidential and parliamentary elections will follow in France: the nationalist right-wing Front National is in the lead according to the polls, but will face serious difficulties in winning a ballot. In Germany, the upswing of the AfD, if confirmed at the September 2017 elections could complicate the formation of coalitions. Political uncertainty and the electoral agenda have led to a slackening of fiscal policies in some countries, with positive short-term effects on demand, but they may have caused a further slowdown in investments. Moreover, the shift in electoral consensus to the advantage of the nationalist parties will make it even more difficult to reform euro institutions and to develop common policies.

[4] See *Weekly Economic Monitor* of 20 May 2016

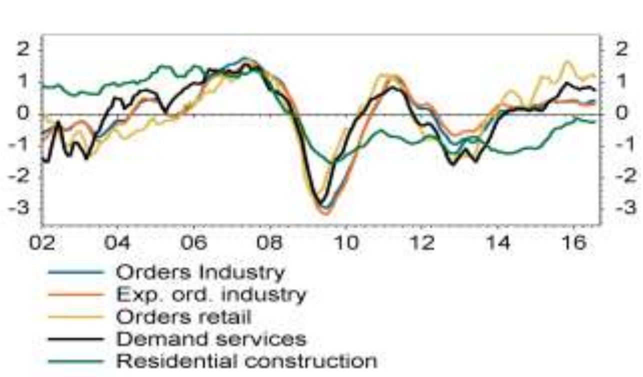
[5] The Constitutional Court ruled as illegitimate the outcome of last spring's vote.

Fig. 1 – Financial conditions have changed little following Brexit and in the summer months in general



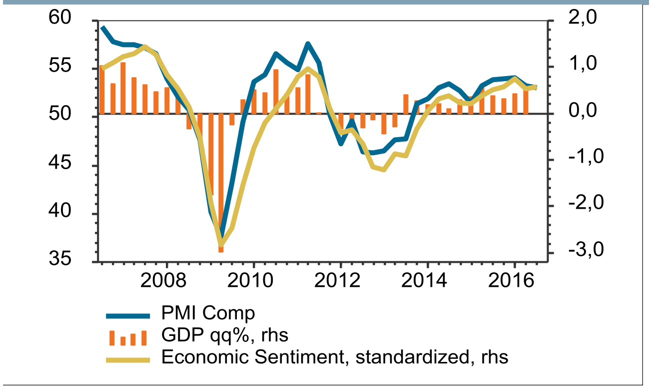
Source: Bloomberg and Intesa Sanpaolo elaborations

Fig. 2 – In the summer, businesses reported a slowdown in demand, especially in services and retail trade



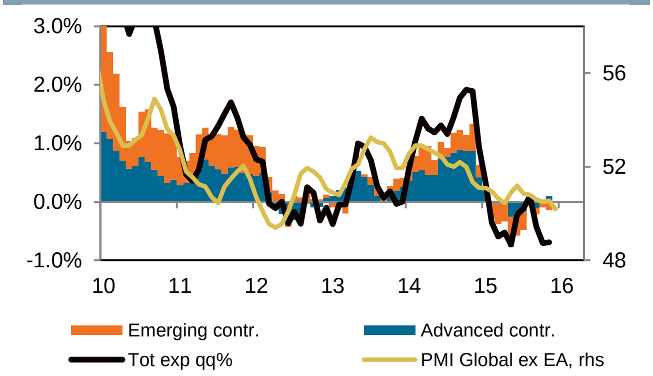
Source: Thomson Reuters and Intesa Sanpaolo elaborations

Fig. 3 – Confidence surveys place GDP growth at 0.3% q/q in the summer quarter as well. Trend at the end of the year still uncertain



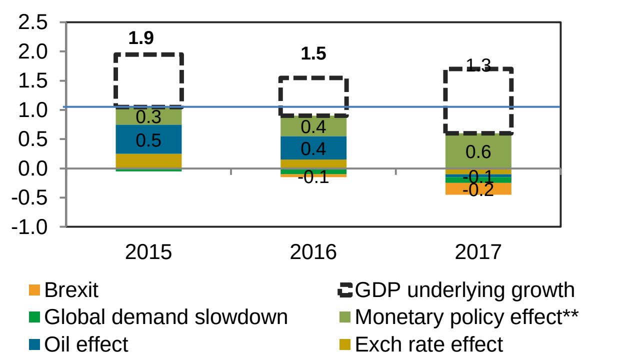
Source: Bloomberg and Intesa Sanpaolo elaborations

Fig. 4 – Foreign demand to remain stagnant



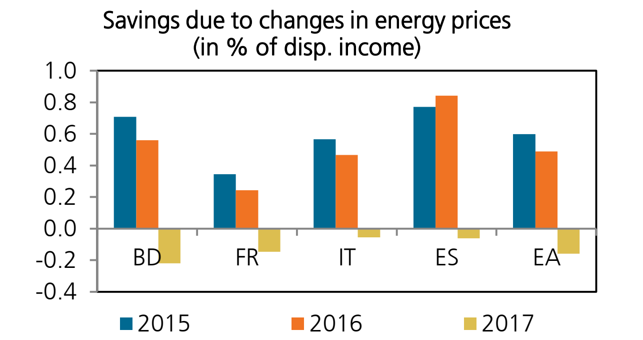
Source: Thomson Reuters and Intesa Sanpaolo elaborations

Fig. 5 – Growth driven in particular by monetary policy next year



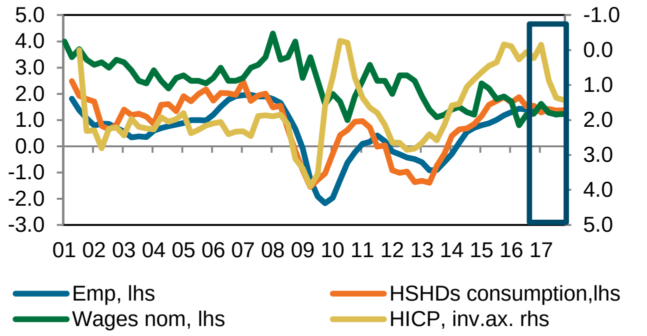
Note: effect of QE on growth: 1.5% in 3 years (Praet, 7 April 2016). The blue line indicates estimated potential growth. Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 6 – Domestic demand will have to continue driving growth. Oil prices will no longer support consumption, but…



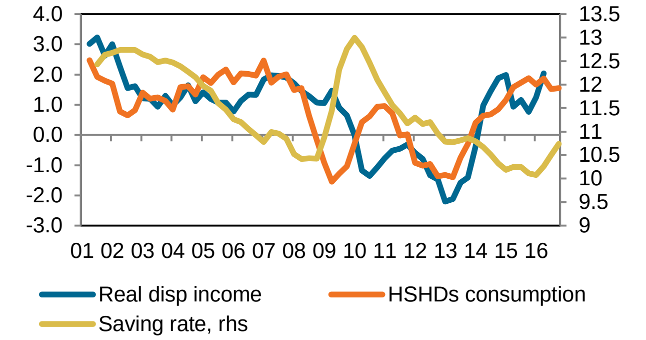
Source: Eurostat, ECB and Intesa Sanpaolo elaborations

Fig. 7 – …Employment and wages should keep growing



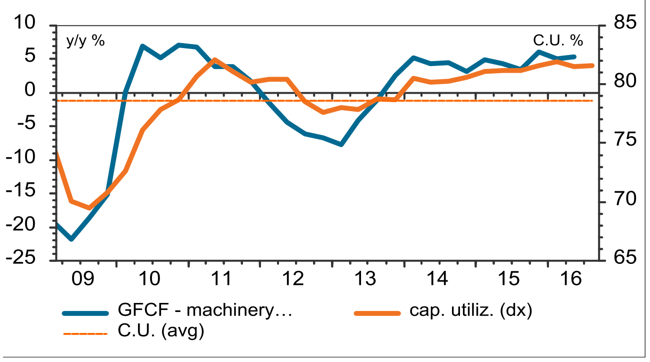
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 8 – The rise in the savings rate should represent a buffer in case of a slowdown in the employment trend



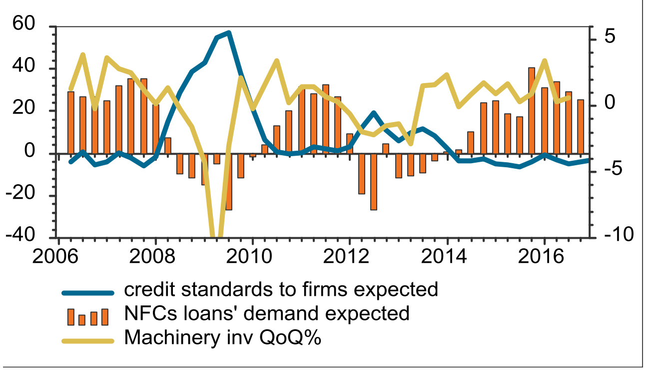
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 9 – Higher production capacity than the average for the past 10 years suggests more robust growth of investments in machinery…



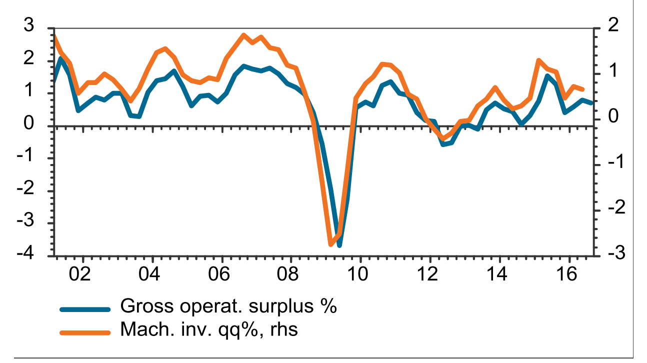
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 10 – …credit conditions and expectations for the demand for loans point to livelier investment growth



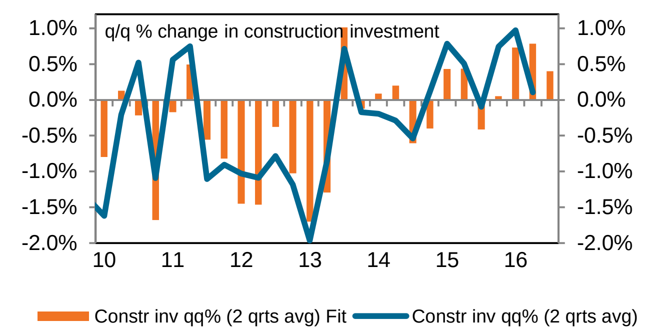
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 11 – Earnings trend compatible with 0.5% q/q growth in 3Q



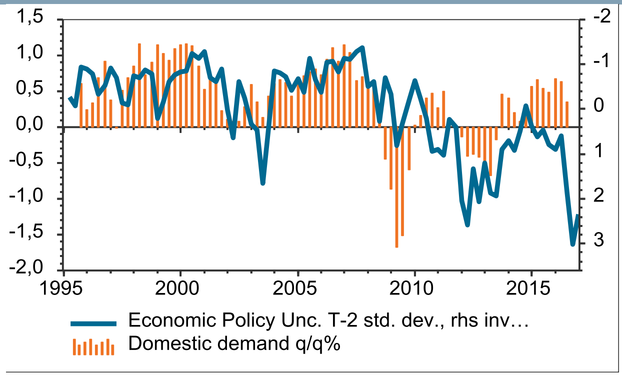
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo elaborations

Fig. 12 – Investments in construction: our indicator suggests modest growth in the summer months as well



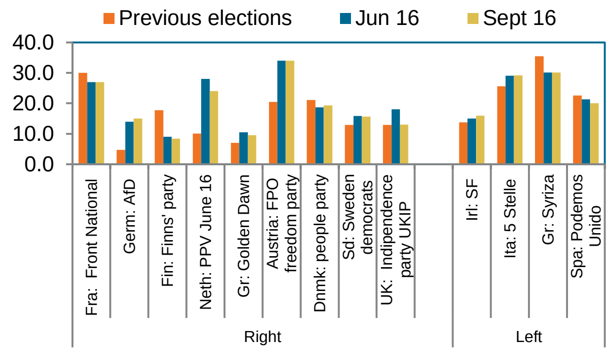
Source: Thomson Reuters-Datastream Charting and Intesa Sanpaolo estimates

Fig. 13 – Economic policy uncertainty at record-breaking levels



Source: Economic Policy Uncertainty, Eurostat and Intesa Sanpaolo elaborations

Fig. 14 – Populists gaining ground in Germany, Austria and Holland



Source: Wikipedia and Intesa Sanpaolo elaborations

Inflation: trend has reversed but the path towards 2% is uncertain

Anna Maria Grimaldi

The low for consumer price inflation seems to be behind us, but price rises will remain modest over the forecast horizon and subject to downside risks. We confirm our inflation forecasts at 0.3% in 2016 with a gradual increase over the next two years (1.3% in 2017 and 1.5% in 2018). Our estimates are broadly in line with consensus estimates and the ECB's latest forecasts (HICP: 1.6% in 2018, from 1.2% in 2016).

The low for inflation should be behind us. Energy is no longer acting as a brake

We think that energy will no longer act as a brake on inflation (see fig. 1) from early 2017, after shaving off an average of 0.5% a year in 2014-16. The contribution from energy prices will remain meagre since we expect a gradual rise in oil prices (from USD 43 per barrel this year to USD 48 in 2017 and USD 53 in 2018), in line with the recent trend, and given the usual lag with which energy prices filter through to domestic prices[6]. Moreover, there are no upwards pressures at the top of the production chain. The appreciation of the effective exchange rate from mid-2015 (+6.0%) has depressed import prices and could put pressure on consumer goods' prices (see fig.2). The rise in inflation towards 2% therefore depends almost entirely on the trend of core inflation. Despite the recovery phase that has now lasted since the end of 2013, and the ECB measures that have been in place since mid-2014, core inflation remains at 0.8%. Signs of a reversal are still only in the early stages: 1) the median, calculated on the various measures of core inflation, has risen by only three-tenths of a point to 0.9%, from a low of 0.6% in early 2015 (see fig. 3); 2) services prices excluding energy, which are more linked to domestic demand, remain modest (see fig. 4); 3) the trimmed mean rose to 0.4% yoy from 0.0% in spring; 4) core inflation excluding taxes seems to have reversed even in peripheral countries (see fig. 5). In the next few months, core inflation is expected to accelerate, largely thanks to a favourable base effect (see fig. 6), but from spring 2017, real upwards pressures on domestic prices will be necessary to ensure that core inflation stabilises at 1.3-1.4%. Going forward, an increase in underlying inflation still depends on the dynamics of the output gap and thus of domestic demand. With 2017-18 growth estimates pointing to a slowdown compared with this year, the output gap will close less rapidly than set out in the Commission's spring estimates (see chart 7), contributing at most 0.1-0.2% to core price inflation[7]. Note also that labour costs have slowed in the first half of this year (see fig. 8) in Germany too, and we do not expect a renewed upturn from the 1.4% registered in 2Q16, as nominal wages growth will moderate and productivity will stagnate.

Core inflation will rise in the next few months, supported by a favourable base effect

Pressures on domestic prices will be necessary from spring 2017

[6] The standard elasticities inherent in the ECB and European Commission models suggest that the effect of a 5% fall/rise in the price of crude oil on headline inflation is between 0.15% and 0.3% after four quarters.
[7] Our model estimates the change in core inflation based on the output gap and lags in the change of energy prices and labour costs.

Risks for inflation are still to the downside, and are driven by the uncertain cyclical outlook, by potential second-round effects on wage growth and domestic prices from the protracted decline in oil prices, and medium-term inflation expectations remaining well off the ECB target (see figs. 11 and 12).

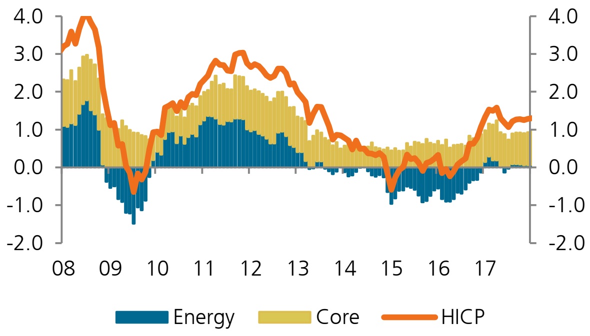
The risks for consumer price inflation are still to the downside

Tab. 1 – Inflation forecasts by country

	GRC	FRA	FRA	FIN	ESP	EA	NLD	CYP	IRL	GER	PRT	BEL	MLT	AUT
2015	-1.1	0.1	0.1	-0.2	-0.6	**0.0**	0.2	-1.5	0.0	0.1	0.5	0.6	1.2	0.7
2016e	0.5	0.2	0.2	0.4	-0.2	**0.3**	0.3	-1.0	0.0	0.4	0.7	1.8	1.1	1.0
2017e	0.8	0.9	0.9	1.0	1.4	**1.3**	1.5	1.5	1.4	1.5	1.7	1.9	1.8	1.8
2018e	0.7	0.9	0.9	1.0	1.3	**1.5**	1.4	1.5	1.5	1.5	1.7	1.8	1.8	1.9

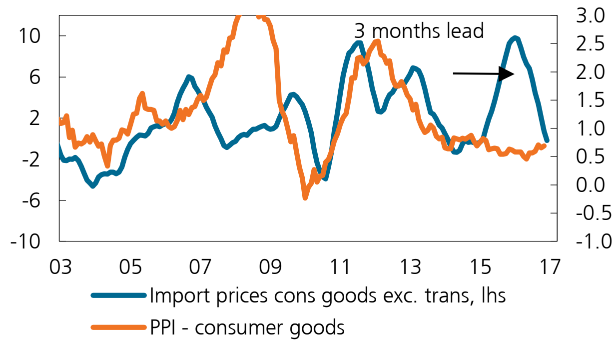
NB: e = Intesa Sanpaolo estimates Source: Eurostat

Fig. 1 – The low for inflation should be behind us, but a rise towards 2% is entirely dependent on core dynamics



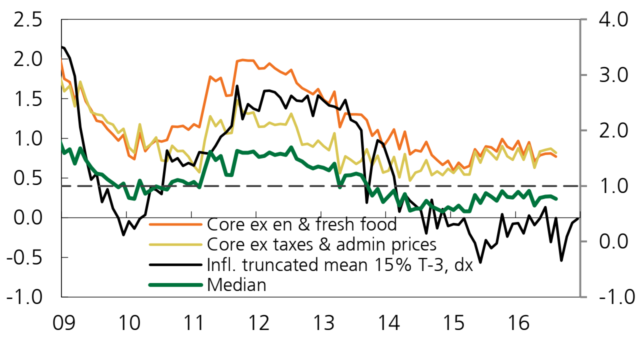
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 2 – No upward pressure in sight at the top of the production chain: import prices starting to fall again due to the recent appreciation in the exchange rate



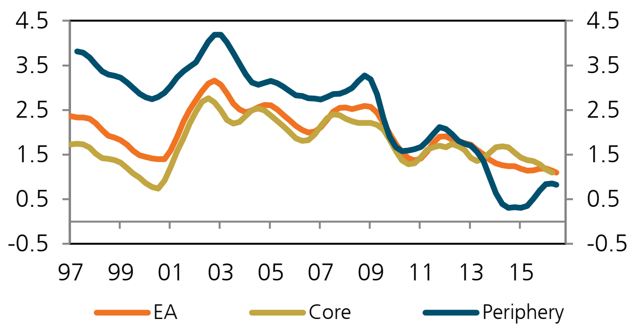
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 3 – Core inflation is sluggish The increase in the trimmed mean since the spring suggests a rise in the next few months



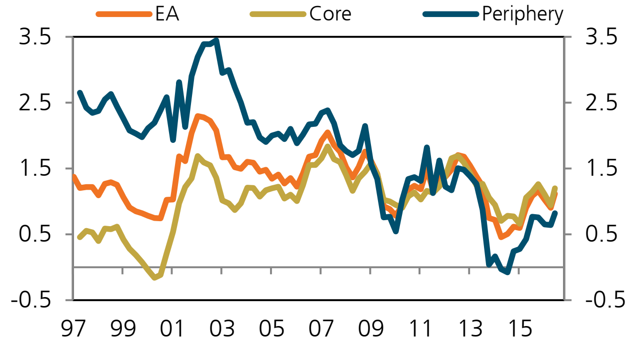
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 – Services prices, typically more closely linked to the trend in domestic demand, remain at low levels



NB: Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. Countries are aggregated with the weightings in the Euro zone HICP
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

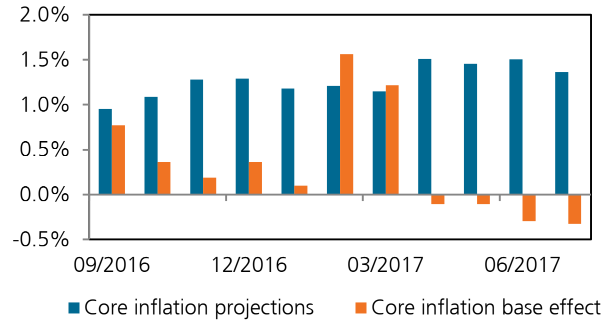
Fig. 5 – "Cyclical" inflation has also reversed in peripheral countries



NB: Cyclical inflation relates to price trends excluding energy, food and tobacco. Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. Countries are aggregated with the weightings in the Euro zone HICP

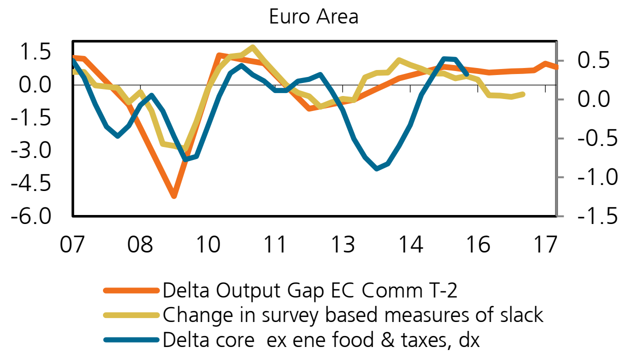
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 6 – Core inflation is expected to rise to 1.3% by March 2017 thanks to the favourable base effect, but real upwards price pressures will be necessary from the Spring onwards



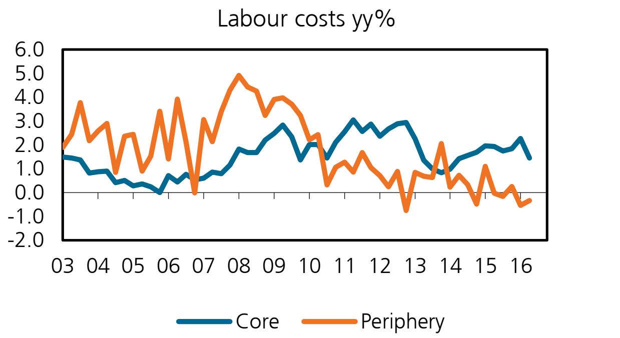
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 7 – The rise in core inflation will depend on how quickly the output gap is closed. Slowing GDP growth does not help



NB: Output gap European Commission change on the previous year. Measures of excess supply from surveys are based on the question from the European Commission's quarterly survey: "Is demand a limit to production?" for industry, construction, services and retail. The series are normalised and aggregated with the weightings of the sectors in value added.
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

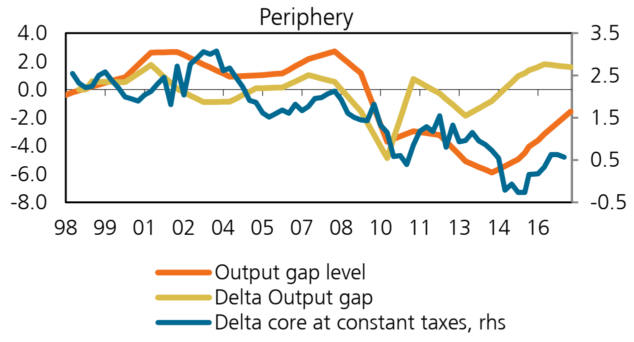
Fig. 8 – Labour costs are decelerating



NB: Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. Countries are aggregated with the weightings in Euro zone GDP

Source: Thomson Reuters-Datastream

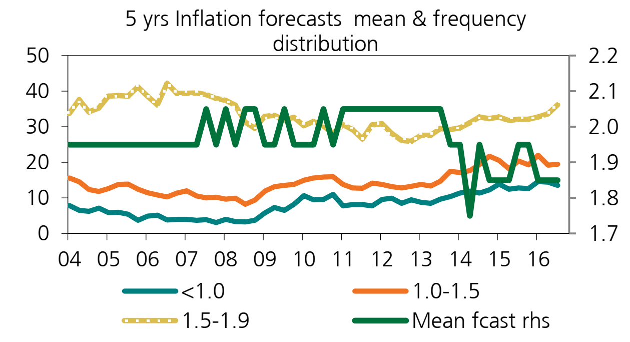
Fig. 9 – The recent rise in inflation in peripheral countries was affected by both the change in the output gap and the level



NB: Peripheral countries = ITA+SPA+GR+PT+IRL; Core countries = GERM+FR+NL+BEL. Countries are aggregated with the weightings in Euro zone GDP

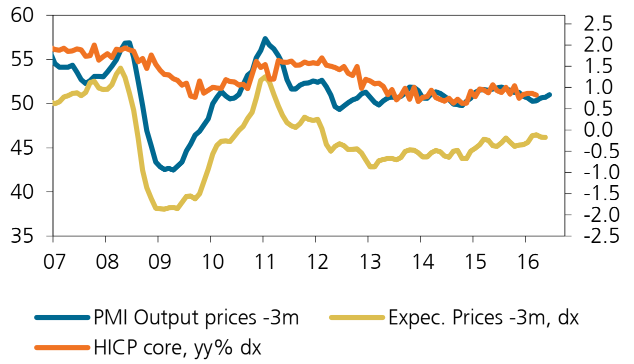
Source: Thomson Reuters-Datastream

Fig. 10 – Medium-term inflation expectations stable only for official forecasters



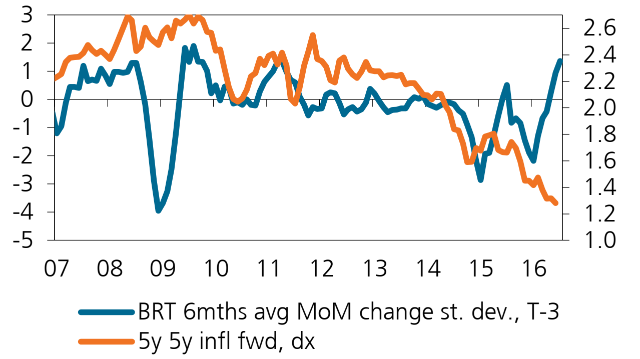
Source: ECB, SPF 3Q 2016

Fig. 11 – Surveys are not suggesting pressures on sales prices



Source: Thomson Reuters-Datastream

Fig. 12 – Risks of second-round effects if inflation expectations remain low compared with the ECB target. Rebound in the price of crude has not raised market price expectations



Source: Bloomberg (5y5y infl forward) Thomson Reuters-Datastream

ECB trying to buy time, but may have to dig deeper

Anna Maria Grimaldi

In September, the ECB kept monetary stimulus unchanged. Draghi stated that the Council had not even discussed the possibility of extending the asset purchases programme beyond March 2017, and that, for the time being, the focus remains on implementing existing measures. The reason is that the data and financial conditions during the summer have not substantially altered the moderate recovery scenario. The new ECB staff estimates trimmed barely a tenth of a point off 2017-2018 growth to 1.6% and have even raised the forecast for 2016 to 1.7%. Inflation is still seen rising towards the target, to 1.6% in 2018, as in the June estimates. The effect of the UK vote on growth has been assessed at around two- to three- tenths of a percentage point and will be offset by the monetary policy measures already in place. The new ECB estimates now fully incorporate the monetary policy measures launched in March (0.6% on growth in three years, one-tenth of a point higher than in June and 0.4% for inflation). Staff estimates are more optimistic than consensus estimates, but the press release specified that the risks are to the downside and that *in*herent in the macroeconomic projections is "*the maintenance of the high monetary stimulus necessary to secure a return of inflation to levels below, but close to, 2%*". In any event, the ECB confirmed its commitment to use "*all the instruments available within our mandate, if warranted*".

ECB has taken time in September, confirming the scenario of a moderate recovery

We think that the ECB's growth scenario could prove to be too optimistic and the Council will have to step up monetary stimulus again in December. We think an interest rate cut is unlikely, although Mr Draghi has defended the use of the measure as effective for easing monetary conditions. Most importantly, the ECB is aware that while the experience has been positive for now, further cuts would trigger limited and short-lived effects on the exchange rate and would probably start to weigh on the profitability of certain parts of the financial system.

We think that the data will compel the ECB to do more in December

An interest rate intervention is unlikely

We think that an effective increase in monetary stimulus could only occur via the extension of the APP beyond March 2017 and/or increasing purchases' volume. It is possible, therefore, that the revisions to the macro scenario are also partly dictated by the need to buy time to arrive to politically acceptable solutions to the increasing limitations of the APP due to the scarcity of German paper. The only opening available in September was that the Council "*tasked the relevant committees to evaluate the options that ensure a smooth implementation of our purchase programme*". We think it unlikely that the ECB has only recently noted the restrictions dictated by such scarcity; it is more likely that there is no consensus within the Council on the decisions to be taken to maintain the credibility of the programme and possibly to continue with the purchases, if necessary, beyond next March. Extending purchases to include senior bank bonds would enable the ECB to expand its monetary base by around EUR 200Bn, but the real

An increase in monetary stimulus translates into additional government securities purchases

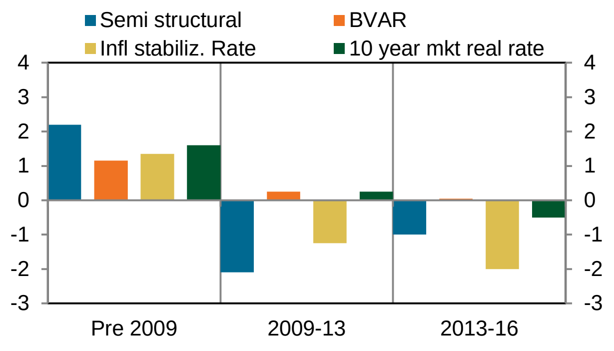
A policy discussion will need to be held within the Council issue that the Council needs to discuss concerns the limits for government bond purchases. Removing the depo limit[8] would allow the ECB to continue making purchases until next spring. Before extending the deadline for the programme, discussions would have to be held on the limits for holding a single issue and perhaps also on the rule for making purchases based on capital quotas. This is likely to cause a great deal of resistance. Despite the decision to leave a large part of the risk connected with securities purchases in the national central banks' balance sheets, the Chairman of the Bundesbank considers the capital key allocation rule essential to ensure that monetary policy does not become subordinate to fiscal policy and to maintain the central bank's independence. But even more interventionist members such as Villeroy (Bank of France) have indicated that patience is needed in assessing the impact of existing measures on growth and inflation. Rimsevic, Knot and Jazbec have stated that the programme can continue in its current form. Stepping monetary policy stimulus is a political decision for the time being the Council is divided and this explains why the ECB tried to buy time in September, justifying its decision with estimates that are perhaps already out-of-date.

Tab. 1 – The ECB's future moves are still conditional on downgrades to the macro scenario

	Estimates in September 2016			ISP & consensus estimates, August 2016		
	2016	2017	2018	2016	2017	2018
GDP yoy %	1.7↑	1.6↓	1.6↓	1.5 (1.5)	1.3 (1.2)	1.5
CPI yoy %	0.2	1.3↓	1.6	0.3 (0.2)	1.3 (1.3)	1.4
Core CPI yoy %	1.0	1.2	1.5↓	0.9	1.2	1.5

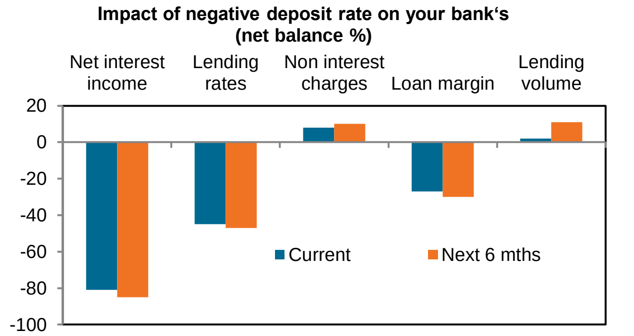
NB: ↓ ↑ indicates the direction of the revisions to the previous ECB estimates; in brackets: new technical assumptions on the exchange rate and oil based on ECB estimates; Consensus Economics estimates for the EUR exchange rate and price of oil are for November 2016, August 2017, August 2018. Intesa Sanpaolo forecasts are annual averages
Source: ECB, June 2016 macroeconomic estimates, Intesa Sanpaolo August 2016 forecasts and Consensus Economics August 2016

Fig. 1 – According to ECB estimates, the "natural" interest rate is negative and would justify additional cuts of the depo rate



Source: ECB calculations: (see Vitor Constancio's speech of 7 July 2016)

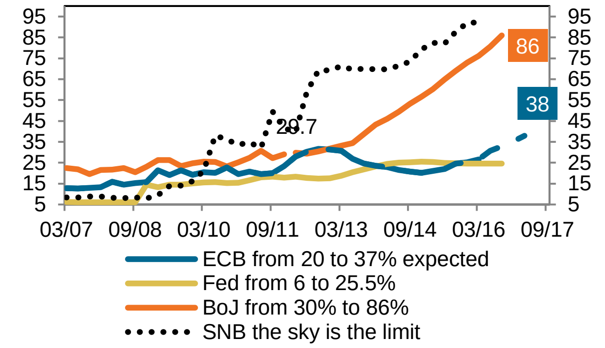
Fig. 2 – But we think that a rate is unlikely given the criticisms raised by many parts of the financial system



Source: Intesa Sanpaolo chart from ECB data

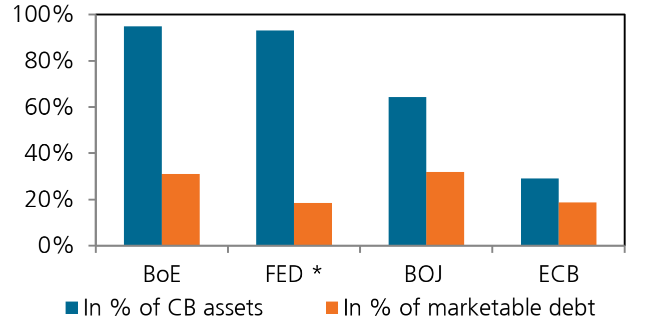
[8] See Intesa Sanpaolo Interest Rate Strategy of 7 September 2016 for more details.

Fig. 3 – The ECB's balance sheet will reach 38% of GDP by march 2017



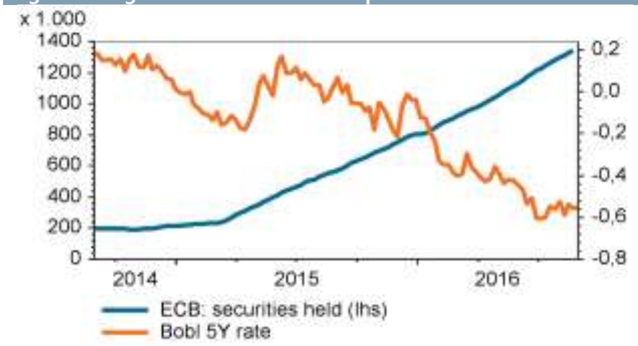
Source: National central banks and Intesa Sanpaolo charts

Fig. 4 – Fed, BoE and BoJ have purchased more government bonds



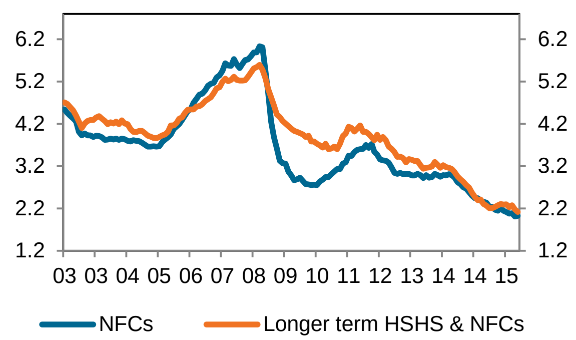
*Only Treasury; Source: National central banks and Intesa Sanpaolo charts

Fig. 5 – Long-term rates react on impulse…



Source: Intesa Sanpaolo chart from ECB data

Fig. 6 – … as does the cost of borrowing for the private sector



Source: Intesa Sanpaolo chart from ECB data

Germany: growing at trend, politics is the real challenge

Anna Maria Grimaldi

In June, we wrote that Germany seemed to have at last embarked on a growth model that focuses less on exports and more on domestic demand (see fig. 2). Data in the last few months would seem to indicate rather the opposite. GDP growth in the spring was driven by net exports, and mainly by demand from the rest of the Euro zone, eastern Europe and emerging markets, including OPEC, which more than offset the fall in flows to the UK and the US[9] (see fig. 3). As expected, consumer spending and construction investment slowed after strong growth in 1Q, inflated by calendar effects and unusual weather conditions, but the weakness in investment in machinery is cause for concern. Owing to strong export growth and the fall in imports[10], the current account surplus has started to grow again and almost reached 9% of GDP in July (see fig. 4), well above the limits forecast by the Macro Imbalance Procedure (MIP). Although the European Commission has frequently recommended efforts be made to stimulate domestic growth, Germany will struggle to use fiscal policy in 2017 to stimulate domestic demand since internal challenges are more political than economic. The period leading up to the elections scheduled for end-summer 2017 (the first possible date is 27 August) looks set to be rather complicated. The right-wing populists of the Alternative for Germany (AFD) party, following their success in March and in September in the local elections, are now represented in ten of the 16 German state parliaments, and are the third largest party in Germany, ahead of the Greens. The shift towards populist positions is clear evidence of disagreement with Merkel polices on immigration and refugees, but the movement also bears the hallmark of economic rigour. The 2017 Budget confirms the objective of a structurally balanced budget again in 2017, despite the increase of around EUR 5Bn in spending on refugees (0.2% of GDP). The medium-term plan also projects modest spending increases (EUR 20.6Bn in four years), with a tiny portion (EUR 1.7Bn, or 0.1% of GDP) for investment in transport and education. Finance minister Wolfgang Schauble is open to tax cuts (of around EUR 15Bn) after the political elections, but for the moment, it would seem that the government wants to make fiscal discipline one of the key points of the election campaign. Thus, we think that Angela Merkel and the CDU would not win back consensus by easing fiscal policy. The rise of the AFD is worrying for German domestic policy, since it would complicate the formation of alliances and risks paving the way for a minority government in Germany too.

Next year's main challenges are political

Although the political framework is complex for next year, the economy remains solid. PMI and IFO indices point to a stabilization of growth at around 0.3%-0.4% qoq from the summer, after the more sustained pace of 2015 (see fig.1). We think that GDP will continue to grow by 1.4% in 2017-18, slowing from this year's figure of 1.8%[11], but still in line with or slightly above potential[12] (1.3%). The surveys suggest that services and retail will moderate (see fig. 5) from the highs of end-2015; industry will probably act as a brake in summer but, in any case, has never made a significant contribution to this recovery. The process of rebalancing growth away from foreign demand and increasingly more with domestic demand will perhaps be slower than we expected. That said, however, the contribution of net exports will be negative over the forecasting horizon (-0.2% this year and -0.3% next year). In our view, consumer spending and investment, particularly in construction, will be the drivers of GDP in the next two years. Growth in household consumption will continue to outstrip GDP (1.5% in 2017), supported by ultra-accommodative financial conditions, fiscal measures (public subsidies and reduced social security contributions) and the resilience of employment income. We have trimmed our consumption

Growth at potential is sustainable, given the more-than-solid fundamentals

Household spending will grow in line with GDP

[9] The fall in exports to the US is probably due to the sharp correction in American inventories in the second quarter.
[10] Falling imports in spring (in both nominal and real terms) most probably reflects the slowdown in domestic demand.
[11] GDP growth is projected to be 1.7% this year and 1.3% next year.
[12] The Bundesbank estimates potential growth at 1.3%. The European Commission estimates potential growth at 1.7%

growth estimates by 0.3% compared with the June figure, since the support provided by the low oil price (0.5% in 2015-16) will disappear. The recent performance of orders, permits and confidence in the construction sector is consistent with an expansionary cycle in **investment in residential construction** at a rate of around 0.6% qoq (2.7% in 2017), and confirms that the fall in investment in 2Q was purely a correction of the excesses seen at year-start because of the unusually mild weather conditions (see fig. 10). During the spring, **investment in machinery** fully corrected the first quarter's sharp increase. This too is likely to have only been a hiatus. The high degree of capacity utilization, amply supportive financial conditions and companies' solid balance-sheet positions (low leverage, falling debt and growing profits) are likely to support the spending of expanding companies. The only aspect of concern is geopolitical uncertainty (see figures 11 and 12).

Residential construction: expansion is still solid

Corporate investment: curbed only by uncertainty

The German labor market is at full employment. **Employment** continues to grow at more sustained levels than indicated by the surveys (1.2% yoy in 2016, from +1.2% at end-2015), thanks to the contribution of the public sector, especially health, social services and transport. **Growth in the number of people in work is likely to slow to 0.9% in 2017**, according to surveys (see fig.7). Further falls in unemployment from the recent lows (6.1%) depend on how quickly the influx of immigrants translates into an increase in participation[13]. **Real labour income is expected to slow to 1.1%-1.4% in 2017 from 2.4% in 2016** due to the rise in **inflation to 1.5% from 0.4%** this year and the slowdown in contractual wage growth to 2.1% yoy from 2.4% yoy in 2015 (see fig. 6). The increase in the minimum wage to EUR 8.84, forecast from 2017, will only make a marginal contribution to the aggregate wages trend. **Risks to the scenario are broadly balanced.** The expansionary phase is sustainable as there are no domestic imbalances; meanwhile, the rise in household savings and the ultra cautious management of the public accounts are likely to enable external shocks to be absorbed. Public finances are expected to remain in a surplus position at 0.4% in 2016 and 0.3% in 2017, from 0.6% in 2015, despite the increased spending for refugees.

Labour market: at full employment

Real wages are slowing due to the rise in inflation to 1.5% and the slowdown in nominal wages.

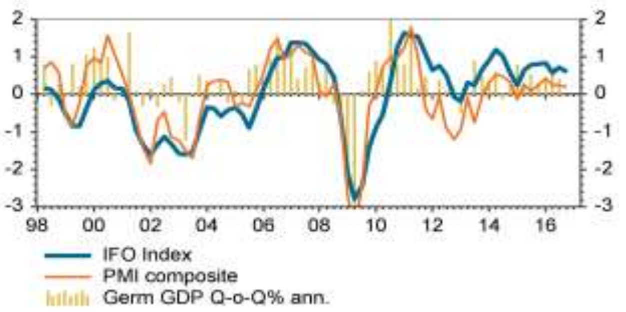
Macro forecasts

	2015	2016	2017	2015	2016				2017		
				4	1	2	3	4	1	2	3
GDP (1995 prices, y/y)	1.5	1.8	1.4	1.3	1.8	1.7	1.9	1.9	1.5	1.4	1.3
- q/q change				0.4	0.7	0.4	0.4	0.3	0.4	0.3	0.3
Private consumption	1.9	1.5	1.5	0.4	0.3	0.2	0.3	0.5	0.3	0.4	0.3
Fixed investment	1.2	2.3	2.7	1.7	1.6	-1.5	0.6	0.8	1.0	0.9	0.6
Government consumption	2.8	3.9	2.5	1.2	1.3	0.6	0.8	0.8	0.7	0.4	0.4
Export	4.6	2.6	2.7	-0.7	1.6	1.2	-0.1	0.8	0.8	0.9	0.4
Import	5.0	3.3	4.0	0.6	1.3	-0.1	1.4	1.0	1.2	1.0	0.8
Stockbuilding (% contrib. to GDP)	-0.5	0.0	-0.1	0.2	-0.3	-0.1	0.6	-0.2	-0.1	-0.2	0.1
Current account (% of GDP)	8.6	9.1	7.4	8.4	9.6	9.5	8.9	8.6	8.1	7.6	7.2
Deficit (% of GDP)	0.5	0.4	0.2								
Debt (% of GDP)	71.2	68.3	66.3								
CPI (y/y)	0.2	0.4	1.2	0.3	0.3	0.1	0.4	0.9	1.3	1.3	1.3
Industrial production (y/y)	0.5	0.3	0.4	-0.4	1.8	-0.9	-1.0	0.0	-0.1	1.0	1.0
Unemployment (%)	6.4	6.1	6.0	6.3	6.2	6.1	6.1	6.1	6.1	6.0	6.0
10-year yield	0.52	0.01	-0.04	0.57	0.28	0.12	-0.13	-0.22	-0.17	-0.09	-0.02
Effective exch.rate (2005=100)	94.9	95.5	96.4	94.7	95.4	95.6	95.7	95.4	95.9	96.4	96.6

NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo data

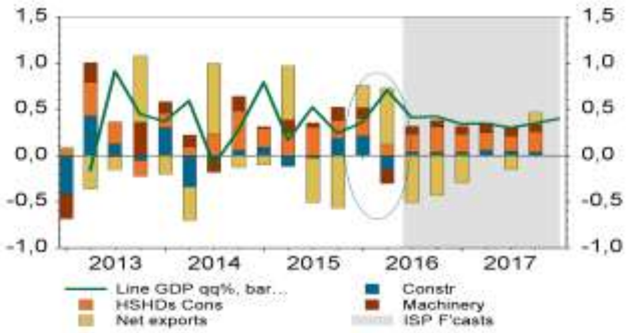
[13] Demand for labour is still largely met from immigration from the rest of the EU (260,000 in 2016), while the German Federal Employment Agency (BA) estimates that, at the moment, only a very small percentage of refugees who arrived last year have managed to gain access to the labour market (32,000).

Fig. 1 – Confidence surveys are consistent with stabilizing growth at 0.4% qoq in 2H 2016 i.e. at potential



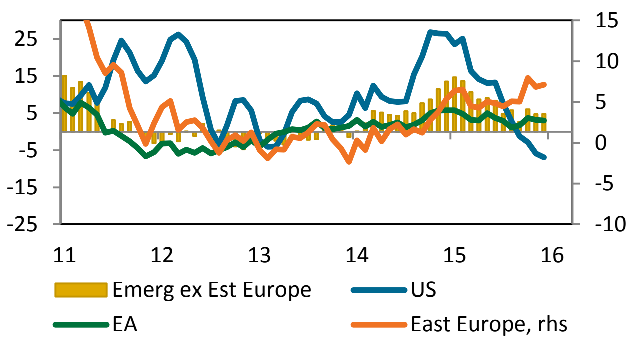
Source: FSO via Thomson Reuters-Datastream

Fig. 2 – Growth driven once again by foreign trade, but this is not likely to last. According to our estimates, the baton is likely to be handed back to consumer spending and investment



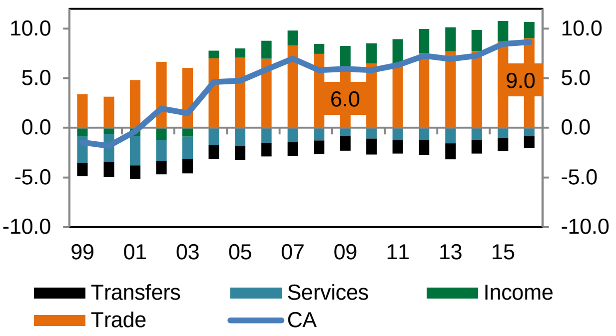
Source: FSO via Thomson Reuters-Datastream

Fig. 3 – Exports supported by demand from the rest of the Euro zone, eastern Europe and emerging markets



Source: FSO via Thomson Reuters-Datastream

Fig. 4 – The current account surplus has almost reached 9% of GDP, well above the limits imposed by the MIP

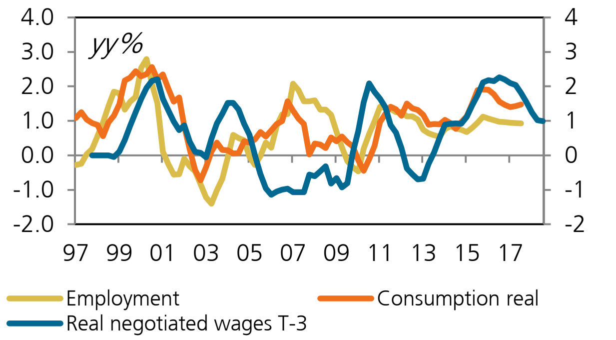


Source: FSO via Thomson Reuters-Datastream

Fig. 5 – Industry slowing again. GDP will still be driven by services and retail, the sectors most linked to domestic demand, but there are signs that it will moderate

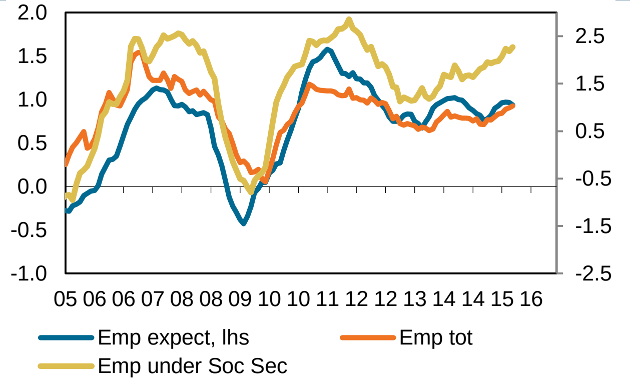
Source: FSO via Thomson Reuters-Datastream

Fig. 6 – Household spending is set to hover around 1.7% in 2016-17, supported by growth in the number of people in work and fiscal measures, while real wage growth is expected to slow



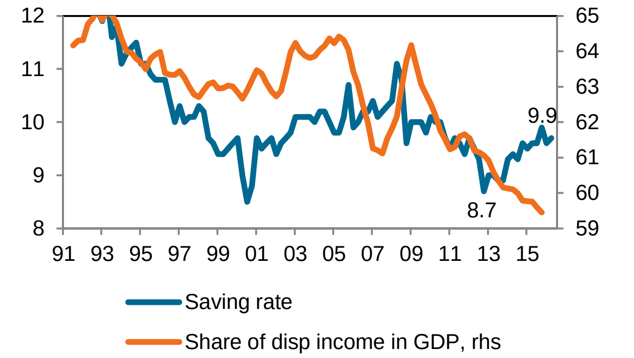
Source: Thomson Reuters-Datastream

Fig. 7 – Employment will continue to grow at higher levels than forecasted by companies



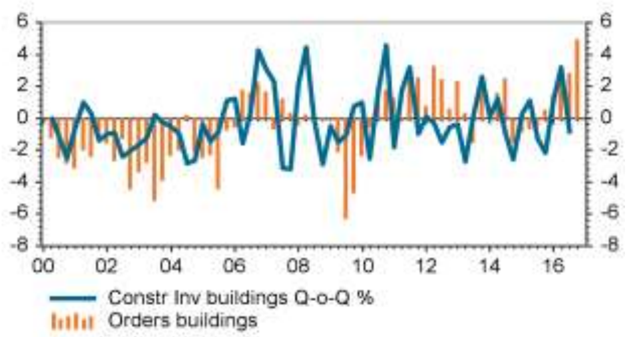
Source: FSO via Thomson Reuters-Datastream

Fig. 8 – The recent rise in the savings rate is likely to provide a buffer in the event of shocks



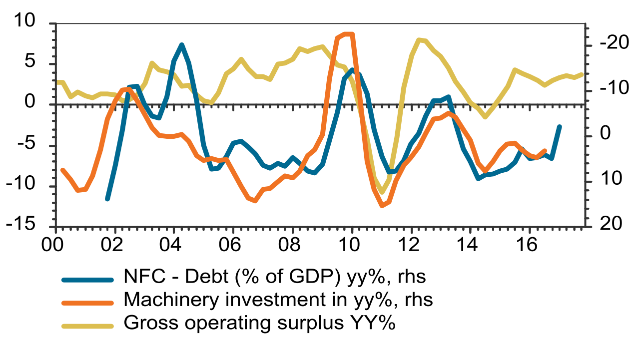
Source: Thomson Reuters-Datastream

Fig. 9 – Construction heading for a rebound after the normal 2Q fall



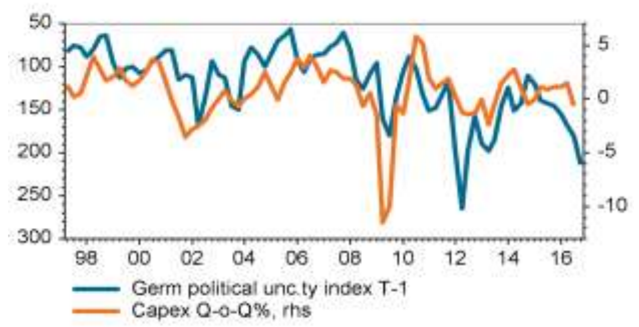
Source: FSO via Thomson Reuters-Datastream

Fig. 10 – Solid financial position of companies and moderate earnings growth point to more buoyant investment spending



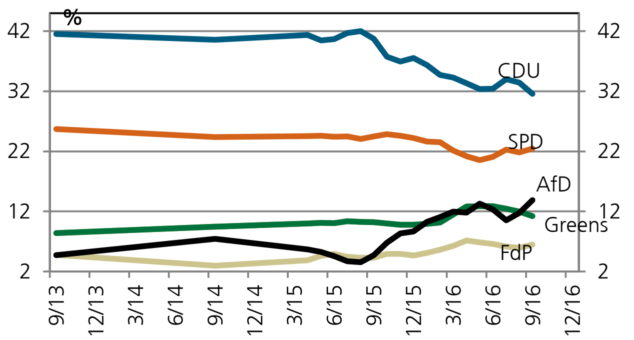
Source: FSO via Thomson Reuters-Datastream

Fig. 11 – The real brake on investment is "the great uncertainty"



Source: FSO & Economic Policy Uncertainty Institute via Thomson Reuters-Datastream

Fig. 12 – Political elections are the real challenge Concern growing over the possibility that the AFD will get into government



Source: Wikipedia

France: growth falls short of expectations

Guido Valerio Ceoloni

GDP revised downward by three-tenths to 1.2% in 2016 and 1.5% in 2017 with risks to the upside

In the second quarter, GDP growth came to a sudden halt: the marginal decrease of 0.1% qoq was due to a **slowdown in consumption and investments, especially in the production sector**. However, a slowdown was expected, especially in investments, after the strong start to the year (GDP up by 0.7% qoq, investments up by 1.3% qoq). The slowdown was rather widespread among major Euro zone economies, but in the case of France, it was **largely due to floods and strikes that affected the country between May and June**, and that were entirely temporary in nature. Growth to date is 1.1% (one-tenth less than the previous estimate), and in the second half of the year, we anticipate a further acceleration supported again by domestic demand. As a precaution, we have lowered the average annual forecast by three-tenths to 1.2% as compared to June. **For this quarter and the next, we project average GDP growth of 0.25% qoq** (1.2% yoy). For **2017** we also revised the projection downward by two-tenths, to **1.5% yoy**.

Consumption up by 1.5% yoy in 2016 and 1.1% in 2017; household investments will stop dropping in 2017, while production investments will rise somewhat

Employment remained stagnant in the second quarter, but in the second half of the year it should resume the growth rate of about 0.2% qoq seen at the beginning of the year due to construction and services. This performance, which is expected to continue in 2017, should lower the unemployment rate to 9.7% next year. **Household consumption continues to be the main driver of growth**, although in the second quarter it came to a complete halt, after rising 1.1% qoq in the first quarter. In the first seven months of the year, purchases of durable goods rose by 6.1% yoy compared with 3.9% yoy for the same period last year. Private consumption will resume its upward trend in the last two quarters of 2016. As an annual average, consumption is expected to grow at the same pace in 2016 as in 2015 and then slow to 1.1% in 2017. Even if gains in purchasing power related to the fall in energy prices will not be seen, household confidence levels are good; the savings rate serves as a damper in the event of a fall in income; employment is rising moderately; and conditions for accessing consumer credit continue to be favourable.

The trend in **household investments** remains flat (up 0.2% yoy), which will lead to an annual average increase in 2017, and we project that investments will finally stop falling after five negative years. **Corporate investment**, which in the second quarter partially erased the rebound in the first quarter (-0.4% qoq vs. +2.0% qoq), is expected to recover in the second half of the year. The increase in production capacity utilisation for the third consecutive quarter (at 83.4%, a historically high level, and a six-year high) suggests that fundamentals (higher profits, increased plant utilisation and financial conditions) could more than offset the impact of increasing uncertainty in the economic environment.

No change in industrial output in 2016. Construction continues to rebound, as services rise.

The economic situation continues to be inconsistent. **Industrial output** in the second quarter was sharply negative, with three consecutive downturns (-0.7% mom on average, with -0.5% mom in manufacturing alone). Although it improved slightly to 48.8 in the third quarter, the PMI continues to reflect decreased activity. INSEE indicators also reflected considerable erosion in the future outlook for activity (from 8.1 in the second quarter to 4.3 in the current quarter), and in particular in foreign orders (from -7.5 to -9.4). Although September could produce a rebound in production, quarterly production is heading for another fall in the third quarter (-0.7% qoq from -0.2% qoq) with a negative contribution of at least one-tenth to GDP. To date, annual industrial output growth has dropped by half compared with 2015 (to 0.5% from 1.0% in the first seven months of the year), and in 2016 we expect almost no change after the 1.5% rise in 2015. With regard to **construction, confidence indicators point to stable activity for the current quarter** (currently 95.0 from 94.9) with a risk of a slowdown at the end of the year (activity index projected at -11.5 from -7.0) following a correction in building permits. However, the recovery of the sector was still tangible and steady compared with 2015, with the average indicator rising to 94.0 from 89.6 in the first eight months, but still below the long-term average (100). Lastly, **the service sector continues to be the most dynamic, with surveys pointing to an acceleration in**

activity at the end of the year (services PMI at 52.3 from 50.7, projected activity at 59.2 from 61.3; INSEE index at 101.3 from 99.3, above the long-term average, and activity level at -7.2 from -7.8) due in particular to domestic, as opposed to foreign, demand (which dropped to -1.8 from 4.0 from July to August). There is also a promising outlook for employment, with related indices now at 8.9 (the highest point since 2011) up from 7.6 in the second quarter.

Deterioration in trade balance in 2016 and 2017 following lacklustre exports

The slowdown in consumption resulted in decreasing **imports** (-1.8% qoq from +0.2% qoq) despite slightly higher **exports** (+0.2% qoq from -0.4% qoq in the second quarter), thereby allowing net exports to make their first positive contribution after three negative quarters (+0.6 from -0.2). We believe that for the rest of the year, the **foreign channel** will make a negative contribution to GDP formation.

Inflation at 0.1% in 2016 and 0.8% in 2017 owing to a recovery in the core component

Inflation should remain weak for the remainder of the year: after remaining close to zero on average for the first two quarters, **in future months it should rise at most by two or three tenths. For 2017, consumer prices are projected to rise by 0.8%** (0.9% on the HICP), resulting from the favourable performance of the underlying component, the increase in energy prices and more buoyant wage increases in 2016.

Nominal deficit set to decline, and structural deficit set to rise in 2017 Rising public debt

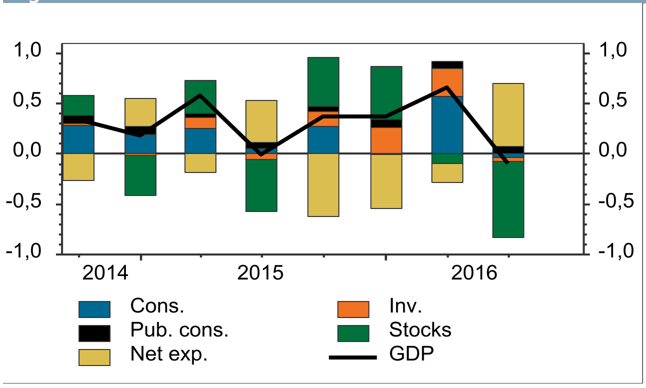
The 2017 budget, which will be submitted at the end of the month, could indicate a growth scenario for next year less than the planned figure of 1.7% in June. Growth estimates could stand at 1.5% for the current year and be revised downward by two-tenths in 2017, to 1.5%. Thus, the nominal deficit is confirmed to decline to -2.7% for 2017 from -3.3% in 2016. The 2016 projections for GDP and the deficit appear optimistic, and thus, the 2017 target of a six-tenth correction to -2.7% is not likely. The Commission more reasonably projects a headline deficit from -3.4% to -3.2% with a three-tenth increase in the structural deficit from -2.4% to -2.7%. This year, **public debt** will rise to 96.5% of GDP from 95.2%, and to 97.0% next year.

Macro forecasts

	2015	2016	2017	2015	2016				2017		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.2	1.2	1.5	1.3	1.4	1.3	1.1	1.1	1.0	1.5	1.7
- q/q change				0.4	0.7	-0.1	0.2	0.3	0.6	0.4	0.4
Private consumption	1.5	1.5	1.1	0.0	1.1	0.0	0.2	0.3	0.3	0.3	0.4
Fixed investment	0.9	2.6	1.7	1.2	1.3	-0.2	0.4	0.4	0.5	0.5	0.5
Government consumption	1.5	1.6	1.3	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.4
Export	6.0	0.9	3.4	0.6	-0.4	0.2	0.4	1.0	1.0	0.8	1.0
Import	6.4	2.2	3.1	2.2	0.2	-1.8	0.9	1.1	0.9	0.9	0.9
Stockbuilding (% contrib. to GDP)	-0.1	-0.4	0.0	0.5	-0.2	-0.8	0.1	0.0	0.2	0.1	-0.1
Current account (% of GDP)	-0.2	-0.5	-0.7	-0.5	-0.7	-0.5	-0.3	-0.4	-0.5	-0.7	-0.8
Deficit (% of GDP)	-3.5	-3.3	-2.9								
Debt (% of GDP)	95.2	96.5	97.0								
CPI (y/y)	0.0	0.1	0.8	0.1	0.0	0.0	0.2	0.3	0.6	0.6	0.9
Industrial production	1.5	-0.1	1.2	0.4	-0.4	-0.2	-0.8	0.7	0.4	0.4	0.5
Unemployment (%)	10.4	10.0	9.7	10.2	10.2	9.9	9.9	9.9	9.8	9.7	9.6
Effective exch.rate (1990=100)	95.3	96.5	97.9	95.3	96.1	96.5	96.8	96.4	97.1	98.0	98.2

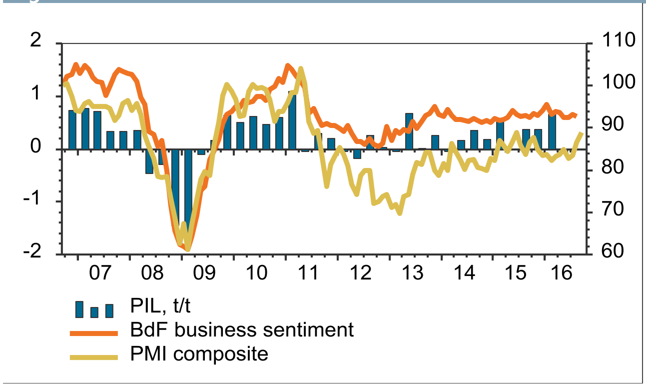
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo data

Fig. 1 – Contribution to GDP



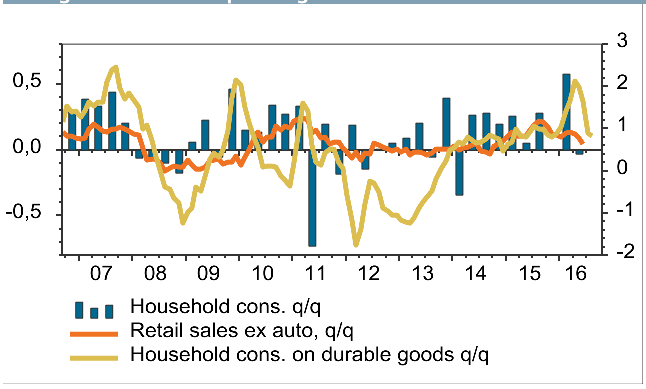
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – GDP and confidence indicators



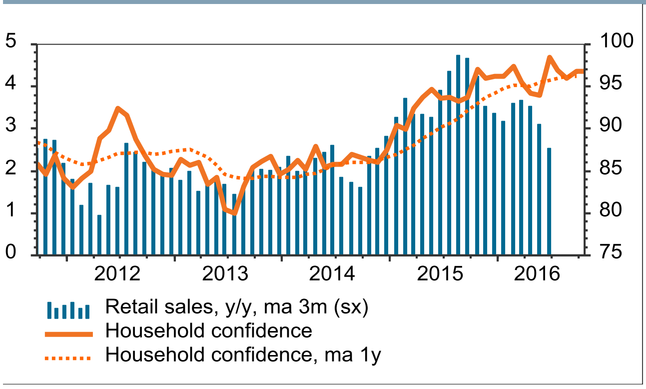
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 3 – Household spending, purchases of durable goods and change in consumer spending



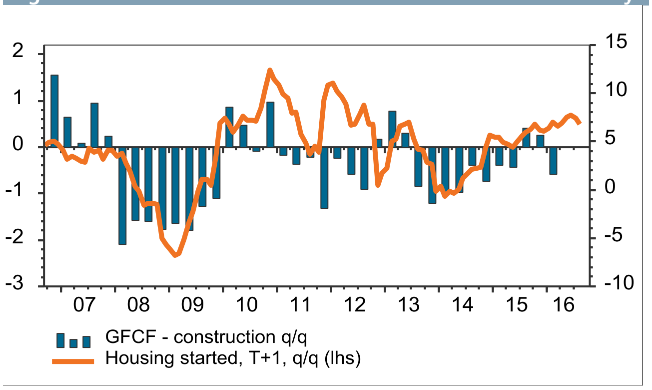
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 4 – Retail sales and household confidence



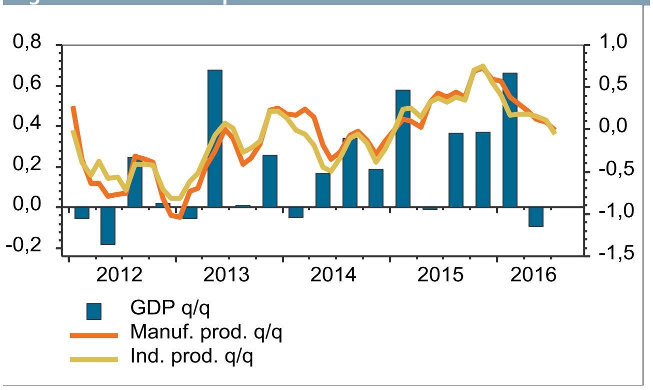
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 5 – Residential investment and construction sector activity



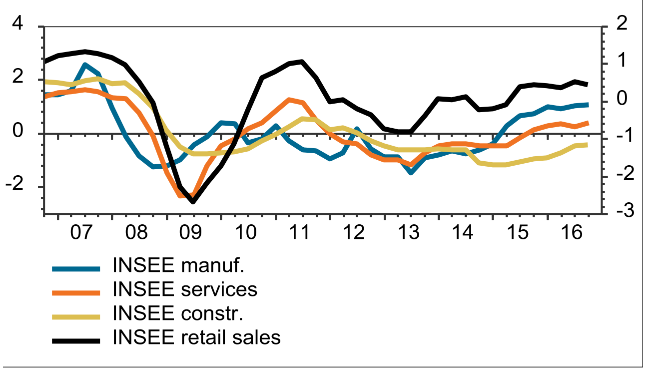
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



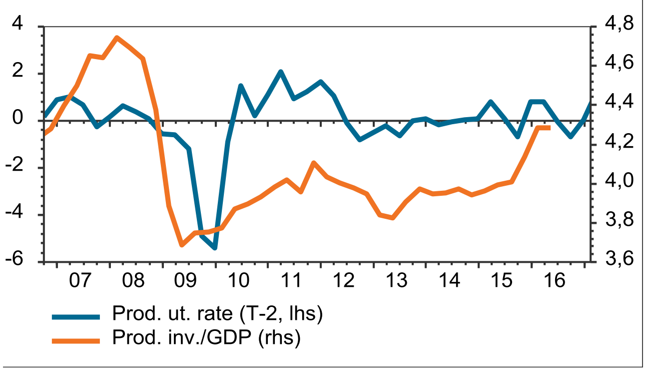
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



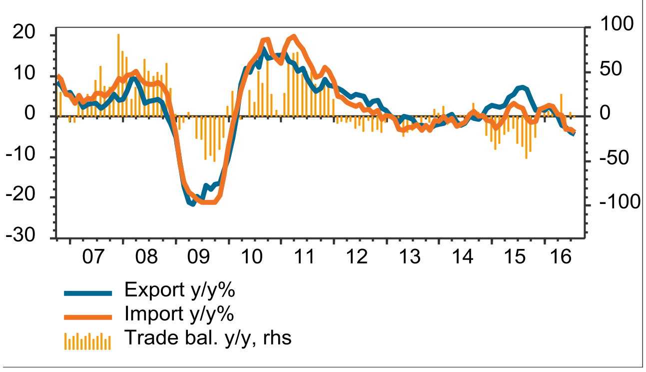
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 8 – Production capacity utilisation and level of investment on GDP



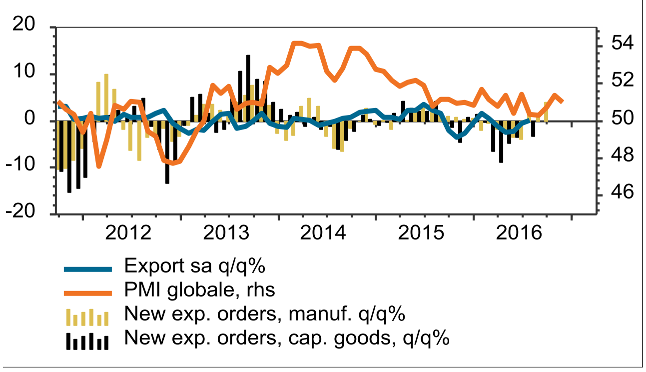
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Trade balance



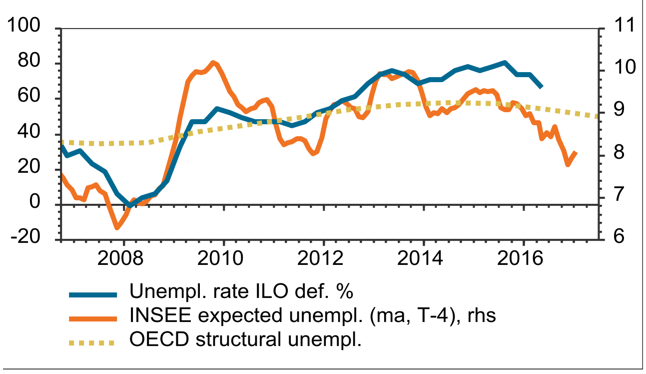
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 10 – Exports, export orders and global PMI



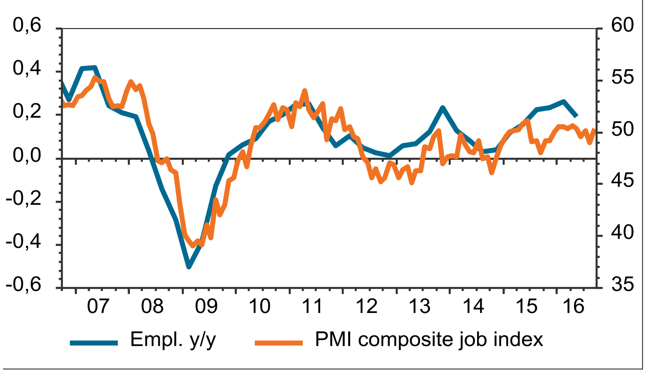
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 11 – Expected and structural unemployment



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 12 – Changes in employment



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Italy: recovery losing momentum. Mounting expectations ahead of the referendum

Paolo Mameli

We have revised down our forecasts for GDP growth in 2016-17

Last month **we revised down our forecasts for Italian GDP growth, after signalling downside risks to them for some time. Our new estimates are 0.8% for 2016 and 1% for 2017.** After stagnating GDP growth in 2Q, the likeliest scenario for the second half of the year is a return to a **very modest pace of expansion, of around 0.1-0.2% q/q**. This is because in the summer quarter in particular, the industrial sector is expected to resume making a positive contribution to value added, after having slowed GDP in the spring months. However, the recent deterioration in business confidence in the manufacturing sector in particular (as well the decline of revenues and manufacturing orders) does not signal a particularly expansionary trend (whereas for the time being at least, the services sector seems to be proving more resilient). Furthermore, the positive contribution of foreign trade to GDP in the spring quarter should be considered as episodic, and going forward domestic demand should go back to being the main driver of growth.

The point is that **most of the support provided by the "exogenous" factors** that had aided the exit from the recession starting at the beginning of 2015 (drop in oil prices, depreciation of the exchange rate, effects of the ECB measures) **dried up before the recovery could be considered as sufficiently widespread.** Specifically: 1) the price of oil hit a low in January 2016; based on our estimates, the price of Brent oil in euros, after having declined by 36% in 2015 and by a further 17% in 2016, could rebound by around 8% in 2017; 2) the euro's real effective exchange rate hit a low in April 2015, and since then it has appreciated by over 3%; 3) the effects of the ECB measures are still in place, and seem to have filtered through to the conditions applied to economic actors: in particular, the rate on new loans to enterprises (1-5Y) dropped to a new long-term low of 2.1% in July.

Consumption still on the rise, but slowing

To date, as mentioned above, the recovery has been driven mostly by domestic demand, and in particular by consumer spending, led in particular by durable goods (+3.4% in 2016 based on our estimates, from +6.9% in 2015 and +3.5% in 2014), also supported by particularly accommodative financial conditions for consumer credit. An important role was played by the auto sector, with registrations on the rise by 17.5% on average in the opening eight months of the year (a high since 1997). Going forward, **durable goods and autos in particular seem to have a further margin for recovery**, as based on Anfia data, the stock of vehicles in circulation remains rather obsolete (at the end of 2015, only 20% of cars was aged less than five years, vs. 34.3% in 2000 and 32.7% in 2010).

The key to the recovery in consumption was the improvement in the real disposable income of households, back into positive territory in 2015 for the first time in eight years. In the 2015-16 biennium, **the recovery in households' purchasing power was explained by: 1) savings on energy spending**, which we estimate at 0.5-0.6% of households' disposable income in 2015-16; **2) the recovery of employment**, up by 0.4% in 2014, 0.8% in 2015, and (in our estimates) by 1.2% in 2016; this factor, in the present year at least, seems to have been more important than the former in supporting a recovery in disposable income. In 2015 (and in part in 2014 as well), the Irpef tax "bonus" had also reaped effects.

The point is that **in 2017 energy savings will disappear** (in fact, energy prices could even rebound), **and the real income of households can only grow on the back of a stronger employment trend**. We estimate savings for households stemming from lower prices in the transport and shelter segments at around 5.1 billion euros in 2015 and 6.2 billion in 2016, i.e. 0.5% of disposable income last year and 0.6% this year. Based on average propensity to spend, this should translate into higher consumption by 4.7 billion euros in 2015 and 5.7 billion in 2016 (0.3% of GDP). In 2017, no further support will come from this front, and energy prices could in fact increase, accounting for an additional 0.2% of disposable income. On the other hand, employment growth should keep contributing to disposable income, albeit at a slower pace than recorded this year. **After accelerating to 1.2% in 2016, we expect the employment trend to slow** to at least 0.7% next year (much will also depend on the government's decision on whether or not to renew incentives on new hiring). As a result, **in 2017 both disposable income and consumer spending should continue to improve, but at slower rates than seen this year: we estimate 0.9% growth** in private consumption, from 1.2% in 2016.

Uncertainty surrounding the outlook on investments

With respect to investments, some signs of an improvement were detected between the end of 2015 and the beginning of 2016, which, however, were not subsequently confirmed. Specifically: 1) the only component which achieved a significant recovery was spending on **means of transport** (+35.7% y/y in 2Q; we estimate an acceleration to +25.1% in 2016, from +19.7% in 2015), driven by investments in replacements (similarly to what mentioned above for consumer spending on durable goods and autos), the development of car sharing platforms, and booming car hire and company fleets. The recovery trend could continue in the second half of the year and in 2017, albeit in all likeliness at a slower pace (+3.1% estimated in 2017); 2) the other component which had shown signs of a recovery in 2H 2015 was **construction spending,** which nonetheless in the course of this year failed to confirm the indications of an uptrend (based on our estimates, the sector failed to contribute positively to valued added in any of the first three quarters). In any case, sector fundamentals seem compatible with a recovery, as business confidence, while on the decline on a par with the other sectors in August, is still on an uptrend (and close to its eight-year highs), in an environment of still more than expansionary financing conditions; 3) the biggest question mark is on investments in **machinery and equipment**: after a promising start to the year, in which a role was played by the possibility of taking advantage of the maxi-amortisation offered on new capital goods, mounting uncertainty on the evolution of the economic picture led companies to exercise great caution, also considering that profits only rebounded marginally from their cycle troughs.

The fact that growth in Italy has been lagging behind the euro area average in recent times is probably explained by two factors: 1) the industrial system was hit much harder than in other countries by the two recessions of 2008-09 and 2012-14; 2) it takes longer in Italy to manage business crises than elsewhere, and this makes the transition process from recession to expansion slower than in other countries. As mentioned above, **the recovery is still not very widespread, and the productive system seems polarised both in terms of sectors of activity** (the few sectors recovering include means of transport and pharmaceuticals, which nonetheless has been showing signs of a slowdown of late) **and, within the same sectors, in terms of companies in good health and companies in distress**.

Foreign trade should at least stop dragging growth

In essence, **in 2017 domestic demand could slow, and the simple fact of foreign trade no longer making a negative contribution, as has been the case this year and the last** (-0.3% both in 2016 and in 2015), **could prevent a slowdown in GDP.**

While the outlook for exports does not seem particularly bright, if nothing else the negative contribution of foreign trade to GDP seen over the past two years should reverse. **The drag on exports from some "critical" regions, in particular among the emerging countries, seems to be easing**: sales to China are already recovering (+10.9% y/y on average in the months between June and August, a high in over two years), as also to Russia (-3.4% y/y on average in the same months, after two years of double-digit declines). Sales to Mercosur and OPEC remain in significantly negative territory, although the low-point of the cycle in these countries seems to have been overcome, therefore a recovery in the course of 2017 is possible. For what concerns the advanced countries, Japan is leading the way at the moment, mostly on the back of the exchange rate factor, but this trend is unlikely to continue next year; exports to the European countries are not expected to pick up, either, and may in fact slow (as is already proving to be the case). Vice versa, after slowing sharply this year (-0.6% in the first eight months of 2016, from +20.9% in 2015), sales to the United States could reaccelerate somewhat in 2017. In a nutshell, **we expect national accounts exports to grow by 2.6% in 2017, from 0.9% in 2016** (with imports on the rise to 2.4% from 2.2% in 2016).

Fiscal policy does not seem to have a margin to change the course of the cycle

Fiscal policy, in waiting for the next Budget Law to be unveiled, **does not seem to be able to count on effective tools to change the course of the cycle in 2017**. Even in the event of negotiations at the European level resulting in the safeguard clauses not having to be entirely covered (this would represent a further slackening, to 0.4% of GDP compared to the 0.4% already proposed by the government in the Economic and Financial Document), the growth-supportive measures the government intends to propose would have to be adequately funded in a context in which further spending cuts seem limited, debt is set to rise further (in our estimation to around 133% of GDP this year, and probably not to drop next year), and the structural deficit is unlikely to improve in 2017. This limits the scope of the "dispersed" expansionary measures which, in the best of assumptions, could be worth a net 0.2% of GDP taken together, and therefore would not be enough, in our view, to have an appreciable impact on the economic cycle.

The referendum holds risks, but also opportunities. Early elections are unlikely to be called without a new electoral law

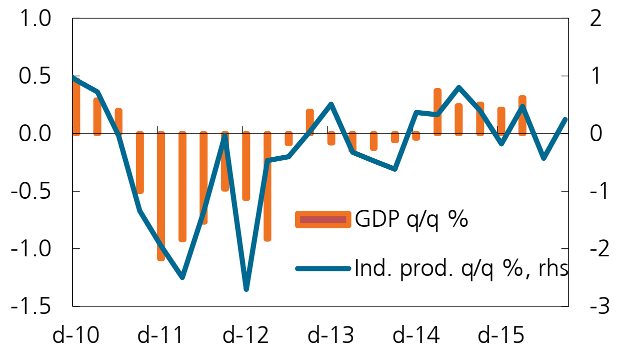
Even after the recent revision, **the balance of risks to the growth scenario is still skewed to the downside. Political risk** is one of the most serious, and should not be underestimated. At present, there are no certainties on the outcome of the constitutional referendum scheduled on 4 December, as based on voting intention polls the margin between support for the "Yes" and "No" campaigns is too slim, and most importantly, the percentage of undecided voters, and of those who intend to abstain, is not only very high, but has grown over time. For the time being, therefore, survey data do not allow a reliable prediction of the outcome of the referendum. In our opinion, if "Yes" votes prevail, prospects in terms of the governability of the country would improve, and therefore the reform agenda would have a better chance of being carried forward. We see three possible scenarios in the event of the "No" vote prevailing at the referendum (in order of probability): 1) the government in office survives the outcome of the referendum (even in the event of the President of the Council resigning, the President of the Republic could ask the government to face a confidence vote in Parliament and to stay in office if the majority proves resilient), albeit weakened; 2) the government in office falls, but the crisis is solved swiftly enough with the formation of an institutional or goal-oriented government, tasked with the priority of reforming the electoral law; 3) the attempt to form a new government fails and the President of the Republic is forced to dissolve Parliament and call early elections (the "Italicum" system would be used to renew the House, and the so-called "Consultellum" proportional system for the Senate). In our view, of the scenarios outlined above, the only one that could have a significantly negative impact on Italy's growth prospects is the calling of early elections (given the substantial risk of ungovernability the new Parliament would face). However, this latter outcome is also the least likely.

Macroeconomic forecasts

	2015	2016	2017	2015	2016				2017		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	0.6	0.8	1.0	1.1	1.0	0.8	0.6	0.7	0.6	0.9	1.1
q/q				0.2	0.3	0.0	0.1	0.2	0.2	0.3	0.3
Private consumption	0.9	1.2	0.9	0.3	0.4	0.1	0.2	0.3	0.3	0.3	0.2
Gross fixed investments	0.6	1.8	1.7	1.0	0.8	-0.3	0.1	0.6	0.6	0.6	0.4
Public spending	-0.7	0.5	0.2	0.6	0.2	-0.3	0.0	0.0	0.1	0.1	0.1
Exports	4.1	0.9	2.6	1.3	-1.2	1.9	-0.5	0.8	0.7	0.7	0.7
Imports	5.8	2.2	2.4	1.1	-0.3	1.5	0.2	0.6	0.6	0.6	0.6
Inv. chg. (contrib., % PIL)	0.5	0.0	0.0	-0.4	0.2	-0.1	0.2	-0.1	-0.1	0.0	0.1
Current account (% of GDP)	2.2	2.6	2.6								
Deficit (% of GDP)	-2.6	-2.5	-2.4								
Debt (% of GDP)	132.2	132.5	132.5								
CPI (y/y)	0.0	0.0	1.1	0.2	-0.1	-0.4	0.0	0.4	1.0	1.2	1.0
Industrial output	0.9	0.6	1.1	-0.2	0.5	-0.4	0.2	0.4	0.2	0.5	0.4
Unemployment (%)	11.9	11.5	11.2	11.6	11.6	11.5	11.5	11.4	11.4	11.3	11.1
10Y rate	1.71	1.30	1.20	1.62	1.49	1.48	1.17	1.05	0.99	1.12	1.28

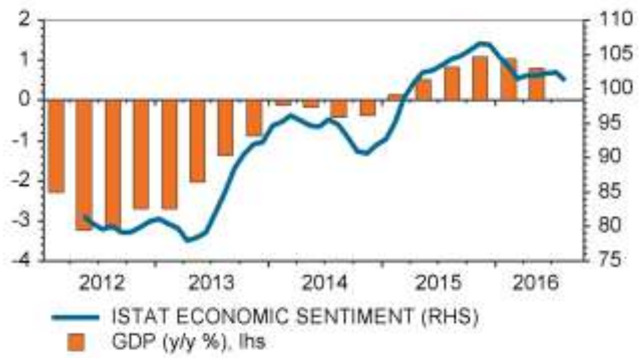
Note: percentage changes annualised on previous period – unless indicated otherwise. Source: Intesa Sanpaolo elaborations

Fig. 1 – GDP may have resumed growing in the Summer quarter, as the industrial sector is expected to have resumed contributing positively…



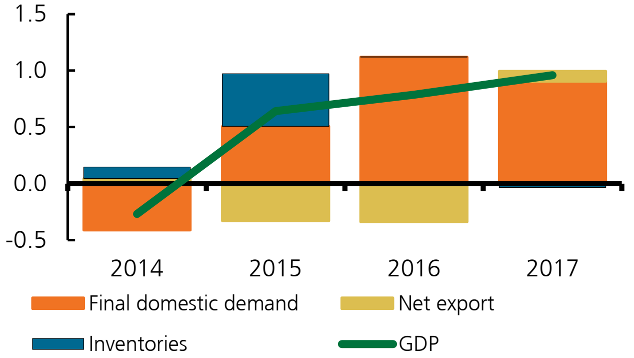
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 2 – …however, survey data do not point to an acceleration going forward



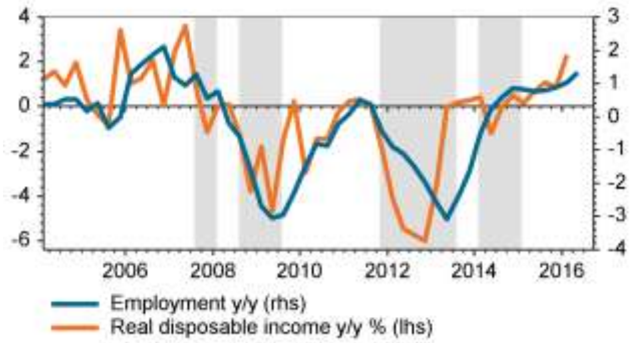
Source: Thomson Reuters-Datastream

Fig. 3 – We expect domestic demand to slow next year. GDP growth may accelerate only if foreign trade stops contributing negatively



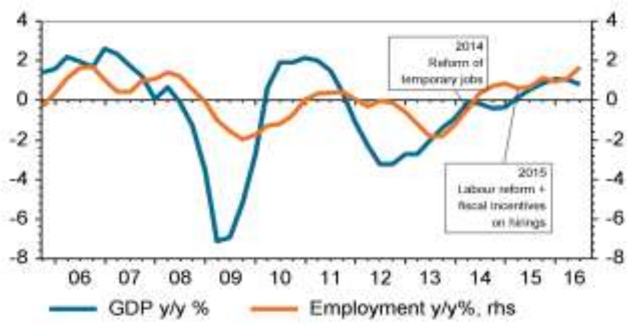
Note: GDP % growth rate and contribution of the main components. Source: Intesa Sanpaolo elaborations and forecasts on Istat data

Fig. 4 – The key to the recovery of domestic consumption this year is higher disposable income, largely thanks to the employment trend



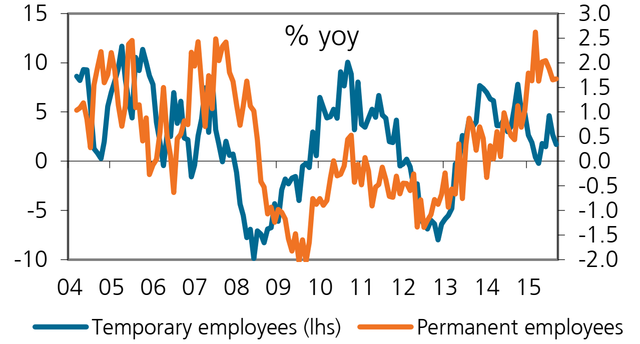
Source: Thomson Reuters-Datastream

Fig. 5 – Employment elasticity to GDP has been high…



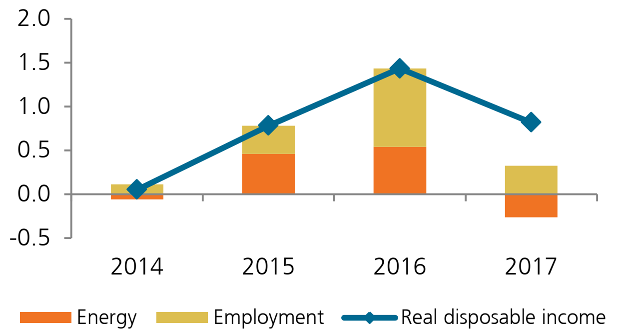
Source: Thomson Reuters-Datastream

Fig. 6 – …also thanks to the incentives offered on new unlimited labour contracts



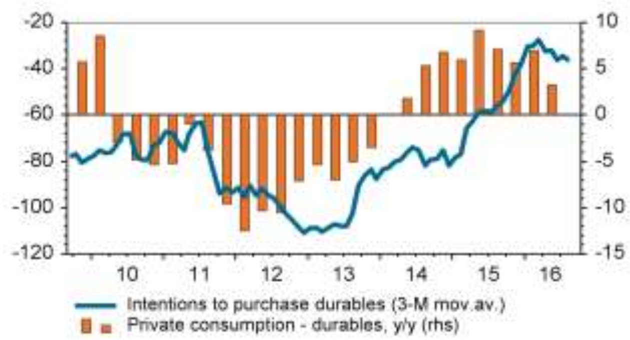
Source: Intesa Sanpaolo elaborations on Istat data

Fig. 7 – However, the employment trend could slow next year, and energy savings will disappear: real disposable income is set to slow



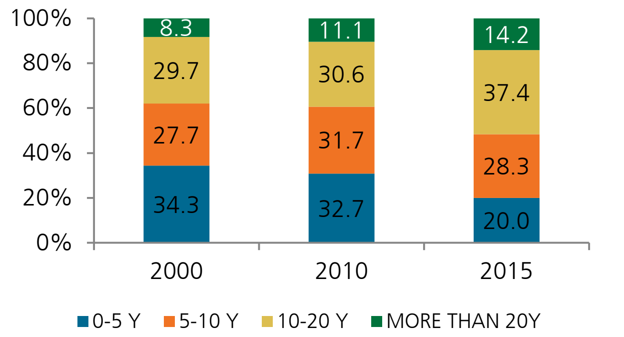
Note: Annual real disposable income % growth rate and contribution from savings on energy spending and other items (mostly job growth). Source: Intesa Sanpaolo elaborations and forecasts on Istat data

Fig. 8 – However, durable goods consumption seems to have a further margin for growth…



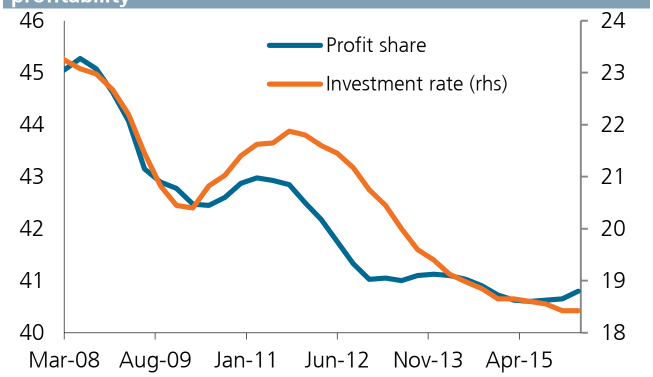
Source: Thomson Reuters-Datastream

Fig. 9 – …particularly in the auto segment, as the stock of vehicles remains obsolete (despite a clear recovery in sales)



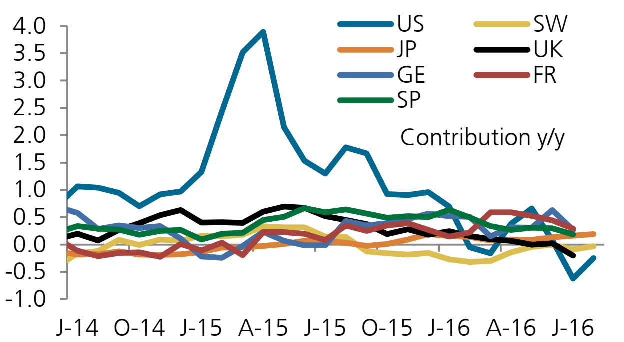
Note: Auto stock % shares by age. Source: Intesa Sanpaolo elaborations on Anfia data.

Fig. 10 – The evolution of investments is more uncertain, due to the lack of progress being made in terms of business profitability



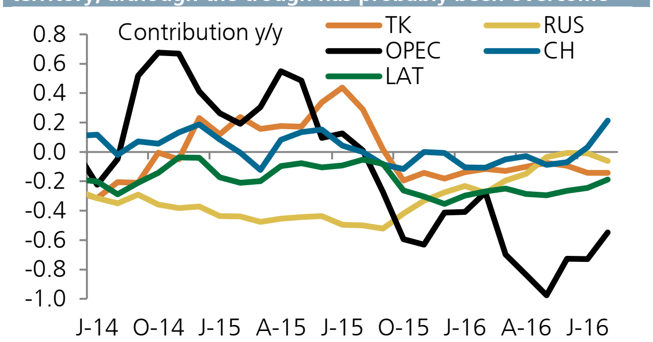
Note: Gross operating margin and gross fixed investments as % of value added to base prices of non-financial firms. Source: Intesa Sanpaolo elaborations on Istat data

Fig. 11 – The United States' contribution to Italian exports is slowing sharply (as is also the case with most European countries)



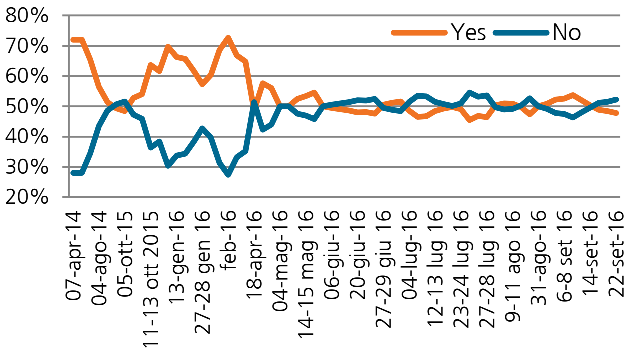
Note: contribution to year-on-year % growth of Italian exports (3m moving average). Source: Intesa Sanpaolo elaborations on Istat data

Fig. 12 – Among emerging countries, exports to Russia and China reversed. OPEC and Latin America still in negative territory, although the trough has probably been overcome



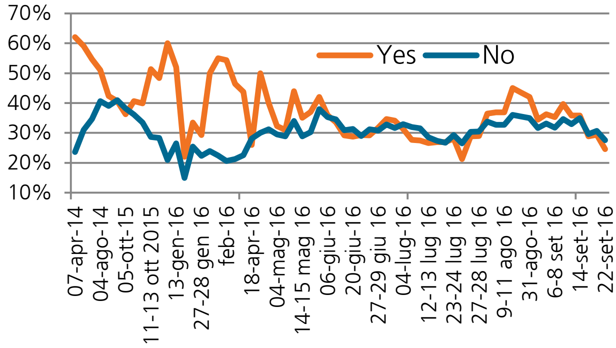
Note: contribution to year-on-year % growth of Italian exports (3m moving average). Source: Intesa Sanpaolo elaborations on Istat data

Fig. 13 – Based on survey data, the gap between "Yes" and "No" voting intentions at the constitutional referendum is too small to reliably forecast an outcome…



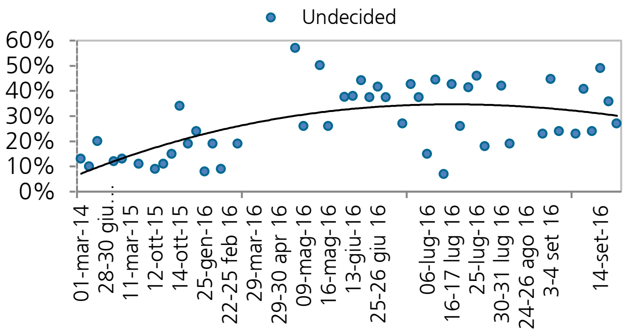
Note: % excluding undecideds and abstainers, average of the three latest surveys. Source: EMG Acqua, Ipsos SRL, Istituto Piepoli, ScenariPolitici–Winpoll, Euromedia Research, Istituto Ixè, Demopolis, Index Research, Tecnè, Eumetra Monterosa, IPR Marketing, Lorien Consulting, Demetra, Demos&Pi and Demetra

Fig. 14 – …especially when considering the shares of undecideds and abstainers



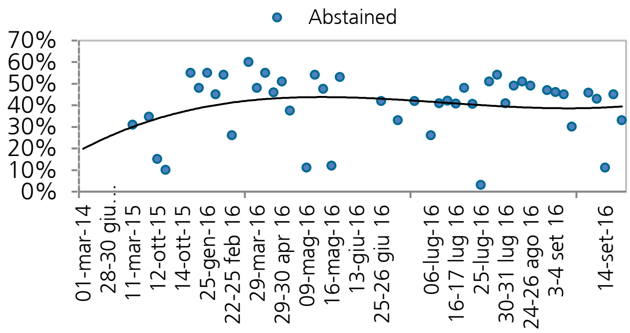
Note: % excluding undecideds and abstainers, average of the three latest surveys. Source: EMG Acqua, Ipsos SRL, Istituto Piepoli, ScenariPolitici–Winpoll, Euromedia Research, Istituto Ixè, Demopolis, Index Research, Tecnè, Eumetra Monterosa, IPR Marketing, Lorien Consulting, Demetra, Demos&Pi and Demetra

Fig. 15 – The percentage of undecideds is still very high…



Source: EMG Acqua, Ipsos SRL, Istituto Piepoli, ScenariPolitici–Winpoll, Euromedia Research, Istituto Ixè, Demopolis, Index Research, Tecnè, Eumetra Monterosa, IPR Marketing, Lorien Consulting, Demetra, Demos&Pi and Demetra

Fig. 16 – …and the share of potential abstainers is even larger, at present



Source: EMG Acqua, Ipsos SRL, Istituto Piepoli, ScenariPolitici–Winpoll, Euromedia Research, Istituto Ixè, Demopolis, Index Research, Tecnè, Eumetra Monterosa, IPR Marketing, Lorien Consulting, Demetra, Demos&Pi and Demetra

Spain: living without a government

Anna Maria Grimaldi

Spain has been without a government for almost a year, but the markets have so far ignored the impasse, thanks to sustained growth in GDP and government bond purchases by the ECB. However, the leniency shown by investors and the European Council over Spain's breach of the Stability Pact[14] will not last forever. Economic growth will start slowing from the second half of this year. In July, in light of events outside the government's control[15], the Council postponed for a year, to 2018, the deadline by which Spain should correct its nominal deficit to below 3%, from the 4.6% estimated for the current year[16]. The structural intervention required from 2017 totals 0.5% of GDP a year, but requires the approval and implementation of the budget. Further delays would put the Commission in a delicate position. In addition, despite strong growth, the country still has various structural difficulties to deal with. In July, the Commission noted "*rebalancing should continue, given the country's high foreign debt exposure. Deleveraging of the private sector proceeds at an acceptable pace, but the same cannot be said of the public sector*" since the debt/GDP ratio is expected to reach 101% in 2017, from 99.1% in 2015. It is by no means certain that, after the regional elections in Galicia and the Basque country, the leader of the socialist party, Pedro Sanchez, will manage to form a government. The risk of a third round of elections cannot be ignored (see focus below). It can only be hoped that growth continues to surprise.

Restoration of political stability can no longer be put off

Correction of the excessive deficit postponed until the next government

In the first half of the year, GDP did better than expected (+0.8% qoq), partly thanks to the surprising upturn in exports. We have therefore upgraded our growth forecast for 2016 to 3.1%, from 2.8% three months ago. The PMIs and the European Commission's economic confidence indicator (see Fig. 1) in the summer remained consistent with a moderation of growth to 0.6 / 0.7% qoq from the second half of this year. In 2017, we expect economic growth to stabilise at around 0.4% qoq. **Annual growth will therefore slow from 3.1% this year to 2.3%**; this rate is still well **above potential** (0.6% according to European Commission estimates).

After the excellent growth rates of 2015-16, growth will be around 2.0% in 2017, still well above trend

We expect exports to slow after the surprising upsurge in the spring (+4.3% qoq), as indicated in the PMIs. Over the forecast horizon, foreign trade will again have a negative impact on growth (-0.4% on average in 2017). Spanish exports have been growing more quickly than those of the Euro zone since mid-2009, but it is unlikely they will continue growing at recent levels both in the short and longer term; further gains in cost competitiveness are not sustainable (after the sharp increases of recent years). It should be noted that the current account balance has not increased for the moment, despite the sharp rise in domestic demand (see Fig. 6), which suggests that domestic demand is being met by domestic production more so than in the past. However, the deterioration in the trade balance (particularly with China, see Fig. 5) was limited thanks to the improvement in the energy balance (see Fig. 4) and this trend will not last, since the low for oil prices is already behind us.

Foreign trade will again have a negative impact on growth in 2017

[14] On 8 August 2016, the European Council decided, with a qualified majority, to reject the application (decided by the European Commission on 12/07/2016) to impose fines, up to a maximum of 0.2% of GDP, on Spain and Portugal, for failing to take concrete measures to correct their excessive deficits, and extended the deadline to 2016 for Portugal and to 2018 for Spain. The decision envisaged that concrete measures would be taken by mid-October, i.e. during the presentation of the budgets for 2017.

[15] Inflation proved lower in 2016 than estimated in the budget, an event that the Commission considers beyond the government's control.

[16] In updating its spring forecasts, the Commission forecast a 2016 deficit of 4.6%, down from 5.1% in 2015.

Over the forecast horizon, **domestic demand will continue to drive GDP growth**. However, the expansion is likely to be more moderate (2.7% and 1.6% next year) compared with the 3.6% recordedlast year. **Household consumption** will continue to grow at a sustained pace in 2017 (2.0% yoy), albeit slowing in comparison to 2015-16 (3.0% yoy, see Fig. 2), owing to the rise in oil prices implicit in our estimates, less robust growth in the number of people in work and modest growth in nominal wages of less than 1.0% (see Fig. 9). Household purchasing power will be partly eroded by the **rise in inflation** from -0.1% to +1.5% in 2017, and probably by the reduction in fiscal policy stimulus.

Consumption will be "less American" from 2017 due to higher crude oil prices and the normalisation of the employment trend

Residential construction has clearly turned the corner[17]. However, the rate of expansion seen in the spring (4.3% qoq) can clearly not be repeated, and we expect a correction in the summer quarter. The stock of unsold houses remains high (see Fig. 12), and could therefore limit growth in new investments to 2.7% on average in 2017, from 5.0% in 2016.

Residential construction: the recovery will continue at a more moderate pace

The expansion of **machinery investment** seems to be mature, since quarterly growth was much higher than the change in production capacity (see Fig. 13). The ongoing improvement in operating margins (see Fig 14), along with the continuation of strongly expansionary financial conditions over the forecast horizon and the prospect of a stabilisation in emerging economies should boost spending on machinery in 2017.

Investments will also slow compared with this year

Employment continued to do better than indicated by confidence surveys, rising by 2.4% y/y, but lower than in the previous six months (3.2%). Surveys point to a slowdown in jobs' growth to 1.8%, in line with the expected moderation in economic activity. Jobs were mainly created in the private sector (1.2 million since the beginning of 2013), while the public sector made a negligible contribution. New jobs were mainly created in services (900,000). Unemployment has fallen more quickly than we expected, from a peak of 26.3% in March 2013 to 19.4% in July 2016. In the last few months, the participation rate has started to rise again, from 59.2% to 59.4%, but is still lower than the 60.5% registered in 2012-13. We expect unemployment to fall over the forecast horizon at most to 18.4% at end-2018, still above pre-crisis levels, but in line with the structural rate (OECD: 18.3%). This is clearly an unacceptable level in terms of social cohesion, and one of the main challenges for the next government. The scenario is **subject to downside risks** deriving from weaker-than-expected demand in the Euro zone and a faster rise in oil prices. The main risk, however, is political. It is however true that, unlike in other countries, the drift towards populism position seems to be losing momentum in Spain. *Podemos Unidos*, the left wing populist movement has recently lost some consensus in the polls (see next sections for more details on Spanish politics)

Employment growing at a sustained pace, but no longer in line with GDP

Unemployment down, but still at an unsustainable level

The main risk is political

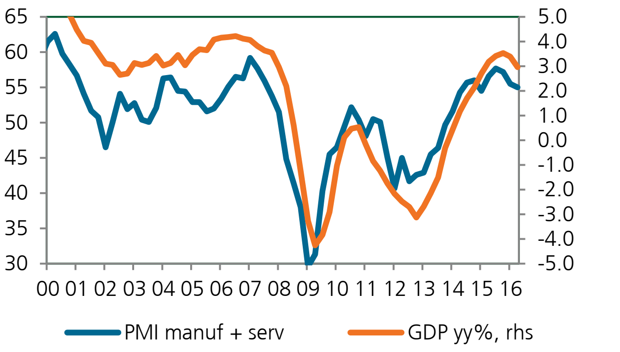
Macroeconomic forecasts

	2015	2016	2017	2015	2016				2017		
				4	1	2	3	4	1	2	3
GDP (constant prices)	3.2	3.1	2.3	3.5	3.4	3.2	3.1	2.9	2.7	2.4	2.1
- q/q change				0.8	0.8	0.8	0.6	0.6	0.6	0.5	0.4
Private consumption	3.1	3.3	2.3	0.7	1.0	0.7	0.7	0.6	0.6	0.5	0.5
Fixed investment	6.4	3.7	2.7	1.1	0.3	1.3	0.5	0.6	0.9	0.4	0.5
Deficit (% of GDP)	-5.1	-4.8	-3.6								
Debt (% of GDP)	99.1	99.7	101.0								
CPI (y/y)	-0.5	-0.1	1.5	-0.3	-0.7	-0.9	-0.1	1.1	1.8	1.9	1.3
Unemployment (%)	21.0	19.1	18.9	21.0	20.9	19.9	19.4	19.1	19.1	19.0	19.0
Effective exch.rate (2005=100)	96.2	97.1	97.7	96.1	96.8	97.0	97.3	97.2	97.4	97.7	97.7

NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

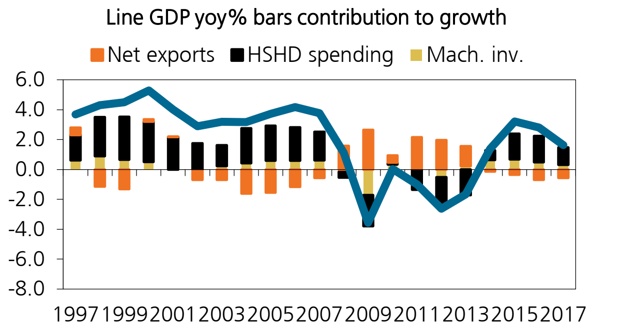
[17] The contribution of residential construction to GDP fell to 5.4% in 2015, after peaking at 11% in 2007, and is now broadly in line with the Euro zone average.

Fig. 1 – Peak has passed but the economy will continue to grow at around 2.5% yoy in the next few months



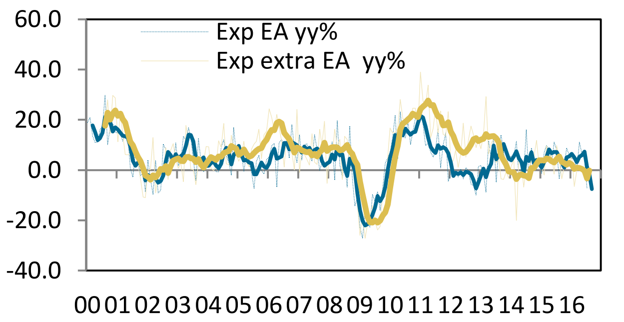
Source: Markit PMI, EU Commission and Intesa Sanpaolo forecasts

Fig. 2 – Growth still supported by domestic demand, especially consumption, but is not sustainable at recent rates Exports will return to making a negative contribution



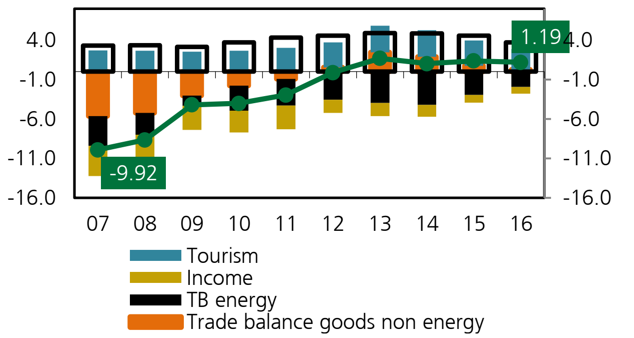
Source: Intesa Sanpaolo chart from INE and Eurostat data

Fig. 3 – Exports to the Euro zone down, but exports to other countries held up



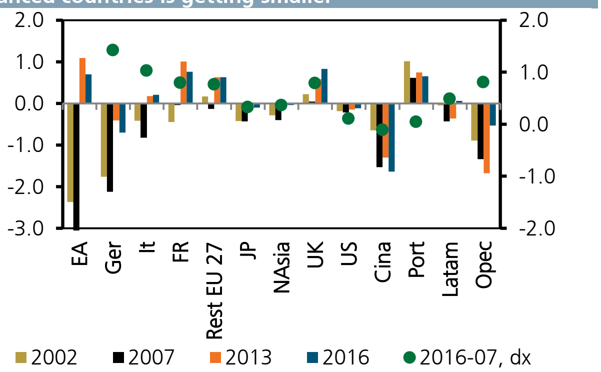
Source: Intesa Sanpaolo chart from Eurostat and INE data

Fig. 4 – The goods balance declined, but the energy balance improved



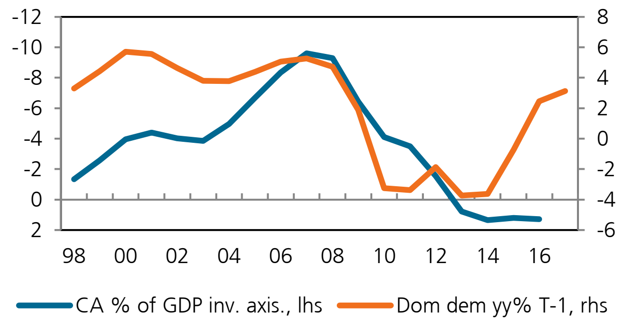
Source: Intesa Sanpaolo chart from Markit and Eurostat data

Fig. 5 – The goods balance with China has begun to deteriorate, while the surplus with the Euro zone and other advanced countries is getting smaller



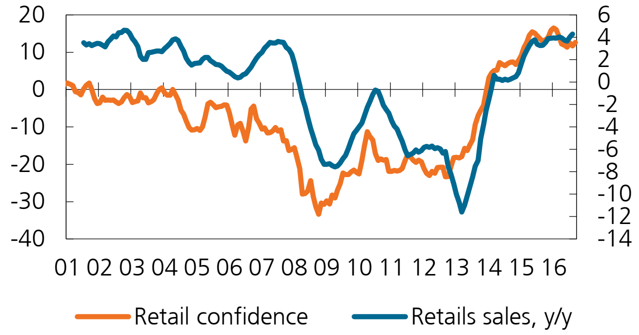
Source: Intesa Sanpaolo chart from Bank of Spain data

Fig. 6 – There is a risk that the return to sustained growth in domestic demand will erode the current account modest surplus



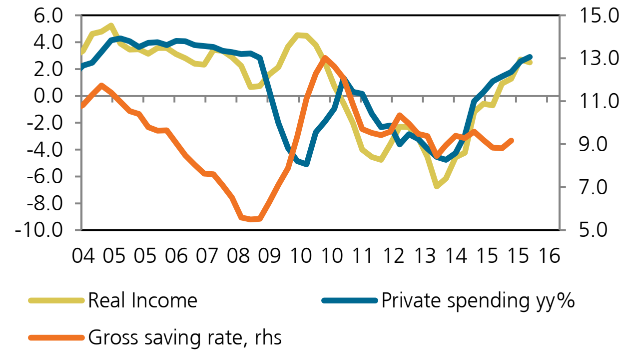
Source: Intesa Sanpaolo chart from Markit and Eurostat data

Fig. 7 – Confidence and retail sales holding up



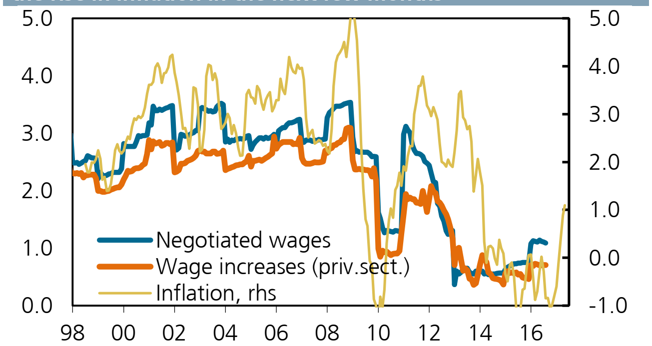
Source: Intesa Sanpaolo chart from INE data

Fig. 8 – Disposable income growing at pre-crisis rates But…



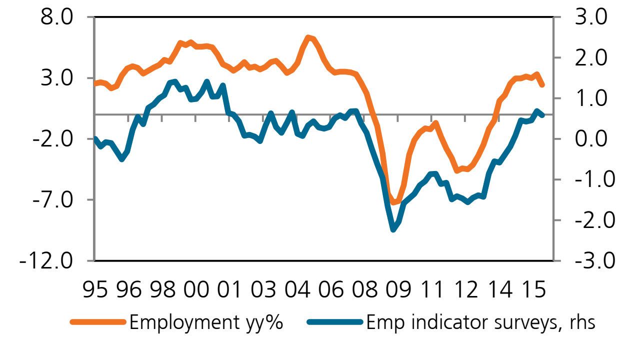
Source: Intesa Sanpaolo chart from INE data

Fig. 9 – … growth in real wages is expected to slow owing to the rise in inflation in the next few months



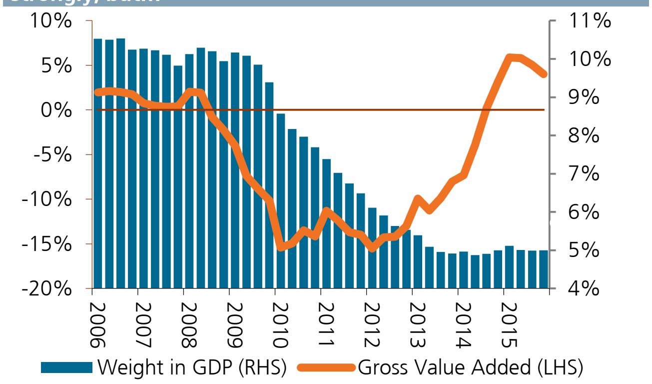
Source: Intesa Sanpaolo chart from INE data

Fig. 10 – Surveys point to a slowdown in employment growth



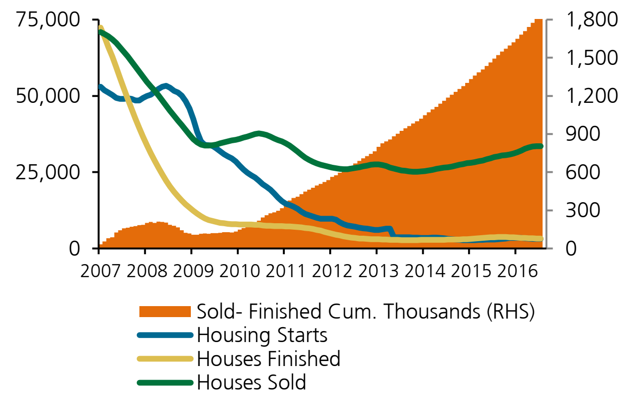
Source: Intesa Sanpaolo charts from UE Commission and INE data

Fig. 11 – Value added in residential construction again growing strongly, but…



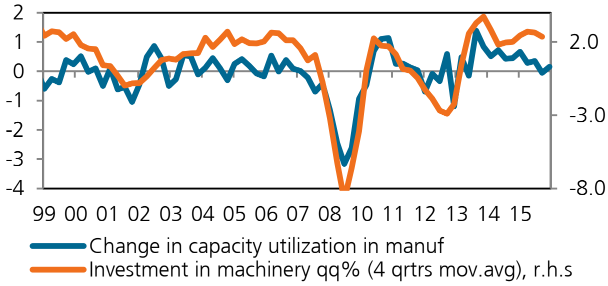
Source: Intesa Sanpaolo chart from INE data

Fig. 12 – …the high stock of unsold houses could limit investment in the next few quarters



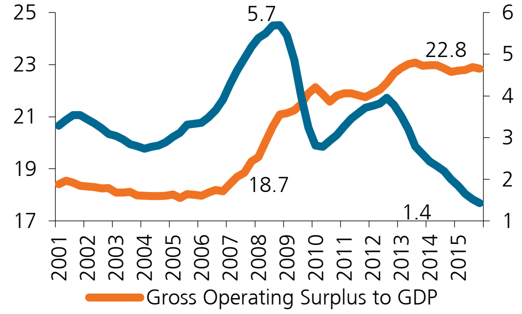
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 13 – Investment in machinery has grown faster than suggested by production capacity utilisation, but…



Source: Intesa Sanpaolo chart from INE and OECD (medium- and long-term equilibrium unemployment rate) data

Fig. 14 – …it will still be boosted by the recent earnings trend and ultra-expansionary financial conditions

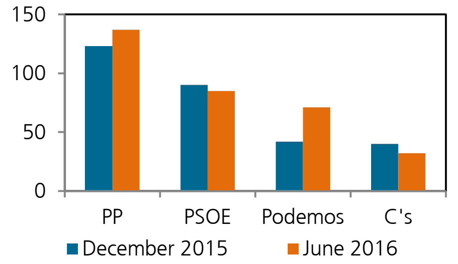


Source: Intesa Sanpaolo chart from INE data

FOCUS Spanish politics: trouble comes in threes

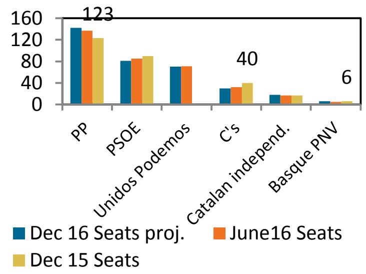
History repeats itself, as proved by Spain's political landscape. The country held elections in December 2015, but the end of the perfect two-party system that has marked the history of the country's democracy in the post-Franco era saw the erosion of the majority enjoyed by both the traditional People's Party (PP), led by current prime minister Mariano Rajoy, and the socialist PSOE, led by Pedro Sanchez. The political parties, not yet accustomed to cross-party alliances, have been unable to form a government in the timeframe established by the constitution (six months), and, on 26 June, the country returned to the polls. The result was marginally better for the PP than in December (see Fig. 1), but not enough to win it back the majority in the country. Negotiations began again in the summer to form a coalition government. At the end of August, Rajoy failed to form a government supported by the PP, the *Ciudadanos* and one deputy from the Canary Islands. The parties were waiting for the result of regional elections in Galicia and the Basque country before giving the socialists, led by Sanchez, a chance to form a government. But the administrative elections in Galicia and the Basque country saw heavy losses for the PSOE (-4 seats in Galicia and -7 in the Basque country), while there was a fairly strong showing from the PP. Sanchez has called a vote for his party's leadership for 23 October, and the congress for 2-4 December, but has not ruled out an attempt to form a government. As figure 2 below shows, Sanchez would not have the votes in favour to form a government unless there was a large coalition with the PP, something which, at present, we believe can be ruled out. The most likely scenario is that a third election will be held on 26 December. At present, opinion polls do not point to a clear winner (see Fig. 2).

Fig. 1 – The PP did better in June than in December, but Rajoy was unable to form a government



Source: Intesa Sanpaolo charts from Wikipedia and El Pais data

Fig. 2 – At present, opinion polls indicate that Rajoy would be unable to form a government even if elections were held for the third time



NB: for December 2016 the opinion poll was conducted by GAD on 6/9/2016. Source: Intesa Sanpaolo charts from Wikipedia and El Pais data

Netherlands: growth to hold in the run-up to the elections

Guido Valerio Ceoloni

GDP set to grow by 1.6% in 2016-2017, but political risk is increasing

In the **second quarter**, the Dutch economy again registered growth, at **0.6% qoq, which is twice the Euro zone average** (annual growth at 1.7% yoy, from 1.1% yoy). The Netherlands is the only major economy to have avoided a slowdown. The main growth drivers were domestic demand, contributing 0.7 pp (matching its 1Q performance) and foreign trade, which contributed 0.2 pp (down from 0.4 pp). Once again, inventories depressed performance, although growth for the year to date stands at 1.3% yoy. We expect to see growth slow by an average of 0.4% qoq in 2Q16, which would still push annual GDP growth up from 1.6% to 2.0% yoy. We have revised down by a tenth of a point our forecast for 2017 to 1.6%. This reflects the emergence of new external uncertainties that will impact the Dutch economy: Brexit, global trade and elections. The risks for the forecasting period are to the downside. In the longer term, the **elections in 2017** could have a negative impact on the country's governability. The right-wing anti-European, anti-immigration PVV is ahead in the polls, which give it 28-29 seats out of 150, between one and four seats more than the current coalition leader, the VVD. However, the situation is characterised by massive fragmentation among voters, which will necessitate the formation of a multi-party coalition.

Consumer spending sluggish in the first half of 2016, despite a variety of support factors and rising wages

Consumer spending should pick up in the second half of the year, after two quarters with average growth at 0.3% qoq, buoyed by low inflation, growth in lending and a healthy labour market. Household confidence improved again in September and is now well above the historic average. Wage growth rose in the second quarter from 0.8% qoq to 1.0% qoq, and will continue to increase over the coming quarters (2.9% yoy in 2016 and 2.3% yoy in 2017). Accommodative financial conditions and government measures in the building sector should continue to buoy up **residential construction**, although we do anticipate a slowdown after the boom in the first half of the year (average growth in 1H16: +4.9% qoq). **Investment in manufacturing** should remain stable in 2016 (average +7.6% yoy from +13.4%), largely due to the contribution of the transport sector. However, we do not expect an upturn in the second half of the year, not least in light of the uncertainties surrounding the outlook. Overall, **capital expenditure is expected to advance by 6.6% yoy in 2016, compared with 9.9% yoy** in 2015, with risks to the downside given the potential negative repercussions of Brexit. We anticipate a natural slowdown in **2017 to 2.2% yoy.**

Exports sluggish, imports buoyed up by domestic demand

Towards the end of the year, the slowdown in global demand is likely to affect **Dutch exports**. We anticipate that exports will grow at a rate of 0.6% qoq (average yoy growth at 2.6% in 2016, versus 5.0% in 2015, and 2.1% in 2017). **By contrast, imports will be buoyed up by domestic demand**, gaining 1.1% qoq (average yoy growth at 3.1% in 2016, versus 5.8% in 2015, and 3.0% in 2017). The Dutch trade surplus should remain virtually unchanged in 2016 at 6.8% of GDP, falling to 5.8% in 2017 in the wake of declining exports and higher imports.

Manufacturing activity on the rise, construction sector still positive but slowing

Cyclical indicators still point to favourable conditions, with manufacturing sentiment indices gaining ground in the summer. Activity in the sector increased during the second quarter, with growth of 0.6% qoq from 0.4% qoq. Production capacity utilisation rates are on the rise: the current rate is 81.7%, which is still below pre-2008 levels (83.5%). **The construction sector is still looking good**, with average confidence levels in the sector at 13.6 in 3Q, compared with 8.2 in 2Q. In the first eight months of 2016, the price of new homes rose by 4.5% yoy, compared with 2.5% yoy for the same period in 2015. Monthly growth figures are on a par with the record levels achieved in 2012, while sales in the first eight months were up 21% yoy.

Unemployment set to hit a new record low of 6.1% in 2016

Employment rates continued to rise: average growth was 0.6% qoq in the first half of the year, with roughly 40,000 new jobs each quarter, largely in the construction and services sectors. Employment growth is likely to slow in the second half, but unemployment is expected to fall to 6.1% in 2016, before stabilising in 2017. The number of people out of work fell by a further

40,000 from January to June, putting unemployment at 550,000. Current net migrant flows appear to be sustainable.

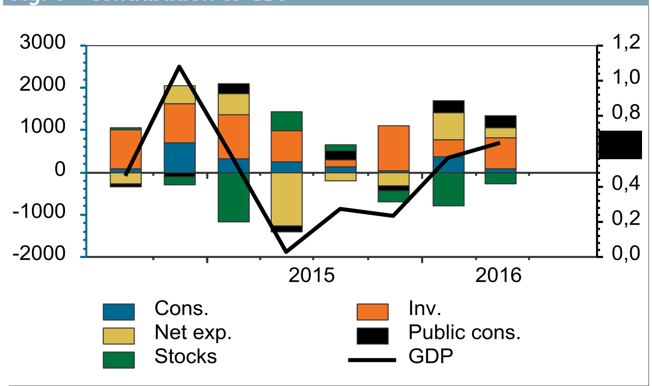
Inflation in line with Euro zone average for 2016, rising to 1.7% in 2017

Inflation remains sluggish, due to the fall in manufacturing prices at the start of the year. The national index is set to fall in 2016 to an annual average of 0.4% yoy (from 0.6%), although the harmonised index will be broadly stable, at 0.3% yoy, from 0.2% yoy, in line with the Euro zone average and now at historic low levels. However, at the end of the year, **a favourable base effect should trigger a rise in consumer prices** particularly in sectors linked to oil. Domestic consumer price inflation is expected to reach 1.7% in 2017 (harmonised: 1.5%), which is higher than the Euro zone average. **Core inflation is expected to remain more or less stable** at 2015 levels – 0.8% from 0.9% – and is set to rise to 1.4% in 2017.

Public finances in hand, deficit already below 3% and public debt under 65%

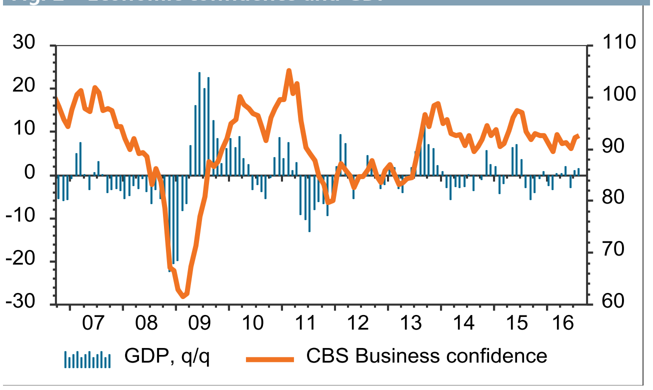
There are no critical issues in the public accounts, with state receipts as a proportion of GDP around 1% higher yoy in the first half of the year, driven by increased tax revenue, which more than offset the decline in oil receipts. At the same time, public spending has remained almost unchanged against 2015. According to the 2017 planning documents, the nominal deficit is set to fall 0.8 pp to -1.1% in 2016, and by a further 0.6 pp to -0.5% in 2017. The government figures are based on 1.7% growth in 2017, which is in line with consensus. Public debt continues to fall and is set to drop two percentage points from 65.1% to 63.0% in 2016 (June 2016: 63.7%), then reach 62.0% in 2017.

Fig. 1 – Contribution to GDP



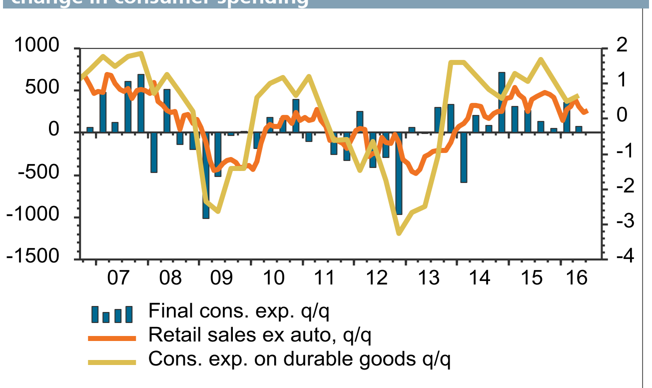
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – Economic confidence and GDP



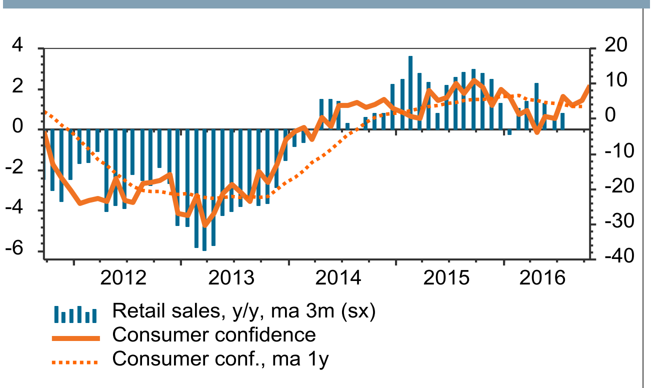
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 3 – Household spending, purchases of durable goods and change in consumer spending



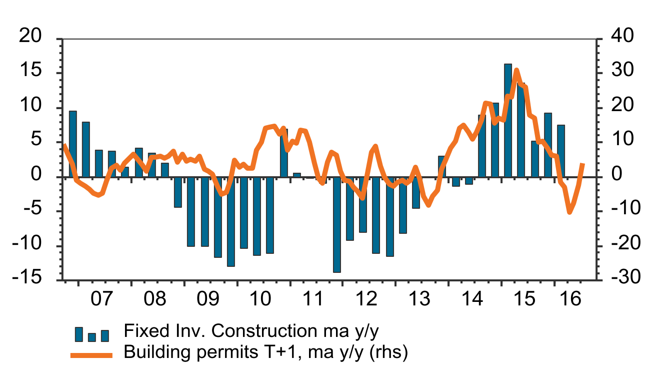
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 4 – Retail sales and household confidence



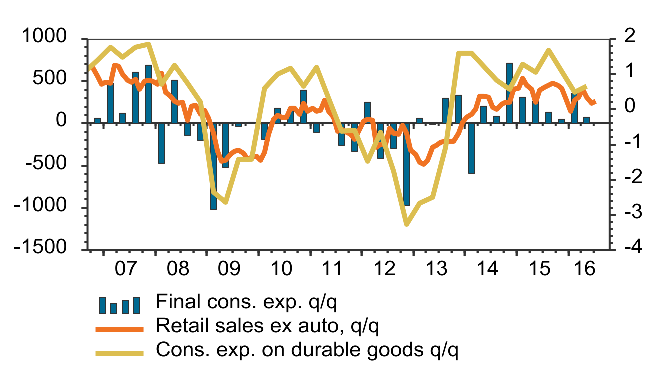
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 5 – Residential investment and construction sector activity



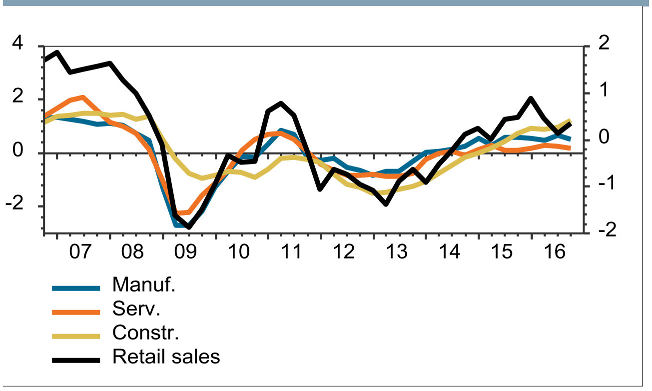
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



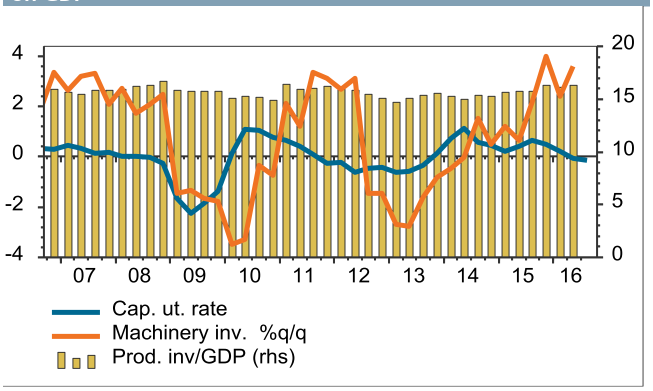
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



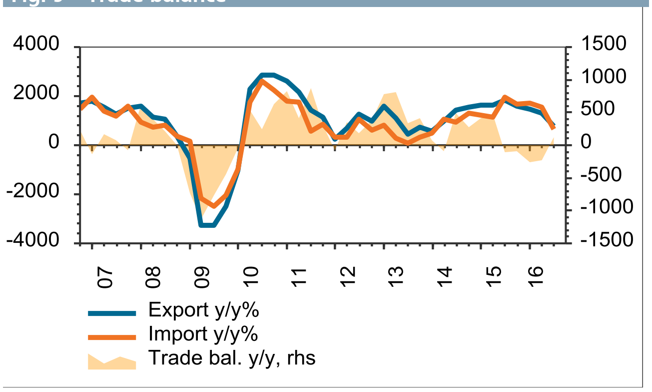
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 8 – Production capacity utilisation and level of investment on GDP



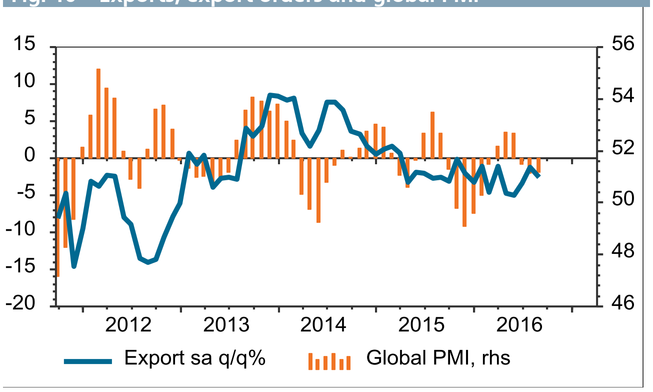
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Trade balance



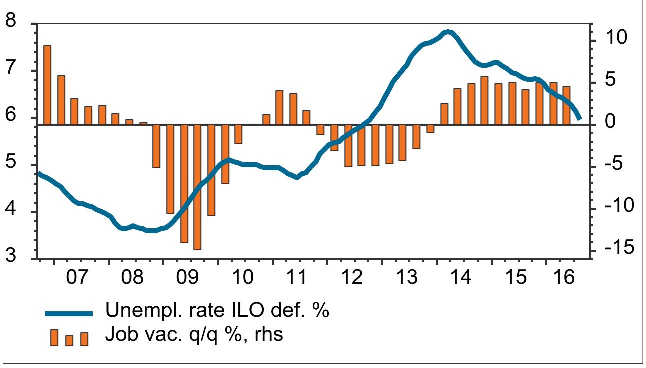
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 10 – Exports, export orders and global PMI



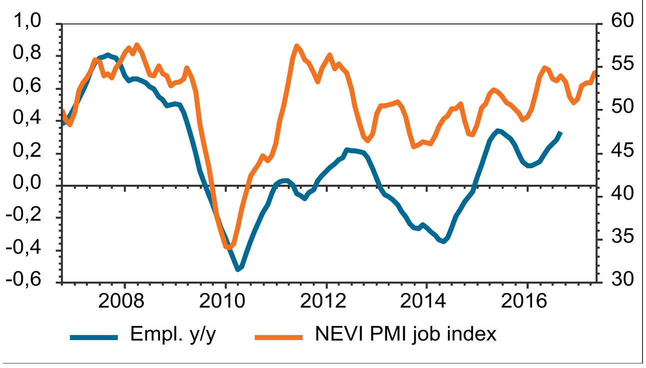
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 11 – Unemployment and job vacancies



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 12 – Changes in employment



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Greece: 2016, another transition year; returning to growth in 2017?

Guido Valerio Ceoloni

We believe the Greek economy will remain in a transition phase again this year: GDP growth in the second quarter was revised down by one-tenth of a point to 0.2% qoq, from -0.2% qoq in March. The main contributor was inventories (+0.5 from +1.8), while domestic demand (-0.2 from -0.9) and foreign trade (-0.1 from -1.1) made a negative contribution despite signs of a rally after the fall in the first quarter. Growth to date is -0.4% yoy. Quarterly consensus estimates for the rest of the year are that GDP will remain broadly flat. The economy and consumption will continue to be squeezed by the tax measures of the third bailout, which are only partly mitigated by the improvement in financial conditions and government measures to disburse EUR 3.5Bn to repay past-due debt to the private sector. **In 2016, fiscal consolidation will total about EUR 5.7Bn**, partly in the form of spending cuts, with public sector consumption expected to be squeezed further (to -1.1% yoy from -0.1% yoy in 2015), and partly in the form of new tax hikes that will erode household spending (to -1.1% yoy from +0.3% yoy in 2015). Banks are continuing the deleveraging process with loans to domestic borrowers down (-3.1% yoy in July, a slight slowdown since the beginning of the year), but non-performing loans represent 50% of bank loans according to IMF estimates. The banking system continues to rely heavily on Eurosystem loans, which, however, dropped to 22.5% of total liabilities, from 26.5% at the beginning of the year. Due to a favourable statistical comparison, especially in the third quarter, investments could post a growing annual average similar to that seen last year (+1.0% yoy), but their contribution to the formation of GDP will be marginal. **Therefore, as an annual average, we project that output will fall by -0.5% yoy from -0.3% yoy, and then start growing again in 2017 by 0.6% yoy** (for 2016 the government has an average growth scenario of 0.3%, while for 2017 the Commission's projections are much more optimistic, pointing to a 2.7% yoy increase in GDP). For the three years from 2017-2019, it is projected that overall fiscal consolidation will amount to 3% of GDP.

Further drop in GDP in 2016 (-0.5% yoy), hopeful signs for 2017 (+0.6% yoy)

There are two crucial events in the bailout process between now and the end of the year:

1. the release of the second tranche of aid totalling EUR 10.3Bn in September was already partially used to service debt (EUR 4Bn), and, as already noted, to pay arrears. The remainder of EUR 2.8Bn will be disbursed after the Ecofin meeting on 10 October, which will follow the **vote on Thursday, 29 September**, when the Athens parliament is required to approve measures proposed by the government (the push for privatisations, reform of the electricity grid and new pension cuts);

2. later, in mid-October, the **second review will begin**, and it is in Athens' interest to complete this by year-end if it hopes to be included in the ECB purchase programme in 2017. Starting in the second half of the year, this could also allow for an initial return to market with small issues of government securities. **The outcome of the second review cannot be assumed,** because government representatives have made it known they do not want to approve new wage cuts or reductions in the numbers of government employees, which are some of the most heavily debated points. However, on paper, Prime Minister Tsipras should have sufficient votes to pass the decree. In order to comply with the public finance correction measures, a primary surplus of 0.5% in nominal terms should be recorded this year.

Based on data for the first eight months of the year, the primary surplus stands at EUR 3.75Bn (-2% yoy) compared to the target of EUR 0.98Bn (on a cumulative basis). The achievement of the 2016 target is not a given, since performance is similar to that seen in 2015, when the target was 40% lower. Meanwhile, the IMF, which has still not decided whether or not to participate in the third bailout, has published its annual assessment in which it stresses that current public finance targets for 2018 (a primary surplus of 3.5%) are unrealistic since output remains weak, and debt restructuring is the only solution for a sustainable return to growth. To summarise, the situation continues to be affected by concrete political and economic risks relating to compliance with agreements for the third aid plan.

Portugal: October will be crucial to avoid another bailout

Guido Valerio Ceoloni

Although GDP growth in the second quarter was revised upwards by one-tenth of a point to 0.3% qoq after recording 0.2% qoq in 1Q, **growth to date of 0.8% yoy remains insufficient to achieve the target of 1.3% yoy set at the beginning of the year,** since for the next two quarters we project an increase in GDP of about 0.3% qoq. The breakdown of components shows that growth in consumption slowed to 0.1% qoq from 1.0% qoq, while capital expenditure remained broadly unchanged at -0.1% qoq, from -0.7% qoq: **thus, domestic demand contributed only 0.1 to the formation of GDP.** Foreign trade offered a marginal positive contribution of one-tenth of a point. Lastly, the increase in inventories added another 0.1. In light of the lacklustre pace of growth (in the last four quarters, GDP rose on average by 0.2% qoq) generated by weak consumption and foreign trade impacted by slowing global demand (China, Brazil and Angola), we have **lowered our estimates for the forecast horizon by two-tenths of a point to 1.1% in 2016 and to 1.2% in 2017 (below the Euro zone average) with risks remaining unbalanced to the downside.** The main focus remains the fragility and low profitability of the banking system (with NPLs representing 12% of loans) and the **new issue of the EUR 5Bn recapitalisation of national bank CAIXA** (half of which in public funds), the instability of the political situation in which the country has found itself for nearly a year, in addition to the **repeated slowdown in investments compared to 2015** (expected to grow by 0.5% yoy this year, from 4.2% yoy) **after the government withdrew planned corporate tax cuts,** which sparked a decline in investor confidence. On a positive note, although unemployment is above the Euro zone average, it dropped in the second quarter from 12.4% to 10.8%. This, in addition to extremely weak inflation and income support policies partly implemented by the government, could promote an upswing in consumption next year (which we currently estimate at 1.9% yoy in 2016 and 1.3% yoy in 2017, up from 2.6% yoy in 2015). The Commission's economic confidence index remained broadly unchanged during the second quarter (at 105.9 vs. 106.2), which is above the Euro zone average.

Lacklustre pace of GDP growth, which this year will slow to 1.1% yoy from 1.5% yoy. GDP growth of 1.2% yoy expected in 2017

Renewed focus on fiscal consolidation

The situation is again being monitored after the European Commission's warning this summer to the ineffective measures taken to date to reduce the excessive deficit, which in 2015 ended at -4.4%[18]. **Following this, the government guaranteed that this year it would meet the target of -**

[18] However, the figure includes one-off extraordinary measures of 1.4% to bail out the banks.

2.7%, and lower the public debt by three points to 126% despite the partial dismantling of austerity policies (especially with regard to public pensions and wages) implemented by the previous government. For the time being, two of the largest agencies (Moody's and S&P) do not plan to revise their country outlook (which, however, is already below investment grade). However, **crucial in this regard will be the date of 21 October, when DBRS** (the sole agency of the four recognised by the ECB to still maintain an investment grade) **will provide its sovereign rating**: at present, the agency's outlook is stable. The week before, parliament must vote on the **2017 budget law;** this **will be submitted to the Commission on 14 October**, although the Commission will probably not give its opinion before November. For next year, the government has set a further deficit reduction target of four-tenths of a point to -2.3%. For the time being, government forecasts are supported by consensus. **Over the short term, a possible downgrade is not the most likely event based on available information**. However, ongoing political and financial fragility make it impossible to rule out new crises in credibility over the medium term. In the event of a downgrade, strong tensions would inevitably be triggered, since Portugal would, at that point, be excluded from the ECB's PSPP, a risk only partially priced into the spread, which is now at around 350 bps. On the other hand, the ECB currently already has 27% of the country's bonds in its portfolio, and if it were to maintain the current pace of EUR 1.5Bn purchases per month, it could reach the maximum limit by year-end.

Asia

Japan: the fiscal boost is crucial, as the BoJ is mostly ineffective

Giovanna Mossetti

Fiscal tightening in 2014-15, and the on-going appreciation of the yen, have hindered the recovery, slowing consumption, corporate investments, and exports. In the past year growth has been fragile, with a string of changes just above and just below zero, unable to display a positive trend (fig. 1). The outlook for the second half of this year and for 2017 is only marginally more optimistic, despite the announcement of a new fiscal package and expectations for further modest monetary stimulus. The forecast for 2016-17 **growth is around 0.4%**, still in line with potential, estimated between zero and 0.5%, therefore still at risk of dipping back into negative territory in case of adverse shocks, even not particularly severe. The fact that growth is failing to accelerate also works against the possibility of inflation rising back towards the BoJ's target.

Macroeconomic scenario: slow progress. The modest expansion of economic activity expected over the next two years should be supported by consumer spending and by public spending (especially investment, see below). **Private consumption** should be driven by the positive trend of the labour market, with an on-going decline of the unemployment rate (at 3% in August, a low since May 1995), despite a modest expansion of the labour force since the beginning of the year. Excess demand for labour has resulted in an increase in real wages in the past year (Fig. 5), which nonetheless has failed to translate into a systematic acceleration of the consumption trend. Two factors are currently holding back households' spending. The first is still the expectation for **fiscal tightening,** and in particular the introduction of a new consumption tax hike in 2018, as is evident in Fig. 6, which shows a significant increase in the savings rate in the wake of past consumption tax hikes. The second factor hindering spending is tied to **inflation expectations**: the percentage of households that expect prices to increase by less than 2% is constantly on the rise, and at its highest since the recession. The percentage of individuals who in July expected price increases dropped to less than 70%, from a peak of 86.5% in 2014, and in line with the levels recorded before the launching of the QQE programme by the BoJ (Fig. 8). The credibility of the inflation goal is decreasing, and is keeping the central bank under pressure (see below). However, the joint enhancement of monetary and fiscal stimulus should help support **consumption, estimated to increase by 0.4% in 2016 and 0.9% in 2017.**

Non-residential fixed investments decreased in the first half of the year, as a result of the appreciation of the exchange rate and of weak global demand, in Asia in particular. In 2Q 2016 and in 2017, a moderate improvement should materialise (+0.5% in 2016, +1% in 2017), thanks to expectations for a depreciation of the yen into the 112 area in 2017, and to the forecast effects of fiscal stimulus.

Net exports are contributing positively to 2016 growth, thanks a sharper decline of imports (due mostly to the drop in energy prices) than exports (Fig. 7). In the next few quarters, the expected depreciation of the exchange rate should result in a recovery of exports, estimated to more than balance the stabilisation of energy prices on the import side.

Fiscal policy. The main development compared to 2Q 2016 is the announcement of the **details of the fiscal package**, expectations for which mounted following the outcome of the summer elections. The government outlined a set of measures aimed in part at supporting near-term growth, and in part at supporting structural growth. The **package is worth 28 trillion yen** in total (5.5% of GDP), will pan out over a multi-year horizon, and includes indirect stimulus measures, such as guarantees on loans unlikely to be very effective. The "**direct" fiscal measures, with potential expansive effects, are worth 13.5 trillion yen (2.5% of GDP**). The core of the fiscal package is represented by **spending, worth 7.5 trillion yen**, most of which will be aimed at infrastructures (6.2 trillion for ports, high speed rail, and other projects), with the rest devoted to mitigating the effects of Brexit and supporting small and medium enterprises. The fiscal package also includes **3.4 trillion yen for the labour market** reform, and **2.7 trillion for interventions in the**

regions hit by the earthquakes of 2016 and 2011. The government estimates, with considerable optimism (excessive, in our view), that the package announced will have a cumulated effect of around 1.1 pp of GDP; the consensus estimate, in line with our forecast, is that **the package may have a 0.1 pp effect in 2016, and a 0.3 pp effect in 2017**. In addition to the nearer term measures, the government also intends to implement labour market reforms, announced some time ago and consistently postponed. In the autumn, the minimum wage will be raised by around 3%, with very modest effects on earned income, given the limited share of workers who receive a minimum wage. The prime minister also said that he intends to adopt the principle of wage equalisation for the same job, reducing discrimination (especially against women), although it remains to be seen whether political consensus is strong enough to support reforms in this direction, aimed at encouraging female participation in the labour market. We expect almost stagnant **public consumption spending** in 2017, as opposed to a solid increase in **public investments** (+2%).

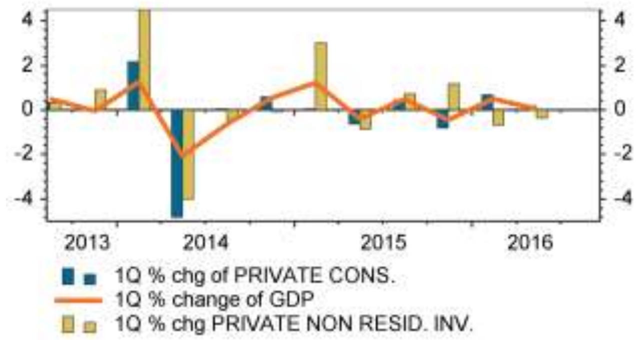
Monetary policy. The **BoJ** has defined a "new framework to strengthen monetary stimulus". The main changes are: 1) "yield curve control"; and 2) "inflation overshooting commitment". In operational terms, the BoJ's strategy changes on several fronts. **1) Curve control.** Monetary policy specifies a **short term policy rate** (unchanged at -0.1%) **and a target level for the long-term rate** (10Y JGB rate of around zero). Purchases will be kept "more or less in line with the current pace", with a change of around 80 trillion yen. The announcement of the average life of purchases is abolished. **The new tools to be used to control the curve are:** i) purchases of JGBs with rates determined by the BoJ; ii) fixed-rate financing operations, with a 10Y maturity (from one year). For the other asset classes, the guidelines previously announced have been confirmed. **2) Inflation-overshooting commitment.** The central bank will continue to expand the monetary base until the change in the CPI excl. fresh food stabilizes above 2% y/y. The change in the monetary base may fluctuate depending on the operations implemented to control the curve, and the monetary base/nominal GDP ratio will probably by higher than 100% in the span of a year, from 80% at present. **The new framework** has two goals: compressing real interest rates and fuelling inflation expectations, with the commitment to overshoot the target. The new approach tackles some of the problems faced by the strategy pursued to date, making new use of existing instruments. However, the changes may not be enough to achieve a significant weakening of the yen and a recovery of inflation, not to mention actual stimulus to growth. In our view, **solving Japan's problem will require** a more radical revolution, with the introduction of some form of **"helicopter money"**: policy authorities are still not under enough pressure to change at the root the existing separation between fiscal and monetary policy.

Macroeconomic forecasts

	2015	2016	2017	2015	2016				2017		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	0.6	0.5	0.4	0.8	0.1	0.8	0.3	0.8	0.5	0.3	0.4
q/q annual rate				-1.7	2.1	0.7	0.1	0.4	0.6	0.1	0.4
Private consumption	-1.2	0.4	0.9	-3.2	2.8	0.7	0.4	0.8	1.3	0.8	1.2
FI - private nonresidential	1.6	0.5	1.0	5.0	-2.6	-0.6	0.9	1.2	1.1	0.9	1.2
FI - private residential	-2.7	4.0	1.3	-1.8	-0.5	21.6	-1.3	-0.4	0.5	0.6	0.7
Government investment	-2.0	-0.6	2.0	-12.2	1.0	10.8	2.2	2.6	1.6	0.7	0.5
Government consumption	1.2	1.8	0.1	3.3	3.6	0.4	0.2	-0.1	0.2	0.0	0.0
Export	2.8	-1.3	0.7	-3.7	0.4	-5.8	1.2	1.1	1.2	1.0	1.1
Import	0.3	-0.4	3.9	-4.2	-2.1	-0.2	4.3	4.3	4.1	3.9	4.0
Stockbuilding (% contrib. to GDP)	0.6	0.0	0.1	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0	0.0
Current account (% of GDP)	3.3	3.9	3.9	3.8	4.0	3.7	4.1	4.0	4.0	3.9	3.9
Deficit (% of GDP)	-5.4	-5.6	-5.9								
Debt (% of GDP)	230.0	233.0	237.8								
CPI (y/y)	0.8	-0.1	0.1	0.2	0.1	-0.3	-0.2	-0.2	-0.3	0.1	0.2
Industrial production	-1.2	-1.7	-0.3	0.1	-4.1	0.8	0.2	-0.8	-0.8	-0.4	0.3
Unemployment (%)	3.4	3.0	2.7	3.3	3.2	3.2	2.9	2.7	2.7	2.7	2.7
JPY/USD	121.0	107.3	108.8	121.4	115.2	107.9	102.4	103.7	106.8	108.6	109.6
Effective exch.rate (1990=100)	125.9	143.7	140.1	126.4	133.7	141.1	150.3	149.7	144.3	140.5	138.6

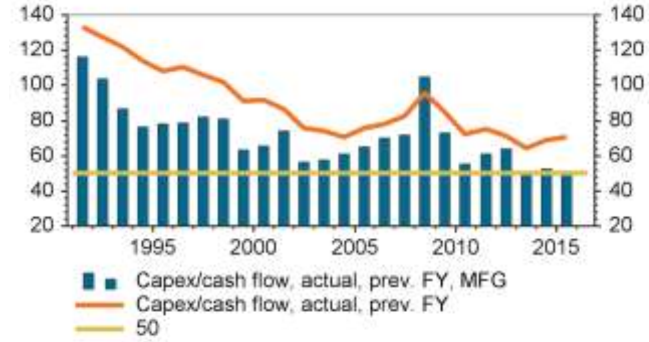
NB: Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Growth: dancing around zero



Source: Thomson Reuters-Datastream

Fig. 2 – Businesses are investing very little…

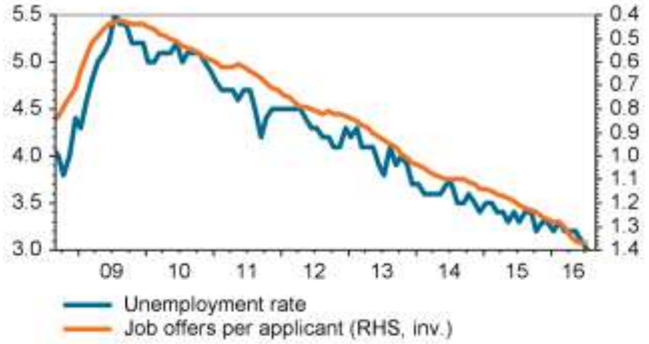


Source: Thomson Reuters-Datastream, indagine Ministry of Finance sui piani di investimento delle imprese

Fig. 3 – …while profits are curbed by the strong yen

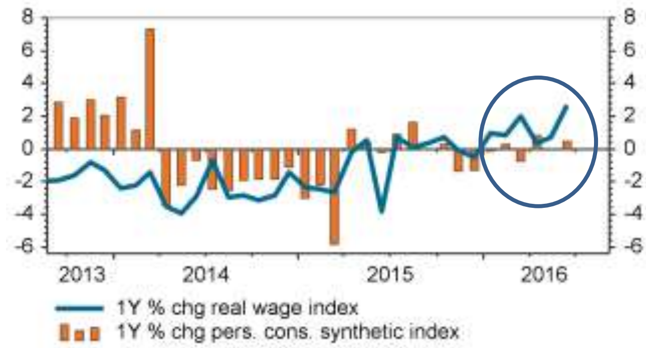
Source: Thomson Reuters-Datastream

Fig. 4 – Unemployment still on the decline



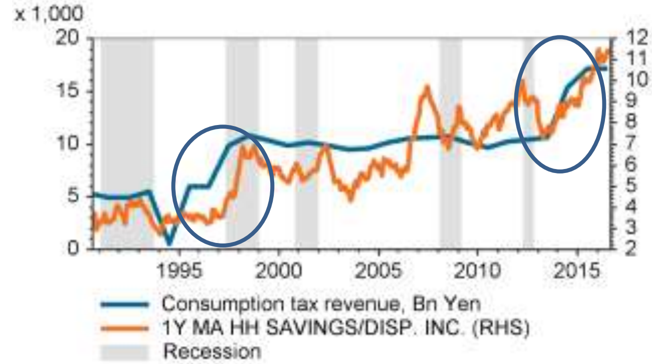
Source: Thomson Reuters-Datastream

Fig. 5 – Consumption weak despite the accelerating wage trend…



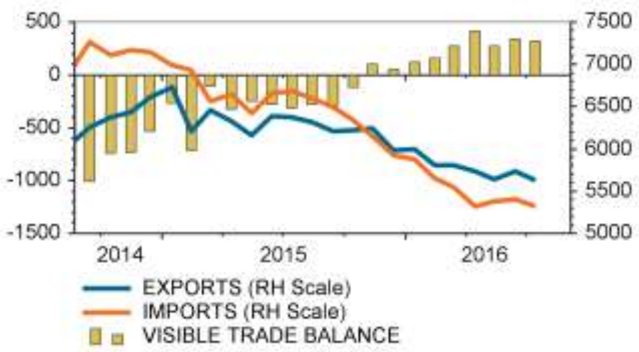
Source: Thomson Reuters-Datastream

Fig. 6 – …with increasingly high savings propensity following the sharp consumption tax hike



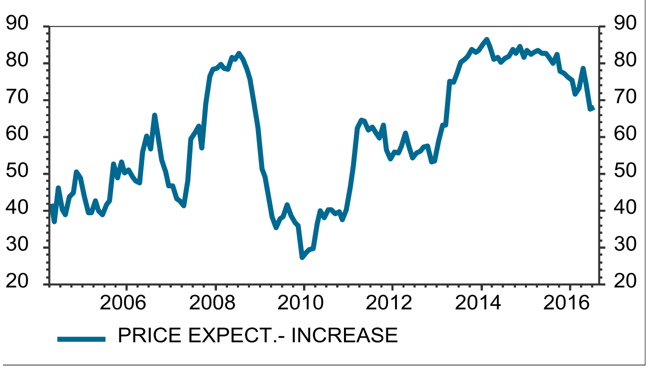
Source: Thomson Reuters-Datastream

Fig. 7 – Trade balance in positive territory at last, thanks to energy prices



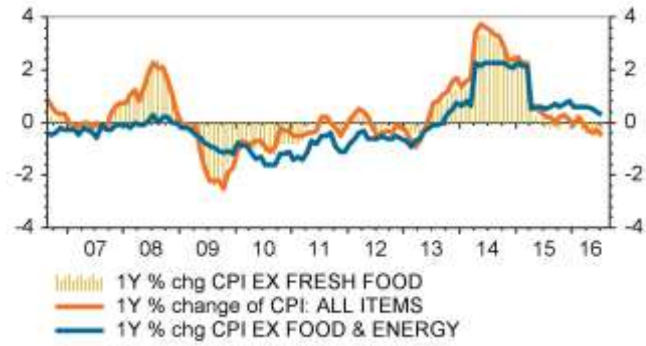
Source: Thomson Reuters-Datastream

Fig. 8 – Drop in the percentage of households that expect price increases



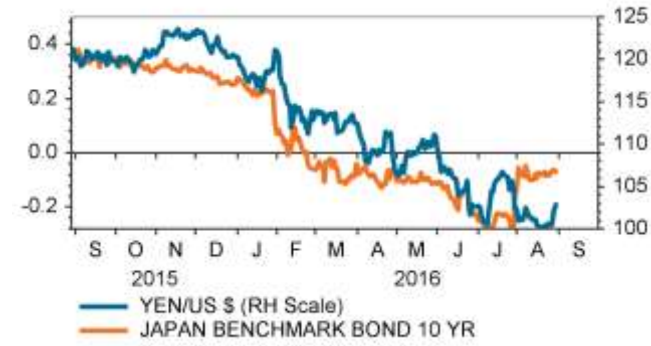
Source: Thomson Reuters-Datastream

Fig. 9 – Core inflation below 1%: the 2% goal remains distant



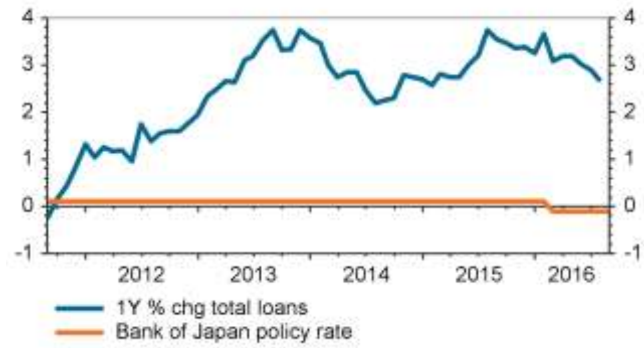
Source: Thomson Reuters-Datastream

Fig. 10 – BoJ: negative effects of negative rates?



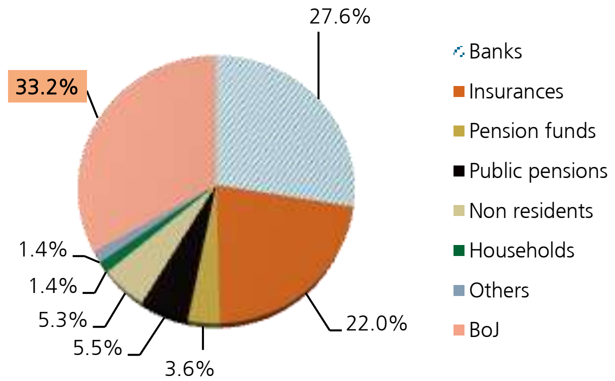
Source: Thomson Reuters-Datastream

Fig. 11 – Ineffective tools at the BoJ



Source: Thomson Reuters-Datastream

Fig. 12 – The central bank is the largest holder of JGBs



Data as at the end of March 2016; total JGBs: 955 trillion yen
Source: Ministry of Finance

China: fiscal and economic policies support growth

Silvia Guizzo

GDP growth remained **unchanged at 6.7% yoy in 2Q**, contrary to our expectations of a slight deceleration. On the demand side, the limited slowdown in private consumption and investment has probably been offset by the increase in public spending. On the supply side, growth held up due to a modest acceleration in the farming and industry sector, while the services sector slowed slightly.

The summer months' figures point to a gradual improvement in corporate confidence, a moderate upturn in exports and industrial output, and a stabilisation of investment and lending growth. New loans remained broadly stable and new social financing has accelerated slightly in relation to GDP in the last four out of six quarters, continuing to support growth in the short term but leaving the medium- to long-term risks unchanged on the downside. In light of the above indications of first-quarter GDP growth slightly above our expectations and of the continuing support of economic and fiscal policy, reiterated over the summer, **we are upgrading our GDP growth forecasts** from 6.3% **to 6.5% in 2016** and from 6.1% to 6.2% in 2017.

In August, **inflation hit its lowest point since the beginning of the year**, decreasing more than expected to 1.3% yoy from 1.8% in July. The fall came on the back of a slowdown in food prices, although the weekly trend suggests that this only temporary. Inflation in producer prices, while remaining in negative territory, is up sharply from the lows seen at the beginning of the year. Both factors points to a moderate rise in inflation in the next few months.

Property prices accelerated further in all cities, exceeding the peaks reached in 2013. We remain sceptical as to whether the property market could continue to rise at the same pace in 2017 given the level of vacant properties and the additional **measures to reduce spending** that the authorities could continue to implement over the next few months.

The debate on the type of stimulus necessary, whether fiscal alone or both fiscal and monetary, to support growth and limit the dampening effect of the reforms in the short term is still under way, but seems **inclined to favour the former,** given the limited scope of the latter. Over the summer, the government continued to reiterate the need to support investment, especially in the private sector, where it remains lacklustre. **Control of financial risk**, however, is one of the **regulators' highest priorities**, as has emerged from some recent statements and from the regulatory interventions in various areas of the non-banking financial sector in the last few months. Moreover, the central bank continues to reiterate its unwillingness to allow the currency to depreciate sharply in both its communications and its actions.

Macroeconomic forecasts

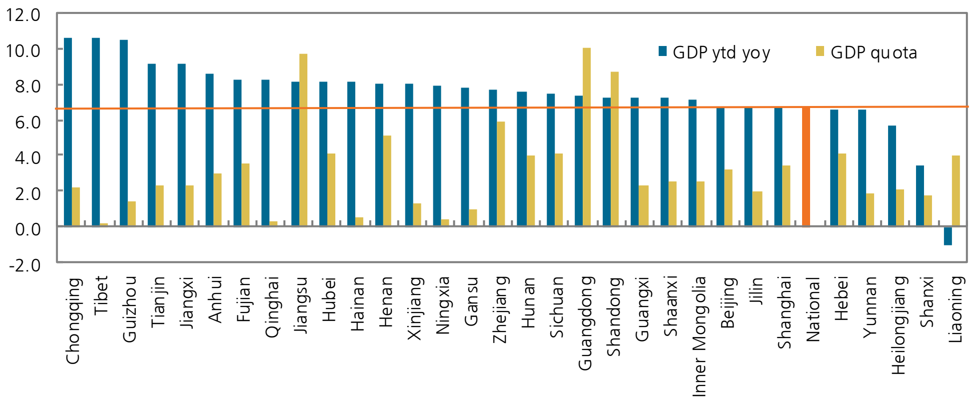
	2011	2012	2013	2014	2015	2016	2017
GDP (constant prices)	9.5	7.8	7.8	7.3	6.9	6.5	6.2
Private consumption	14.7	9.6	7.9	8.2	7.6	7.5	6.9
Public consumption	5.6	6.2	5.1	3.7	10.3	16.2	8.1
Fixed investment	9	8.7	9.3	6.9	7.5	5.6	4.4
Exports	10.2	5.8	7.9	8.6	0.6	3	4.5
Imports	11.2	6.6	10.6	8.7	1.5	3.5	3
Industrial output	10.7	8.4	8	7.4	6.1	6	5.2
Inflation (CPI)	5.4	2.6	2.6	2	1.4	2.1	2.4
Unemployment rate (%)	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Average salaries	16.8	14.4	11.8	9.2	8.5	7.4	7
90-day interbank rate (average) (%)	5.3	4.2	4.9	4.8	3.8	2.9	3
USD/CNY exchange rate (average)	6.46	6.31	6.15	6.16	6.28	6.61	6.67
Current account balance (CNY Bn)	874	1360	912	1713	2077	1510	1239
Current account balance (% of GDP)	1.8	2.5	1.5	2.7	3.0	2.1	1.6
Budget balance (% of GDP)*	-2.4	-3.4	-3.5	-3.6	-4.4	-4.6	-4.7

NB: Percentage change versus previous period - except where otherwise indicated; *IMF Article IV August 2016. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

GDP growth remained unchanged at 6.7% yoy in 2Q, contrary to our expectations of a slight deceleration. On the demand side, the limited slowdown in private consumption and investment was offset by increased public spending. The contribution of foreign trade was again negative. As regards supply, growth held up due to a modest acceleration in the farming and industry sector while the services sector slowed slightly.

GDP figures by province, which if aggregated continue to exceed national GDP in terms of both the level and rate of growth, show that only five provinces report growth lower than Chinese national growth, with Liaoning recording a second consecutive quarter of negative yoy growth (-1.0%). The other provinces recorded much higher growth with rates above 10% in Guizhou, Tibet and the municipality of Chongqing.

GDP growth rates and weightings in 1H16



Source: CEIC

In Liaoning, the contraction in growth was due to the continuing downwards trend in the industrial sector, in place for the last six quarters, and to a sharp slowdown in services. Growth in the industrial sector has also been in negative territory for several quarters in the central province of Shanxi and in the municipality of Shanghai; in both of them, however, the services sector continues to record high growth (7.6% and 11.6% respectively).

The summer months' figures point to a gradual improvement in corporate confidence, a moderate upturn in exports and industrial output, and a stabilisation of investment and lending growth. In light of the above indications of first-quarter GDP growth slightly above our expectations and of the continuing support of economic and fiscal policy, reiterated over the summer, **we are upgrading our GDP growth forecasts** from 6.3% **to 6.5% in 2016** and from 6.1% to 6.2% in 2017.

Foreign trade data recorded a **moderate improvement** over the summer although yoy changes are still negative (-6.7% 3m yoy for imports and -4.0% 3m yoy for exports in August). The base effect was favourable, but seasonally-adjusted figures show that the trend is improving, **especially for exports**. The foreign orders component of the PMI recovered slightly, although it is still below 50 in both the NBS and Markit surveys, while the upturn in total orders was more sustained. **Imports** benefited from the rise in commodity prices, but in volume terms the increase mainly related to coal and certain metals. This could therefore be linked with stock-building, given the decrease in inventories for deliveries of aluminium, coal and, to a lesser extent, copper futures at the Shanghai stock exchange.

The PBOC's quarterly survey on industrial enterprises registered a further **increase in corporate confidence** in 3Q, taking it above 50 after a year, thanks partly to the improvement in orders, especially domestic orders, which was also recorded in the PMIs. Growth in **industrial output**

stabilised at 6.0% ytd yoy over the summer thanks to an improvement in the monthly variations in line with the recovery of the PMIs. The indices remained at around 50, although they continue to show severe difficulties for SMEs. Industrial output stabilised despite the closure of a number of factories, aimed at reducing pollution levels ahead of the G20 meeting, and was in line with the increase in electricity generation. However, part of the increase in electricity generation could be due to the use of air-conditioning equipment given the exceptionally high temperatures during the summer. The stock-building cycle, which fell to its lowest levels in April/May, could also have contributed to this. The **production capacity utilisation index** is still above 50, but it is gradually falling from its April high.

Capital expenditure recorded growth of 8.1% ytd yoy in August, unchanged from July but lower than the figure of 9% in June. Projects under construction continue to accelerate but new investment in the first eight months of the year is 4% lower than the same period in 2015. After surging in the first half of the year and peaking in April, investment in state-owned companies slowed to 21.4% cum yoy in August. This marginal slowdown was offset by a slight upturn in investment in companies funded by foreign capital; meanwhile, private sector investment recorded growth of 2.1% ytd yoy, unchanged on July, but at the lows of the series. Overall, the **slowdown in total investment** continues to be **mitigated by the resilience of investment in infrastructure**, predominantly that in the public sector and concentrated in the central and eastern regions; this is also the infrastructure most involved in the "*One Belt, One Road*" project. **Private investment remains lacklustre**, except in the central and eastern regions where it is stabilising, and is being driven down by the fall in investment in both the manufacturing sector (-4.6% ytd yoy) and the services sector (-11.2% ytd yoy). In the north-eastern provinces (Liaoning, Jilin, Heilongjiang), private investment plummeted by 30%.

Investment in the property sector stabilised (5.4% ytd yoy in August vs 5.3% in July), partly thanks to growth rates that are still above 10% in the central regions (+10.7% ytd yoy), but are slowing compared with the April peak (+7.2%). Residential building recorded a similar trend. Residential floor space sold continues to rise at a sustained pace (+25.6% yoy in m^2 in August), enabling the stock of unsold property, after years of increases, to be reduced by 0.7% yoy in the first eight months of 2016. The stock of unsold commercial buildings, however, continues to rise (+22.2% in the same period). **Prices of residential buildings accelerated further** in first-tier cities (with average increases of 3.4% mom in August, led by Shanghai: +37.8% yoy and + 5.8% mom) despite the anti-speculative measures restricting the purchase of second homes introduced in the first half of the year. There was also a sharp uptrend in prices in second- and third-tier cities, some of which have introduced restrictions more recently, with average monthly increases that exceeded or equalled those seen at the peak in 2013.

We remain sceptical as to whether the property market could continue to grow at this pace in 2017, given the level of inventory and the additional **measures to reduce spending** that the authorities could implement in the next few months. Recently, Ma Jun, chief economist at the PBOC, issued a warning about the **unsustainability of the property prices trend** and the consequences if a bubble were to burst, emphasising the need to find measures to prevent a bubble forming and to scale down lending growth in the property sector. Lending growth rose from 24.0% yoy in 2Q, essentially supported by a sharp acceleration in mortgages (+31.0% yoy).

Retail sales accelerated slightly (+10.2% yoy in real terms vs 9.8% in July and the low of 9.3% in April), driven mainly by the rise in **car sales** (+24.4% yoy in August). During the summer, consumer confidence improved considerably according to the National Bureau of Statistics survey, while remaining broadly unchanged (Unionpay, ANZ) or declining (Westpac) in other surveys. The **labour market seems stable**: the average urban unemployment rate recorded in 31 cities, at 5.1% in August, returned to spring levels after a low of 5% in the summer, while the national rate remains unchanged at 4%. The number of new jobs in the first eight months of the year is slightly less (-0.4%) than in the same period in 2015, while the employment component of the Markit services PMI, the only one to have remained above 50, deteriorated until it reached the 50 threshold in August. The Manpower Survey for the fourth quarter rose slightly after reaching a low in 3Q, but remains close to the lows of the series.

In August, **inflation hit its lowest point since the beginning of the year**, falling by more than expected to 1.3% yoy from 1.8% in July. The decline came on the back of a slowdown in food sector prices, due to falling fruit and vegetable prices and the net deceleration of meat prices. Core inflation, at 1.6% yoy, returned to June levels, while services inflation remained stable at just above 2%. The decline in food prices could be temporary as shown by the trend in weekly prices, while producer price inflation, although still in negative territory, is up sharply on the lows of the beginning of the year. We are therefore sticking with our forecast of a moderate rise in inflation over the next few months.

Growth in medium- to long-term **bank lending** since the beginning of the year has been driven by property mortgages, while short-term credit has recorded a modest slowdown. Growth in outstanding bank loans stabilised at around 13% yoy in the summer, slowing only slightly on the figure of 14.3% yoy in 2015. Total social financing showed a similar trend. While growth in new bank loans slowed (+9.8% yoy in the first eight months of 2016 vs 15.2% yoy in 2015), the flow of social financing, which is growing at a similar rate (+10.3% yoy), picked up compared with 2015 (-6.5% yoy), driven by the recovery in foreign currency loans and trust loans, as well as by the increase in bond and equity issues. New loans remained stable and new social financing have accelerated slightly in relation to GDP in the last four out of six quarters, continuing to support growth in the short term but leaving the medium- to long-term risks unchanged on the downside.

The increase in debt (especially corporate debt) and **non-performing loans** (NPLs), which are still rising (+31.6% in 2Q), albeit at a slower pace than in 2015 (+51.2%), are still cause for concern, with the ratio of NPLs to total loans unchanged at 1.75%. **Special mention loans** i.e. those that have not been repaid but that the banks not yet classify as non-performing, are also rising rapidly. These loans amount to more than twice the number of non-performing loans and, together with the latter, rose from 3.8% of GDP in 2Q14 to 6.7% in 2Q16. If they were included in NPLs, this category would account for about 6% of total loans, but the rating agencies and various analysts estimate that the real ratio could be between 15% and 20%. Another potential source of risk also comes from **wealth management products** (WMPs), due to both the apparent discrepancy between the maturities of assets and liabilities and the size of the market. The amount in circulation has gradually risen from 23.3% at end-2014 to 37.1% of GDP in 2Q16, even though the authorities have intervened several times to regulate the sector.

Control of financial risk, however, is one of the **regulators' highest priorities**, as has emerged from some recent statements and from the regulatory interventions in various areas of the non-banking financial sector in the last few months. In the summer, the various competent authorities (PBOC, China Banking Regulatory Commission, CBRC, China Securities Regulatory Commission, CSRC, and China Insurance Regulatory Commission, CIRC) issued new, more stringent regulations on wealth management products, P2P (peer-to-peer) loans, management funds and life insurance products in the insurance sector. The PBOC and CBRC are also continuing to press the banks to ensure better risk management, including via the greater use of creditor committees [19], in an attempt to restructure corporate debt rather than demanding an impossible reduction or ceasing to grant loans.

Over the summer, the government continued to reiterate the need to support investment, especially in the private sector. A press release from the State Council in early September points to an easing of the restrictions on investment in infrastructure, with equal access to private investors in sectors such as education and health. It also encouraged state-owned companies to invest in the electricity grid in rural areas and in telecommunications, and policy banks to provide the necessary loans, reaffirming their support to the banks that will continue to remove non-performing loans and that need a capital increase. According to press reports at the end of August, a plan has been drawn up and circulated among the ministries, reviving policies announced previously to cut companies' costs and increase their profitability, together with a plan to revive the north-eastern regions, with new investment in transport and energy infrastructure as well as farming and urbanisation projects. Companies with a suitable credit rating will be able to launch issues on the international markets. The National Development Reform Commission (NDRC) continued to approve projects to invest in infrastructure totalling CNY 196.6Bn in September, a sharp rise on the figure of CNY 60Bn in August. The finance ministry is also thought to be considering reform of the tax code, which would see a reduction in the rates on certain products that have always been considered luxury goods (such as cosmetics) and an increase on alcohol and tobacco, as well as a greater transfer of consumption tax income from central government to the provinces.

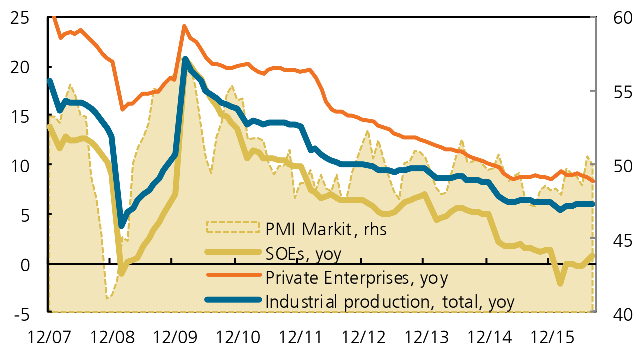
At the beginning of August, a report published on the NDRC website, which suggested that interest rates and the reserve requirement ratio should be cut as soon as the opportunity arose, was suddenly removed, although it had already been picked up by the press. This incident highlights that there is an ongoing debate among the Chinese authorities on the type of stimulus required (whether it should be purely fiscal or fiscal and monetary) to support growth and limit the restrictive impact of reforms in the short term. Subsequent comments by the PBOC (via the head of the National Bureau of Statistics, Sheng Songcheng) hinted at a preference for a rise in the deficit and warned against increasing companies deposits (preferred to investments, as indicated by the anomalous growth of M1, which was much higher than M2) and household mortgages, as well as the risks that a further rate cut would involve for the exchange rate. The PBOC therefore indicated there was little room for manoeuvre for monetary policy. Monetary conditions have indeed remained favourable, with a fall in yields on both the government and corporate curves over the summer, supported by open market operations and medium- to long-term refinancing. We do not therefore expect a change in strategy at least in the next two quarters.

The CNY/USD exchange rate remained relatively stable over the summer, neither exceeding 6.70 (the mid-July peak) nor dropping below 6.62; the effective exchange rate recorded a similar trend. Foreign currency reserves fell by a total of USD 20Bn between the end of June and the end of August, bringing the total to USD 3,185Mn, just below the May figure. The PBOC continues to reiterate its unwillingness to allow the currency to depreciate sharply in both its communications and its actions, as shown by the off-shore intervention that recently pushed up rates on deposits in CNY on the Hong Kong stock market. The losses recorded by speculators who had bet on a greater depreciation of the Chinese currency at the beginning of the year, probably acted as a further anchor for the exchange rate, which in any event continues to be supported by a current account balance well in positive territory and stronger-than-expected

[19] Temporary committees comprising at least three creditor banks of companies struggling to repay large amounts initially trialled in Henan in the spring.

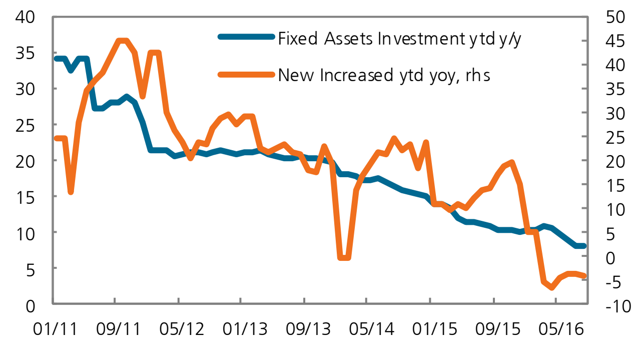
growth. We reiterate our scenario of limited depreciation in tandem with the launch of Fed rate hikes for the end of the year, followed by a slight appreciation next year.

Fig. 1 – Industrial output stabilises



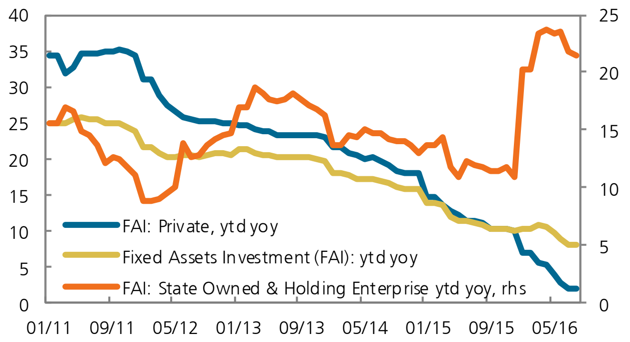
N.B. Value added in real terms. Source: CEIC, Markit

Fig. 2 – Investment and new investment



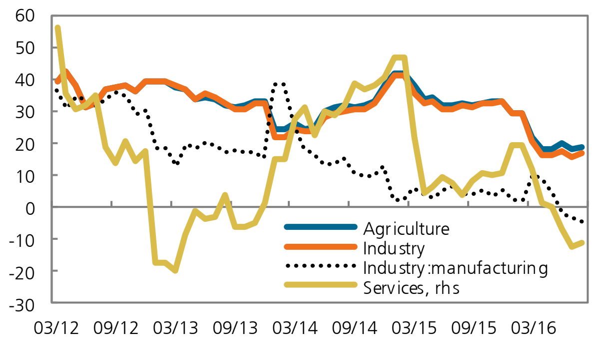
Source: CEIC

Fig. 3 – Private sector investment continues to slow



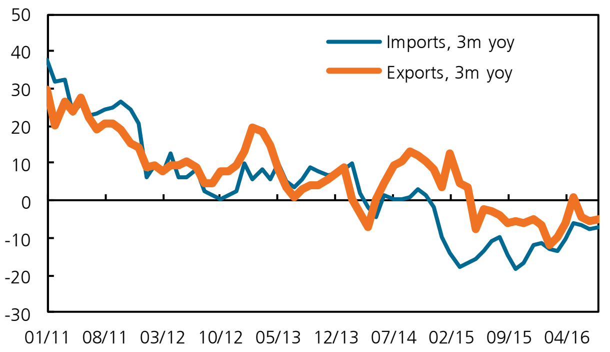
Source: CEIC

Fig. 4 – Private sector investment is dragged down by the service and manufacturing sectors



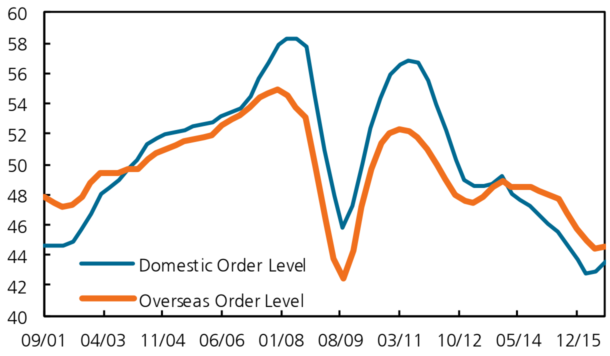
Source: CEIC

Fig. 5 – Foreign trade holds up



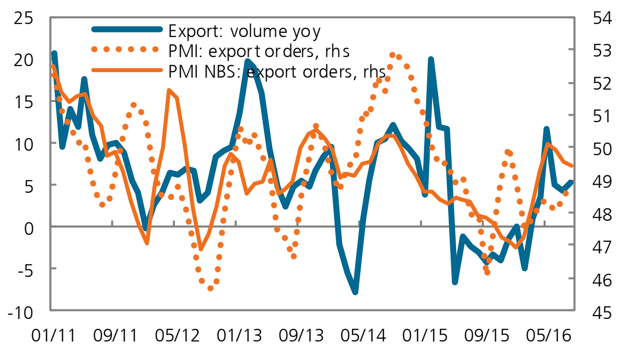
Source: Bloomberg, CEIC

Fig. 6 – Industrial enterprise survey



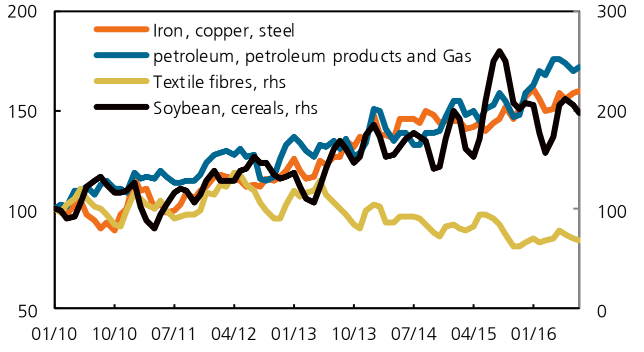
* Four-quarter moving average. Source: CEIC

Fig. 7 – Exports improving, including in volume terms



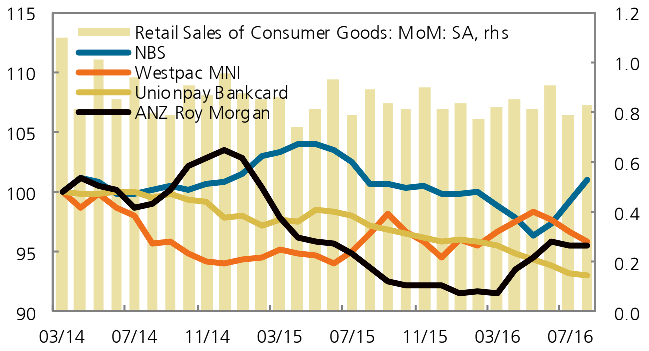
Source: CEIC

Fig. 8 – Raw material imports in quantities



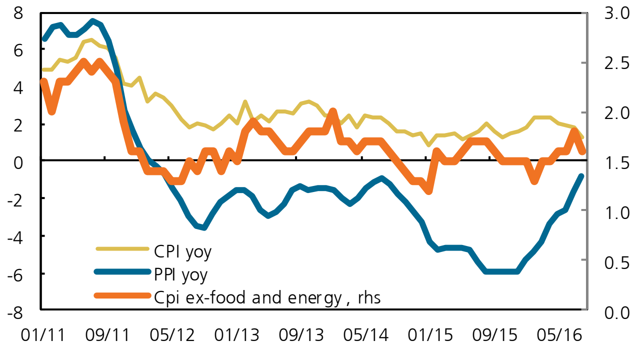
NB: Imports in tons, 3m moving average, rebased at 01/01/2010 = 100. Source: ISP chart from CEIC data

Fig.9 – Contradictory confidence indices



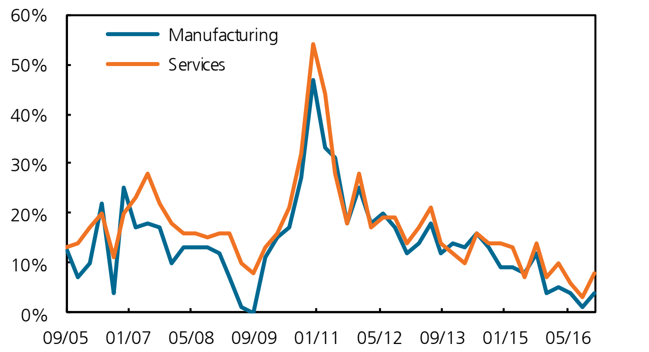
N.B. Confidence indices, 3-month moving average, rebased to March 2014=100. Source: CEIC

Fig. 10 – Inflation



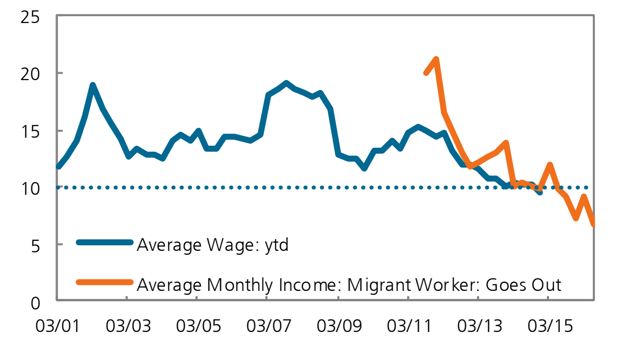
Source: CEIC, Bloomberg

Fig. 11 - Manpower survey: hiring intentions



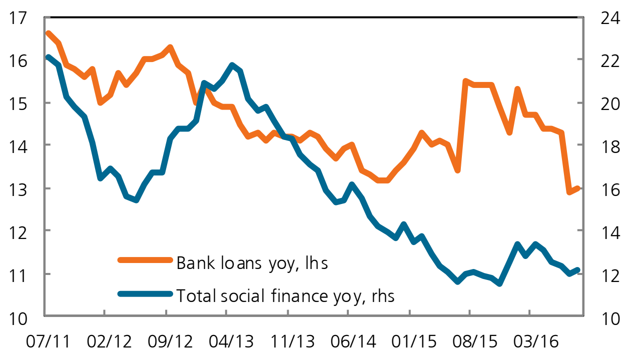
Source: Bloomberg, four-quarterly moving averages.

Fig. 12 – Wages growth still high but slowing



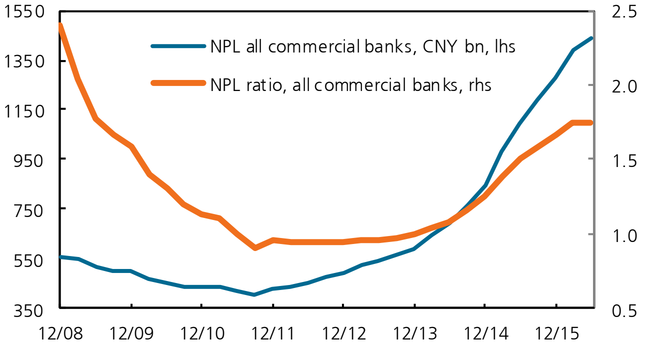
Source: CEIC

Fig. 13 - Lending stabilises



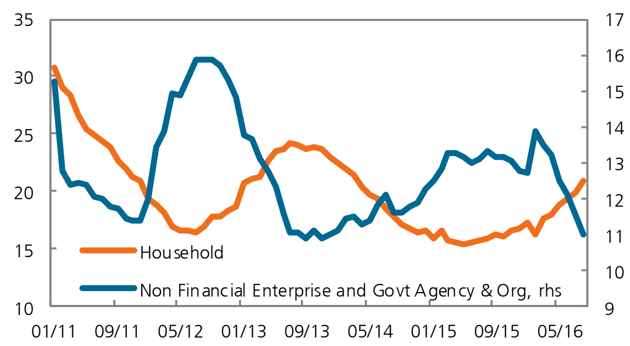
NB: stock, monthly figures, % yoy chg. Source: CEIC and Intesa Sanpaolo estimates

Fig. 14 – Non-performing loans continue to rise



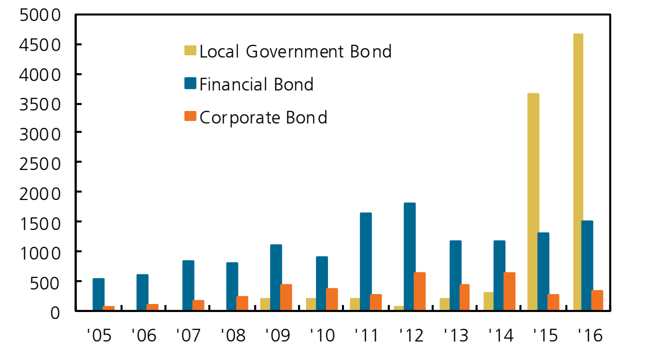
NB: Non-performing loans (NPL) of commercial banks. Source: CEIC

Fig. 15 - Bank lending (chg. % yoy)



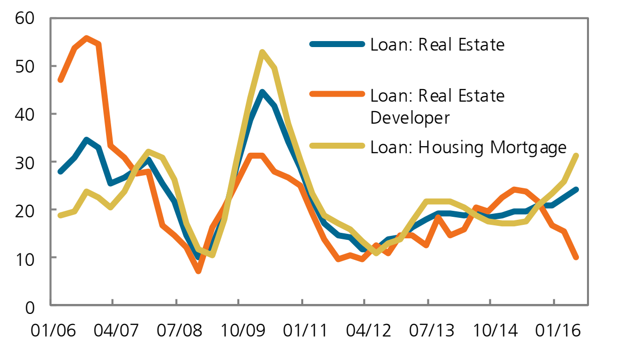
Source: CEIC

Fig. 16 – Net issues (CNY m.)



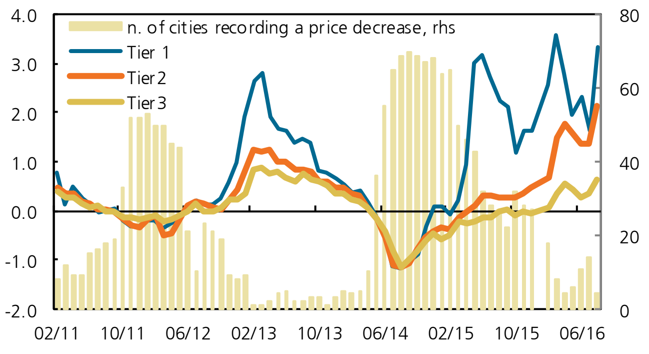
N.B. 2016 up to August. Source: Intesa Sanpaolo chart from CEIC data

Fig. 17 – Real estate sector loans



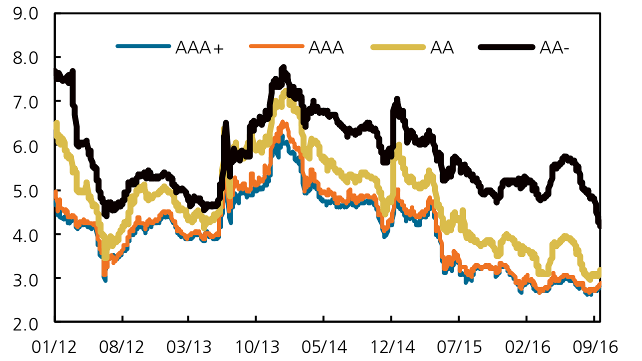
Source: CEIC

Fig. 18 – Real estate market: a new bubble?



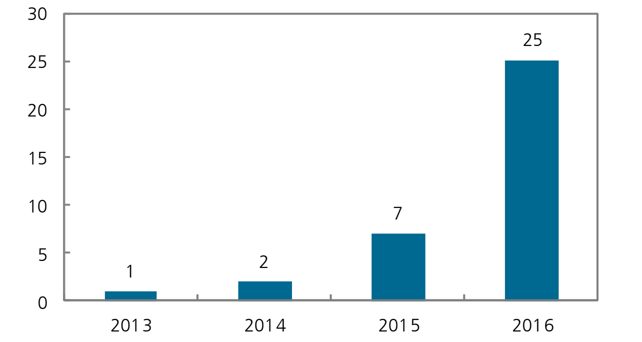
Source: Bloomberg and Intesa Sanpaolo estimates

Fig. 19 – Yields on 1-year corporate bonds



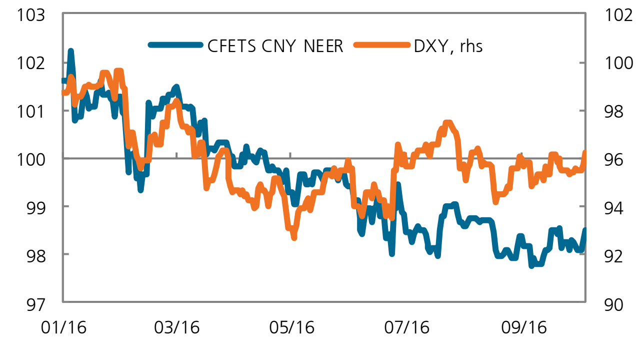
Source: CEIC

Fig. 20 – Number of corporate bond defaults



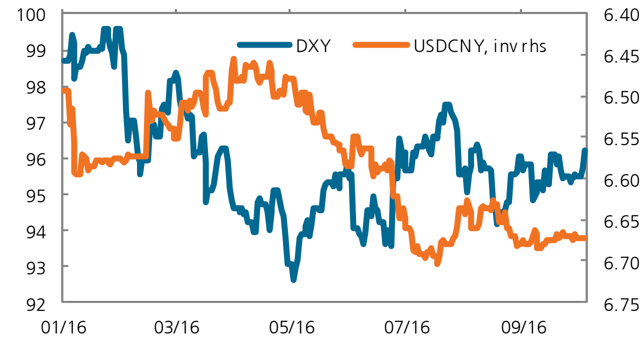
N.B. 2016 at 22 September. Source: Bloomberg

Fig. 21 – Effective exchange rate: CNY and USD



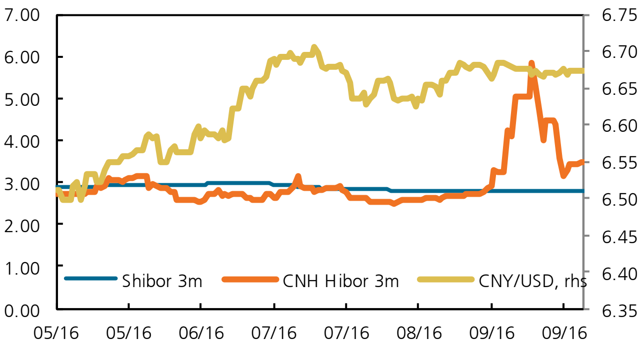
Source: Intesa Sanpaolo charts from CEIC, CFETS and Bloomberg data

Fig. 22 – CNY/USD and effective exchange rate



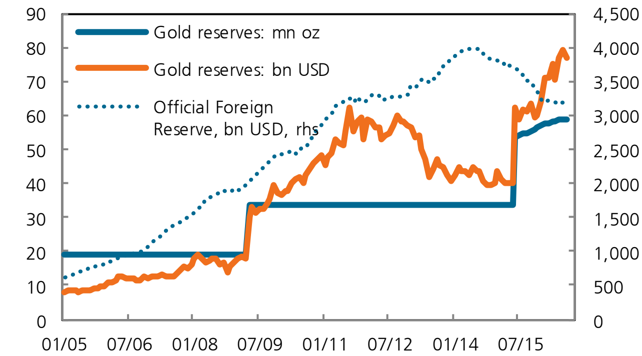
Source: Intesa Sanpaolo chart based on Bloomberg data

Fig. 23 – Shibor and CNH Hibor rates



Source: Bloomberg

Fig. 24 – Foreign currency reserves



Source: CEIC, Bloomberg

India: consumption offsets contraction in investments

Silvia Guizzo

GDP growth slowed to 7.1% yoy in the second quarter, from 7.9% in the first, despite an acceleration in quarterly terms, due to a significant negative base. A sharp rebound in public consumption (18.8%) offset a moderate slowdown in private consumption and, in combination with a positive contribution from foreign trade, partly offset the contraction in fixed investments that has been under way since the first quarter. Value-added GDP growth decelerated less rapidly (from 7.4% to 7.3% yoy), reflecting an upturn in services, driven by the property sector and Public Administration services.

In the national accounts, investment data declined for the second consecutive quarter, down 3.1% yoy after a fall of 1.9% in the first three months of the year, despite a favourable base effect. Monthly figures for capital expenditure from the public accounts shrank by 16.4% yoy in the first seven months of the year. The number of investment proposals submitted by industrial companies to the Ministry of Industry for approval, meanwhile, rose by 15.2% yoy in the same period (compared with an 8.4% increase for the whole of 2015) and, after months of decreases, total investments also rose (by 14.7% yoy). In its September bulletin, the Reserve Bank of India (RBI) estimates the capital expenditure of private companies currently planned for fiscal year 2016-2017 (FY 2016-17) at INR 674Bn. New investments of INR 838Bn would be required to reach the level of the previous fiscal year, i.e. an increase of more than double in the next half-year. In the meantime, after a two-year positive trend, the CMIE (Centre for Monitoring Indian Economy) states that the number of completed projects declined steeply in the second quarter, while the number of suspended projects rose. There is still little likelihood of a recovery in investments, therefore, despite government efforts to improve business conditions, particularly in terms of availability of infrastructure. India climbed four places to 155th in the World Bank's Ease of Doing Business index in 2016, rising six places in the "starting a business" category and 29 for access to electricity. India also rose 19 places in the Logistics Performance Index, from 54th place in 2014 to 35th in 2016. Meanwhile, economic policy during the year continued to support foreign investment, with measures to attract greater foreign investment. Growth in bank lending was stable, at just over 8%. While lending to industry continued to falter - although companies continued to be supported through other financing channels (share or bond issues on both the domestic and foreign markets) - lending to the services sector and to households picked up.

Growth in industrial output remained flat over the summer (up 0.2% 3m yoy in July), dragged down by the weak manufacturing sector and the contraction in non-durable consumer goods and capital goods. The latter has been declining since the beginning of the year (-20% 3m yoy) and, according to the RBI, is mainly attributable to the volatility and contraction of rubber cable orders. Stripping out capital goods production, industrial output was up 2% 3m yoy, a positive but nevertheless low rate of growth. The expectations component of business confidence for 3Q improved, but did not exceed the 1Q peak, and the trend was the same in orders. However, the steady improvement seen in the orders component of the PMI, which reached 54.8 in August, points to a moderate recovery in industrial output in the next few months.

Although changes in the trend remained negative, foreign trade improved over the summer, particularly exports excluding oil (down 0.1% 3m yoy in July). However, imports excluding oil again contracted significantly (by 12.1% 3m yoy in August), although they recovered from the low of -16.7% seen in May. The trend in cargo traffic remained positive, but limited, while foreign orders increased, suggesting a stronger exports trend in the next few months.

The net acceleration in passenger traffic, particularly domestic traffic, argues positively for sustained consumption, further supported by accelerating wage growth in rural areas. The RBI's quarterly survey shows a minimal decrease in consumer expectations in the second quarter and an increase in the current assessment, which both remain at high levels, particularly expectations. The assessment of the labour market was in line with that of the first quarter, i.e. one of a marginal decline, as also recorded by the Manpower survey. The percentage of businesses planning to hire is high, but down for the fourth consecutive quarter. The continuing positive trend in the labour market, the increase in domestic passenger traffic and expectations of a recovery in the agricultural sector mean that, in any event, **the outlook for private consumption is still positive for the rest of the year**. The trend in both public and private consumption, combined with a positive contribution from foreign trade, is likely to offset the contraction in investments during 2016. We are therefore leaving **unchanged our GDP growth forecast of 7.5% for 2016**. A recovery in investments should support **the consolidation of growth** at these levels **in 2017.**

After peaking at 6.1% yoy in July, **inflation fell to 5% in August**, driven down by a deceleration in food prices, particularly meat and vegetables. Stripping out food and energy, inflation has remained at 4.6%-4.7% in the last four months and, at the same time, wholesale price inflation has returned to positive territory, rising to 3.7%. The upward trend in oil prices and in pump prices will cancel out the deflationary effect so far seen in the CPI transport component. We expect food prices to continue to decelerate in the short term and, in view of the food segment's greater weight than the fuel segment in the CPI basket, as well as a base effect that will remain positive in the next few months (but steadily decreasing until the end of the year), we expect to see inflation, although rising, to remain just above 5% in the next two quarters, before subsequently falling. We therefore believe that a cut of 25bps by the end of the year is still probable, but we would associate the probability of a subsequent cut with a decline in core inflation.

The slowness of the decline in core inflation is a concern for the **RBI**, which, at its August meeting (the last with Governor Rajian), once again left rates unchanged, reiterating an accommodative monetary policy stance, stating that it would act as soon as it had room for manoeuvre and would continue to maintain sufficient levels of liquidity to support economic activity. At the end of August, the government appointed the **new Governor of the RBI**, **Urjit Patel**, who is regarded as a "hawk", is one of the deputy governors since 2013 and has been chairman of the committee of experts for the reform of the Monetary Policy Framework, which provided for the introduction of an inflation target and a Monetary Policy Committee. In view of the Governor's background, his appointment indicates strong continuity with the previous management, and has definitely helped to buoy the rupee in the last month.

The **rupee** remained largely stable against the dollar over the summer, and, after peaking at 68 at the end of June, appreciated to around 66 in September. It may experience further periods of pressure in the fourth quarter, when the Fed implements its first interest rate hike and around USD 25Bn (out of USD 127Bn) in non-residents' deposits mature, from September: with respect to these, however, the RBI announced, back at its April meeting, that the deposits and their associated swaps are hedged by forward purchases and that it will take appropriate steps to combat any increase in volatility. The improvement in external vulnerability indicators and the limited current account deficit will continue to support the exchange rate.

Another **government reshuffle** took place in the first week of July, with the creation of 19 new ministries, 17 assigned to members of the BJP and seven to regional parties in the states in which the 2017 elections will take place. The number of ministers has thus risen from 45 to 78, close to the constitutional limit of 82. Electoral considerations thus seem to have won the day over the idea of "minimum government, maximum governance", which was the rallying cry of Prime Minister Modi's election campaign. However, this meant that, thanks to the cooperation of the regional parties, the summer session of Parliament finally **passed the bill on the taxing of goods and services** (Goods and Services (G&S) Tax) in the **upper house** (3 August) with minimal amendments. This approval marks a significant step forward in the area of reform, although it is hard to imagine that the G&S tax will come into force before April 2017. The bill has already been reapproved by the lower house (8 August) and was ratified by a majority of individual states, but a recently appointed committee (G&S Council) must first establish tax rates, exemptions and a dispute resolution mechanism.

The Ministry of Finance recently announced **changes to the process of forming the public budget**, which should encourage greater effectiveness and efficiency in spending. The presentation and approval of state budget will be brought forward by around one month (from the end of February for the former and mid-May for the latter, which is the current schedule), planned and unplanned expenditure (subsidies, defence, pensions) will no longer be separated and the Railway budget will be incorporated into the public budget. The separation of the two sets of accounts was a legacy of the British system, in force since 1924, and their aggregation is positive, as the tighter controls to come could result in less waste and less political and electoral spending. Such expenditure has previously been a feature of the management of the railway accounts, particularly under coalition governments. The early preparation of the budget will enable more rapid implementation of spending programmes, which have now been brought forward in rural areas, partly due to the summer monsoons, to the start of the fiscal year. Work to prepare the budget will begin in mid-October and preliminary GDP estimates will be available from 7 January, rather than from 7 February.

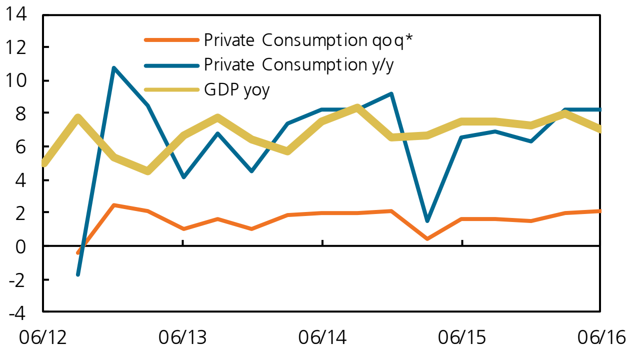
The **public deficit** in the first four months of FY 2016-17 has already reached 74% of the annual target, which is largely in line with the historic performance, given that revenues tend to increase in the second half of the year. The budget is notwithstanding burdened by a lack of clarity on the coverage of the 23.6% increase in wages planned for around 10 million employees and public pension holders, in accordance with the recommendations of the Seventh Pay Commission, and which was approved at the end of June. The government has allocated a total of INR 700Bn (around 68% of the total requirement, i.e. INR 1.02Trn), dividing this amount between various ministries without providing any details, and approved, at the end of June, an increase of INR 849Bn for 4.7 million employees and 5.2 million pensioners by the end of this fiscal year. Similar uncertainty has beset income from privatisations, which is still well below target. Unless the trend is reversed in the next few months, the government may have to review expenditure or the fiscal deficit target of 3.5%.

Macro forecasts

	2011	2012	2013	2014	2015	2016	2017
GDP (constant prices)	7	5.6	6.3	7	7.2	7.5	7.5
Private consumption	7.3	6.7	5.7	6.7	7	7.8	7.6
Public consumption	7.9	4.6	2.2	9.5	0.9	9.9	6.1
Fixed investment	6.2	2.3	7.4	2.8	5.8	-1.9	5.7
Exports	18.2	10	4.4	7	-6.3	3.7	4.8
Imports	18.4	11.3	-6	0.5	-3.9	-2.1	3.2
Industrial output	4.8	0.7	0.6	1.8	3.2	2.1	5.7
Inflation (CPI)	8.3	9.4	9.9	6.6	4.9	5.2	4.6
Unemployment rate (%)	5.8	5.6	5.6	5.6	5.5	5.5	5.4
Average salaries	14.3	19.3	11.2	10.7	10.4	10.1	9.8
3-month MIBOR (average)	9.5	9.5	9.3	9.1	8	6.9	6.1
USD/INR exchange rate (average)	46.7	53.5	58.6	61.0	64.2	67.39	66.10
Current account balance (INR Bn)	-2945.1	-4893.2	-2779.6	-1661.2	-1450.6	-579.7	-771.9
Current account balance (% of GDP)	-3.5	-5.1	-2.5	-1.4	-1.1	-0.4	-0.5
Budget balance (% of GDP)	-6.9	-5.5	-5.5	-4.3	-3.5	-3.8	-3.4

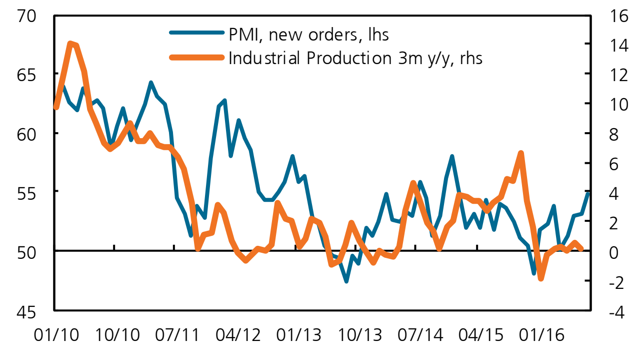
NB: % changes versus previous period – except where otherwise indicated. Figures relate to the calendar year. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Fig. 1 – Growth continues to decelerate, but remains above 7%



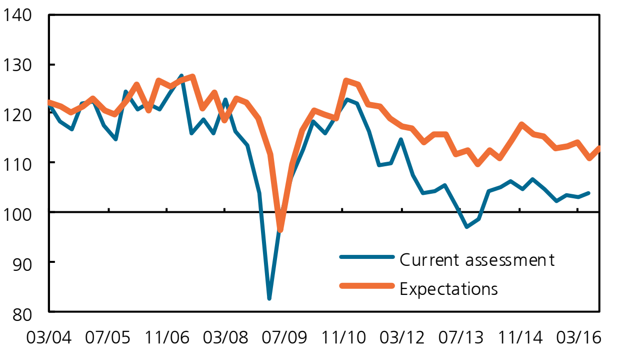
* Moving average for 4 quarters. Source: CEIC

Fig. 2 – The trend in industrial output remains fragile but new orders improve



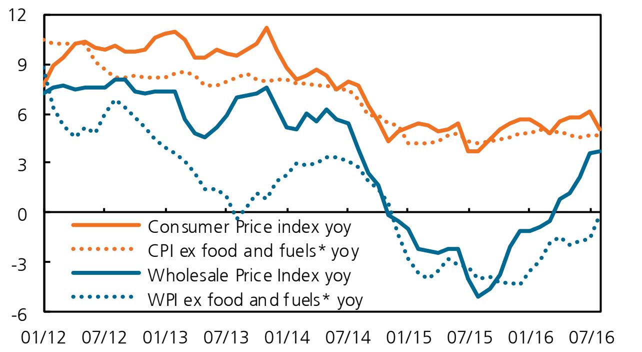
Source: Markit-HSBC, CEIC

Fig. 3 – Business expectations*



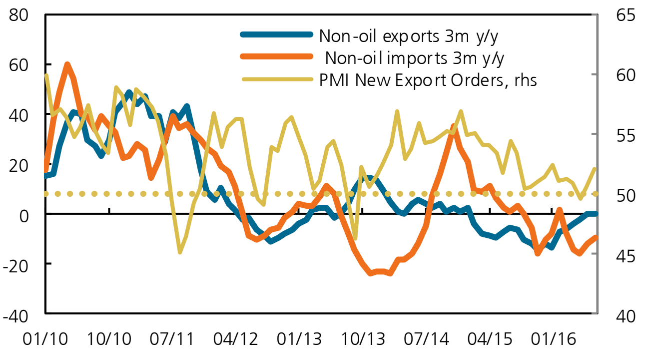
NB: (*) Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India.

Fig. 4 – No decrease in core inflation



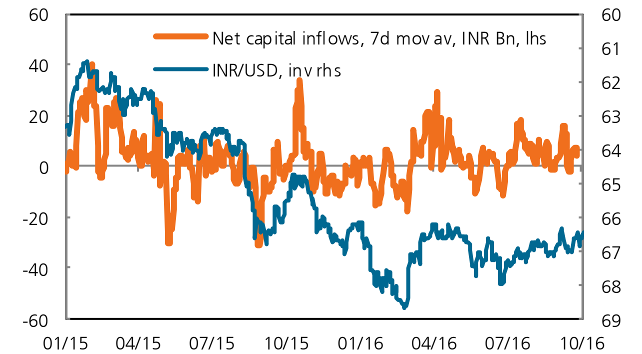
NB: (*) Intesa Sanpaolo estimate. Source: CEIC

Fig. 5 – Exports improve



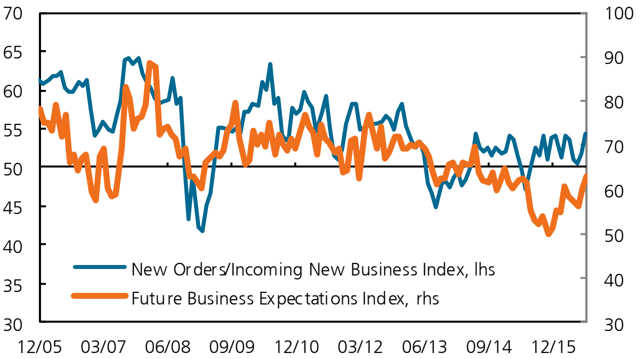
NB: Moving average for 3 months. Source: Intesa Sanpaolo charts based on Bloomberg and Markit data

Fig. 6 – The rupee recovers from the lows seen in February



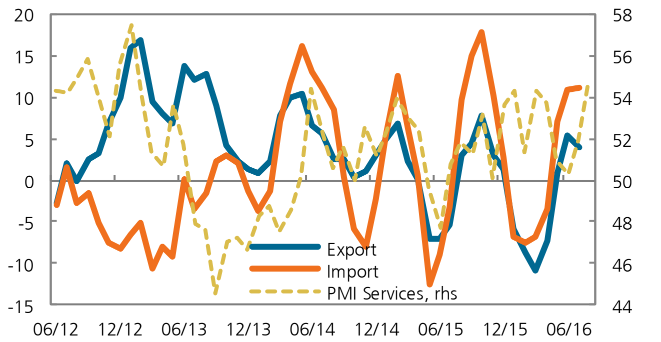
NB: (*) Net purchases by foreign institutional investors. Source: CEIC

Fig. 7 – Services: expectations and orders stabilise



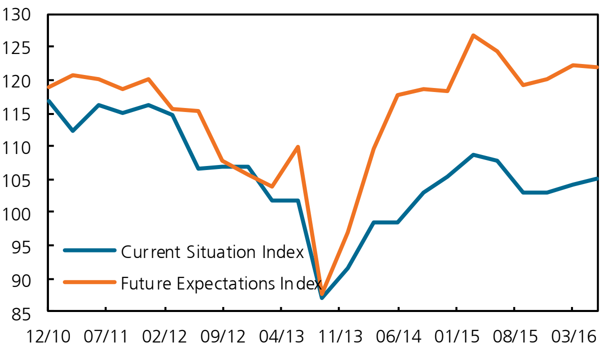
Source: Markit

Fig. 8 – Trade in services



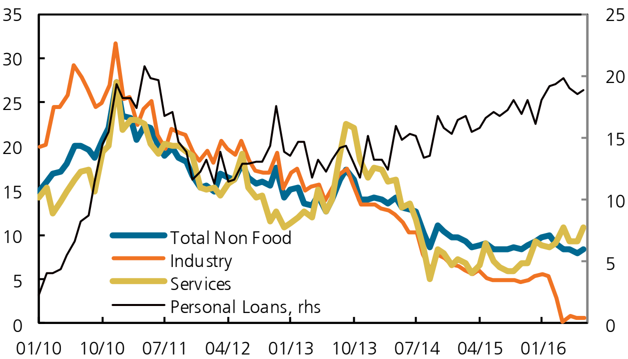
Source: CEIC

Fig. 9 – Consumer confidence



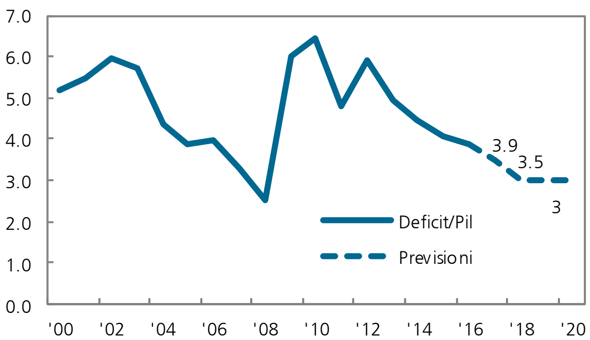
NB: RBI's quarterly consumer confidence survey. Source: CEIC

Fig. 10 – Lending to industry slows (% change yoy)



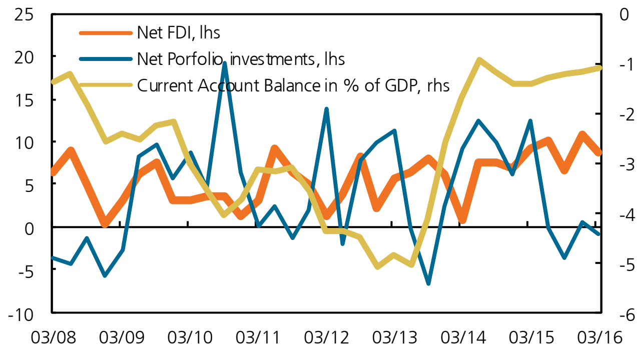
Source: CEIC

Fig. 11 – Public accounts (%)



Source: CEIC, Ministry of Finance

Fig. 12 – Current account balance



NB: left-hand axis in USD billions. Source: Intesa Sanpaolo chart from Bloomberg data

Currency markets: the Fed's gradualism caps the dollar's upside

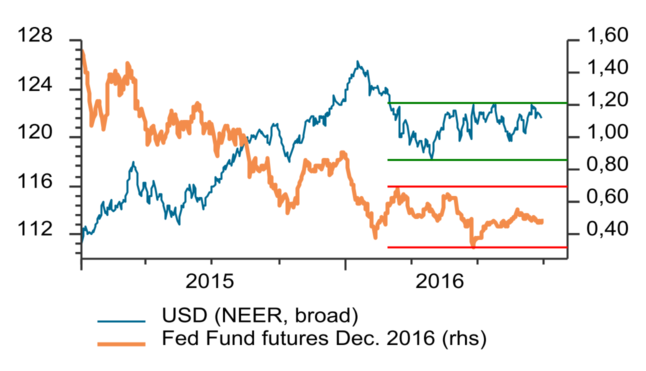
Asmara Jamaleh

Compared with three months ago, the most important developments on the currency markets again related to the central banks. In general, they reiterated the need to maintain accommodative monetary policies with greater conviction than previously. In some cases, the existing stimulus was further expanded, while in others, the banks simply indicated that it would be appropriate to maintain expansionary conditions for longer.

The market waits for a still highly cautious Fed. A hike in December will have a modest impact on the dollar

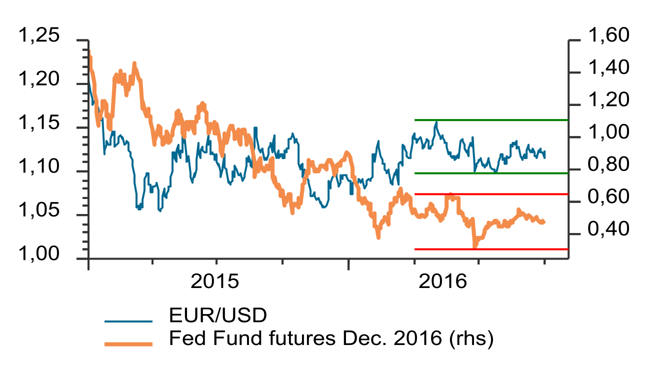
The Fed is moving in the same direction, again postponing the timing of the second interest rate hike, now expected in November-December, one year on from the first. At the FOMC meeting of 21 September, the Fed downgraded its interest rate projections, outlining a picture of more gradual hikes than in its June's projections: the new path is for one rise this year and two rises the next year, while in June, two were projected for this year and three for next. As for 2018, expectations for three rate rises remain unchanged. The revision may not seem particularly significant in absolute terms, because it includes two fewer rises over two years. If we consider, however, that the rate hike path was already fairly gradual by previous standards, the revision becomes significant in terms of market implications. This is likely to have a generally downside effect on the dollar. This means that when the Fed implements the second rise, the dollar should strengthen further, although the movement will probably be modest in size. Beyond the short term, over the next year, the dollar is likely to move within the medium/low end of the range seen this year. However, risks to the scenario are to the upside: if the US economy performs better than expected, prompting the Fed to implement more than two rises next year, the dollar would benefit, because the rates path incorporated into market prices remains more gradual than that projected by the Fed.

Fig. 1 – The Fed's gradualism caps the dollar's upside



Source: Thomson Reuters-Datastream

Fig. 2 – The Fed's gradualism favours the euro's trading range dynamics



Source: Thomson Reuters-Datastream

The ECB has indicated that it is in no hurry (or at least there is no need) to increase monetary stimulus. This plays in the euro's favour…

EURO - As expected, the euro's main trend was again to move sideways, within a range half the size of last year's: 1.07-1.16 EUR/USD this year vs. 1.04-1.21 EUR/USD in 2015. The dominant theme was again the contrasting monetary policies of the ECB and the Fed, with the exception of a small interlude coinciding with the UK referendum. The euro fell sharply on the result of the referendum, from 1.14 to 1.09 EUR/USD in one day, and remained on the defensive for several weeks. Thereafter, however, the Brexit effect eased, something in which the ECB also played a part. The ECB indicated that the UK's exit from the EU represents a downside risk for the Euro zone, but did not consider it necessary to adopt new stimulus measures, and merely stated that it was ready to do so if necessary.

And this was not all: in the new growth and inflation estimates presented at the meeting on 8 September, there was almost no downwards revision to June's pre-referendum scenario, despite both the referendum result and the recent signs of weakness in economic figures for the area.

Growth was in fact marginally upgraded this year to 1.7% (+0.1%), and revised down by only 0.1% to 1.6% in both 2017 and 2018. Revisions to inflation forecasts were even more insignificant: unchanged at 0.2% this year, cut by just 0.1% to 1.2% next year and again unchanged at 1.6% in 2018. These were tweaks rather than revisions. Basically, in their respective meetings in September, the Fed showed that it was in no hurry to raise rates, and – symmetrically – the ECB indicated that it was in no hurry (or at least did not need) to increase monetary stimulus. This again plays in the euro's favour, providing it with ample support from below, and preventing it from depreciating, despite the fact that ECB rates are zero and are set to remain so for a long time, even while the Fed raises rates this year and the next.

…but monetary policy divergence remains, and favours the sideways movement of the euro/dollar exchange rate

Here too, we therefore maintain that the scenario for the euro will mainly be one of moving sideways in a range of 1.10-1.15 EUR/USD over one year. Specifically:

i. the signs that the Fed will implement its hikes extremely gradually confirmed at the FOMC meeting of 21 September (see above) helps to maintain an area of support around 1.10 EUR/USD, strengthened by the fact that – as we have said several times – the ECB is nearing the end of the expansionary phase;

ii. the prospect that the Fed will in any case raise rates over the next two years while the ECB will keep them at zero (or marginally above) will help maintain a resistance area around 1.15 EUR/USD.

The “definitive” exit from the range, in about 12 months or just over, is likely to occur via an upside breakout, with a move from the 1.10-1.15 band to the 1.15-1.20 EUR/USD band, when the ECB will also begin the (slow) process of normalising monetary policy. Risks to the scenario are to the downside. Should the US economy perform better than expected, prompting the Fed to implement more than two rate hikes next year, the euro would be negatively impacted (downside in the medium/low end of the 1.05-1.10 EUR/USD range), also because the Fed rate hike path incorporated by the market is more gradual than that envisaged by the Fed itself.

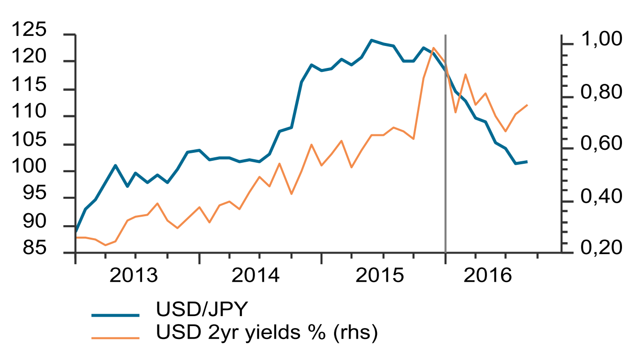
Returning to the short term, a fall just below 1.10 EUR/USD (downside target around 1.08 EUR/USD) is still possible should the Fed raise rates before the end of the year. In this period, however, the exchange rate is likely to react more than usual to Euro zone figures, given that the scenario outlined by the ECB at its September’s meeting was not downgraded from June, despite the signs of weakness coming from the figures. This exposes the euro to greater sensitivity to the downside should Euro zone figures prove disappointing.

Expectations that the yen would weaken unfulfilled, despite monetary easing…

YEN - Widespread expectations that the yen would weaken have gone unfulfilled from one quarter to the next, but were legitimate, and the reasons for this can be explained ex-post. Recent developments do not provide cues to trigger a rapid downwards reversal, but suggest that the upwards trend of the yen is likely to be coming to an end.

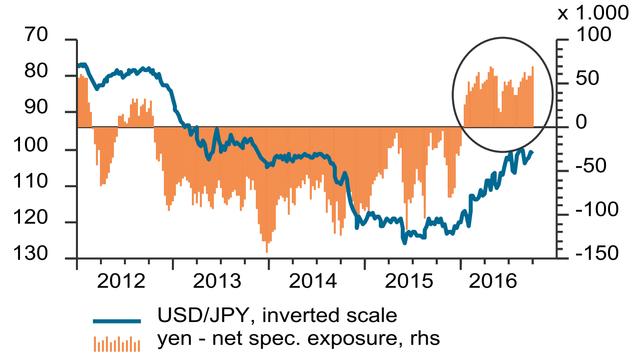
The yen has appreciated significantly since the beginning of the year: +22% against the dollar (from just above 120 USD/JPY to just below 100 USD/JPY) and +20% against the euro (from just above 130 EUR/JPY to just below 110 EUR/JPY). However, expectations that the currency would weaken were theoretically legitimate, since it was reasonable to assume that the combination of increasingly expansionary BoJ monetary policy and the likely continuation of rate hikes by the Fed would cause the yen to depreciate.

Fig. 3 – Expectations of Fed rate rises ease and the yen rises



Source: Thomson Reuters-Datastream

Fig. 4 – Unusual speculative long yen positions this year



Source: Thomson Reuters-Datastream

There are four main reasons for this:

1. after the rate hike in December 2015, the Fed has only postponed the second rise from one meeting to the next – and it still hasn't arrived;
2. the BoJ waited a long time before providing new monetary stimulus, and when it did so, introducing negative rates, the markets were not convinced;
3. uncertainties at the beginning of the year regarding global growth, and later, those relating to the UK referendum sparked an increase in risk aversion, providing support to the yen;
4. substantial speculative yen longs have been taken on the speculative market, an unusual phenomenon in terms of its size (record highs) and duration (the market has been uninterruptedly long on yen since the beginning of the year, and was much more heavily and uninterruptedly short on yen in the three previous years). The speculative position probably reflects a combination of the three previous points.

…however, the trend is likely to come to an end, and the divergence in monetary policies will favour a modest depreciation of the yen against the dollar

Conversely, the reasons why the yen's upwards trend should be coming to an end are:

1. the second Fed rate hike is expected soon (in November-December), and after a break of one year, the next few rises will be more "regular": according to indications from the latest FOMC meeting, there are likely to be five rises in 2017-2018. In addition, the rate hike path projected by the Fed is extremely gentle by previous standards, but the one priced in by the market is even more gradual, meaning that the sensitivity of the dollar will be asymmetrical (larger to positive surprises from the US economy than to disappointments);
2. the BoJ has overhauled its policy, maintaining QQE (which may be expanded) and adding two new pillars: "yield curve control" and an inflation overshooting commitment:
   - yield curve control will enable it to keep rates and yields stable within a narrow band around zero, i.e. extremely low over the long term;

- the overshooting commitment will enable it to anchor expectations of rising inflation, because it expects to maintain QQE with yield curve control until inflation has steadily risen above the 2% target. This should make the BoJ's policy action more credible in the eyes of the markets as regards achieving the inflation target, since it helps strengthen expectations that inflation will rise. However partial the purchasing power parity check may be in reality, expectations that a currency will depreciate may go unfulfilled in the long term, if, in addition to the fact that the conditions that would make it fall directly and in the short term are not in place (such as a widening of spreads), these conditions are also not in place in an environment in which consumer prices continue to fall. In this way, both pillars are likely to contribute to the weakening of the yen;

3. the episodes of risk aversion that affected the markets in the first three quarters of the year are unlikely to be repeated;

4. the speculative yen longs are set to decrease in the next few months, both because they have been substantial for some time and because the uncertainties (see previous points) that contributed to their formation have at least in part been resolved.

These considerations justify the maintaining of a bearish outlook for the yen for the end of this year and next year. The trend will however be modest, and the extent of the fall limited, because:

1. the Fed rate hike path will be extremely gradual by previous standards, and the end point for rates lower;

2. the BoJ's new monetary policy outline represents an improvement on the previous model, but precisely for the long-term nature on which much of its (expected) effectiveness is based, we are unlikely to see tangible effects in the short term, particularly in terms of market impact, as regards both rates (which are already at zero or below), and, even more so, the exchange rate;

3. the uncertainties that have assailed the global environment for much of this year are set to disappear, reducing overall risk aversion, but new risk aversion episodes, typically external in nature, cannot be ruled out in advance.

For this reason, the yen is likely to fall to 103-105 USD/JPY over the 1m-3m horizon, and head towards 110-112 USD/JPY over 12 months. Only around half of its appreciation this year will therefore be reabsorbed. It is however likely to fall more significantly against the euro next year (towards 125 EUR/JPY) owing to the simultaneous strengthening expected in the EUR/USD (see above). The opposite is likely to occur in the short term, since both the yen and the euro are likely to fall against the dollar when Fed raises rates.

Risks are still slightly unbalanced towards the upside for the yen in both the short and medium term.

STERLING – The policy response to the EU referendum outcome by the Bank of England was much larger and articulate than expected, which should prove to be positive for sterling.

Sterling's reaction to the EU referendum outcome was in line with expectations. The BoE's policy response was larger than expected

The outcome of the UK referendum of 23 June caused a depreciation of the pound, shifting downwards its fluctuation range from above GBP/USD 1.40 to below this threshold, from an average pre-referendum level in 2016 of GBP/USD 1.44 (high of 1.50) to a post-referendum average to date of GBP/USD 1.32 (low of 1.27).

This depreciation should prove persistent, in the sense that the exchange rate will stay at new levels below its pre-referendum quotations for a rather long time.

Sterling's depreciations should prove to be "persistent"

However, this does not mean that it will drop further from the new lows hit recently, levelling off inside an even lower range. In our view, if the impact of Brexit remains "under control", i.e. within the terms forecast by the Bank of England in its Inflation Report of 4 August (see below), the recent depreciation of the pound should mostly have priced in the Brexit scenario. Therefore, new lows could be hit in the event of data falling short of expectations, prospecting a more negative outlook for the domestic economy than outlined by the BoE.

Sterling should weaken further in the presence of another rate cut

At a later stage, sterling should gradually recover, provided that UK GDP growth does not enter recession

One factor which should help support the pound, not in the sense of triggering a swift recovery, but rather of limiting its downside, is the credibility of the Bank of England's policy strategy in taking on the negative effects of Brexit. The monetary stimulus package announced at the meeting of 4 August proved to be larger and more articulated than expected, and includes new measures aimed at guaranteeing full transmission of monetary policy to the real economy.

The BoE' package comprises:

1) A 25bp cut in Bank rate to 0.25% (unanimously);
2) An expansion of the asset purchase scheme for UK government bonds of £60 billion, taking the total stock of these asset purchases to £435 billion (6 out of 9 majority);
3) New - the purchase of up to £10 billion of UK corporate bonds (8 out of 9 majority);
4) New - a Term Funding Scheme, TFS, to re-inforce the pass-through of the cut in Bank Rate (unanimously).

Each measure has been motivated by the BoE:

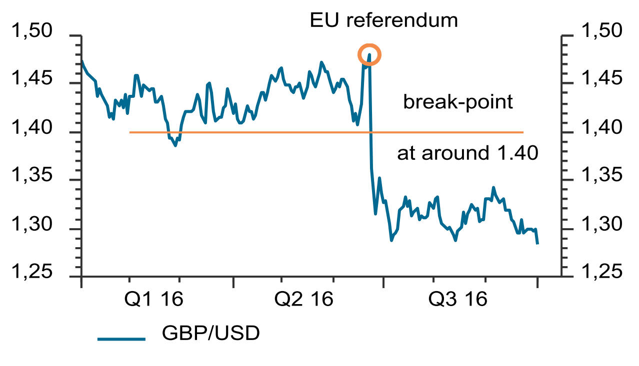
1) "The cut in Bank Rate will lower borrowing costs for households and businesses";
2) "The expansion of the asset purchase programme for UK government bonds will lower the yields on securities that are used to determine the cost of borrowing for households and businesses and is also likely to trigger portfolio rebalancing into riskier assets by current holders of government bonds, further enhancing the supply of credit to the broader economy";
3) "Purchases of corporate bonds could provide somewhat more stimulus than the same amount of gilt purchases. In particular, given that corporate bonds are higher-yielding instruments than government bonds, investors selling corporate debt to the Bank could be more likely to invest the money received in other corporate assets than those selling gilts. In addition, by increasing demand in secondary markets, purchases by the Bank could reduce liquidity premia; and such purchases could stimulate issuance in sterling corporate bond markets;
4) "The TFS will provide funding for banks at interest rates close to Bank Rate. This monetary policy action should help reinforce the transmission of the reduction in Bank Rate to the real economy to ensure that households and firms benefit from the MPC's actions. In addition, the TFS provides participants with a cost effective source of funding to support additional lending to the real economy, providing insurance against the risk that conditions tighten in bank funding markets.

Therefore, this is a package of targeted measures which should support growth by making monetary policy and credit policy conditions as expansive as possible across the board, guaranteeing widespread and efficient transmission of the stimulus package to the real economy.

This is crucial, because, according to the BoE, the impact of Brexit on the UK economy could be very strong: growth has been revised downwards by 1.4% in 2017, from 2.2% to 0.8%, and by

0.5% in 2018, from 2.2% to 1.7%. On the other hand, the forecast for this year has been left unchanged at 2.0%, as the very strong performance in the first half of the year should balance the slowdown expected in 2Q (in which the BoE does not expect a recession in any case). Inflation was revised up from 0.9% to 1.3% this year, from 1.8% to 2.0% in 2017 (on target), and from 2.2% to 2.4% (above target) in 2018. However, this will not prevent the BoE from injecting new monetary stimulus in the next few months if needed, as the current environment calls for temporary "priority" to be given to growth, rather than to inflation. Further stimulus may come both in the form of a further reduction of policy rates, which in any case the BoE does not intend to cut to zero or lower, and of an expansion/extension of the terms of other measures (purchases of government bonds, corporates and TFS).

Fig. 5 – Sterling after the EU referendum



Source: Thomson Reuters-Datastream

Fig. 6 – Brexit effect according to the BoE

	GDP growth			CPI inflation (*)		
	IR pre-referendum	IR post-referendum		IR pre-referendum	IR post-referendum	
2016	2.0	2.0	=	0.9	1.3	↑
2017	2.2	0.8	↓↓	1.8	2.0	↑
2018	2.2	1.7	↓	2.2	2.4	↑

(*) Inflation: year end values (4Q)

(**) IR pre-referendum = May IR; IR post-referendum = August IR

Source: Bank of England

At its meeting of 15 September the BoE acknowledges that, to date, the impact of Brexit on the domestic economy has been less negative than expected, but opens the door to a rate cut before the end of the year if data releases between now and the end of October confirm the slowdown scenario outlined in the August Inflation Report.

The September's meeting provided very interesting indications. As expected, monetary policy parameters were left unchanged, after the large stimulus package introduced last month and the rate cut from 0.50% to 0.25%. The decision was take unanimously.

In line with Carney's indications during his recent parliamentary hearing, the BoE acknowledged that the information hitherto provided by data releases have sent slightly better signals on the near-term scenario than envisaged in the August Inflation Report, and added that the immediate impact of the stimulus measures put in place last month was positive.

However, the central bank stressed that these positive signals do not allow for any educated guesses to be made on the outlook for the domestic economy in 2017 and subsequently, and that for the present year, a significant slowdown is still expected in 2H, albeit not as sharp as anticipated last month.

Specifically, the uncertainty generated by the outcome of the referendum should have a more negative impact on investments than on consumption. No deterioration was detected on the labour market, although it is as yet too early to understand how companies will adjust their hiring plans in light of the new business environment that will take shape as a result of Brexit. With respect to economic growth in the main trade partner countries, indications have been in line to date with the assumptions made in August, confirming expectations for an ongoing moderate growth trend in the next three years. Lastly, for what concerns domestic inflation, the

BoE continued to expect a rise to around the 2% goal in the first half of 2017, although it believes it may prove slightly lower in the remainder of 2016.

However, the crucial data releases will be the ones on the agenda between now and the end of October, on which the BoE will focus in drawing up the new Inflation Report, that will be published on occasion of the next meeting on 3 November.

The central bank has indicated that if the data broadly confirm the scenario outlined in the August IR, a majority of Board members expects to vote for a final rate cut by the end of the year (meeting of 3 November or 15 December). This could directly place the bank rate at its lowest "allowed" limit, which for the BoE is close to zero, albeit in slightly positive territory. The indication is clear: the overall picture must not necessarily deteriorate compared to the picture drawn by the August IR to induce the majority of BoE board members to vote in favour of a rate cut. Rather, an evolution of the picture approximately in line with the scenario drawn up in August will be sufficient. This indication makes a rate cut before the end of the year very likely, as the data releases lined up between now and the end of October, on the other hand, are not likely to surprise on the upside, as has been the case so far. At that point, the likeliest date for a rate cut is November, with a point of arrival for the bank rate (in a single move) at between 0.15% and 0.05% (presumably 0.10%).

As for the effects on the pound, this should weaken in view of another rate cut before the end of the year, maybe below post-referendum lows, with downside at around GBP/USD 1.25 since the Fed should instead hike rates by year end. New lows could be experienced also versus the euro, but these should remain approximately within the EUR/GBP 0.90 mark, since a rate hike by the Fed should send the euro lower too.

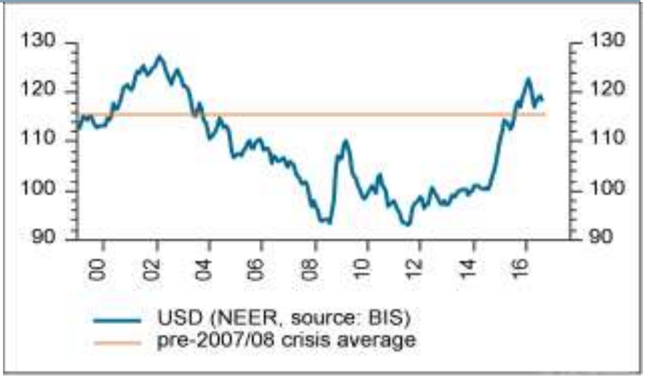
Subsequently, barring disappointments from the growth trend, sterling should gradually recover, heading for a target of around GBP/USD 1.40 towards the end of next year. Expectations for a modest recovery in the course of 2017 reflect the assumption that the impact of Brexit on the domestic economy is approximately as estimated by the BoE – and therefore already priced in by the market – and not worse: namely, the UK is not heading for a recession. Against the euro, the pound should essentially stabilise at around EUR/GBP 0.85, close to its current levels, as in the near term the euro is also expected to weaken against the dollar, on a potential Fed funds rate hike.

In both cases, the recovery expected beyond the short term should keep sterling below its pre-referendum levels on the one-year horizon.

Risks to the forecasting scenario are in any case skewed to the downside, both against the dollar and – especially – against the euro, given the considerable uncertainty clouding the actual fallout of Brexit on the UK economy, not so much in the near term, as in the medium-long term.

What we know "for sure" about Brexit is that, in the next few months at least, the negative effects on UK economy will be certain (albeit of uncertain size), whereas the negative fallout on the euro area is less certain, and the US economy will certainly be shielded from any effects (at least direct). As a consequence, it can be said that the single currency, while essentially maintaining a positive correlation with sterling, should drop less than the pound when the (trade-weighted) dollar strengthen, and rise more than the pound when the dollar weaken.

Fig. 1 – Dollar, nominal effective exchange rate

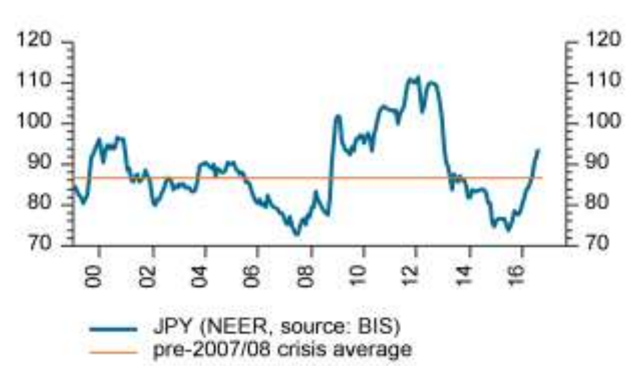


Source: Thomson Reuters-Datastream

Fig. 2 – Euro, nominal effective exchange rate

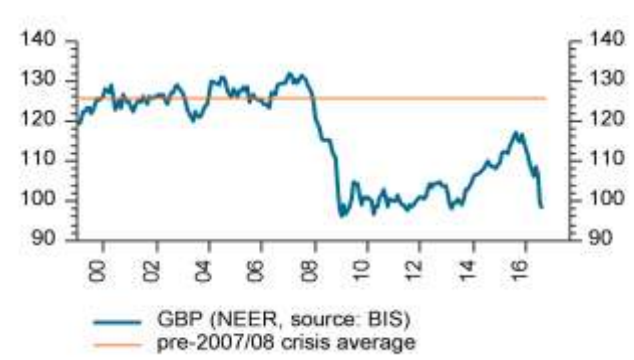
Source: Thomson Reuters-Datastream

Fig. 3 – Yen, nominal effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 4 - Sterling, nominal effective exchange rate



Source: Thomson Reuters-Datastream

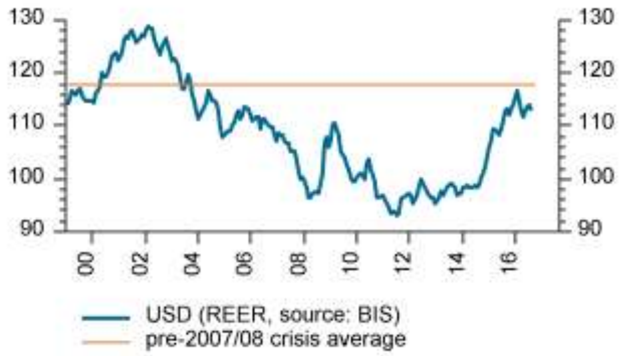
Fig. 5 – Yuan renminbi, nominal effective exchange rate

Source: Thomson Reuters-Datastream

Fig. 6 – Indian rupee, nominal effective exchange rate

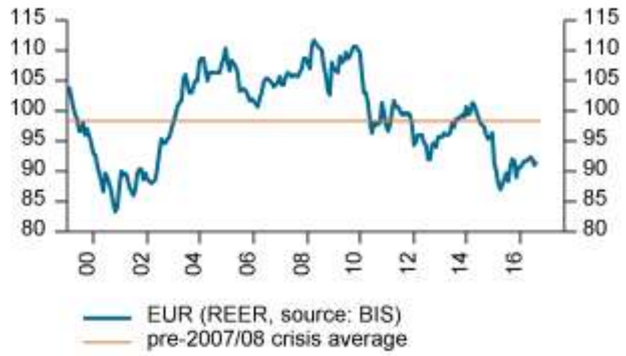
Source: Thomson Reuters-Datastream

Fig. 7 – Dollar, real effective exchange rate



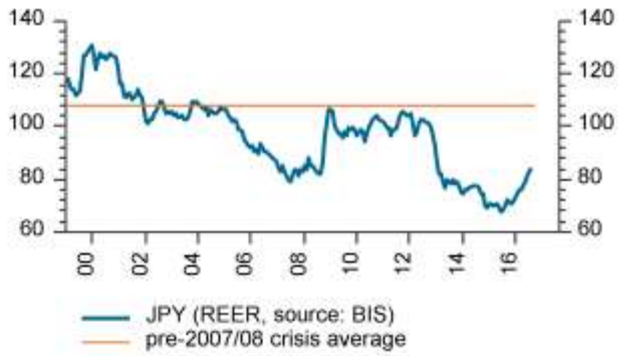
Source: Thomson Reuters-Datastream

Fig. 8 – Euro, real effective exchange rate



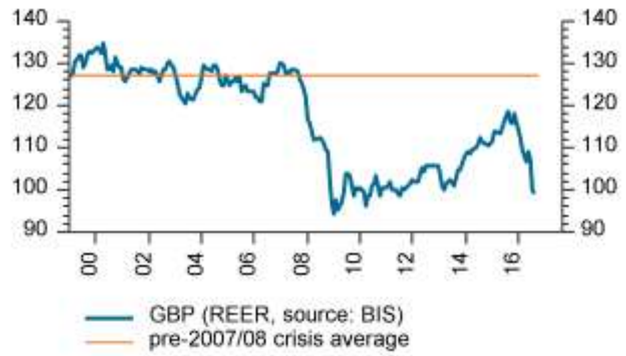
Source: Thomson Reuters-Datastream

Fig. 9 – Yen, real effective exchange rate



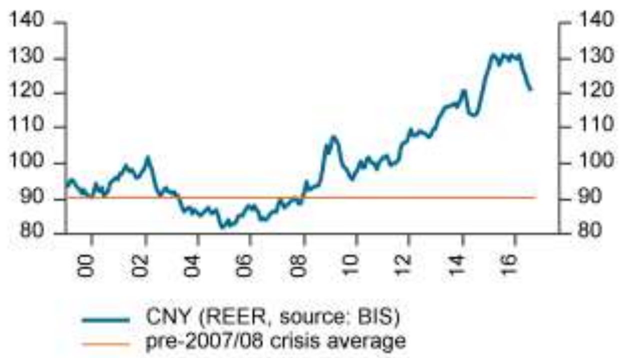
Source: Thomson Reuters-Datastream

Fig. 10 - Sterling, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 11 – Yuan renminbi, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. 12 – Indian rupee, real effective exchange rate

Source: Thomson Reuters-Datastream

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Appendix

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