LIVERPOOL INVESTMENT LETTER

March 2018

Cardiff Business School

Ysgol Busnes Caerdydd

Julian Hodge Institute of Applied Macroeconomics

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LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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The Julian Hodge Institute was launched in autumn 1999 in a new collaboration between the Cardiff Business School of Cardiff University and Hodge. The aim of the Institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. The research has been particularly germane in recent years and has proved to be of significant social and political relevance as Europe has navigated the difficulties of the global financial crash, the Eurozone crisis and most recently the UK referendum on EU membership. The Liverpool Investment Letter is written by Patrick Minford, with the assistance of other members of the Group; in particular the emerging markets section is written by Anupam Rastogi, and the focus on Japan is written by Francesco Perugini. The Investment Letter is published monthly.

The Liverpool Research Group in Economics is pursuing a research programme involving the estimation and use of macroeconomic models for forecasting and policy analysis. The Group is now mainly based in Cardiff Business School, Cardiff University, and is indebted to the School and to the Hodge Foundation for their support. The Group's activities contribute to the programmes being pursued by the Julian Hodge Institute of Applied Macroeconomics. This Liverpool Investment Letter is typeset by David Meenagh and published on behalf of the group by Liverpool Macroeconomic Research Limited, which holds the copyright

ISSN 0951-9262

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CONTENTS

Page

The Normal News Continues 3

The UK economy continues to grow resiliently and productivity is picking up sharply as the labour market tightens. The Brexit prospect is coming steadily nearer and, as the fog dissipates, business, especially smaller business, increasingly likes what it sees replacing the curiously unpredictable world of EU protectionism and invasive regulation. Theresa May's Mansion House speech has charted a course for a trade deal that the EU Commission would be wise to conform to, as the alternative no deal will give it a nasty shock from which it might never recover.

Focus on Japan 5

Market Developments 6
Summary and Portfolio Recommendations

Indicators and Market Analysis
Foreign Exchange 8
Government Bond Markets 9
Major Equity Markets 10
Emerging Equity Markets 11
Commodity Markets 16

UK Forecast Detail 17
World Forecast Detail 19

THE NORMAL NEWS CONTINUES

The growth rates being predicted for the UK economy are increasingly focused around 2%. Productivity growth picked up in the second half of 2017 (with hours of work falling) to an annual rate of nearly 4%. The labour market is tightening and this is finally being understood as related both to wage growth and to productivity. Wage growth is finally rising, though still in nothing like a serious inflationary surge. There is nervousness about the progress of automation and robotics. Probably also there is some spare labour supply among part-time workers.

Inside the firm however there is increasing utilisation of labour capacity, we would think. Huge amounts of labour were taken on in the recovery, with wages seen as rather cheap. But now supplies are tightening and labour needs to be used better within the firm. How could hours of work fall? Much of this could be related to the commitment to ‘flexitime’ and also to the release of women and men on maternity/paternity, now built into many HR systems. There is also lifetime learning and release for training, all of which is now expected as part of the HR two-sided promise.

It is interesting that the solid progress of the economy is proceeding against the background of Brexit negotiations that have now been given new life by Theresa May’s recent Mansion House speech. In it she committed to definite exit from the protectionist EU Customs Union and the intrusive Single Market, into a situation where the UK sets its regulative agenda and also its mission for free trade, besides resuming normal civilised-country control of immigration. Smaller companies are already responding well to the promise of all this. It is often forgotten how much uncertainty is created by the EU’s obscure, fitful and idiosyncratic agenda of protection and backward-looking regulation. Interestingly by pitching his tent inside the EU’s Customs Union Jeremy Corbyn has underlined the backward protectionist nature of his own programme for the UK. This programme has little appeal either to consumers or to innovative producers. The CBI has welcomed the Corbyn programme, in yet another of its strange policy follies over the years since its 1970s heyday with ‘sherry, beer and sandwiches at No 10’. The CBI is now the voice of protected vested interests, a mere 10% of the economy — but even in this 10% much is highly productive and well able to hold its own in world markets — half our exports of manufactures go to non-EU markets.

The EU Commission response to May’s proposals has been predictably aggressive, with much talk of ‘cherries and cake’. What this means in translation is that the EU’s protectionist ‘cake’ and the ‘cherries’ on it in the form of protection for specific sectors like cars and chemicals cannot be ‘shared’. But the UK is not asking to share in any protectionism. It will abolish it with respect to the outside world, for the benefit of its own consumers and indeed of the outside world. All it is doing is offering to have free trade between the UK and the EU, solely; any trade passing through the UK to the EU would be unaffected.

Table 1: Summary of Forecast

	2016	2017	2018	2019	2020	2021	2022
GDP Growth[1]	1.8	2.2	2.0	1.9	1.9	2.2	2.3
Inflation CPI	1.1	2.6	2.5	2.1	2.0	2.1	2.8
Wage Growth	2.4	2.0	2.3	1.8	1.8	2.6	3.6
Unemployment (Mill.)[2]	0.8	0.8	0.8	0.7	0.7	0.6	0.5
Exchange Rate[3]	80.6	74.9	75.0	74.5	73.1	72.4	71.7
3 Month Interest Rate	0.5	0.4	0.6	1.2	2.4	3.1	3.1
5 Year Interest Rate	0.7	1.1	1.4	2.5	3.5	2.9	2.6
Current Balance (£bn)	-87.4	-65.6	-54.3	-49.4	-39.0	-26.4	-15.4
PSBR (£bn)	45.1	40.1	33.4	24.2	6.6	-6.6	-10.8

[1]Expenditure estimate at factor cost
[2]U.K. Wholly unemployed excluding school leavers (new basis)
[3]Sterling effective exchange rate, Bank of England Index (2005 = 100)

This new agreement would be made under WTO laws; it is not generally realised that the WTO will from now on be the only source of international law on the EU and our mutual trade and general commercial relations. Under WTO rules we must both observe strict non-discrimination on goods and services; this specifically includes discrimination in favour of our own residents. Thus we cannot deny recognition of each other’s standards when they transparently achieve the same objects or indeed as now are actually the same. This applies as much to chemicals as it does to financial services.

The EU Commission still seems to be blissfully unaware of this, thinking that on day one of Brexit it can suddenly pull out of recognising UK standards. Yet this will be quite illegal as well as absurd. For an organisation as dependent on international law as the EU this is a surprising development.

Should there be no deal and so no transition, the EU Commission will get a great shock. First, its money will not arrive for the transition period, leaving a big 10% hole in two years of the budget. Second, EU producers will be paying around £13 billion a year in tariffs into the UK Treasury. Third, the same EU producers will suddenly find that their UK prices are dropping fast under the impact of world competition in the UK market.

If it attempts to impose regulative barriers against UK goods and services (attacking ‘cake and cherries’) it will face a ferocious battle in the WTO courts, which it will lose in short order. Undoubtedly such a battle will cause short term disruption; but this will cut both ways and will further foment extreme dislike of the EU among ordinary EU citizens and firms, such as we are already seeing in Italy, Southern Europe and the Visegrad countries. It would be an ugly episode but it would be quite short.

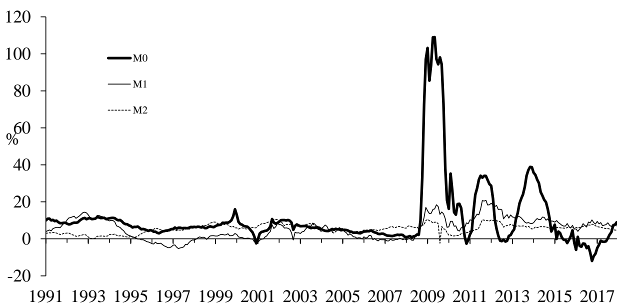
In our costings of the ‘no deal’ scenario we find that the UK makes gains while the EU makes losses as above. The UK gains are the mirror image of the losses above; but on top of

these gains it gets to the Brexit end game faster, which is a substantial advantage.

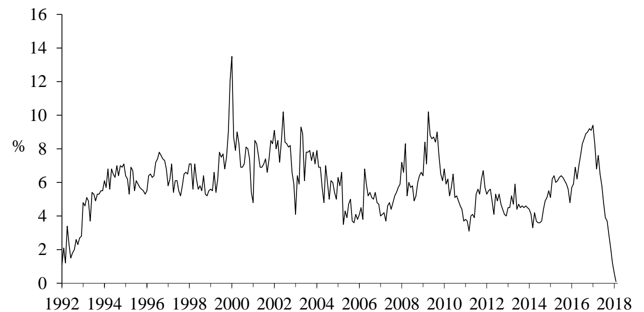
It is sad that we have to discuss these things when a ‘win-win’ deal is so obviously available. But the reason is simple: the EU does not and never has understood the gains from free trade. It is built on the principles of mercantilist protectionism where the aim is to reduce the exports of your trade partners and maximise your own exports. Never mind that the losers are your own consumers and your own economy, as well as less powerful foreign suppliers, such as those from developing countries. The aims of such ‘realpolitik’ theft from citizens at home and abroad have always, from Bismarck to Juncker, been to build up the power of the federal state.

However, the difference today is that there is a world trade and commercial order under the WTO; and the EU’s policies are illegal if enacted to create non-tariff barriers against the UK by the use of discriminative standards. Hence ‘no deal’ cannot include such illegal behaviour. It can solely extend to tariffs. But if the EU goes the route of tariffs on UK trade it will be a spectacular own goal. As this realisation dawns on the EU mercantilists a Canada-plus deal will inevitably emerge from the Channel fog.

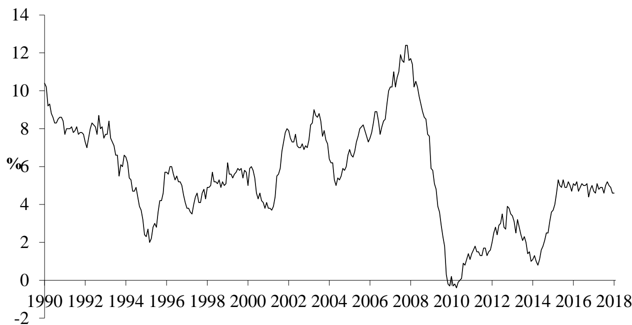
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



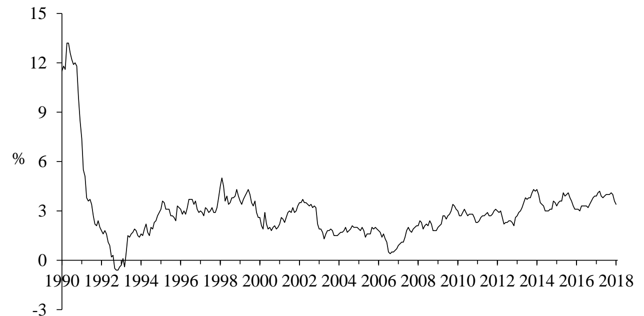
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Kuroda gets second term as Bank of Japan Governor

On February 16th Japanese government nominated Haruhiko Kuroda as Bank of Japan (BOJ) governor , handing the veteran finance chief more time to battle deflation and kick-start the domestic economy. Kuroda's nomination was among those submitted to the Diet in a document seen by reporters, and had been widely expected. The government also nominated BOJ Executive Director Masayoshi Amamiya, seen as playing a critical role in crafting easing policy under Kuroda, and Waseda University Professor Masazumi Wakatabe as BOJ deputy governors. The reappointment would make Kuroda the first person to serve a second term at the BOJ since 1961.

By giving the architect of Japan's monetary stimulus another five years, Prime Minister Shinzo Abe has signalled a renewed commitment to an escape from deflation. "Aiming for steady progress towards the inflation target, we judged it most suitable to carry on entrusting the leadership of monetary policy to Kuroda," said Yoshihide Suga, chief cabinet secretary. "The government wanted a governor who recognised the importance of escaping deflation and had the "unshakeable conviction" to do so", Suga added at a press conference.

Handpicked by Shinzo Abe to steer the former economic powerhouse out of a dangerous cycle of falling prices, Kuroda has guided the key monetary plank of the prime minister's vaunted Abenomics economic policy. He took the helm in March 2013, with a mandate to deploy what was called a monetary "bazooka" to breathe life into the nation's moribund economy. He has overseen a policy of ultra-aggressive monetary easing, adopting in January 2016 the BOJ's first-ever policy of negative interest rates — effectively charging lenders to park their cash at the central bank. The BOJ has also pledged to keep the yield on 10-year government bonds around zero by buying as many as necessary.

However, Kuroda has failed in his mission to hit the inflation target of 2% — the most recent figure was 0.9% in December. But he can point to more success recently on the GDP front, with the country currently enjoying its longest unbroken spell of quarterly growth since the bubble days of the late 1980s. With the economy picking up and with inflationary shoots beginning to spring forth, market experts say Kuroda's greatest future challenge will be to exit the easing policy. Indeed, few days after his reappointment Kuroda said that the central bank will discuss, at least in principle, an exit policy from its current aggressive monetary easing in fiscal 2019 if the 2% inflation target is reached. "If we decide that there is sufficient momentum toward the 2% inflation goal, and if there is a need, … we will consider adjusting monetary policy," said Kuroda. "The debate over the exit strategy is something I have spoke on before. There are two circumstances. One is what to do with the expanded balance sheet, and the other is how to normalize the short-term interest rates", he added. However, he also admitted that "it's not the time for an exit from government bond-buying. The BOJ needs patiently to continue the current powerful monetary easing."

Overall, the appointments are unlikely to change the balance of power on the BOJ's policy board, with the retiring deputy governors holding similar views, but it recommits the central bank to stimulus at a time when the US Federal Reserve is raising interest rates. "We would interpret the proposal to reappoint Governor Kuroda and nominate Wakatabe, known as a reflationist, as a strong message from the Abe administration to pursue the current monetary easing scheme, including yield curve control," said Naohiko Baba, chief economist at Goldman Sachs in Japan.

Indeed, expansionary monetary policy along with structural reforms is what Japan needs to overcome deflation and sustained economic growth. Despite the longest growth run in nearly three decades, Japan's economic outlook remains far from robust as uncertainty abounds over wage growth and business investment. Under Abenomics, Shinzo Abe's program of radical monetary easing, fiscal spending and vows of structural reforms, the economy grew by 0.1% quarter-on-quarter in the October-December period, marking the eighth straight quarter of expansion. It slowed from a revised 0.3% q-o-q increase in the previous quarter and was below the median forecast from economists polled by Reuters. Many economists expect the economy to keep growing at a moderate pace this year. The key question now is whether domestic demand can pick up further and help the economy sustain its recent growth momentum, economists said. "Private consumption has been recovering on the back of modest wage growth, but is not solid enough to absorb shocks when something bad happens," said Yuichiro Nagai, an economist at Barclays Securities Japan Ltd.

Economists are also focusing on how companies might handle pay hikes in annual negotiations between management and labour unions toward mid-March amid record earnings and the tightest labour market conditions in decades. More robust wage growth is seen as critical for consumers to increase spending and for the government to consider when it will be safe to declare an end to decades of deflation. Bolstering domestic demand has been a challenge for the export-reliant economy ahead of the planned sales tax increase from 8% to 10% slated for October 2019. Consumption took a hit after the previous hike in 2014.

MARKET DEVELOPMENTS

The Trump trade proposals should be seen as shaking up a trade order in which theft of trade and intellectual property has become routine. China has abused WTO rules and so has the EU. The UK has a strong interest in the rule of international commercial law within the WTO. After Brexit it will become a major champion of it. The US will happily quieten down its trade aggression once the WTO rules become better observed by China and the EU.

Once again what we see in US policy is a shaking up of a complacent poorly functioning international environment, rather as we have seen in climate change and in bank regulation. Long term this shaking up will be good for growth in productivity and profits. It will also move the world from subsidising governments via cheap debt towards proper returns on equity in the private sector.

Table 1: Market Developments

	Market Levels		Prediction for Feb/Mar 2019	
	Feb 6	**Mar 7**	**Previous Letter**	**Current View**
Share Indices				
UK (FT 100)	7141	7147	9891	9898
US (S&P 500)	2695	2728	3267	3306
Germany (DAX 30)	12393	12114	19642	19200
Japan (Tokyo New)	1743	1716	2162	2128
Bond Yields (government				
UK	1.58	1.51	1.50	1.50
US	2.79	2.90	3.00	3.00
Germany	0.69	0.57	0.80	0.80
Japan	0.07	0.03	0.10	0.10
UK Index Linked	−1.51	−1.55	−1.00	−1.00
Exchange Rates				
UK ($ per £)	1.39	1.39	1.30	1.30
UK (trade weighted)	79.02	78.57	76.10	76.10
US (trade weighted)	96.67	96.89	102.4	102.4
Euro per $	0.81	0.81	0.85	0.85
Euro per £	1.13	1.12	1.11	1.11
Japan (Yen per $)	109.3	106.0	114.1	114.1
Short Term Interest Rates (3-month deposits)				
UK	0.52	0.59	0.70	0.70
US	1.82	2.05	1.80	1.80
Euro	−0.41	−0.41	−0.20	−0.20
Japan	−0.25	−0.15	0.10	0.10

Table 2: Prospective Yields [1]

Equities: Contribution to £ yield of:

	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.60	2.0	2.5	34.00		42.10
US	1.99	2.4	1.9	16.90	6.36	29.55
Germany	3.30	1.9	1.6	55.00	1.31	63.11
Japan	1.90	1.2	0.8	22.00	−0.77	25.13
UK indexed[2]	−1.68		2.5	1.00		1.96
Hong Kong[3]	2.60	6.0	1.9	−7.00	6.36	9.86
Malaysia	3.30	5.3	1.9	52.00	6.36	68.86
Singapore	3.50	2.4	1.9	11.00	6.36	25.16
India	1.40	8.1	1.9	28.00	6.36	45.76
Korea	1.10	2.6	1.9	−20.00	6.36	−8.04
Indonesia	2.20	5.3	1.9	29.00	6.36	44.76
Taiwan	2.80	2.3	1.9	15.00	6.36	28.36
Thailand	3.20	3.0	1.9	23.00	6.36	37.46

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	1.51	0.10		1.61
US	2.90	−1.00	6.36	8.26
Germany	0.57	−2.30	1.31	−0.42
Japan	0.03	−0.70	−0.77	−1.44

Deposits: Contribution to £ yield of:

	Deposit Yield	Currency	Total
UK	0.59		0.59
US	2.05	6.36	8.41
Euro	−0.41	1.31	0.90
Japan	−0.15	−0.77	−0.92

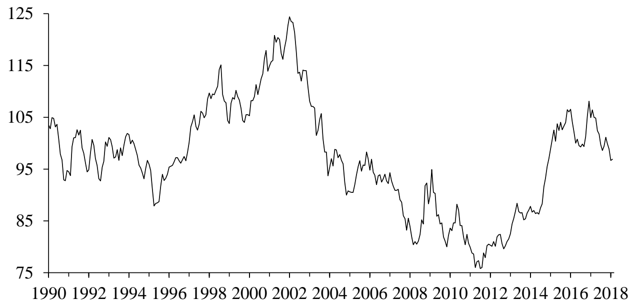
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

Table 3: Portfolio(%)

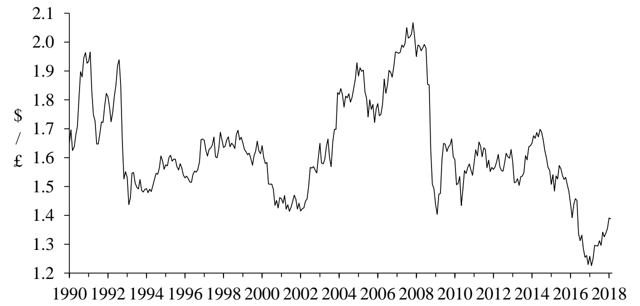
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	February Letter	**Current View**	**February Letter**	**Current View**	**February Letter**	**Current View**
UK Deposits (Cash)	5	5	5	5	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
German Bonds	-	-	-	-	-	-
Japanese Bonds	-	-	-	-	-	-
UK Shares	19	19	14	14	17	17
US Shares	14	14	19	19	16	16
German Shares	14	14	14	14	21	21
Japanese Shares	9	9	9	9	11	11
Hong Kong/Chinese Shares	4	4	4	4	4	4
Singaporean Shares	4	4	4	4	4	4
Indian Shares	4	4	4	4	4	4
Thai Shares	3	3	3	3	3	3
South Korean Shares	4	4	4	4	4	4
Taiwanese Shares	4	4	4	4	3	3
Brazilian Shares	4	4	4	4	3	3
Chilean Shares	4	4	4	4	3	3
Mexican Shares	4	4	4	4	3	3
Peruvian shares	4	4	4	4	3	3
Other:						
Index-linked bonds (UK)	-	-	-	-	-	-

INDICATORS AND MARKET ANALYSIS
FOREIGN EXCHANGE MARKETS

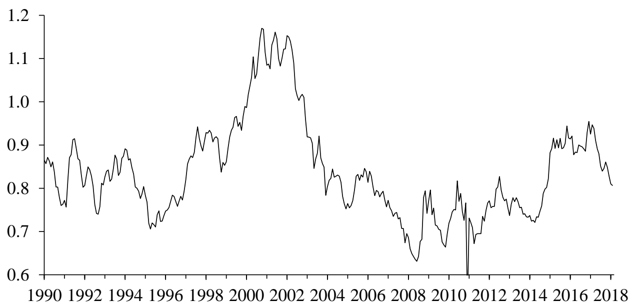
US : Trade Weighted Index
(Bank of England 1990 = 100)



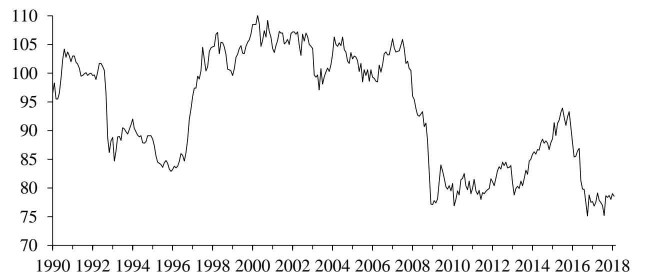
UK: Dollars Per Pound Sterling



Euro per US dollar



UK: Trade-Weighted Index
(Bank of England 1990 = 100)

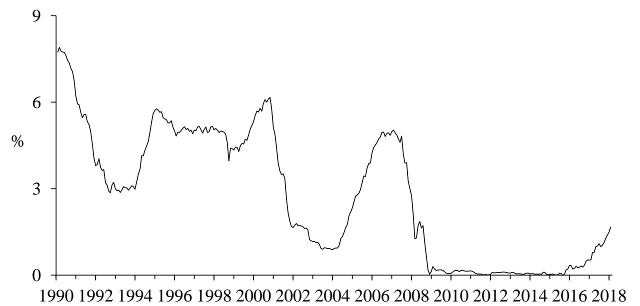


Japan : Yen Per U.S. Dollar

GOVERNMENT BOND MARKETS

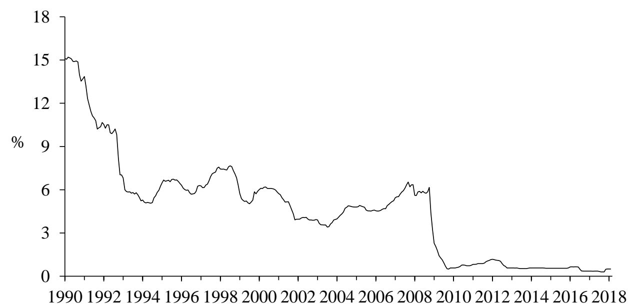
U.S.: Yield on Long-Term Government Bonds

U.S. : 3-Month Treasury Bill



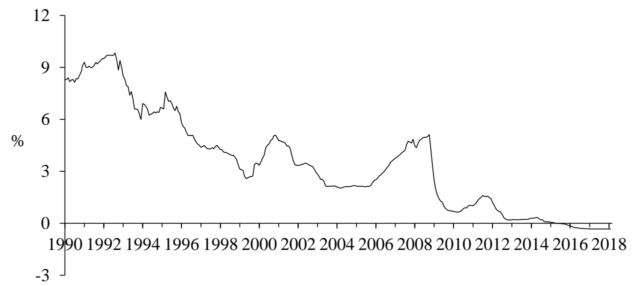
U.K.: Yield on Long-Term Government Bonds

U.K. : 3-Month Certificate of Deposit Rate

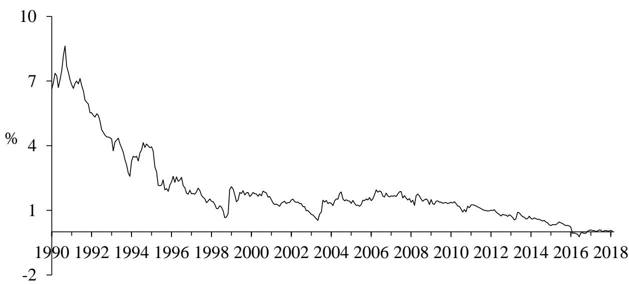


Germany: Yield on Public Authority Bonds

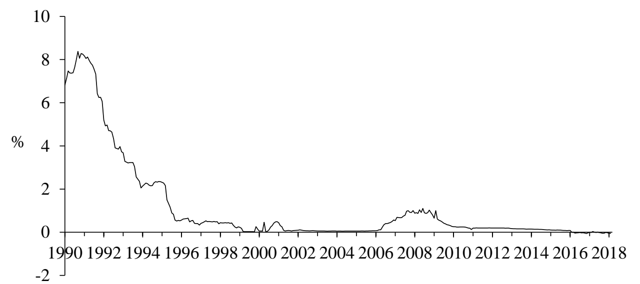
Germany : 3-Month Interbank Deposit Rate



Japan: Yield on Long-Term Government Bonds

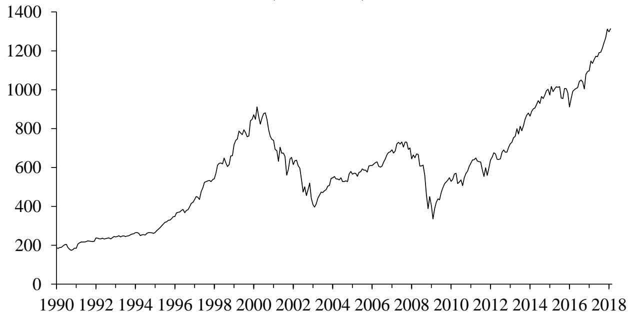


Japan : 3-Month Money Market Rate

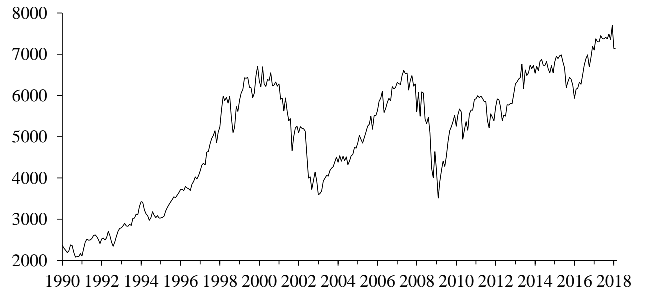


MAJOR EQUITY MARKETS

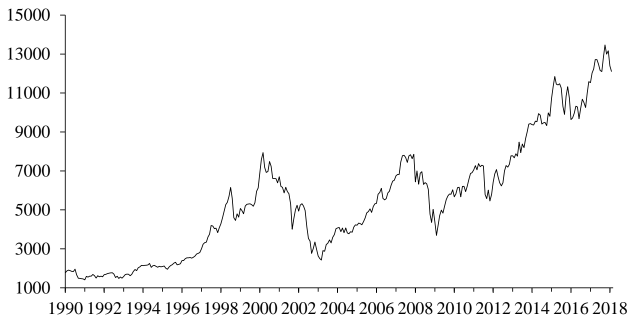
U.S. : S & P 400 Industrial
(1985=100)



U.K. : FTSE-100 Index
(10 April 1962=100)



Germany : DAX 30



Japan : Tokyo S.E. New
(1985=100)

EMERGING MARKETS

Anupam Rastogi

India

The Indian economy picked up pace in the October–December quarter due to stronger growth across services and industry. A rebound in industrial activity, which stabilized after GST related disruptions, is expected to push growth higher, along with strength in the services segment. For FY2018 as a whole, we expect GDP growth to be around 6.5%, implying a residual of 7.2% for the fourth quarter.

For FY2019, we expect GDP growth to pick up to 7.6% on the back of an improvement in private consumption demand, an increase in capacity utilization rates and the revival of the private capex cycle. The push from government spending is likely to continue in FY2019 with its share in GDP likely to rise to 11.7% from 11.2% in FY18.

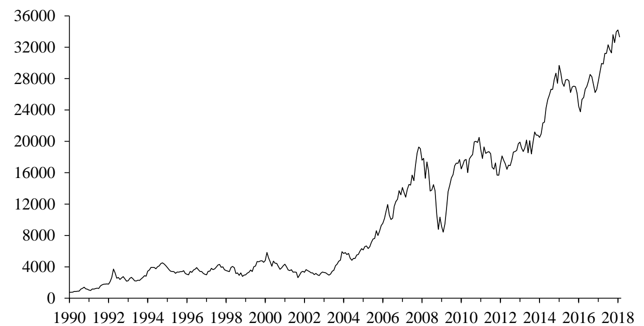
The 2018 budget included some measures that will stabilize the rural economy that was disproportionately hit by the demonetization policy and is yet to recover. The annual budget did not suggest the pro-business stance of the government and it was more pro-poor to attract poor voters towards the ruling party.

Retail inflation eased in January from a 17-month high in the prior month. Price rises are still above the RBI's medium-term target of 4% on rising energy costs and expectations for an increase in rural spending by the government. Consumer prices rose 5.07% in January from a year earlier. However, the central bank forecasts the pace could pick up to as fast as 5.6% by September once the government begins spending for the fiscal year starting April 1. Yields on 10-year Indian government bonds have climbed nearly half a percentage point since late December when the Reserve Bank of India announced plans to increase its borrowing for the financial year ending in March. We expect the central bank not to tighten monetary policy in the run up to the election and crush the green shoots of growth in the investment cycle.

India's exports grew by 9% to USD 24.38 billion in January, helped by a healthy growth in shipments of chemicals, engineering goods and petroleum products, even as the trade deficit widened to an over three-year high. The trade gap soared to USD 16.3 billion in January on account of a 26.1% increase in imports to USD 40.68 billion due to increased inbound shipments of crude oil.

The rupee had been on a weak trend this week amid worries over US rate hikes and outflows from domestic capital markets. The rupee had fallen to 65.10 intra-day against the US dollar in the last week of February.

India: BSE Sensitive



India's second-largest state bank said it had uncovered an alleged scam involving some $2 billion in transactions at a Mumbai branch. It involves a high profile diamond merchant Nirav Modi, who isn't related to Indian Prime Minister Narendra Modi. The Reserve Bank of India says the alleged fraud reflects a failure of internal controls. Two junior employees at a Punjab National Bank branch in Mumbai are accused of colluding with the firms by issuing fraudulent documents that allowed them to obtain credit. The bigger fallout of this is that India's Finance Ministry has set a 15-day deadline for state-run banks to identify and plug loopholes in their respective systems regarding operational and technical risks. We think that there will be credit squeeze to corporates in the months to come and may force the public sector bank employees to go into their shell.

The consequence from India's biggest banking fraud is spreading to the market for trade financing, as foreign lenders become more reluctant to accept the guarantees from their local counterparts that underpin the loans. Citigroup Inc., Deutsche Bank AG, Standard Chartered Plc and HSBC Holdings Plc are among banks reducing exposure to these transactions, used by smaller companies to access short-term dollar funding. As questions are raised about the creditworthiness of guarantees from Indian state-run banks, rates have risen by as much as 0.5 percentage point for some types of financing.

	16–17	17–18	18–19	19–20	20-21
GDP (%p.a.)	7.1	6.5	7.6	8.1	8.2
WPI (%p.a.)	4.5	3.5	4.0	4.1	4.0
Current A/c(US$ bill.)	-24.0	-26.0	-20.0	-24.0	-26.0
Rs./$(nom.)	68.2	65.0	64.5	65.5	66.5

China

A sharper-than-expected slowdown in the Chinese economy this year is raising concerns as regulators tighten the screws on financial risks. The official manufacturing purchasing managers index, a gauge of China's factory activity, dropped to its lowest level in 19 months at 50.3 in February from 51.3 in January. Manufacturing activity fell sharply in February as plants closed for the Lunar New Year and demand for Chinese exports waned. But data from China, early in the year, must always be treated with caution due to business and price distortions caused by the timing of the long Lunar New Year celebrations, which fell in late January 2017 but started in mid-February this year.

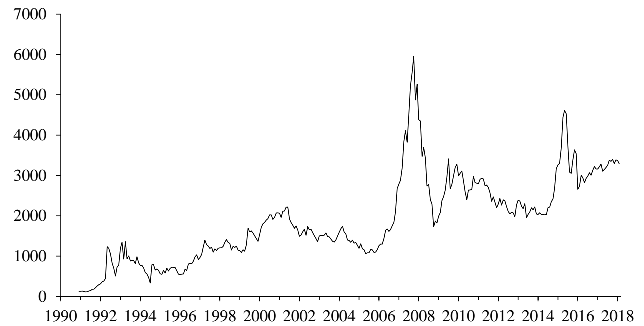
The producer price index rose 4.3% in January from a year earlier, the smallest rise in 14 months and compared with 4.9% in December. The consumer price index rose 1.5% from a year earlier, in line with expectations and slowing from December's gain of 1.8%. China's inflation rate is expected to grow 2.2% in 2018 as higher agricultural food prices will increase food inflation. In particular, there will be higher vegetable prices due to adverse weather conditions, whilst higher grain costs will be due to a rise in fertilizer prices. Non-food inflation will also increase because of electricity tariff hikes, which is expected to have 3% to 5% price hike, as well as higher inflation expectations.

China plans to reduce its annual budget-deficit target to just under 3% of total economic output. The target will be set at 2.9%. The target, which was set at 3% the past two years and hasn't been cut since 2012, is subject to approval at the annual National People's Congress opening on March 5. Now, there is a realization within the government that it is in fact impossible for China to cut debt levels or cease relying on bank financing without hurting growth. As a result, the goal to deleverage, as written in the nation's economic plans for the past two years, has been softened into a mission to control the growth of debt this year.

In recent months, the central government has been calling a halt to new projects in the construction of subway systems all over the country, including two separate, $4 billion subway projects in Inner Mongolia.

The first month of 2018 saw the yuan's central parity rate gain more than 3% against the U.S. dollar. The yuan traded at 6.3050 per dollar in the last week of February in Shanghai, close to a level it had last hit in 2015 before China rocked global markets through a surprise devaluation of the currency. But, there are four factors that will shield exports from a surging yuan: demand for Chinese goods will stay strong, peer group currency is appreciating as well, exporters hedge more than ever as exporters have become more adept at using hedging tools to defend their profits and there are more value-added exports. Therefore, China's outbound shipments have become less sensitive to increases in the yuan over the years. Given the exchange rate management

China: SSE Composite Index



of China, we expect the yuan's exchange rate to remain stable in the long term with more "two-way movement."

China's stock market wasn't in great shape even before the past month's slide. The rally leading into it was driven by a few dominant industry players, favoured by investors concerned that smaller companies would be squeezed by higher funding costs and a slowing economy. After climbing 13% in 2017, the Shanghai Composite Index plunged 12% in a little over two weeks. The structural imbalance is unlikely to change for now, suggesting more volatility ahead for the already notoriously wild Chinese stock market.

The People's Bank of China appointed JPMorgan Chase Bank N.A. as a yuan-clearing bank in the U.S., the first non-Chinese lender for such a role globally and a further step to promote international use of the currency. The arrangement is made under the auspices of U.S.-China strategic economic dialogue and in conjunction with the U.S. Federal Reserve.

China edged closer to a return to one-man rule as the Communist Party prepared constitutional changes that would allow Xi Jinping to serve as President indefinitely. In his first term, President Xi Jinping took control of China's economy. In the second, he is putting in charge a trusted ally he has known since middle school. Signs that Mr. Xi is planning to stay for the long haul intensified in October, when the Communist Party declared him its greatest living theorist and appointed him to a second five-year term as party chief without a likely successor. We flagged it in the November 2017 Letter (page 14).

Proposed constitutional changes that would allow Mr. Xi to stay in power indefinitely would also shift more influence to his inner circle. Few are more central than Mr. Xi's behind-the-scenes economic steward, Liu He, who will be named Vice Premier, in charge of a wide swath of the economy — the financial system and the industrial sector — at the annual meeting of China's legislature that starts on March 5th. As a Communist Party loyalist, Mr. Liu is likely to push forward with gradual market-oriented changes within the state-led model, as opposed to drastic shifts that could prove destabilizing and hurt the party.

Mr. Liu studied at Harvard's Kennedy School of Government in the 1990s and is fluent in English. He understands the importance of the private sector in creating the vast majority of jobs in China and force state firms to be more accountable — but he is unlikely to suggest a major overhaul.

	16	17	18	19	20
GDP (%p.a.)	6.5	6.9	6.5	6.0	5.6
Inflation (%p.a.)	2.0	2.2	1.5	2.2	2.0
Trade Balance(US$ bill.)	510	400	380	350	300
Rmb/$(nom.)	6.7	6.6	6.5	6.6	6.7

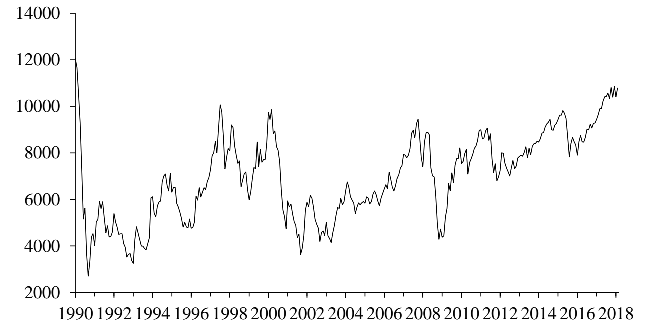
South Korea

South Korea's economy posted 3.1% growth in 2017, higher than the 2.8% pace set in the previous year. In the 4th quarter of 2017, South Korea's economy grew 3.0% from the previous year. South Korea's economy seems to be experiencing an upward trend, having seen the greatest acceleration in its growth for seven years during the third quarter of 2017. The impetus for this is global demand for its electronics, which has succeeded in mitigating the effects of regional concerns. In 2018, the economy is relying on robust domestic consumption to prop up growth in the first quarter after exports, grounded by struggling car exporters.

Inflation eased to 1% in January, the slowest in 17 months as fresh food costs declined. Consumer prices are likely to rise only 1.7% in 2018, down from 2017's 1.9% increase. This would be below the 2% target set by the Bank of Korea. Market expectations are that any more monetary tightening by the Bank of Korea, since its November hike, will take a gradual path given weak consumer price pressures. The BOK kept the benchmark interest rate steady at 1.5% in its January 18 policy review, as widely expected, and flagged concerns about economic uncertainties and soft inflation, which remain hurdles to policy tightening this year. The central bank said it would maintain an expansionary policy for the time being, citing an anticipated slowdown of investment and low consumer price inflation in the country.

The country's overall exports expanded by 22.2% year on year to $49.2bn in January. South Korea's exports have now increased for 15 consecutive months. South Korea's imports surged by 20.9% year on year to $45.5bn in January, resulting in a trade surplus of $3.7bn. South Korea's external sector is expected to boost its economy significantly this year, as well as warmer relations between the governments of South Korea and China could translate into more Chinese tourists visiting Korea this year. A healthy global economy will also support demand for Korean semiconductors, general machinery and petrochemicals. The economy got a boost from the PyeongChang Winter Olympics this year.

The current-account surplus is expected to narrow to $79 billion in 2018 from $81 billion in 2017, as commodity prices such as oil increase, along with domestic consumption.



Political observers believe that North Korea asked South Korean President Moon Jae-in to a summit in Pyongyang, possibly seeking to drive a wedge between Seoul and Washington. Kim Jong Un's sister Kim Yo Jong delivered the invitation during weekend meetings at the Winter Olympics in Pyeongchang.

Prosecutors sought a 30-year prison sentence and a $110 million fine for South Korea's former President for her involvement in a corruption scandal that brought down her administration and led to the jailing of high-ranking government officials and business leaders. The conservative former President is accused of colluding with her long-time confidante, Choi Soon-sil, to extract money from family-run Korean conglomerates, known as chaebols, in return for government favours. The court is expected to deliver a verdict for Ms. Park on April 6.

	16	17	18	19	20
GDP (%p.a.)	2.8	3.2	3.0	2.6	2.5
Inflation (%p.a.)	1.0	1.9	1.7	1.8	1.9
Current A/c(US$ bill.)	88.0	88.0	86.0	80.0	78.0
Won/$(nom.)	1160	1100	1120	1140	1150

Taiwan

Taiwan's GDP growth will continue to be helped by the growing world economy. However, as China slows down, it may impact Taiwan's growth as well.

Taiwan's inflation rate inched down from 1.2% in December to 0.9% in January. The decrease in CPI was due to the Lunar New Year timing, which started on February 15 this year

from January 27 in 2017. Taiwan's CPI will increase from 0.6% last year to 1.2%, as it will be driven by improving domestic demand, as well as the tobacco tax. The rise of CPI inflation will pull the real interest rate out of the negative zone.

Both Taiwan's exports and imports registered double-digit growth in January, mostly due to global economic recovery and demand ahead of the Chinese Lunar New Year holiday. Taiwan's exports rose 15.33% from a year earlier in January, growing at a double-digit pace for three consecutive months. Exports were driven by the demand for consumer goods. Taiwan's imports in January increased 23.3% compared with the same period last year. Taiwan's trade surplus in January stood at 2.42 billion U.S. dollars, down 30.8% from the same period last year.

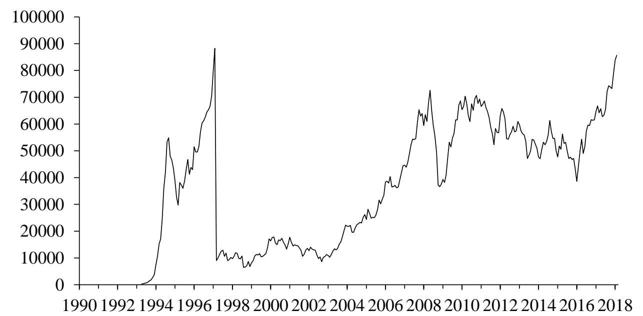
Taiwan's stock market dropped by over 500 points — nearly 5% — after the Dow Jones industrial average dropped in the first week of February. It has remained subdued since then.

	16	17	18	19	20
GDP (%p.a.)	1.4	2.6	2.5	2.3	2.3
Inflation (%p.a.)	1.0	0.6	1.2	1.2	1.2
Current A/c(US$ bill.)	64.0	68.0	68.0	70.0	71.0
NT$/$(nom.)	32.5	32.0	29.6	30.0	30.5

Brazil

Brazil's GDP forecasts for 2018 are around 3%, a growth rate the economy last hit in 2013. Unemployment is at 11.8%, but it has been declining for nine months, from a peak of 13.7% in March 2017. The government is more optimistic about the economy and hopes that economic reforms, reduction of the state's presence in the economy and higher productivity may boost the country's growth rate to between 3.5% and 4%.

The inflation rate in Brazil remains below the central bank's 3% to 6% target range, at 2.9% in January. This permitted the Brazil's central bank to trim its benchmark lending rate to a record low to 6.75%, from 7%. With unemployment remaining relatively high and the economy just starting to recover from a two-year recession, the central bank is likely to stay put on the lending rate where it stands for months to come. The bank's monetary-policy committee has already indicated it would hold the Selic at this level in its next meeting in March.



After the central bank's success in getting inflation under control, Brazil government wants to formalise bank's de facto autonomy. While welcoming the prospect, the governor Goldfajn was wary of the proposal to add employment to the institution's duties. Finance Minister Henrique Meirelles has reiterated his support for an autonomous central bank. But its passage in the Congress would not be easy.

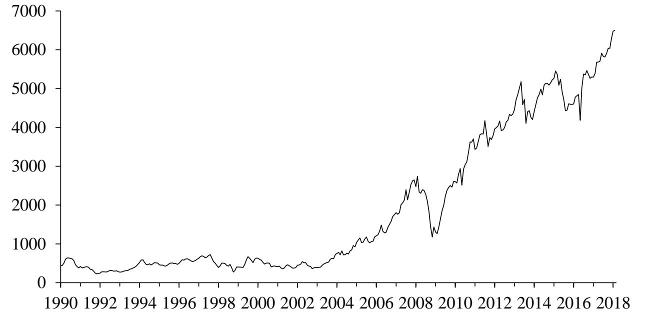
Confidence in Brazil's stock market rally remains unshaken heading into the third year. Brokers, investors and strategists are optimistic about a stronger economy. The benchmark Bovespa stock index is likely to rise around 6% to a record high of 91,250 by the year-end, according to a poll conducted in the last week of February. The latest survey suggests that the Bovespa will mark a 20% gain this year, capping off a 111% rally since the end of 2015, easily making Brazil one of the world's best-performing stock markets.

	16	17	18	19	20
GDP (%p.a.)	-3.6	1.1	2.5	3.0	3.2
Inflation (%p.a.)	6.3	2.8	4.0	4.1	4.2
Current A/c(US$ bill.)	-28.0	-4.0	-5.2	-8.0	-8.5
Real/$(nom.)	3.5	3.2	3.2	3.2	3.2

Other Emerging Markets

Hong Kong: FT-Actuaries

Indonesia: Jakarta Composite



Malaysia: FT-Actuaries (US$ Index)

Thailand: Composite Index

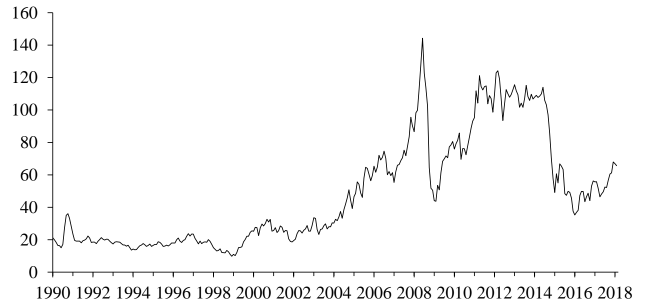
Thailand: Composite Index

Philippines: Manila Composite

COMMODITY MARKETS

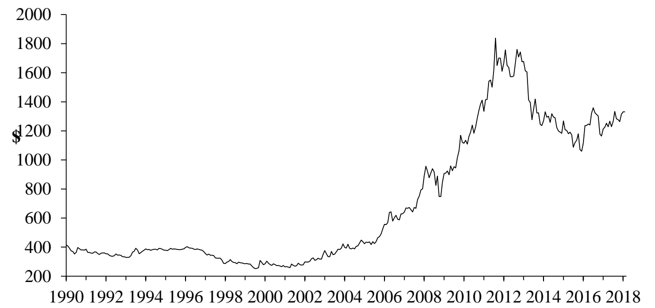
Commodity Price Index (Dollar)
(Economist, 2000=100)

Oil Price: North Sea Brent (in Dollars)

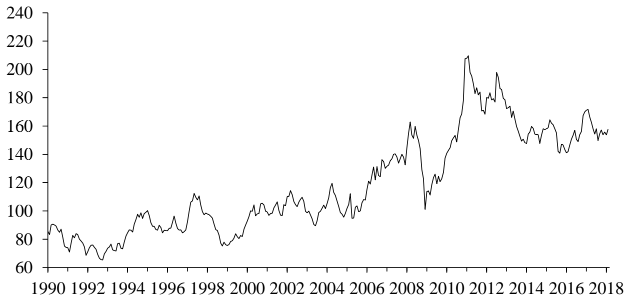


Commodity Price Index (Sterling)
(Economist, 2000=100)

Gold Price (in Dollars)



Commodity Price Index (Euro)
(Economist)



UK FORECAST DETAIL

Prices, Wages, Interest Rates and Exchange Rate Forecast (Seasonally Adjusted)

	Inflation %[1] (CPI)	Short Dated (5 Year) Interest Rates	3 Month Int. Rates	Nominal Exchange Rate (2005=100) [2]	Real Exchange Rate[3]	Real 3 Month Int. Rates %[4]	Inflation (RPIX)	Real Short Dated Rate of Interest[5]
2016	1.1	0.7	0.5	82.1	80.6	-1.0	1.9	-1.7
2017	2.6	1.1	0.4	77.1	74.9	-2.0	3.3	-1.4
2018	2.5	1.4	0.6	76.4	75.0	-1.5	3.1	-1.0
2019	2.1	2.5	1.2	75.6	74.5	-0.9	2.8	0.2
2020	2.0	3.5	2.4	74.1	73.1	0.2	2.7	1.2
2021	2.1	2.9	3.1	73.0	72.4	0.2	2.8	0.5
2017:1	1.9	0.6	0.3	76.8	73.9	-2.1	3.3	-0.3
2017:2	2.6	1.2	0.4	77.3	75.3	-2.0	3.2	-1.1
2017:3	2.8	1.2	0.4	77.2	75.3	-2.0	3.3	-0.5
2017:4	2.9	1.2	0.5	76.9	75.3	-1.9	3.4	-0.4
2018:1	2.6	1.3	0.5	77.1	75.3	-1.5	3.1	-0.3
2018:2	2.5	1.5	0.6	76.6	75.2	-1.5	3.1	0.6
2018:3	2.5	1.5	0.6	75.7	74.2	-1.4	3.1	-0.1
2018:4	2.5	1.5	0.7	76.1	75.2	-1.4	3.1	0.4
2019:1	2.1	2.5	0.8	76.6	75.2	-1.3	2.8	-0.5
2019:2	2.1	2.5	0.8	75.5	74.3	-1.2	2.8	-0.4
2019:3	2.1	2.5	1.1	75.3	74.2	-1.0	2.8	-0.4
2019:4	2.1	2.5	1.8	75.1	74.3	-0.2	2.8	-0.1

[1] Consumer's Expenditure Deflator
[2] Sterling Effective Exchange Rate Bank of England
[3] Ratio of UK to other OECD consumer prices adjusted for nominal exchange rate
[4] Treasury Bill Rate less one year forecast of inflation
[5] Short Dated 5 Year Interest Rate less average of predicted 5 year ahead inflation rate

Labour Market and Supply Factors (Seasonally Adjusted)

	Average Earnings (1990=100)[1]	Wage Growth[2]	Unemployment (New Basis) Percent[3]	Millions	Real Wage Rate[4] (1990=100)
2016	253.2	2.4	2.2	0.8	142.9
2017	257.8	2.0	2.2	0.8	142.1
2018	263.9	2.3	2.1	0.8	141.7
2019	268.7	1.8	2.0	0.7	141.2
2020	273.2	1.7	1.9	0.7	140.6
2021	281.4	3.0	1.6	0.6	141.9
2017:1	255.8	2.4	2.1	0.8	143.9
2017:2	256.3	1.7	2.2	0.8	141.2
2017:3	259.8	2.1	2.2	0.8	142.3
2017:4	259.5	2.0	2.2	0.8	141.1
2018:1	261.2	2.1	2.1	0.8	142.9
2018:2	262.8	2.6	2.1	0.8	141.1
2018:3	265.6	2.2	2.1	0.8	141.7
2018:4	266.2	2.6	2.0	0.7	141.0
2019:1	265.3	1.6	2.0	0.7	142.1
2019:2	268.5	2.1	2.0	0.7	141.1
2019:3	270.0	1.7	2.0	0.7	141.1
2019:4	271.1	1.9	1.9	0.7	140.6

[1] Whole Economy
[2] Average Earnings
[3] Wholly unemployed excluding school leavers as percentage of employed and unemployed, self employed and HM Forces
[4] Wage rate deflated by CPI

Estimates and Projections of the Gross Domestic Product[1] (£ Million 1990 Prices)

	Expenditure Index	£ Million '90 prices	Non-Durable Consumption[2]	Private Sector Gross Investment Expenditure[3]	Public Authority Expenditure[4]	Net Exports[5]	AFC
2016	159.4	763130.9	440238.4	292912.0	198473.7	-55145.2	113348.0
2017	162.8	779568.4	447220.8	297451.9	199478.8	-49716.2	115424.6
2018	165.9	794590.2	455625.1	299857.2	200245.3	-43280.0	117858.2
2019	169.0	809541.5	465605.1	303926.7	200695.7	-40400.3	120284.1
2020	172.3	825206.6	476269.2	305305.4	201423.9	-34950.6	122842.0
2021	176.1	843441.4	485909.2	309134.3	202752.9	-28559.5	125795.9
2017/16	2.2		1.6	1.6	0.5		2.0
2018/17	2.0		1.9	1.0	0.4		2.1
2019/18	1.9		2.2	1.4	0.2		2.1
2020/19	1.9		2.3	0.5	0.4		2.1
2021/20	2.2		2.0	1.3	0.7		2.4
2022/21	2.3		2.0	2.7	-0.4		2.4
2017:1	161.6	193453.0	111073.9	73556.2	51435.0	-14278.1	28888.6
2017:2	162.3	194338.3	111485.4	73924.4	49462.3	-11901.3	28633.8
2017:3	163.3	195457.5	111947.0	74780.4	49336.1	-11847.1	28760.0
2017:4	164.0	196319.7	112714.5	75190.9	49245.4	-11689.6	29142.1
2018:1	164.8	197254.3	112852.8	74349.1	50854.4	-11513.1	29289.0
2018:2	165.6	198214.1	113552.8	74664.3	49963.7	-10595.0	29371.9
2018:3	166.4	199176.7	114256.6	74949.1	49779.7	-10289.0	29520.2
2018:4	167.0	199945.0	114962.8	75894.7	49647.5	-10882.9	29677.2
2019:1	167.8	200919.0	115328.3	75359.1	50223.8	-10152.1	29839.5
2019:2	168.6	201889.2	116041.1	75576.5	50207.6	-9947.7	29987.7
2019:3	169.4	202869.6	116756.5	75564.6	50155.0	-9460.6	30145.5
2019:4	170.3	203863.7	117479.2	77426.5	50109.3	-10840.0	30311.4

[1] GDP at factor cost. Expenditure measure; seasonally adjusted
[2] Consumers expenditure less expenditure on durables and housing
[3] Private gross domestic capital formation plus household expenditure on durables and clothing plus private sector stock building
[4] General government current and capital expenditure including stock building
[5] Exports of goods and services less imports of goods and services

Financial Forecast

	PSBR/GDP %[1]	GDP[1] (£bn)	PSBR (£bn) Financial Year	Debt Interest (£bn)	Current Account (£ bn)
2016	2.3	1960.1	45.1	58.7	-87.4
2017	2.0	2040.6	40.1	61.5	-65.6
2018	1.6	2132.8	33.4	63.8	-54.3
2019	1.1	2221.1	24.2	67.6	-49.4
2020	0.3	2312.7	6.6	65.2	-39.0
2021	-0.3	2419.2	-6.6	62.0	-26.4
2017:1	-3.0	493.2	-14.6	15.0	-17.5
2017:2	2.4	501.6	12.0	15.2	-18.9
2017:3	1.6	507.5	8.4	15.3	-17.7
2017:4	1.4	514.1	7.4	15.5	-11.5
2018:1	2.4	517.7	12.4	15.5	-12.3
2018:2	1.8	525.4	9.6	15.7	-16.8
2018:3	1.6	531.2	8.4	15.9	-15.2
2018:4	1.3	537.5	7.3	16.0	-10.0
2019:1	1.5	539.1	8.0	16.3	-9.8
2019:2	1.3	547.1	7.0	16.4	-15.8
2019:3	1.1	553.1	6.2	16.7	-13.7
2019:4	1.0	560.1	5.6	17.2	-10.1

[1] GDP at market prices (Financial Year)

WORLD FORECAST DETAIL

Growth Of Real GNP

	2014	2015	2016	2017	2018	2019
U.S.A.	2.6	2.9	1.5	2.2	2.7	2.4
U.K.	2.9	2.2	1.8	2.2	2.0	
Japan	0.3	1.4	0.9	1.6	1.4	1.1
Germany	1.9	1.7	1.9	1.9	2.3	1.8
France	1.0	1.0	1.1	1.6	1.9	1.7
Italy	0.1	1.0	0.9	1.3	1.4	1.1

Real Short-Term Interest Rates

	2014	2015	2016	2017	2018	2019
U.S.A.	–0.1	–1.1	–1.5	–0.9	–0.3	0.5
U.K.	–2.2	-0.5	–1.0	–2.0	–1.5	–0.9
Japan	–0.6	0.1	–0.4	–0.8	–1.0	–1.1
Germany	–0.2	–0.6	–2.0	–2.0	–2.0	–2.1
France	0.1	–0.2	–1.3	–1.6	–1.7	–2.1
Italy	0.0	0.0	–1.7	–1.4	–1.6	–2.1

Real Long-Term Interest Rates

	2014	2015	2016	2017	2018	2019
U.S.A.	0.7	0.3	0.5	0.8	1.0	1.5
U.K.	–0.7	–1.0	–1.7	–1.4	–1.0	0.2
Japan	–0.4	–0.5	–1.0	–1.1	–1.3	–1.5
Germany	–0.7	–0.9	–1.7	–1.4	–1.4	–1.1
France	0.0	–0.7	–0.9	–0.9	–0.8	–0.6
Italy	1.1	0.4	0.1	0.3	0.4	0.6

Index Of Real Exchange Rate(2000=100)[1]

	2014	2015	2016	2017	2018	2019
U.S.A.	83.9	93.0	94.0	94.5	94.8	95.0
U.K.	93.1	91.6	80.6	74.9	75.0	74.5
Japan	59.8	56.0	58.4	58.3	58.1	58.4
Germany	99.9	94.7	95.0	94.3	94.9	95.1
France	100.8	96.2	96.0	95.3	95.1	95.5
Italy	107.5	102.1	102.0	101.2	101.1	101.1

[1] The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation in the real exchange rate.

Growth Of Consumer Prices

	2014	2015	2016	2017	2018	2019
U.S.A.	1.6	0.1	1.3	2.0	2.1	2.1
U.K.	1.7	0.2	1.1	2.6	2.5	2.1
Japan	2.8	0.8	0.1	0.5	0.9	1.1
Germany	0.9	0.3	0.5	1.7	1.7	1.8
France	0.5	0.0	0.1	1.0	1.3	1.5
Italy	0.2	0.1	–0.1	1.4	1.1	1.4

Nominal Short-Term Interest Rates

	2014	2015	2016	2017	2018	2019
U.S.A.	0.0	0.2	0.5	1.2	1.8	2.5
U.K.	0.6	0.6	0.5	0.4	0.6	1.2
Japan	0.2	0.2	0.1	0.1	0.1	0.1
Germany	0.1	–0.1	–0.3	–0.3	–0.2	–0.1
France	0.1	–0.1	–0.3	–0.3	–0.2	–0.1
Italy	0.1	–0.1	–0.3	–0.3	–0.2	–0.1

Nominal Long-Term Interest Rates

	2014	2015	2016	2017	2018	2019
U.S.A.	2.2	2.2	2.5	2.8	3.0	3.5
U.K.	1.8	1.3	0.7	1.1	1.4	2.5
Japan	0.3	0.3	0.0	0.1	0.1	0.1
Germany	0.5	0.6	0.1	0.5	0.6	0.9
France	0.8	0.5	0.7	0.9	1.1	1.4
Italy	1.9	1.6	1.7	2.0	2.3	2.6

Nominal Exchange Rate
(Number of Units of Local Currency To $1)

	2014	2015	2016	2017	2018	2019
U.S.A.[1]	89.04	103.08	101.91	102.20	102.40	102.50
U.K.	1.65	1.53	1.35	1.30	1.29	1.28
Japan	106.67	121.11	108.61	112.18	114.10	114.30
Eurozone	0.76	0.90	0.90	0.88	0.85	0.86

[1] The series for the USA is a trade weighted index (1990=100); the series for the UK is $ per £

* Forecasts based on the Liverpool World Model