Macroeconomic Outlook

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Macroeconomic Outlook

Index

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Based on information available up to 30.09.2014

Debilitated by uncertainty

Luca Mezzomo

The global economy continues to grow, but against a backdrop plagued by uncertainty and little optimism about the future. This is also why, despite monetary accommodation, investment is struggling to take off – even in healthier advanced economies.

In July to August, the global PMI fell only marginally from the multi-year highs reached in early summer to 55.5, a move that could be seen as a signal of solid expansion in the world economy. However, the strength indicated by the aggregate diffusion index masks a reality that is complicated and in several respects far from reassuring. Firstly, sustained levels depend on the improvement in services: the manufacturing sector has only partially recovered from its spring slowdown. In addition, there is growing geographical dispersion: the real industrial production indices show more widespread areas of weakness than was the case at the end of 2013, and the PMI economic survey points to a decline in the Euro zone and some emerging countries (Brazil, Russia, Turkey). In general, growth forecasts have been downgraded many times.

The climate of uncertainty has been heightened by the crisis between Russia and Ukraine, which only started moving more clearly towards a negotiated outcome in recent weeks. Several western countries have imposed limited economic sanctions on Russia, which responded by banning imports of some goods (especially agricultural products) and hinting at additional retaliation. The sanctions, although on a small scale, come on top of a worsening economic situation in Russia and the collapse of other emerging markets; this is causing a sharp slowdown in trade flows and making firms more cautious in their assessment of the global outlook. However beneficial it might be to both Russia and Western Europe to strengthen mutual trade ties, the European Union will be obliged to reduce its dependence on Russian supplies of natural gas, while Russia might find it strategically beneficial to forge greater economic and financial links with Asia. In general, the crisis shows no signs of coming to a quick resolution, and it is possible that the damage to trade flows will prove persistent.

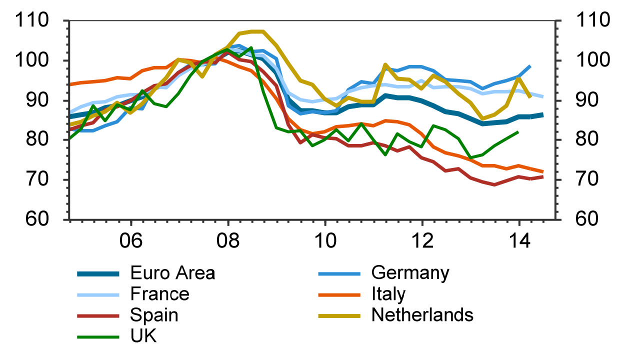
The weakness in global demand is cause for concern, especially for economies lacking satisfactory domestic demand, such as the Euro zone. Second-quarter Euro zone GDP was disappointing, but this was partly due to temporary factors (long bank holiday weekends, weather). Q3 is expected to see an upturn in economic growth, but against a background of deteriorating corporate confidence, little investment growth, and stagnation/contraction in two major countries – France and Italy.

Despite the very discouraging signals still coming from economic surveys, and rising risks, conditions are still in place for economic recovery to strengthen next year. The first positive is the strength of domestic demand in the US, which we think will continue in the coming months. The second positive is currency realignments: the euro is depreciating more and more, and this will marginally boost European output. Some emerging markets that had a very weak first half may be over the worst, such as Brazil. Conversely, the dollar's strength could accentuate the weakness of raw materials prices and hurt exporting countries; and in general, given the current modest rates of growth, global trade is showing no signs of a marked acceleration.

With international demand weak and uncertain, it would make sense for countries struggling to emerge from recession to adopt more accommodative economic policies. On the tax front, it is likely that various Euro zone countries in 2015 will decide to ignore the fiscal restrictions stipulated by the Stability and Growth Pact and exploit the narrow margins of flexibility available. It would be appropriate if countries with more solid balance sheets, such as Germany, used the room for manoeuvre to stimulate aggregate demand and encourage the rebalancing process within the Euro zone; however, it is doubtful this will happen, despite the growing chorus of requests to this effect. This means that the Euro zone will continue to float in a limbo of low growth and low inflation, hoping that in the meantime none of the risk scenarios for the global economy materialises.

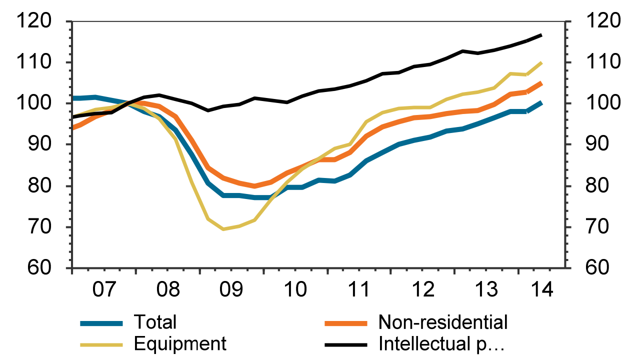
On the monetary front, diverging economic trends are fuelling expectations of a pronounced lag between interest rate cycles, which, as mentioned, is reflected in exchange rate movements. Anticipation has been mounting in recent months that the Federal Reserve might start raising rates by mid-2015, whereas the markets are expecting Euro zone monetary policy to remain extremely accommodative for much longer, and that the ECB might even go so far as to launch a government securities purchase programme. However, we should not entertain too many illusions about the effectiveness of monetary policy in triggering a recovery where there is none – given firms' pessimism about the outlook for demand and the tight constraints on fiscal policy. There is also likely to be strong expansion in the monetary base in Japan, which we are expecting to extend the stimulus programme currently under way. Since monetary tightening by the Fed will be neither imminent nor severe, financial conditions will remain broadly accommodative. Moreover, an overly quick movement by the dollar could lead to a postponement of rises in the fed funds rate.

Non-residential capital investment (2007=100)



Source: Eurostat, Datastream Charting

United States: Gross capital investment



Source: U.S. Dept. of Commerce, Datastream Charting

A worrying aspect of the economic outlook is subdued growth of capital spending, which seems at odds with the zero interest rate policy or the aggressive expansion of the monetary base. In general, firms are showing great reluctance to invest, even in countries with growing domestic demand and low fiscal pressure. In the US, for example, it was 1Q14 before investment spending by non-financial firms started outstripping internal cash flow. In the Euro zone, non-financial firms still had a positive net financial account balance of 1.7% of GDP in 1Q14. In general, investment has rebounded less strongly than in other economic cycles. Looking at the level of investment spending, net of residential building, Eurozone data show that excess capacity accumulated in some countries during the crisis, which explains much of the broad and persistent contraction in investment in Italy and Spain (in these two countries, there is still a gap of 28-29% compared with 2007 levels). In other cases, the period of low investment may be the temporary result of needing to deleverage, or of a previous period of excessive capital expenditure – phenomena that are not necessarily bad for long-term prospects. But even Germany, despite its much better growth rate and higher production capacity utilisation, has failed to exceed the levels in 2007. Even in the US, despite the success of its economic recovery policies, non-residential investment is only 4.7% above the end-2007 levels, although some components (including investment in machinery) have performed very well and recently accelerated. The reluctance to invest may damage the growth potential of advanced economies, in addition to dampening the recovery under way.

Economic growth by geographical region	2011	2012	2013	2014	2015
USA	1.6	2.3	2.2	2.2	3.2
Japan	-0.4	1.5	1.5	0.9	1.4
Eurozone	1.6	-0.6	-0.4	0.8	1.1
Eastern Europe	4.0	2.4	1.6	1.3	1.9
Latin America	2.8	2.7	2.4	1.3	2.3
OPEC	4.0	4.9	2.8	2.7	4.4
East Asia	7.4	5.8	6.1	6.1	5.9
Africa	3.4	3.1	3.6	3.3	4.1
World growth	3.9	3.5	3.2	3.1	3.7

Source: Intesa Sanpaolo charts

Commodity price forecasts	2011	2012	2013	2014	2015
Oil price; Brent crude spot$/barrel	111.5	112.0	108.4	105.6	100.7
	+40.2	+0.4	-3.2	-2.6	-4.6
Non-fuel commodities price index	190.0	171.0	169.0	164.9	160.4
	+17.9	-10.0	-1.2	-2.4	-2.7
World price of metals	229.7	191.0	182.9	168.0	161.5
	+13.5	-16.8	-4.2	-8.1	-3.9
Agricultural raw materials world price	153.5	134.0	136.2	138.5	128.2
	+22.7	-12.7	+1.6	+1.7	-7.5

NB: annual average levels and changes
Source: Intesa Sanpaolo calculations

Overview by region

United States:

robust growth follows Q1 pause

The contraction in GDP in Q1 (-2.1% yoy ann.) proved temporary; growth has already recovered sharply in Q2 and should now strengthen to around 3%. Final consumer demand is supported by positive fundamentals for businesses and households. The labour market continues to improve: the unemployment rate is still falling and should reach the equilibrium estimated by the Fed (5.2-5.5%) by end-2015. Under-employment is falling, although the Fed says there is still a "significant" amount of unused resources.

Rise in inflation will now be reined in by strengthening dollar

Inflation is still above the Fed's target. The trend towards 2% will be reined in by exchange rate appreciation and falling energy prices, but boosted by the closing of the output gap. Salaries are still growing slowly, but firms are reporting that rises are on the way.

First rate hike expected in June 2015

The FOMC remains cautious about the exit strategy and is still signalling that rates will remain at current levels for a "considerable time" after purchases end in October. The fed funds rate is still the main policy rate, but the Fed will use the rates on excess reserves and reverse repos to control market rates. We think the market has underestimated future policy rate hikes. The first increase looks set for June 2015; rates could rise to 1.25% by end-2015, reaching 3.5% by end-2017.

Euro zone:
economic outlook deteriorates unexpectedly, growth forecasts downgraded

The summer data clearly show that the weakness in the spring months will extend into the second half of the year. The currency's depreciation to its current level was largely priced into our estimates in June, and in itself does justify upward revisions to our forecasts. The speed of the recovery in the coming year will therefore depend on growth in domestic demand. Fiscal policy will be moderately restrictive, given that it will be difficult to significantly "bend" the EU rules. We have downgraded our Euro zone growth forecasts for 2014 to 0.8% and for 2015 to 1.1% (from 1.5% previously), which are significantly below consensus estimates. Performance will continue to vary markedly within the Euro zone. Growth will be driven by Germany, which after the temporary summer slowdown should resume expansion in the second half of 2014, and also by Spain. France and Italy, hampered by structural domestic problems, will post below-average growth (0.7% and 0.6%).

Inflation will be nearer 1% than 2% in the coming years

In any case, growth momentum in the next twelve months will be insufficient to significantly close the output gap. Therefore, the risks for consumer price inflation are still to the downside. Until 2016, in the absence of any violent shocks from energy price recovery, inflation will remain nearer 1.0% than 2.0%.

The probability of the ECB announcing a programme of quantitative easing is currently less than 50%. The ECB might decide to intervene, but only if the economy and inflation produce fresh surprises compared with the latest staff estimates. But whatever the case, it will wait at least until March 2015 to assess the effect of the measures already announced (new long-term refinancing auctions and ABS purchase programme).

Asia

Japan: monetary stimulus will continue in 2015; volatility still driven by fiscal policy

During 2014 and 2015, Japan will feel the effect of the massive structural fiscal tightening prompted by the doubling of the consumer tax rate, which was raised from 5% to 8% in April 2014 and is set to increase further to 10% in October 2015. The tax hike in April 2014 triggered sharp volatility, with a spike in frontloading between the end of 2013 and early 2014, followed by a substantial contraction in consumer spending and GDP in the second quarter. The restrictive effects of the increase in indirect taxes have been moderated by the temporary expansion of public investment and the considerable monetary stimulus. Annual growth in 2014-15 is set to be around 1%, which is still considerably better than the BoJ's estimate of potential growth of 0-0.5%. A year on from the rollout of "Abenomics", the figures look good; the recovery has survived the fiscal clampdown and prices are rising steadily, thanks to the credible reversal in monetary policy. For the time being, inflation – stripping out the consumer tax rise – is in line with the central bank's projections at around 1.3% yoy, but weak demand makes it likely that the target of 2% inflation by 2015 will not be achieved. In the autumn, economic policy will still be the crucial factor in how the outlook develops. In October, the government is likely to confirm its plan to increase consumer tax with effect from October 2015 and will probably implement at least some of the structural reforms, announced in June, aimed at boosting potential growth. If fiscal policy continues down the road of consolidating and strengthening long-term growth, the BoJ could contribute a further stimulus, to be implemented in 2015 (for as long as is needed – hence probably into 2016 at least), with a higher target for the monetary base, to be achieved by means of bigger JGB purchases. Real interest rates will remain strongly negative, and the currency may further depreciate against the dollar.

China: economy slowing, reined in by residential building

After the Q2 improvement, cyclical indicators between June and August show the trend is now slowing, mainly as a result of the downturn in investment in residential building, while consumer spending and exports continue to hold up. We are maintaining our GDP growth forecasts for this year and next: the slowdown should continue, to 7.3% this year and 7.1% next. Despite price pressure from food and the reorganisation of energy tariffs, the rise in inflation should, however, be limited: the annual average for 2014 is seen at 2.3%, and at 2.5% in 2015. We believe that the central bank will continue to provide liquidity to the market through open-market transactions and to prevent excessive and/or lasting rises in money market rates. We interpret the 20-bps cut in the 14-day reverse repo transaction rate in September, and the longer maturity of loans provided through the Standing Lending Facility, from this perspective. We also believe that the PBOC will make no adjustments to the cash reserve ratio or to rates unless there is a sharp drop in macro figures in the coming months.

India: economic outlook is improving

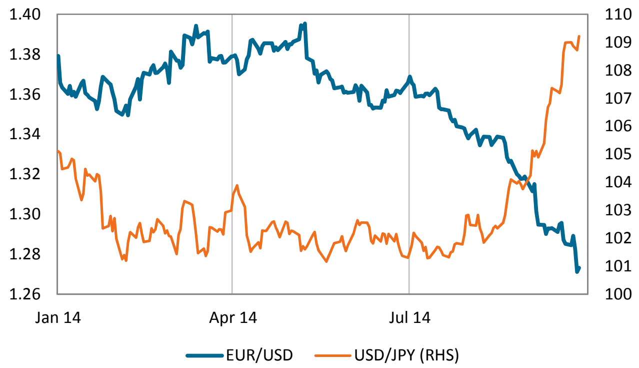
We have upgraded our growth forecast for India in 2014 from 4.7% to 5.3% for various reasons. India's GDP grew by 5.7% yoy in Q2, appreciably faster than in the previous two quarters (4.6% yoy), with support coming from an uptick in investment and public consumption, and from an excellent performance by exports. The business and consumer confidence indices both rose, and passenger and cargo traffic grew throughout the summer, mirroring the recovery in imports and the health of industrial output – all of which confirms the improvement in economic activity, including in Q3. We expect further acceleration, to 5.6%, in 2015. The rupee remains exposed to volatility, despite an improving outlook for the domestic economy and indicators of external vulnerability.

Currency markets: the dollar cycle has started

The currency markets have at last **taken note of the extent of the reversal** on which the **Fed** is going to be embarking in the next few months. The dollar continued to appreciate, not only consolidating itself against major currencies (excluding sterling), but also surging against emerging currencies.

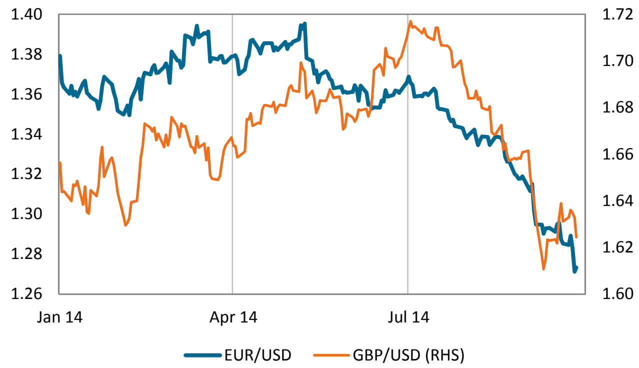
The reversal gained ground when the Fed recognised how well the US was recovering, and admitted that **if the labour market improved more markedly or rapidly than forecast, the first rise in Fed Funds could occur earlier** than expected.

Fig. 1 – The fall of both the euro and the yen vs. the dollar



Source: Thomson Reuters-Datastream

Fig. 2 - The fall of both the euro and sterling vs. the dollar



Source: Thomson Reuters-Datastream

The first overture in this regard was made in an important speech by Janet Yellen in mid-July. The message was then taken up by the Federal Open Market Committee (FOMC). What is interesting about this from the market's point of view is that **these developments have occurred among the "majors" in somewhat different ways and at somewhat different times**. Specifically: **(i)** the fall of the **euro** was more rapid than expected, **(ii)** while the **yen** fell later but, when it did, at headlong speed, **(iii)** and **sterling**, on the contrary, appreciated for a considerable period.

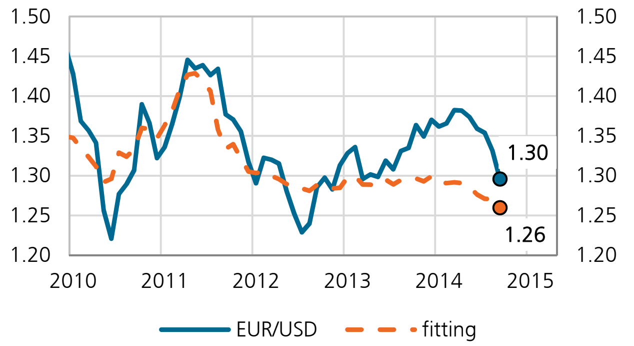
It may well be that such differences in behaviour will also be observable over the coming months.

In the second quarter, **between July and September, the euro fell by ten points, from 1.36 to 1.26 EUR/USD** (from a peak for the year at 1.4000: 1.3993 in early May). The descent below 1.3000 – which occurred in September – thus happened before it was expected to. The factors facilitating this were **(1)** the **deterioration of the macroeconomic landscape in the Euro zone** (recovery and inflation weaker than expected) and **(2)** the **response from the ECB**. In September, the latter announced a small but unexpected cut in official rates, an ABS-buying programme and an explicit openness to the adoption of other unconventional measures, first among them the possible extension to the programme of government securities purchases, which maximised the divergence between the ECB's policy and the Fed's.

The euro's spontaneous fall, together with the already strengthening dollar caused the exchange rate to make the theoretical adjustment it needed. According to our estimates, which are based on the relationship between the EUR/USD exchange rate and short-term Euro zone and US yields, the current "fair value" should settle at around 1.26 (see Fig. 3), and this is where the euro has now fallen to.

This level is consistent with a combination (see Table 1) of European yields at zero and US yields at 0.50%, representing the current value of yields. If the Fed were to raise its rates next year while the ECB not only kept its own at zero but also announced a government securities purchase programme, the "fair value" of the exchange rate would fall still further. In particular, as projected by the model, a combination of European/US rates of 0-1.0% would produce an equilibrium value for the euro of 1.23 euros to the dollar, with the single currency's **downside** possibly extending as far as **between 1.25 and 1.20** EUR/USD over the 3m-6m horizon.

Fig. 3 – Estimates based on the relationship between the EUR/USD and short-term Euro zone and US yields



Source: Thomson Reuters-Datastream

Table 1 – Estimated "fair value" of the EUR/USD exchange rate for various combinations of rates

		US short-term yields (%)			
		0.00	0.25	0.50	1.00
Euro Area short-term yields (%)	0.00	1.3045	1.2859	1.2676	1.2318
	0.25	1.3280	1.3091	1.2905	1.2540
	0.50	1.3520	1.3328	1.3138	1.2767
	1.00	1.4013	1.3814	1.3617	1.3232

Source: Intesa Sanpaolo Research Department estimates

After this period, the downward phase is likely – in the absence of any further deterioration in the Euro zone – to come to an end. Moreover, the fact that the euro's value against the dollar had fallen below 1.30 earlier than expected would be likely to trigger both growth and a reduction in inflation towards its target, thus making the ECB's job easier.

Money policy divergence is even more extreme in the case of the yen. If the Bank of Japan were to announce an extension to its monetary stimulus, which we see as highly plausible, the monetary base would continue to grow rapidly in 2015, while the US would experience only 'physiological' growth, with interest rates rising too. The yen's recent violent movement might in part have anticipated this scenario, but the potential to depreciate is still there. We expect a further decline down to the level of 110-115.

Conversely, the pound sterling will, like the dollar, continue to be borne up by the increasingly imminent reversal in the monetary policy cycle. The fluctuations in the expectations of the BoE's actions and the interaction of these with news of US monetary policy explain the sharp volatility shown by the pound recently. We think it possible that the pound will hit new highs against the euro in the coming months.

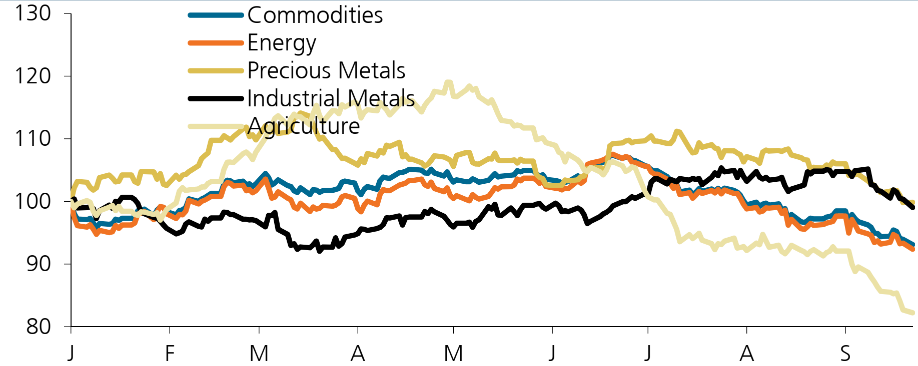
The risk inherent in these forecasts is that if the dollar strengthens too much and too fast, the United States could end up with a worse trading balance, which would import inflation and put the brakes on growth. This would make the Federal Reserve even more cautious when evaluating its next monetary policy steps, and might prompt corrective action on the currency markets.

Commodities: excess supply

Daniela Corsini

In the next few months, the commodity markets will mainly be guided by the US dollar, global economic growth and geopolitical tensions. In particular, the traditional negative correlation between U.S. dollar and commodities will likely exert significant downside pressure on the segment. For many of the main commodities, significant price rises are not sustainable without a substantial cut in the supply on the physical market.

S&P GSCI Total Return Indices (100=31.12.2013)



Source: Intesa Sanpaolo chart based on Bloomberg data

We had an unusual summer this year. After 2012 and 2013, we had grown used to exceptional weather conditions in the summer, with record heat and droughts, and rising commodity markets. In contrast, this summer was cool and, as in 2011, commodity prices fell much faster than expected, when it became clear that geopolitical tensions, which had fuelled the prices of certain commodities in the first half of the year, had not further exacerbated limits on physical supply.

Furthermore, in the last few months, the sector as a whole has been driven downwards by the strengthening of the dollar and by the disappointing macro data published in Europe and emerging countries, which has led to downwards revisions in estimates for global commodity demand. Energy and agricultural commodities, in particular, suffered a rapid deterioration in supply and demand fundamentals: oil prices were negatively affected by downwards revisions of global consumption forecasts and rising production in the US and Libya, while cereal prices collapsed as the production season, marked by abundant harvests, wore on.

In the next few months, the commodity markets will mainly be guided by the US dollar, global economic growth and geopolitical tensions.

US dollar

The Fed has mapped out its path towards a more restrictive monetary policy: the monthly securities purchase programme will be concluded in October, and we will probably see the first rate rise around mid-2015. Furthermore, the US economy is accelerating, while Europe and Japan remain weak and the main emerging countries are slowing down. All these factors suggest that the US dollar will continue to strengthen in the coming months. The traditional negative correlation with commodities is likely to put significant downside pressure on the sector. Historically, the commodities most exposed to the strengthening of the dollar are oil, gold and industrial metals, particularly copper.

Global economic growth forecasts

After the disappointing macroeconomic data published in the last few months, we consider further downside revisions to growth estimates for Europe, China and Russia as likely. Probably, these announcements will temporarily depress market sentiment and fuel fears that the current growth forecasts for global commodity demand will prove too optimistic. Conversely, assuming an improvement in macroeconomic data, the publication of relatively optimistic forecasts for the next two years could generate some upside pressure towards the end of the year. Traditionally, the publication of data showing a strengthening of the economy benefits energy and industrial metals, to the detriment of gold and silver.

As regards China, the Asian giant is the world's largest consumer of many commodities, so a sustained recovery in prices in the segment cannot be separated from the positive state of health of the Chinese economy in general, and of the manufacturing and construction sectors in particular. The latest macroeconomic figures published in China have been disappointing overall. In particular, some of the indicators most followed by the commodity markets reflect the slowdown in the economy: in August, industrial output grew by 6.9% yoy (vs. 8.8% expected), the lowest since December 2008; capital investment rose by 16.5% (vs. 16.9% expected), the lowest since February 2011; and retail sales advanced by 11.9% (vs. 12.1% expected), the lowest since February 2011. Furthermore, total energy production registered its first decline on an annual basis for more than four years. Although the contraction was in part explained by the base effect for the high demand recorded last summer, when Chinese cities were hit by a record heat wave, this figure also reflects the weakness of industrial demand. In addition, the property sector remains weak, owing to the tight credit market and the cooling measures imposed by the government.

Geopolitical tensions

In the view of investors, geopolitical risks temporarily took a back seat in the summer, as there were no significant interruptions to oil and gas supply due to the crises in Ukraine and Iraq. We believe, however, that the geopolitical risk will again become an important market driver in the next few months.

Specifically, on 16 June, Russia cut gas supplies to Ukraine under the pretext that it had failed to pay off its debts. On the two previous occasions that the supply was cut, in January 2006 and January 2009, gas supplies in transit to Europe were significantly reduced owing to the withdrawals by Ukraine to meet its domestic requirements. In our view, the risk of interruptions to gas supplies to Europe will also be significant this winter. Currently, the only resources available to the Ukraine government to make up for the lack of 25 billion cubic metres of Russian gas a year, which made up approximately half the domestic requirement, are to use stocks (only half full), imports from Slovakia (once at full capacity, the new oil pipeline should be able to transport 10 billion cubic metres a year) and to cut domestic consumption (increasing gas prices by up to three times to stimulate energy saving).

Assuming a modest reduction in total flows of Russian gas to Europe in the winter, we will see a moderate rise in gas prices along the whole forward curve. If, however, the reduction were to be significant enough to lead to a temporary interruption of Russian supplies passing through Ukraine, market prices could easily rise again to the highs registered in 2012 and 2013, obviously with more significant increases in the front of the curve. However, excluding the hypothesis of a particularly harsh winter, any peaks in prices should be followed by a rapid return of prices to lower levels. In fact, most European countries are quite prepared for such an eventuality, since gas storage levels are very high and, following the wet summer, hydroelectric reservoirs are also full. In addition, we do not currently believe that Russia can afford a prolonged block on supplies to its main export market and we therefore consider that it will be forced to increase transit volumes fairly quickly.

As regards long-term risks, current international sanctions against Russia could damage prospects for future oil and gas production, given the difficulty of financing the very expensive projects in the Arctic and Siberia, which require huge capital and extremely advanced technology. Any downwards revisions to production forecasts will provide long-term support to oil prices.

In Iraq, the current conflict represents a serious threat to the future of the global oil market, given the size of Iraq's current output and the potential growth in production from these fields. Moreover, the US is ready to intervene in Iraq with targeted air strikes and has not officially ruled out the possibility of bombing the infrastructure controlled by the militant jihadists of the Islamic State in Iraq and Syria (ISIS). Clearly, if the existing infrastructure were to be damaged, it would take even longer, and be far more difficult, to return to full production. At the time of writing, ISIS seem to control about ten oil fields (six in Syria and four in Iraq) and manages to sell approximately 80,000 barrels of oil a day on the black market, mainly for industrial use and electricity generation in ISIS-controlled areas. However, there is a risk that part of this oil could be exported illegally to neighbouring countries via truck, given the difficulties experienced by the governments in controlling this region, and, even if it is very unlikely, it may even be mixed with oil sold on international markets.

Some commentators have suggested that low oil prices could be used as a weapon against ISIS, because they would erode the revenues on which the organisation depends. However, the prices at which oil is traded in these regions is much lower than international benchmarks, and the militants do not currently seem concerned by long-term economic drivers, such as covering fixed production costs. For this reason, a significant fall in international prices would only damage western production at higher marginal cost, but would not erode the supply of oil sold illegally on the black market.

Given the instability of the current geopolitical situation, we maintain a persistent, but low, risk premium in our forecasts.

Our forecasts for the commodities universe

Our forecast model is based on a combination of the current estimates of supply and demand fundamentals for individual commodities, our base macroeconomic scenario and expected changes in the geopolitical balance, which is still beset by major uncertainties.

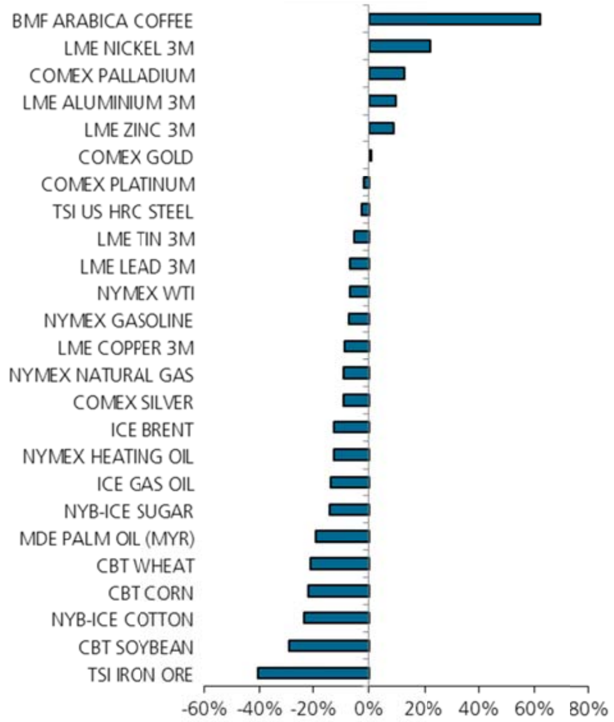
In the energy segment, we expect that Saudi Arabia will gradually cut its oil exports in the next few months and that prices will rise towards the price range considered appropriate by most OPEC members, namely between USD 100 and USD 110 per barrel for Brent oil. However, the expected strengthening of the US dollar will exert significant downside pressure. We forecast an average price of USD 99.7 per barrel for Brent in 4Q14 and USD 100.7 in 2015, while for WTI, we put the average price at USD 92.5 per barrel in 4Q14 and USD 93.2 in 2015.

In the fourth quarter, we expect downside pressure on gold and silver, owing to the strengthening of the dollar and the weakness of investment demand, while we expect prices for platinum and palladium to remain broadly stable.

For industrial metals, we see prices remaining stable overall: many metals are stuck in price ranges for which the support is represented by high marginal costs of production, while the level of resistance is determined by high inventories. Furthermore, the strength of the dollar and the uncertainties weighing on the main emerging economies are preventing a sustained rise in industrial demand for these commodities. Specifically, we expect that the segment will mainly be influenced by macroeconomic data to be published by China in the next few months.

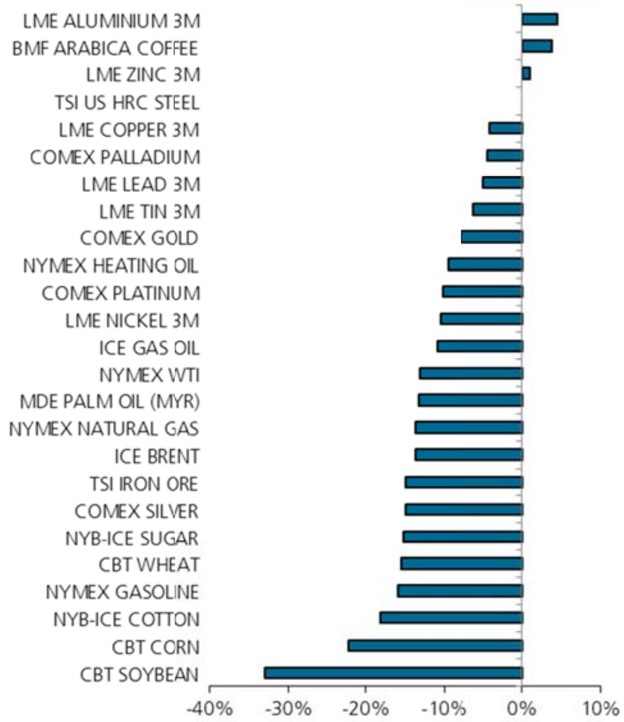
For agricultural commodities, the main market drivers are global production and consumption forecasts. For cereals, the USDA is predicting an abundant harvest and a marked rise in ending stocks in the 2014/15 season. The substantial deterioration in supply and demand fundamentals recorded in the last few months will prevent significant rises in prices.

Performance since beginning of year to 22.09.2014 (spot prices)



Source: Intesa Sanpaolo chart based on Bloomberg data

Performance in 3Q (from 30.06 to 22.09.2014)



Source: Intesa Sanpaolo chart based on Bloomberg data

Oil: waiting for the OPEC cut

Oil prices are likely to remain weak until the first clear signs of a reduction in supply on the physical market appear. In the short term, macroeconomic factors will exert renewed negative pressure on prices, due to the risk of further downwards revisions to economic growth forecasts in Europe and China and the expected strengthening of the U.S. dollar.

At the beginning of June, the markets have been very worried about the ability of OPEC members in general, and Saudi Arabia in particular, to increase their production over the summer to meet the growing global requirement, thereby maintaining a well-balanced market and prices within the USD 100-110 per barrel range, which most OPEC members consider appropriate both for producers and consumers. The International Energy Agency (IEA), OPEC and the US Energy Information Administration (EIA) expected that OPEC would have to increase its total production in the second half, providing a greater quantity of oil than the production target of 30 million barrels a day (Mb/d), confirmed at OPEC's last half-yearly meeting held on 11 June in Vienna.

However, over the summer, a series of disappointing macroeconomic figures in Europe and China and weather that was cooler than the seasonal average in many regions led to a slew of downwards revisions in demand for oil. Conversely, optimism over the growth of production in North America (also boosted by the low menace of hurricanes) and the expectation that Libyan output would make a swift return to the market quashed concerns regarding the availability of oil on the physical market.

Moreover, in the view of investors, geopolitical risks temporarily took a back seat as there were no significant interruptions to supply due to the crises in Iraq and Ukraine, while US monetary policy returned to the limelight. The dollar strengthened substantially against the main currencies, in response to the forthcoming end of the securities purchase programme and the forecast of a first rate hike in 2015.

As a result, the markets inevitably responded to the weakening of fundamentals, the reduction in the perceived geopolitical risk and the strengthening of the dollar by selling oil in favour of other assets, such as US dollars and equities. At the beginning of September, WTI and Brent hit lows not seen since May 2013 and July 2012 respectively.

At the time of writing, financial market sentiment is still negative towards oil, as shown by the low levels of speculative positions registered by the US Commodity Futures Trading Commission (CFTC).

Supply and demand fundamentals

According to the latest estimates published in September, for the next quarter and the whole of 2014, the IEA, OPEC and EIA continue to expect that growth in non-OPEC production volumes will outstrip growth in global demand. For example, according to EIA estimates, spare capacity, virtually all of which is in Saudi Arabia, will again start to expand in 4Q, to 2.68 Mb/d, from an estimated 1.98 Mb/d in 3Q. This would take average spare capacity for 2014 up to 2.18 Mb/d, from 2.14 Mb/d in 2013.

For 2015, the three main forecasters expect the markets to be broadly balanced, with an increase in non-OPEC supply in line with the expected rise in global demand, in volume terms. The EIA estimates that spare capacity will expand to 3.13 Mb/d in 4Q15, with an average of approximately 2.74 Mb/d over the year, even thanks to the partial return of Libyan production. Commercial stocks in OECD countries should grow from 2.551 billion barrels at end-2013 to 2.580 billion at end-2014 and 2.604 billion at end-2015.

According to consensus forecasts, next year, OPEC will reduce its average production below the current production target of 30 Mb/d in order to balance the markets ("call on OPEC crude").

The expectation of an overall easing in the market, together with low prices, could prompt OPEC member countries to revise down their overall production target to 29.5 Mb/d, as suggested by the OPEC Secretary-General El-Badri on 16 September. OPEC's next biannual meeting is due to take place on 27 November.

Supply and demand estimates for 2014, published by OPEC, IEA and EIA

Estimates at September 2014, in million barrels	Total Demand	Non-OPEC Supply	LNG OPEC Supply	"Call on OPEC Crude"
OPEC	91.2	55.9	5.8	29.5
vs. 2013	1.1	1.7	0.2	-0.8
IEA	92.6	56.3	6.4	29.9
vs. 2013	0.9	1.6	0.1	-0.6
EIA	91.5	55.9	6.1	29.6
vs. 2013	1.0	1.8	0.0	-0.3

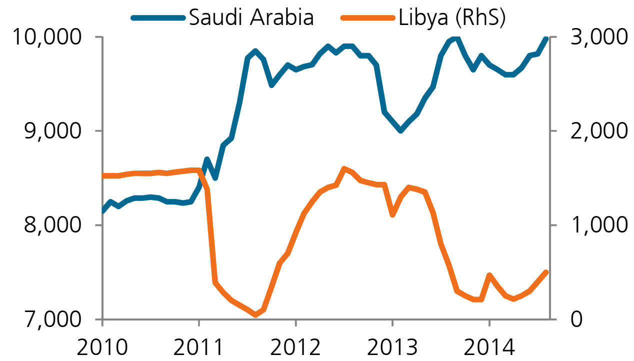
Source: Intesa Sanpaolo chart from data published by the Organization of the Petroleum Exporting Countries (OPEC), the International Energy Agency (IEA) and the US Energy Information Administration (EIA)

Supply and demand estimates for 2015, published by OPEC, IEA and EIA

Estimates at September 2014, in million barrels	Total Demand	Non-OPEC Supply	LNG OPEC Supply	"Call on OPEC Crude"
OPEC	92.4	57.2	6.0	29.2
vs. 2014	1.2	1.2	0.2	-0.3
IEA	93.8	57.6	6.6	29.6
vs. 2014	1.2	1.3	0.2	-0.3
EIA	92.9	57.2	6.3	29.5
vs. 2014	1.3	1.2	0.2	-0.1

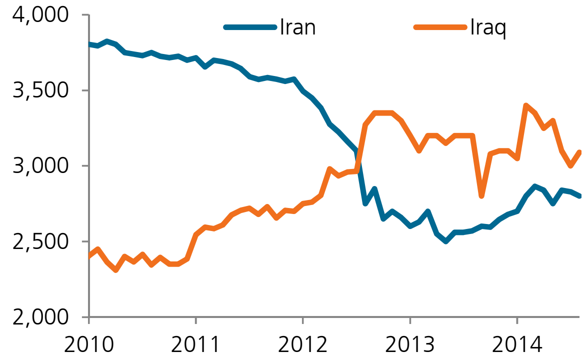
Source: Intesa Sanpaolo chart from data published by the Organization of the Petroleum Exporting Countries (OPEC), the International Energy Agency (IEA) and the US Energy Information Administration (EIA)

Production in Saudi Arabia and Libya (right-hand scale) and...



Source: Intesa Sanpaolo chart based on Bloomberg data

...production in Iran and Iraq, in thousands of barrels/day



Source: Intesa Sanpaolo chart based on Bloomberg data

Forecasts

Our forecasts incorporate the expectation that Saudi Arabia will gradually cut its oil exports in the next few months. As stated several times by the Saudi Oil Minister, the price range considered appropriate is between USD 100 and USD 110 per barrel. Furthermore, high fiscal spending is eroding the budget surplus and further raising the budget break-even oil price to around USD 90 per barrel.

OPEC's decision to announce a cut in the official target will mainly be politically motivated, and will depend on the level of oil prices around the half-yearly meeting and developments in diplomatic relations with Russia.

In fact, the average oil price that balances Russia's books is even higher than that for Saudi Arabia: around USD 114 per barrel for Urals crude for the 2013 budget. Convincing OPEC to cut its target to protect prices was probably one of the unofficial reasons for the meeting held in mid-September between Russian Energy Minister Alexander Novak and OPEC Secretary-General El-Badri. However, the Saudis may not be particularly motivated to hurry to Russia's aid, given Moscow's role in supporting the Iraqi and Syrian governments.

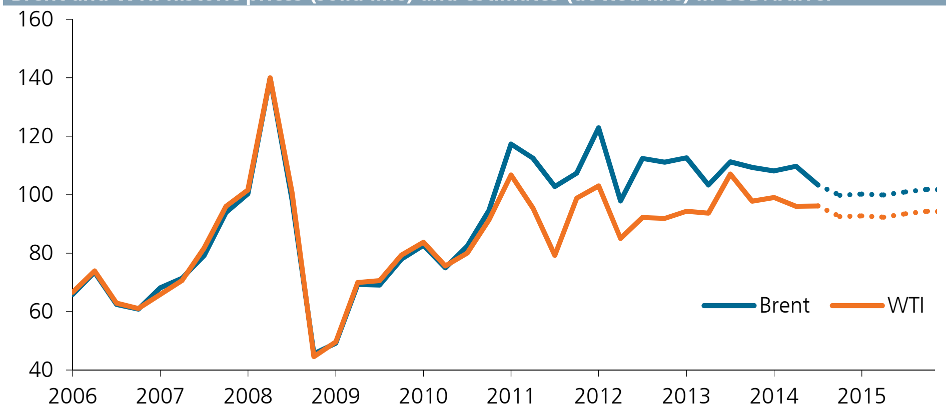
Our baseline scenario forecasts that oil prices will remain weak in the next few weeks. This expectation is justified by the fear that macroeconomic factors will exert renewed negative pressure on prices. We expect further downwards revisions of economic growth forecasts to be announced, particularly for Europe and emerging countries, and believe that the monetary policy stance adopted by the Fed will further strengthen the dollar. We expect that Brent will only return and remain firmly above USD 100 per barrel when the first clear signs of a reduction in supply on the physical market appear.

Currently, our estimates for 2015 incorporate an ongoing but low geopolitical risk premium, since we do not expect the current conflicts in Ukraine and the Middle East to lead to significant reductions in the oil supply on the physical market, excluding Libya, in the short term. We think that Libyan production will remain highly volatile over the next year, due to the unstable political situation in the country and the government's lack of control over the territory. However, the other OPEC members should not have any difficulty in making up any reductions in exports from Libya, given that the organisation's overall spare capacity is expected to expand.

As regards our long-term forecasts, we believe that the crisis in Iraq has seriously damaged the country's development potential, leading to a marked downwards revision in future production estimates. For this reason, we expect that longer-term maturities on the forward curve will remain pegged to high levels, at around USD 95 per barrel, for some months to come.

Compared to the previous quarterly scenario, outlined in June, we have downgraded our estimate for Brent oil to an average price of USD 99.7 for 4Q14 and USD 100.7 for 2015, and our estimate for WTI oil to an average price of USD 92.5 for 4Q14 and USD 93.2 for 2015. The changes are due to the downwards revision of global demand forecasts following the disappointing data published in Europe and China. We forecast an average spread between Brent and WTI of approximately USD 7.5 per barrel for 2015, but we expect it to remain volatile, influenced by the relative strength of the US economy.

Brent and WTI: historic prices (solid line) and estimates (dotted line) in USD/barrel



Source: Intesa Sanpaolo estimates. Intesa Sanpaolo chart from Bloomberg data

Price estimates for Brent

at 23.09.2014	4T14	1T15	2T15	3T15	4T15	2014	2015	2016
Estimates	99.7	100.2	99.8	101.0	101.8	105.2	100.7	101.9
Bloomberg Median	107.0	106.0	104.4	106.0	104.0	N.A.	104.3	103.0
Forward Contracts	98.0	99.4	99.9	100.1	100.1	N.A.	99.9	99.4

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

at 23.09.2014	4T14	1T15	2T15	3T15	4T15	2014	2015	2016
Estimates	92.5	92.7	92.3	93.5	94.3	95.9	93.2	94.5
Bloomberg Median	99.0	100.0	98.0	98.2	97.0	N.A.	98.9	95.0
Forward Contracts	90.3	89.8	89.6	89.3	89.1	N.A.	89.4	88.4

Source: Intesa Sanpaolo chart based on Bloomberg data

United States – Growth is here, the Fed is warming up the engines

Giovanna Mossetti

- The GDP contraction in the first quarter (-2.1% qoq, ann.) has proven to be temporary; there was a strong turnaround in growth in the second quarter, which is expected to stabilise at around 3% in the second half (3.2% qoq, ann.) and in 2015.
- Final demand in the private sector has been buoyed by positive fundamentals for both businesses and households. Meanwhile, the labour market has continued to improve. Unemployment continues to fall, and is forecast to reach the longer-run level, estimated by the Fed at 5.2-5.5%, by end-2015. The monthly increase in nonfarm payrolls should remain at around 215,000, in line with the average for January-August 2014. Under-employment keeps falling, although according to the Fed slack is still "significant".
- Inflation remains below the Fed target. The trend towards 2% will be reined in by exchange rate appreciation and falling energy prices, but boosted by the closing of the output gap. Wages are still rising slowly, but businesses are signalling imminent increases.
- The Federal Open Market Committee (FOMC) remains cautious about the exit, and has indicated that interest rates will stay at their current levels for a "considerable time" after the asset purchase programme ends (October). The Fed funds rate is still the main policy rate, but the Fed will use the excess reserves rate and the reverse repo rate to control market interest rates.
- In our opinion, the market is underestimating future increases in policy rates. Intesa Sanpaolo forecasts an initial increase in June 2015, rising to 1.25% at end-2015, to 2.5-2.75% at end-2016 and to 3.5% at end-2017.

Forecast Table

	2013	2014	2015	2013	2014				2015		
				4	1	2	3	4	1	2	3
GDP (1996 US$,y/y)	2.2	2.2	3.2	3.1	1.9	2.6	2.3	2.2	3.5	3.2	3.2
q/q annual rate				3.5	-2.1	4.6	3.2	3.4	3.0	3.1	3.2
Private consumption	2.4	2.4	2.8	3.7	1.2	2.5	2.9	3.0	2.7	2.7	2.6
Fixed investment - nonresid.	3.0	6.4	6.3	10.4	1.6	9.7	7.5	8.0	5.3	4.9	5.3
Fixed investment - residential	11.9	3.1	11.7	-8.5	-5.3	8.8	11.4	12.2	12.2	12.3	12.0
Government consumption	-2.0	-0.5	0.7	-3.8	-0.8	1.7	0.7	0.5	0.6	0.8	0.8
Export	3.0	3.2	5.5	10.0	-9.2	11.0	4.1	4.5	5.4	5.5	5.8
Import	1.1	4.1	4.5	1.3	2.2	11.3	3.8	3.0	3.3	5.1	5.7
Stockbuilding (% contrib. to GDP)	0.0	0.0	0.0	-0.1	-0.3	0.3	-0.1	-0.1	-0.1	0.0	0.1
Current account (% of GDP)	-2.4	-2.4	-2.1	-2.1	-2.6	-2.6	-2.4	-2.2	-2.1	-2.1	-2.2
Federal Deficit (% of GDP)	-4.9	-4.5	-4.2								
Gov. Debt (% of GDP)	122.8	124.7	123.8								
CPI (y/y)	1.5	1.8	1.6	1.2	1.4	2.1	1.8	1.8	1.5	1.1	1.8
Industrial production (y/y)	2.9	4.0	4.6	5.0	3.9	5.2	2.6	5.3	5.2	4.7	4.6
Unemployment (%)	7.4	6.2	5.6	7.0	6.7	6.2	6.2	5.9	5.8	5.6	5.5
Fed Funds	0.25	0.25	0.48	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.58
Effective exch.rate (1973=100)	76.0	78.2	81.9	76.0	77.1	76.5	77.9	81.4	82.0	82.1	81.9

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: EcoWin, Intesa Sanpaolo

United States on track for 3% + growth

The US is back on track for growth: after the derailment of the first quarter (-2.1% qoq, ann.), the second quarter saw a strong recovery (+4.6% qoq, ann.), while the third-quarter data point to growth of at least 3% qoq, ann. in the second half.

The contraction early in the year was a temporary phenomenon, caused partly by bad weather and partly by problems in adjusting consumption estimates as the healthcare reform came into force. Looking beyond the widespread volatility of the first half of the year, the economic data suggest robust growth in private domestic demand, in both the second half and in 2015, along with continuing growth in employment at around 2% yoy, in a context of ongoing ultra-expansive financial conditions and a neutral fiscal policy. We forecast growth of 3.2% in 2015 and 3% in 2016, still above potential, with unemployment at the longer-term levels estimated by the Fed (5.2-5.5%) by the end of 2015, and inflation stabilising at close to 2% from end-2015 onwards. The outlook for growth, the labour market and inflation indicates that the conditions exist for a turnaround in monetary policy, which is forecast for mid-2015. We are maintaining a forecast of gradual hikes through 2015-17, bringing short-term interest rates towards 3.5-3.75% at end-2017, with a steeper upward trend than so far incorporated by Fed funds futures, but moderate overall. The Fed's efforts to remove the monetary stimulus will be helped by the appreciation of the dollar, which will continue in 2015.

We see the risks for the outlook as balanced. On the one hand, the fundamentals driving the trend in private demand are sound, after the long adjustment that followed the financial crisis. For consumption, household balance sheets are in order, debt servicing is at an all-time low, employment growth has stabilised at levels above workforce growth, and fiscal policy is likely to remain neutral for the next two years. For non-residential investment, the strengthening of the outlook for final demand coupled with less political uncertainty has boosted the trend upwards, sustained by the need to rebuild capital after many years of "under-investment". Moreover, financial conditions remain very accommodative and earnings are at record highs.

With expected growth of around 3-3.2%, employment should at least be in line with the trend to date, with an increase in the monthly numbers in work of between 200k and 220k in 2014-2015. In this scenario, the output gap should continue to narrow, before disappearing in 2016 (in line with Congressional Budget Office (CBO) forecasts) and inflation should get close to 2% over the next two years. With monetary policy explicitly linked to developments in the macroeconomic scenario, any slowdown/acceleration in growth would be accompanied by changes to the timing of the removal of the monetary stimulus, which should help to balance the risks. As the Fed's turnaround on interest rates approaches, market volatility could increase and there may be a rapid rise in yields if there is a marked improvement in the macroeconomic data. However, the FOMC's caution in managing the exit should curb the extent of the fluctuations.

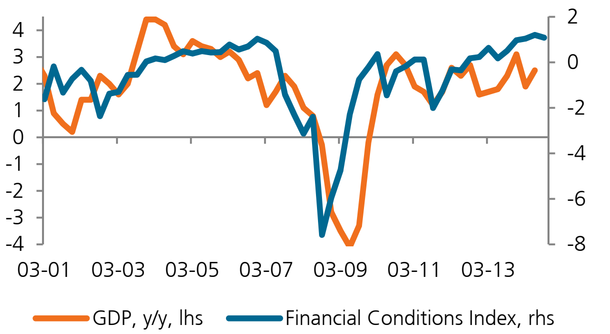
Non-residential fixed investment – Non-residential investment had already bounced back in the second quarter (+9.7% qoq, ann.), after the stagnation early in the year (+0.2% qoq, ann.), and the signs for the third quarter are very positive. Capital expenditure has also been strong for both structures (+12.6% qoq, ann. in 2Q) and machinery (+11.6% qoq, ann. in 2Q). The third quarter could see a moderate slowdown, but surveys in the summer months showed signs consistent with a solid recovery for the end of 2014: ISM orders, at 66.7 in August, are at their highest levels since 2004, and have risen continuously since February 2014. The net percentage of companies intending to increase capital expenditure is growing. Industrial and commercial lending is soaring (double-digit growth mom, ann. in each month from June to August, with particularly strong growth in non-residential construction). The forecast is for growth in non-residential fixed investment of 6.4% in 2014 and 6.3% in 2015.

Labour market – The adjustment in the labour market is the key factor in forecasts for 2015, in both macroeconomic and monetary policy terms. Our assessment remains positive, with estimated monthly growth in non-agricultural jobs of around 220k, corresponding to an annual increase of 2% yoy, as expected from end-2013 onwards. Based on the Atlanta Fed's Jobs Calculator, assuming an unchanged participation rate of 62.8% and monthly numbers in work of around 210,000 (in line with the average at the start of 2014), **unemployment** should settle at **5.8% at end-2014, 5.4% in mid-2015 and 5% at end-2015**. The central scenario for more long-term unemployment formulated by the FOMC in September is 5.2-5.5%. The most important thing is that the other variables considered crucial by the Fed to assess unused resources in the labour market shows a clear improvement (see Figs 7-10). These include data on flows (open positions, voluntary resignations), duration of unemployment and the percentage of long-term unemployed and extended unemployment (U-6, which includes discouraged workers, workers marginally attached to the labour force and workers in part-time employment for financial reasons (see Fig. 8)). Wages are still very moderate, but companies are indicating that they will have to adjust to the new market conditions.

Private consumption – First-quarter weakness in consumption (+1.2% qoq, ann.) is also a distant memory. Consumption early in the year had felt the effects not only of the bad weather, but also problems with estimating medical costs (especially for hospital services) immediately after the entry into force of the healthcare reform. In the second quarter, growth rose again to +2.5% qoq, ann., with marked increases for both durable goods and services, with a particularly strong recovery for the healthcare component. For the next few quarters, we forecast **growth in consumption of between 2.8% and 3% qoq, ann.** There are several mutually reinforcing factors at work buoying personal spending: a significant improvement in the labour market (current income expected to rise as uncertainty subsides), expansionary financial conditions, especially for consumer credit, low inflation, accelerating real income and a continuous rise in financial and real wealth. The financial accounts for the second quarter showed a further increase in net household wealth (net wealth/available income at their highest levels since 2007, see Fig. 5). It is significant that debt rose by 3.6% qoq, ann. in the second quarter, despite near-stagnation in the mortgage sector, driven up by consumer credit in the context of a positive trend in savings (to 5.6% in the third quarter of 2014, from 4.1% at end-2013). We forecast **consumption growth of 2.4% in 2014 and 2.8% in 2015.**

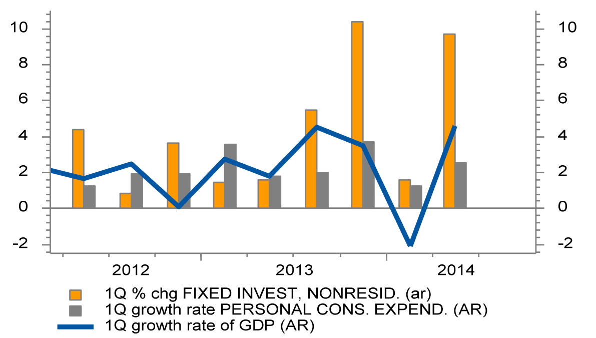
Net exports – Net exports contributed almost nothing to overall growth. Non-oil imports should be robust, reflecting the relative strength of the US economy. The continuous increase in oil production has led to a structural downward trend in imports in the energy sector. From mid-2014, there will be a more pronounced effect due to the appreciation of the dollar, which has already strengthened by around 3% in effective terms since the start of the year. Divergent growth rates and monetary policy outlook for the US and the rest of the world will continue and become more pronounced in 2015, strengthening imports and weakening exports. The forecast **for 2015 is an increase of 5.5% in exports and 4.1% in imports.**

Fig. 1 – Financial conditions still ultra-expansionary



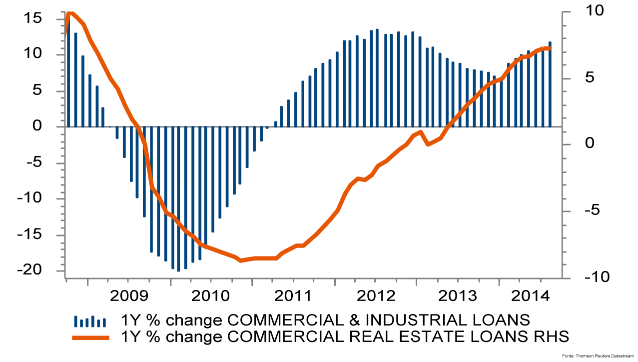
Source: Bloomberg

Fig. 2 – Private domestic demand supports the recovery



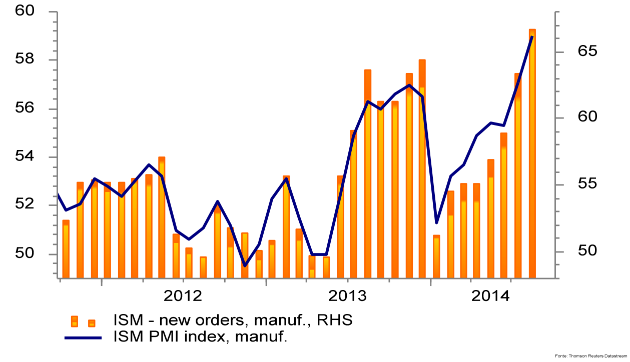
Source: Thomson Reuters-Datastream

Fig. 3 – Industrial & Commercial loans keep moving up



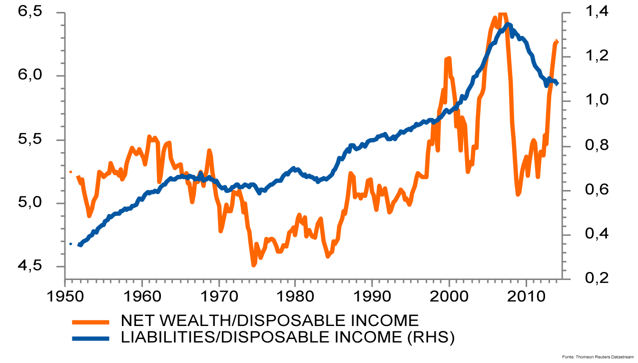
Source: Thomson Reuters-Datastream

Fig. 4 – Manufacturing ISM and new orders point to an acceleration in growth



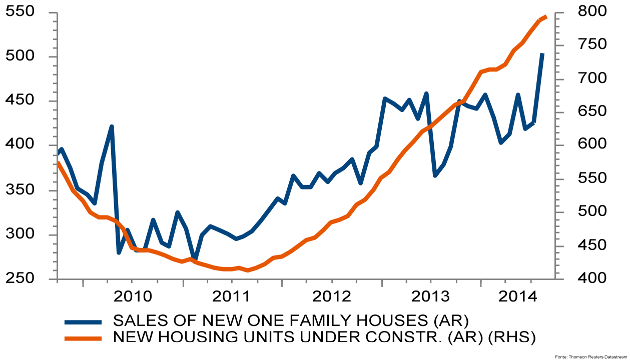
Source: Thomson Reuters-Datastream

Fig. 5 – Net wealth and liabilities as % of disposable income: household balance sheets are in order



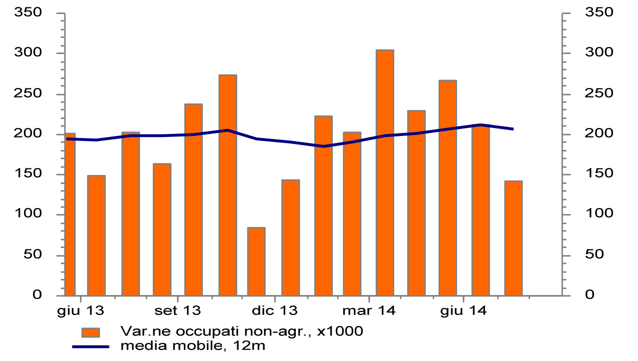
Source: Thomson Reuters-Datastream

Fig. 6 – Residential construction: gradual recovery



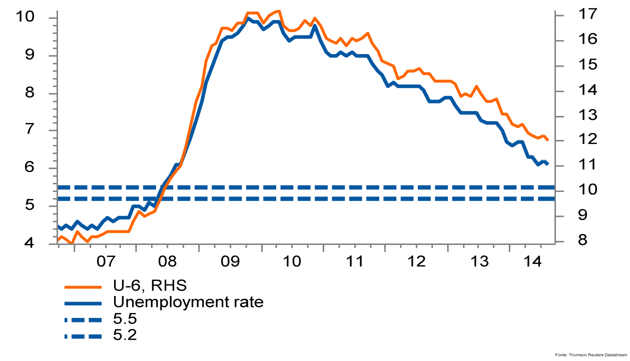
Data in thousands of units (ann.) Source: Thomson Reuters-Datastream.

Fig. 7 – Nonfarm payrolls growth on average close to +200k per month



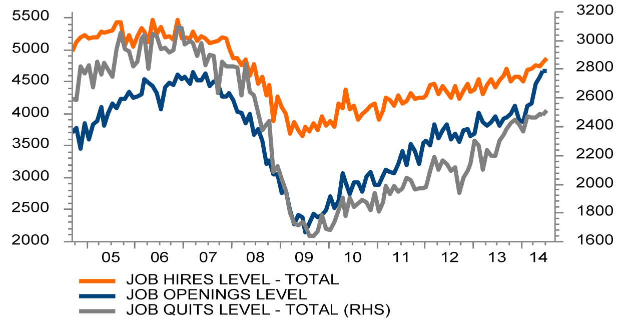
Source: Thomson Reuters-Datastream

Fig. 8 – Unemployment very close to the longer run level projected by the Fed



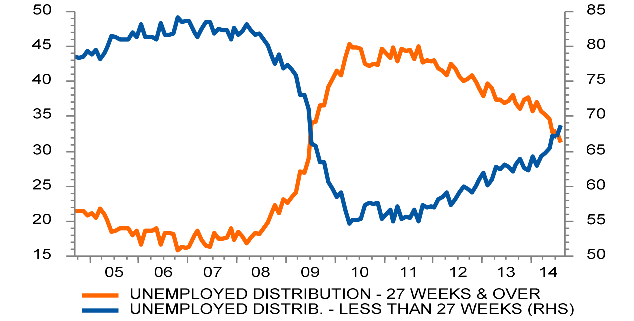
U6= Unemployment rate, expanded to include discouraged workers, workers marginally attached to the labour force, and workers in part-time employment for financial reasons. 5.2-5.5%: estimated range for longer-term unemployment, FOMC, September 2014
Source: Thomson Reuters-Datastream, Federal Reserve Board.

Fig. 9 – Supply and demand flows confirm the improvement in the labour market



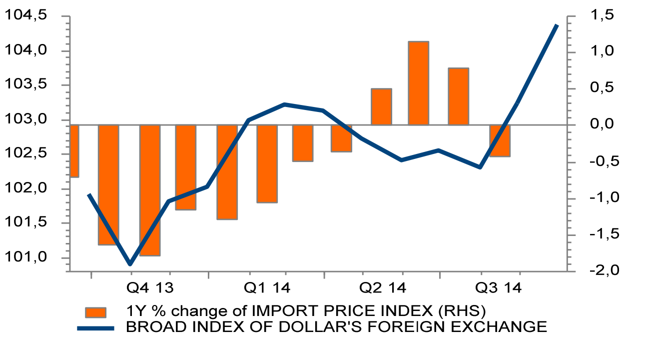
Source: Thomson Reuters Datastream

Fig. 10 – The breakdown of unemployment by duration is normalising: the % of long-term unemployed keeps falling



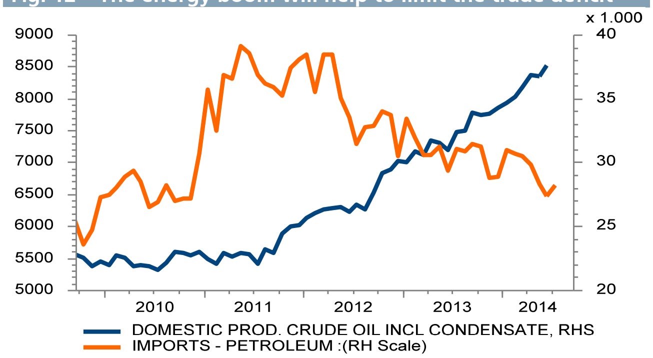
Source: Thomson Reuters Datastream

Fig. 11 – Effective dollar exchange rate and import prices



Source: Thomson Reuters-Datastream

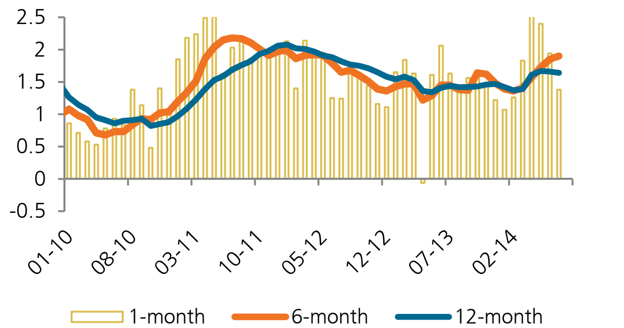
Fig. 12 – The energy boom will help to limit the trade deficit



Source: Thomson Reuters-Datastream

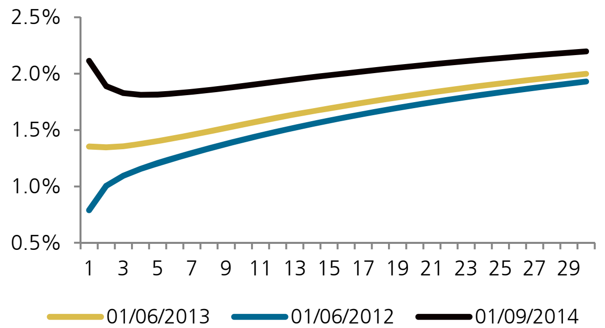
Inflation – Inflation has hovered at around 1.5% yoy in the last few months, and is still expected to stay at 1.5-2% over a medium/long-term horizon. The recent appreciation of the dollar, together with falling oil prices, has helped curb import prices. Inflation will probably also remain below the Fed's target in 2015. The closing of the output and unemployment gaps, the upward trend in rents and the stabilisation in healthcare prices though imply that a return to disinflation is unlikely: core PCE is expected to stay at between 1.5% and 2% yoy in 2015. Moderate price rises are leaving plenty of room for manoeuvre for the Fed to manage the exit very gradually.

Fig. 13 – Trimmed mean of the core consumer deflator is stabilising



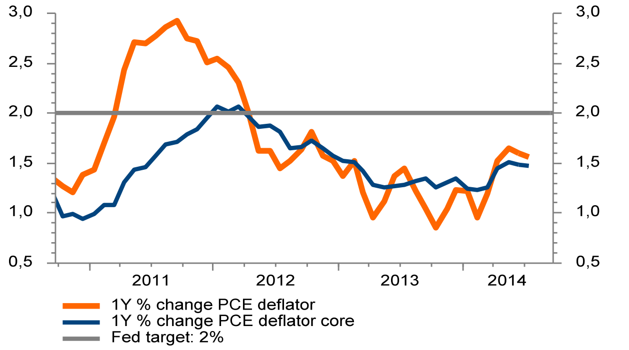
Annualised changes in the trimmed mean of the consumer spending deflator. The trimmed mean is an alternative measure of core inflation that excludes items with the most extreme changes. The Dallas Fed's measure, an excellent estimate of the actual trend of core PCE, excludes 24% of the lower distribution tail and 31% of the upper tail of monthly price changes. Source: Dallas Fed.

Fig. 14 – The reflation sought by the Fed is here, but remains limited, also thanks to dollar appreciation



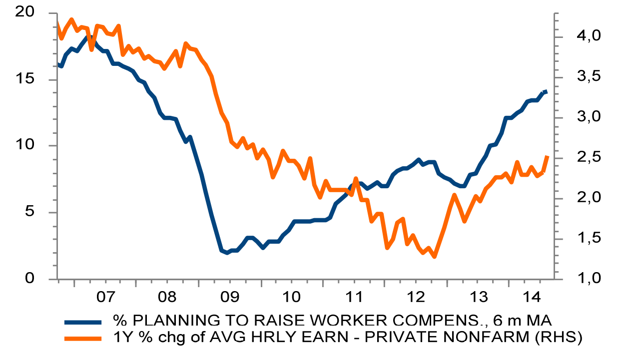
Inflation expectations estimated using a model based on market data and analyst forecasts, see http://www.clevelandfed.org/research/commentary/2009/0809.cfm X-axis: years. Source: Cleveland Fed.

Fig. 15 – Inflation is lukewarm with no significant pressures either up or down



Source: Thomson Reuters Datastream

Fig. 16 – Wages on their way up



Source: Thomson Reuters Datastream

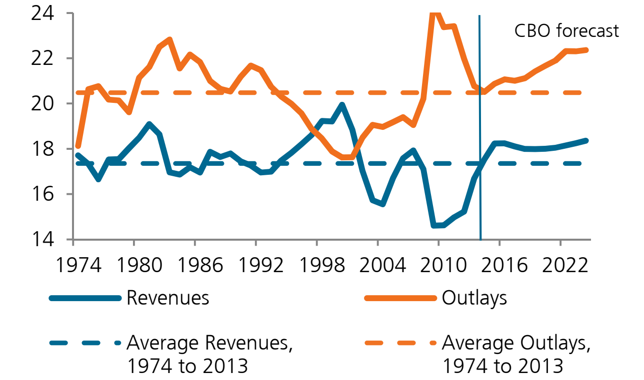
Fiscal policy – Automatic pilot until 2016

Fiscal policy in the period 2014-15 is expected to remain at the margins of the macroeconomic landscape, after years in which it was the main player. The mid-term elections to renew the entire House of Representatives and one-third of the Senate will take place in early November. The vote could alter the balance of power in Congress. The polls are currently pointing to a Republican majority in the House (current seats: Republicans, 233 and Democrats, 199), with a possible increase in the current margin (see http://www.realclearpolitics.com/epolls/2014/house/2014_elections_house_map.html). In the Senate, which is currently Democrat (55 Democrats, 45 Republicans), there could be a swing to a Republican majority (see http://www.realclearpolitics.com/epolls/2014/senate/2014_elections_senate_map.html).

A Republican majority in Congress could result in a push to abolish the healthcare reform, although we think that this is unlikely to happen for reasons of political expediency. If Congress started on the road towards abolishing Obamacare, the President would probably use his line-item veto power. Partial veto gives the Administration the power to remove specific parts of a bill proposed by Congress, with no effect on the other measures in the approved text, thus reducing the likelihood of "blackmail" by the Houses. Moreover, current polls indicate that the margin in the Senate is very narrow for both parties, and that any Republican victory would probably only create a majority of a few seats. It therefore seems more likely that **2015-16 will be a period of truce, in preparation for the presidential elections of 2016**, partly because the federal accounts, assisted by the favourable cycle and extraordinarily low yields, are on a virtuous path (see Fig. 18).

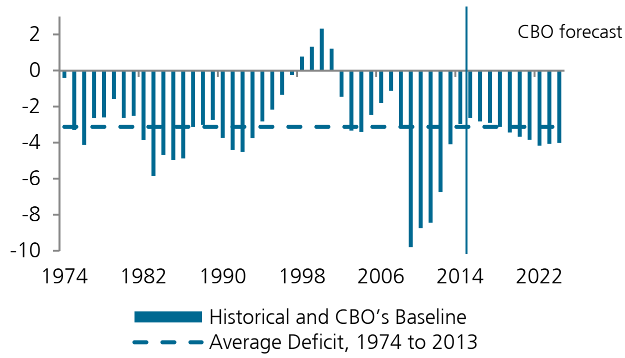
Potential obstacles to this soothing scenario are 1) the need to increase the debt limit once again, which is likely to be binding again in March 2015, and 2) approval of the budget or of continuing appropriation acts for 2015. The high stakes on both points mean the necessary measures may be nodded through. We forecast that **Congress will be essentially frozen in the next two years** and will only concern itself with ordinary administration.

Fig. 17 – Spending under control only until 2016



Source: Congressional Budget Office. Figures as a % of GDP

Fig. 18 – Deficit/GDP ratio falling until 2015, before rising again



Source: Congressional Budget Office. Figures as a % of GDP

Monetary policy – Small steps towards the exit

The strengthening of the recovery shown in the data and surveys, and the continuous improvement in the labour market, are pushing the Fed to gradually prepare for a change in monetary policy. During this run-up period, the Committee is gathering a broad and very diverse spectrum of opinion on the date of the first interest rate hike and the subsequent interest rate path. This is clear from the point graph, which shows the projections of each meeting participant over a time horizon of up to end-2017. However, despite the presence of a consistently "hawkish" group, the consensus remains clustered around Yellen's very cautious position. The compass used to determine monetary policy is the assessment of the adjustment of the labour market as measured by a broad set of indicators of unused resources.

The sequence of decisions over a one-year horizon is punctuated by a series of "stages":

1) end of the asset purchase programme (October);

2) change in interest rate guidance: removal of the "considerable time" and introduction of explicit links between rate hikes and the evolution of the macroeconomic scenario, with reference to slack in the labour market (our forecast: between October and December);

3) further change in guidance to indicate that the first hike is approaching and that the increases will be gradual (our forecast: first half 2015);

4) first interest rate hike and indication of "patience" in removing the monetary stimulus (our forecast: June 2015).

In more operational terms, in September the FOMC issued a statement containing guidelines for the "normalisation" of monetary policy[1]:

- the reinvestment policy for coupons and maturing securities will be suspended after the beginning of the rate hikes;
- the Committee does not intend to sell the securities in its portfolio, and in particular intends to retain MBS holdings to maturity, apart from possible limited sales to handle residuals;
- the fed funds rate will continue to be the main policy rate: the fed funds target range will be reached by adjusting the rate on excess reserves;

[1] Policy Normalization Principles and Plans, (http://www.federalreserve.gov/newsevents/press/monetary/20140917c.htm)

- **reverse repo operations and other instruments will be used as necessary** to control the Fed funds rate; in particular, reverse repo operations will be used as little as possible and abandoned when no longer needed to control the fed funds rate.

In light of developments in the economic outlook, with a stronger recovery and a steady decrease in unused resources, **what is the FOMC's message**? The key guiding principles for monetary policy are as follows:

- **the first rate hike is still some way off**, given the persistence of "significant" slack, even though the economy is expanding at a "moderate" pace and conditions of the labour market have "somewhat" improved;
- the Committee intends to raise rates gradually, but the **consensus on the level of interest rates at the end of each year** has moved upwards over the entire forecast horizon compared with June;
- the Committee consensus still sees it as important not to risk the market anticipating the expected date of the first hike, generating significant movements in interest rates, through changes in the guidance;
- the interest rate guidance (the "considerable time") will be altered in a way that is more explicitly linked to changes in data when the economic situation improves further (and/or the date of the first rate hike expected by the FOMC is closer).

"the FOMC's emphasis is naturally shifting to questions about the degree of remaining slack, how quickly that slack is likely to be taken up, and thereby to the question of under what conditions we should begin dialling back our extraordinary accommodation" (J.Yellen, August 2014).

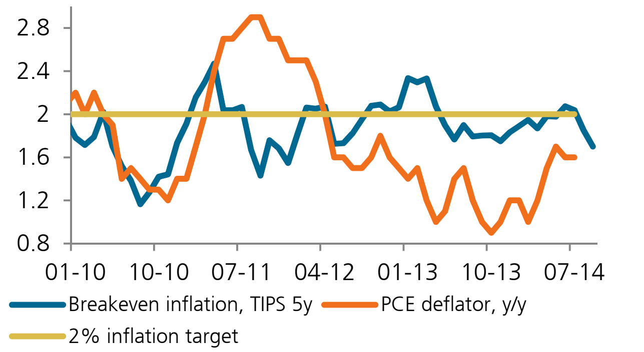
The Committee, with the various forms of communication now available (guidance, interest rate projections, cycle assessment), has indicated that it prefers not to change the expected start date for the hikes, even though "collectively" it has revised the rates trend upwards in the forecasting period.

The rate projections from now on are formulated in terms of a range, as will be the monetary policy target when the hikes begin. The interest rate path in September has been revised upward by around 25bps for the end of each year compared with the June projections: median at end-2015 of 1.35% from 1.15% in June; median at end-2016 of 2.85% from 2.5% in June (see Fig. 20). For the end of 2017 (the June projections stopped at 2016), the median projection is 3.75%, in line with the estimated longer-term rate. The macroeconomic scenario of 2017 is in line with longer term projections. The central projections for inflation and unemployment (1.6-1.9% for inflation and 4.9-5.3% for unemployment) are at the Fed's projected longer-term levels, while expected growth (2.3-2.5%) is slightly higher than potential growth (2.0-2.3%). Moderate inflation and exchange rate appreciation contribute to the patience shown by the FOMC in formulating its rate guidance. However, the increased confidence in the soundness of the recovery is clear from the steady upward trend in interest rate projections, up 25bps for end-2015 and end-2016 in every quarter since the start of 2014.

In September, there were two dissenters (Fisher and Plosser) with regards to the formulation of guidance (in July the only dissenter was Plosser). **Dissents** will probably be a constant feature as the date of the first hike approaches, given the diversity of views in the Committee, but **will not change the final decisions significantly**; in any case, these will be determined by a consensus between the centre and the doves, led by Yellen and members of the Board.

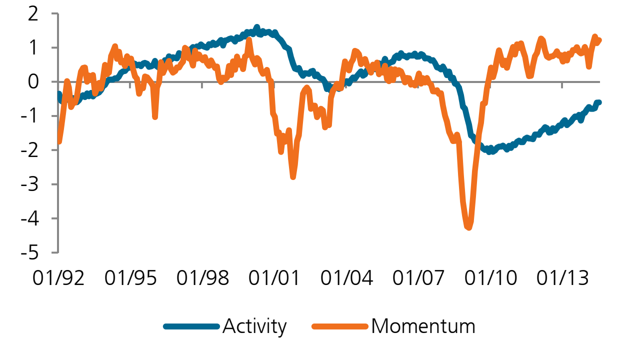
We are maintaining our **forecast of a first interest rate hike in June 2015, with rates of 1% to 1.25% at end-2015, 2.5% to 3% at end-2016 and around 3.75% at end-2017.**

Fig. 19 – Inflation still below 2%



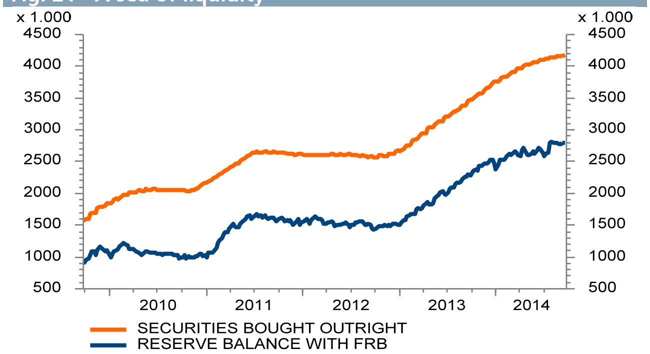
Source: Bloomberg

Fig. 20 – Labor Market Conditions Indicators: level and speed of adjustment in the labour market



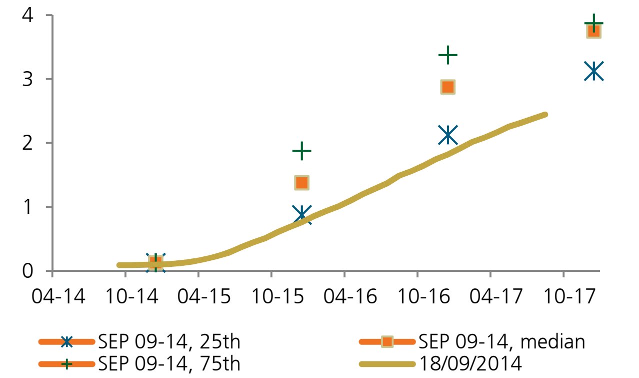
Source: Federal Reserve Bank of Kansas City

Fig. 21 - A sea of liquidity



Source: Federal Reserve Board of Governors, Tab. H.4.1. Figures in USDM

Fig. 22 – Is the market underestimating future interest rate rises?



Source: Source: Bloomberg and Intesa Sanpaolo from Federal Reserve Board data. Continuous lines: Fed funds futures; SEP= summary of economic projections, September 2014

Euro zone – slow and uncertain recovery. ECB waiting on the sidelines

The scenario in brief

Paolo Mameli
Anna Maria Grimaldi

- We have revised downwards our Euro zone growth forecasts for 2014 to 0.8% and for 2015 to 1.1% (from 1.5%), significantly below consensus estimates. Summer data have clearly indicated that the weakness of the spring months will extend into the second half of the year.

- The depreciation in the exchange rate to its current level was largely priced into our estimates in June. The speed of the recovery in the coming year will therefore depend on growth in domestic demand. Fiscal policy will be moderately tight as it will be difficult to significantly "bend" the EU rules.

- Performance will continue to vary markedly within the Euro zone. Growth will be driven by Germany, which, after the temporary summer slowdown, should resume expansion in the second half of 2014, and by Spain (1.7% both). Hampered by structural domestic problems, France and Italy will post below-average growth (0.7% and 0.6%).

- The scenario remains subject to a high degree of uncertainty fuelled by geopolitical tensions and the difficulty of assessing the impact of the stimulus measures introduced by the ECB, and of fiscal policy measures, which will be detailed in the 2015 budget.

- In any case, growth momentum in the next twelve months will be insufficient to trigger a significant closing of the output gap. The risks for consumer price inflation are, therefore, still to the downside.

- The probability of the ECB announcing a programme of quantitative easing is currently less than 50%. The ECB might decide to intervene, but only if the economic cycle and inflation produce fresh surprises compared with the latest staff estimates. But, in any case, it will wait at least until March 2015 in order to assess the effect of measures already announced.

Previsioni

	2013	2014	2015	2013	2014				2015		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	-0.4	0.8	1.1	0.5	1.0	0.7	0.7	0.7	0.8	1.1	1.2
- q/q change				0.3	0.2	0.0	0.2	0.3	0.3	0.3	0.3
Private consumption	-0.6	0.7	1.1	0.1	0.2	0.3	0.2	0.3	0.3	0.3	0.3
Fixed investment	-2.8	1.1	1.9	0.9	0.2	-0.3	0.2	0.2	0.4	1.0	0.9
Government consumption	0.1	0.8	0.4	-0.3	0.7	0.2	0.1	0.1	0.0	0.1	0.1
Export	1.5	2.6	3.7	1.4	0.1	0.5	0.7	0.8	1.0	1.1	0.9
Import	0.4	2.9	3.7	0.7	0.8	0.3	0.5	0.9	1.0	1.4	0.9
Stockbuilding (% contrib. to GDP)	0.0	0.0	-0.1	-0.2	0.2	-0.2	-0.1	0.1	0.0	0.0	-0.1
Current account (% of GDP)	2.6	2.7	2.8	2.8	2.3	2.2	2.4	2.1	2.1	2.0	2.0
Deficit (% of GDP)	-3.0	-2.6	-2.2								
Debt (% of GDP)	93.5	94.7	96.5								
CPI (y/y)	1.4	0.6	1.1	0.8	0.7	0.6	0.4	0.9	0.9	1.2	1.1
Industrial production (y/y)	-0.7	1.0	1.5	0.6	0.2	0.0	0.4	0.0	0.2	0.8	1.0
Unemployment (%)	11.9	11.5	11.1	11.9	11.7	11.6	11.5	11.4	11.2	11.2	11.1
3-month Euribor	0.22	0.22	0.08	0.24	0.29	0.30	0.18	0.10	0.09	0.08	0.08
EUR/USD	1.33	1.33	1.25	1.36	1.37	1.37	1.33	1.25	1.23	1.24	1.26

NB: Percentage change versus previous period except where otherwise indicated. Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Economic outlook: an uncertain and uneven recovery

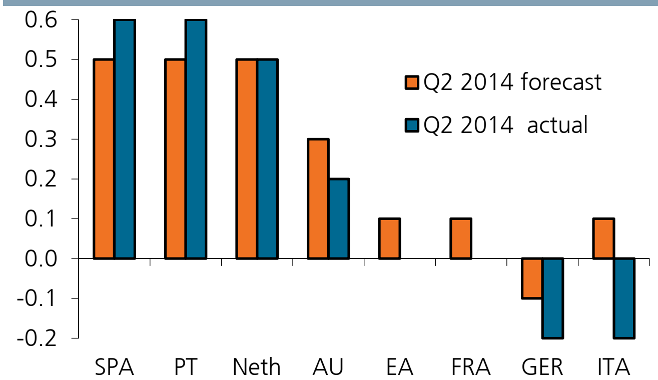
Paolo Mameli

The recovery in the Spring months has been weaker than expected: GDP remained stable in the second quarter after advancing 0.2% qoq at the beginning of year. Economic activity rose two-tenths of a point in Italy and Germany and has been stagnant since the start of the year in France. In contrast, the recovery has held up better than expected in Spain and Portugal.

Growth momentum is weaker than expected in Germany too

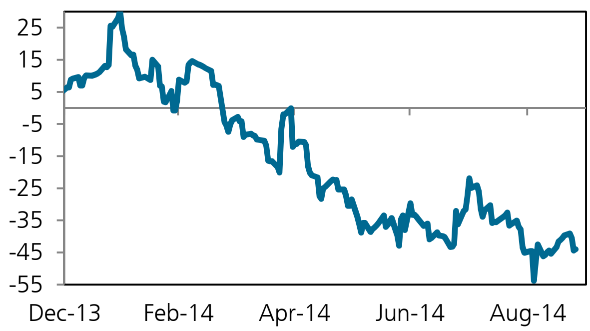
The slowdown in the German economy should be a temporary phenomenon linked to a correction in investment in residential construction and consumer spending after the strong impetus at the beginning of the year provided by the exceptionally mild weather. The Bundesbank estimates that, stripping out the weather effect, GDP growth in the first half of the year was on average 0.25% qoq, a slight slowdown on the 0.4% qoq in the second half of 2013. The slowdown in France and Italy is linked to a rather disappointing performance by exports (0.0% qoq and 0.1% qoq respectively), and the lack of recovery in investment in machinery and buildings. The weakness of France and Italy, which account for 38% of the Euro zone, is more worrisome because it appears to reflect more structural factors.

GDP growth surprised on the downside in the Spring months...



Source: Intesa Sanpaolo chart based on consensus, Bloomberg and Eurostat

... and economic data continued to surprise on the downside during the Summer

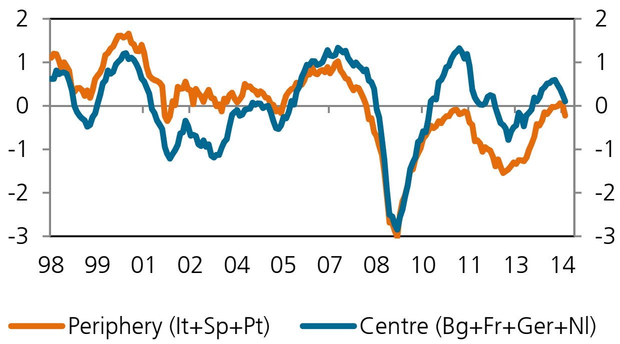


Source: Credit Suisse economic surprise index for the Euro zone

Confidence surveys also suggest modest growth at the end of 2014

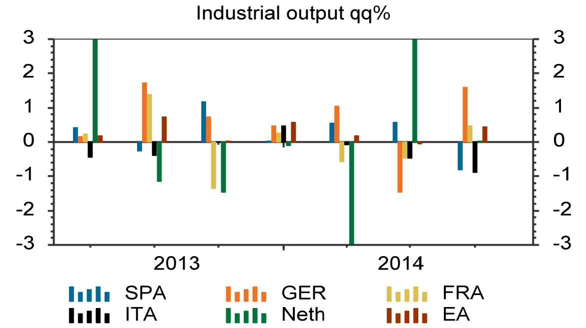
During the Summer months, PMI economic surveys and the European Commission's economic confidence index put the Euro zone average around levels (respectively 52.9 from 53.4 and 101.4 from 102.2) consistent with economic activity being almost at a standstill during the Summer too. Industrial output data for July put the sector on course for growth of 0.4% qoq, after it stalled in Spring, which gives hope for marginally positive GDP growth in the Euro zone. Confidence surveys have clearly signalled a slowdown in the cycle in the entire Euro area, although the recovery seems to have become slower, particularly in Italy and France. The indications from the global PMI excluding the Euro zone point to a recovery in exports from the end of Summer due to the acceleration in demand from advanced economies, especially the US and the UK. This additional stimulus should be boosted by the impact of the recent depreciation in the euro. Growth rates will continue to vary markedly within the Euro zone. In Germany, GDP should in fact return to growth of 0.2-0.3% qoq as the industrial output data for July (although inflated by exceptional factors such as the minimum number of vacation days and an order of capital goods with a high unit value) have put output on track for recovery in September. Output is also expected to grow marginally in France in the Summer quarter, while Italy and Spain will experience negative drag after the publication of the July data.

Manufacturing business confidence has slowed not only in the periphery but also in the core



Source: Intesa Sanpaolo chart based on BNB, IFO, INSEE, ISTAT and European Commission data (for Spain and Port.)

July's output figures indicate a decrease in activity in Italy and Spain, but a rebound in the Euro zone average thanks to France and Germany

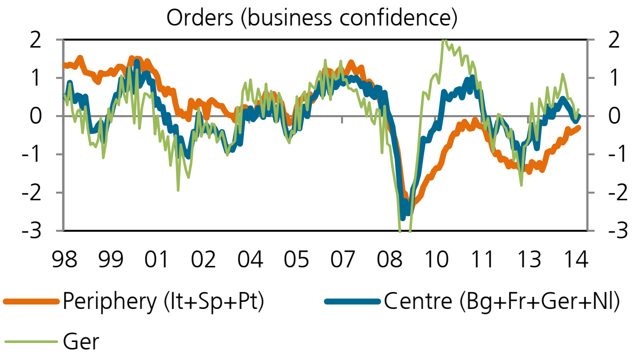


Source: Intesa Sanpaolo chart based on Eurostat data

Overall, our central scenario **forecasts growth of 0.1-0.2% qoq in the third quarter and a slight acceleration to 0.3% qoq at the end of 2013/early 2015**, which is slightly weaker than the scenario outlined in June. We believe that the continued uncertainty (related in part to geopolitical tensions) could also weigh on exports and investment at the turn of the year. Stagnation in the middle of the year together with the revision in growth for the end of this year and start of the next have reduced the average for 2014 to 0.8% from 1.1% and the forecast for 2015 to 1.1% from 1.5%.

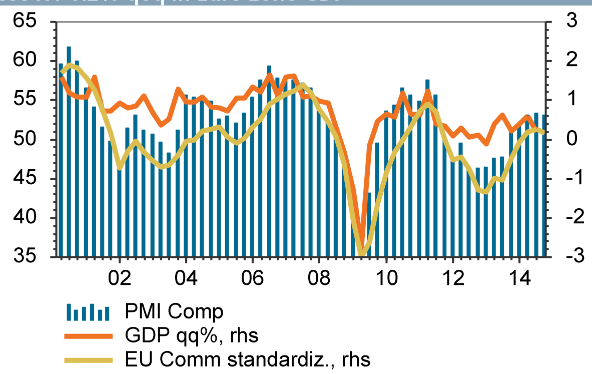
2015 estimate down to 1.1% from 1.5%

Demand from the core (especially Germany) began to slow in the spring and so far there are no signs of a turnaround



Source: Intesa Sanpaolo chart based on survey of business confidence in the manufacturing sector

PMI and European Commission indices suggest an increase of at most 0.1-0.2% qoq in Euro zone GDP

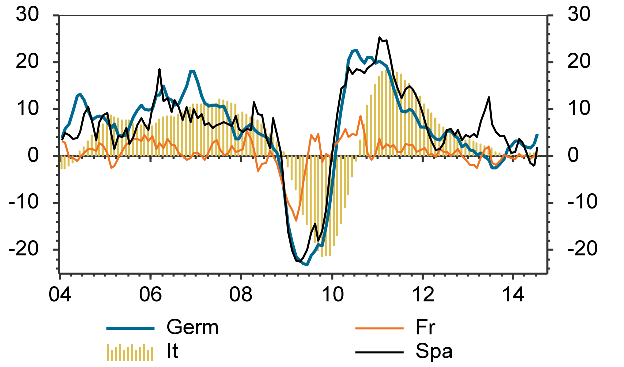


Source: Intesa Sanpaolo chart based on Markit and European Commission data

We still believe Euro zone exports will be boosted by the acceleration in growth in other advanced economies (mainly the US) and exchange rate depreciation. The depreciation in the exchange rate since March 2014 (about 4.5%) is only slightly higher than the consensus forecast of June and our estimates. It has therefore had no impact on the forecasts for Spring 2015 onwards. Our scenario incorporates growth in exports of 3.7% in 2015 (from 2.6% estimated for the current year), while imports are also expected to accelerate by 3.7% on average in 2015 from 2.9% of this year. Consequently, **foreign trade should provide a net contribution to GDP growth of at least two-tenths of a percentage point** (compared with a zero contribution in 2014 for the first time in four years). The real issue in the assessment of the macro scenario is what will happen with domestic demand, in particular corporate investment spending.

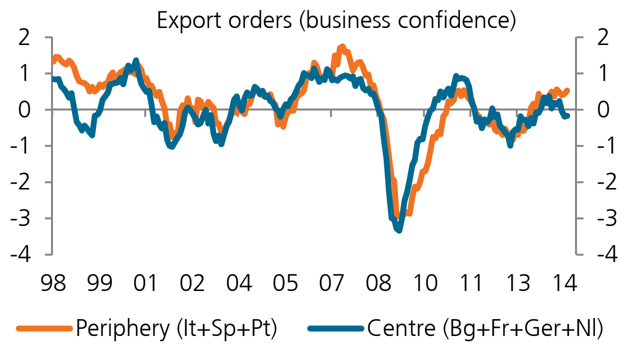
Support at the turn of the year will be driven by the exchange rate and demand from other advanced economies

Exports held up in Germany and Spain, but stagnated in France and Italy



Source: Intesa Sanpaolo chart based on Eurostat data

Over this period, peripheral Euro zone countries show a greater pick up in orders from abroad



Source: Intesa Sanpaolo chart based on national business confidence surveys in the manufacturing sector

The real issue is the growth in domestic demand and how it will respond to the ECB's measures

As Draghi indicated in his speech of 11 September in Milan, investment is "one of the notable victims of this crisis" and an essential element to ensuring the recovery is sustainable. His recipe to jump start investment is a mix of monetary policy, fiscal policy and structural reforms.

As regards monetary policy, having interest rates close to zero should help support all demand components most sensitive to the cost of borrowing and therefore corporate investment in particular. Of course the problem is that the drop in official interest rates has, at least in certain countries, not translated into a fall of the same magnitude in the interest rates charged on loans to businesses. Furthermore, aided by the sharp drop in inflation, medium/long-term rates charged to companies in several key countries like Spain and Italy are not only higher than in 2010-11 (when they went into negative territory), but at high levels in absolute terms (3.7% based on loans outstanding of 1-5 years). There is clearly a problem here in transmitting to the real economy the impetus from monetary policy, which the ECB is trying to tackle with unconventional measures. About these, it is very difficult to assess the impact on the cycle. However,

1) the new TLTROs will not, in our view, play a decisive role in triggering recovery, since the current weakness in the credit channel is not due to scarce liquidity, as is also evident from the relatively limited use (82.6Bn) of the first auction of 22 September, nor, in contrast to a couple of years ago, to any restriction on the supply side, but rather to problems on the demand side (the cycle is too weak to have an adequate credit requirement, which is to say that the borrowers are seen as too high-risk); with this in mind, the new mechanism will work only with difficulty, given that it does not introduce anything new that might improve the borrower's credit rating (only "guarantee" mechanisms have any impact on the perception of creditors' risk status); clearly, the new auctions will bring about a (further) reduction in the cost of bank financing and may help (further) ease lending conditions, but we do not see these aspects as key to the development of the cycle;

2) we do not even consider the ABS purchase programme to be crucial, mainly because the ECB has stated that it will buy mainly senior tranches, which risks making the measure no more than just another liquidity supply tool.

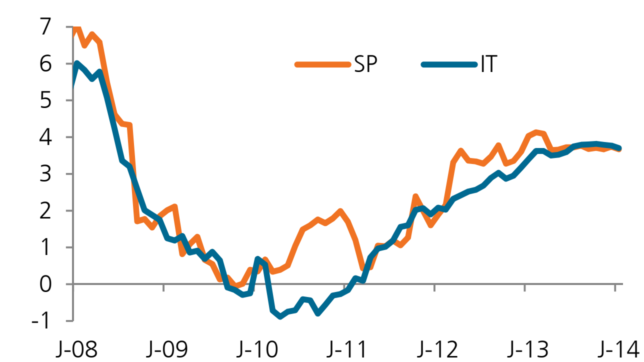
There are little margins for fiscal policy to support demand as, at least in theory, a tightening amounting to 0.3% of GDP is needed in 2015

To sum up, then, monetary policy currently has rather "blunt" weapons at its disposal. Since the ECB's courses of action cannot have the effect of "magic bullets", the most effective tool, in theory, as a means of sustaining recovery in a weak-demand situation like the present one, would be fiscal policy. The point is that margins appear to be at least thin. On average, the requirement to meet the targets set out in the Stability Programmes would involve an adjustment in 2015. Specifically, a comparison between the situation under existing legislation and the targets defined by Europe would require an adjustment of the order of 0.3% of GDP next year. At the time of writing, the national budget laws, which, at least in theory, should put into effect the adjustment requested for 2015, have not yet been drafted, and so it is not clear whether or not this would be effective. However, in the "worst case" scenario, in which this is fully translated into legislative provisions, there would probably be a negative impact of around -0.2% on 2015 GDP.

It is true, however, that a “virtuous” restructuring of public finances, intended - as in the efforts made by various countries (Italy first among them) - to strip out "unproductive" expenditure to finance cuts to direct taxes and social security contributions (although, in some countries, higher indirect taxes could also be necessary) would have, other effects on the government budget balance being equal, a positive effect on the economic cycle. This effect would not, however, seem to be enough to fully offset the negative impact of the entry into effect of the “traditional” fiscal policy multiplier. The only country capable of wielding any significant fiscal leverage is Germany, which, however, seems to have no intention of complying with the many calls to use tax cuts to stimulate domestic demand, acting as "Europe's engine". At European level, it is to be hoped that the current debate on the general direction of financial policies will at least identify larger margins for increasing public investment; moreover, the exact nature of the EUR 300Bn package over three years just announced by the new President of the European Commission also remains to be seen.

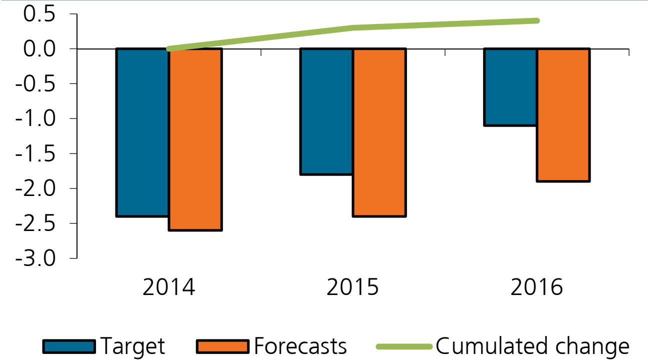
In summary, bearing in mind the possibility that fiscal consolidation might not be fully implemented, as well as the mitigating effect of the other factors already mentioned and, most importantly, the hopefully more virtuous restructuring of public finance, the effect of fiscal policy in 2015 on the economy could be slightly less than that indicated by the multiplier mechanism, at -0.1% of GDP.

The increase in interest rates on corporate lending in a number of countries (in real terms) indicates problems with the transmission of the monetary policy stimulus



NB: rates on 1-5 year (outstanding) loans to non-financial businesses, deflated by the CPI. Source: Intesa Sanpaolo chart based on ECB data

To achieve the governments' budget targets, a correction of around 0.3% of 2015 GDP would be required (at least in theory)



Source: EU-IMF Programmes for countries in an adjustment programme and 2014 Stability Programmes for the rest of the countries (target); European Commission (projections); Intesa Sanpaolo chart

Structural reforms are important but may not have a significant impact in the short term

As for "structural" reforms, the other potential levy to trigger growth, Mr Draghi referred, in his speech, as mentioned above, to two types of measures:

1) a regulatory framework that is more favourable to growth and the development of new businesses, which would entail less bureaucracy, simplification, greater legal certainty; more labour market flexibility; and more openness to competition, especially in certain service segments (regulated professions);

2) better and wider access by businesses to the capital market, which means developing alternative sources of finance other than banks, such as stock and bond markets, securitisations, lending by insurance companies and asset managers, venture capital and joint finance; developing a properly functioning and transparent ABS market; greater integration of the stock and corporate bond markets; all with the aim of creating a union of capital markets that extends to all the EU Member States.

While we agree that it is important to focus on structural reforms, we think that such efforts will struggle to have any appreciable impact on growth in 2015 in that: a) the time required to address these issues will of necessity be protracted; b) once approved, the reforms will generate effects on the economic cycle in the medium term rather than immediately. So, we cannot even expect that this channel will significantly accelerate the economic recovery, at least in the next 12 months.

In theory, the conditions are in place for a (modest) economic recovery, mainly on the investment front

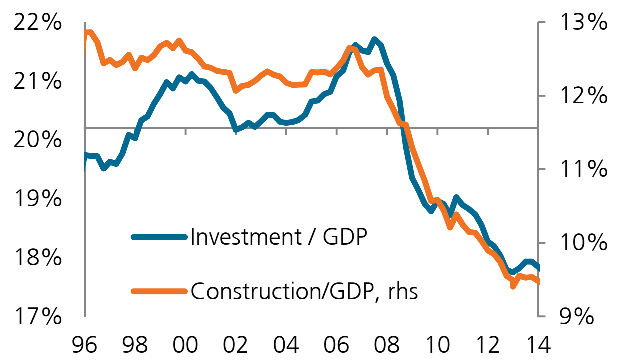
To sum up, it is currently very difficult, in the current economic policy mix, to identify any "structural" stimulus that will generate a significant recovery in domestic demand. This is the very reason that the present recovery will continue to be modest, in our view, including over the next year. On the other hand, it is also true that some of the conditions for an economic recovery are in place. As regards investment in particular, quite apart from the need to rebuild capital after the epic fall over recent years (investment fell by around 20% from its pre-crisis peak, compared with the 15% recorded during the 1992 recession, and, despite the recent recovery, investment is still very close to its historic lows in terms of GDP), the impetus towards recovery might well come from:

1) improved profit margins, although recent developments in the economic outlook raise doubts as to the sustainability of this trend;

2) improved lending conditions (according to the July BLS forecast, banks relaxed their criteria for lending to businesses in the second quarter of 2014 – the first time they have done this since 2007) - and, more generally, financial conditions and access to the capital markets (also facilitated by the ECB's new measures).

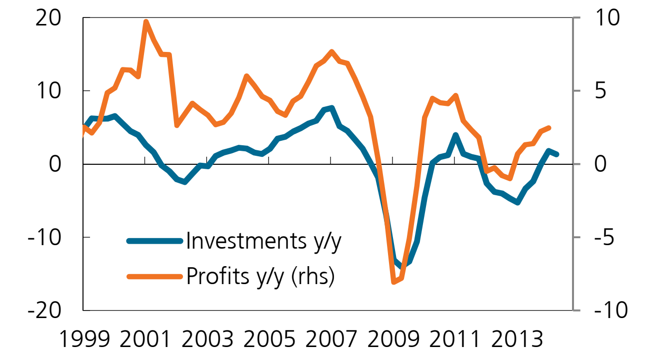
On the other hand, under-utilisation of production capacity and, particularly, the high degree of uncertainty that is still hampering growth in demand, are causing businesses to defer decisions on spending. At this stage, demand from abroad is becoming weaker, while domestic demand is not yet strong enough to pick up the baton.

Investment is at historic lows in relation to GDP



Source: Intesa Sanpaolo chart from Eurostat data

Capital spending will be encouraged by improvements in companies' gross operating margins, which are already making their presence felt



Source: Intesa Sanpaolo chart from Eurostat data

Demand from abroad appears to have been reduced, not only as a result of geopolitical tensions

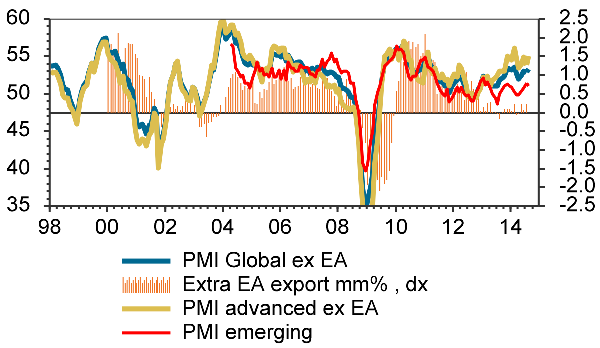
Demand from abroad appears to have significantly slowed recently. Exports increased by almost 0.3% qoq on average in the first half of the year (following the 0.7% qoq average of 2013). Geopolitical tensions were some of the reasons but not the only ones.

There are, in essence, two ways in which geopolitical tensions between Russia and Ukraine impact Euro zone exports. First of all, there is a decline in sales to Russia, due to the slowing economy in that country (Russian GDP contracted in the first half of the year, and is expected to continue its drop in the remaining quarters of 2014). Added to this is the impact of the ban on the import of certain foodstuffs imposed by Russia on various countries, including those belonging to the Euro zone. We assume that the present tensions will continue (i.e. neither a quick resolution nor an increase) and so exports to Russia will continue to fall over the coming year at the same rate as that seen recently. As Russia accounts for 4.8% of the Euro zone's foreign demand, a drop of 14% in exports to that country (as seen in the first half of the year) would, if it persisted for a year, have a negative impact of around 0.7% on Euro zone export growth (and of some 0.3% on its GDP). Conversely, the impact of reduced exports to Ukraine (-28% in the first six months of the year, but amounting to just 0.8% of the total) will be limited, at barely one-tenth of a percentage point of GDP.

However, the weakening of foreign demand for goods and services from the Euro zone is only partly due to geopolitical tensions. There has also been a noticeable fall in exports to Turkey (-8%), as well as to Brazil (-6%), India and the OPEC countries (-2%). In short, it appears that reduced demand from a number of emerging countries is curbing exports. At the opposite extreme, sales to the Anglo-Saxon countries (UK: +8%, and US: +6% in the first half of 2014) are remaining robust, as are sales to Eastern Europe (Poland, the Czech Republic and Hungary: +8%) and China (+8%).

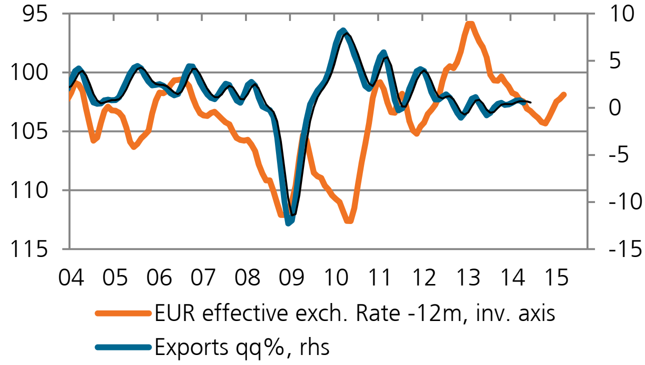
The apparent weakness in exports in the first half of the year may be due to the exchange rate (which reached 1.37 against the dollar in the first half of 2014, compared with the present 1.26). However, this factor is now moving in the opposite direction, accelerating markedly in September. In our estimates, which are based on the Oxford Economics simultaneous equations forecasting model, a 10% change in the euro/dollar exchange rate, if permanent, would, after a year, translate into a change of 1.8% in exports, 0.7% in investment, and 0.8% in Euro zone GDP. It follows, then, that, if the exchange rate were to remain at current levels (-4.5% compared with the 2014 average), it would result in an increase of 0.8% on exports, 0.3% on investment and 0.4% on GDP next year. It must also be said, though, that the depreciation of the euro had already been largely taken into account in our June forecasts.

The global PMI for non-Euro zone countries points to a recovery in exports over the next few months, largely thanks to the contribution of the developed countries



Source: Intesa Sanpaolo chart based on Eurostat and Markit data

The weaker effective exchange rate (-4.5% from its peak in March 2014) is likely to help sustain exports

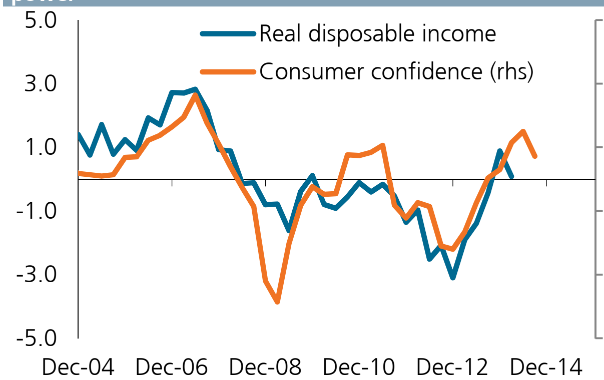


Source: Intesa Sanpaolo chart based on Eurostat and ECB data

The modest recovery in consumption could continue

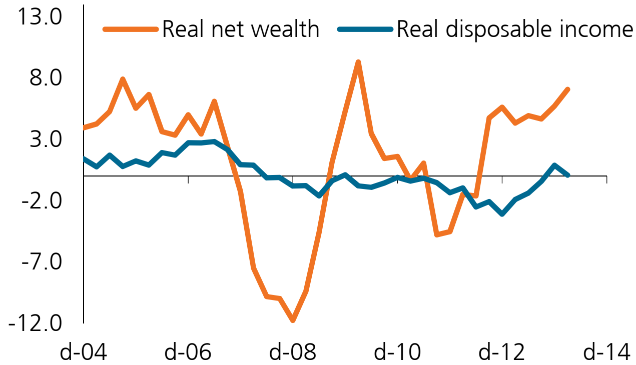
Turning to consumption, we take the view that, in the second half of the year, this could continue to grow at the average rate of 0.2% qoq seen during the last year, starting from Spring 2013. We have recently seen a downturn in consumer confidence, which could be connected with the decline in disposable income observed in early 2014; in any event, the conditions appear to be in place for a continued modest recovery (which could rise to 0.3% qoq in 2015). 2014 has, in fact, been the first year in which households have seen their disposable income increase in real terms (+0.4%) after four years of contraction. Of course, we will need to wait until 2015 to see if this improvement in disposable income translates into higher spending. The labour market, too, while still weak, seems to have got through its worst, given that unemployment peaked at 12% last year and then started to fall, down to 11.5% in July; while this decline will remain very gradual, next year we should see an average unemployment rate of nearly one percentage point lower than last year.

The recent decline in consumer confidence appears to be connected with the slowdown in the recovery of purchasing power



Source: Intesa Sanpaolo chart and forecasts based on Eurostat data

Consumer spending recovery (albeit modest) may be boosted not only by income but also by the wealth effect

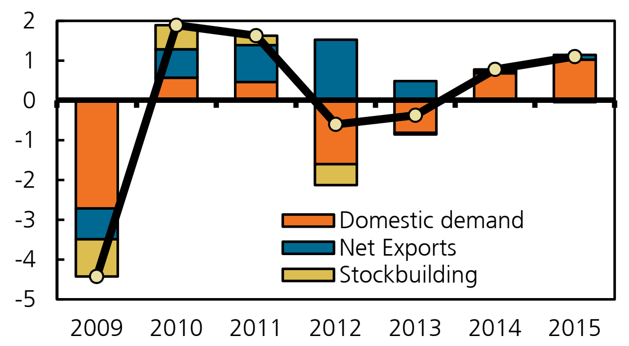


Source: Intesa Sanpaolo chart based on Eurostat

Our forecast for 2015 is lower than the consensus

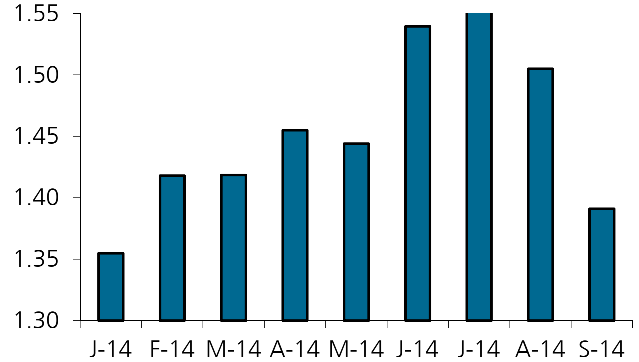
In summary, the cycle will, in 2015, continue to will highly dependent on abroad, and the recovery in final domestic demand (net of inventories) will be modest (1% versus 0.8% in 2014). Nonetheless, the conditions are in place for a recovery in investment (+1.9%, thanks to investment in machinery and equipment, while investment in construction will continue to increase only slightly, at a rate lower than that of GDP) and consumption will speed up (to 1.1% from this year's figure of 0.7%). Inventories could knock at least one-tenth of a percentage point off growth. Our forecast for 2015 GDP (1.1%) is lower than the consensus.

Intesa Sanpaolo estimates of the main components of demands



Source: Intesa Sanpaolo charts and forecasts based on Eurostat data

A process of downward revision to the consensus estimates of Euro zone GDP in 2015 is under way (and we believe it will go on through the next few months)



Source: Consensus Economics

Inflation close to 1.0% also in 2016; exchange rate risks subsiding but growth is weakening

Anna Maria Grimaldi

Inflation fell more than expected over the summer months, to 0.4% in August (see Fig. 1). Generally speaking, most analysts and the ECB have overestimated the consumer price trend in 2014. On average, inflation is projected to close the year at 0.6%, compared with 1.4% in 2013. More than 70% of the slowdown in consumer prices in the last 12 months has been due to energy and food (see Fig. 2). Effective exchange rate appreciation (+10% between September 2012 and April 2014) is expected to have had an effect of 0.4-0.5%.

Food and energy have caused more than 70% of the decline in Euro zone inflation

Excluding food and energy, consumer price trends have slowed by only four-tenths of a point in the past year; after hitting a low of 0.6% in May, prices climbed back to 0.9% in August. The moderation in underlying inflation partly reflects a slowdown in non-energy goods prices between March (+0.4%) and July (0.0%) of 2014. A decrease in goods prices is usually due more to global factors than domestic ones, as goods are either imported or include a large proportion of imports. Services inflation excluding the transport component, which is typically more affected by domestic factors, also helped to curb core inflation. The fall in services prices is mainly due to the reduction in communications prices in 2013, a phenomenon that emerged in the mid-2000s and which is not attributable - or only minimally - to weakness in domestic demand. However, the slowdown in non-energy services inflation in 2014 also reflected the leisure, hotels and restaurants components, which are more directly influenced by demand-related factors (see Fig. 4). Inflation net of energy, food, tobacco, taxes and administered prices (cyclical inflation) rose to 0.7% in August from 0.5% in May, and is more or less unchanged year-on-year. Cyclical inflation is still lower in the peripheral countries than in the core countries.

Exchange rate depreciation, which has been more rapid than our June forecast, has eliminated one of the main downside risks

August should indicate the lowest point for inflation, since the decline in underlying inflation is likely to come to a halt. However, the negative effect of the energy component could continue. We confirm our forecast of a gradual rise in inflation over the forecast horizon, with a projected 1.1% rise in 2015, while our 2016 estimate is now 1.3%, one-tenth of a point less than previously. With regard to external factors, the forecast is based on an oil price of USD 100-102/barrel in 2015-16 (marginally lower than in June), and a decrease in the effective exchange rate to 98.78 from the current 99.5 (the same as in June). However, compared with our June projections, the exchange rate will be marginally lower in 2014 and in 2015, as the adjustment in the summer months was faster than expected. The effect of external factors is therefore expected to be broadly unchanged on the June forecasts, as lower oil prices will be offset by a slightly weaker exchange rate. Inflation volatility over the forecast horizon will still be attributable to food and energy trends. The energy component's contribution to the consumer price trend is expected to rise from -0.1% in 2014 to 0.1% in 2015, significantly less than the 0.6% recorded in the period 2003-12. We expect to see a gradual rise in the food component from early 2015, when statistical effects relating to the mild weather in 2014 will cease to be a factor in the year-on-year comparison. We expect food prices to climb back gradually to 2% over the forecast horizon. On average, food prices should contribute 0.2% to inflation, which is again less than in 2003-12 (0.5%).

Our forecast for underlying inflation is only a slight increase over the forecast horizon, to 1.3% at the end of 2016. In our more recent projections, GDP growth is just 1.1%, or 0.4 points less than the June forecast. The momentum from the cycle will therefore be too weak to trigger the closing of the output gap (which we expect to remain largely unchanged at -3.4% according to the latest OECD estimates for 2014). Consequently, we are assuming that labour costs will remain under control, slowing to 0.7% in 2015 before regaining ground to about 1.2% in 2016. The fall in labour costs is due to moderate wages growth (1.7% in 2015 and 2.0% in 2016) as the productivity cycle accelerates.

The ECB's core inflation forecasts seem overly optimistic

Our forecasts are in line with the latest ECB forecasts for 2015, but are lower for the first half of 2016. The discrepancy is due more to domestic factors than assumptions about external factors. Compared with our forecasts, the ECB estimates include an oil price that is around USD 4 higher in 2015-16, but a flat effective exchange rate over the forecast horizon. The difference is due to the underlying inflation estimate: the ECB expects a rise to 1.2% in 2015 and 1.5% in 2016, compared with 1.1% in 2015 and 1.3% in 2016 according to our forecast. The ECB's growth forecasts for 2015 and 2016 (1.6% and 1.9% respectively) are much more optimistic than our scenario (1.1% and 1.4% respectively). On this reasoning, the output gap in the ECB forecasts will narrow by around half a point by the end of 2016, while according to our growth forecasts, it will be broadly unchanged, at -3.4%. It is also true that the ECB has always shown a certain amount of scepticism about the impact of changes in the output gap on underlying inflation. There has been a substantial downwards revision to ECB core inflation forecasts for 2014-15 since December 2013.

The ECB has said that the risks to the September inflation forecasts are balanced. However, we believe that the balance of risks for the ECB forecasts is still to the downside, as GDP growth forecasts seem overly optimistic. Risks arising from external factors are likely to be limited and marginally to the upside. According to the ECB, effective exchange rate depreciation of around 4.5 points in 2015 (simulated using an exchange rate of EUR 1.24), would result in a fall in inflation of between 0.1% and 0.3% in 2015 and in 2016. Meanwhile, the ECB has specified that a 6% increase in oil prices in 2015 and a 10% increase in 2016 (not improbable if geopolitical tensions intensify in oil-producing countries such as Russia) would push inflation up by 0.1% and 0.2% respectively.

Risks to the consumer price trend largely depend on the strength of the recovery

Broadly speaking, inflation will stay closer to 1.0% than 2.0% until the end of 2016. The risks for the inflation outlook are still to the downside, but have reduced to some extent since June, due to the correction in the euro. The depreciation in the effective exchange rate is consistent with our June forecasts, but the fact that it took place more rapidly has considerably reduced what we had identified as the main external risk factor. At this point, and if exchange rate depreciation continues, the main downside risk for consumer prices lies in cyclical trends, which have turned out to be weaker than forecast. It is also possible, as we emerge from this particularly severe crisis, that not only the change in the output gap but also its extent (it is currently at its widest since 1998) could affect core prices. Crude estimates of the ratio between unused capacity in the economy of peripheral countries and core price trends at constant tax rates confirm that, since 2010, core inflation has been explained not only by changes in the output gap, but also by its extent (see Figs 13 and 14).

Lastly, we cannot ignore the fact that, if inflation remains significantly lower than the ECB forecast in the long term, there is a risk that price projections will start to change more markedly. Short-term price forecasts based on surveys of businesses and households are stable, and indices of price charged have actually risen in recent months (see Figs 20 and 21). Medium-term forecasts have also begun to change. According to the ECB's survey of Professional Forecasters, five-year projections dropped to 1.8% in the second quarter and then rose to 1.9% in July. However, five-year forward inflation expectations have fallen in the past five months, and the trend did not reverse following the measures announced in September (see Figs 20 and 22). The ECB is clearly concerned about the change in inflation forecasts and risks to medium-term price stability, and will confirm that it is "ready to use other unconventional measures and/or alter the composition of the interventions already prepared if the cycle continues to slow".

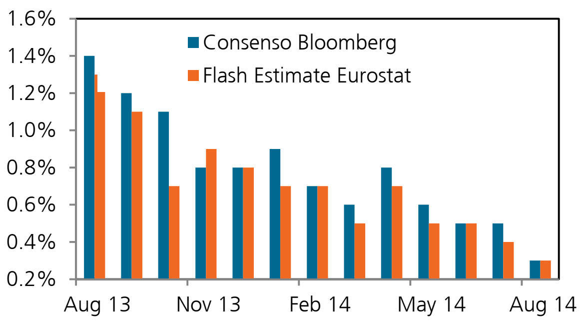
The longer inflation remains at current levels, the greater the risk of medium-term forecasts moving away from 2%

Table 1 – Comparison of key growth assumptions based on ECB and ISP inflation estimates

	2013	2014	2015	2016	4° trim. 2016
USD/EUR Sett 14 BCE	1.33	1.36	1.34	1.34	
USD/EUR Giu 14 BCE	1.33	1.38	1.38	1.38	
USD/EUR ISP	*1.33*	*1.34*	*1.26*	*1.28*	
*USD/EUR Consenso**	*1.33*	*1.34*	*1.27*	*1.28*	
Nom eff exch rate Sett 14 BCE	3.8	1.4	-0.8	0.0	
Nom eff exch rate Giu 14 BCE	3.7	2.6	0.1	0.0	
Nom eff exch rate ISP	*3.7*	*2.2*	*-4.0*	*2.0*	
Oil BCE Sett 14	108.8	107.4	105.3	102.7	
Oil ISP Sett 14	*108.8*	*105*	*100.7*	*102*	
Oil Consensus Sett 14	*108.8*	*103.9*	*103.4*		
Inflazione headline Sett 14 BCE*	1.4	0.6 *(0.7)*	1.1 *(1.1)*	1.4 *(1,4)*	1.5 *(1,5)*
Inflazione headline Sett 14 *ISP*	*1.4*	*0.6*	*1.1*	*1.4*	*1.5*
Inflazione headline Sett 14 *Consenso*	*1.4*	*0.6*	*1.1*	*1.5*	
Inflazione core Sett14 BCE*	1.1	0.9 *(1.0)*	1.2 *(1.2)*	1.5 *(1.5)*	
Inflazione core Sett 14 *ISP*	*1.1*	*0.9*	*1.0*	*1.1*	
Inflazione core stima sulla base dei fattori stagionali	*1.1*	*0,9*	*1.1*	*1.2*	
Crescita del PIL AE Sett BCE	-0.4	0.9	1.6	1.9	
Crescita del PIL AE Sett ISP	-0.4	0.8	1.1	1.4	
Crescita del PIL AE Sett Consenso	-0.4	0.9	1.4.	nd	

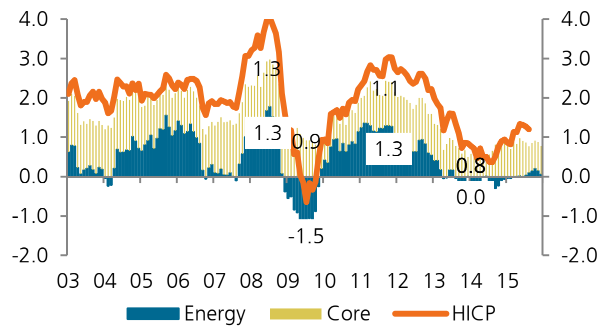
*EUR consensus estimates relate to September 2015 and 2016. ECB estimates in June 2014 in brackets
Source: ECB and Intesa Sanpaolo estimates

Fig. 1 – In the past year inflation surprised on the downside 8 out of 12 times



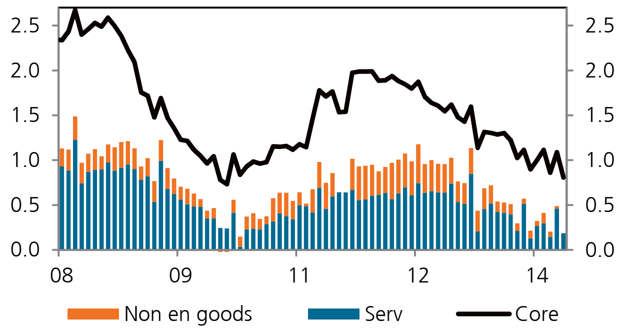
Source: Intesa Sanpaolo chart based on Eurostat and Bloomberg data

Fig. 2 – The fall in inflation is largely due to volatile components



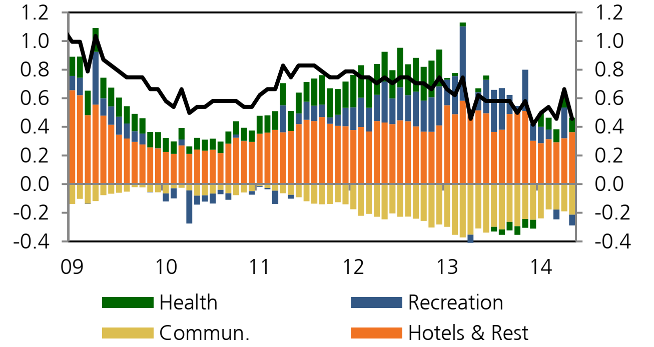
Source: Intesa Sanpaolo forecasts based on Eurostat data

Fig. 3 - The slowdown in core inflation is due to falling non-energy goods prices, but non-energy services prices have also slowed recently



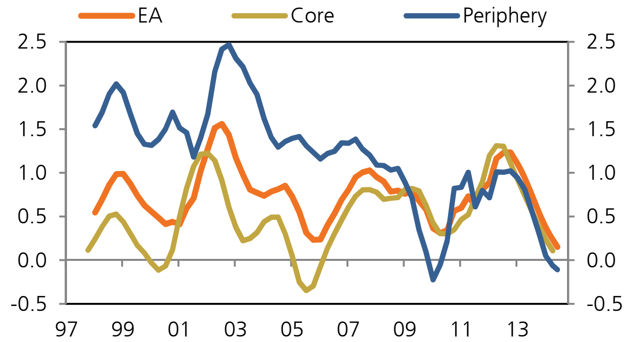
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 4 - The fall in services inflation is not only due to telecommunications, but also hotels and restaurants



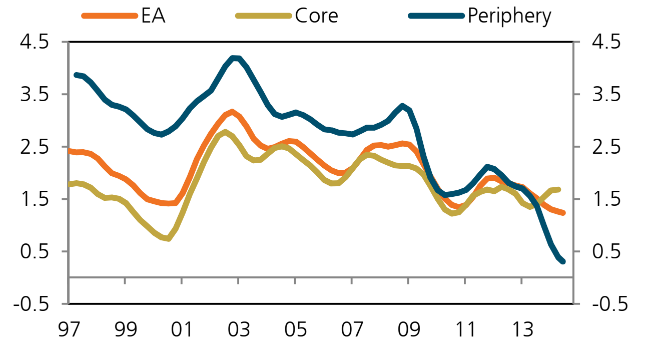
Source: Intesa Sanpaolo forecasts based on Eurostat data

Fig. 5 - Non-energy goods inflation in the peripheral countries is zero, but this aggregate is more affected by external factors (exchange rates)



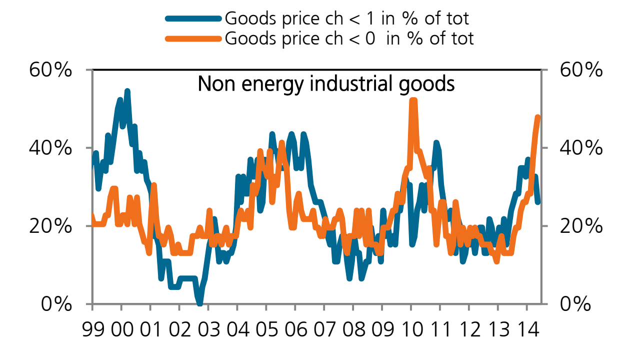
NB: Peripheral countries = Ita+Spa+Gr+Pt+Irl; Core countries = Germ+Fr+ Nl+ Bel
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 6 – Services prices most closely linked to domestic factors have slowed more than non-energy goods prices in the peripheral countries



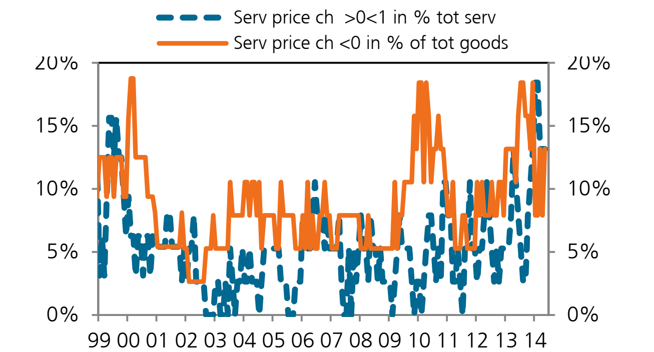
NB: Peripheral countries = Ita+Spa+Gr+Pt+Irl; Core countries = Germ+Fr+ Nl+ Bel
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 7 – On average in the Euro zone, the percentage of goods with prices in negative territory is no higher than in the past, but...



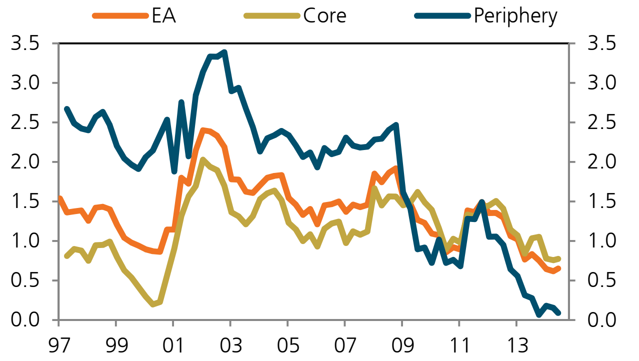
NB: Percentages are calculated from 46 non-energy goods sub-indices
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 8 – ... the percentage of services with changes of less than 1.0% is still at an all-time high



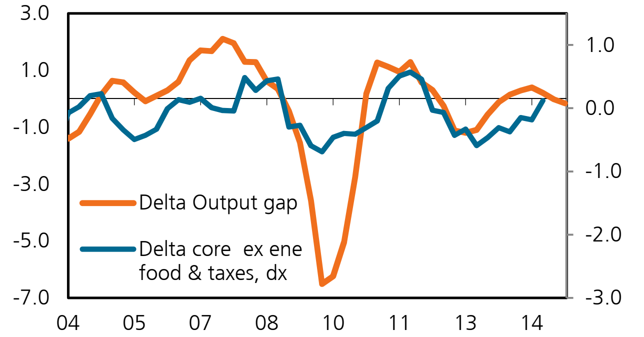
NB: Percentages are calculated from 38 services sub-indices
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 9 - Core inflation net of taxes has not only slowed in the peripheral countries but also in the core countries



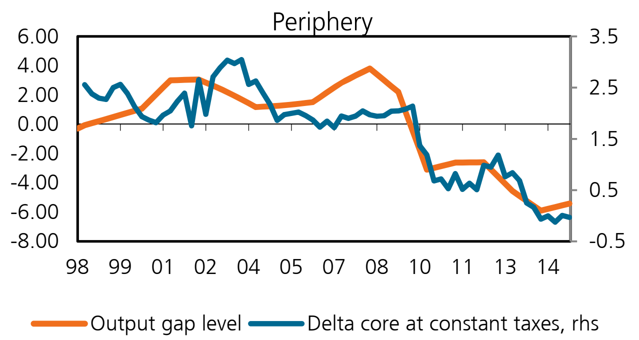
NB: Peripheral countries = Ita+Spa+Gr+Pt+Irl; Core countries = Germ+Fr+ Nl+ Bel
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 10 – Growth momentum over the forecast horizon will, in our view, be insufficient to close the output gap further



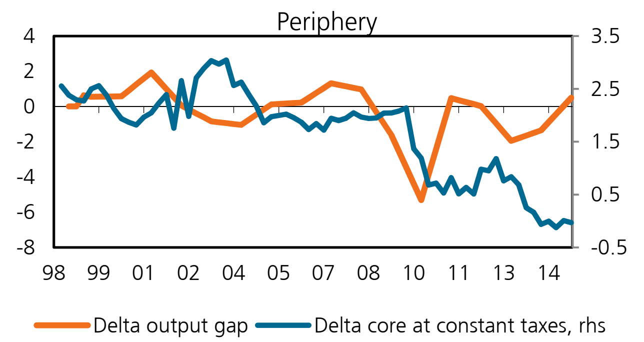
NB: We use OECD estimates for the output gap
Source: Intesa Sanpaolo chart based on OECD and Eurostat data

Fig. 11 – More recently in the peripheral countries, the core inflation trend has depended more on the level than…



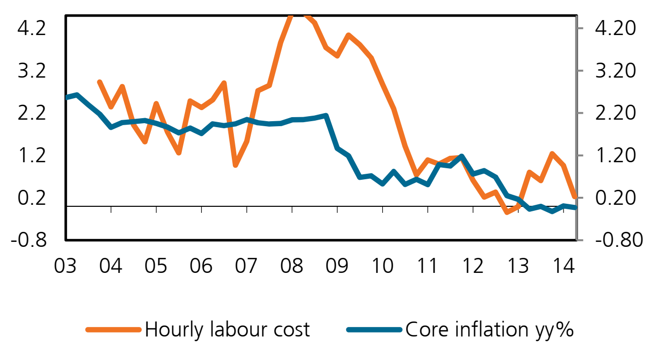
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 12 – …the change in the output gap



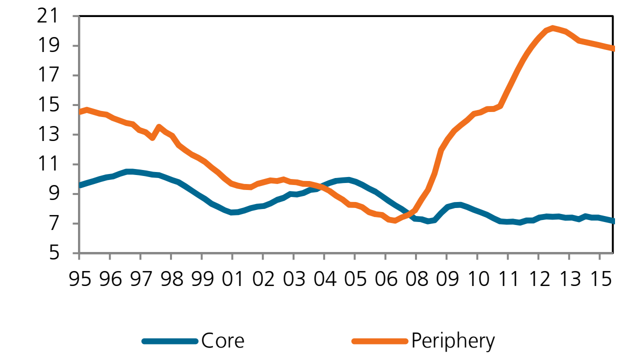
NB: We use OECD estimates for the output gap
Source: Intesa Sanpaolo chart based on OECD and Eurostat data

Fig. 13 – The process of wage moderation in the peripheral countries is temporary but will not come to an end any time soon, partly because of…



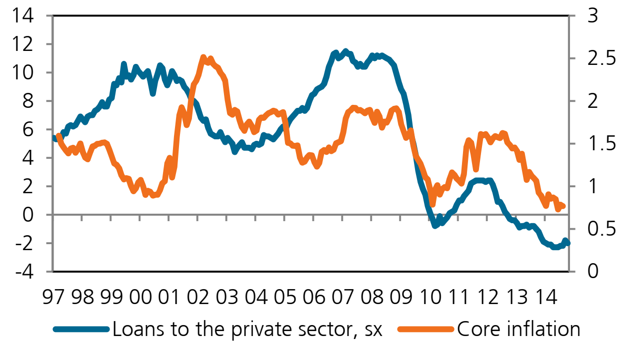
NB: The output gap is based on OECD estimates
Source: Intesa Sanpaolo chart based on OECD and Eurostat data

Fig. 14 – … the high unemployment level, which we expect to fall only slowly over the forecast horizon



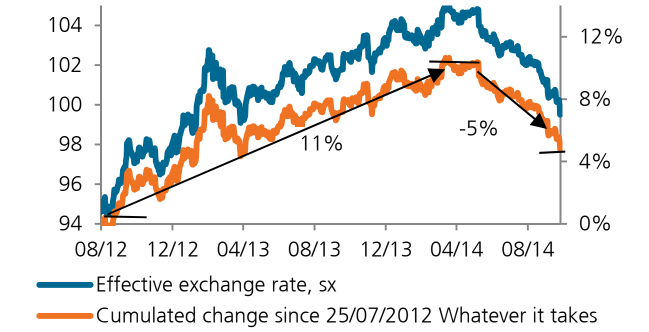
NB: The output gap is based on OECD estimates
Source: Intesa Sanpaolo chart based on OECD and Eurostat data

Fig. 15 – Credit continues to contract



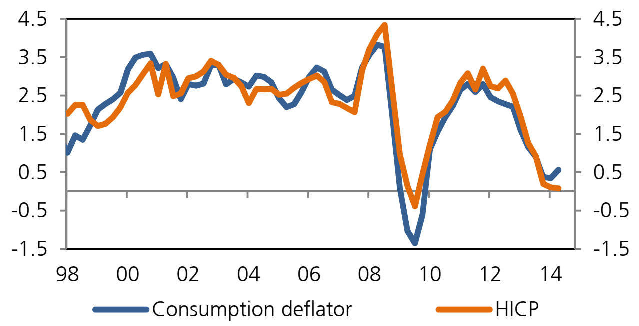
Source: Intesa Sanpaolo chart based on ECB data

Fig. 16 – Exchange rate depreciation eliminates one of the main downside risks for headline inflation



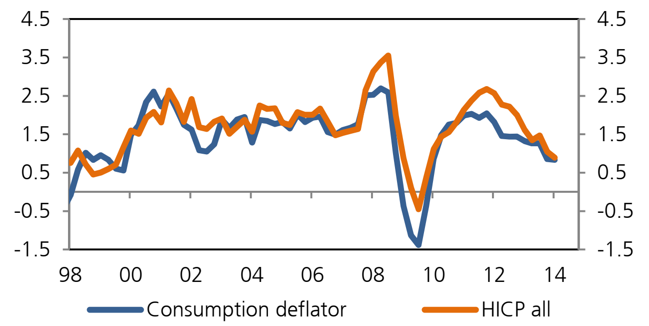
Source: Intesa Sanpaolo chart based on ECB data

Fig. 17 – The consumption deflator confirms that prices have fallen more steeply in the peripheral countries than…



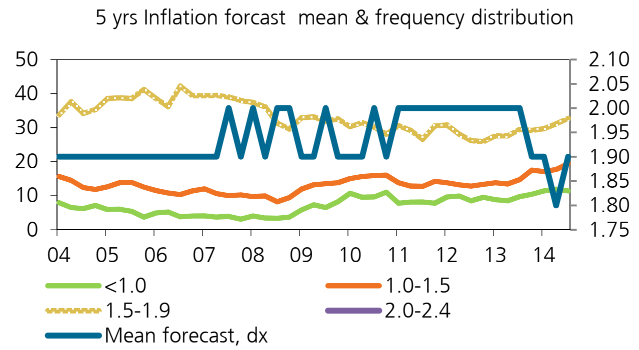
NB: Peripheral countries = Ita+Spa+Gr+Pt+Irl
Source: Intesa Sanpaolo chart based on Eurostat data

Fig. 18 - …in the core countries



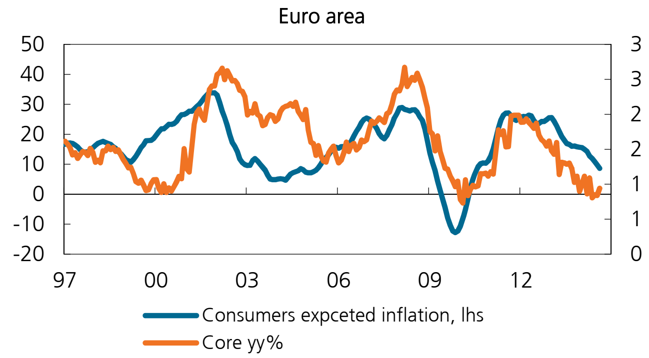
NB: Core countries = Germ +Fr+ Nl+ Bel
Source: Intesa Sanpaolo forecasts based on Eurostat data

Fig. 19 - Medium-term forecasts in the Survey of Professional Forecasters (SPF) fell to 1.8% on average, and the frequency distribution shifted further towards the lower end



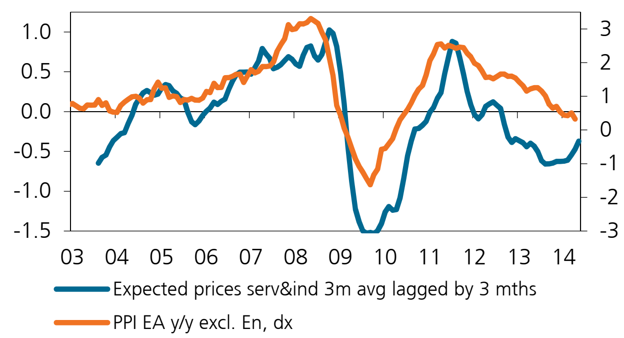
NB: 5 yrs Inflation forecast mean & frequency distribution Source: Intesa Sanpaolo chart from ECB Survey of Professional Forecasters (SPF)

Fig. 20 – Household expectations are sliding slowly downwards, but have not reached record lows



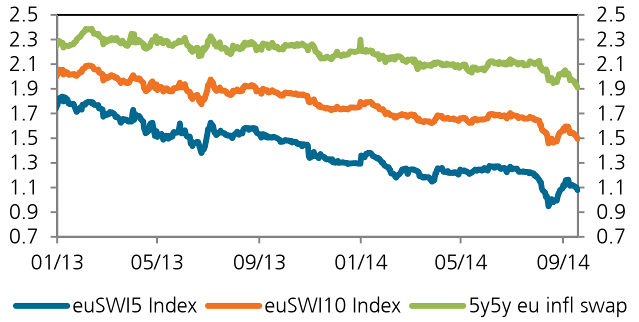
Source: Intesa Sanpaolo chart based on ECB data

Fig. 21 – Downward pressure at the top of the supply chain excluding energy seems to have subsided



NB: expectations of average prices offered from indices of prices offered in industry, services, retail and construction, taken from the EU Commission survey. The series are standardised.
Source: Intesa Sanpaolo chart based on EU Commission and Eurostat data

Fig. 22 – Market inflation forecasts have been sliding downwards in recent months



Source: Intesa Sanpaolo chart based on Bloomberg data

ECB: the slow march towards a more active management of the balance sheet

Anna Maria Grimaldi

In our June Outlook we warned that the ECB would probably be forced to make a move before the autumn, as the measures announced in June would likely prove insufficient to contrast the risks to short-term growth, as well as contain a possible rise in real interest rates. One of the options we mentioned was the announcement of an ABS purchase programme for the autumn. In September, the ECB acknowledged the downside risks to the macroeconomic outlook and falling inflation expectations and a further cut to the refi rate (to 0.05%) and the deposit rate (to -0.2%). Moreover, as we had expected, it was forced to announce an ABS (ABSPP) and covered bond (CBPP3) purchase programme.

ECB moves in line with June expectations

The key point is that Mario Draghi, during his Testimony at the European Parliament on 22 September, stated that the ECB: "is starting a transition from a monetary policy framework predominantly founded on passive provision of central bank credit to a more active and controlled management of our balance sheet." Through its asset purchase programmes and TLTROs, the ECB aims to expand its balance sheet by approximately EUR 1Trn, bringing it back to the 2012 level.

In 2015, the decline in ECB assets could be in the order of EUR 440Bn to 470Bn, or 22% of the total of which EUR 335Bn outstanding from the 2011-12 LTROs and EUR 140Bn from the SMP.

A 1 trillion expansion of the ECB balance sheet can be hardly achieved with the TLTROs, we think. The take up at the September auction added up to 82.6 billion euros, less than estimated by Reuters Consensus (100 billion). Net liquidity creation was just over 60 billion euros, as 26 billion taken out at the 2011 – 12 LTROs were repaid. Even assuming much stronger demand at the December auction, we doubt gross liquidity creation will exceed 300 billion euros at the first two auctions, falling short of the upper limit of 400 billion euros (7% of loans to the non-financial private sector, net of mortgages), given the scarce interest of banks in countries where money rates are already at zero or in negative territory. In 2015, 140 billion of government securities purchased with the SMP are coming to maturity on the top of the 335 billion from the first two LTROs. Thus, the ECB's balance sheet could shrink by an additional 22%.

Will ABS purchases turn out to be a 2-best for QE?

Thus if the ECB wants to stop its balance sheet from contracting further or bring it back to the 2012 peak levels, it will have to be aggressive on ABS purchases. More than one Member of the GC hinted the program could entail sizeable purchases. Draghi suggested the assets' pool which the ECB can target is rather ample (just under 1 trillion euros) as the ECB will buy not only senior tranches of traditional ABS placed with investors but also retained ABS. As for asset types, the ECB more than one member of the GC suggested the ECB will buy not only senior but also mezzanine tranches if backed by national or supranational guarantees.

The purchases will also include RMBS (real estate mortgage back securities) which represent 60% of outstanding ABS. As per the geographical break down 80% of ABS are originated in Itlay. In terms of geographical breakdown, 80% of mortgage securitisations originate in Italy, France, Spain, and Holland.

indications provided by several members of the Governing Council on the size of the programme and on the type of purchases, lead us to believe that through the purchase of ABSs the ECB aims not only to kick start a specific segment of the market, but also to free risk capital for banks, and therefore room for the issue of new loans; at the same time, the ECB will want to encourage investors to move along the credit curve. In essence, the impression is that the ECB intends to make ABS purchases a surrogate of full-fledged QE.[2]

Table 1 - Securitisation in the Euro zone by type of loan and country (EUR Bn)

	Debt securities	Traditional securitized loans		
		of which	*NFC*	HSHDS
MT	1.1			
PT	25.7	33.1	4.9	27.7
DE	44.6	40.09	2.6	35.8
LU	84.6	52.18	6.3	1.0
BE	86.1	85.2	16.4	63.4
IT	193.3	236	58.5	119.0
FR	210.4	174.1	10.7	126.2
ES	232.9	148	29.7	117.9
IE	249.7	169.5	50.5	44.8
NL	338.5	304.1	10.57	192.9
Euro area	1467	1250	190.4	728.6

Source: Intesa Sanpaolo chart based on ECB data

Assuming that the senior tranches represent between 25% and 30% of the total outstanding issue, the asset pool that the ECB could initially target would probably amount to EUR 300-400Bn.

Statements by Council Members about the possibility of initially including only senior tranches, followed by purchases of secured mezzanine tranches, leads us to believe that the ECB:

I. will indicate a maximum quantity for purchases of senior tranches and will reserve the power to increase this in case of need;

II. will not specify the time horizon over which it plans to make the purchases;

III. will specify that the composition of purchases may change over time and include new securitisation issues, as well as mezzanine tranches;

IV. will provide at least a rough indication of the procedures it will use to price ABS not placed with end-investors.

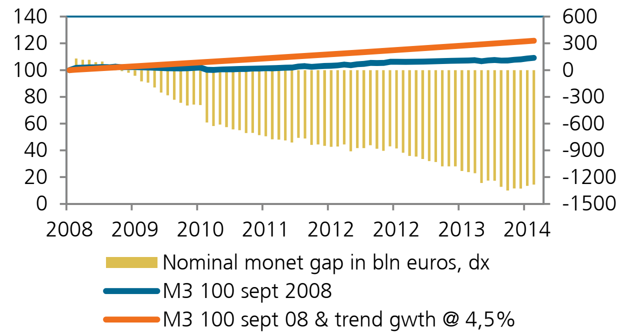
The success of the ABS purchase programme depends not only on its scale, but also on how aggressive the ECB will be is in terms of the prices offered, particularly for retained ABS for which there is no market. The ECB will have to be aggressive on pricing if it wants to contribute to banks balance sheets' repair

[2] A quantitative stimulus programme in the strictest sense implies an expansion of the central bank's balance sheet in order to achieve a set goal in terms of the money base, and to reap effects on the size of reserves held by banks.

ensure that the banks give up their paper and that investors move along the risk curve, providing incentives for the development of a market for more junior tranches, stimulating the primary market, narrowing credit spreads and helping to free up venture capital for the banks.

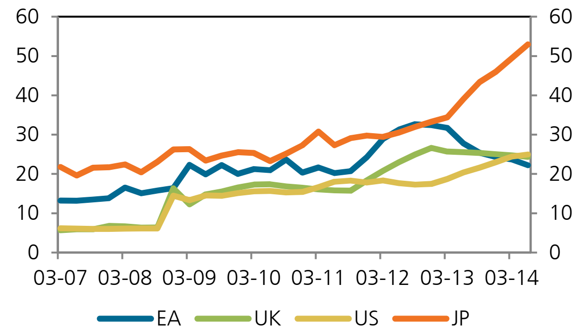
What else will the ECB do? We believe that the likelihood of a quantitative easing program which includes purchase of government securities is still less than 50%, but it is also true that after its September measures, the ECB does not have much left to do to give fresh momentum to monetary policy. If the recovery continues to slow in the early months of next year, and if take up at December and March TLTROs is low, the ECB could first of all opt to increase ABS purchases. Only if outlook for inflation was to deteriorate further or real euro interest rates were to start moving in tandem with US rates (in the wake of an imminent turnaround in US rates), the ECB would move to a QE. The operational obstacles associated with a QE announcement should not be underestimated, as we pointed out in the *Weekly Economic Monitor* of 02.05.2014. For now, the markets still believe that the ECB would be prepared to step in with government purchases, should the measures adopted prove ineffective. The ECB has thus been able to manage market expectations with its statements, and this is what counts when policy rates are at the lower bound.

Fig. 1 – The theoretical currency gap from September 2008 to today is EUR 1.2Trn



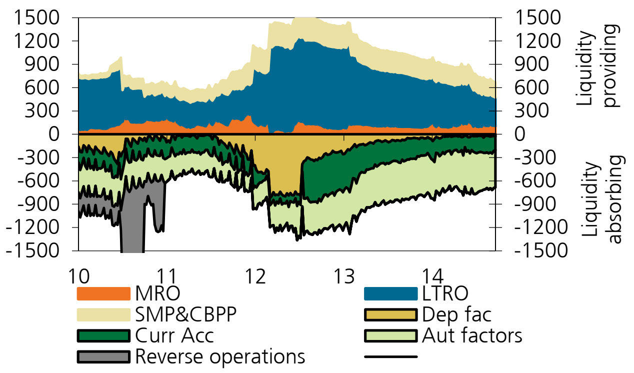
Source: Intesa Sanpaolo chart based on ECB data

Fig.2 – An expansion of EUR 1Trn would take the ECB's balance sheet to the 2012 level



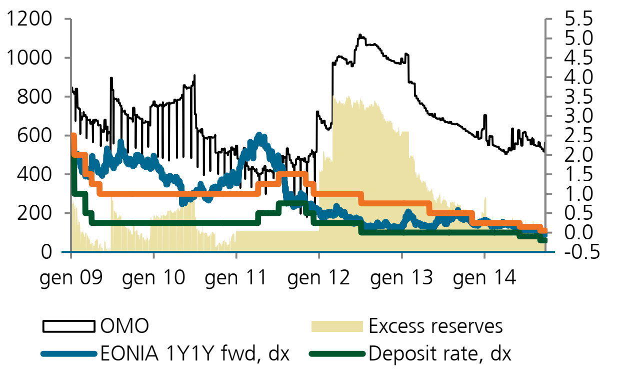
Intesa Sanpaolo chart based on national central bank data

Fig. 3 – But this time, balance sheet management should be more controlled by the ECB, due to the ABS purchases



Source: Intesa Sanpaolo chart based on ECB data

Fig. 4 – The structure of short-term interest rates will be influenced by surplus reserves generated through the TLTROs



Source: Intesa Sanpaolo chart based on ECB data

Germany: pacing down

Anna Grimaldi

The outlook in brief German GDP growth will accelerate from 1.5% this year to 1.7% (1.5% net of calendar effects) in 2015. Thus, the country will continue to grow above potential (1.4% for the Bundesbank, 1.2% for OECD). Our assessment of the macro scenario remains positive, albeit revised downwards from June, when we expected growth of 1.7% in 2014 and around 2% in 2015. Q2 growth numbers and economic surveys in the summer months suggest that the recovery is proceeding more slowly than expected. Lending and company investment are particularly weak, also considering the high labour utilisation. The outlook for 2015 is weighed down by geopolitical uncertainty and the weakness of exports towards Russia and Eastern Europe. The country maintains relatively solid fundamentals, but in our view, the domestic economic policies mix is not well targeted to sustain GDP growth in the medium term. The country has ample scope to shift to more growth friendly fiscal policy and to boost domestic demand growth through income tax cuts, a cut in pensions spending (which has in fact grown in the current two-year period) and an increase in public infrastructure investment, but it is unlikely to move in this direction.

The recovery is slower than expected

Short-term outlook. In the spring, GDP surprisingly contracted by 0.2% qoq, after advancing 0.5% qoq in Q1. The weakness was due to a sharp fall in construction investment, after the year got off to a strong start as a result of the exceptionally mild weather. But slower growth is also due to a genuine slowdown in the pace of expansion of manufacturing activity. The Bundesbank estimates that stripping out the weather effect, GDP growth was on average 0.25% qoq, from 0.4% qoq in 2H13. The slowdown in the German economy is due not only to the deceleration of Easter European demand but also of orders from the rest of the euro zone. Up to July the resilience of trade flows to developed countries outside the Euro zone, notably the US and the UK supported exports' growth. The IFO index fell for four consecutive months between June and September, coming in at 106.3, and eroding almost all of last year's gains. Generally, three consecutive falls in the headline IFO index are considered indicative of a trend-reversal or a halt in the production cycle. The composite PMI hovered at 54.5 on average in the summer, from 55.2 in 2Q, and the manufacturing index is at its lows since May 2013, in the wake of a sudden drop in external and domestic demand. Hard data on orders (+4.8% mom) and industrial output (+2.5% mom) for July suggest a sharp upturn in activity at the start of the summer. However, the Bundesbank notes that July's orders and production figures were inflated by exceptional factors: a large shipping order (which typically leads to an increase in production with a significant lag), the lower number of school holidays and the fact that the large factories, particularly in automotive industry, only shut down in August. Thus there is a risk that the August's orders and output figures will post a sharp correction. Thus the underlying growth momentum is better captured by the trend in industrial surveys, which are clearly pointing to a slowdown in production and more cautious expectations for the coming months. We are revising down our GDP growth forecast in 3Q and 4Q from +0.4% qoq to a modest +0.25% qoq. Growth could hover just below 0.4% qoq at the beginning of 2015, since we should see a gradual pick up in global demand, particularly in advanced countries.

GDP growth at 0.25% qoq in 2H14

Over the forecasting horizon, growth is likely to be driven increasingly more by domestic demand rather than by foreign trade, as happened in 2013. In July, goods exports rose by 2.2% qoq, following an increase of 0.5% qoq in June. Over the turn of the year, we could see a slowdown in exports owing to geopolitical tensions as well as statistical factors. Yet, from Q2 exports should gain speed as trade flows are expected to pick up at the beginning of 2015, Additional impulse should come from the ongoing euro depreciation. On average, we expect exports to advance by 3.5% in 2014 and by 4.1% in 2015. Given the high imported content of German exports, we expect imports to grow by 3.1% in 2014 and by 4.6% in 2015. The net contribution of foreign trade will be marginally positive in 2014 and -0.1% in 2015. Thus, the current account surplus is therefore expected to close only gradually over the forecast horizon.

Waiting for domestic demand to pick up further

Note that revisions to national accounting data and the switch to the ESA 2010 national accounting system[3] involved changes to current account balance estimates, which since 2006 have exceeded 6% of GDP for much of the period and not in every year as in previous estimates. In the first half of this year, the current account surplus was an average of 6.9% of GDP.

With a negative contribution from net exports, domestic demand is expected to add 1.4% in 2014 (from 0.5% in 2013), accelerating to 1.6% in 2015.

Consumer spending is expected to grow by an average of at least 1.3%, thanks to the resilience of employment and…

After the semi-stagnation in 2Q, we see consumer spending growing by 0.3% qoq per quarter in the second half of the year, and by 0.4% qoq in 2015. Household confidence remains at elevated levels, and real disposable income should expand by 1,3% also next year. According to the IFO job indices, employment growth should hover at 0.8% - 0.9% yoy in the next few months, which would imply quarterly growth of 0.2% qoq (unchanged from the spring quarter), or the creation of approximately 40,000 jobs a month. The unemployment remained unchanged for the past 8 months at 6,7%, thus close to its structural level. We deem unlikely large declines in the unemployment rate over the coming months, as indicated by the IAB barometer, unless there is an increase in immigration in excess of the 300,000 estimated by the Bundesbank. Unemployment is seen remaining broadly unchanged at its recent levels, and falling at best towards 6.3% for the end of 2015.

…Wages to grow by 2.6% over the forecast horizon

Wage growth should be supported by negotiated wages, which should be up by 3%, after the 3.5% increases granted with the first signed agreements, signed at the beginning of the year. As in a second stage the negotiated wage rises are typically less substantial. Moreover, the increases agreed for employees in the banking sector and the metalworking industry are around 2.3%. At the beginning of July this year, the German Parliament approved the introduction of a national minimum wage of EUR 8.50 per hour starting from January 2015. The minimum wage level may be revised by the Wages Commission in 2016 and modified at the beginning of 2017. The farm foods, hotel and restaurant sectors, where hourly rates are lower than the minimum, are only expected to comply fully by 2017. The minimum wage will apply to approximately five million workers, or 14% of the workforce. According to a recent CESIFO study, the introduction of the minimum wage could lead to 900,000 job losses, mainly "mini jobs", so the measure could be counter-productive in terms of income redistribution, and could generate a revenue loos for the government of approximately EUR 1Bn. Given the high degree of uncertainty and the effect that this typically has on German households' spending decisions, growth in consumer spending is unlikely to outstrip that of disposable income, and we therefore expect the savings rate to stabilise around 9.2%.

Risks for employment from the introduction of the minimum wage

What is required for a more sustained capex cycle?

The fall in GDP in the spring is partly due to a halt in investment in machinery, which is rather anomalous compared with previous cycles, given that production capacity utilisation is now at normal levels. In the spring, approximately 52% of the companies interviewed in the IFO survey on industrial investment planned to increase spending on investment in 2014 in order to expand existing capacity, while the objective of replacing existing capacity was stated only as a secondary reason for higher spending. It is possible that the upturn in spending on machinery has only been delayed. Lending to manufacturing companies, which usually anticipates more sustained growth in investment spending, remains lacklustre, despite the fact that the latest lending survey conducted by the Bundesbank shows that conditions are virtually neutral[4]. It is

[3] The revisions concerned nominal GDP in particular, which is approximately 3% higher between 1991 and 2013 compared with the ESA 2005 accounting system.

[4] The latest edition of the survey on credit conditions for the first time includes a question on the level of, and not just the change in, credit conditions. Banks were explicitly asked to assess recent credit conditions

possible, however, that the recovery in investment spending will be less marked than in previous cycles (on average 7.9% between 2004 and 2008). First of all, the high degree of uncertainty could prompt companies to limit increases in spending, while it cannot be ruled out that German companies will continue to shift part of their production to locations closer to end consumers, and thus that they are continuing to shift investments outside Germany and the Euro zone, as the Bundesbank noted in December's bulletin. Over the forecast horizon, we expect machinery investment to grow by 3.0% in 2014 and 3.6% in 2015, which is below our June estimates.

Residential construction still growing, but at a slower rate

The period of expansion for residential construction could continue in 2014-15. In the first half of this year, investment in construction grew by an average of 6%. The quarterly fall in the spring offset the sharp growth at the beginning of the year due to the exceptionally mild weather. Figures on residential building permits and orders point to a continued sustained trend in investment in construction in 2014-15, but less so than in the last year and a half (2.1% yoy). We expect average growth of 1.5% in 2015, from 3.9% this year (which was boosted by the strong start to the year).

Inflation has fallen by more than expected in 2014, to 0.8% in August, from 1.4% a year ago. The drop in inflation is mainly due to the lower contribution from the energy component, although the increase in the prices of services slowed significantly to 0.3% from 2.4% the year before. Core inflation fell to 1.4% yoy, from 2.3% yoy at the end of 2013. We believe that the low for German inflation is now behind us, and that the trend reversal in commodity prices together with higher labour costs expected for the current year is set to push inflation towards 1.3% for end-2014. We expect average annual inflation of around 1.0% this year, and 1.5%-1.7% in 2015. The depreciation of the exchange rate will affect production prices with a lag of approximately six months, so we will probably have to wait until mid-2015 to see a slight upturn in inflation. Note that our estimates have incorporated the weakening of the euro exchange rate to 1.26 now for several months, yet those levels were expected by early 2015 and not already in September. The quicker depreciation of the euro can thus help inflation to turn earlier than expected.

The risks for the scenario are still tilted to the downside, and could result from the ongoing geopolitical uncertainty, with negative effects not just on exports. Germany exports to China account for 2% of GDP and those to Russia for 1.3%; a sudden deceleration in the "hottest" emerging countries could, therefore, have a considerable effect on German growth prospects, but would be unlikely to derail the recovery. Risks for growth largely relate to the development of the outlook in the Euro zone, a very important commercial partner for Germany, accounting for 28% of German exports. Another short-term risk factor is the failure of domestic demand to take off. In theory, consumer spending and investment should embark on a more sustained growth path of 1.4%-1.5% on average, given the solid outlook for real disposable income, financial conditions that are expected to remain extremely expansive and the already high labour utilisation. Recently however, spending decisions, particularly by companies, seem to be more motivated by the degree of political uncertainty than by fundamentals.

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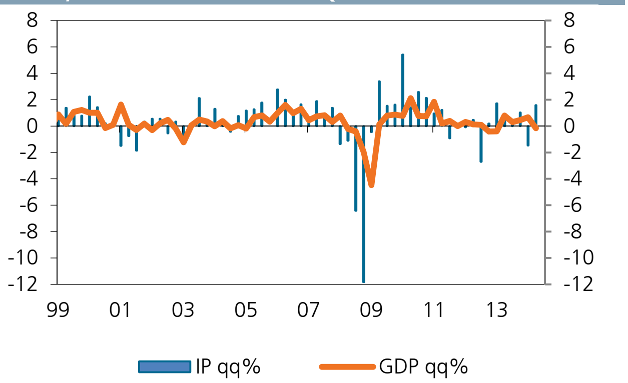
compared with the beginning of 2003 (when the survey was launched) and with 2Q10. Previously, the level of credit conditions was approximated from cumulative quarterly changes since the start of the survey. Credit conditions were tightened before 2010 in both Germany and the Euro zone as a whole, that is before the sovereign debt crisis. While cumulative changes from 2010 to today suggest marginally more restrictive credit conditions for large companies, the specific question on the level of credit conditions indicates that they are more restrictive than the reference level both for small and large companies (see Bundesbank Monthly Report, August 2014 pp. 44-47).

Public finances. We confirm our forecast of a balanced budget in 2014 and a slight surplus in 2015. Public finances will continue to benefit, over the forecast horizon, from a fall in interest expenditure and fairly cautious spending management. The Ministry of Finance's medium-term forecasts show a budget surplus of 0.3% from 2016 onwards, and therefore a fall in the debt/GDP ratio towards 60% in 2018. Projections also show a structural surplus of around 0.3%, but this largely reflects a fall in interest expenditure in relation to GDP. Germany is unlikely to bow to pressure to relax its fiscal policy to stimulate domestic demand and thereby contribute to the process of rebalancing internal imbalances within the Euro zone. In its July Report, the Bundesbank maintained that it would also be more appropriate to change the spending mix in favour of infrastructure investment and reduce pensions spending, but in any case, the debt/GDP ratio should be taken back to 60% as quickly as possible in order to reduce the impact of demographic factors on the future debt trend.

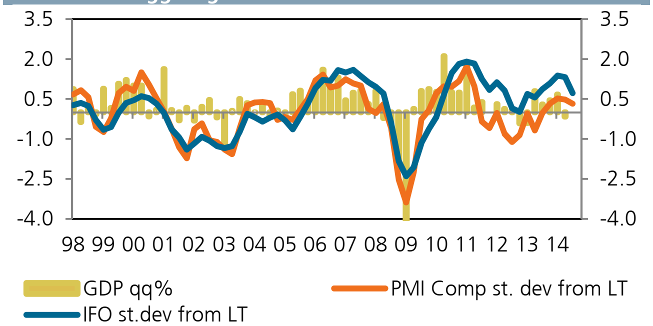
Public finances under strict control, no opening to measures to support domestic demand

July production figures point to an upturn in activity in the summer, after the fall in GDP in 2Q



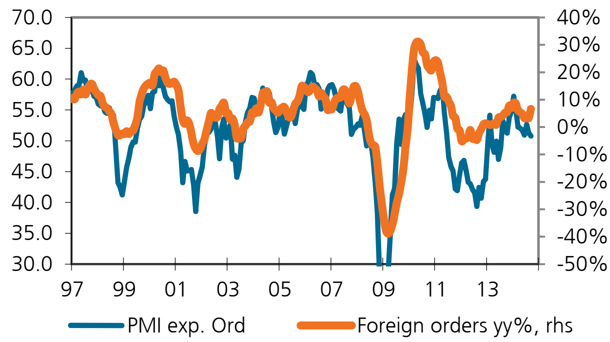
Source: Intesa Sanpaolo chart from FSO data

The IFO and PMI confidence indices are consistent with continued sluggish growth in the summer



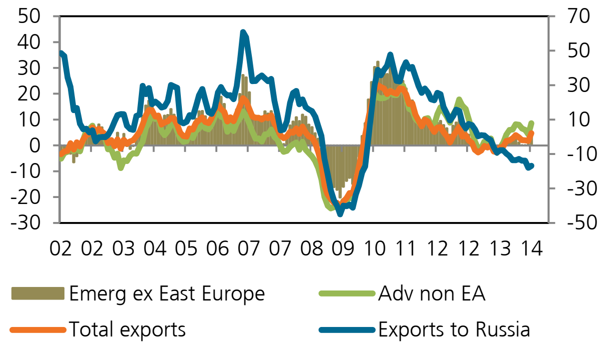
Source: Intesa Sanpaolo chart from Markit, IFO and FSO data

The manufacturing PMI points to a drop in foreign demand



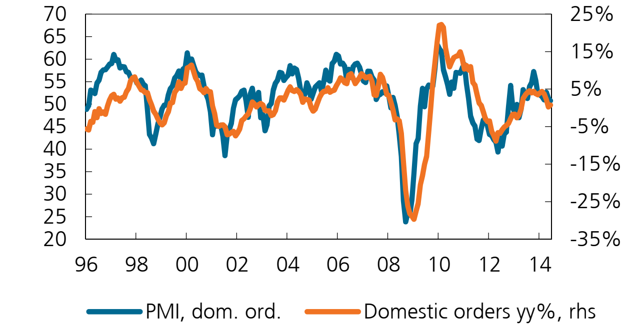
Source: Intesa Sanpaolo chart from Markit and FSO data

Exports sustained by advanced and emerging countries excluding Eastern Europe at the beginning of 3Q



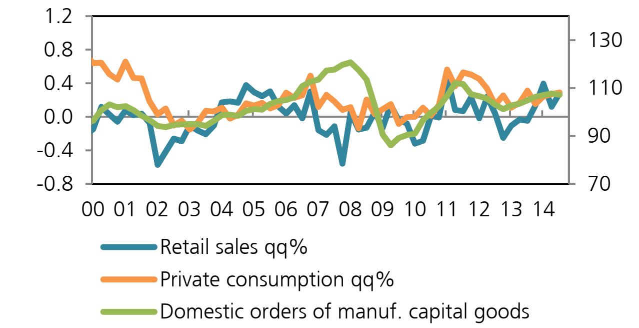
Source: Intesa Sanpoalo chart from Markit and Deutsche Bundesbank data

But domestic demand is also heading for a slowdown



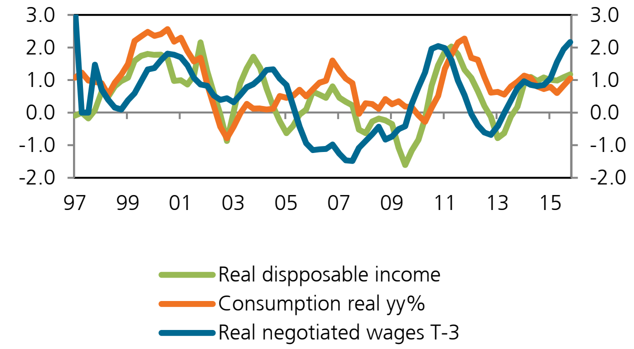
Source: Intesa Sanpaolo chart from Markit and FSO data

Retail sales point to a resilience in consumer spending over the summer



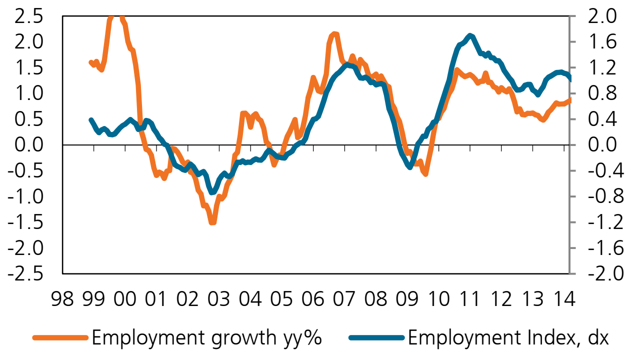
Source: Intesa Sanpaolo chart from IFO and FSO data

The trend in real disposable income expected to ensure growth in consumer spending of at least 1.3% in 2015



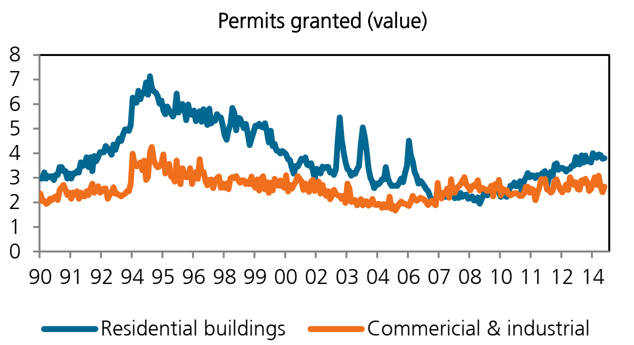
Source: Intesa Sanpaolo chart from FSO data

IFO employment survey points to employment growth of 0.8% on an annual basis, in line with the creation of a monthly average of around 40,000 jobs



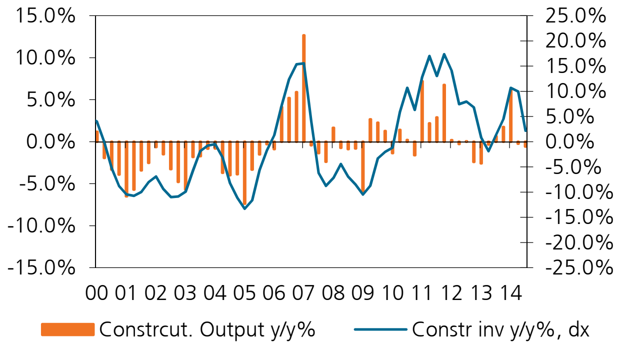
Source: Intesa Sanpaolo chart from IFO and FSO data

Expansion in residential construction is expected to continue, but at a slower pace



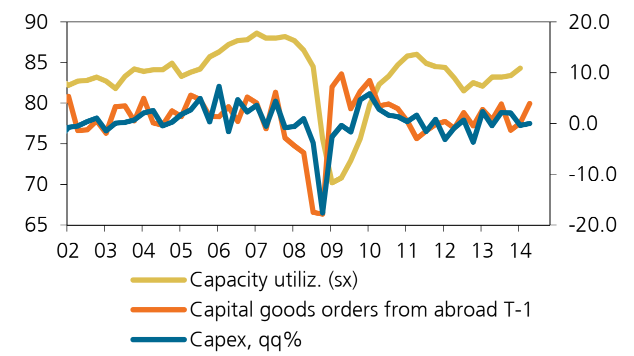
Source: Intesa Sanpaolo chart from FSO data

Output in construction at the beginning of 3Q suggests more sluggish growth on an annual basis



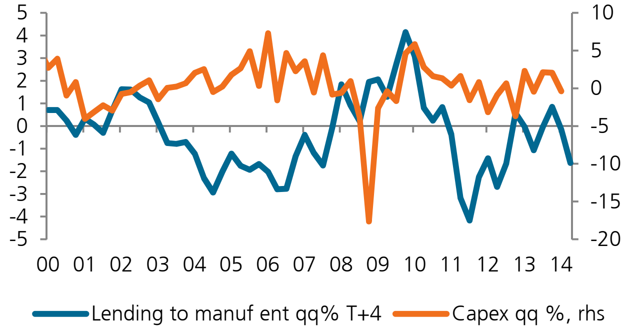
Source: Intesa Sanpaolo chart from FSO data

Company investment remains weak



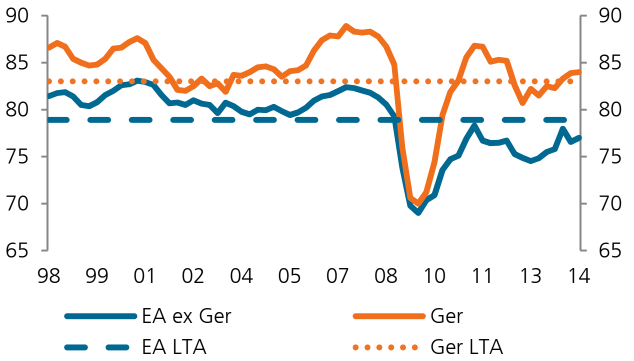
Source: Intesa Sanpaolo charts from FSO and European Commission data

Lending to companies is sluggish



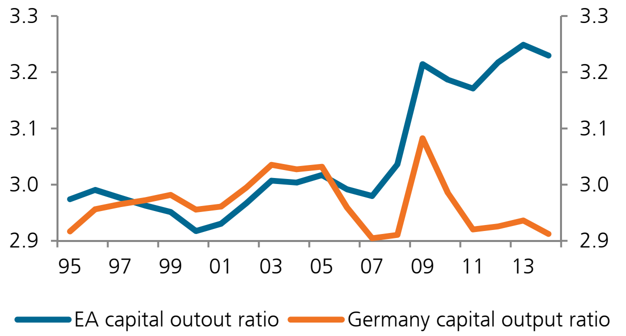
Source: Intesa Sanpaolo chart from Deutsche Bundesbank and FSO data

Production capacity in Germany has returned to normal levels, but remains low in the rest of the Euro zone



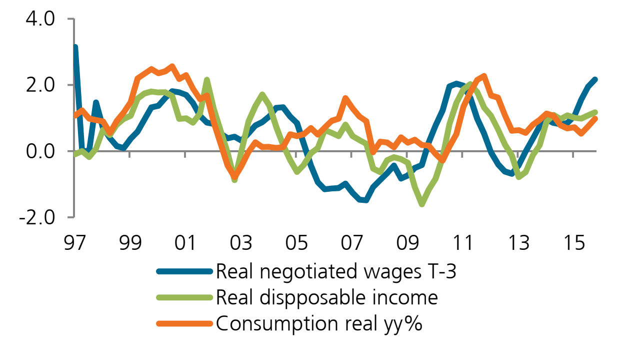
Source: Intesa Sanpaolo charts from European Commission data

The capital output ratio is considerably lower than the Euro zone average



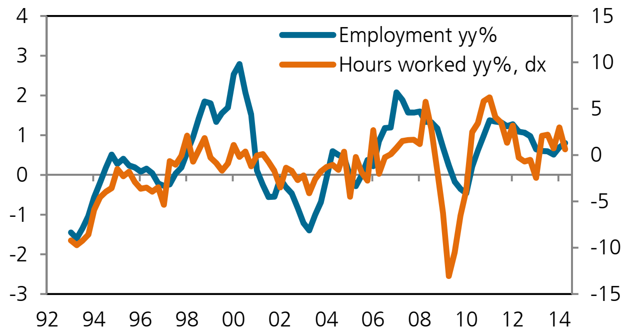
Source: Intesa Sanpaolo charts from European Commission data

Consumer spending should recover rapidly, supported by growth in real incomes of over 1%



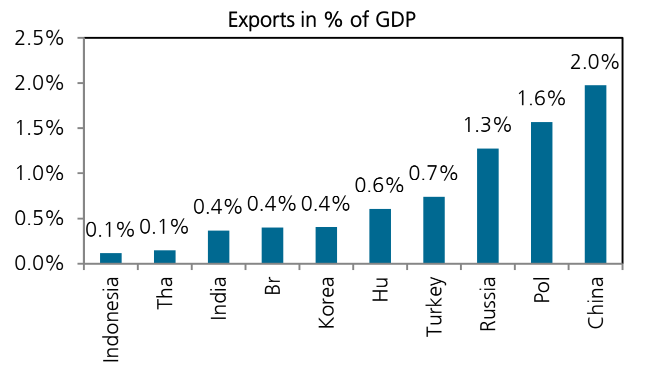
Source: Intesa Sanpaolo chart from Economic Policy Uncertainty and FSO data

The increase in labour utilisation could come through working hours in the next quarter



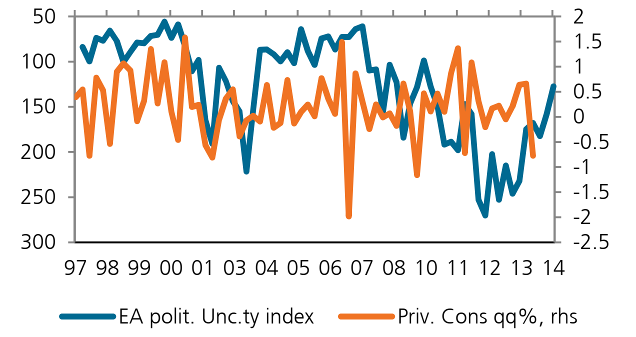
Source: Intesa Sanpaolo chart from FSO data

A slowdown in Russia and China could have a considerable impact on German growth through exports and...



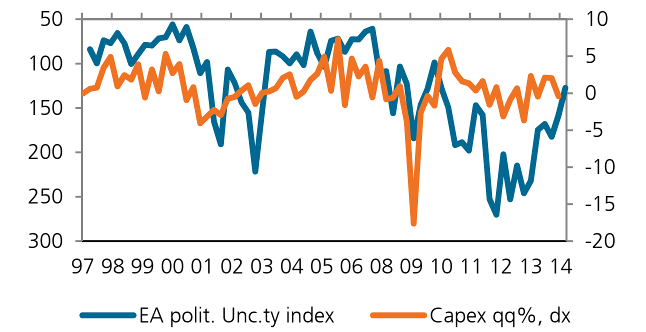
Source: IMF direction of trade statistics

... indirectly through confidence. Uncertainty is reining in consumer spending and ...



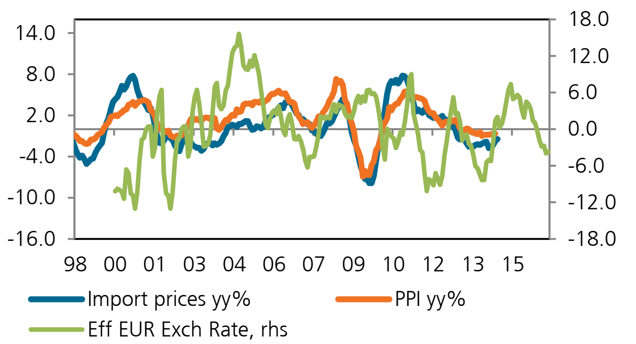
Source: Intesa Sanpaolo chart from Economic Policy Uncertainty and FSO data

... company investment



Source: Intesa Sanpaolo chart from Economic Policy Uncertainty and FSO data

Upstream pressure in the production chain remains to the downside for the time being. The depreciation of the exchange rate will not be felt on import prices for some time yet



Source: Intesa Sanpaolo chart from FSO data

Forecast Table

	2013	2014	2015	2013	2014				2015		
				4	1	2	3	4	1	2	3
GDP (1995 prices, y/y)	0.2	1.5	1.5	1.1	2.2	1.3	1.3	1.2	1.0	1.6	1.8
- q/q change				0.5	0.7	-0.2	0.3	0.3	0.4	0.4	0.5
Private consumption	0.9	1.0	1.3	-0.8	0.8	0.1	0.3	0.3	0.4	0.3	0.3
Fixed investment	-0.6	3.5	2.6	1.1	2.9	-2.2	1.0	0.3	0.3	1.8	1.2
Government consumption	0.7	0.9	1.3	-0.1	0.4	0.1	0.2	0.5	0.3	0.3	0.3
Export	1.7	3.3	4.1	1.7	0.0	0.9	1.0	0.4	1.1	1.2	1.3
Import	3.2	3.6	4.9	0.7	0.5	1.6	0.0	1.0	1.4	2.0	1.0
Stockbuilding (% contrib. to GDP)	0.1	0.0	0.1	0.2	-0.2	0.4	-0.5	0.2	0.2	0.1	-0.1
Current account (% of GDP)	6.9	6.8	6.2	7.2	7.2	6.8	6.9	6.4	6.3	6.1	6.2
Deficit (% of GDP)	0.2	0.3	0.5								
Debt (% of GDP)	77.2	75.1	74.3								
CPI (y/y)	1.5	1.1	1.6	1.3	1.2	1.1	0.8	1.3	1.4	1.6	1.7
Industrial production (y/y)	0.1	1.9	2.4	0.5	1.1	-1.5	1.6	0.1	0.5	1.0	1.2
Unemployment (%)	6.9	6.7	6.5	6.9	6.8	6.7	6.7	6.7	6.6	6.5	6.5
10-year yield	1.61	1.30	1.33	1.79	1.72	1.42	1.05	1.01	1.06	1.29	1.47
Effective exch.rate (2005=100)	99.6	99.9	98.6	100.4	100.8	100.5	99.7	98.4	98.1	98.3	98.9

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

France: 2014 disappointing; 2015 recovering moderately

Guido Valerio Ceoloni

The outlook for the current year is gloomy, with the economy as a whole in stagnation. Domestic demand is now the only growth driver, but it will not push GDP above 0.4% in 2014; there is a slight risk that the forecast will be revised up by one-tenth of a percentage point. The construction sector is still mired in crisis and industrial output remains stagnant. Net exports are flat. Some progress is likely in 2015, when GDP could improve to 0.7%. The public accounts are still not in order, with the government forced once again to ask for more time to ensure that excess austerity measures do not deepen the economic crisis. Inflation will be very low until 2017.

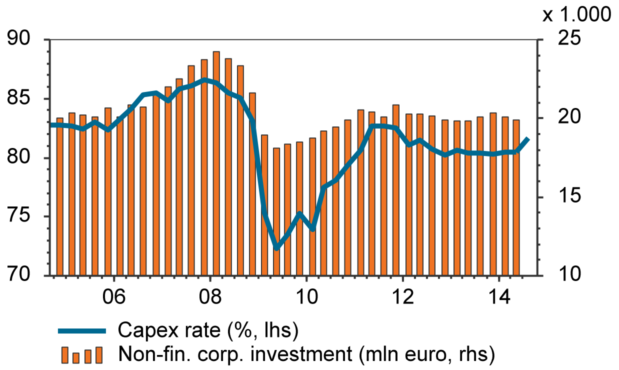
Another disappointing year for growth

Contrary to the government's encouraging promises in January, 2014 is again shaping up to be a disappointing year for the French economy. GDP remained stagnant in the first two quarters and will almost certainly hamper the pace of recovery in the Euro zone in the second half of the year. The industry is expected to be broadly stagnant from now until the end of the year, while construction is likely to continue its contraction phase. Only the services sector is showing modest growth in support of the – albeit very moderate – level of activity for the rest of 2014. This leads us to revise down our GDP forecasts from 0.8% to 0.4% for the current year and from 1.2% to 0.7% for 2015.

Industry remains at a standstill in 2014; but picking up in 2015

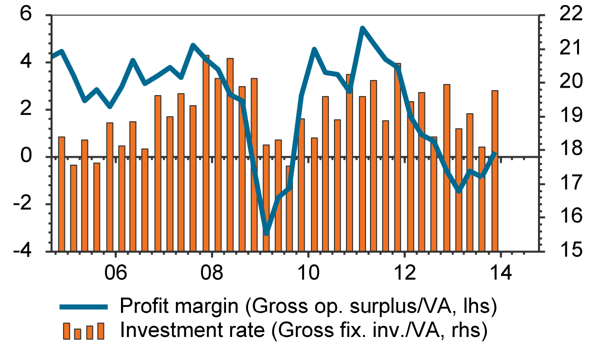
The most worrying situation is the French manufacturing sector, which according to the PMI surveys is performing worse than those of Germany, Italy and Spain. The PMI index, which had initially fallen below 50 in August 2011, is not managing to stage a clear-cut recovery. Although the trend has improved from 45.6 in 2012 to 47.0 in 2013, and to 49.4 in the first eight months of 2014, the pace of improvement is the slowest of all the main European economies, leaving France lagging behind Germany (53.4), Spain (53.1) and Italy (52.4). After growing slightly by 0.6% qoq in March, manufacturing fell again (-1.2% qoq) in June, and we forecast another decline, or at least stagnation, in the last quarter, which would give an annual average increase of 0.6%. Annual average energy generation, however, is likely to remain broadly unchanged, making up from June onwards (+1.5% yoy) the ground lost in the first five months of the year (-2.5% yoy) due to the exceptionally mild weather. Overall, industrial output in the rest of the year could grow at around 0.5% yoy on average, perhaps supported by a weaker euro than in the first half of the year; however, the improvement will not be enough to make up the contraction of 1.1% yoy in the first half, and output is therefore likely to decline by around 0.3% in 2014, from -0.6% in 2013. We do not expect its contribution to GDP to be more than one-tenth of a percentage point in the third quarter and perhaps one-and-a-half-tenths of a point in the fourth.

Manufacturing: reduced capacity utilisation



Source: Intesa Sanpaolo chart based on Eurostat and INSEE data

Manufacturing: profits squeezed

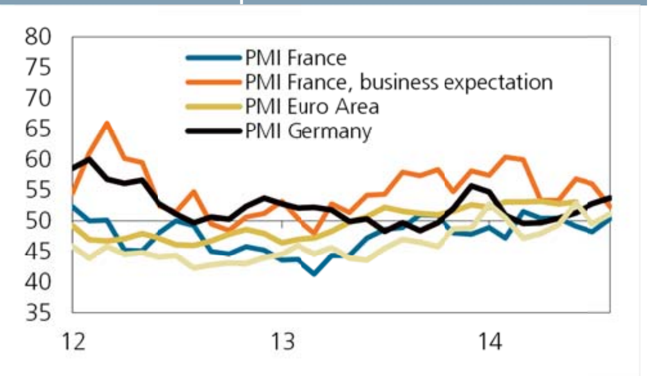


Source: Intesa Sanpaolo chart based on Eurostat and INSEE data

Activity in the services sector, however, is no more lively, with the PMI index fluctuating from 47.1 in 2012 to 46.6 in 2013 and to 49.6 in 2014. Here too, the pace of recovery is extremely slow compared with France's European counterparts, with the Spanish and German sectors at 55.1 and Italy at 51.6. After stagnating in the first two months of the year, activity picked up slightly, but further fluctuations saw it dip back down in May and June. During the summer, there were some tentative signs of recovery, with orders improving from 49.5 to 52.2 in August. The services sector remains more sluggish than manufacturing. It grew by 0.2% qoq in March and by 0.1% qoq in June, and we are confident it will expand by at least 0.1% qoq per quarter for the rest of the year, given that the purchase of services accounts for 50% of total household consumption (the other 50% is split equally between spending on housing and on manufactured goods). Expectations for the next three months are, all things considered, fairly positive in the sector, at least compared with industry and construction. Clearly the outlook is far from rosy, but, if nothing else, we think that services have already bottomed out and are therefore likely to continue to rise. Moreover, the sector is not as badly affected by the profit squeeze as manufacturing, given that the unit labour costs of services, compared with those of industry, have progressively come down since the second half of 2012.

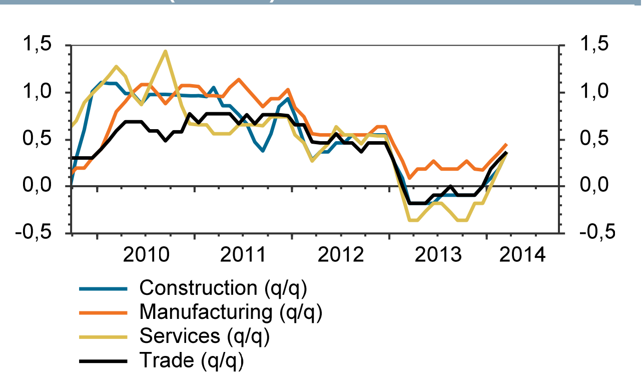
Services are improving moderately but there are still risks to the downside

French services set the pace



Source: Markit

Unit labour cost (2008=100)

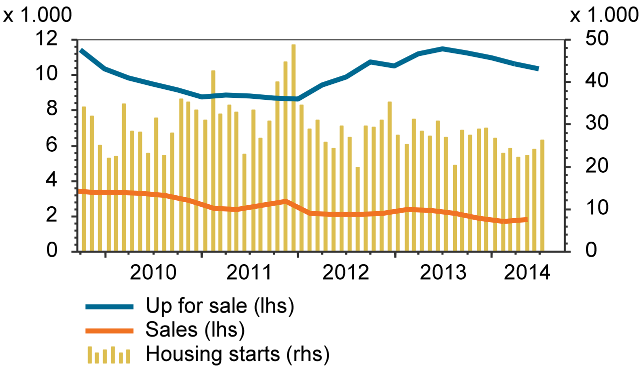


Source: Intesa Sanpaolo chart based on INSEE data

Construction recorded the biggest drop in the Bank of France's activity index in February (-3, in absolute terms); except for March, when it rose to 0, it was parked in negative territory in every month until July. According to data collected by the National Federation of Builders for the year to May, building permits and lay-downs fell by 22.2% and 14.2% respectively in the residential sector and by 12.9% and 14.3% in the production sector. Building activity in the production sector is at its lowest since 1980. The biggest drop seems to be in the residential sector, as also borne out by the number of mortgages granted: after recording another set of very positive figures in December, these slowed until April, and from May onwards became negative (-1.8% in July). Overall, construction fell by 1.5% qoq in Q2 after a fall of 1.6% in the first quarter. The National Federation of Builders also forecast a decrease in buildings to 18 million sq. m. in 2014, from 20.7 million sq. m. in 2013. The sharp contraction in the sector is due to the abolition of government grants to local communities, in line with the 2015-2017 three-year plan to cut public spending. We must also bear in mind that, historically, building land for sale has been in short supply in France, which has made it very expensive; this is therefore a bottleneck to growth in the construction sector. Business is becoming less profitable for construction companies, which have seen their margins eroded from 14.6% in 2008 to 9.9% in 2012 and to 8.7% in 2013.

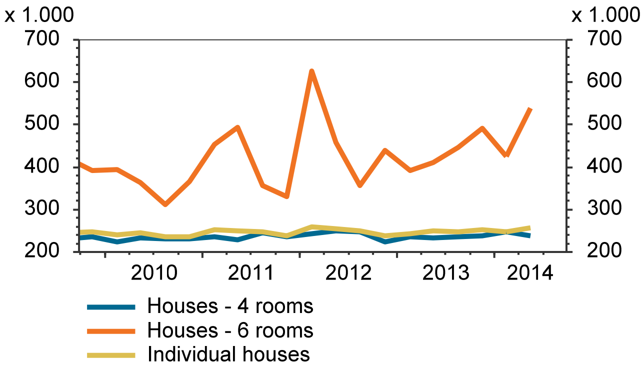
Decline in the building sector continues

Excess supply in the building sector…



Source: Intesa Sanpaolo charts based on French ministry of ecology and sustainable development data

… but house prices are not falling significantly (figures in EUR 000)



Source: Intesa Sanpaolo charts based on French ministry of ecology and sustainable development data

One reason for the poor performance of the new homes sector is the lower number of middle income households able to access loans on easy terms, despite low interest rates: but although the net effect is excess of supply, this has not pushed prices down, which are burdened by fixed costs that cannot be squeezed without overly eroding profit margins. Looking at the outlook for the next few months, we think that activity will fall further in August and not substantially improve in the autumn, although some positive surprises might be provided by "green" building, which has received support from government subsidies on energy transition. In addition, some positive effects to reduce contraction in the sector could come from a raft of new regulations announced last month to simplify property rentals. Overall, we see the change in activity in the construction sector in the next two quarters at around -1.2/-1.4% qoq, which equates to a fall of about one-tenth of a percentage point per quarter. Based on the latest data available to June, the construction sector in France employs about 1.2 million workers and accounts for about 9% of GDP.

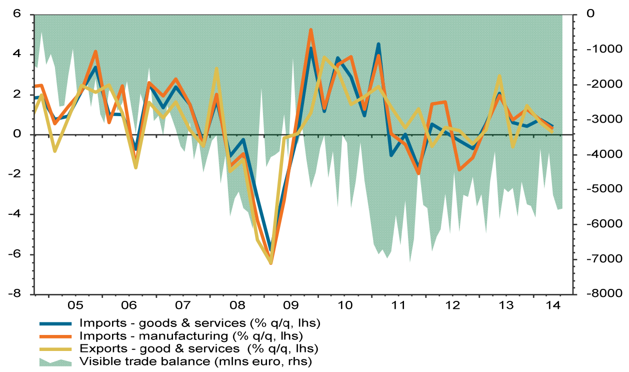
Contribution to GDP by net exports zero or thereabouts

Which components of demand are causing the weakness in the French economy? Although foreign orders have deteriorated, they are pretty much in line with other economies. The contribution to GDP by net exports has become minimal in this phase; we think it will be zero over the next two quarters or at worst marginally negative, but the outlook also remains bleak for the first half of 2015. The only positive point on this front is the relative improvement in the visible trade balance, which although still in the red is slowly reducing the - albeit still substantial - deficit. Specifically, France's trade deficit with the Euro zone is still expanding, whereas it is stable against Asian countries and the US.

Domestic demand is the only growth driver left

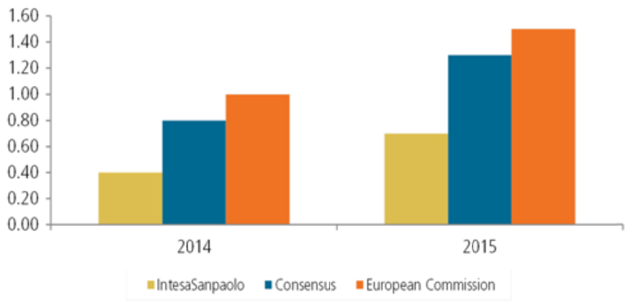
Domestic demand is, therefore, the only component contributing positively to GDP. It is still more or less holding up. Car sales, which were falling, rose from -1.4% qoq in March to 0.3% qoq in June, while consumer durables recovered to 1.0% qoq in June from 0.5% qoq in March. This shows that although growth in the important household spending component is resilient, it, too, is going through a weak phase, contributing one-tenth to GDP in Q3 and perhaps two-tenths in Q4. The French economy, which is traditionally driven by domestic demand, is feeling the impact of the slowdown in consumption, as public spending cuts have reduced the support provided by government incentives. Overall, consumption in June (+1.0% qoq) made up the ground it lost in March (-1.1% qoq), but we are not expecting the pace of growth in the remainder of the year to match that seen in Q2. This will lead to an annual average of around 1.2%, which although clearly an improvement on the -0.3% yoy in 2013, will not include the rebound that was expected this year that should have boosted growth. Households are still highly cautious about personal spending. Consumers, in light of persistent weakness on the labour market and uncertainty over the fiscal outlook after Hollande launched the solidarity pact at the beginning of the year, are preferring to save. Fiscal uncertainty is also affecting businesses, and the financial fragility of many medium-sized companies is acting as a drag. The CICE (competitiveness and employment tax credit) seems to have been used to strengthen their finances: increased output, employment and new investment will not materialize until the end of 2015, not before. But, more generally, over the last two years or so only about 80% of French industrial capacity has used, compared with the historical average of 84.7%. The INSEE index of manufacturing confidence, which has been fluctuating between 96 and 100 since the start of the year, is also in line with expansion this year of at most 0.4-0.5%. The manufacturing sector's weakness also stems from the gradual erosion of profitability margins, in turn caused by persistent cost rigidity that is driving up real wages faster than productivity. Erosion of profitability, added to excess of capacity, is discouraging capital expenditure.

Imports and exports on falling trend



Source: Intesa Sanpaolo chart based on INSEE data

GDP forecasts for 2014 and 2015



Source: Intesa Sanpaolo, Bloomberg, European Commission

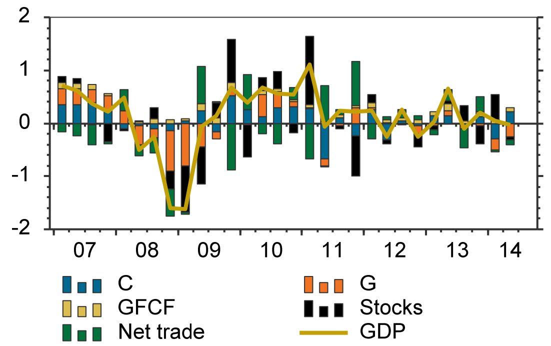
Inflation very low until end-2015. No appreciable fall in unemployment until 2016

Inflation is forecast to remain very weak this year, as in the whole of the Euro zone: the CPI is expected to accelerate slightly in the last quarter, but the annual average should slow from 0.9% to 0.6%, one-tenth of a percentage point less than our previous estimate. Prices have been partly contained by the low cost of energy and lagging production capacity, which has dampened production prices. For 2015, however, we confirm our previous estimate of CPI accelerating to 0.8%, hopefully supported by a return to growth and a recovery in domestic demand. However, based on the current forecast, it will be 2017 before inflation rises above 1.0%. Regarding the outlook for the labour market, unemployment, having reached record levels, is not expected to improve this year, despite the Hollande's promises, who has had to contend with economic stagnation dragging on longer than expected: capacity utilization remains historically low, while the construction industry, which employs more than one million workers, remains mired in crisis, and policy measures have so far proven insufficient to reverse the current trend. We are therefore confirming our forecast of 9.7% for this year. 2015 could see a marginal fall to 9.6%, but the number of jobless will remain broadly stable next year as well, and an appreciable decline will not be visible until 2016, when GDP growth exceeds 1%.

Public finances not restored until 2017, debt and deficit still rising

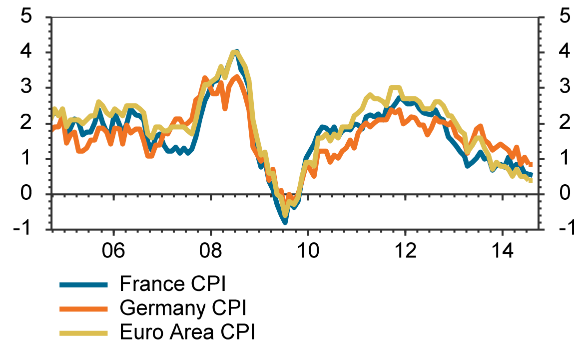
News from public finances is not likely to be encouraging. After the summer's government reshuffle, which saw ministers resigning in droves amid rancour over counter-cyclical policies and excessive austerity, Sapin, the new Minister of Finance, announced that this year's fiscal targets will not be met and that France, although still determined to pursue them, will need more time. We think the deficit will increase again this year, from -4.3% to -4.4%, due to lower-than-expected tax revenues, stagnation and low inflation, despite almost all the planned cuts having been implemented. In 2015, however, the deficit will likely revert to its level in 2013 but no lower, i.e. -4,3%, then fall below 3% from 2017, which is the target for 2015. But we see the structural deficit falling this year to 2.9% from 3.0%, and to 2.7% in 2015. Public debt will rise from 93.5% to 96.0% this year and to 96.8% next year. Overall, fiscal consolidation is likely to be about 0.7-0.8% of GDP over the next two years, given that the much-heralded EUR 50Bn of cuts in the three-year period 2015-2017 (EUR 21Bn thereof in 2015) has been reconfirmed. But there is still uncertainty as to the measures needed to achieve these. After the respite public finances received in 2014, the government will inevitably need to become more active on this front next year. In this respect, fiscal policy might still hold some surprises given the fragility of the current government. According to the EU agreement, fiscal consolidation this year would have to be around 0.1% of GDP to nail the deficit target of -3.9%. But given recent developments, the impact of fiscal policy this year will actually be neutral. The climate of political uncertainty and frequent government reshuffles will therefore continue to weigh in the medium term, and this doubt is spreading to both consumers and manufacturing sectors. Moreover, in the absence of exogenous forces, it is becoming increasingly clear that the weakness afflicting the French economy since 2012 can only be reversed by implementing all (hopefully in 2015) the structural measures designed to restore competitiveness, which are long-delayed and only partially implemented.

Contribution to GDP



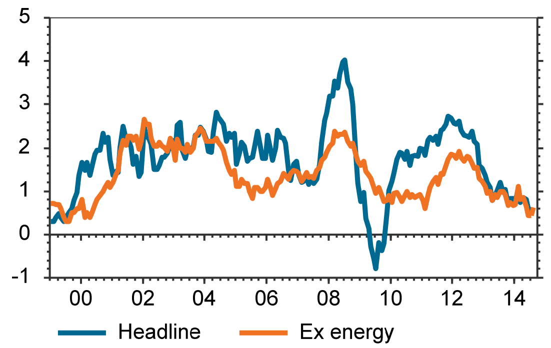
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

CPI



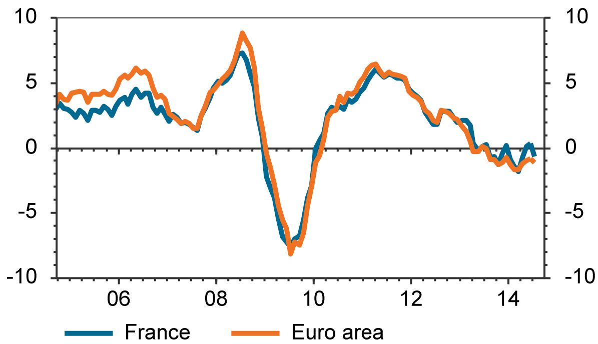
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

French non-energy CPI



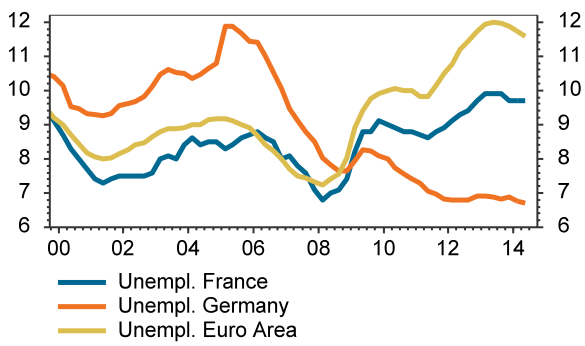
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

PPI



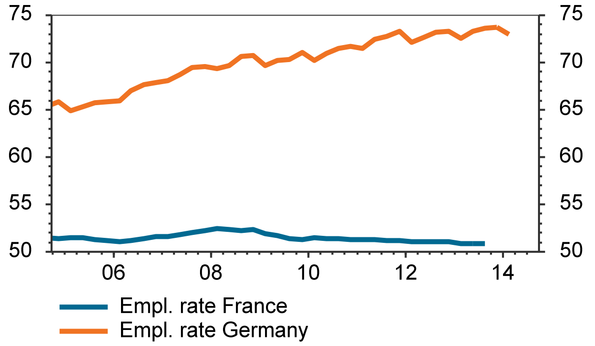
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Unemployment



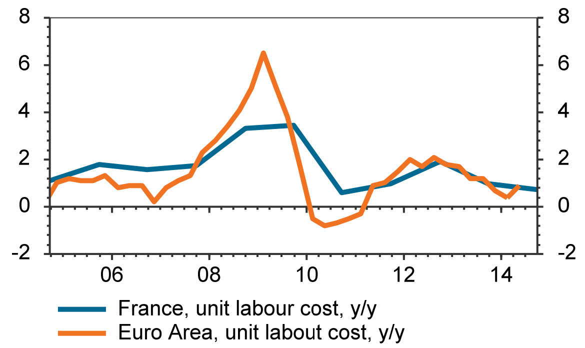
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Employment



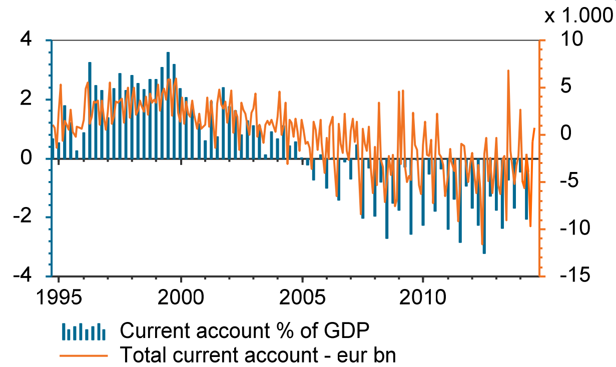
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Unit labour cost



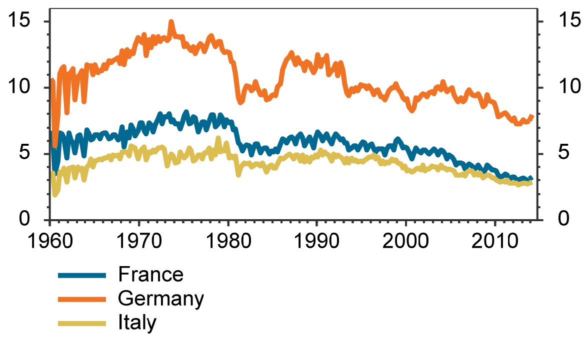
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Current account balance



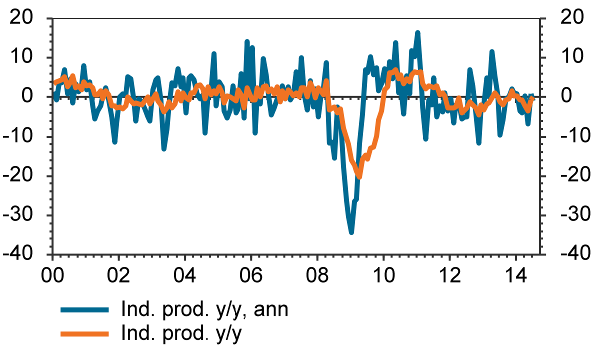
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Global exports



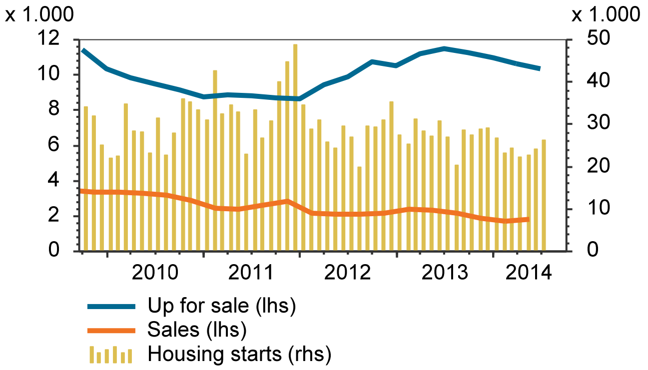
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Retail sales



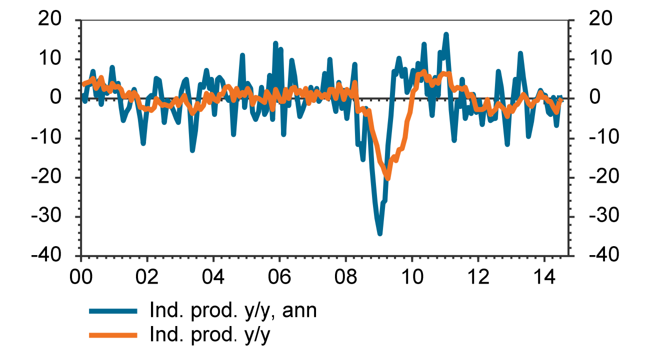
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

New house building, total



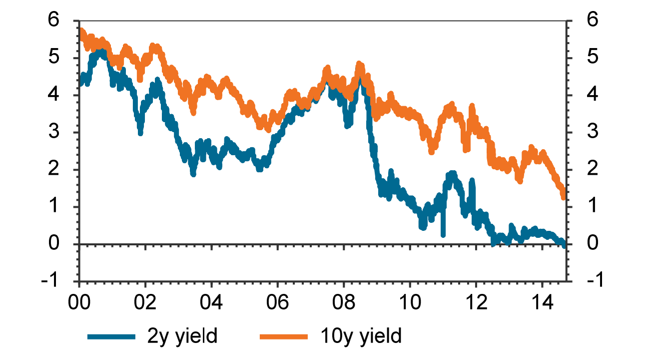
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Industrial output



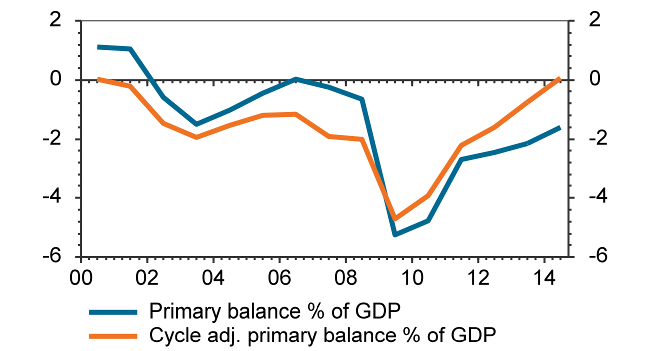
Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

2-year and 10-year Govt. bond yields



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Primary balance



Source: Intesa Sanpaolo chart based on Thomson Reuters-Datastream data

Forecast Table

	2013	2014	2015	2013	2014				2015		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	0.4	0.4	0.7	0.8	0.8	0.1	0.3	0.3	0.4	0.6	0.8
- q/q change				0.2	0.0	0.0	0.1	0.2	0.1	0.2	0.2
Private consumption	0.3	0.2	1.2	0.2	-0.5	0.4	0.3	0.2	0.4	0.3	0.2
Fixed investment	-0.8	-2.2	0.5	-0.1	-0.9	-1.1	-0.6	-0.3	0.3	0.7	0.7
Government consumption	2.0	1.8	0.7	0.6	0.4	0.4	0.3	0.3	0.1	0.0	0.1
Export	2.4	2.3	2.7	1.5	0.6	0.1	0.0	0.4	0.8	1.0	1.1
Import	1.9	2.9	3.3	0.4	0.8	0.4	1.0	0.7	0.8	1.2	0.4
Stockbuilding (% contrib. to GDP)	-0.2	0.5	-0.1	-0.3	0.5	-0.1	0.2	0.2	-0.2	-0.1	-0.2
Current account (% of GDP)	-1.3	-1.3	-1.7	-0.6	-0.9	-1.2	-1.4	-1.8	-1.8	-1.9	-1.6
Deficit (% of GDP)	-4.3	-4.4	-4.3								
Debt (% of GDP)	93.5	96.0	96.8								
CPI (y/y)	0.9	0.6	0.8	0.6	0.7	0.6	0.4	0.7	0.6	0.8	0.8
Industrial production	-0.7	-1.0	0.5	0.3	-0.6	-0.5	0.2	0.0	0.3	0.3	0.0
Unemployment (%)	9.9	9.7	9.6	9.7	9.7	9.7	9.7	9.6	9.6	9.6	9.5
Effective exch.rate (1990=100)	107.5	107.6	105.9	108.2	108.5	108.6	107.5	105.8	105.3	105.5	106.2

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: Intesa Sanpaolo

Italy: still hard times

Paolo Mameli

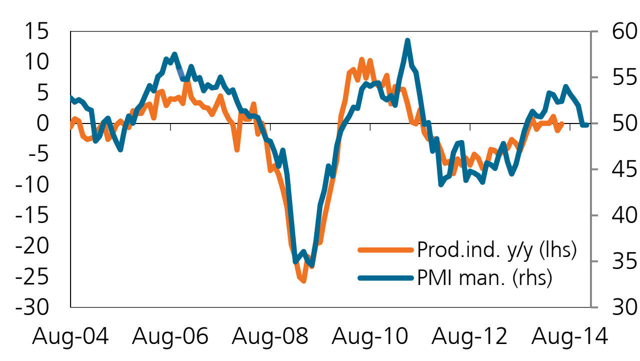
Summer brought with it a spate of negative news about the economic cycle, which set off a general process of a downwards revision of growth estimates for this and next year. In theory, the conditions are in place for a recovery, but uncertainties over the economy and taxation are curbing spending decisions; in addition, household and company incomes have improved from record lows, but only moderately. The change in 2014 GDP is now very likely several tenths below zero; our forecast for recovery in 2015 still stands, but we have revised our estimate down to 0.6%. The cycle is still highly dependent on foreign trade: with an ongoing weak domestic demand, support will come from the recent depreciation of the exchange rate.

No dearth of negative news over the Summer

The summer was very disappointing, not only because of the weather but also because of the economic situation. Bad news came in waves: firstly, on 10 July, as regards figures for industrial production in May, pointing to a stagnating Q2 GDP, later confirmed by national accounting figures released on 6 August, with the second consecutive fall in economic activity (-0.2% after the -0.1% qoq at the start of the year). Then, on 12 September, figures for July industrial production were released: after picking up in June, output fell considerably (-1% mom) the following month, casting a shadow over the performance of economic activity in the third quarter as well. In fact a third consecutive decrease in GDP is likely (talk is emerging of a triple dip in Italy, i.e. a third recession after that of 2008-09 and 2011-13, even though it is probably more correct to say that the second recession never ended). In the meantime, confidence indicators regarding both companies and households, which had picked up considerably between Spring 2013 and Spring 2014, fell significantly in July and above all in August; the decline was widespread (regarding in particular future expectations) and can't be explained by one-off factors.

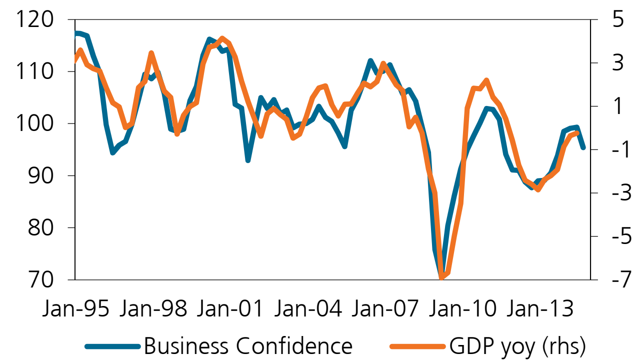
In this scenario of a marked deterioration in prospects for domestic demand, the only good were exogenous - from the announcement of ECB measures (a further cut in rates, new TLTROs and ABS buying programme), as well as the considerable depreciation in the exchange rate (with positive effects on competitiveness and therefore on the cycle). As for reforms, progress is being made but at a very slow pace (see *focus*).

Were survey results a false signal for industry?



Source: Intesa Sanpaolo calculations on ISTAT and Markit figures

Leading indicators now point to a slowdown in the cycle



Source: Intesa Sanpaolo calculations on ISTAT figures

Why has the cycle been so disappointing?

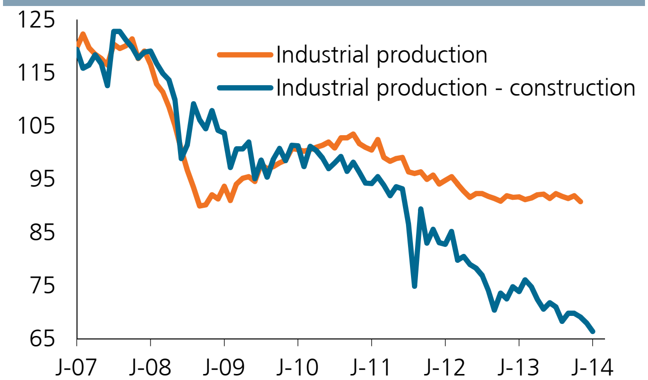
We shall first try to analyze why the economic situation was so disappointing in the first half of the year, to understand whether these factors may be considered as temporary or otherwise and thus whether they will fall off in the rest of the year. The negative surprise concerned above all investments:

1) the construction industry was still heavily affected by a recession, but this was to be expected and a recovery in the rest of the year will certainly not come from demand in this segment (nor in 2015, in our opinion); this drag to the cycle will probably persist over the next few quarters (a negative impact due to the rainy climate in Summer in Northern Italy cannot be ruled out);

2) without considering the significant volatility recently recorded by investments in transport equipment (accounting for a smaller percentage of the total), spending on machinery and equipment was disappointing (-1.5% qoq in the second quarter): based on industrial production figures, this component is not even expected to recover in the third quarter. However, we believe the conditions are in place, at least in theory, for capital expenditure to pick up (see below), so this segment may recover from as early on as the final part of the year;

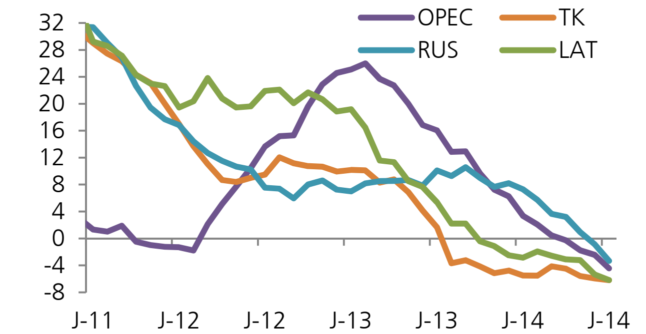
3) like other European countries, the energy sector performed poorly in the first quarter, because of the particularly mild Winter. This effect was reversed in the Spring, but could have slowed down the cycle again in the third quarter (because of the climate, as temperatures were not lower than average).

Production in the construction industry increasingly peaking



Source: Intesa Sanpaolo calculations on ISTAT figures

Exports to Russia, as well as to Turkey, OPEC countries and Latin America down considerably



Note: moving averages at 3 months of % yoy changes Source: Intesa Sanpaolo calculations on ISTAT and Bank of Italy figures

The other component that partially disappointed expectations in the first half of the year was exports (just +0.1% qoq in both the first and second quarter, against a mean +0.8% qoq in the second half of 2013). The main causes include:

1) geopolitical tensions affecting trade with Ukraine and Russia (and partly with other East European countries) and with some Middle Eastern countries. In particular exports to Russia fell by 8.5% yoy in the first seven months of the year (however, in terms of total exports, this figure is limited, accounting for -0.2%); these tensions are, by their very nature, temporary, but could continue for some time;

2) a weaker demand from various emerging countries, as reflected by the considerable drop in exports to Latin America (-7.4% yoy in the first 7 months of the year), Turkey (-7.3%) and OPEC countries (-7.9%): this factor (with a negative effect on total exports, considering these three areas alone, is significant: -0.9%) is not set to recede soon, as the slowdown in the cycle of numerous emerging countries could persist in the short term;

3) the negative impact of a stronger Euro, characterizing most of the first half of the year: the EUR/USD exchange rate recorded an average of 1.37 in the first half of the year, against the current figure of 1.29 (see below as regards the importance of this factor); however, this effect has already been reversed;

4) lastly, the negative impact of exports to Switzerland due to the sharp rise in gold sales

recorded during peak moments of the financial crisis (between the end of 2011 and the start of 2013) is decreasing: exports to Switzerland recovered from -22.7% yoy in January to -0.8% yoy in July (contribution to export yoy: from -1.1% to zero).

On the other hand, consumer spending was positive for the first time in three years, increasing in the first two quarters of the year, albeit to a modest extent, and was up by 0.2% yoy midway through 2014. There was also a mirroring effect from imports and inventories; with both falling in the first quarter (with opposite effects on the cycle), and then increasing in the second quarter.

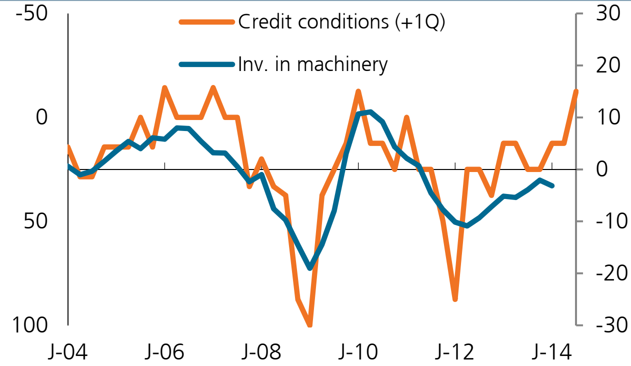
The conditions for a recovery in investments still apply…

Looking forward, we think conditions are in place for a recovery in the last quarter of the year, above all as regards investments in machinery and equipment. In fact:

1) despite the fall in confidence indicators, the situation on the demand side is expected to improve next year over the current year (although to a lesser extent than previous forecasts);
2) credit conditions are improving, as reflected by results for Italy of the latest Bank Lending Survey (the criteria used to approve loans and open credit lines for companies became more flexible in the Spring than they had been for four and a half years; moreover, as regards loan and credit line applications, the relative importance of fixed investment among factors contributing to net demand for loans - which has only occurred one other time over the last six years);
3) economic policies are providing support:
    a. the payment of outstanding public administration arrears is continuing (updated at 21 July, 26.1 billion had been paid to companies and 30.1 billion had already been allocated to debtor organizations for the payments); with the new discount mechanism in place in the banking sector (which could benefit indirectly from the ECB's ABS buying programme), this figure could reach 57 billion by mid-2015;
    b. an improvement in financial conditions and access to capital markets may come from:
        i. the effects of ECB measures (TLTROs + ABS buying programme, even if the impact for Italy could be significantly reduced if buying only concerns senior tranches);
        ii. the simplification of corporate bond regulations and extending the possibility of loan provision to insurance and securitization companies (measures contemplated in the "competitiveness decree"[5]);
        iii. the effects of the "Sabatini-bis" law, which aims to improve credit access for SMEs and since coming into force on 31 March, has received applications for a value of over 2 billion (from 6,815 SMEs);
    c. several recent government measures have established tax incentives for investments, and in particular a 15% tax credit for investments in machinery made from the second half of 2014 to the first half of 2015, which is greater than the average of the 5 previous years; the measures are a sort of revised, yet "minor" version of the Tremonti law (the government estimates just over 4 billion "to be covered by incentives" this year and the same amount the next year; the "bonus is therefore worth 1.2 billion, but may only be paid out from 2016 onwards; moreover the fairly high unitary investment limit excludes very small companies from the incentives).

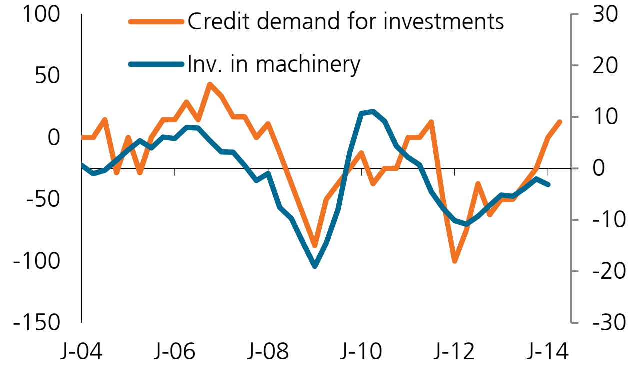
[5] Law decree no. 91 of 24 June 2014 - "Urgent measures to […] relaunch and develop businesses, reduce costs of electricity rates, and to immediately define obligations arising from European regulations" – Gazzetta Ufficiale no. 144 of 24 June 2014, converted into Law no. 116 of 11 August 2014, – "Conversion into law, with amendments, of law decree no. 91 of 24 June 2014, " – Gazzetta Ufficiale no. 192 of 20 August 2014

Credit conditions have become more flexible than they have been in years



Source: Intesa Sanpaolo calculations on ISTAT and Bank of Italy figures

There are also signs of demand for investment loans picking up



Source: Intesa Sanpaolo calculations on ISTAT and Bank of Italy figures

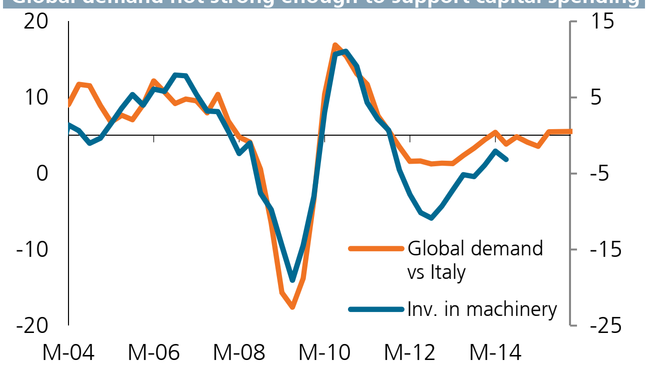
…and exports will benefit from the recent depreciation in the exchange rate.

As for exports, a sort of "relay race" is taking place between sales to non-EU countries and sales to EU countries. Although geopolitical tensions will continue to have an impact on sales to non-EU countries, at least in the short term (Russia accounts for 2.4% of Italian exports and is vital for some sectors such as the furniture industry – 7.1% and the clothing/leather industries - 6.2%, which are not subject to the embargo) and the slowdown in some emerging countries such as Brazil will continue, the recent depreciation in the exchange rate will be of considerable support.

According to our estimates (using the *Oxford Economics Forecasting* simultaneous equations model), a depreciation of 10% in the EUR/USD exchange rate (if permanent) would have an impact of 2.4% on exports and 1.1% on GDP, after one year. Consequently:

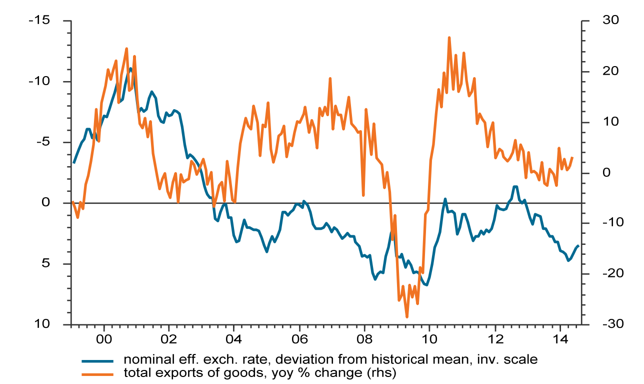
1) if the EUR/USD exchange rate in 2015 were to remain at current levels (1.29 against an average of 1.34 in 2014), the impact would be +0.4% on GDP;
2) if the EUR/USD exchange rate in 2015 were to change in line with our forecasts (1.26), the impact would be even greater, i.e. 0.6%;
3) the impact could be significant, even starting from the remaining months of 2014. According to our estimates, the exchange rate would be 1.30 in the second half of the year, from 1.37 in the first half, and the impact on GDP in the second half of the year would be 0.2%.

Global demand not strong enough to support capital spending



Source: Intesa Sanpaolo calculations on ISTAT and Oxford Economics Forecasting figures

Export will be supported by a weak exchange rate



Source: Intesa Sanpaolo calculations on ISTAT and BIS figures

Uncertainty is hampering spending decisions

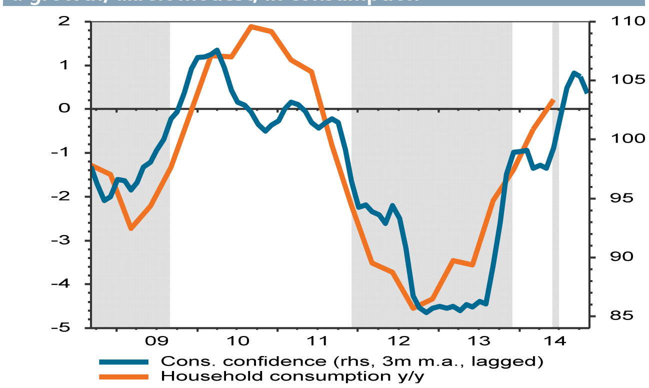
As regards consumer spending, we believe the recovery starting in the first half of 2014 may continue into the second half, albeit at a moderate pace (0.1/0.2% qoq). As for the IRPEF bonus effect (see below), this was saved more than spent. More generally, as regards household spending, as for company expenditure, the improvement in income conditions (reflected by the rebound from lows in spending power in the case of households and profit margins in the case of companies) did not impact spending decisions. In our opinion, there are two reasons to explain this trend:

1) despite a rebound from record lows, levels of income for households and profits for companies remain very low;

2) the considerable uncertainty over the economic and fiscal situation has led households (and presumably companies too), to save more than to spend (in fact the saving rate recorded an upwards trend in the last few quarters).

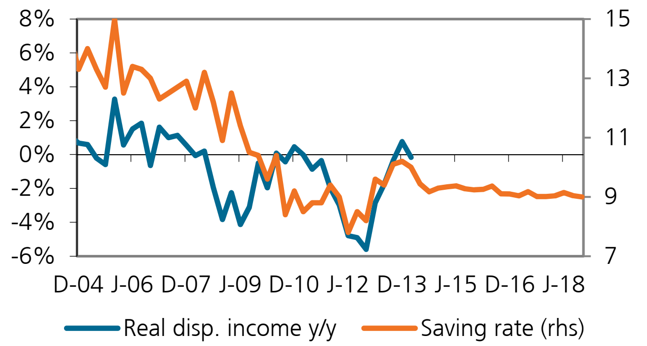
In our view, as recovery strengthens, this uncertainty will be mitigated and income improvements may generate greater spending. The fact that the recent slowdown in the European cycle proves temporary is fundamental in this regard. At present, without any sustainable drive from domestic demand, the Italian cycle is very dependent on exports; as mentioned previously, the only good news of late comes from factors that may have a positive impact on exports before they do so on domestic demand (above all the exchange rate).

Despite the recent downturn, surveys are still consistent with a growth, albeit modest, in consumption



Source: Intesa Sanpaolo calculations on ISTAT figures

The rebound from record lows in disposable income is reflected nearly entirely in an increase in the saving rate



Source: Intesa Sanpaolo calculations on ISTAT figures

Estimates for 2014-15 GDP revised downwards

In brief, the disappointing trend of the cycle in the first half of the year, and the concrete possibility of another downturn in economic activity in the Summer months, have lowered estimates on GDP growth for this year, to at least -0.2%; however the risks on this forecast are on the downside and will depend above all on how negative the decrease in GDP will be in the Summer months (figures will be released on 14 November). The knock-on effect from the current year, plus a slight downwards revision of prospects for the last part of 2014 and the first half of 2015, have led us to revise our estimate for next year, to 0.6%. Our projections are lower than consensus forecasts, which were in September -0.1% for the current year and +0.9% for 2015.

Forecast Table

	2013	2014	2015	2013	2014				2015		
				4	1	2	3	4	1	2	3
GDP (constant prices)	-1.8	-0.2	0.6	-0.9	-0.4	-0.2	-0.3	-0.1	0.1	0.5	0.9
- q/q change				0.1	-0.1	-0.2	-0.1	0.3	0.1	0.2	0.3
Private consumption	-2.6	0.2	0.9	0.0	0.1	0.1	0.1	0.3	0.2	0.2	0.3
Fixed investment	-4.6	-1.8	0.7	0.7	-1.0	-0.9	-0.6	0.2	0.3	0.4	0.6
Government consumption	-0.8	0.4	0.3	0.2	0.4	-0.1	0.0	0.1	0.1	0.1	0.1
Export	0.0	1.8	3.0	1.2	0.1	0.1	0.3	0.7	0.8	0.9	1.0
Import	-2.9	1.6	2.9	0.2	-0.1	1.0	0.4	0.6	0.7	0.8	0.9
Stockbuilding (% contrib. to GDP)	-0.1	-0.2	-0.3	-0.4	-0.1	0.2	-0.1	0.0	-0.1	-0.1	-0.1
Current account (% of GDP)	1.0	1.6	1.7	2.7	-0.2	2.0	1.7	2.8	-0.4	2.0	1.9
Deficit (% of GDP)	-2.8	-2.9	-2.7								
Debt (% of GDP)	127.9	131.9	132.2								
CPI (y/y)	1.2	0.3	0.8	0.7	0.5	0.4	0.0	0.4	0.5	0.7	1.0
Industrial production	-3.1	-0.6	0.5	0.5	-0.1	-0.5	-0.9	0.1	0.1	0.7	0.5
Unemployment (%)	12.2	12.6	12.3	12.5	12.6	12.5	12.6	12.6	12.5	12.4	12.2
10-year rate	4.31	2.92	2.32	4.16	3.64	3.10	2.63	2.30	2.21	2.19	2.33
Effective exch.rate (2010=100)	99.7	99.8	98.9	100.3	100.5	100.3	99.7	98.7	98.5	98.6	99.1

NB: Percentage change on previous period (unless otherwise indicated). Source: Intesa Sanpaolo calculations

Spain: party time again?

Anna Maria Grimaldi

Overview. Spain grew more strongly than expected last year, thus we have raised our growth forecast to 1.5% yoy for 2014 and to 1.7% for 2015. The recovery in the Spring encompassed exports, domestic demand and, for the first time, job creation. Over the forecast horizon, Spain will therefore grow faster than the Euro zone average, and in 2016 could even outperform Germany (figures 1 and 2). 2015 is an election year, and the country is likely to come under close scrutiny from investors. The last Parliament restored confidence and interest in the country, thanks to the bank restructuring plan negotiated with the European Commission and reforms of the labour market and public administration.

Risks to the forecast. Although positive about Spain, we remain cautious; our forecast is lower than consensus (1.8%) since the deleveraging process needs to continue. The risk is that, after the recent surge, demand might again grow less than our estimate (1.7%) and/or that the current account deficit will widen again. The doubt remains that the improvement in recent years is largely cyclical rather than structural, and next year will be the testing time. Between February and July, the goods balance went back into the red when imports in excess of exports rose, particularly in the capital goods and consumer sectors. A recovery in imports against a rebound in domestic demand is appropriate, but in the medium term, internal growth cannot be funded externally as Spain still has a high level of external debt. Therefore, the competitive gains made in recent years, which have driven a net recovery in the current account balance, will have to be consolidated. Moreover, although tentative signs have emerged on the labour market, additional reforms are much needed (training, policies and employment agencies), especially to reabsorb the manpower shed by the construction industry and its supply chain. The latest OECD estimates show that the structural unemployment rate (25% in 2015, up from 15% in 1998-2009) remains one of the highest in the Euro zone. The high public debt (93.9% in 2013) is a potential vulnerability should markets reverse and start doubting Spain's credibility in addressing its structural problems.

Short-term outlook. Spain returned to growth in the second half of last year, driven by a gradual recovery in exports, especially to countries outside the Euro zone. The first half of this year saw domestic demand also recovering, powered first by consumption and then by investment in machinery. On a quarterly basis, Spanish growth (+0.5% qoq on average in 1H14) outperformed Germany's and the Euro zone average, probably because weather factors and the crisis between Russia and Ukraine had less impact on output growth. In particular, growth in business investment was stronger than was suggested by the sector's confidence indices, and the level of capacity utilisation remained below the historical average (figures 9 and 10). We expect industrial investment of 3.0% this year and 2.4% next. With regard to construction investment, the correction in the residential sector looks to be well advanced since the housing/GDP ratio is back below the Euro zone average and close to pre-crisis levels (and employment in the sector is slightly above the level at the end of the 1980s). We expect residential construction to stabilise in 2H15. With regard to household spending, the average pace of growth in recent quarters (0.6% qoq) seems overly supported, particularly given the growth in disposable income (see below); the tax cuts planned for 2015 should offer moderate support in the order of two- to three-tenths of a percentage point, but the details have yet to be defined (rates for incomes below EUR 24,000 are expected to reduce by 13% and the maximum rate from 52% to 47%). We expect household spending to ease by about 0.4% qoq on average. The contribution of foreign trade to GDP growth should average zero over the forecast horizon. Exports are set to grow 3.4% in 2014 and accelerate to 4.5% next year. We also think that after a re-stocking cycle, annual growth in imports will slow over the forecast horizon from an average of 4.6% this year to 4.0% in 2015.

Surveys point to a fairly gradual improvement in employment

Labour market. Unemployment fell to 24.5% on average in Q2 from 27.1% at the start of 2013. Spain's jobless figure remains at highs not seen since the 1970s, and is one of the major challenges in the coming years. Unemployment will fall very gradually in 2014, when we project it will average around 24.2%. In 2015, when the recovery gathers speed, we should see more sustained employment growth, and hence a more rapid fall in unemployment to 23.7%-24.0%. Economic surveys suggest that average annual growth in employment could stagnate in Q3 and Q4. Collective agreements in 2014 resulted in wage increases of 0.4-0.5% yoy in Q1 and Q2, down from 0.6% on average last year. Real salaries have therefore returned to positive territory, thanks to cooling inflation. The average annual cost of labour moved to 0.9% yoy in the first six months of the year, from 0.6% in 2013. We anticipate labour cost growth of 0.9-1.1%, which is sharply down on the 4.5% seen in preceding growth cycles.

Inflation will stay below 1.0% until mid-2016

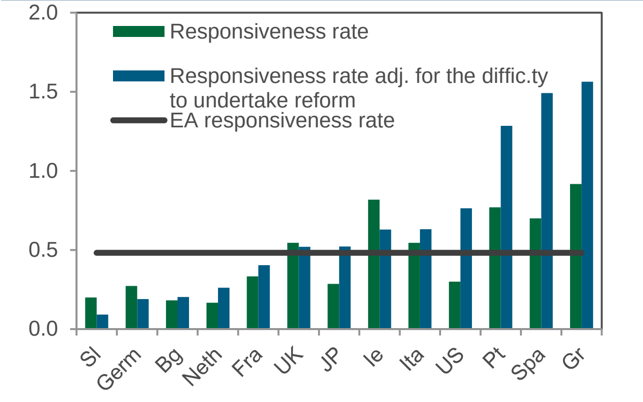
Spanish inflation looks to have bottomed out in August at -0.5% yoy, with the measure on the Harmonised Index of Consumer Prices (HICP) rising to -0.3% yoy in September and the domestic figure to -0.2%. Inflation should remain around zero for a good part of 2015 before edging slightly above 1.0% in 2H16. Underlying inflation will remain close to zero in 2014 and 2015, reined in by the large amount of slack in the economy and by wage moderation. The slowdown in Spanish inflation, which started in September 2012, is partly due to the coming off from the annual comparison of the effect of the VAT hike in October 2012 and changes in administered prices; but it is also the result of more fundamental phenomena, such as the slowdown in services inflation, which is more marked than for non-energy goods. Slowing services inflation is not only due to the fall in communications prices (typically associated with a supply shock), but also to the easing of inflation in the restaurant and leisure business. Spain is also not immune to the risk of deflation, but this risk should be reduced as growth picks up, especially in domestic demand.

Public finances The correction is postponed until 2015, an election year, when it is unlikely there will be any significant structural improvement

Waiting for the 2015 budget

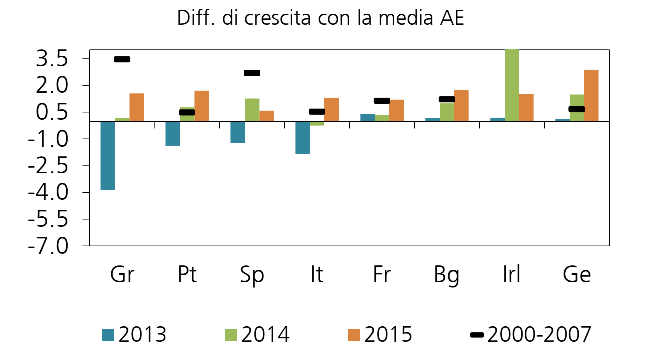
Spain's deficit closed at 7.1% of GDP in 2013, compared with -10.6% in 2012. Adjusted for contributions to the banking system, the deficit was 6.6% of GDP. Debt rose to 93.9% of GDP. In 2014, we expect public finances to improve to 5.6% of GDP, as indicated by the government in the update of the Stability Programme (SP). This target looks achievable based on the quarterly accounting data. The SP confirms the target of bringing the deficit back down to 3% in 2016 and balancing the budgetary position structurally in 2017. The SP projects debt will peak at 101.7% in 2015, then fall. We think the targets set in the SP are fairly ambitious and await the 2015 budget for details, particularly of the measures postponed to next year; for the time being, we are maintaining a broadly unchanged deficit estimate of 5.6% in 2016, compared with 5.7% this year. On 8 July, the European Council acknowledged the recommendations by the European Commission on the updated SP, confirming that the strategy for rebalancing the public finances was not enough to achieve the medium-term objective and that additional structural efforts will be required from 2015. The Council stressed that the government's growth forecasts for 2015 of 2.0% seemed overly optimistic. In particular, the Council noted that the tax cuts (at end-June the Spanish government announced that the expenditure ceiling for 2015 would be lower than in 2014 at 3.2%) that would enable the government to reduce personal income tax (-13% for income of less than EUR 24,000, and a cut in the maximum rate from 52% to 47%) and corporation tax (from 30% to 25% in 2016) were not sufficiently specified. The remaining effort required in 2015-17 would therefore equate to approximately four percentage points of GDP, a considerable amount and one of the highest estimated in the Euro zone. In our opinion, Spain will struggle to bring about the structural correction of two points of GDP necessary to close the gap between the Commission's and the government's estimates of the structural balance. Moreover, 2015 is an election year. We forecast that the deficit will fall to 5.0% of GDP at best, and debt will continue to rise to 104% of GDP in 2015 and to 107% of GDP in 2016, before starting to fall in 2017.

Fig. 1 – High level of reform has enabled Spain …



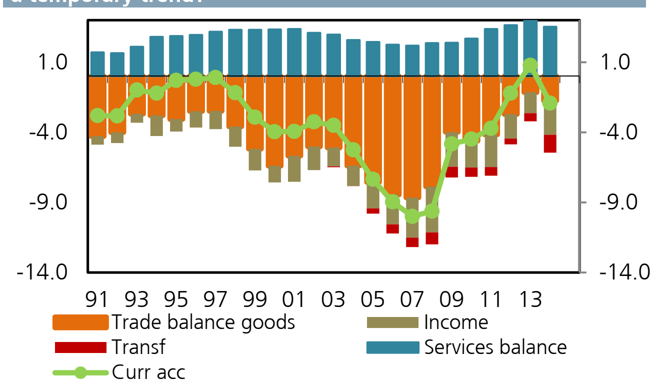
Source: Intesa Sanpaolo chart based on OECD data

Fig. 2 - …to return to higher growth than the Euro zone average



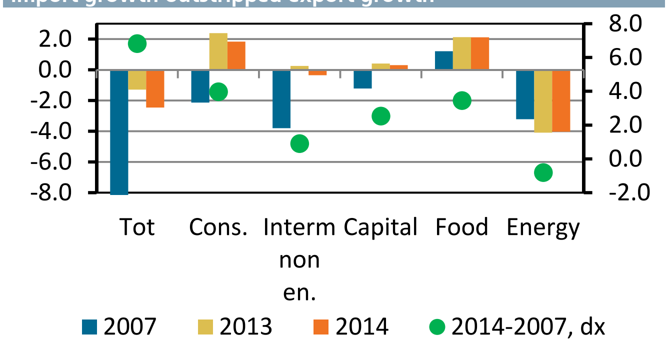
Source: Intesa Sanpaolo forecasts based on Eurostat data

Fig. 3 – Is the worsening goods balance a cyclical downturn or a temporary trend?



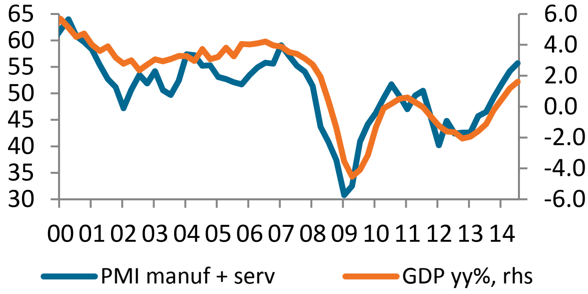
Source: Intesa Sanpaolo chart based on INE and Bank of Spain data

Fig. 4 – Balance of consumer and capital goods deteriorates, as import growth outstripped export growth



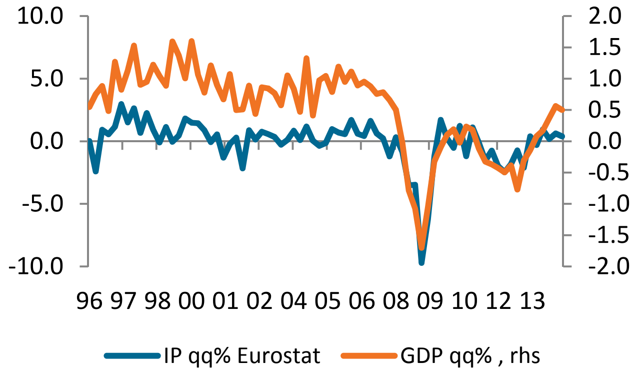
Source: Intesa Sanpaolo chart based on INE and Bank of Spain data

Fig. 5 – PMI indices confirm the recovery is continuing and gaining ground



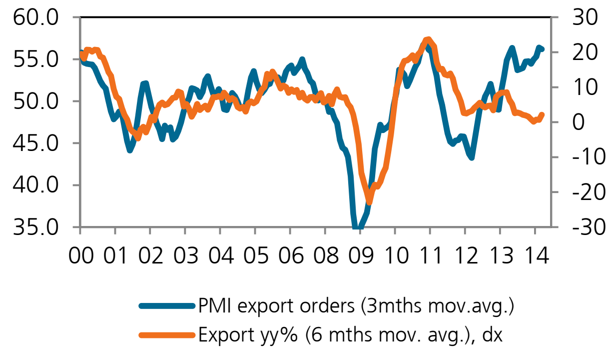
Source: INE. Intesa Sanpaolo chart based on Markit data

Fig. 6 – Output data suggest slight dip in GDP growth, to 0.4% qoq in summer from 0.6% qoq in spring



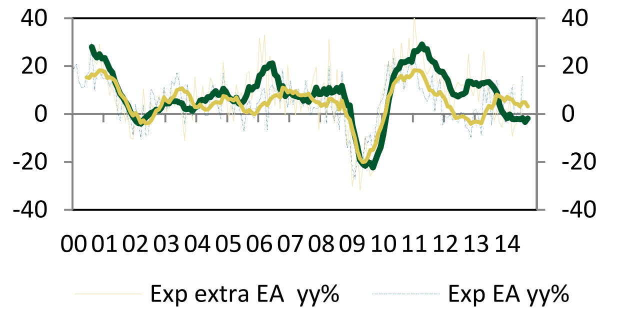
Source: Intesa Sanpaolo based on INE data

Fig. 7 – Markit PMI points to accelerating exports in coming months



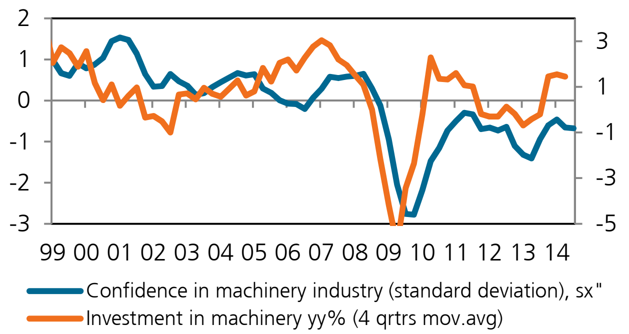
Source: Intesa Sanpaolo chart based on INE and Markit data

Fig. 8 – Exports supported by countries outside the Euro zone, but trend in trade flows still uncertain



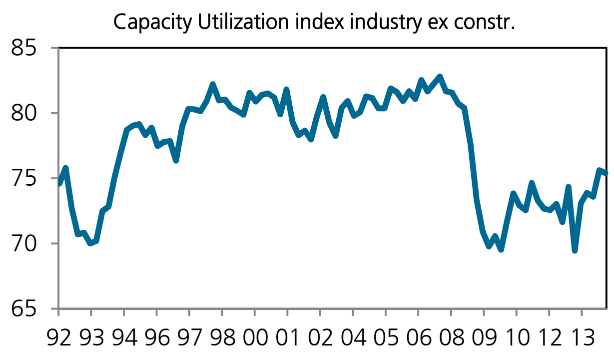
Source: Intesa Sanpaolo chart based on INE data

Fig. 9 – Investment in machinery grew faster than suggested by the upturn in confidence and…



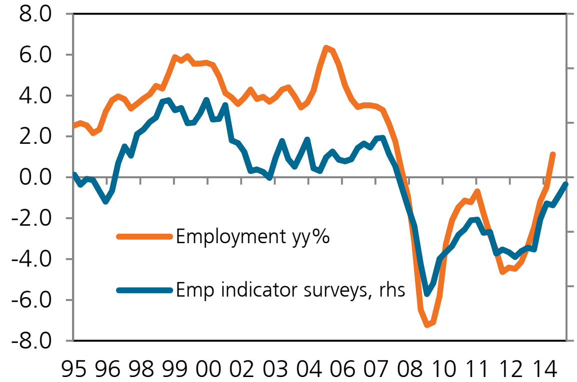
Source: Intesa Sanpaolo chart based on European Commission and Eurostat data

Fig. 10 – … production capacity



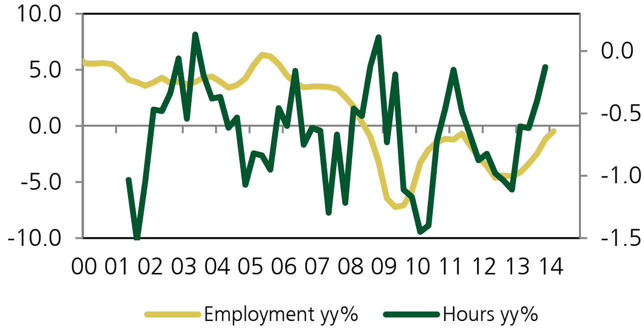
Source: Intesa Sanpaolo chart based on European Commission and Eurostat data

Fig. 11 – Recovery is extending to the labour market



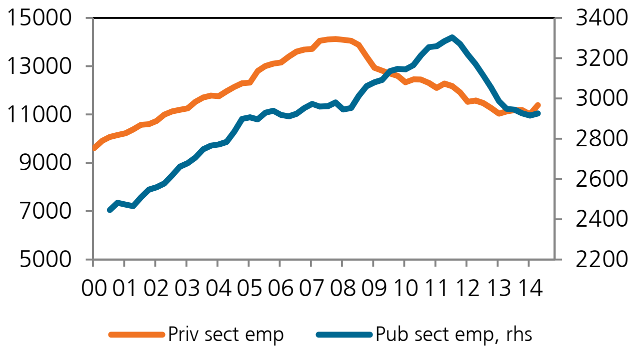
Source: Intesa Sanpaolo chart based on INE data

Fig. 12 – Rise in labour input largely through an increase in working hours



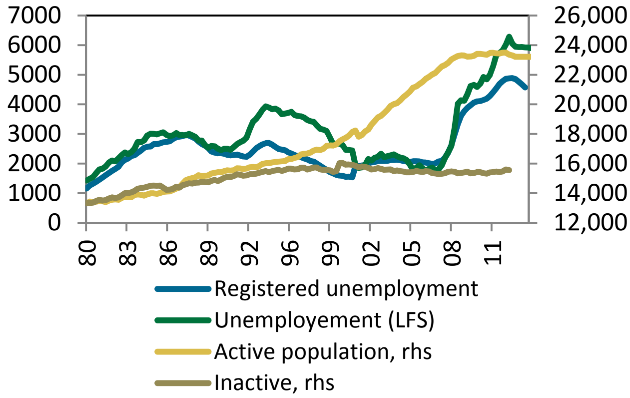
Source: Intesa Sanpaolo charts based on European Commission and INE data

Fig. 13 – Private sector starting to create jobs again



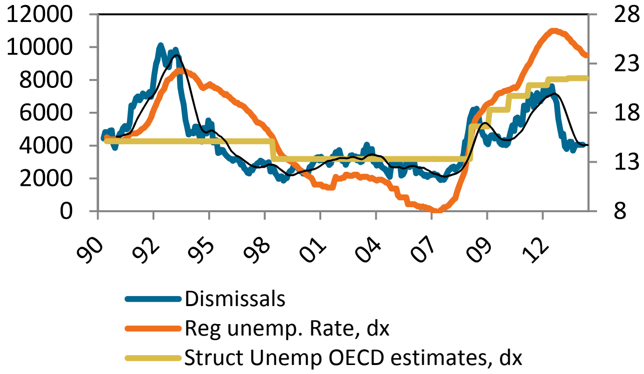
Source: Intesa Sanpaolo chart based on INE data

Fig. 14 – Number of unemployed has fallen by more than the active population, but unemployment rate will fall fairly gradually



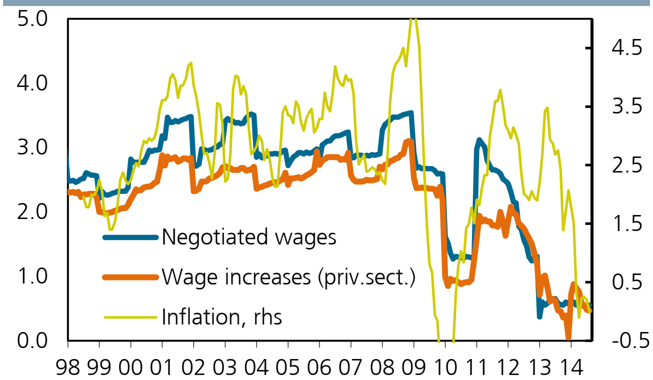
Source: Intesa Sanpaolo chart based on INE data

Fig. 15 – Fall in unemployment rate will be modest Structural rate needs to be brought down



Source: Intesa Sanpaolo chart from INE and OECD (structural unemployment rate) data

Fig. 16 – Wage moderation continues



Source: Intesa Sanpaolo chart based on INE data

Forecasts – Spain

	2013	2014	2015	2013	2014				2015		
				4	1	2	3	4	1	2	3
GDP (constant prices)	-1.2	1.3	1.7	-0.2	0.5	1.2	1.6	1.8	1.8	1.7	1.6
- q/q change				0.2	0.4	0.6	0.5	0.3	0.4	0.4	0.4
Private consumption	-2.1	1.9	1.7	0.5	0.5	0.7	0.2	0.3	0.6	0.4	0.4
Fixed investment	-5.1	1.6	3.9	0.7	-0.7	0.6	2.6	0.8	0.9	0.6	0.6
Deficit (% of GDP)	-7.1	-5.7	-4.8								
Debt (% of GDP)	94.0	97.6	103.2								
CPI (y/y)	1.4	0.0	0.2	0.1	0.0	0.2	-0.3	0.2	-0.2	0.2	0.2
Unemployment (%)	26.1	25.4	24.7	26.1	25.8	25.7	25.6	25.4	25.2	25.1	24.9
Effective exch.rate (2005=100)	99.7	99.4	98.6	100.1	100.1	99.8	99.3	98.5	98.3	98.4	98.8

NB: Percentage change on the previous period - unless otherwise stated. Source: Intesa Sanpaolo

Netherlands: growth to accelerate from 2015

Guido Valerio Ceoloni

After the mild winter that cut energy consumption (natural gas in particular), reducing GDP by 0.4% qoq, the Dutch economy resumed, in the summer quarter, the moderate expansion seen in December 2013, with growth of 0.5% qoq. Output was sustained in particular by net exports, which registered a sharp increase after stagnating in the previous quarter. We believe that net exports, revitalized by a more favourable exchange rate and recovering foreign demand, particularly in the UK, will be the main driver of the recovery from 2013, when GDP contracted by 0.7% yoy. We therefore expect very gradual but constant improvement, with GDP growth for this year seen coming in at 0.7% yoy, and at 1.3% yoy next year. Compared with our previous estimates, the figure for 2014 has been revised up, since we expect an upturn in capital investment in the second half of the year. In the following three years (2016-2018), we confirm our previous estimate of a stabilization of annual growth at around 1.5% yoy. For the current quarter, we forecast growth of 0.2% qoq, from 0.5% qoq in June.

Domestic demand is expected to remain rather flat overall, owing to weak consumer spending. In this respect, the contribution of household spending to GDP is expected to be practically zero; the employment market is still pricing in the difficult economic conditions of 2013, and household debt remains high, with a price correction taking place on the property market from the bubble levels of 2013. We therefore expect the increase in consumer spending for the current quarter to be almost zero, after growth of 0.2% qoq in June.

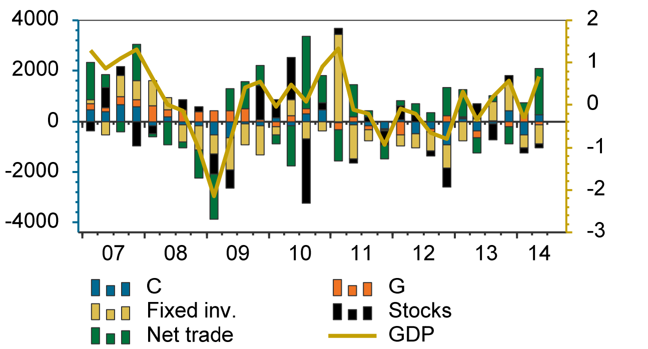
While it remains the main growth driver in the medium term, net exports may have been affected in the current quarter by the slowdown in the German economy, the Netherlands' main trade partner along with Belgium and the UK. We expect the crisis in western Europe, which affected the German economy in the summer, will also have an impact on the Dutch economy, reducing total exports, while imports are expected to bounce back (approximately +1.0% qoq) after falling significantly in June (1.1% qoq). The contribution of net exports to GDP could therefore be negative, at approximately -0.4%, from +1.2% in June. Conversely, we expect inventories to make a bigger contribution to GDP in the third quarter, owing to the fall in German orders over the summer.

Industrial output is seen gradually improving in the short term, and in the third quarter, we expect an expansion in output of around 0.7% qoq from -1.9% qoq, while in the fourth quarter, the pace should pick up to 1.3% qoq: average annual growth is therefore seen at -1.6% yoy, from +0.5% yoy in 2013, while for next year, the increase should be around 2.5% yoy.

As regards prices, inflation increased by a tenth of a point in August, to 1.0% from 0.9% the previous month, and we believe that the annual low is behind us. From now until winter, we expect a fairly rapid upturn in prices. CPI could return above 2% from autumn onwards, although the annual average is likely to be stable at 1.3%, down from 2.5% in 2013, due to the modest increases in wages, weak domestic demand and low energy costs for the whole of the first half. Prices are expected to continue to rise next year, but at a quicker rate and with an expected average of 2.5%, thereby returning to 2013 levels. Unemployment fell to 8.0% in August, with the quarterly figure en route for a decrease of 8.1% qoq, from 8.6% qoq. The improvement from a numerical viewpoint is significant, but we must consider that this figure is also partly influenced by the drop in the participation rate, which shows that labour market conditions have not yet returned to normal, despite the fact that the level in itself is positive compared with the annual high of 8.8% recorded in February. We expect, however, that unemployment will fall very gradually: we forecast an average of 8.4% for the current year and 8.3% for 2015.

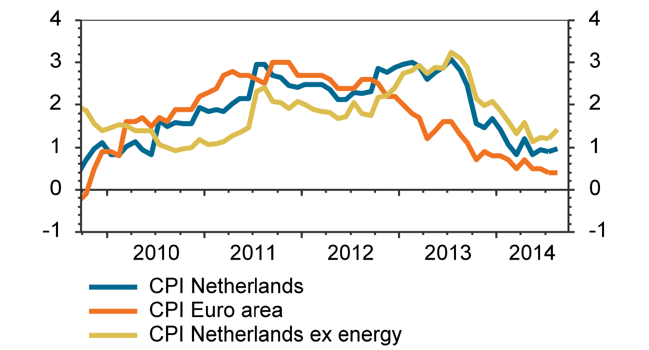
Finally, although negative compared with the past, the country's public finances remain positive, all things considered, compared with the difficulties faced by countries such as France and Italy. Control over the public accounts and cost containment measures have been implemented at a brisk pace and on schedule; we do not therefore believe that further austerity measures will be necessary. We expect the deficit to come in at 2.7% of GDP this year (previous forecast: 2.8%), from 2.5% in 2013, while next year, it is expected to fall by one point to 1.8% of GDP. The increase in the deficit from 2013 to 2014 was due to the combined effect of the sale of mobile telephone operator licenses and the nationalization of bank SNS Reaal, in which the government invested a total of approximately EUR 2.2Bn to acquire a stake. Following a report in June by Eurostat, the stake held by the Dutch government was reduced to EUR 1.13Bn, and the impact on the 2014 deficit should therefore be a tenth of a point lower than previously forecast. Stripping out these one-off effects, the structural deficit should therefore remain unchanged this year at 1.3% of GDP and fall to 0.8% of GDP next year. Finally, the public debt is seen growing slightly to 73.8% this year, falling to 73.4% in 2015 and stabilizing from then on. The risks to the forecasts are balanced, and relate for the most part to exogenous trends in the global macro economy.

Contribution to GDP



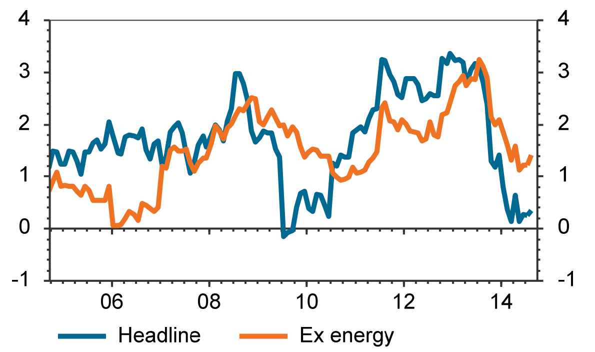
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI



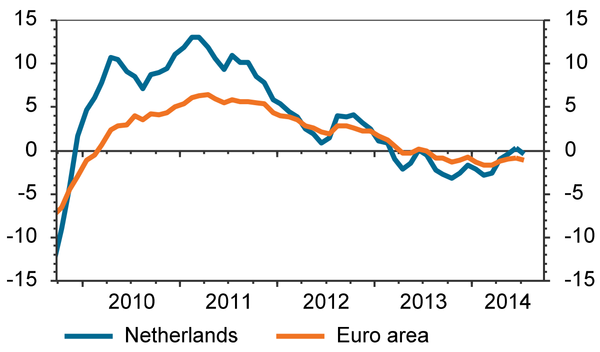
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

CPI excluding energy



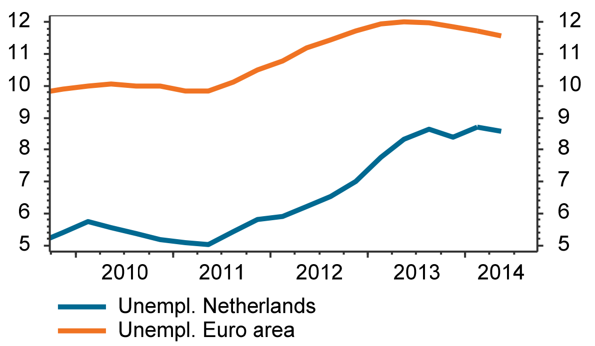
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

PPI



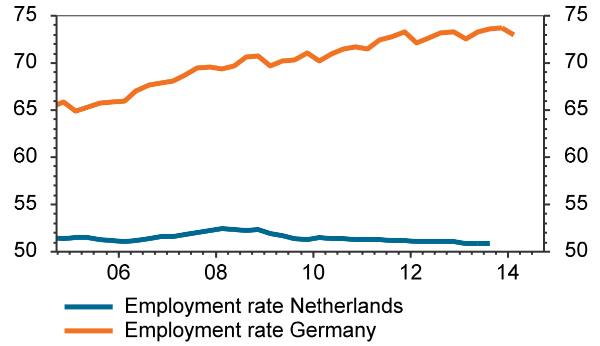
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unemployment



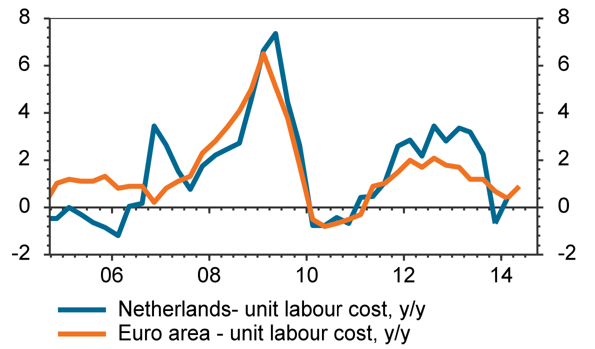
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Employment



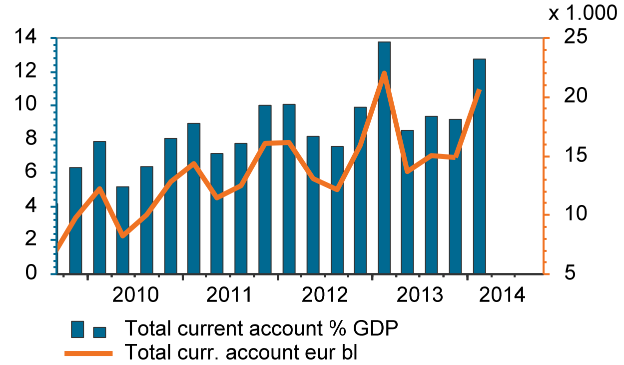
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Unit labour cost



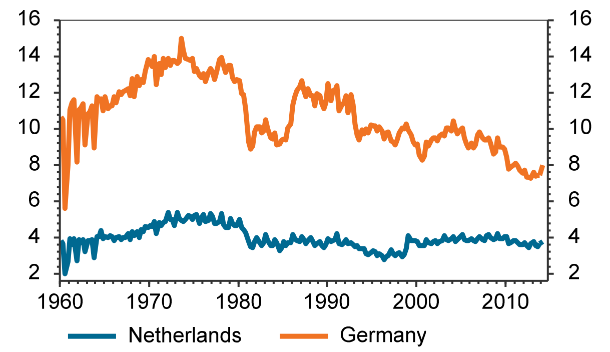
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Current account balance



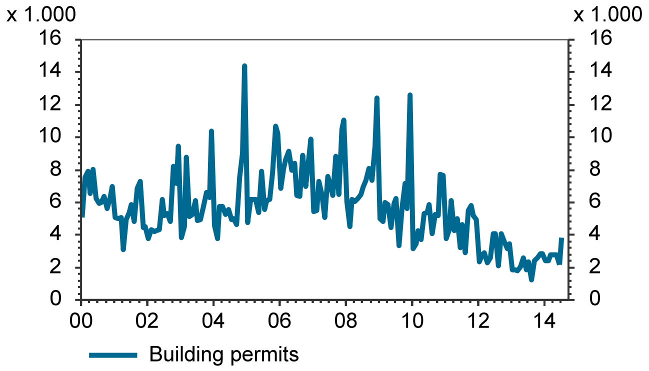
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Global exports



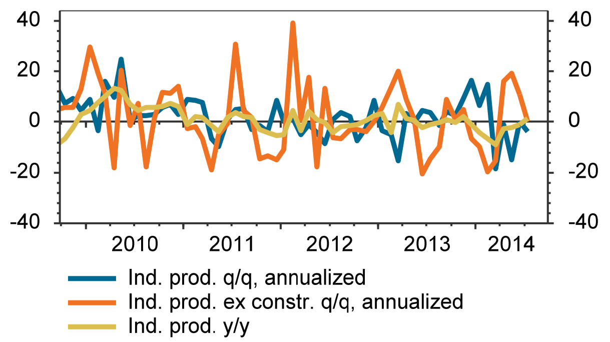
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Retail sales



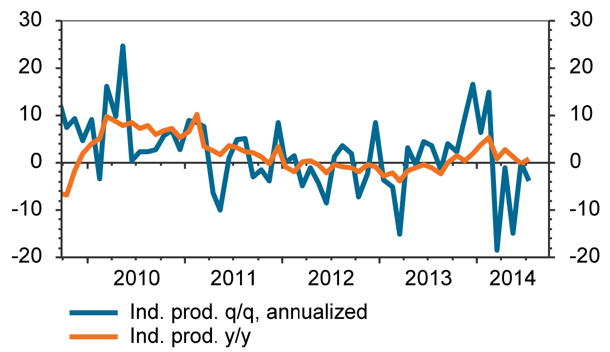
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Industrial output (excl. construction)



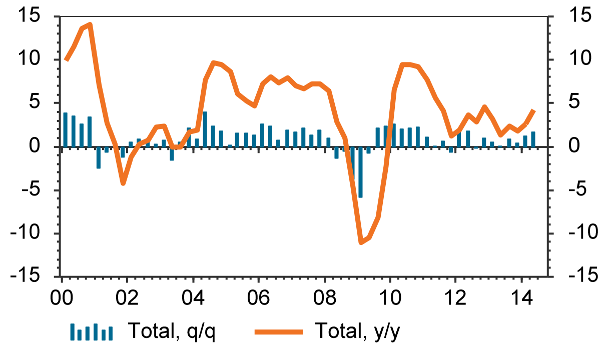
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Industrial output (manufacturing)



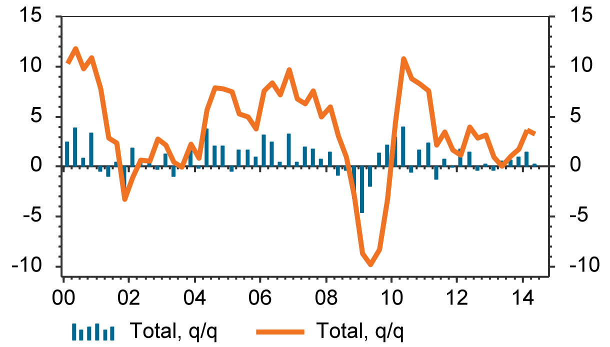
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Exports of goods and services



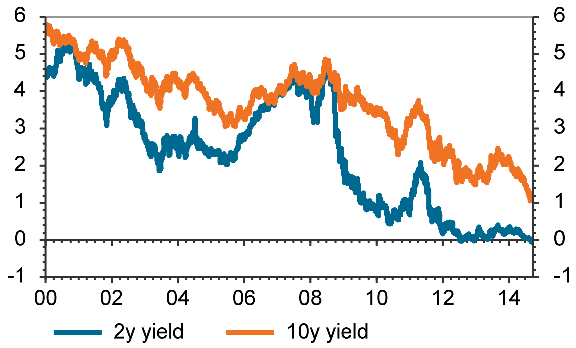
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Imports of goods and services



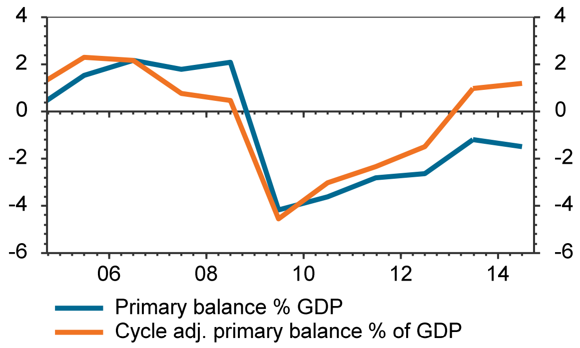
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

2-year and 10-year Govt. bond yields



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Primary balance



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Asia

Japan: a brief pause, before another ride on the fiscal rollercoaster

Giovanna Mossetti

- During 2014 and 2015, the Japanese economy will feel the effects of the massive structural fiscal tightening due to the doubling of the consumer tax rate, which was raised from 5% to 8% in April 2014 and is set to be increased further to 10% in October 2015.
- The tax hike in April 2014 triggered sharp volatility, with a spike in frontloading between the end of 2013 and early 2014, followed by a significant contraction in consumer spending and GDP in the second quarter. The restrictive effects of the increase in indirect taxes have been moderated by the temporary expansion of public investment and the large on-going monetary stimulus. Annual growth in 2014-15 is set to be around 1% (forecast: 1% in 2014 and 1.3% in 2015), still considerably better than the BoJ's estimate of potential growth of 0%-0.5%.
- A year on from the roll-out of "Abenomics", the assessment is positive; the recovery has survived the fiscal clampdown and prices are rising steadily thanks to the credible shift in monetary policy. For the time being, inflation - stripping out the consumer tax rise - is just short of the central bank's projections at around 1.3% yoy, but weak demand makes it likely that the target of 2% inflation by 2015 will not be achieved.
- In the autumn, economic policy will still be the crucial factor in the evolution of the outlook. In October, the government is likely to confirm its plan to increase the consumer tax in October 2015 and to implement at least some of the structural reforms announced in June, aimed at boosting potential growth. If fiscal policy continues down the road of deficit reduction and strengthening long-term growth, the BoJ could supply further stimulus in 2015 (for as long as is needed - hence probably into 2016 at least), with a higher target for the monetary base and bigger JGB purchases. Real interest rates will remain strongly negative and the currency may further depreciate against the dollar.

Forecast Table

	2013	2014	2015	2013	2014				2015		
				4	1	2	3	4	1	2	3
GDP (constant prices, y/y)	1.5	0.9	1.4	2.4	2.7	0.0	0.3	0.9	-0.1	2.3	2.6
q/q annual rate				-0.5	6.0	-7.1	3.2	1.9	2.0	2.2	4.3
Private consumption	2.0	-0.4	0.5	1.5	8.4	-19.0	7.4	1.6	1.2	1.2	5.9
FI - private nonresidential	-1.4	5.3	1.8	3.9	34.8	-18.8	0.0	2.0	3.5	4.2	15.6
FI - private residential	8.8	0.5	0.0	10.1	8.2	-35.6	15.4	6.0	0.1	-0.1	-0.1
Government investment	11.5	3.2	-3.5	5.8	-9.8	-2.0	2.0	2.0	-6.4	-6.4	-6.4
Government consumption	2.0	0.6	1.2	0.8	-0.7	0.3	2.0	2.0	1.2	1.2	0.4
Export	1.5	7.1	5.2	1.1	28.6	-2.0	-0.2	6.5	6.8	6.9	6.4
Import	3.3	6.9	2.3	15.7	28.0	-20.6	2.0	6.0	3.2	3.6	16.6
Stockbuilding (% contrib. to GDP)	-0.4	0.1	0.2	-0.1	-0.7	1.5	-0.4	0.0	0.0	0.1	0.1
Current account (% of GDP)	0.7	0.0	0.5	0.0	-1.1	0.5	0.3	0.2	0.4	0.6	0.1
Deficit (% of GDP)	-9.3	-8.8	-7.1								
Debt (% of GDP)	224.7	228.7	230.8								
CPI (y/y)	0.4	2.9	1.6	1.4	1.5	3.6	3.3	3.0	3.0	0.9	0.6
Industrial production	-0.6	4.1	4.1	7.6	12.5	-14.4	8.8	5.0	5.1	5.2	8.3
Unemployment (%)	4.0	3.6	3.3	3.9	3.6	3.6	3.8	3.3	3.3	3.2	3.3
JPY/USD	97.6	104.8	112.4	100.4	102.8	102.1	104.0	110.3	111.5	112.3	112.8
Effective exch.rate (1990=100)	145.2	135.0	128.3	139.7	136.3	136.8	135.9	130.9	129.8	128.8	127.7

Note: Percentage annualised growth rates over previous period, if not otherwise specified. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

A volatile recovery, with some disappointments

The Japanese economic scenario is moderately positive. Despite volatility generated by the April consumption tax hike, and significant fiscal consolidation, the recovery is continuing at a moderate pace. The government maintains fiscal consolidation as its priority, and leaves the task of supporting growth in the short term to monetary policy. In the autumn, structural reforms with medium/long-term effects, should be approved aimed at increasing potential growth. Inflation is stably positive, but lower than the BoJ's target rate: we expect the central bank to step up monetary accommodation for 2015 at its meeting at the end of October.

In the first half of the year, the Japanese economy was marred by strong volatility as expected, tied to the consumption tax (CT) hike from 5 to 8%. The second half of 2014 and the first half of 2015, on the other hand, should see moderate growth, with modestly positive changes in private domestic demand, a possible recovery in exports, thanks to the expected further depreciation of the yen, and public investments support in the central months of 2014 and in 2015 (to counterbalance the effects of the CT hike). In the second half of 2015, the scenario will turn volatile again, with a strong acceleration (in 3Q) followed by a sharp contraction (in 4Q), due to the expected CT hike from 8 to 10% in October 2015.

The 2014-2015 scenario, therefore, will continue to be dependent on fiscal changes and by on-going fiscal consolidation. Despite significant structural fiscal consolidation, the Japanese economy should in any case grow at a faster pace than the potential rate (estimated by the BoJ at 0.5%), albeit by little, in the 2014-15 biennium. We forecast growth of 0.9% in 2014, and 1% in 2015.

Inflation is stably in positive territory, although it is unlikely to reach the BoJ's 2% target by the end of FY 2015. However, the transition to a "normal" economy, characterised by stably positive inflation, now seems to have been completed, beyond the volatility tied to the increase of indirect taxes in 2014-15. The inflation expectations of households, businesses, and markets, are all in positive territory and likely to lead to further long-term changes in the behaviour of economic agents. As regards firms, the positive trend of sales prices is resulting in a structural improvement in current and projected profits, as evident from data and surveys, and is at last allowing a pick-up of the trend of nominal wages.

Given the current demographic trends, the supply of labour is weak, and could only be strengthened by a further recovery in nominal wages, and/or structural reforms encouraging the participation of women (proposed by the government, but of very uncertain implementation). On a 2-3 year horizon, however, excess demand for labour should prove persistent, therefore helping to support the wage trend. As regards households, an expanding labour market in terms of employment and wages, and the return of positive inflation, should support moderate consumption growth in both real and nominal terms, despite fiscal consolidation. Also likely to begin, given the credible positive inflation scenario, is a lasting phase of radical reallocation of household portfolios, hitherto concentrated on deposits and liquidity (53% of total financial assets, equivalent to around 1,700 trillion yen); savings should be shifted to more remunerative assets, such as stocks and bonds, with asset diversification by currency.

Until 2016, the outlook for the Japanese economy will therefore continue to be dominated by economic policy decisions. Our forecasts for modestly positive growth and for an inflation rate of around 1.5% net of indirect taxes, is based on expectations for 1) an increase of the CT to 10% in October 2015, and the possible introduction of transitory fiscal stimulus measures to spur public investment spending; 2) extension to 2015-2016 of qualitative and quantitative monetary policy easing introduced by the BoJ at the beginning of 2013, with a likely increase of the monetary base, to be achieved through larger purchases of medium-long term JGBs.

Private demand: reflation supporting consumption and investment, despite fiscal consolidation

Non-residential fixed Investments – Business activity slowed visibly in 2Q, following implementation of the CT increase, but prospects for 2H point to a modest expansion of activity, and to a recovery in fixed investments. Survey indices are back to expansionary levels; industrial production is rising again, although at a rather slow pace (Fig. 3), and orders are show solid increases. The outlook for investments points to a lasting recovery in the coming quarter, tied to a number of mutually supportive factors. Return to positive inflation, and the recovery in final demand, are at least affording pricing power to enterprises, with a positive fallout on their profitability, as made obvious by sector surveys (assessment of profits and sales), and by the statistics on profits published by the Ministry of Finances. Secondly, real interest rates have been in negative territory since 2013, and financial conditions have been markedly accommodative. Lastly, the economy is now in a situation of full utilisation of productive capacity, as judged by firms: the March 2014 Tankan survey found that companies believe, for the first time since 2008, that excess productive capacity has been fully reabsorbed. Therefore, we expect investments to keep growing in 2015 at a moderately positive pace (forecasts: 5.5 % in 2014, 2.8% in 2015).

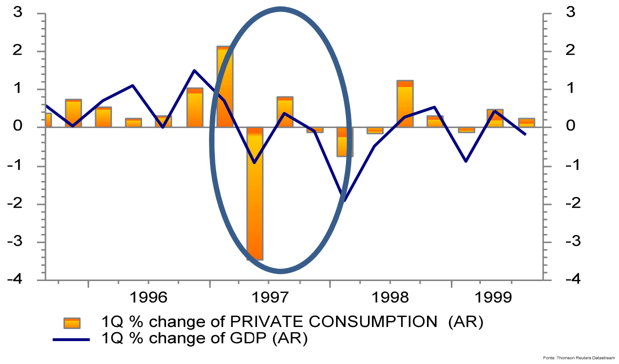
One factor that is holding back industry is the quasi-stagnation of exports (Fig. 5), despite the depreciation of the yen, under way since the end of 2013 (Fig. 6). The slowdown in growth in Asia in particular is weighing on demand for exports, although data in the past few months point to a moderate recovery. Exports to Asia account for 53% of the total, followed by exports to the United States (18%), and the EU (10%). China alone absorbs 18% of Japan's total exports. The likely acceleration of the US recovery, combined with the depreciation of the yen against the dollar, should support a strengthening of Japanese exports, although the overall contribution of net exports to growth will stay negative in the foreseeable future.

Consumption and labour market - The economy has been growing at rates well above potential since 2012, resulting in a progressive narrowing of the output gap (now closed to zero, according to BoJ estimates[6], see also Fig. 10), and in excess demand materialising on the labour market (since 2013). In the summer months, the unemployment rate rose from its recent low of 3.5% (May 2014) to 3.8% (Fig. 7). The reading should be interpreted positively, as it stems from an increase in the participation rate (Fig. 8), while both employment numbers and job openings are on the rise (jobs to occupant ratio of 1.1 in July and August, a high since June 1992). Between the end of 2014 and the end of 2015, we expect the trend of the unemployment rate to turn back down, with payroll growth prevailing over the participation weakness.

Excess demand for labour, and the return of inflation to positive values, combined with the recovery of company profits, have helped reverse the trend of nominal wages, that accelerated moderately in the contract-renewal phase last spring, and have now been on the rise for over a year (Fig. 9). The role played by wages is essential in guiding the consumption trend which, due to fiscal consolidation, is expected at -0.4% in 2014, and then to rise modestly in 2015 (+0.4%). Inflation expectations are also contributing to the expansion of households' spending (Fig. 11). Until well into 2016, the path of actual inflation will be influenced by the CT hikes, but consumers are by now perceiving that the price scenario has changed structurally compared to the deflation period.

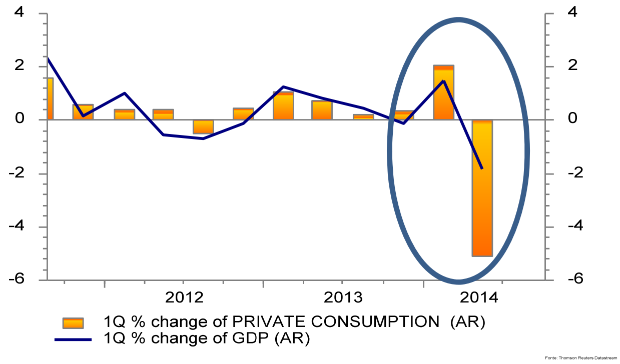
[6] http://www.boj.or.jp/en/mopo/outlook/gor1404b.pdf

Fig. 1 - GDP and consumption in 1997-98…



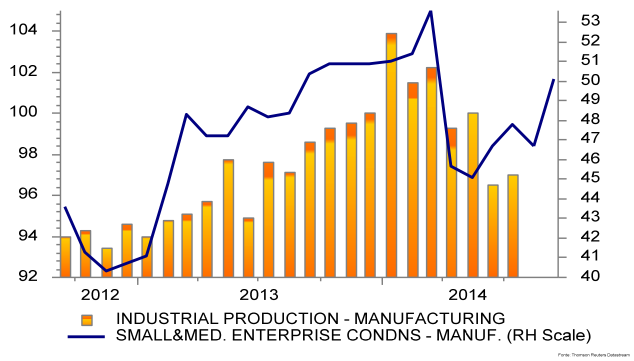
Source: Thomson Reuters-Datastream

Fig. 2 - … and in 2013-14



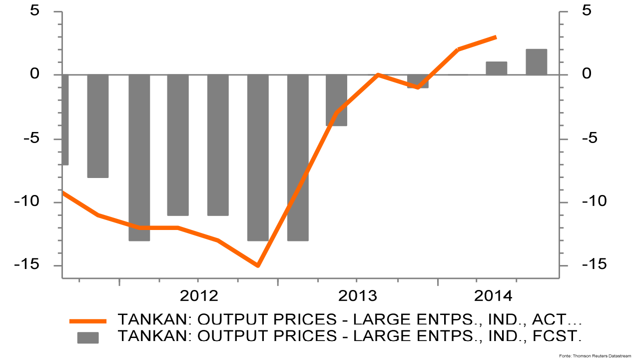
Source: Thomson Reuters-Datastream

Fig. 3 – Business activity recovering…



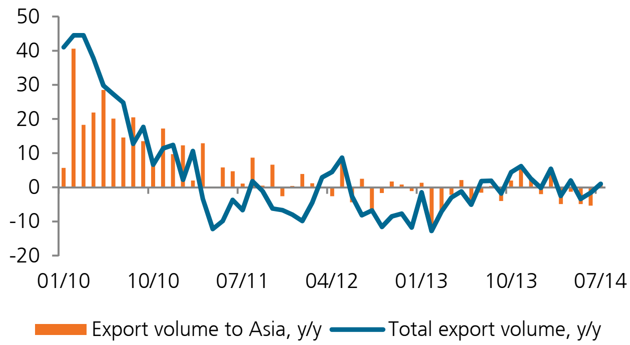
Source: Thomson Reuters Datastream

Fig.4 - … and price-setting behaviour consistent with a deflation-free scenario



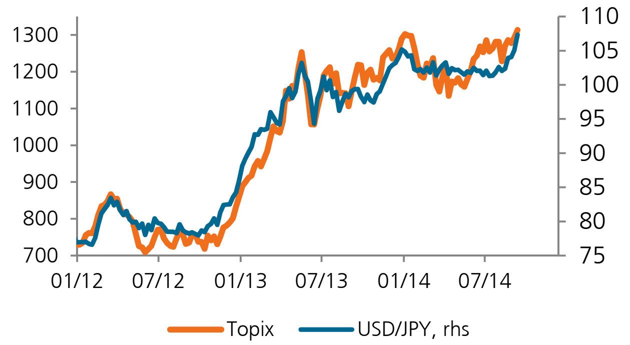
Source: Thomson Reuters Datastream

Fig. 5 - Exports sluggish…



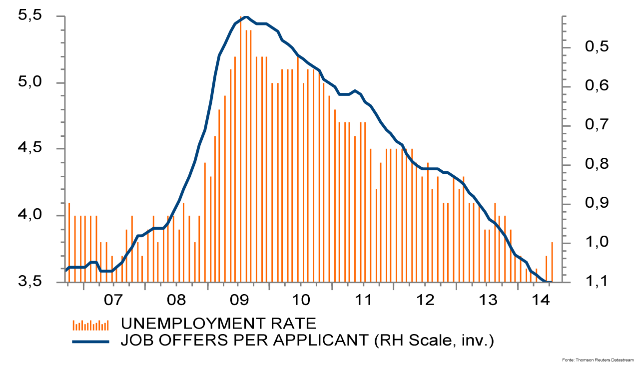
Source: Bloomberg

Fig. 6 - … but market confidence helped by the exchange rate



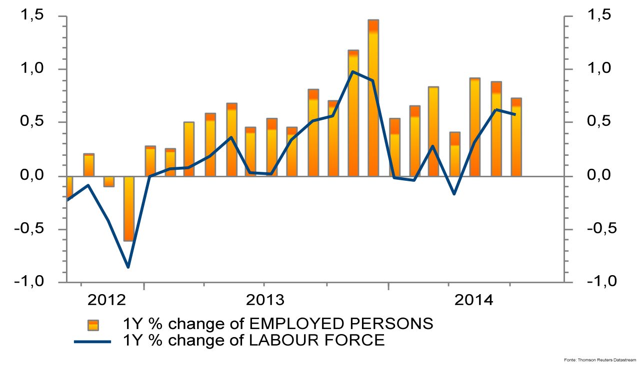
Source: Bloomberg

Fig. 7 – Unemployment rate and jobs-to-applicant ratio



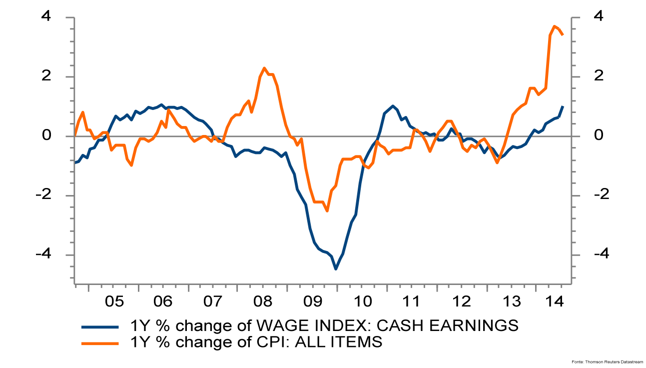
Source: Thomson Reuters-Datastream

Fig. 8 – Payrolls and labour force on the rise, although part-time contracts prevail



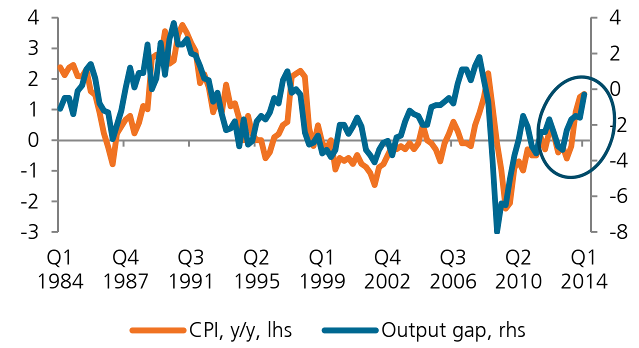
Source: Thomson Reuters-Datastream

Fig. 9 – Wages and inflation



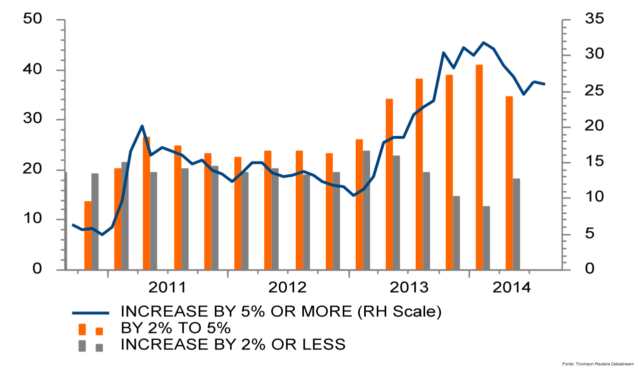
Source: Thomson Reuters-Datastream

Fig. 10 – Output gap and inflation: tighter relationship than in the past



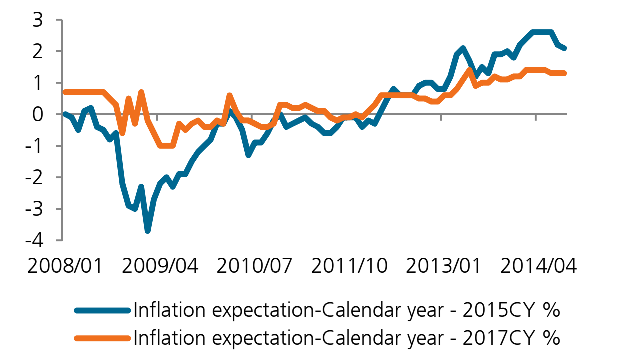
Source: Thomson Reuters-Datastream

Fig. 11 – Inflation expectations of households: soundly positive



Source: Thomson Reuters-Datastream

Fig. 12 – Markets expect positive inflation, but below the BoJ target



Source: Intesa Sanpaolo elaborations on Japanmacroadvisors data. Expectations based on inflation as implied by JGB linkers

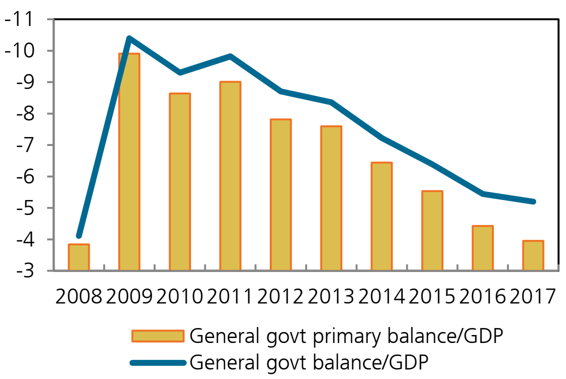
Fiscal policy – A menu based on fiscal consolidation and structural reforms

Fiscal policy remains geared to the structural consolidation of public accounts. The Ministry of Finance defines the fiscal situation as "severe" and "worsening due to higher spending", social security in particular. The second objective of the government's economic policy is to step up potential growth through structural reforms. The medium-long term plan is still to halve the primary deficit compared to its 2010 level by the end of FY2015 (from -6.6% to -3.3% of GDP), and to achieve a primary surplus by the end of FY2020. The targets laid out for the primary deficit should be reached through primary spending control and a progressive increase in fiscal revenues, supported by positive nominal GDP growth in excess of 3% a year. A crucial part of interventions on spending will concern the pension sector, with reforms still to be put in place, whereas on the front of revenues the lion's share will be accounted for by the CT hikes, which should end in October 2015. Thanks to the containment of the primary balance, the government expects to stabilise the debt/GDP ratio in FY2015 and achieve a gradual decline subsequently, up to 2020 (187.9% of GDP), beyond which the trend will turn moderately upwards again on the horizon considered (2023).

In the autumn, the government should announce its final decision on the CT increase scheduled in October 2015 (from 8 to 10%). In the opening weeks of September, doubts were raised on the economy's ability to face up to a new increase in indirect taxes; however, we believe the government will push on with the second tax hike, accompanying it, as was the case in 2014, with a temporary increase in public spending on investments. An additional budget worth around 4-5 trillion yen (around 1% of GDP) could be approved by December, together with the budget for the next fiscal year. The government also has other important commitments lined up for the next few months, first among them the implementation of the structural reforms outlined in June, which should include changes to the functioning of the labour market (liberalisation of immigration and of work-hours, reform of employee health care schemes, incentives encouraging the participation of women) and a reform of corporate taxation. On this front, the government's aim is to reduce the corporate tax rate towards 20% (from 39% at present) over a period of several years, starting in FY2015.

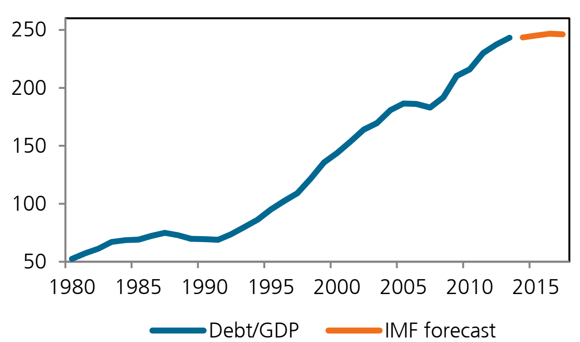
We expect the **budget for FY2015 to confirm the deficit consolidation path**, with indications of a likely stabilisation of the debt/GDP ratio by the end of 2016. On-going virtuous fiscal policy is also a necessary condition for the BoJ to consider the possibility of stepping up monetary accommodation for 2015.

Fig. 13 – Consolidation of public accounts to continue…



Source: IMF

Fig. 14 - … with a likely stabilisation of the debt/GDP ratio

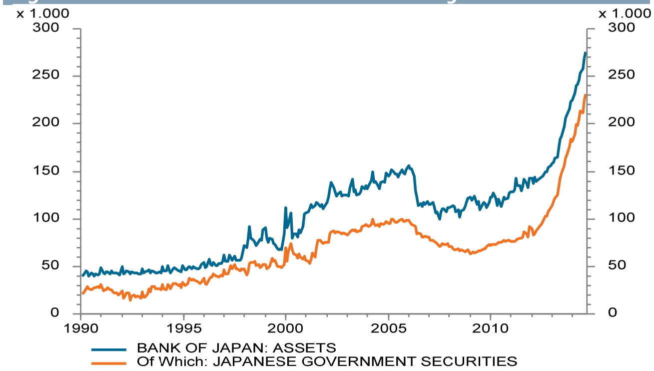


Source: IMF

Monetary policy - The same old story… - The BoJ has kept monetary stimulus unchanged following implementation of the CT hike in April, with the aim of gathering information on the evolution of the scenario. At the end of October, the central bank will publish its semi-annual report on activity and prices, updating its projections for the next three years. To date, indications have pointed to an inflation forecast of around 1.25% "for some time" (net of the tax hike). In recent months, inflation has followed the path envisaged by the BoJ, which acknowledges that prices are around half-way to reaching the 2% goal by the end of 2015. In the latest periodic assessment of economy, stagnating exports and uncertainty clouding forecast final demand were highlighted, despite the strong depreciation of the exchange rate and ultra-accommodative financial conditions. Inflation expectations are rising very modestly (Fig. 12) and remain well below 2% in 2017, when the transitory effects of the CT hikes will have disappeared. **Our forecast is that at its meeting at the end of October the BoJ may announce an increase in the monetary base target for 2015,** to be achieved through a new increase in medium-long term JGB purchases, on condition of the government confirming its plans to hike the CT again in October 2015.

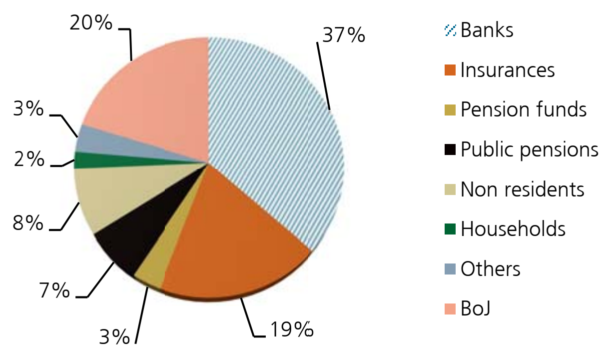
Against this background of continuing monetary accommodation, the exchange rate would depreciate further, possible stabilising at least at 110 against the dollar, with persistent downward pressures on yields at the long end of the curve. The BoJ's balance sheet (at around 50% of GDP in 2014) would continue to expand, with an increasing share of public debt held by the central bank. In 2Q 2014, the BoJ held 20% of total outstanding JGBs and T-bills, and 18.7% of JGBs (vs. 8.5% of JGBs in mid-2011). The monetisation of a part of the public debt is a necessary factor in curbing the risk of a Japanese debt crisis. We expect the compression of yields to also be strengthened by a reallocation of households' portfolios to the advantage of assets other than deposits, which for now account for the lion's share of total financial assets.

Fig. 15 – BoJ balance sheet will continue to grow



Source: Thomson Reuters Datastream

Fig. 16 – Public debt holders (JGBs + T-bills)



Source: Ministry of Finance. Data as at 2Q 2014

China: property sector drags down investment

Silvia Guizzo

- GDP grew by 7.5% yoy in 2Q, slightly up on the figure of 7.4% in 1Q, and by 2% qoq vs. 1.5% in 1Q, thanks to the positive performance of agriculture and services. After the 2Q improvement, cyclical indicators between June and August suggested the trend was now slowing, mainly as a result of the downturn in investment in residential building, while consumer spending and exports continue to hold up.

- Investment in transport infrastructure and in social housing continues to slow the deceleration in total investment, still hampered by weakness in the property market, which deteriorated in the summer. The fall in residential property prices and the difficulties faced by smaller property companies, as well as the number of unsold units, confirm the forecast of a further slowdown in the property sector in the next few months, despite the easing of anti-speculative measures in various regions of the country. This is expected to negatively impact the employment market and dampen consumer spending next year; private consumption this year will continue instead to support growth, together with a slight acceleration in exports. Our GDP growth forecasts for this year and next therefore remain unchanged, with continued downside risks.

- Consumer price inflation fell to 2.0% yoy in August, from 2.3% in the two previous months, thanks to the drop in food prices, although we think this is temporary. A significant rise in meat prices looks likely in the next few months, which, in tandem with the possible reform of domestic gas prices next year, could spark a rise in total inflation. In the absence of upside pressure from other segments, the rise in inflation should, however, be limited: the annual average for 2014 is seen at 2.3%, and at 2.5% in 2015.

- In recent statements, the Authorities have confirmed that they intend to continue their policy of limited and targeted support for lending, as well as measures to contain and regulate lending outside the banking sector. We believe that the central bank will continue to provide liquidity to the market through open-market operations and to prevent excessive and/or lasting rises in money market rates. We interpret the 20 bps cut in the 14-day reverse repo transaction rate in September, and the longer maturity of loans provided through the Standing Lending Facility, from this perspective. We also believe that the PBOC will not make any adjustments to the cash reserve ratio or to rates unless there is a sharp drop in macro figures in the next few months.

Macro forecasts

	2009	2010	2011	2012	2013S	2014P	2015P
GDP (at constant prices)	9.2	10.4	9.3	7.7	7.7	7.3	7.1
Consumer spending	10.3	8.2	10.3	9.4	8.5	8.4	8
Public consumption	6	11.4	12	5.5	7.4	7.2	7.4
Capital investment	22.4	11.3	8.7	9	9.2	6.8	6.5
Exports	-11.4	26.1	4.1	3.1	5.8	6.6	7.2
Imports	2.7	19.4	5.3	4.1	7.8	5.7	6.9
Industrial output	9.9	12.3	10.3	7.9	7.8	7.3	7.2
Inflation (CPI)	-0.7	3.3	5.4	2.6	2.6	2.3	2.5
Unemployment	4.3	4.2	4.1	4.1	4.1	4.1	4.0
Average wages	10.4	14.1	16.8	14.4	13.4	11.1	10.5
90-day interbank rate (average)	1.7	2.7	5.3	4.6	5	5.2	5
USD/CNY exchange rate (average)	6.83	6.77	6.46	6.31	6.15	6.14	6.10
Current account balance (CNY bn)	1662	1604	874	1360	1124	1621	1476
Current account balance (% of GDP)	3.2	3.1	1.7	2.6	2.2	3.1	2.9
Budget balance* (% of GDP)	-3.9	-4.0	-1.8	-2.5	-3.6	-3.6	-3.3

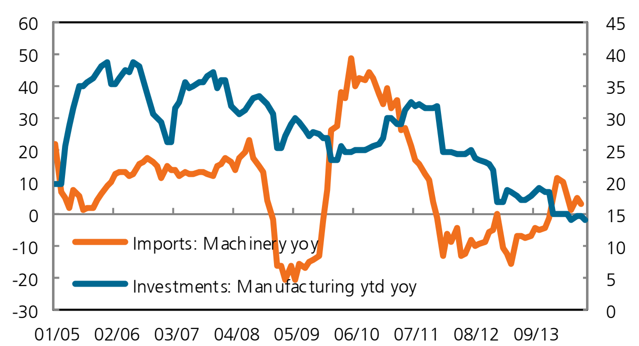
NB: Percentage change versus previous period except where otherwise indicated; *IMF Article IV 2014 estimate
Source: Oxford Economic Forecasting and Intesa Sanpaolo

Real economy and inflation

GDP grew by 7.5% yoy in 2Q, slightly up on the figure of 7.4% in 1Q, and by 2% qoq vs. 1.5% in 1Q, thanks to the positive performance of the agricultural sector (+3.9% yoy, from 3.5% yoy in 1Q), but also of services, where growth continues to outstrip that of manufacturing (+8% yoy vs. 7.4%). The July and August figures in general pointed to a fresh slowdown, after the improvement registered in the second quarter, with the exception of consumer spending and exports, which continue to hold up.

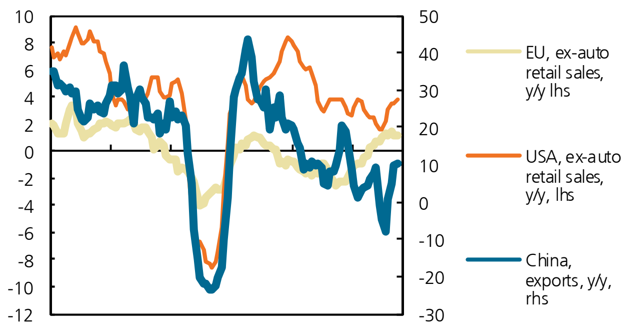
Industrial output rose by 6.9% yoy, compared with 9.0% in July, the lowest since 2008. The figure was affected by the comparison with the sharp rise in the year-earlier month, but the overall ytd change (+8.5% yoy), which was not influenced by these effects, also slowed, to 8.8% in June and July, and the monthly seasonally adjusted increase was a mere 0.2%, compared to advances of more than 0.6% in the previous six months. The deceleration was driven by the energy (electricity and gas) production sector and manufacturing, particularly the production of cars and ferrous and non-ferrous metals, but also by the food sector. Whereas the added value of this sector may have been affected by falling food prices, the figures confirm that the slowdown in other segments was due to volume. This is in line with the process of consolidation in heavy industry, the slowdown in the property sector and the trend in the PMI index. The fall in the total orders component in August (from 53.3 in July to 51.3), which outstripped that of foreign orders, confirms the weakness in domestic demand; this is also signalled by the trend in investments and imports, as well as cargo traffic figures. The breakdown of the PMI by company type shows a deterioration in the outlook for medium-sized companies between May and August, while the outlook for small companies was broadly unchanged and weak, although better than at the beginning of the year. The survey on industrial companies for 3Q confirms that entrepreneurs confidence has weakened, with a fall in the total orders component, although this is still higher than the low in 1Q14.

Manufacturing sector investment



Source: CEIC

Exports hold up



Source: Bloomberg

Nominal urban capital investment slowed further (16.5% ytd yoy in August, down from 17.2% ytd yoy in May), on the back of growing weakness in residential building (+10.8% ytd yoy in August), which is now at 2012 lows, and in investment in the property sector. Investment in transport infrastructure continues to hold up, supported in particular by investment in the railways (+20.6% yoy) and waterways, and probably accounts for the bulk of the increase in new investment (24.4% yoy). Investment in the manufacturing sector remained broadly unchanged (10.1% yoy in August vs. 10.2% yoy in May), and the limited improvement in machinery imports from last year's lows point to stability in the next few months.

Imports continue to stagnate (-2.3% yoy in August and -1.5% yoy in July; +0.4% 3m yoy), reflecting weak domestic demand. Imports of ordinary goods are still falling (-2.8% 3m yoy in August), while imports for processing trade have picked up slightly (+5.3% 3m yoy). Exports, conversely, have improved further (+10.4% 3m yoy in August, from +0.5% 3m yoy in May), supported by higher demand in the US and Europe, and by the resilience of ASEAN countries; however, exports to Japan continue to slow (-0.2% 3m yoy in August). These trends fuelled a further increase in the trade surplus to USD 200 billion in the first eight months of the year, compared with USD 154 billion in the year-earlier period. However, we believe that the upturn in exports will be limited, given the weak outlook of the eurozone and the marginal slowdown in South-East Asian economies.

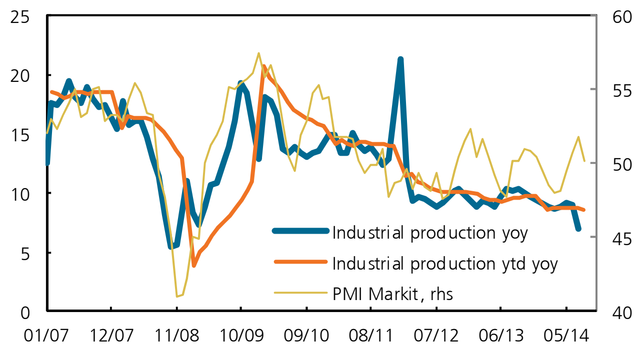
Retail sales slowed slightly in August year-on-year (+11.9% yoy vs. 12.2% yoy in July), but on a cumulative basis growth has remained stable at 12.1% since May, and monthly growth (+0.9% mom) is in line with previous months. In real terms, however, retail sales rose slightly, thanks to the fall in inflation. Sales of cosmetics, jewellery, clothing and household appliances are accelerating, while car sales are slowing. Despite being higher than the quarterly average and significantly improved on last summer's lows, the statistical office's consumer confidence index registered a slight fall over the summer, while the Unionpay index contracted sharply. The labour market is still positive, the urban unemployment rate is steady at 4.1%, and the number of employed people has risen. However, growth in new jobs is slowing slightly, while the number of unemployed people in urban areas has marginally increased over the last four quarters. The Manpower survey of companies' hiring intentions for 4Q signals a further increase in new hires, but is at its lowest since 2010, particularly for the manufacturing, property and financial sectors. The continued slowdown in the property sector is bound to have an impact on the economy, and therefore on the labour market – partly due to its links with many manufacturing sub-sectors – with a dampening effect on consumer spending next year.

Consumer price inflation fell to 2.0% yoy in August, from 2.3% in the two previous months, thanks to falling inflation in the food sector, down from 3.7% yoy in June to 3% yoy in August, and in the transport sector. There are no signs of pressure on other segments; stripping out food and energy, inflation has remained broadly unchanged since February, although it fell marginally in August (1.6% yoy vs. 1.7% in the two previous months). Production prices continue to fall (-1.2% yoy in August), reflecting the price trend in industrial materials (-1.4% yoy), which is likely to remain weak in the next few months. Pork stocks, however, point to a substantial rise in meat prices in the coming months; in tandem with this, a reform in domestic gas prices next year could spark an increase in total inflation. In the absence of upside pressure from other segments, the rise in inflation should, however, be limited: the annual average for 2014 is seen at 2.3%, and at 2.5% in 2015.

The property market has slowed even further, although some indicators have partly been affected on a year-on-year comparison by the sharp rise in the year-earlier period; however, this effect is progressively lessening in the second half. Floor space sold fell by 10% yoy in August, and residential property sales fell by 10.9% yoy in value terms; office sales declined by 19.5%. Sales of commercial property are still positive, but slowing sharply compared with last year (+7.5% yoy in August vs. +18.3% yoy at end-2013). The number of cities recording property price falls rose steeply, from 10 in April to 69 in August, out of 70 cities surveyed, and prices have fallen for four consecutive months. The estimated average fall of prices in August is 1.1% mom (1.2% mom in first-tier cities), which is much higher than the average fall during the slowdown in 2012 (low of -0.3% mom) and in line with the end-2008 figure (-0.8% mom according to the old survey). The property sector confidence index dipped only marginally over the summer, remaining just above 2012 lows, while the property sub-index of the Shanghai stock exchange was again in line with the overall index, which has been positive since the end of August. Credit growth in the real estate sector, which was strong at least until June (19.2% yoy), could however fall in the next few months, given the general slowdown in both bank and non-bank lending. The central government has not yet officially expressed its opinion on the nationwide relaxing of anti-speculative restrictions imposed in recent years, especially on the purchase of second homes, but it hoped that more mortgages would be granted to households.

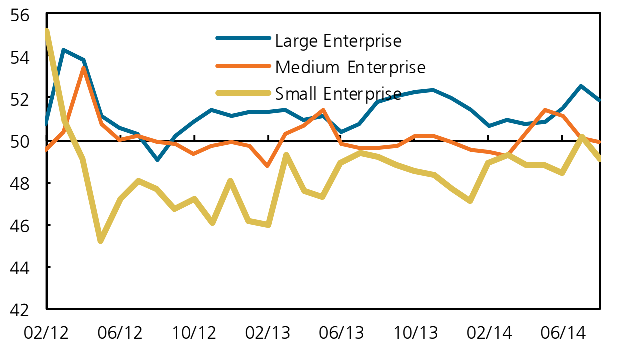
The authorities are also assessing the possibility of allowing listed property companies that meet solidity requirements to issue medium- to long-term securities on the interbank market, and to use the proceeds to build non-luxury property only. Meanwhile, many local governments have in any case relaxed various anti-speculative measures introduced previously. Property analysts believe that the modest relaxation of monetary policy, the government's support for social housing, the increase in transactions in response to the discount policies offered by some property developers and the low household debt will stabilise the market in the last part of the year. However, the recent figures on residential property prices and the difficulties faced by smaller property companies owing to higher financing costs, as well as the number of unsold units, confirm the forecast of a further slowdown in the property sector in coming months.

Industrial output is slowing further



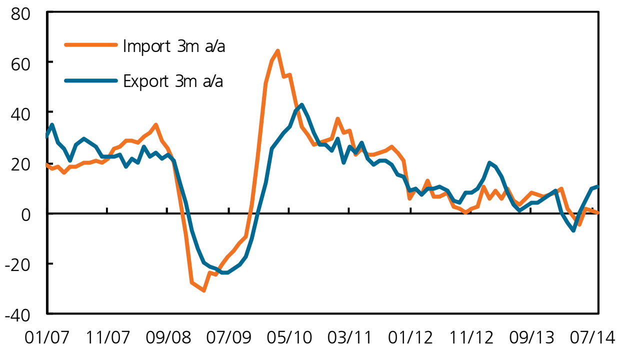
Source: CEIC, Markit

PMI outlook is weakening again



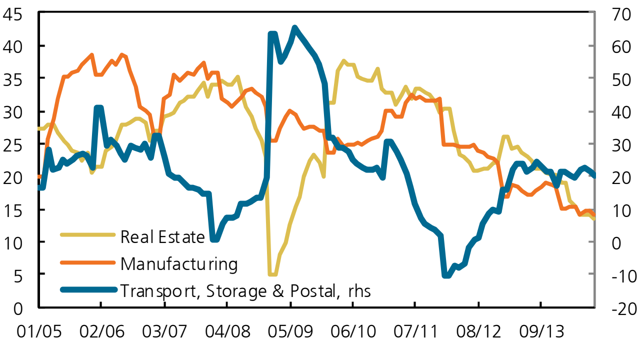
NB: Manufacturing PMI; Source: CEIC

Imports continue to show signs of weakness



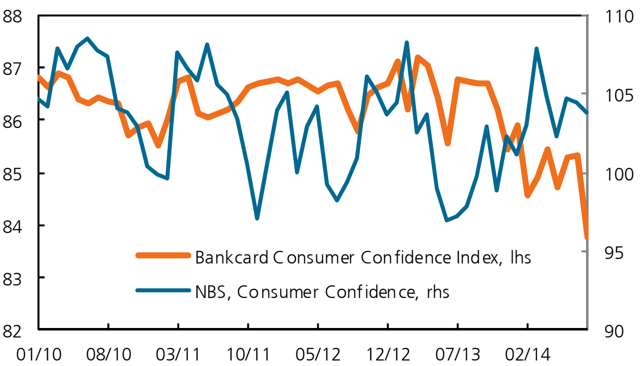
NB: Chg. % 3m yoy. Source: Bloomberg

Investment in transport infrastructure is holding up (%)



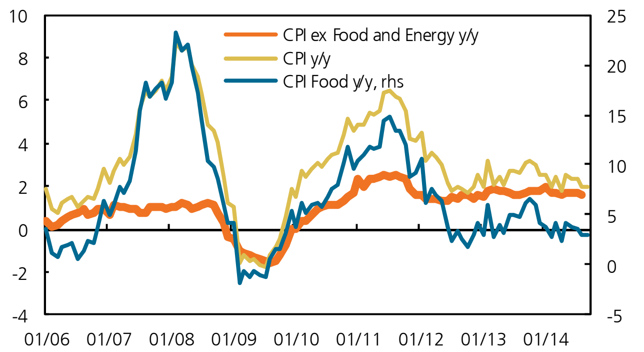
NB: Nominal investments, chg. yoy. Source: CEIC

Consumer confidence is falling



Source: CEIC

Core inflation remains stable



Source: Bloomberg

Economic and fiscal policy

At the end of August, the National People's Congress Standing Committee approved the new Budget Law, which had not been revised since 1995 and will come into effect at the beginning of 2015. The Law incorporates some of the reform proposals that emerged during the Third Plenum in autumn 2013. It provides that henceforth, all state-sector income and expenditure will be included in the budget, including spending by the financial vehicles of local governments and income from the sale of land rights, all items that have to date been off-balance sheet. Furthermore, it enables local (provincial and municipal) governments to issue securities within the limits of a quota set by the State Council (and approved by Parliament and the Standing Committee) to raise funds to be allocated exclusively to investment spending, in accordance with the changes made to the existing pilot project in the spring[7]. It also contains various provisions to ensure public access to state budget documents. The new Budget Law moves in the direction of the fiscal reform proposal outlined in the Third Plenum, although it does not tackle the important problem of redistributing responsibility for spending and authority and capacity for imposing taxation between local governments and central government; the authorities probably intend to deal with this in another related law in the future.

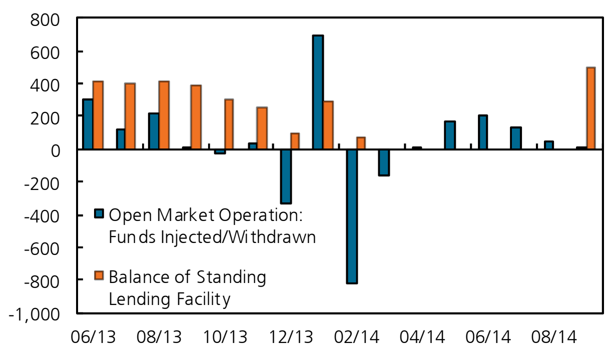
Policies aimed at reducing surplus production capacity in certain sectors and providing support to small companies continued. At the beginning of August, the Ministry for Industry and Information Technology ordered that every new plant producing steel, cement, electrolytic aluminium or plate glass must be matched by the closure of an existing plant with an at least equivalent or greater production capacity in certain specific regions. Shortly afterwards, and in response to the fact that certain local governments had failed to comply, a decree was issued prohibiting the opening of new cement and sheet glass production facilities. The government raised the level of revenue (from CNY 20,000 to CNY 30,000) below which small companies will be exempt from paying VAT and income tax from 1 October until the end of 2015, as well as import duty on imports of high-tech machinery that is not available in the country.

Monetary policy and foreign exchange

Lower new bank loans in July and August reduced the growth rate to 5.1% ytd yoy in the first eight months of 2014, from 13% in June. The trend was even worse for total social finance, which fell by 6.4% yoy in the same period, owing to the drop in trust loans and bankers' acceptances. The stock of both aggregates continues to gradually decelerate. Short-term bank loans are slowing in particular, whereas the trend in long-term loans remains better and broadly stable. The further increase in non-performing loans, both in absolute terms (+28.7% yoy in 2Q14) and, marginally, in relation to total loans, continues to point to a slowdown in credit growth in the next few months. In addition, corporate demand for loans fell in the third quarter according to the banking sector confidence survey conducted by the PBOC, to just under its 2012 lows. M2 growth again slowed, to 12.8% yoy in August from 14.7% yoy in June, and the growth rate of local currency deposits (10.1% yoy in August) is at its lowest since the series began.

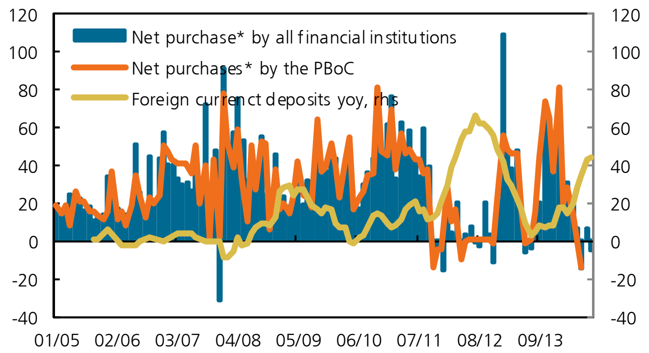
[7] See Quarterly Macroeconomic Outlook, June 2014:

Liquidity injected by the PBOC (CNY billion)



Source: CEIC

Private citizens are accumulating foreign currency



Source: CEIC and ISP estimates. * monthly change in foreign currency reserves and banks' foreign currency purchase position, in USD billion, left-hand scale

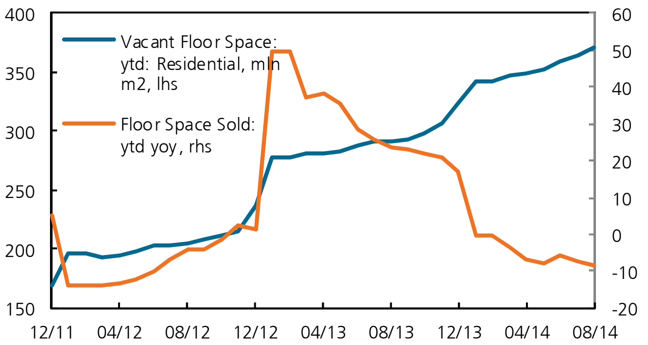
Net issue of liquidity through open-market transactions and ordinary reverse repos has gradually fallen from its June high, while targeted refinancing transactions have continued. The overnight rate fell by 50 bps from its July high, but at around 2.85%, remains above its spring lows. The press recently reported the granting of a three-month CNY 100 billion loan to each of the five large state banks[8] in September – not officially confirmed either by the PBOC or the individual financial institutions – through the Short Term Liquidity Facility or Standing Lending Facility (SLF). This instrument was introduced in 2013, together with short-term liquidity operations (SLO), to manage the significant demand for liquidity through loans collateralised by securities. Initially limited to the big banks and for loans with maturities from one to three months (renewable), it was then extended to all banks in January 2014, with very short maturities (overnight, seven and 14 days).

The PBOC granted a lower amount of loans (CNY 290 billion) through the SLF in January 2014 before the beginning of Chinese New Year's holidays, but at the same time it issued funds totalling CNY 700 billion through ordinary reverse repos, albeit with shorter maturities. The amount of liquidity injection was hence comparable to this recent one. We do not believe that the PBOC is changing its monetary policy stance, but we think that the measure is largely of a preventive nature, given the rise in demand for liquidity at the end of the quarter. This is caused by financial institutions needing to meet liquidity requirements, and was this time exacerbated by the start of the holiday week for the foundation of the People's Republic (from 1 October, National Day of the People's Republic of China) and by various IPOs expected in the next few weeks/last quarter of the year[9]. At present, liquidity is also coming under further pressure from the upturn in foreign currency deposits (+43.6% yoy). This is being temporarily sustained by expectations of further appreciation in the dollar in the next few months, which is motivating private citizens not to convert them, as well as the possibility of PBOC measures to dampen excessive expectations of yuan appreciation, as happened in the spring. Foreign currency purchases by financial institutions have in fact returned to their summer lows, as have those of the central bank.

[8] Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China and Bank of Communications.

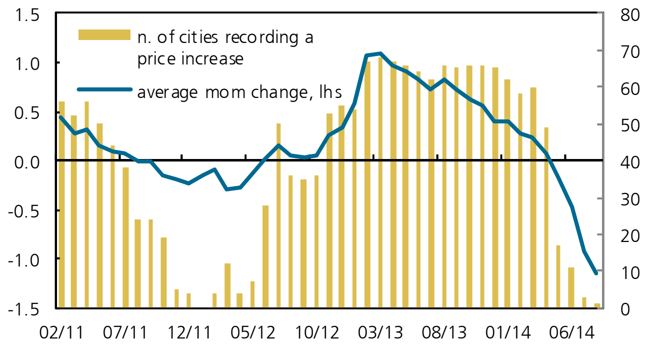
[9] Initial Public Offerings (IPOs), which were suspended from October 2012 to December 2013, recommenced in January 2014 when the China Security Regulatory Commission (CSRC) began granting approvals again, albeit slowly to start with as it was still in the process of revising the regulations, subsequently published in May. According to Bloomberg, 44 approvals have been granted since June; 11 were announced in mid-September, and a further 56 are expected during the fourth quarter. There are approximately 600 IPO applications awaiting approval from the CSRC.

Residential property: stock of unsold property remains high



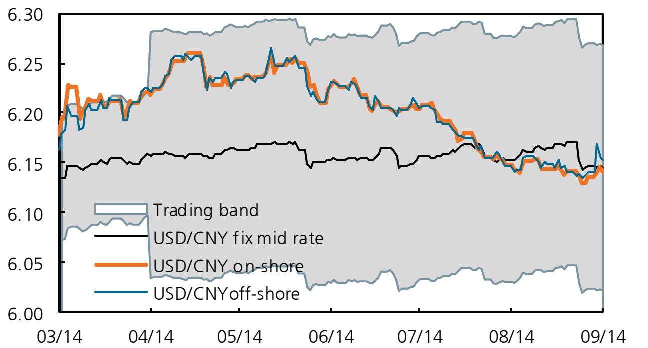
Source: Bloomberg, CEIC

Residential property prices are slowing significantly



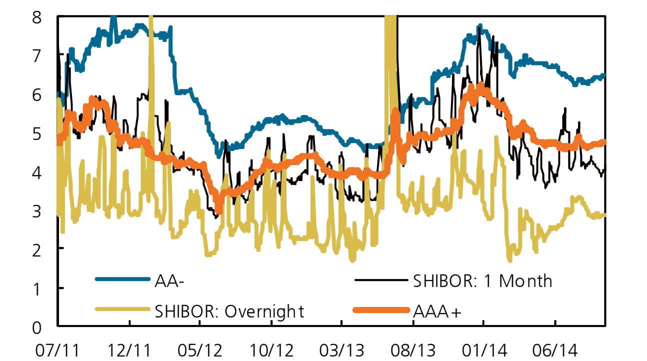
Source: Intesa Sanpaolo chart from CEIC data

The yuan is stabilising



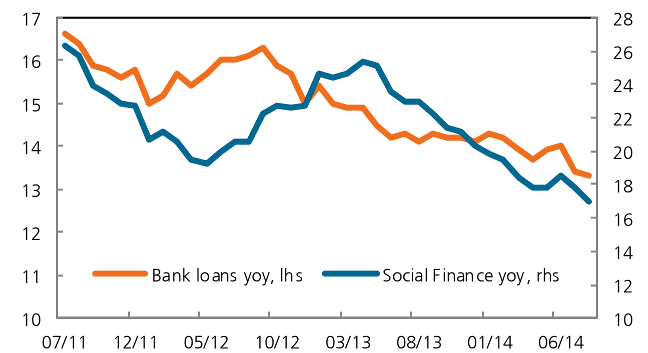
Source: Intesa Sanpaolo chart from Bloomberg data

Money market and one-year corporate rates



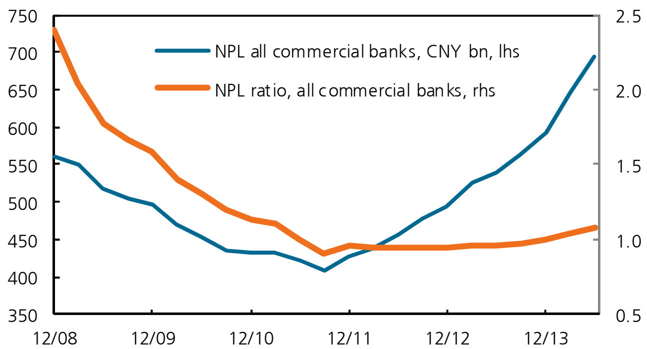
Source: Intesa Sanpaolo chart from Bloomberg data. NB: Graph cut off at 8%

Lending is slowing



NB: stock, monthly cumulative data, % yoy. Source: CEIC and Intesa Sanpaolo estimates

Non-performing loans continue to rise



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

In recent statements, the authorities have confirmed that they intend to continue their policy of limited and targeted support for lending, as well as measures to contain and regulate lending outside the banking sector. We believe that the central bank will continue to provide liquidity to the market through open-market transactions and to prevent excessive and/or lasting rises in money market rates. We interpret in this sense the cut in the 14-day repo rate from 3.70% to 3.50% in reverse repo transactions in September, in response to the jump to around 4% of the same rate on the interbank market, and the longer maturity (three months vs. 14 days) of loans through the SLF. We also believe that the PBOC will make no adjustments to the cash reserve ratio or to official rates unless there is a sharp drop in macro figures in the coming months.

Having appreciated by 2% against the dollar between its end-May high (6.26) and mid-August low (6.14), the yuan has subsequently stabilised at an exchange rate of around 6.13-6.15, with a high of 6.17 in mid-September. The ample trade surplus will continue to favour limited appreciation in the medium to long term, but this will be offset by both the slowdown in economic growth and the PBOC's desire to prevent one-way bets on appreciation.

India: improving confidence helps economy

Silvia Guizzo

- India's GDP grew by 5.7% yoy in Q2, appreciably faster than in the previous two quarters (4.6% yoy), with support coming from an uptick in investments and public consumption, and from an excellent performance by exports, which more than offset the marginal slowdown in private consumption. The business and consumer confidence indices both rose, and passenger and cargo traffic grew throughout the summer, mirroring the recovery in imports and the firming of industrial output – all of which confirms the improvement in economic activity, including in Q3. Based on these elements, we have upgraded our growth forecast for 2014 from 4.7% to 5.2%.

- The public finance budget for FY 2014-15, as well as maintaining the target for consolidating the public accounts, contains measures in various sectors to support consumption and investment. On top of these come measures by the central bank – which kept its policy rates unchanged – to boost liquidity, encourage infrastructure lending and increase financial inclusion. These factors, together with the attendant improvement in investor confidence, should mean more sustained growth in investment in 2015, boosting GDP growth to 5.5%.

- Consumer price inflation, after 7.8% yoy in August, fell to just above June's low (7.5% yoy) on the back of a rebound in food prices. Food price growth remains under some upside risk in the coming months, although it is counterbalanced by various government measures to eliminate bottlenecks in the distribution of agricultural and food products and discourage speculation. Inflation is expected to remain at 8.1% yoy on average in 2014 and slow only slightly to 7.2% in 2015, given the recovery forecast for domestic demand. We think, in light of this background, that the Reserve Bank of India (RBI) will leave rates unchanged in the coming months and only relax monetary policy in 2015 if inflation were to fall more quickly than expected. This could lead to further upward pressure on real rates, which are already at the pre-crisis levels of 2008, when economic growth was much higher.

- Increased capital inflows have boosted foreign exchange reserves further and contained the rupee's depreciation against the US dollar in the 60-61 range. The latter event, which was triggered by the US dollar's general appreciation in anticipation of rate hikes by the US Federal Reserve (Fed), confirms that the rupee will remain exposed to volatility, despite the improvement in the outlook for the domestic economy and in external vulnerability indicators.

Macro forecasts

	2009	2010	2011	2012	2013	2014P	2015P
Gross Domestic Product*	6.5	9.3	7.7	4.8	4.7	5.2	5.5
Private Consumption	6.9	7.5	10.1	5.7	4	5.7	5.8
Public Consumption	9.2	7.9	6.2	7.6	4.4	4	4.8
Total Fixed Investment	-0.7	15.2	11.5	2.4	1	3.3	4.8
Exp. of Goods and Serv.	-7.7	13.8	20.8	8.3	5.3	6.1	6.8
Imp. of goods and serv.	-8.3	17.8	18.2	11.6	-1	1.5	5.2
Industrial production	0.2	9.7	4.8	0.7	0.6	3.3	6.3
Inflation (CPI)	9.7	10.3	9.6	9.7	10.1	8.1	7.2
Unemployment rate (%)	6.5	6.1	5.8	5.6	5.6	5.6	5.7
Average wages	9.1	17.5	15	16.4	11.2	10.7	10.1
Short term interest rate (%)	5.5	6.3	9.5	9.5	9.3	9	8
Exchange rate USD/INR (average)	48.4	45.7	46.7	53.5	58.6	60.7	61.6
Current account balance (bn INR)	-1249	-2498	-2945	-4893	-2780	-1624	-2882
Current account balance (% of GDP)	-2.2	-3.6	-3.6	-5.4	-2.7	-1.4	-2.2
Government balance (in % of GDP)	-7.4	-4.0	-7.2	-5.8	-5.9	-4.7	-4.3

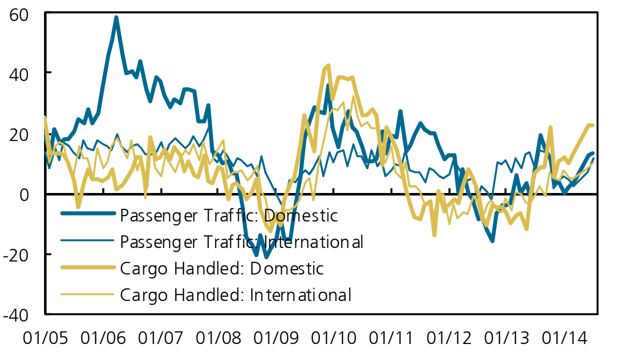
NB: Percentage change versus previous period except where otherwise indicated. * constant prices at factor costs. Figures refer to the calendar year.
Source: Oxford Economics Forecasting and Intesa Sanpaolo

Real economy and inflation

India's GDP grew by 5.7% yoy in Q2, which was appreciably faster than in the previous two quarters (4.6% yoy), buoyed by the uptick in investment (+7.0% yoy vs. -0.9% yoy in Q1) and public consumption, and by an excellent export performance (+11.5% yoy), which more than offset the marginal slowdown in private consumption. On the supply side, the acceleration in the services sector (+6.6% yoy vs. +5.8% in Q1) was accompanied by a recovery in manufacturing (+4.0% yoy) after four quarters of stagnation. Passenger and cargo traffic grew throughout the summer, mirroring the recovery in imports and the firming of industrial output, and confirms the improvement in economic activity, including in Q3.

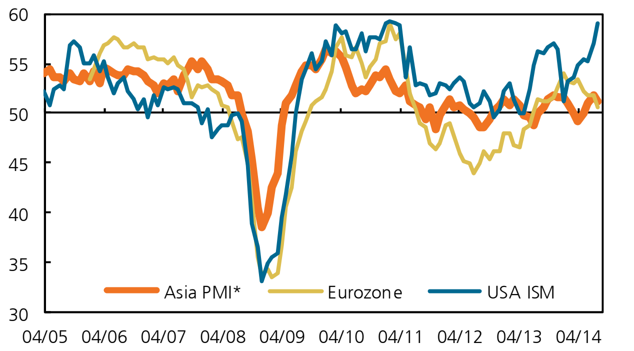
Industrial output rose only 0.5% yoy in August; this lacklustre performance compared with the previous months' rebound was partly caused by a highly unfavourable base effect, but also by drag from negative growth in consumer goods, particularly durables (-20.9% yoy in August). Capital goods production, though still volatile (-3.3% yoy in August), was marginally up on the first-quarter lows. Electricity and mining output remains positive and expansive. The modest quarterly increase in industrial output (+3.1% 3m yoy) mirrors the growth in the orders component of the manufacturing PMI, which was still well above the 50 point threshold despite August's slowdown (54.5 for both total and foreign orders in August). The RBI's Industrial Outlook Survey shows an improvement in the Q3 outlook, which is the highest for the last six quarters, and a sharp fall in pessimism over the cost of finance.

Domestic economic activity improves



Source: CEIC

Recovery in global demand patchy



Source: Intesa Sanpaolo charts based on Markit and Bloomberg data. * India, China, Japan, South Korea, Singapore, Hong Kong, Taiwan, weighted by region's GDP.

The Q2 improvement in investment (seasonally adjusted: +1.6% qoq vs. average growth of 0.2% qoq in the previous four quarters) was triggered by a quicker turnaround of approvals by the Investment Committee and the Project Monitoring Group for projects which the new government is also supporting. This should help investment continue its recovery in H2 too. In its September monthly bulletin, the RBI estimates financial assistance-backed investment approved in FY 2013-14 at INR 2,513Bn, 18% lower than in FY 2012-13. And based on the investment proposals in FY 2013-14 and firms' spending plans, the RBI puts planned investment in FY 2014-15 at INR 1,242Bn. New investment of INR 1,270Bn would be needed from the private sector in the current fiscal year to beat the previous year's figure. The RBI believes this scenario to be plausible given the improvement in business confidence and the measures to encourage long-term bank lending (see next section). However, we think that the recovery in investment will initially be modest. Growth in lending to the non-food sector, although still buoyant (+12.6% yoy in July), continues to slow on the back of a deceleration in lending to both infrastructure and services; however, loans to households remain stable. The number of industrial investment proposals has fallen sharply again (-28.7% yoy in July). However, overall volume is recovering with a much more contained decline (-1.2% yoy in July), while machine imports, which were still contracting sharply in 1Q14 (latest data), appear to be staging no more than a cautious recovery, according to the Ministry of Trade's announcement in August.

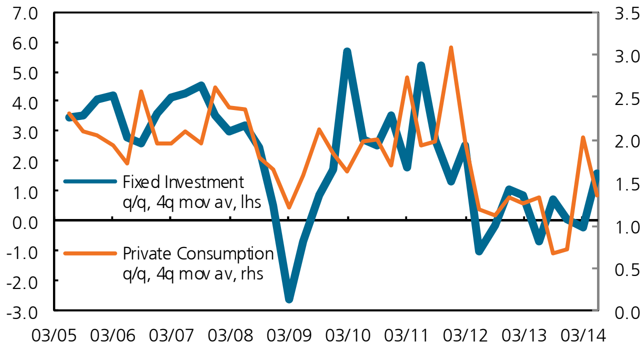
Car sales growth accelerated to 17.5% in May from 13.2% in June. Consumer confidence improved in Q2, with the current situation component edging just above the 100 point threshold and the forecast component leapfrogging the series' previous highs. The PMI employment component, which has been trending down since 2013, is still just above the 50 mark, signalling that conditions on the labour market remain positive if less upbeat. The Manpower survey of companies' hiring intentions in Q4, although slightly down, is still close to the series' highs.

The services PMI fell to 50.6 in August from a peak of 54.4 in June, mainly due to the fall in the sub-indices for expectations and total orders. Contrasting with this are the data for tourist arrivals, which accelerated between June and August (+13.1% yoy in August), and in mobile phone subscriptions.

After almost a year of falls, imports (+4.7 3m yoy in August) followed a positive albeit declining trend for the three months from June to August, thanks to the recovery in non-oil imports (+7.3% 3m yoy in August). Exports continued to hold up (+6.3% 3m yoy in August vs. 1.7% 3m yoy in May); the downtrend is partly due to the comparison with a strong increase in the year-earlier period. The trade deficit in the first eight months of the year remained well below the year-earlier figure (USD 84.4Bn vs. USD 115.4Bn), especially net of oil. Growth in foreign orders in the manufacturing PMI suggests that exports will hold firm, but the improvement in the trade deficit will gradually erode as domestic demand increases in the absence of a sharp acceleration in global demand. Demand from the US and Japan is improving, but the outlook for the Euro zone is more precarious and only a modest increase is expected from other south-east Asian countries. The current account deficit is expected to deteriorate slightly, to 2.2% of GDP in 2015 from its 1.4% low in 2014, and then start falling again.

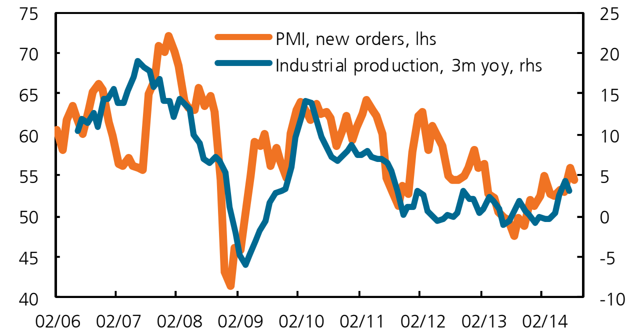
Consumer price inflation was 7.8% yoy in August, down slightly from July's figure of 8% yoy, but above June's low (7.5% yoy); this was caused by a rebound in food prices (+9.2% yoy in August after 8.0% yoy in June). This was supported by price increases in pulses, fruit and vegetables, and was only partially offset by the unexpected slowdown in the price of fuel and electricity. The fall in oil prices, by almost USD 12/barrel between end-June and mid-September, triggered three cuts in petrol prices. Non-food inflation is still falling (6.4% yoy in August vs. 7.3% yoy in May), with all categories experiencing a gradual but broad-based slowdown. Wholesale price inflation plummeted from 6.2% in May to 3.7% in August, driven down by the same dynamics, suggesting that consumer price inflation will stay at its current level. The summer monsoon season (south west) from 1 June to 21 September was below the historical long-term average of 11%, according to figures from the Indian Meteorological Institute, with spikes of 21% in north-western regions. The latter deviation was, however, less than initially feared. Food inflation remains under some upside risk in the coming months, although it will be counterbalanced by various government measures to eliminate bottlenecks in the distribution of agricultural and food products and discourage speculation. Inflation is forecast to remain around 8.1% yoy on average in 2014 before falling to 7.2% yoy in 2015

Marginal improvement in investment



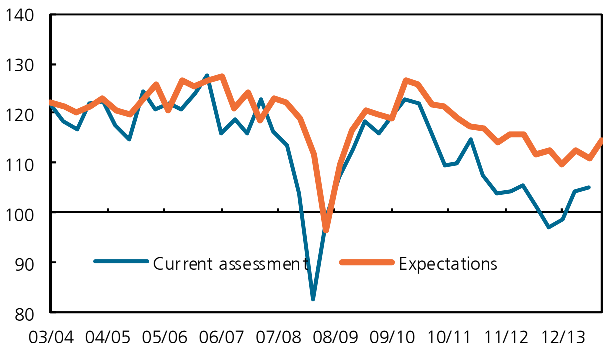
Source: Intesa Sanpaolo chart based on CEIC data

Tentative improvement in Industrial output



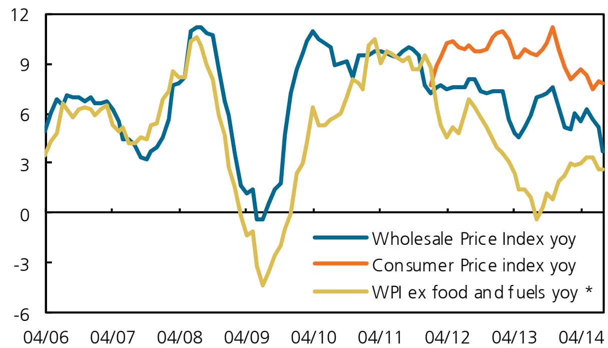
Source: Markit-HSBC, CEIC

Further improvement in business confidence*



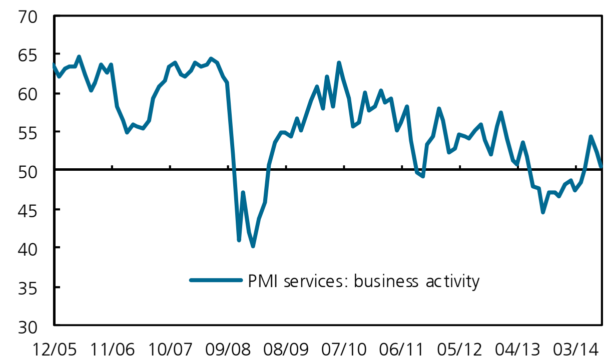
*Business Expectation Index, Industrial Outlook Survey. Source: Reserve Bank of India

Inflation slows, thanks to food and energy



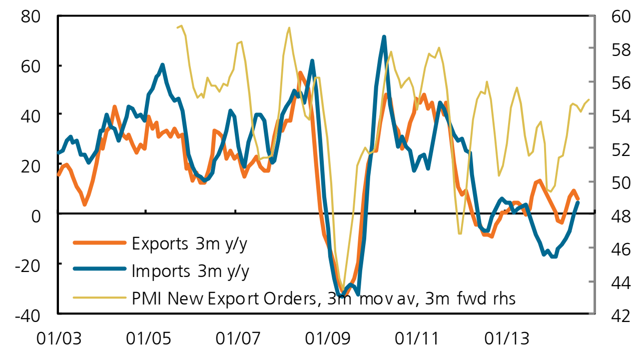
*Stima ISP. Fonte: CEIC

Services sector expected to slow



Source: Markit

Imports show signs of improvement



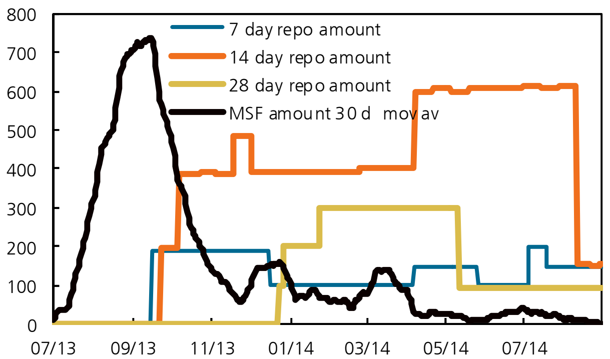
Source: CEIC, Markit

Economic and monetary policy

On 10 July, the government announced its **budget** for FY 2014-15, confirming the target of reducing the deficit to 4.1% contained in the provisional budget presented in spring, and then gradually bringing it down to 3% in FY 2016-2017. The forecast reduction mainly derives from an expected increase in non-debt receipts (i.e. different from government bond issues), especially tax receipts and the proceeds from the sell-off of government shareholdings. Revenue from the latter, which in the past has failed to meet expectations, will be used in part to recapitalise public banks and also for investment in the railways. The budget also includes a fall in total subsidies, from 2.3% in FY 2013-14 to 2% in FY 2014-15, via a reduction in fuel subsidies offset by an increase in subsidies on food and fertilizers. Capital expenditure has increased marginally, to 1.8% of GDP, but remains below the FY 2010-11 peak of 2%. In addition to the deficit reduction targets, the budget also presented various measures to redu ce inflation and support growth; these latter included raising some tax exemption limits for both personal income and corporate earnings. On top of these measures are commitments to introduce a Goods and Service Tax (GST), which has been repeatedly postponed for several years, by 2015, and to provide greater incentives for inward foreign investment[10].

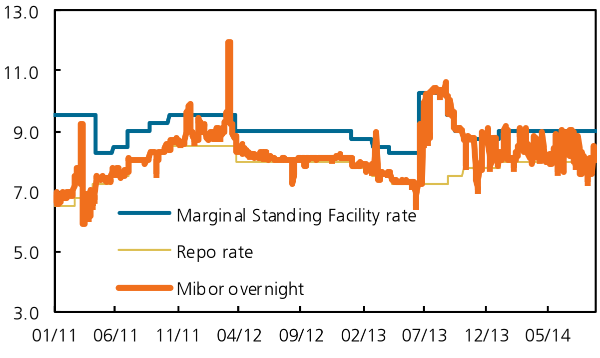
The government has now taken steps on various fronts to fulfil its electoral promises, although the approvals may not be as easy or as fast as expected. Although the coalition government (National Democratic Alliance, NDA), led by the party of Prime Minister Narendra Modi (BJP), has obtained a historic majority in the lower house (Lok Sabha), it has a minority position in the upper house (Rajya Sabha), compared to both the opposition coalition (United Progressive Alliance, UPA, led by the Congress party) and the regional parties. The upper house is the regional representative elected by the parliaments of the individual states[11] and must approve the measures passed by the lower house, although any rejection is not binding, and it can only propose amendments to the budget. Nevertheless, this could slow progress. Moreover, some measures, such as the introduction of the GST, require a constitutional amendment approved by two-thirds of the houses and half of the individual states.

Number of short-term repos increasing (INR Bn)



Source: Bloomberg

Overnight rate more volatile



Source: Bloomberg

The recent rulings of the Supreme Court, which cancelled 214 out of 218 coal block permits allocated since 1993 and already declared illegal in the summer, add to these political difficulties. The Court sentence allowed already operational mines to continue operation temporarily (up to March 31st 2015) while paying a tax of INR 295 per ton of extracted coal and ordered a new auction of mine permits. Many companies will be forced to import coal at a higher price than the domestic one, with possible negative impacts on inflation and on the balance of payments.

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[10] The budget also proposes increasing the limits on holdings by foreign investors from 26% to 49% of capital in the defence and insurance sectors, and allows 100% shareholdings in the railway infrastructure.

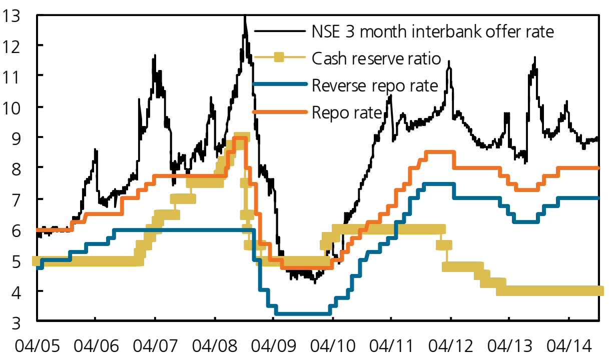
[11] It comprises 245 members elected by proportional representation by the parliaments of the individual states, as well as ten members appointed by the President of the Republic.

The central bank has relaxed the rules on long-term bank loans for financing infrastructure projects;[12] it has also announced a programme promoting greater financial inclusion that enables the poorest families to open bank accounts, as well as plans to offer banking services via mobile phone. It has maintained policy rates at the same time, but, at its August meeting, shaved another 50bps off the statutory liquidity ratio (SLR) to 22% of net demand and time liabilities (NDTL). The RBI is gradually reducing the liquidity provided through overnight repos and increasing liquidity through 7-day and 14-day repos, which were re-introduced in late 2013 and may now account for up to 0.75% of NDTL. However, the volatility of the overnight rate is rising dramatically, forcing the RBI to increase the frequency of operations. The central bank says that inflation risks are more balanced than in June with regard to the target of 8% yoy by January 2015, but remain to the upside for the longer-term target of 6% yoy by January 2016. It is therefore ready to respond in an appropriate manner if they materialise. Oil prices, against expectations and despite rising geopolitical risk, fell during the summer, and the rupee has stabilised thanks to strong capital inflows. These factors have helped curb inflation, but could easily reverse. We think it plausible in this context that the RBI could leave interest rates unchanged in the coming months; it might also taper monetary policy moderately in 2015, but only if inflation falls faster than expected. This could lead to further upside pressure on real rates, which are already at the pre-crisis levels of 2008, when economic growth was much higher.

External vulnerability and exchange rates

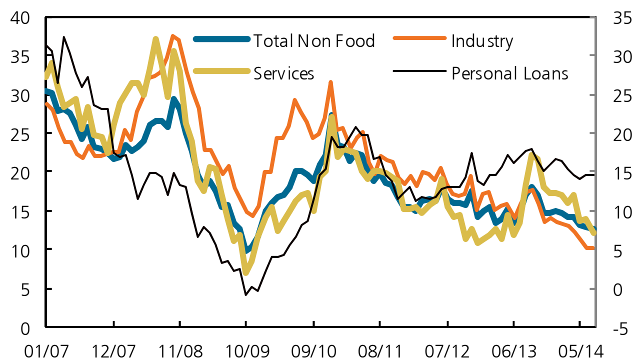
Despite the overall improvement in the current account balance in 1Q14 (-1.0% of GDP vs. -2.8% for the whole of 2013), the data for 2Q14 are slightly worse (-1.8% of the quarter GDP vs. -0.3%) than in Q1, due to an increase in the trade deficit and a decrease in the surplus on services accounts. Conversely, the capital account balance improved significantly, thanks to the rebound in both direct investment and portfolio investment. This trend should continue in Q3, given the sustained monthly growth in flows of portfolio investment from foreign institutional investors. This boosted foreign exchange reserves to USD 292Bn in August from USD 285Bn at the end of May, and helped contain depreciation of the rupee against the dollar to the 60-61 range. The rupee's slide, which was triggered by the dollar's general appreciation in anticipation of rate hikes by the Fed, demonstrates that the exchange rate remains exposed to volatility despite the improvement in the domestic economic outlook and indicators of external vulnerability.

RBI leaves rates on hold



Source: Bloomberg

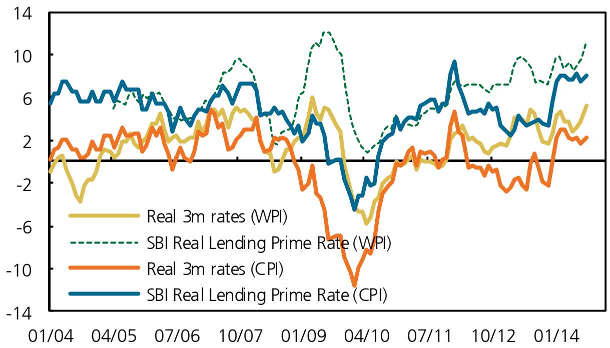
Lending slows (yoy)



Source: Bloomberg

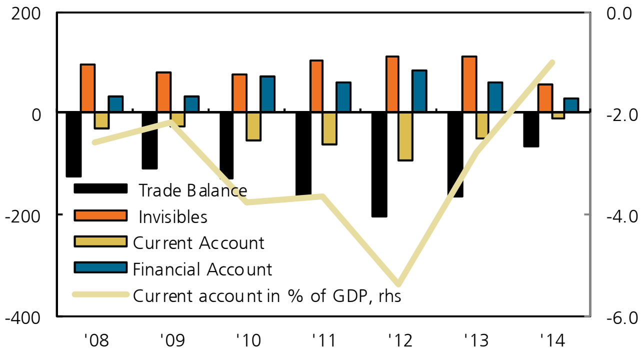
[12] On 15 July, it stripped out issues of long-term bonds to finance infrastructure projects and social housing from the calculation of SLR and CRR, and allowed longer repayment terms (to 25 years from the current 10) for loans to finance projects in infrastructure or energy raw materials (Core Industries). On 5 August, it relaxed the rules on calculating the CRR and SLR for SLR holdings under the Held to Maturity category).

Real rates rising



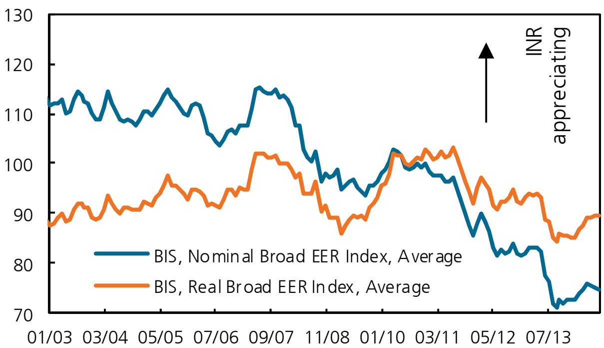
Source: Intesa Sanpaolo chart from Bloomberg data

Current account balance (USD billions)



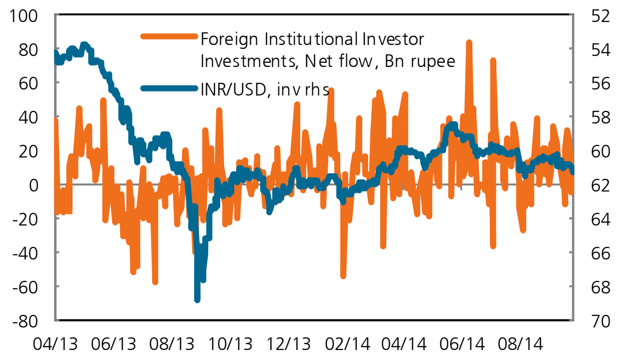
NB: First quarter 2014. Source: Bloomberg

Effective exchange rate



Source: CEIC

Return of capital is stabilising the rupee



NB: left-hand scale in INR billions. Source: CEIC

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Appendix

Analyst Certification

The financial analysts who prepared this report, and whose names and roles appear on the first page, certify that:

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