LIVERPOOL INVESTMENT LETTER

January 2015

Cardiff Business School
Cardiff University

Julian Hodge Institute of Applied Macroeconomics

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

Editorial and Research Direction: Patrick Minford[†].

Senior Research Associates: Kent Matthews[†], Anupam Rastogi, Peter Stoney, Bruce Webb[†], John Wilmot.

Research Associates: Vo Phuong Mai Le[†], David Meenagh[†], Francesco Perugini.

[†] Cardiff Business School

The Julian Hodge Institute was launched in autumn 1999 in a new collaboration between the Cardiff Business School of Cardiff University and Julian Hodge Bank. 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. This research has been given especial relevance by the ongoing discussions on the extra powers regularly requested by the European Union and also by the recent crisis in the eurozone.

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 Jane 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 Bruce Webb and published on behalf of the group by Liverpool Macroeconomic Research Limited, which holds the copyright

ISSN 0951-9262

Disclaimer

The Liverpool Investment Letter is a publication intended to provide information to investors and investment managers acting on their own initiative. No responsibility can be taken by Liverpool Macroeconomic Research Limited for decisions made by our readers. Whilst every attempt is made to ensure the accuracy of the contents, no guarantee of such accuracy is given.

LIVERPOOL INVESTMENT LETTER

January 2015

CONTENTS

	Page
Where Are We In The Business Cycle?	3
The world business cycle is now strongly underpinned by falling commodity prices and going into a prolonged upturn phase. The challenge for policy is now to withdraw stimulus; but the signs are politicians are continuing to stimulate for electoral reasons.	
Focus on Japan	5
Market Developments	7
Summary and Portfolio Recommendations	
Indicators and Market Analysis	
Foreign Exchange	9
Government Bond Markets	10
Major Equity Markets	11
Emerging Equity Markets	12
Commodity Markets	18
UK Forecast Detail	19
World Forecast Detail	21

WHERE ARE WE IN THE BUSINESS CYCLE

Many people are talking about the prospect of a world slowdown, led perhaps by China and the euro-zone. Clearly both these continental economies have problems, the euro-zone's being the hubristic introduction of the euro and China's being the product of over-enthusiastic credit stimulus when the crisis hit. But we need to think globally, as the world economy vibrates to more than the pulse of individual problems.

In fact, the situation is more likely to be the opposite. We are now at the stage in the world business cycle where the material-consuming economies are recovering against a backdrop of massive capacity in materials production. The peak in real commodity prices is now a few years behind us; and in the run-up to that peak it was an excellent time to invest in materials capacity and technology. In the decade or so from 2002 raw material prices were on a roll; allowing for inflation, non-energy prices more than doubled and oil prices roughly tripled so that returns to new materials capacity and technology development was huge-see charts following.

This was also a period of strong boom in the consuming countries; during most of it commodity prices were low in real terms and profits in final production were high. The world boomed until the crisis hit in 2009. Swings in real commodity prices are like tax cuts/rises levied by material producers on material consumers. In the early stage of the world business cycle upturn when raw material prices are low, taxes have effectively been cut so that consumption of materials and production of finished output grows strongly. As the recovery grows mature and material-producing capacity is used up, material prices start to rise — taxes are being raised. The boom grinds to a halt as the world 'runs out' of raw material capacity. Material prices by now are at their peak; but of course the slowdown in final production and so in material consumption now begins to generate excess capacity in material production, further fed by new capacity and technology coming on stream with the inevitable delays from commissioning.

As it does so, and this is where we are currently in that cycle, raw material prices start to fall sharply; we are back with tax cuts and another upswing. Oil prices are down to around $50 a barrel, about a third of their peak — a drop of 66%. Non-energy prices are down about 40% from their peak. This time around the main new source of excess capacity is US shale oil. In the 1980s it was mainly a huge drop in energy use with greater fuel efficiency of transport. But even without these dramatic single elements there is a myriad of smaller effects of the same sort.

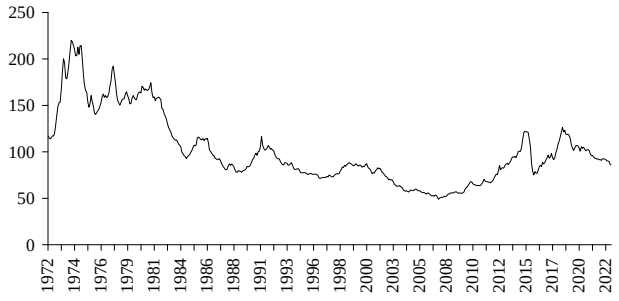
When tax cuts are on the scale we are witnessing, the chances of another slowdown are exceedingly remote. World growth is running in the 3–4% range and that is perfectly normal for an upswing in which there is not

Table 1: Summary of Forecast

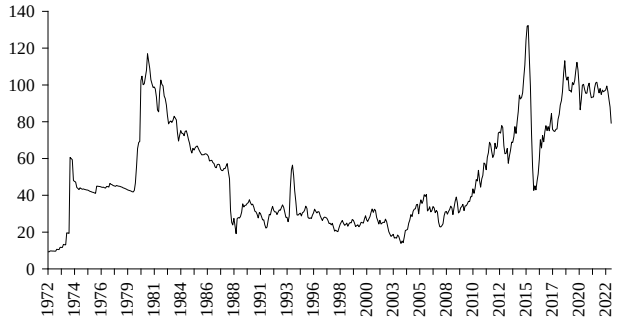
	2010	2011	2012	2013	2014	2015	2016
GDP Growth[1]	1.9	1.6	0.7	1.7	2.8	2.5	2.4
Inflation CPI	4.5	3.5	2.1	1.9	1.8	2.0	2.0
RPIX	4.8	5.3	3.2	3.1	2.5	2.7	2.5
Unemployment (Mill.)							
Ann. Avg.[2]	1.5	1.5	1.6	1.4	1.1	0.9	0.8
4th Qtr.	1.5	1.6	1.6	1.3	1.0	0.9	0.8
Exchange Rate[3]	80.4	80.0	83.0	81.5	90.1	88.8	88.0
3 Month Interest Rate	0.7	0.9	0.9	0.6	0.6	0.9	2.0
5 Year Interest Rate	2.4	2.0	0.9	1.3	1.9	2.1	2.3
Current Balance (£bn)	–34.9	–23.2	–53.2	–62.2	–71.0	–73.0	–75.0
PSBR (£bn)	118.6	96.6	110.5	91.3	105.5	93.8	84.9

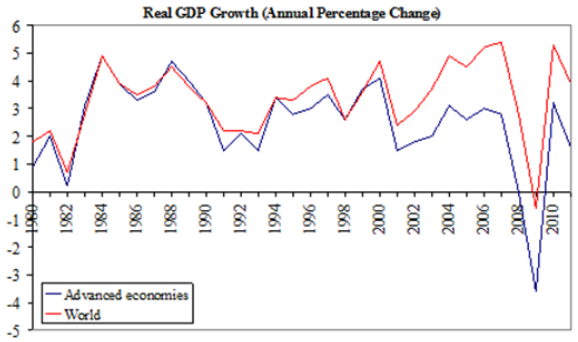
[1]Expenditure estimate at factor cost
[2]U.K. Wholly unemployed excluding school leavers (new basis)
[3]Sterling effective exchange rate, Bank of England Index (2005 = 100)

Commodity Real Price Index - Non Energy (2010=100)



Price of a barrel of oil, US$, 2010 prices

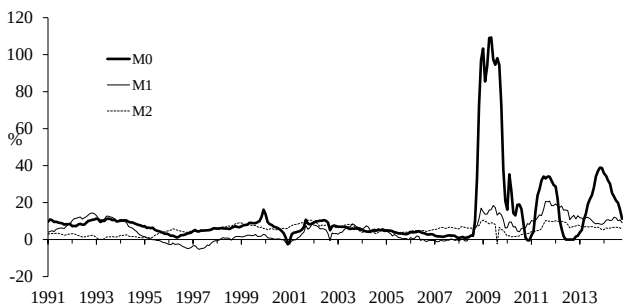




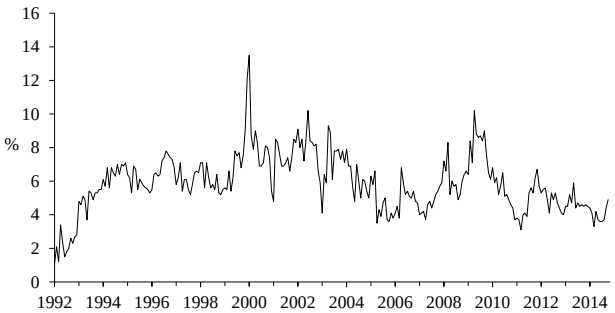
vigorous credit creation such as occurred in the 2000s. The challenge for central banks and governments is not to over-stimulate the world business cycle in this upswing phase. This means that monetary policy now needs to turn cautious and budget deficits need to be brought down. Unfortunately usually government policy is still in panic mode at this stage of the cycle, eager to 'make sure' there will be the strongest possible recovery, so that unemployment comes down fast in time for the electoral cycle.

It is for this reason we need to return to rules of fiscal and monetary behaviour that are cautious but traditionally counter-cyclical. Monetary policy needs to be tuned to taking away the 'punch bowl' as the party warms up. Fiscal policy needs to push down current deficits and pay down debt/GDP ratios as soon as deficits become low enough to reduce them. It is not happening; all the signs are the opposite. The central banks are keeping money too loose for too long; governments are tiring of cutting deficits. We will make the same mistakes in the coming business cycle as we did in the last.

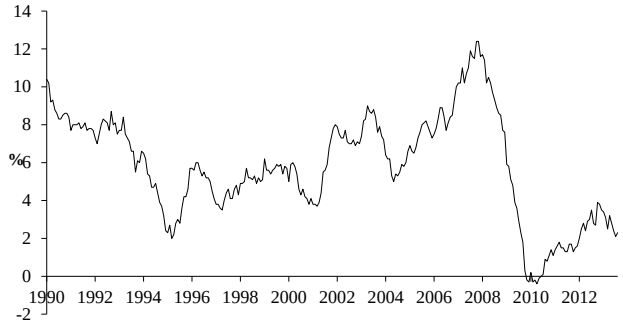
U.S.: Growth in Monetary Aggregates (Yr - on - Yr)



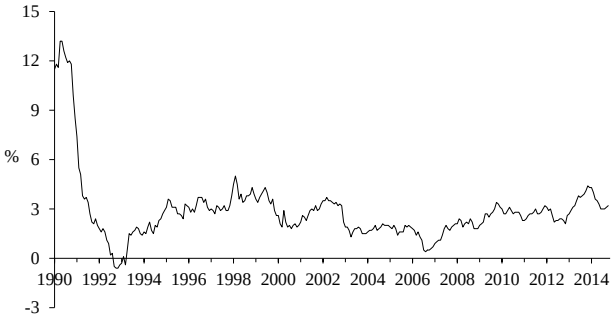
UK: Notes and Coins in Circulation Growth



Eurozone M3 Growth



Japan: Growth of M2+CD's



FOCUS ON JAPAN

Francesco Perugini

Shinzo Abe wins new term

As widely expected Shinzo Abe has tightened his grip on power after his Liberal Democratic Party (LDP) won a comfortable majority in general elections on the 14th of December. Abe's LDP locked up a solid majority of 290 seats — they held 295 seats before the election — and with its junior coalition partner, Komeito, will hold more than two-thirds of the Lower House — 325 seats. That means the coalition retains its super majority, giving it the power to override bills rejected by the Upper House and pass them into law.

The victory gives Abe breathing room to pursue some unpopular items on his agenda, such as restarting the nuclear reactors three years after the Fukushima meltdown — currently, all 48 of Japan's reactors are offline — and expanding the military's global reach by lifting the post-war ban on collective self-defence. Most importantly, the landslide election win will give him another chance to proceed with his reflationary policy. "We postponed the consumption tax hike, and I hope we can now start to raise wages and create a virtuous cycle so that people can really feel that the economy is recovering," he said at a press conference after the polls.

Under Abe, stock prices have doubled and many large corporations such as Toyota Motor Corporation are reporting record profits. That is thanks largely to the fall of the yen, triggered when Abe's handpicked governor of the Bank of Japan (BOJ), Haruhiko Kuroda, unleashed two rounds of monetary easing to flood the financial system with cash. However, many investors are waiting to see whether he will use the mandate to accelerate the structural changes to the economy he has promised.

So far, he has not shown much inclination to carry through with the overhauls most closely watched abroad, such as shaking up Japan's rigid labour markets and eliminating agricultural tariffs. This is the main reason why many voters stayed away from the polls. Indeed, turnout hit a record low of just over 52%, a drop of seven percentage points from the last Lower House election in 2012, which itself set a record for low turnout — the lowest since the end of the second world war (see the chart below taken from The Wall Street Journal). The public's confusion over the purpose of the snap election, coupled with the cold winter weather and the lack of a clear alternative to the LDP, especially with respect to the growth policy, are the other reasons why the electorate gave up on political participation. Nevertheless, Abe remains confident. "We have received a vote of confidence on the administration of the past two years", he said on a TV program late on the election day. "I will try to gain public support when carrying out policies, but without being complacent".

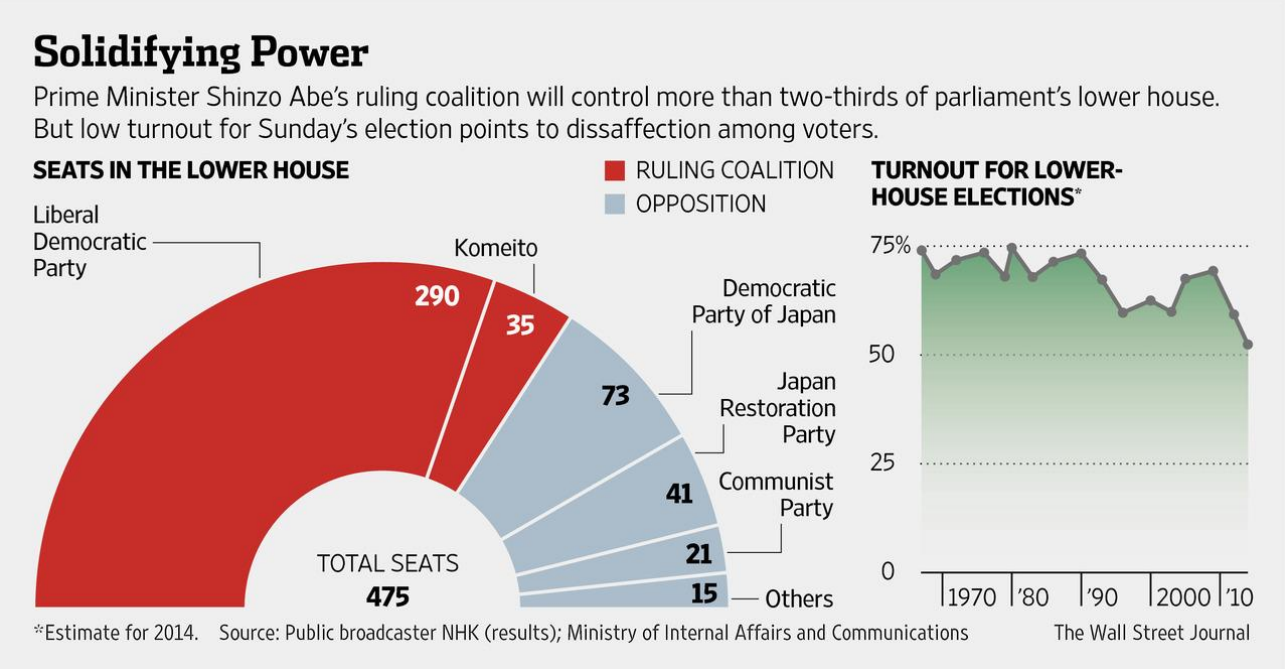
What lies ahead now? Despite Japan having recorded two quarters of negative growth, Abe said he would press ahead with a second tax increase in April 2017. Repeating a phrase he used during the campaign, Abe insisted that Abenomics was "the only way" for Japan to start on the road to economic recovery.

His government has just approved an economic stimulus package worth ¥3.5 trillion aimed at helping the country's lagging regions and households with subsidies, merchandise vouchers and other steps — the government said it expects the stimulus plan to boost Japan's GDP by 0.7%. The government is also considering setting the scale of general-account spending at ¥97 trillion yen in its fiscal 2015 initial budget draft, a record high.

Abe says from next spring he will designate special local zones where the government promotes deregulation and supports regional economic revival while the ruling LDP's tax panel plans to cut Japan's corporate tax rate by more than 3 percentage points in fiscal 2015 and 2016.

On the monetary policy front, BOJ Governor Haruhiko Kuroda stressed the bank's readiness to increase its monetary stimulus to meet its price goal. "BOJ will continue to take action" to vanquish deflation, he recently said at a press conference. He also defended his "shock-and-awe" policy on 31 October, when the annual pace of base money expansion accelerated to ¥80 trillion from the previous ¥60 to ¥70 trillion range set in April 2013 — to achieve this target, the purchases of Japanese government bonds increased from ¥50 trillion to ¥80 trillion per annum. But some observers do not see Kuroda as a maverick, a man who has been breaking all the rules in Tokyo. Rather they believe he has fallen into the same trap that ensnared Masaru Hayami, the BOJ leader from 1998 to 2003 who pioneered quantitative easing. Just as then, by assuming responsibility for reenergizing growth, the BOJ is unintentionally becoming a crutch for politicians eager to seize any excuse to avoid challenging vested interests. Kuroda's policies have indeed been bold — bolder than anything Abe himself has been willing to attempt. But the BOJ's policies are allowing the government to sidestep its responsibility. That must stop if Abenomics is to come off life support. Kuroda should begin nudging Abe to do something with his popular mandate for change.

The revival of the Japanese economy is the central question on which the Abe premiership will be judged. Now that he has secured four more years for himself as prime minister, Abe must use his new mandate to complete his ambitious programme of reform and restore sustainable growth. "We are likely to see more of what we've seen — piecemeal reforms moving more or less in the right direction, but at a fairly slow clip and no bold breakthroughs because of this election," said Gerald Curtis, a professor at Columbia University and long-time observer of Japan politics.


Solidifying Power
Prime Minister Shinzo Abe's ruling coalition will control more than two-thirds of parliament's lower house. But low turnout for Sunday's election points to dissaffection among voters.
SEATS IN THE LOWER HOUSE
RULING COALITION
OPPOSITION
Liberal Democratic Party
290
Komeito
35
Democratic Party of Japan
73
Japan Restoration Party
41
Communist Party
21
Others
15
TOTAL SEATS
475
TURNOUT FOR LOWER-HOUSE ELECTIONS*
75%
50
25
0
1970
'80
'90
2000
'10
*Estimate for 2014. Source: Public broadcaster NHK (results); Ministry of Internal Affairs and Communications
The Wall Street Journal

MARKET DEVELOPMENTS

With the world business cycle in prolonged upswing, equities continue to offer the best value. Policy and market panics over renewed recession will give plenty of opportunities to buy.

Table 1: Market Developments

	Market Levels		Prediction for Dec/Jan 2015/16	
	Nov 28	Dec 30	Previous Letter	Current View
Share Indices				
UK (FT 100)	6723	6547	9721	9460
US (S&P 500)	2068	2080	2680	2717
Germany (DAX 30)	9981	9806	13764	13620
Japan (Tokyo New)	1410	1408	1924	1920
Bond Yields (government				
UK	1.93	1.79	2.00	2.00
US	2.17	2.19	2.10	2.10
Germany	0.70	0.54	1.50	1.50
Japan	0.42	0.44	0.70	0.70
UK Index Linked	–0.68	–0.74	0.10	0.10
Exchange Rates				
UK ($ per £)	1.57	1.56	1.56	1.56
UK (trade weighted)	86.7	87.9	82.3	88.6
US (trade weighted)	95.5	97.0	85.5	85.5
Euro per $	0.80	0.82	0.79	0.79
Euro per £	1.26	1.28	1.23	1.23
Japan (Yen per $)	119.0	119.0	98.0	98.0
Short Term Interest Rates (3-month deposits)				
UK	0.60	0.60	2.10	1.10
US	0.27	0.19	0.70	0.70
Euro	0.04	0.10	0.50	0.50
Japan	0.00	0.05	0.70	0.70

Table 2: Prospective Yields [1]

Equities: Contribution to £ yield of:

	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.40	2.5	2.0	40.00		47.90
US	1.90	3.0	1.6	26.00	–0.26	32.24
Germany	2.60	1.4	1.5	36.00	3.65	45.15
Japan	1.70	1.4	2.0	33.00	17.44	55.54
UK indexed[2]	–0.74		2.4	–5.00		–3.74
Hong Kong[3]	2.60	7.0	1.6	7.00	–0.26	17.94
Malaysia	3.30	5.2	1.6	58.00	–0.26	68.14
Singapore	3.50	4.5	1.6	36.00	–0.26	45.34
India	1.40	7.0	1.6	21.00	–0.26	30.74
Korea	1.10	4.2	1.6	0.00	–0.26	6.64
Indonesia	2.20	6.1	1.6	41.00	–0.26	50.64
Taiwan	2.80	3.0	1.6	26.00	–0.26	33.14
Thailand	3.20	4.1	1.6	38.00	–0.26	46.64

Bonds: Contribution to £ yield of:

	Redemption Yield	Changing Nominal Rates	Currency	Total
UK	1.79	–2.10		–0.31
US	2.19	0.90	–0.26	2.83
Germany	0.54	–9.60	3.65	–5.41
Japan	0.33	–3.70	17.44	14.07

Deposits: Contribution to £ yield of:

	Deposit Yield	Currency	Total
UK	0.60		0.60
US	0.19	–0.26	–0.07
Euro	0.10	3.65	3.74
Japan	0.05	17.44	17.49

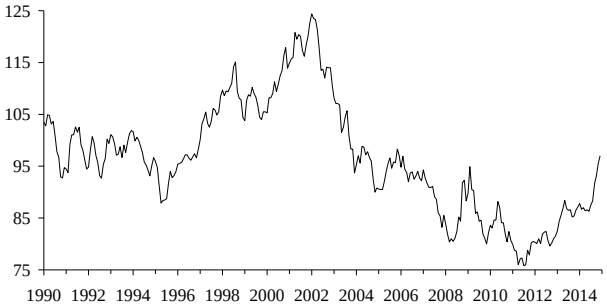
[1] Yields in terms of €s or $s can be computed by adjusting the £-based yields for the expected currency change.
[2] UK index linked bonds All Stocks
[3] Output based on China.

Table 3: Portfolio(%)

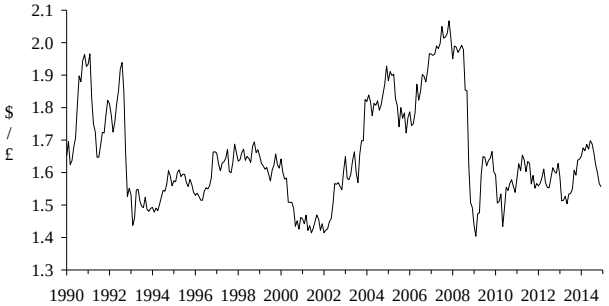
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	December Letter	**Current View**	**December Letter**	**Current View**	**December Letter**	**Current View**
UK Deposits (Cash)	5	5	5	5	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
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

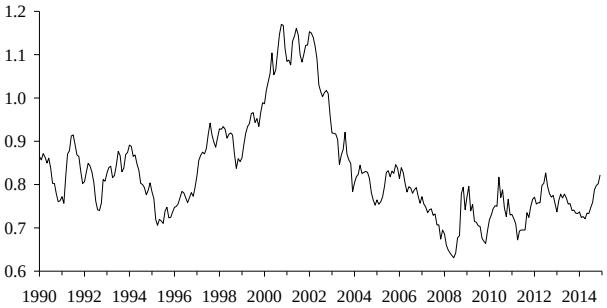
US : Trade Weighted Index
(Bank of England 1990 = 100)



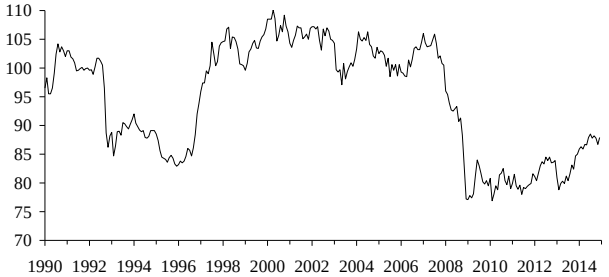
UK: Dollars Per Pound Sterling



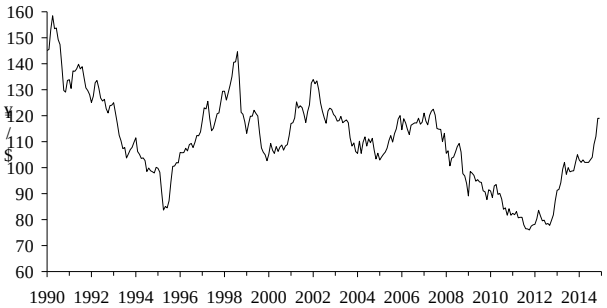
Euro per US dollar



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



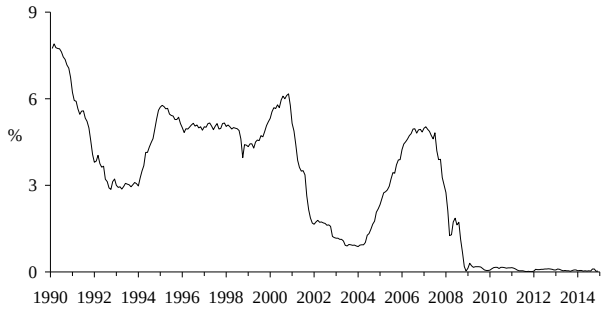
Japan : Yen Per U.S. Dollar



GOVERNMENT BOND MARKETS

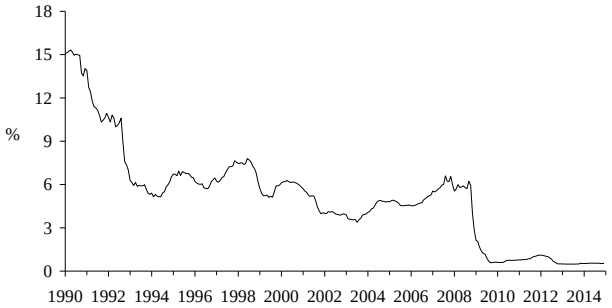
U.S.: Yield on Long-Term Government Bonds

U.S. : 3-Month Treasury Bill



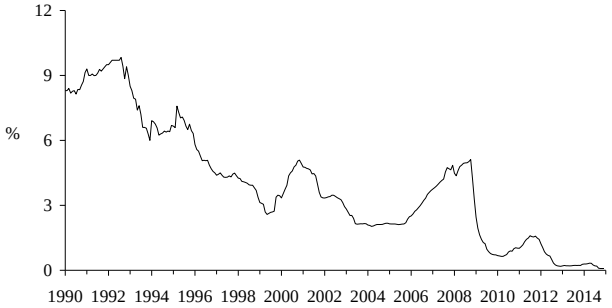
U.K. : Yield on Long-Term Government Bonds

U.K. : 3-Month Interbank Rate



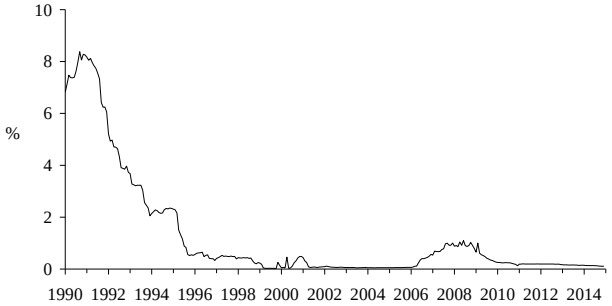
Germany: Yield on Public Authority Bonds

Germany : 3-Month Interbank Deposit Rate



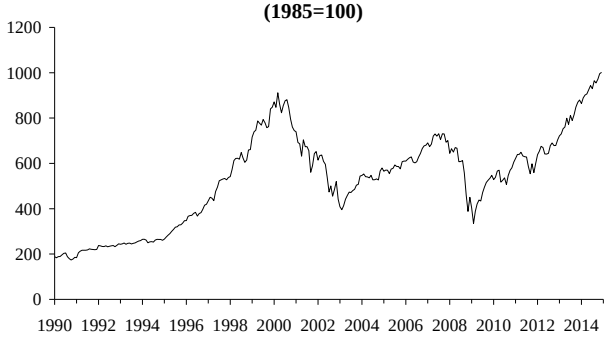
Japan: Yield on Long-Term Government Bonds

Japan : 3 Month Money Market Rate

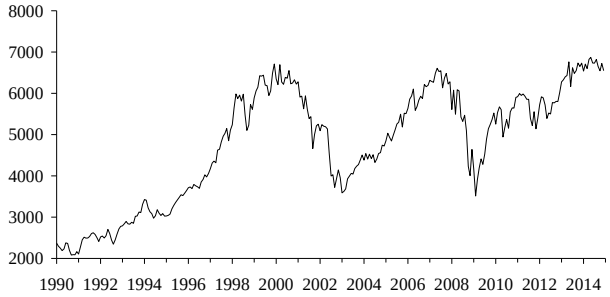


MAJOR EQUITY MARKETS

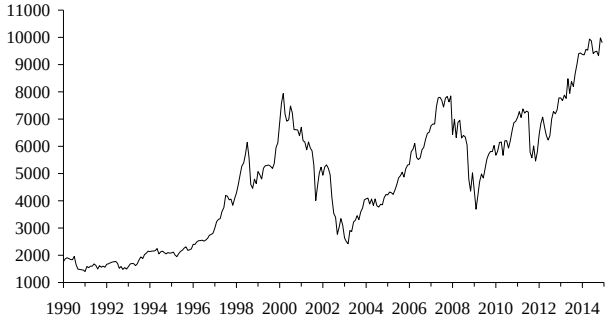
U.S. : S & P 400 Industrial
(1985=100)



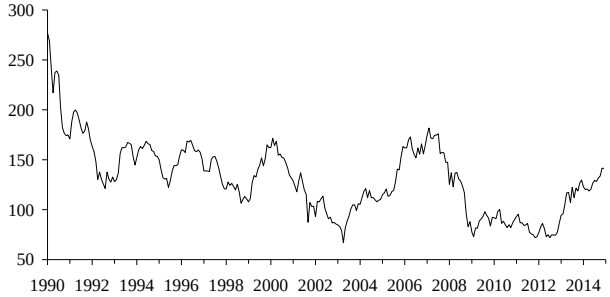
U.K. : FTSE-100 Index
(10 April 1962=100)



Germany : DAX 30



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



EMERGING MARKETS

Anupam Rastogi

India

India's government expects the economy to grow 5.5% in the year through March, recovering significantly from the below 5% expansion in the previous two years. After two years of below 5% growth, India is expected to grow at 7% in the next financial year. The seasonally adjusted HSBC India Manufacturing Purchasing Managers' Index, prepared by Markit, rose to 54.5 in December from 53.3 in November. A healthy rise in new orders, both from domestic and overseas clients, has helped to boost activity.

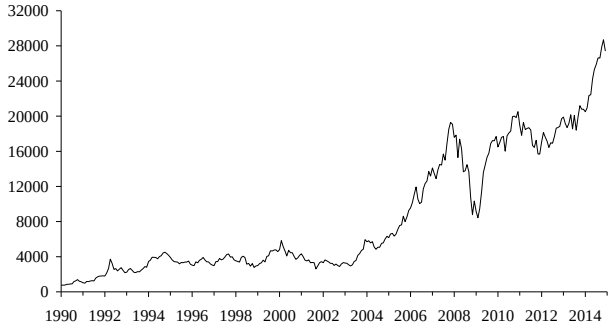
India's consumer inflation rate dropped to 4.4% in November while wholesale prices were flat from year-earlier levels that month, raising hopes that India may be close to bringing its inflation troubles under control. But, demand for investment goods — another important indicator of manufacturing activity — slowed during November.

India's trade deficit widened to the highest in 18 months in November as strengthening demand for gold pushed up imports. The deficit swelled to $16.9 billion, compared with $9.6 billion a year earlier and $13.4 billion in October. But, India's exports resumed climbing in November, brightening prospects that a recovery in the south Asian economy would strengthen. Exports rose 7.3% from a year earlier to $26 billion, after a 5% fall in October. Imports rose 26.8% to $42.8 billion as gold imports jumped to $5.6 billion from $835.8 million a year earlier.

Imports of non-oil commodities such as coal, iron and steel also rose significantly, pointing to strengthening economic activity. At present, we do not expect the current-account deficit to exceed 2% of gross domestic product in fiscal year 2015, as the recent slack in commodity prices would ease the pressure on imports.

For most of 2014, the rupee traded in a narrow 60 to 63 range against the U.S. dollar, weakening just about 2% during the year. That was significantly better than its performance in 2013 when it had fallen to a record low of 68.85 against the dollar. It had ended 11% lower last year than in 2012. RBI governor Raghuram Rajan has presided over an increase in India's dollar reserves, which hit $315bn in November, up from $291bn during the same month last year. The policy of the Indian central bank, which allowed banks to accept deposits from overseas Indians and raise overseas loans, helped the rupee. Declining oil prices reduced India's import bill while a new pro-business government in New Delhi generated optimism

India: BSE Sensitive



about the economy, helping attract billions of dollars of foreign money and further easing pressure on the currency.

Official data show until the middle of December, foreign investors had invested as much as $43 billion in Indian debt and stocks, a nearly fourfold jump from last year's $11 billion. Out of this, nearly $17 billion went into Indian equities in 2014. Indian shares ended 2014 with 30% gains, posting their best annual performance in five years.

Some political analysts are getting impatient with the new government as it has not announced any big bang reform agenda. In our opinion, Prime Minister Modi is front-loading his reform agenda with the flurry of executive orders to get the legislative wheels in motion after the previous coalition government stalled the economy by failing to make changes to the way India runs. The Bharatiya Janata Party-led cabinet has pushed through eight pieces of temporary legislation — known as ordinances — since coming to power in May. Looking at these ordinances, a businessman will not put his money into projects. He will wait to hear from Parliament before starting investments. But, the intention of the government is clear. The action reflects the government's desire to push its economic agenda despite protests from opposition parties that blocked the passage of several key bills in the most-recent parliament session.

The key ordinances are in the insurance sector and in the land acquisition act. The insurance sector ordinance raises the limit on foreign direct and portfolio investment in insurance companies to 49% from 26%. However, it also specifies that control over management at these firms must remain in Indian hands. The government is hoping that allowing more foreign investment in insurance will attract more long-term capital into the sector, where the potential market is huge.

In an interesting report on India, Goldman Sachs is predicting that after more than 15 years stuck in China's slipstream, India could surpass China in the next two years in terms of real gross domestic product expansion. The report predicts that India will grow faster than China from 2017 onwards.

Very broadly, since coming to power in May 2014, Mr. Modi has moved cautiously, focusing on streamlining government, tackling corruption and removing bureaucratic hurdles to business. At the federal level, Mr. Modi has gone for low-hanging fruit: reducing the powers of labour inspectors, replacing onerous paperwork with digital submissions and bringing a raft of modest labour-law amendments that remove restrictions on women working at night, improve factory conditions for workers, ease regulations on hiring apprentices and facilitate overtime. He has shaken bureaucrats from their sense of entitlement and made it clear they are there to serve the people, not line their pockets. On foreign policy, he has been quick to establish a more pragmatic doctrine based on India's self-interest. He has forged closer ties with Asian neighbours, including Bangladesh, Japan and Australia, and moved quickly to patch up the vital relationship with the US. He will be rewarded in January with a visit from Barack Obama on Republic Day.

All eyes are now on the next parliament session, due in February, in which the government will lay out its budget and its agenda for economic growth in the coming 4½ years.

	11-12	12-13	13-14	14-15	15-16
GDP (%p.a.)	6.2	4.5	4.7	6.0	7.0
WPI (%p.a.)	9.0	7.5	7.0	6.5	6.0
Current A/c(US$ bill.)	-40.0	-88.0	-50.0	-50.0	-50.0
Rs./$(nom.)	49.5	54.5	60.0	61.0	62.0

China

In the third quarter, the Chinese economy expanded 7.3% and growth for the full year could fall below the government target of about 7.5%. We expect it to be closer to 7% in 2015. The slower growth does not mean lower quality growth but the opposite. This growth projection is in line with the Chinese policy of moving away from an export oriented economy to a domestic growth oriented economy. Recently, for the first time, consumption contributed more to growth than investment. As part of that move, China is allowing wages to rise. The only issue is that there may be a large number of job losses in the manufacturing sector. We expect Beijing to do everything which would maintain a healthy job growth.

The government's official manufacturing Purchasing Managers Index, a gauge of conditions in the industry, slipped to 50.1 in December from 50.3 a month earlier. PMI indicated that wholesale prices for raw materials and

manufactured goods continued to fall, with the official PMI sub-index for raw material prices dropping to 43.2, the lowest figure for 2014.

The average price of new homes in 70 Chinese cities continued to fall in November,signalling a decline in home prices hasn't run its course. But, on a month-over-month basis, average home prices fell at a slower pace, as some developers started to rein in discounts after Beijing unexpectedly cut interest rates and eased mortgage rules nationwide in December. Housing prices in November slipped 0.6% on a month-over-month basis, compared with a 0.8% fall in October.

The consumer-price index rose 1.4% year-over-year in November. Producer prices fell 2.7% during the month for the 33rd consecutive month of decline, highlighting lower global prices for commodities such as energy, ferrous metals and chemicals as well as excess capacity in many Chinese industries.

China has stealthily cut the reserve requirement ratio for banks, one of China's key macroeconomic management tools. This was done to push more credit in the economy.

China's currency fell nearly 3% in 2014, the first annual drop since it became a more-or-less convertible currency in the 1990s. However, in trade-weighted, inflation-adjusted terms, the yuan rose 5% in the first 11 months of 2014, following an 8% increase the year before. The yuan is no more undervalued now. While the current-account surplus rose as a percentage of the economy this year, the long-term trend is toward balance.

After years of allowing nearly uninterrupted gains in the yuan, China is more willing to let it depreciate modestly while seeking to add flexibility to its trading. The shift comes as the People's Bank of China grapples with what some within the central bank call "unprecedented" downward pressure on the yuan, thanks to a strengthening U.S. dollar and a slowing Chinese economy. The yuan has fallen more than 2% against the dollar in 2014, putting it on

track for its first annual decline in five years. But the PBOC is unlikely to permit the yuan to slide more than 3% against the dollar because a big yuan depreciation could cause money to flow out of the country just when China needs funds to spur economic growth.

Currently, the PBOC allows investors to push the yuan's value 2% in either direction from its reference rate in daily trading. The range may be further widened in 2015. The last time the band was widened was in March 2014, when it was increased to 2% from 1%. Beijing is gunning for the International Monetary Fund to declare the yuan a global reserve currency this year, like the dollar, the euro and the Japanese yen.

The Shanghai market gained 45% this year. How far it will be able to sustain this growth is anybody's guess. The market behaves like a casino and some stocks go up and down 10% in a day or so without having any corporate news.

China has proposed allowing foreign investors and brokerages to trade some futures contracts granting the latter access to a vast, potentially lucrative but notoriously volatile market.

	11	**12**	**13**	**14**	**15**
GDP (%p.a.)	9.2	7.7	7.7	7.5	7.0
Inflation (%p.a.)	4.3	2.6	3.5	2.5	2.5
Trade Balance(US$ bill.)	210	214	220	220	200
Rmb/$(nom.)	6.3	6.3	6.2	6.2	6.3

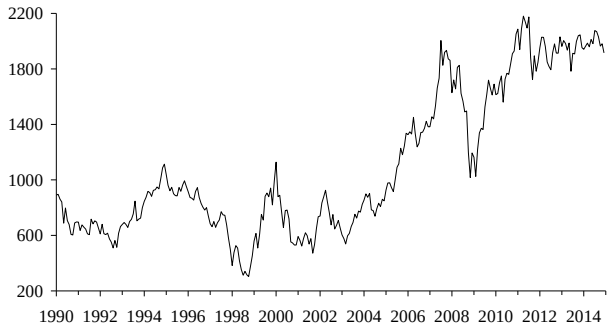
South Korea

Weaker than expected domestic consumption and competition from Japan and China has forced South Korea to lower its bullish growth forecasts for this year and next year. The finance ministry downgraded its growth forecast for 2014 to 3.4% and revised down its growth expectations for 2015 to 3.8% from its earlier estimate of 4.0%. The consumer and business sentiments had been weaker than expected because of economic uncertainty.

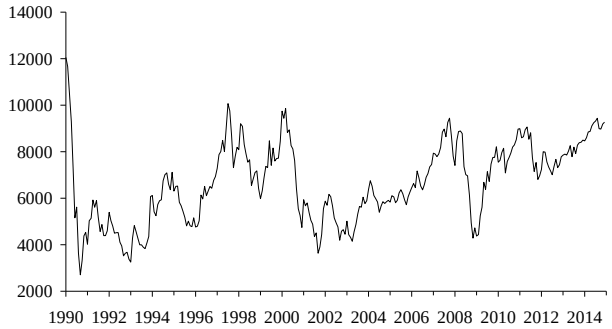
The Bank of Korea cut interest rates twice in 2014, most recently in October to a record low of 2.0%, in an effort to boost consumption. Domestic spending remains weak, however, due to structural reasons such as high housing prices and costly private education. The exports, which account for more than half of gross domestic product, fell 1.9% in November 2014 from a year earlier, hit by the weaker Japanese yen

We expect two more rate cuts by the Bank of Korea in the first quarter of this year and there is good probability that the government may come up with a supplementary budget to boost growth.

Korea: Composite Index



Taiwan: Weighted TAIEX Price Index



Exports are falling amid cooling demand from China. Moreover, Korean manufacturers are increasingly squeezed between lower-cost Chinese competitors and Japanese rivals who are helped by the weaker yen in sectors including cars, electronics, steel, chemicals and shipbuilding.

	11	**12**	**13**	**14**	**15**
GDP (%p.a.)	3.6	2.0	2.8	3.7	4.0
Inflation (%p.a.)	4.0	2.2	1.3	2.0	2.5
Current A/c(US$ bill.)	27.0	44.0	71.0	80.0	80.0
Won/$(nom.)	1100	1100	1100	1080	1130

Taiwan

Taiwan's GDP will grow 3.4% in 2014 and 3.5% or more next year. Taiwan's output gap, which measures how far actual output is below the economy's full potential, seems to have got bridged now. Hence, the government expects domestic corporate investments to grow 5.6% in 2015, faster than its estimated 4.1% in 2014.

In November 2014, Taiwan's exports to the U.S., mostly electronics and machines, rose 11% from a year earlier — the biggest growth among all of Taiwan's overseas markets. Although direct shipments to the U.S. were only about one-tenth of Taiwan's total exports of $26.68 billion last month, much of the island's exports to China and Southeast Asia — totalling $15.69 billion at nearly 60% of

Taiwan's overall exports — were actually further processed and then re-exported to the U.S.

It seems that people of Taiwan do not like President Ma Ying-jeou's policy of moving Taiwan closer to China. Mr. Ma hoped that economic gains would outweigh voters' distrust of Beijing, which claims Taiwan as part of its territory.

In the local elections held at the end of November 2014, Mr. Ma's ruling Nationalist Party, or Kuomintang, was routed in municipal elections — a vote implies as a rejection of the government's China policies. A triumph of the opposition Democratic Progressive party resulted in the resignation of President Ma Ying-jeou as chief of the KMT.

Many in Taiwan have argued that Taiwan's industrial base is being hollowed out as dependence on China grows. Information-technology companies in the past decade have moved big portions of their business to the mainland, where costs are lower. Some 850,000 Taiwanese live in China, or about 8% of Taiwan's workforce. China absorbs two-thirds of Taiwan's overseas investment and 40% of its exports.

	11	**12**	**13**	**14**	**15**
GDP (%p.a.)	4.0	1.3	2.1	3.4	3.4
Inflation (%p.a.)	1.2	1.9	1.2	1.5	1.5
Current A/c(US$ bill.)	18.0	41.7	50.6	57.4	60.0
NT$/$(nom.)	30.0	29.5	30.0	31.0	32.0

Brazil

Brazil's economy managed to get out of recession after clocking sub-zero growth in the first half of 2014. It is expected to grow 0.2% this year. But, inflation remained high at an annual rate of 6.6% in November and the budget deficit reached 5.8% of gross domestic product in November. The government hopes that economic growth will recover gradually, and consumer and business confidence will improve progressively. The outlook to us looks bleak.

To rein in inflation, the central bank has raised its benchmark interest rate 11 times since April of last year, from a record low of 7.25% to 11.75% now. The rate increases need time to take effect. According to Brazilian central bank president Alexandre Tombini, inflation will remain high during most of 2015 and should approach the 4.5% central point of the target range some time near the end of 2016. The central bank plans to continue its program of regularly auctioning currency-swap contracts, a move that could help prop up the country's rapidly weakening currency.

The real weakened dramatically in December. The real is trading around 2.70 to the dollar. Brazil's domestic economic problems, including high inflation, are contributing to the real's weakness as are events abroad, including the plunging ruble, weak manufacturing figures from China and concern the U.S. might be poised to raise interest rates.

President Dilma Rousseff began her second term in office on January 1, with promises to fight corruption and fix the economy, acknowledging the many challenges facing Brazil over the next four years. She is starting her second term without the political goodwill and robust economic growth she inherited four years ago.

Her pledge came as Brazil confronts flat growth, stubbornly high inflation, ballooning debt and a potentially explosive corruption scandal at state-controlled oil giant Petróleo Brasileiro SA, or Petrobras. Brazilian prosecutors allege that executives at Petrobras conspired with construction companies to inflate the cost of contracts, skimming off as much as $1.5 billion to enrich themselves while funneling kickbacks to Ms. Rousseff's Workers' Party and its allies. Ms. Rousseff hasn't been implicated in the scandal, and leaders of her party have repeatedly denied allegations of involvement. Police have already filed charges against 36 suspects, including two former Petrobras officials. Opposition has called for her impeachment. It seems that governance will take back seat when she is involved in fire-fighting.

Ms. Rousseff's cabinet has 39 members, more than any other of the world's 10 biggest economies. The Workers' Party is the biggest in the lower house of Congress and the second biggest in the Senate, but falls far short of a majority in both. Hence, the president has forged alliances with other political parties, in part by awarding them control of ministries.

Her new economic team has already begun belt-tightening to reduce growing deficits. Earlier this week the government announced measures that will cut unemployment and retirement benefits. Lawmakers haven't yet approved the measures. Brazil's fiscal accounts are in such poor shape that the nation is scrambling to preserve its investment-grade credit rating following a downgrade last year.

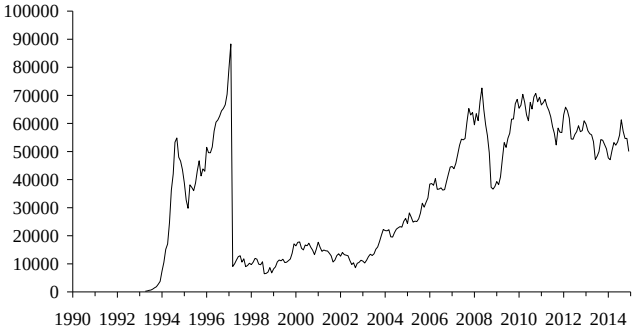
Joaquim Levy, Brazil's new finance minister, is tasked with preserving Brazil's hard-won investment-grade credit rating, obtained in 2008. He has made clear that controlling government spending is one of his main priorities.

Brazil's Planning Minister Nelson Barbosa said that better fiscal performance in the future will increase confidence, and only then private sector investment can be expected to grow. He promised to restore growth but not before fiscal adjustments.

Brazilian economy in the next two years would depend on the price of crude oil. If it stays low, Brazil will face very challenging time ahead.

	11	**12**	**13**	**14**	**15**
GDP (%p.a.)	2.7	0.9	2.5	0.2	1.5
Inflation (%p.a.)	6.5	5.8	5.9	6.5	6.0
Current A/c(US$ bill.)	-52.6	-60.0	-75.0	-70.0	-70.0
Real/$(nom.)	1.5	2.0	2.3	2.4	2.6

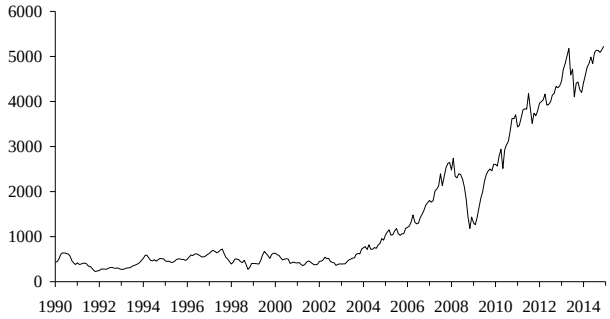
Brazil: Bovespa



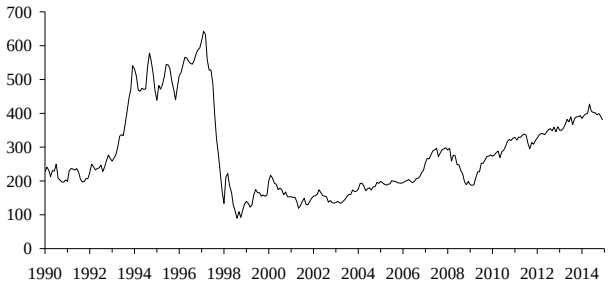
Other Emerging Markets

Hong Kong: FT-Actuaries

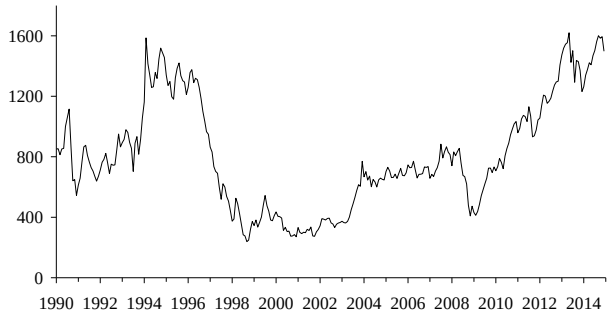
Indonesia: Jakarta Composite



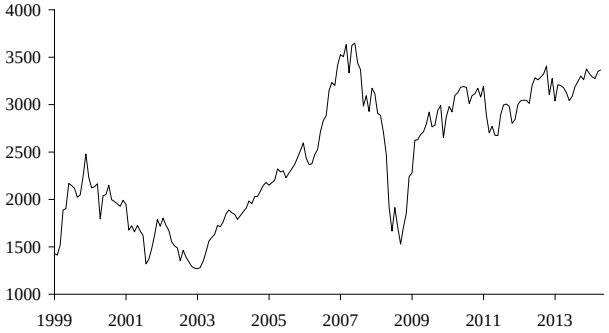
Malaysia: FT-Actuaries (US$ Index)



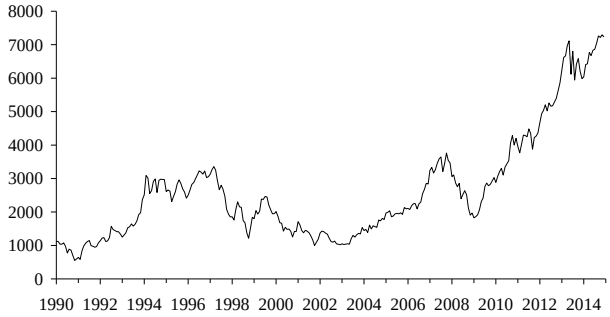
Thailand: Composite Index



Singapore: Straits Times Index

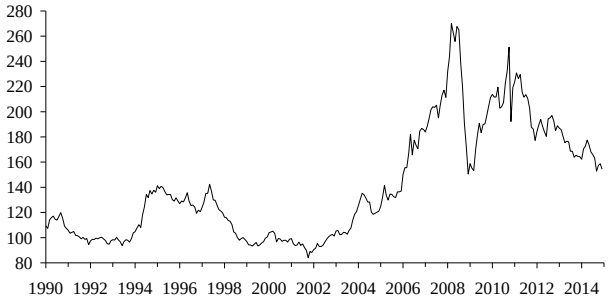


Philippines: Manila Composite

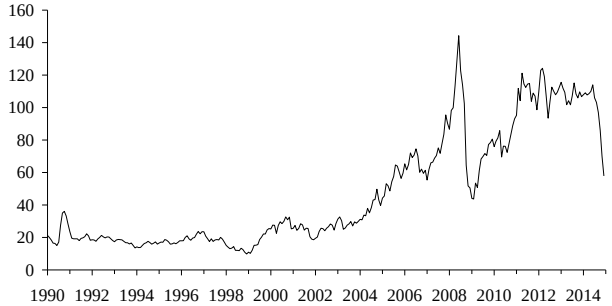


COMMODITY MARKETS

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

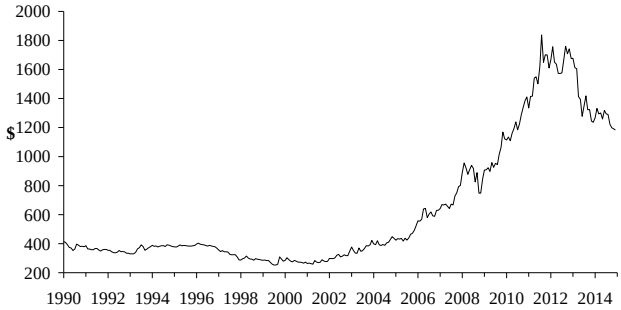


Oil Price: North Sea Brent (in Dollars)

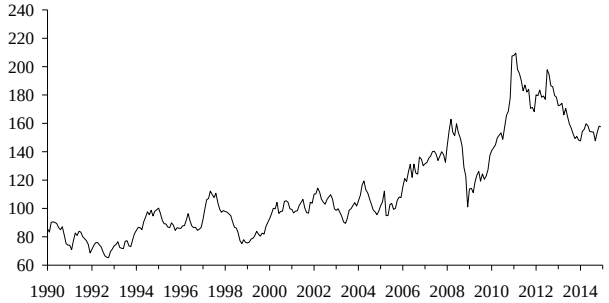


Commodity Price Index (Sterling)
(Economist, 2000=100)

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]
2010	4.5	2.4	0.7	80.4	83.4	-3.6	4.8	0.1
2011	3.5	2.0	0.9	80.0	83.5	-2.4	5.3	0.0
2012	2.1	0.9	0.9	83.0	87	-1.1	3.2	-1.0
2013	1.9	1.3	0.6	81.5	85.5	-1.3	3.1	-0.7
2014	1.8	1.9	0.6	90.1	95.7	-1.5	2.5	-0.1
2015	2.0	2.1	0.9	88.8	95.4	-1.1	2.7	0.1
2013:1	2.0	1.0	0.6	80.4	84.1	-1.1	3.3	-0.9
2013:2	1.7	0.9	0.5	80.6	84	-1.5	3.1	-1.0
2013:3	2.1	1.5	0.5	81.3	85.2	-1.5	3.2	-0.4
2013:4	2.0	1.7	0.5	83.6	88.7	-1.2	2.7	-0.2
2014:1	1.7	1.8	0.6	85.6	90.5	-1.5	2.7	-0.2
2014:2	2.1	1.9	0.6	86.9	91.7	-1.8	2.6	-0.1
2014:3	1.6	1.8	0.6	98.5	104.8	-1.2	2.4	-0.2
2014:4	1.7	1.9	0.6	89.2	95.8	-1.4	2.5	-0.1
2015:1	2.0	2.1	0.7	88.7	95.2	-1.3	2.7	0.1
2015:2	1.9	2.0	0.8	88.6	95.2	-1.2	2.7	0.0
2015:3	1.8	2.1	0.9	89.5	95.8	-1.1	2.6	0.1
2015:4	2.0	2.1	1.1	88.6	95.6	-0.9	2.7	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)
2010	228.3	2.4	4.6	1.50	136.1
2011	233.9	2.5	4.6	1.53	134.8
2012	237.2	1.4	4.7	1.59	133.8
2013	239.8	1.1	4.2	1.42	132.7
2014	242.3	1.1	3.0	1.05	131.7
2015	248.7	2.7	2.6	0.90	132.6
2013:1	236.4	0.7	4.6	1.54	131.7
2013:2	242.0	1.9	4.4	1.49	134.5
2013:3	239.8	0.7	4.1	1.39	132.5
2013:4	240.9	1.2	3.7	1.27	132.0
2014:1	241.0	1.9	3.4	1.17	132.0
2014:2	241.8	0.0	3.1	1.08	131.6
2014:3	241.8	0.8	2.8	0.98	131.4
2014:4	244.5	1.5	2.8	0.95	131.7
2015:1	246.1	2.1	2.7	0.93	132.1
2015:2	248.0	2.6	2.6	0.91	132.4
2015:3	248.7	2.9	2.6	0.89	132.8
2015:4	252.0	3.1	2.5	0.87	133.1

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
2010	143.9	689101.2	422182.6	240534.5	185935.8	-47493.4	112058.3
2011	146.3	700438.2	417164.2	249604.5	184946.5	-35376.4	115900.7
2012	147.2	705054.3	419635.9	261594.0	188488.8	-43484.5	121179.9
2013	149.8	717247.3	421289.2	280778.8	188740.9	-43733.8	129827.8
2014	154.0	737361.4	421900.8	303605.6	189790.7	-42652.0	135283.0
2015	157.8	755842.5	429872.6	315028.3	193150.9	-42988.5	139221.1
2010/09	1.9		0.0	15.4	0.0		9.6
2011/10	1.6		-1.2	3.7	-0.5		3.5
2012/11	0.7		0.6	4.8	1.9		4.7
2013/12	1.7		0.4	7.2	0.2		7.1
2014/13	2.8		0.1	8.6	0.6		4.7
2015/14	2.5		1.9	3.8	1.8		2.9
2013:1	148.2	177400.0	105685.6	65146.2	47958.7	-9903.7	31486.8
2013:2	149.1	178563.8	105184.7	64540.2	46390.0	-8539.6	29011.4
2013:3	150.4	180087.1	105145.2	74507.3	47119.5	-13313.8	33371.1
2013:4	151.3	181196.4	105273.6	76585.1	47272.8	-11976.7	35958.4
2014:1	1152.5	182545.6	104859.8	73795.4	48766.6	-10531.4	34344.8
2014:2	1153.9	184210.0	105426.4	75025.6	46985.7	-10617.5	32610.2
2014:3	1154.6	185132.7	105470.0	77347.1	46873.0	-10753.0	33803.7
2014:4	1154.9	185473.0	106144.6	77437.4	47165.3	-10750.1	34524.3
2015:1	1155.9	186607.1	106671.4	75212.7	49960.4	-10752.3	34485.1
2015:2	1156.9	187899.1	107200.8	78822.4	47084.9	-10749.7	34459.4
2015:3	1159.0	190308.1	107732.8	80476.0	47855.5	-10744.9	35011.6
2015:4	1159.6	191028.2	108267.5	80517.2	48250.2	-10741.7	35265.1

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)
2010	8.8	1357.7	118.6	36.6	-34.9
2011	6.8	1431.6	96.6	42.8	-23.2
2012	7.5	1479.5	110.5	46.4	-53.2
2013	5.9	1552.5	91.3	47.1	-62.2
2014	6.5	1621.9	105.5	52.4	-71.0
2015	5.5	1698.6	93.8	56.0	-73.0
2013:1	3.5	375.0	13.0	11.9	-14.5
2013:2	8.1	373.7	30.3	11.2	-7.2
2013:3	5.0	386.5	19.3	11.5	-20.9
2013:4	8.2	396.2	32.4	12.0	-19.7
2014:1	2.4	396.1	9.3	12.4	-17.6
2014:2	8.1	398.5	32.4	12.9	-19.9
2014:3	7.4	402.9	29.6	13.0	-16.1
2014:4	8.2	408.4	33.4	13.2	-17.3
2015:1	2.4	412.1	10.0	13.3	-18.0
2015:2	7.0	416.7	29.0	13.6	-20.2
2015:3	5.1	422.3	21.6	13.8	-17.3
2015:4	6.2	428.7	26.6	14.2	-17.5

1 GDP at market prices (Financial Year)

WORLD FORECAST DETAIL

Growth Of Real GNP

	2010	2011	2012	2013	2014	2015
U.S.A.	2.5	1.6	2.3	2.2	2.3	3.0
U.K.	1.9	1.6	0.7	1.7	2.8	2.5
Japan	4.7	–0.4	1.7	1.6	0.3	1.2
Germany	4.1	3.6	0.4	0.1	1.4	1.3
France	1.9	2.1	0.4	0.4	0.4	0.8
Italy	1.7	0.6	–2.3	–1.9	–0.3	0.4

Growth Of Consumer Prices

	2010	2011	2012	2013	2014	2015
U.S.A.	1.6	3.1	2.1	1.5	1.7	1.3
U.K.	4.5	3.5	2.1	1.9	1.8	2.0
Japan	–0.7	–0.3	0.0	0.4	2.8	1.4
Germany	1.1	2.1	2.0	1.5	1.0	1.2
France	1.5	2.1	2.0	0.9	0.6	0.6
Italy	1.5	2.8	3.0	1.2	0.2	0.4

Real Short-Term Interest Rates

	2010	2011	2012	2013	2014	2015
U.S.A.	–3.0	–2.0	–1.4	–1.6	–1.2	–0.8
U.K.	–3.6	–2.4	–1.1	–1.3	–1.5	–1.1
Japan	0.5	0.2	–0.2	–2.6	–1.3	–1.3
Germany	–1.3	–0.6	–0.9	–0.8	–1.0	–1.4
France	–1.3	–0.6	–0.3	–0.4	–0.4	–0.9
Italy	–2.0	–1.6	–0.6	–0.2	–0.2	–0.9

Nominal Short-Term Interest Rates

	2010	2011	2012	2013	2014	2015
U.S.A.	0.1	0.1	0.1	0.1	0.1	0.6
U.K.	0.7	0.9	0.9	0.6	0.6	0.9
Japan	0.2	0.2	0.2	0.2	0.1	0.2
Germany	0.8	1.4	0.6	0.2	0.2	0.1
France	0.8	1.4	0.6	0.2	0.2	0.1
Italy	0.8	1.4	0.6	0.2	0.2	0.1

Real Long-Term Interest Rates

	2010	2011	2012	2013	2014	2015
U.S.A.	1.2	0.3	0.2	0.4	0.7	1.5
U.K.	–0.2	–0.2	–1.4	–1.0	–0.4	0.0
Japan	0.3	–0.2	–0.7	–1.2	–1.3	–1.1
Germany	1.2	1.2	0.2	0.1	–0.5	–0.7
France	1.6	1.7	0.7	0.5	–0.2	–0.5
Italy	1.2	1.5	0.7	0.5	–0.2	–0.5

Nominal Long-Term Interest Rates

	2010	2011	2012	2013	2014	2015
U.S.A.	3.1	1.9	1.8	2.1	2.5	3.4
U.K.	2.4	2.0	0.9	1.3	1.9	2.1
Japan	1.2	1.0	0.9	0.7	0.5	0.8
Germany	2.8	2.7	1.6	1.6	1.2	1.2
France	2.8	2.7	1.6	1.6	1.2	1.2
Italy	2.8	2.7	1.6	1.6	1.2	1.2

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

	2010	2011	2012	2013	2014	2015
U.S.A.	84.0	79.8	81.6	82.1	83.0	83.2
U.K.	88.6	88.7	92.4	90.8	101.7	101.3
Japan	79.5	80.6	79.6	63.5	61.1	60.7
Germany	101.3	100.1	96.7	99.0	100.5	100.2
France	103.5	102.9	99.5	100.7	101.7	101.4
Italy	107.4	107.2	105.2	106.9	107.8	107.0

[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.

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

	2010	2011	2012	2013	2014	2015
U.S.A.[1]	83.73	78.08	80.90	85.50	88.60	89.00
U.K.	1.58	1.61	1.59	1.55	1.56	1.55
Japan	87.48	79.36	80.51	98.00	104.50	104.00
Eurozone	0.75	0.71	0.78	0.79	0.74	0.75

[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