Morgan Stanley

November 29, 2015

MORGAN STANLEY RESEARCH

2016 Outlook

Global Macro Outlook

A Slow Slog Back

2016 will likely mark a slow slog back towards trend growth and central bank targets. DM has moved out of the repair stage, but repair remains under way in EM. We expect it to be less onerous in 2016 though. Hence, the drag from EM on global growth should reduce. While growth converges across the Atlantic, monetary policy diverges as the Fed hikes and the ECB eases. The outlook crucially relies on the DM consumer holding up in the face of rising inflation, normalising interest rates and elevated political uncertainty.

Growth: Slow recovery, as drag from EM declines: For the second consecutive year, EM has held back global growth in 2015. Looking ahead, we expect domestic demand in DM to hold up relatively well and, with a less onerous adjustment process in EM, growth should recover over the course of the year. We therefore expect a modest uptick in global growth to 3.3%Y next year from the low point of 3.1%Y this year, with DM growth holding steady at 1.8%Y and EM growth improving to 4.4%Y next year from 4.0%Y in 2015. However, our expectations of the growth uptick in 2016 are less optimistic than the consensus for both DM and EM.

Inflation: Inching towards central bank target ranges: The inflation debate will focus on whether and when central bank inflation targets will be hit and, with the exception of Asia, not be about outright deflation any longer. We continue to expect global headline inflation to rise gradually, led by DM, due to stabilising energy prices and rising core inflation. In addition, we forecast inflation trends to converge between highflation and lowflation countries and between headline and core.

Central banks: At the dawn of a new Fed tightening cycle: The start of a new tightening cycle in the US defines the monetary policy outlook. After a first hike in December, we expect the Fed to pause until June. For the first time since the early 1990s, monetary policy will likely decouple across the Atlantic. With respect to EM, Fed tightening causes concerns among investors as to whether tighter financial conditions could trigger shifts in capital flows and risk attitudes. With respect to China, we expect a gradual decoupling of monetary conditions under the new RMB regime.

Key risks: Fed rate hikes, China deflation, EU/EM politics: As ever, a number of risks could undermine the still sluggish recovery. Top of our list is the Fed's tightening cycle and its repercussions on financial conditions in the US and in dollar-indebted EM economies. Right behind the Fed is the risk of deflation in China and potential spillovers onto its main trading partners. Finally, we are keeping a close eye on political developments in Europe and in EM, which could dent private sector confidence.

MORGAN STANLEY RESEARCH
GLOBAL ECONOMICS TEAM

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Morgan Stanley Real GDP Forecasts

	15e	2016e		2017e		18-20
%Y	MS	MS	Cons.	MS	Cons.	MS
GLOBAL	**3.1**	**3.3**	**3.5**	**3.7**	**3.8**	**3.6**
G10	**1.8**	**1.8**	**2.1**	**1.8**	**2.0**	**1.6**
US	2.4	1.9	2.5	1.8	2.5	1.8
EA	1.5	1.8	1.7	1.8	1.7	1.4
Japan	0.5	1.2	1.1	0.8	0.7	1.2
UK	2.4	2.0	2.3	2.3	2.2	2.1
EM	**4.0**	**4.4**	**4.6**	**5.0**	**5.1**	**5.1**
China	7.0	6.7	6.5	6.6	6.3	6.0
India	7.4	7.9	7.8	8.0	7.9	7.8
Brazil	-3.2	-3.0	-1.2	1.2	1.5	2.0
Russia	-3.9	-0.8	0.0	1.7	1.5	1.5
Global*	2.3	2.1	2.6	2.7	2.9	2.4

Source: Morgan Stanley Research forecasts.
Note: The above aggregates are PPP-weighted. Global* is weighted by long-term market exchange rates and is given here for comparison. Cons. = consensus

Country Focus

US: Testing the Waters .... p 17
Euro Area: It's the Policy, Stupid................. p 18
Japan: Better Economy Triggers Late 2016 BoJ Regime Change .... p 19
UK: A Policy Slowdown............................. p 20
Australia: Housing Joins Resources Unwind, but Hope on Fiscal?..................... p 21
China: Gradual Slowdown, Persistent Disinflation .... p 22
India: Adjustment Phase Over, Gradual Recovery in Growth Ahead........................ p 23
Korea: Lacklustre Growth in 2016............. p 24
Indonesia: What Kind of Growth Recovery Will We See? .... p 25
Russia: Still in Adjustment Mode .... p 26
Turkey: Back to Basics or Business as Usual? .... p 27
Brazil: Uncertainty Leads to Pain.............. p 28
Mexico: Holding Steady .... p 29

For important disclosures, refer to the Disclosures Section, located at the end of this report.

Morgan Stanley

A Slow Slog Back

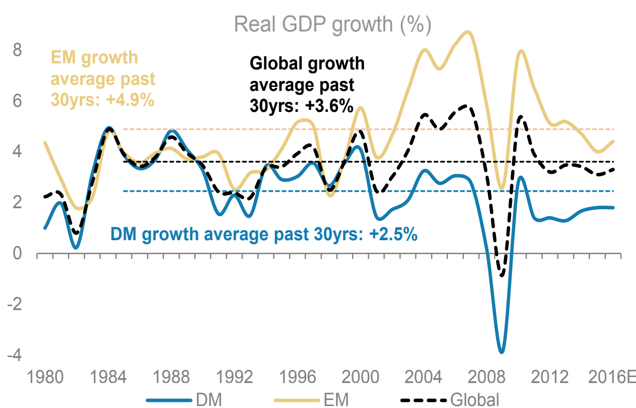
Elga Bartsch & Chetan Ahya

Global Growth Outlook: Still Repairing for Recovery

Challenges, both cyclical and structural in nature, have beset the economic expansion since it began almost six-and-a-half years ago. 2015 marks the fourth year that the global economy has not been able to achieve its long-term (30-year) average growth of 3.6%Y, due to falling potential growth and demand deficiency. As DM and EM economies oscillated between repair and recovery modes within their respective cycles, every stage of the global cycle has been marked by weakness in either DM or EM, keeping global growth below its long-term average.

Exhibit 1

Global GDP Growth Still Below Long-Term Average



Source: National data, IMF, Morgan Stanley Research forecasts

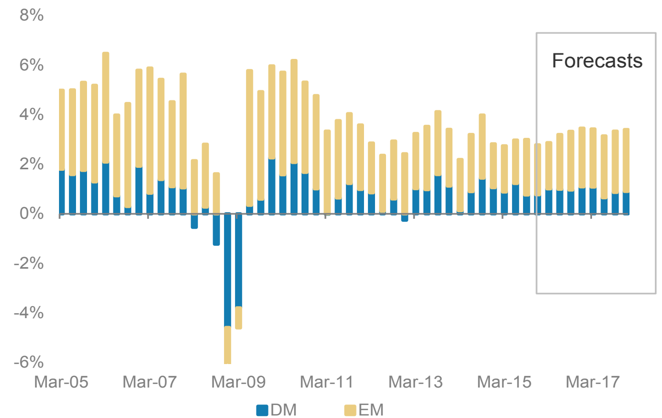
DM has now moved out from the repair stage and growth is recovering. The repair process remains under way in EM, as economies have had to reverse their 'bad' sources of growth (loose fiscal and monetary policies) and also had to contend with a slower pace of US monetary accommodation and of China's demand growth. Consequently, **2015 will mark the second consecutive year that global growth is being held back by EM.** Indeed, in recent months, the accelerated pace of adjustment in EM has led investors to raise fresh concerns about whether the global economy will tip over into recession.

Continued Recovery Rather than Recession

While recession risks exist and are reflected in our bear case scenarios, **we think that the global economy will once again be able to skirt recession,** as we expect DM domestic demand to hold up and the drag from EM to reduce.

Exhibit 2

Global Growth – Still a Sub-Par Recovery



Source: National data, IMF, Morgan Stanley Research forecasts

We expect DM domestic demand to be sustained due to healthy fundamentals in household balance sheets, wage growth holding up and also because DM central banks are actively managing their monetary policy stance in a way that supports domestic demand so that the inflation targets are not compromised. From the perspective of EM, initial signs of improvement in macro stability are filtering through in a number of countries and hence the need for restrictive policies should reduce. Taken together, **global growth should recover on a cyclical basis to 3.3%Y next year from the low point of 3.1%Y this year,** with DM growth holding steady at 1.8%Y and EM growth improving to 4.4%Y next year from 4.0%Y in 2015.

Two Key Debates on Growth for 2016

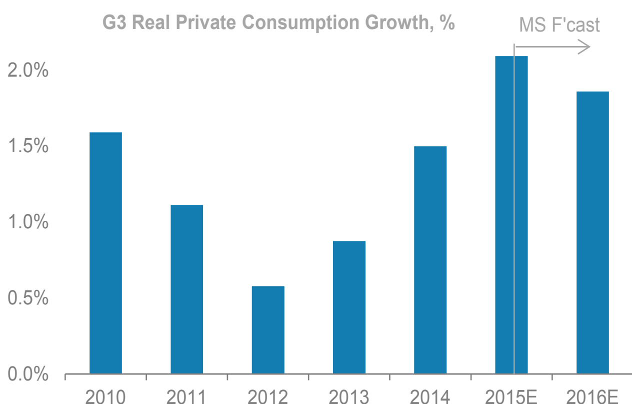
In our view, the outcome of two key issues – **the resilience of domestic demand in DM and the state of the adjustment in EM** – will determine the 2016 growth trajectory and will ultimately swing the outlook between continued recovery or recession.

Key Debate 1: DM Domestic Demand

The key anchor to growth in DM has been the consumer amid external uncertainties. Looking back at 2015, DM consumer spending was boosted by a number of tailwinds – job growth, wage increases, saving from lower oil and commodity prices and a still accommodative monetary policy.

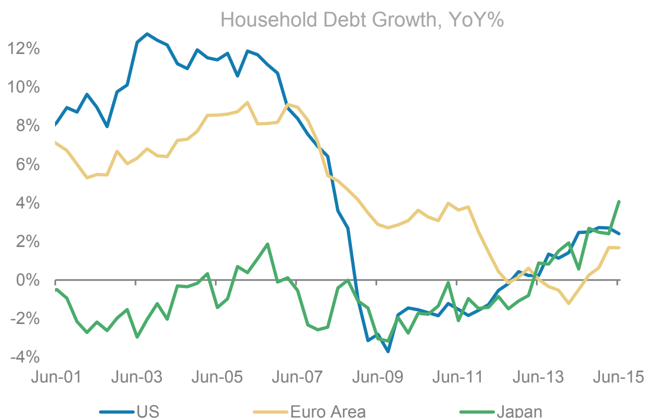
As some of these benefits will likely be less supportive in 2016 with the projected, gradual rise in oil prices and also the rise in interest rates in the US and UK, **we expect a moderating, though still healthy, pace of growth in private consumption in DM in 2016,** with the growth moderation more pronounced in the US and UK. While the DM consumer will face a number of headwinds going into 2016, healthy consumer balance sheet fundamentals, wage growth holding up and a more growth-conducive fiscal policy environment will remain supportive of consumption growth, in our view. As it is, reflecting a more accommodative monetary environment, household credit growth in G3 economies has been improving (see Exhibit 4). Moreover, at the margin, we expect fiscal policy to turn more supportive of growth, with the agreement of the US fiscal package and potential additional spending in the euro area, due in part to the influx of refugees, which will also be supportive of DM consumption prospects.

Exhibit 3
Private Consumption in DM Holding Up



Source: National sources, Morgan Stanley Research; Note: G3 includes US, EA, Japan

Exhibit 4
Household Credit Growth Improving



Source: Haver Analytics, Morgan Stanley Research

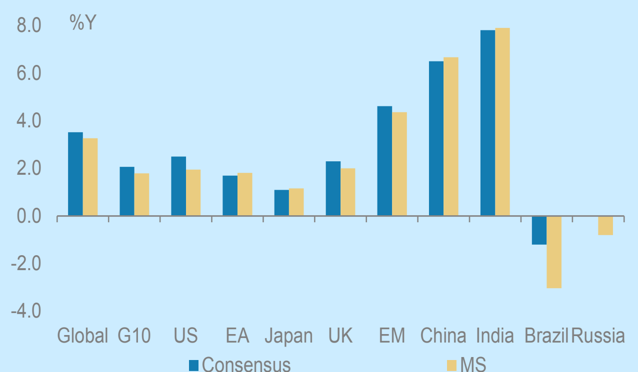
Where We Differ from Consensus

Developed markets: We continue to be moderately more bullish than consensus on the **euro area** and **Japan's** growth outlook even though consensus is creeping up on us now. As before, we are materially more bearish on the outlook for the US and the UK. In the **US,** our forecast for not even 2%Y growth next year compares to the current consensus of 2.5%Y. In the **UK,** our forecast of 2.0%Y is still 30bp below the consensus. What used to be an out-of-consensus call for a December Fed rate hike is now a broadly shared view. Our forecast of three Fed rate hikes over the course of 2016 – one less than before – is smack in between the two hikes the market prices in and the four that the SEP projections imply.

When it comes to inflation, we remain below the consensus in the **US,** where we only see 1.7%Y on average compared to 1.8%Y on consensus expectations. While markets still debate further easing from the BoJ, we continue to think that there will be no further monetary policy easing in **Japan.** In the **euro area,** we are in agreement with the consensus regarding the additional action the ECB is likely to take in December. But we disagree with the market pricing that sees the chances of action rising continuously in 1H16.

Emerging markets: In EM we remain moderately more optimistic than the market on India, but materially more bearish on Brazil, where we again cut our forecasts materially, and Russia. On inflation, we expect disinflationary pressures to be persistent in China and forecast a deceleration in inflation to 1.1%Y in 2016, which is much lower than consensus expectation of 2.0%Y. In contrast, we are more concerned than the consensus on Brazil's inflation outlook, forecasting 8.2%Y as compared to the consensus expectation of 6.6%Y.

Exhibit 5
2016 Growth Forecasts: MS versus Consensus

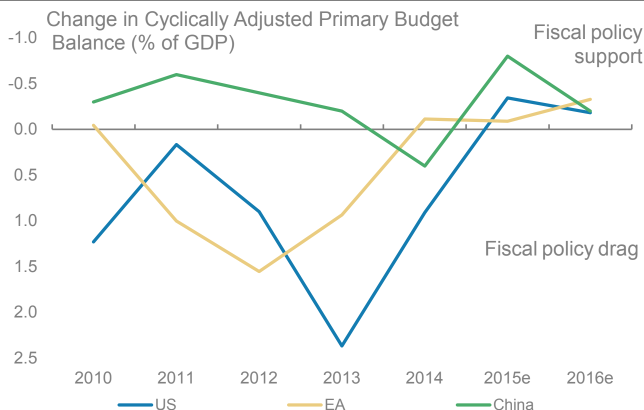


Note: Global, G10 and EM consensus aggregates are calculated using the same PPP weights and country subsample as MS aggregates. Consensus aggregates are not comparable to those directly available on Bloomberg.
Source: Bloomberg, Morgan Stanley Research forecasts

Specifically, in the **US,** we believe that strong consumer balance sheet fundamentals, stabilising energy prices and strengthening wage growth will result in slower but better-balanced growth in consumer spending. In **Europe,** with the boost from lower energy prices receding (resulting in higher inflation denting real incomes) and a number of political events which could lead to a rise in uncertainty, consumers will likely face headwinds in 2016. In **Japan,** we are projecting a gradual recovery in consumption, mainly because of improvement in real income. Tight labour markets will continue to place upward pressures on wages, which should support the consumer. Moreover, there will be front-loaded spending or rush demand ahead of the next consumption tax hike in April 2017, supporting consumption in 2H16. For the **UK,** both fiscal and monetary tightening will impact the consumer, on top of the impact on consumer confidence in 3Q16 due to UK's in/out referendum on EU membership (which is expected to be a close call).

Exhibit 6

Fiscal Policy to Be Supportive of Growth



Source: National data, Morgan Stanley Research

Key Debate 2: State of EM Adjustment

Over the last three years, EM has been in the adjustment phase, led by three key factors: i) A slowdown in China; ii) A reduced pace of monetary accommodation in the US; and iii) Unwinding of own domestic misallocation of capital which caused macro stability challenges. While the adjustment process has been fairly intense this year, **we expect the process to be less onerous in 2016, and hence expect the drag from EM on global growth to reduce.**

The adjustment can be seen in three different EM groups:

(1) China: China's GDP growth has been slowing since 2012 as signs of misallocation and a decline in return on capital employed continued to force policy-makers to slow investment growth. However, another leg of a sharp slowdown in growth took place since December 2014 and intensified the EM adjustment process. MS-CHEX, our proprietary measure of China's industrial activity, which tends to influence China's non-oil imports, decelerated from 7.2%Y in December 2014 to a recent low of -1.3%Y in March 2015 (the last print in October 2015 was 0.2%Y). During this period, China's imports volume growth also decelerated from 4.4%Y in December 2014 to a post-2009 low of -8.3%Y in March 2015 on a three-month trailing basis (the last print in October 2015 was -3.6%Y). The slowdown in domestic demand in China has adversely hit commodity exporters and emerging Asian economies, which had seen a significant rise in China's share in their goods exports post credit crisis.

Our Key Forecast Changes at a Glance

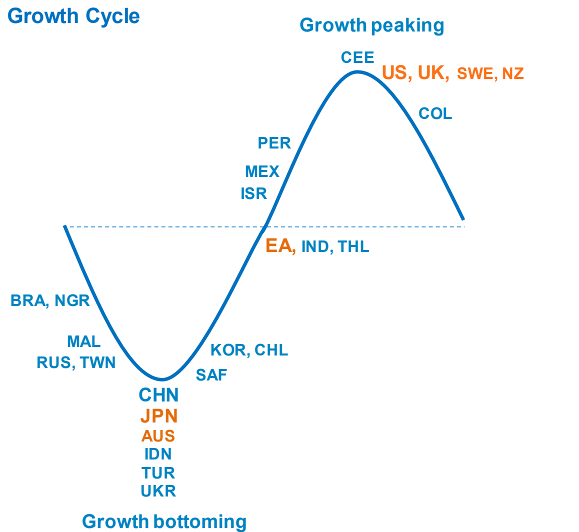
Growth: We lower our global growth forecast for 2016 to 3.3%Y from 3.4%Y previously, with marginal downward revisions in both DM and EM. We lower our growth forecasts for the euro area and China by 0.1pp, and we have made significant downward adjustments to our growth forecasts for Brazil (from -1.2%Y to -3.0%Y) and Japan (from 1.6%Y to 1.2%Y). For Russia, while we continue to expect the recession to extend to 2016, we are now building in a narrower contraction of -0.8%Y (-1.3%Y previously). Meanwhile, we increase our UK growth forecast by 0.1pp.

Inflation: We bring down our 2016 global inflation forecast by a touch to 2.7%Y from 2.8%Y previously. However, our DM inflation forecast rises to 1.5%Y from 1.4%Y previously, while EM inflation slips to 3.7%Y from 3.8%Y previously. Country-wise, we have raised our inflation forecasts most materially for Brazil (by 190bp) and to a smaller extent for the US (by 20bp) and the UK (by 10bp). Elsewhere in Russia, China and Japan, we have lowered inflation forecasts by 80bp, 40bp and 30bp, respectively.

Monetary policy: We expect fewer Fed rate hikes in 2016, later BoE rate raises and more stimulus by the ECB, the PBOC and a host of central banks in emerging markets and possibly even the BoJ. Fiscal policy should also be easier in the US, the euro area and Japan and there should be continued fiscal support in China.

Exhibit 7

Global Growth Cycle: DM Leading, EM Lagging



Source: Morgan Stanley Research; position corresponds to country's stage in growth cycle.

(2) Commodity exporters (top three EM in this group are Brazil, Russia and Indonesia): While USD appreciation was already resulting in an exogenous monetary tightening in these countries, a simultaneous downward trend in commodity prices and weakness in non-commodity exports hit these economies hard. Domestic demand in these economies has been impacted adversely since 2Q15, as reflected in the trend for real imports.

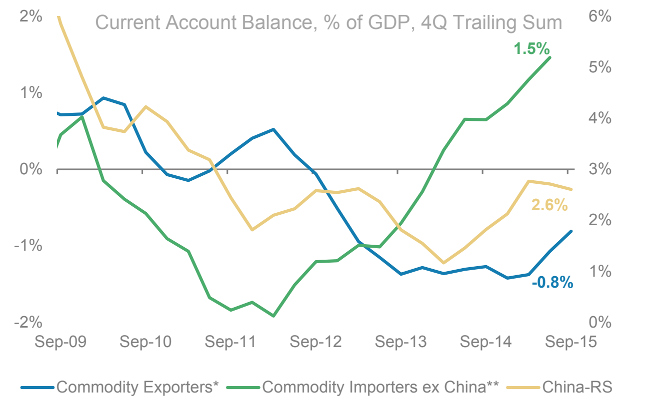
(3) Commodity importers (top three EM in this group are India, Korea and Turkey): Commodity importers in EM have also seen a slowdown in exports but their domestic demand has seen a positive offset in the form of the terms of trade, which has also helped to improve their current account balance. Lower inflation has encouraged the central banks to ease monetary policy even as the dollar has been rising.

Advanced Stage of Adjustment, EM Drag to Decline

While we think the EM adjustment is not yet complete, we expect the EM drag on global growth to reduce as all three factors – terms of trade, real rates needed in response to the rise of the dollar and unwinding of domestic misallocation – will become less onerous. Particularly on the issue of real interest rates, the top ten EM excluding China have now lifted their real interest rates about 270bp higher than US real rates. With real rates remaining high as EM continues on the adjustment path, a number of them, though not all, are likely to see improvement in macro stability indicators including their current account balances and inflation. Indeed, we expect more EM central banks to cut policy rates, though still on a selective basis, in 2016.

Exhibit 8

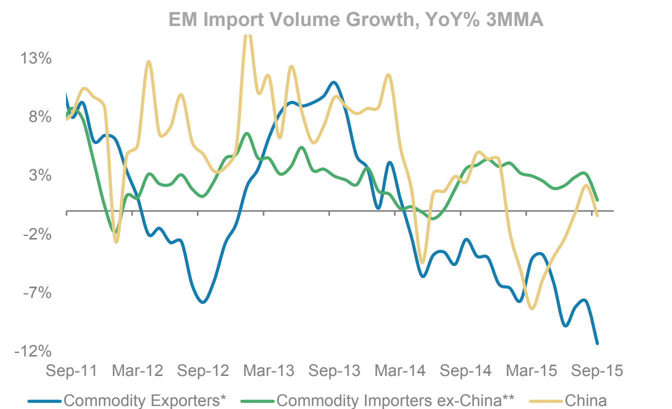
Current Account Balances Improving for Commodity Importers/Exporters, Stable for China



Source: CEIC, Haver Analytics, Morgan Stanley Research; *Including Indonesia, Brazil and Russia; **Including India, Korea, Taiwan, Thailand, Mexico, Turkey and Poland.

Exhibit 9

Slowdown in Domestic Demand Most Pronounced for Commodity Exporters



Source: CEIC, Haver Analytics, Morgan Stanley Research; *Including Argentina, Brazil and Malaysia. **Including Korea, Taiwan, Thailand, Mexico and Turkey.

In China, we believe that overall GDP growth will remain in a downward channel, marked by mini-cycles. China's economy is facing the headwinds posed by weaker demographics, high levels of debt and disinflationary pressures. However, policy-makers will continue to defend the downward trend of growth using monetary and fiscal policy support to prevent any social stability risks arising from a quick, sharp slowdown. The sharp slowdown in growth between 4Q14 and 1Q15 prompted an acceleration of policy response – with the pace of cuts to real interest rates intensifying and a significant uplift in on-budget fiscal spending. We expect China's growth to improve slightly over the next 3-4 months and face a gradual slowdown in 2H16 again. Hence, while spillover effects from a China slowdown should reduce in 2016, they are unlikely to go away completely.

Commodity exporters, which have been the weakest link within EM in 2015, should continue to be on the adjustment path, particularly **Brazil** and **Russia.** However, we expect the pace of contraction to narrow for these economies in 2016 compared to 2015. **Commodity importers** are likely to see a slight improvement in their growth trend from 2Q16 onwards.

Structural Issues Still Holding Back the Global Economy

While we think the global economy will be able to skirt recession, the recovery will remain a sub-par one, in our view. **Our growth expectations for 2016 are less optimistic than the consensus for both DM and EM and 2016 will be the fifth year where global growth will remain below the trailing 30-year average of 3.6%Y.** This long period of sub-par growth trend is a reminder of the slowing global potential growth due to the headwinds from high levels of debt, weakening demographic trends and persistent disinflationary pressures (the '3D' challenge). While these challenges have been prevalent in DM for some time, an increasing number of EM countries are now also facing this similar challenge.

Debt – EM joining DM in debt build-up: Out of the top 10 DM plus top 10 EM countries, we now have eight countries with debt/GDP above 250% and five with debt/GDP above 200% (but <250%). Aggregate debt/GDP of these countries has increased from 201% in 2007 to 235% in 2014.

Demographics – global age dependency ratio on the rise: After a long period of steady decline, global age dependency (the ratio of non-working to working age population) has been rising since 2013 as per UN data (see Exhibit 12). In other words, the global ageing population is now growing faster than the working age population. **Out of the top 20 DM plus EM economies, 14 have seen a rise in dependency ratio.**

Moreover, growth in global working age population will be 1.0%Y in 2016 compared with 1.4%Y in 2010 and 1.8%Y in 2005 (see Exhibit 14). The global demographic trend would be even more challenging if we exclude Africa and the Indian subcontinent. Although India is working towards building an enabling environment to reap its demographic dividend, it is not as aggressive as China was over the last 15 years. Efforts in Africa are even slower than in India.

Exhibit 10

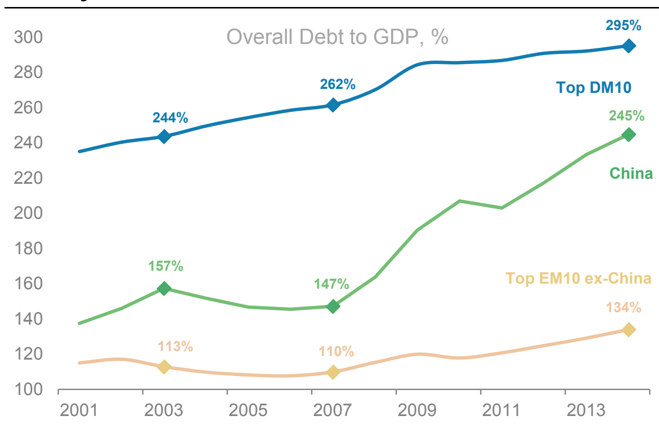
The 3D Challenge: Debt, Demography & Disinflation

	Debt	Disinflation			Demographics	
	Debt to GDP (2014) %	PPI %Y*	CPI %Y**	GDP deflator %Y^	Working age population growth %Y 2005	2015E
Top 10 DM						
US	249	-1.6	0.2	0.9	1.2	0.3
Japan	483	-3.7	0.0	2.1	-0.5	-1.1
Germany	225	-2.3	0.3	2.1	-0.6	-0.1
UK	281	-1.3	-0.1	1.0	0.8	0.1
France	352	-2.4	0.1	1.4	0.6	-0.3
Italy	312	-3.0	0.3	0.5	0.2	-0.5
Spain	375	-3.6	-0.9	0.7	1.6	-0.8
Canada	225	-0.4	1.0	-0.3	1.3	0.4
Australia	287	0.7	1.5	-0.4	1.5	1.0
Netherlands	317	-9.1	0.4	0.9	0.5	-0.2
Top 10 EM						
China	245	-5.9	1.3	-0.7	1.7	-0.1
India	137	-3.8	5.0	1.7	2.2	1.7
Russia	95	14.3	15.6	6.0	0.3	-0.7
Brazil	139	9.4	10.3	8.2	1.7	1.2
Indonesia	77	5.3	6.2	4.0	1.6	1.6
Mexico	70	1.5	2.5	2.4	1.9	1.8
Korea	281	-4.5	0.9	2.7	1.0	0.3
Turkey	108	5.7	7.6	8.5	1.8	1.7
Taiwan	183	-8.5	0.3	2.9	0.9	0.1
Thailand	241	-3.1	-0.8	-0.5	0.9	0.2

Source: UN, CEIC, Haver Analytics, Morgan Stanley Research; Note: We rank the countries based on GDP size on a PPP basis *Data as of 3Q15 for Australia, Sep-15 for Brazil, Indonesia, France, Italy, Spain, Canada, Australia and Netherlands; **Data as of Oct-15 for all countries except for Japan (Sep-15) and Australia (3Q15); ^Data as of 3Q15 for China, Indonesia, Mexico, Thailand, US, Japan and France and 2Q15 for all other countries.

Exhibit 11

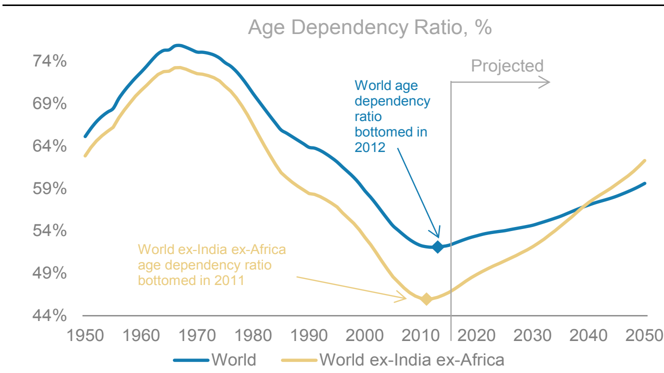
Aggressive Debt Build-Up Post the Credit Crisis, Led by China



Source: CEIC, Haver Analytics, Morgan Stanley Research; Note: Top 10 DM countries are the US, Japan, Germany, UK, France, Italy, Spain, Canada, Australia and the Netherlands. Top 10 EM countries are China, India, Russia, Brazil, Indonesia, Mexico, Korea, Turkey, Taiwan and Thailand. We rank the countries based on their GDP size on a PPP basis.

Exhibit 12

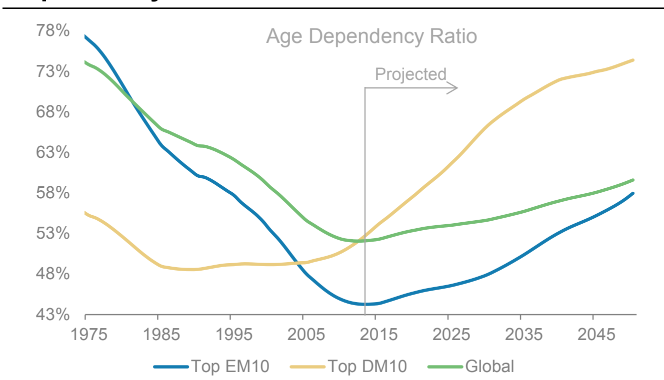
Global Age Dependency Ratio on Rise Since 2013



Source: UN estimates, Morgan Stanley Research; Note: Top 10 DM countries are the US, Japan, Germany, UK, France, Italy, Spain, Canada, Australia and the Netherlands. Top 10 EM countries are China, India, Russia, Brazil, Indonesia, Mexico, Korea, Turkey, Taiwan and Thailand. We rank the countries based on their GDP size on a PPP basis.

Exhibit 13

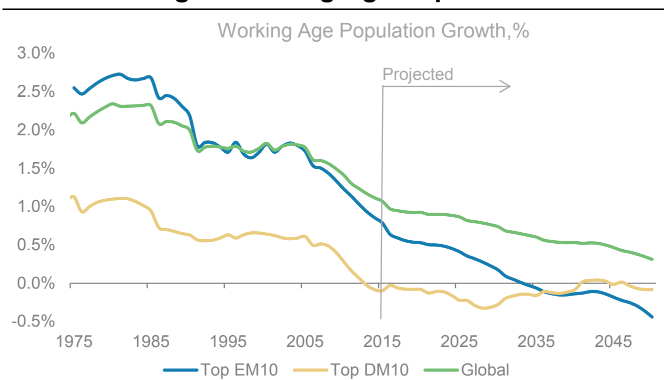
Both EM and DM Countries Facing Rise in Age Dependency Ratio…



Source: UN estimates, Morgan Stanley Research; Note: Top 10 DM countries are the US, Japan, Germany, UK, France, Italy, Spain, Canada, Australia and the Netherlands. Top 10 EM countries are China, India, Russia, Brazil, Indonesia, Mexico, Korea, Turkey, Taiwan and Thailand. We rank the countries based on their GDP size on a PPP basis.

Exhibit 14

…and Slowing in Working Age Population Growth



Source: UN estimates, Morgan Stanley Research; Note: Top 10 DM countries are the US, Japan, Germany, UK, France, Italy, Spain, Canada, Australia and the Netherlands. Top 10 EM countries are China, India, Russia, Brazil, Indonesia, Mexico, Korea, Turkey, Taiwan and Thailand. We rank the countries based on their GDP size on a PPP basis.

Disinflation – pressures have been persistent: While many of the DM and EM economies have begun to see tighter labour markets, the global manufacturing and tradable goods sector (including commodities) faces the challenges of excess capacity due to the Asia ex Japan region, led by China. Weaker external demand and the slippage of manufacturing capacity utilisation have led to weaker corporate pricing power. In turn, **14 out of the top 20 DM plus EM economies are in outright producer price deflation.** While we expect DM core inflation to be lifted towards central bank inflation targets, led by the services component, core inflation in EM is expected to decelerate further in 2016, weighing on the global core inflation trajectory. For more details on the trajectory of global inflation, please see our inflation section on the following page. **This environment of lowflation is only adding to the challenge of managing debt dynamics.**

Productivity Boost Key Defence Against Slowing Potential Growth

These structural headwinds have meant slowing potential growth. While central banks particularly in DM have been relatively successful in managing the headwinds from the 3D challenge to keep the global expansion cycle intact, **reviving growth in a sustainable manner will require a boost to productivity growth.**

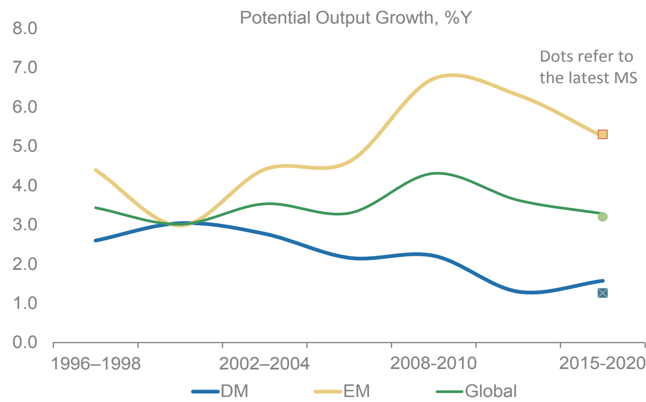
An accelerated pace of policy reforms, which boosts potential growth, would undoubtedly be welcome in both DM and EM. However, the **slippage in potential growth has been more pronounced in EM** (see our Autumn Outlook for more details on why potential growth has slipped). According to IMF estimates, potential growth in EM has slipped from 6.7%Y in 2008-10 to 5.2%Y in 2015-20; potential growth in DM has slipped by a smaller 60bp (from 2.2%Y to 1.6%Y) over the same period. Moreover, the fact that most of the EM economies are operating below their potential suggests a more urgent need for accelerated action in EM.

The productivity trend in EM suffered significantly over the last seven years. The incremental capital output ratio (ICOR), an indicator measuring units of incremental capital needed to generate units of incremental GDP, has been rising since the onset of the credit crisis.

This weak productivity dynamic has meant that EM has been facing challenges to revive growth without an increase in imbalances in the form of price stability and/or financial as well as external stability. Indeed, over the last few years many parts of EM have seen signs of imbalances in the form of high inflation/deflation dynamics, rising debt to GDP, concerns over asset quality in the banking systems and weakening external balances (current account and/or dependence on external debt).

Exhibit 15

Potential Output Growth Headed Lower Especially in EM, DM Subdued



Source: IMF, Morgan Stanley Research forecasts

We believe that the productivity cycle in EM can be characterised by a four-stage process:

- **Distortion:** Distortion of economic incentives due to bad policy choices leading to misallocation of resources;
- **Imbalances:** Misallocation of resources, manifested in the form of the price stability, financial stability (rising debt/GDP) and/or external stability risks;
- **Correction** (adjustment): Imbalances force policy-makers to accept slower growth and adjust macro policy settings, rehabilitate balance sheets and change the economic incentive structure for economic agents; and
- **Emergence** of a new, sustainable productivity growth cycle. Currently, we believe that most emerging markets are in the advanced stage of the adjustment phase, with a few of them likely to get into a new sustainable growth phase in 2016.

Our bottom line on global growth: The global economy is projected to remain on an expansion path, though the recovery remains distinctly sub-par, with risks skewed towards the downside. The *cyclical* challenge of EM remaining in the adjustment phase (though less onerous in 2016 as compared to 2015) and *structural* issues of slowing global potential growth due to the headwinds from the '3D' challenge – high levels of **d**ebt, weakening **d**emographic trends and persistent **d**isinflationary pressures – coupled with relatively slow progress in enacting reforms to lift potential growth by both DM and EM should keep challenges to global growth alive.

Inflation – Better but Still Below the Norm

After inflation was hotly debated among investors earlier this year, notably in the deflation versus reflation controversy (see *Global Economics: From Deflation Scare to Reflation Run*, June 13 2015), the inflation debate will likely focus on a number of new issues in 2016:

- For starters, the **inflation debate will likely become more nuanced and zoom in on whether and when central bank targets will be hit.** The debate on whether the global economy is at danger from deflation or whether it stands to benefit from reflation is unlikely to be as intensive as it was in 2015. We continue to expect global headline inflation to rise gradually, led by DM, due to stabilising energy prices and rising core inflation. On average, we expect a DM inflation rate of 1.5%Y in 2016, up from a previous forecast of 1.4%Y and from an estimated 0.3%Y in 2015. Compared to our Autumn Outlook, we are raising our inflation forecasts in the US, the UK and, materially, in Brazil. We reiterate our above-consensus inflation forecast in Japan and mark to market our euro area numbers.

Exhibit 16

Morgan Stanley Global Inflation Forecasts

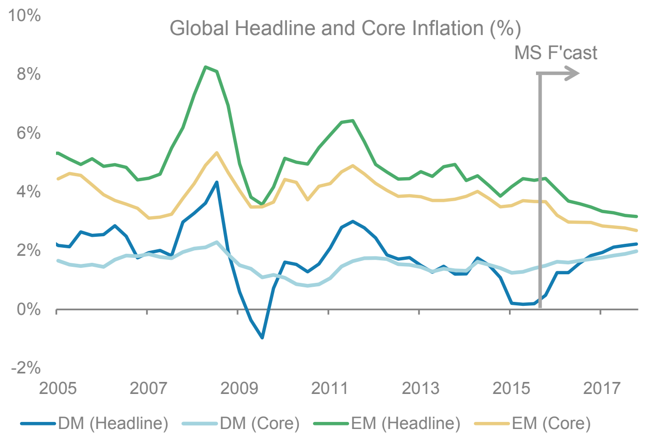
	2015e		2016e		2017e	
	Sep	Dec	Sep	Dec	Sep	Dec
GLOBAL*	**2.6**	**2.6**	**2.8**	**2.7**	**2.8**	**2.8**
G10	**0.3**	**0.3**	**1.4**	**1.5**	**2.1**	**2.1**
US	0.1	0.2	1.5	1.7	2.2	2.3
EA	0.1	0.1	1.3	1.3	1.7	1.8
Japan	0.6	0.9	1.3	1.0	2.6	2.5
UK	0.1	0.0	1.2	1.3	1.5	1.5
EM*	**4.4**	**4.4**	**3.8**	**3.7**	**3.4**	**3.2**
China	1.5	1.5	1.5	1.1	1.5	1.1
India	4.8	4.8	4.9	4.9	4.5	4.5
Brazil	8.7	8.9	6.3	8.2	5.0	6.0
Russia	15.5	15.5	8.6	7.8	7.2	6.4

Source: Morgan Stanley Research forecasts; Note: Global* and EM* aggregates are calculated excluding Argentina and Venezuela.

- Furthermore, **inflation trends should start to converge across countries** as the divergence between the lowflation experienced by commodity importers, both in DM and EM, and the highflation suffered by many commodity exporters on the back of a sharp deterioration in their terms of trade will likely give way to a renewed convergence in inflation trends. Notable exceptions to this common trend are Argentina and Venezuela, which remain plagued by hyperinflation and where we had to raise our forecasts again. On the whole, we think DM will lead headline inflation higher thanks to stabilising energy prices and rising underlying inflation pressures, while EM will remain on a path of disinflation, driven by a normalisation of inflation from very high levels in commodity-exporting countries.

Exhibit 17

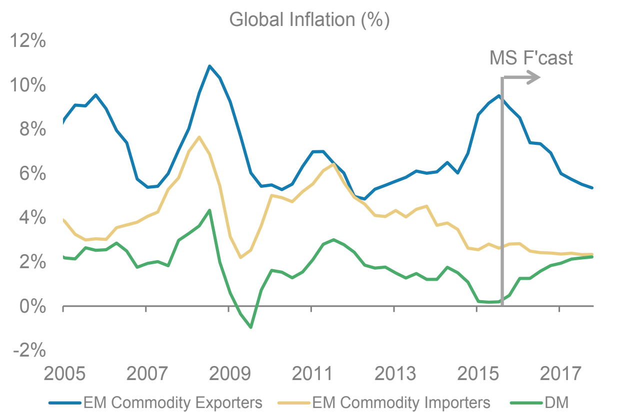
Inflation: Gradual Rise in DM, Decline in EM



Source: Haver Analytics, Morgan Stanley Research forecasts

Exhibit 18

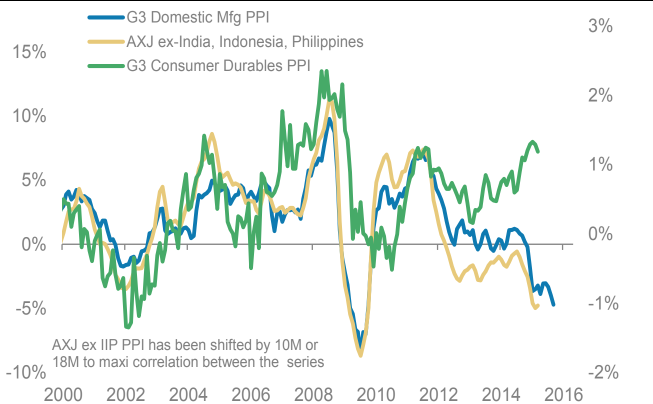
Headline Inflation Starts to Converge between Commodity Importers and Exporters



Source: Haver Analytics, Morgan Stanley Research forecasts

Exhibit 19

AXJ PPI Deflation Pulls G3 Manufacturing Prices Lower but Not Consumer Durables



Source: Haver Analytics, Morgan Stanley Research forecasts

- In addition, more timely and often more publicised **headline inflation should realign with core inflation again.** Across DM, we expect headline inflation to gain 1.25pp between now and end-2016 and core to increase by 0.25pp. In the US and the euro area, headline inflation is likely to be above core at the end of next year while in Japan and even more so in UK it will likely stay below core. Note that in the US, there is an growing gap between core CPI and the more commonly used core PCE, causing core inflation on the former definition to be about 0.5pp below the latter version (see *US Economics & Strategy Insights: Inflation: The CPI-PCE Wedge*, June 25, 2015), which is expected to remain close to 2%Y, while core inflation in the euro area and Japan – based on CPI metrics – are expected to rise from the current low levels. Core inflation trends in EM are more mixed compared to DM, with disinflationary pressures expected to continue in some parts of EM (e.g. AxJ) but inflation forecast to rise in other parts (e.g. India).

  With energy prices experiencing such big swings over the last year and with these swings reverberating in the coming year through very material base effects, **the focus for many investors will turn to core inflation trends,** we think. Globally, core inflation should stay broadly stable, drifting towards the lower end of the 2.25-2.5%Y range over the forecast horizon. While core inflation in DM countries is likely to inch higher, reaching 1.5%Y by end-2016, in EM economies, where it typically plays less of a role in the policy discussion, core inflation is likely to fall by about three-quarters of point between the end of this year and the end of next year, when our experts on aggregate peg it at a touch below 3%Y. Within DM, core inflation is likely to hover sideways in the US next year. By contrast, it will likely rise moderately in the euro area, somewhat more significantly in the UK and steeply in Japan. Within EM, there are also mixed fortunes for core inflation, with China and Brazil expecting a modest moderation, Russia a steep fall and India a small increase in core inflation.

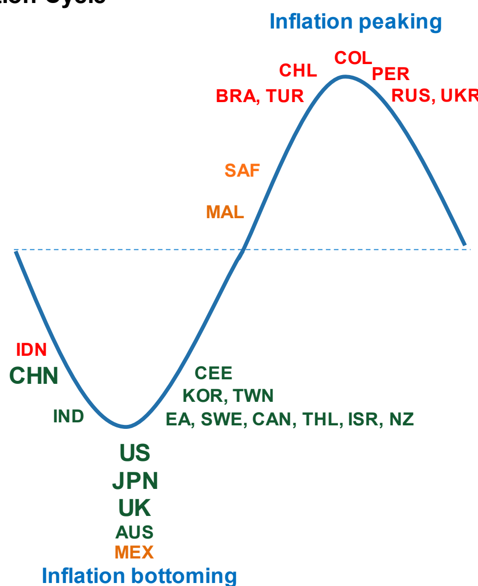
- Finally, the **deflation debate will likely move from Europe, which many investors thought would become the next Japan, to China.** Potential parallels include possible capital misallocation, excessive currency strength and persistent excessive capacities (see *Asia Economics: Intensified Deflationary Pressures Require Further Monetary Easing*, August 19, 2015). In China, like in much of AXJ, deflationary pressures are intensifying, with PPI 5.9% lower than a year ago, having been in negative territory for 44 consecutive months. Compared to autumn, we have lowered our 2016 CPI forecast from 1.5%Y to 1.1%Y. Across Asia, nine out of ten countries are

currently in producer price deflation and four also in negative territory on their GDP deflator. These disinflationary pressures could be transmitted to DM and other EM via the import price channel, the foreign exchange channel and the commodity channel, acting as a drag on the global inflation trajectory. On balance, however, we don't expect AXJ disinflation to derail the gradual rise in global inflation over the course of 2016.

Downside Risks Still Dominate Our Inflation Forecasts
Also in 2016, the risks to our inflation forecasts will likely tilt to the downside for several reasons:

- First, while our **inflation forecasts are based on oil futures,** our commodity team reckons that oil prices could be lower for much of the year.
- Second, DM **inflation is highly auto-correlated,** meaning that past inflation, which was very low, drives a good part of future inflation (see *"What Drives Inflation in the Major OECD Economies?"* OECD Economics Department Working Papers, No. 854, OECD Publishing). Third, the **effectiveness of QE in boosting growth and inflation, as opposed to asset prices, might be limited** and declining over time.
- Finally, **growth might once again disappoint.** Our bull-bear scenarios typically show a negative bias for the growth outlook in the view of the respective country experts (see pages 14-15 for a detailed discussion of our bull-bear scenarios).

Exhibit 20
Global Inflation Cycle: Reaching a Turning Point



Source: Morgan Stanley Research; Note: Position corresponds to country's stage in inflation cycle, colour to current inflation level relative to central bank's inflation target (red ≥ target ceiling, amber within the target range, green < target).

Global Monetary Policy Starting to Shift

At Long Last, We Are Getting Lift-Off in the US
The defining moment in monetary policy-making in 2016 will likely be the first Fed tightening campaign since June 2004. We expect the Fed to move cautiously and pause until June 2016 after the first rate hike this December. Nonetheless, the dawn of a new tightening cycle in US monetary policy will be crucial and the debate on how fast and how far it will go and whether it could eventually even trigger another recession over the next two years has already started.

Hard Decoupling vs. Europe, Soft Decoupling vs. China
For the first time since the early 1990s, we will have outright decoupling of monetary policy across the Atlantic as the Fed raises rates and the ECB cuts them. With respect to EM more broadly, the new Fed tightening cycle causes concerns among investors as to whether the tighter financial conditions could trigger shifts in capital flows and risk attitudes. With respect to China more specifically, there is a gradual decoupling of monetary conditions as China pursues its new RMB regime. Under this new regime, the PBOC will likely keep RMB stable on a trade-weighted basis instead of unilaterally pegging it against USD. The new RMB regime together with additional reduction in policy rates and reserve requirements by the PBOC will allow monetary conditions in China to decouple from the US to a greater extent than before.

Global Monetary Policy to Stay Accommodative
Given the modest recovery that is being pencilled in, we see monetary policy remaining accommodative over the forecast horizon. Relative to our previous forecasts, we are expecting a slower pace of lift-off in the US, a later start in the UK and more monetary accommodation in the euro area. Across the EM world, we have also pencilled in more rate cuts for those central banks that are already in easing mode and the same or a smaller number of policy rate hikes for those central banks that are still in tightening mode.

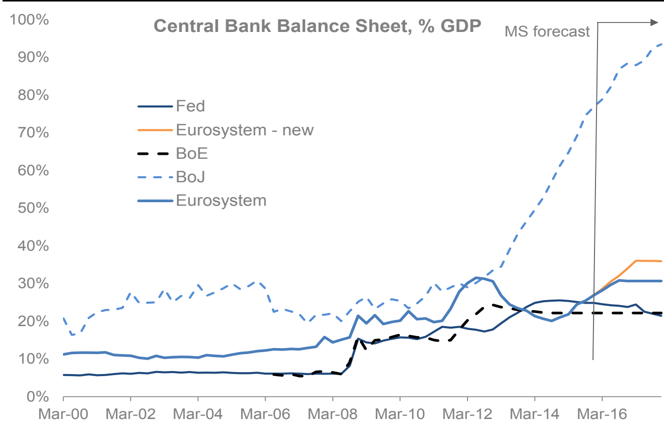
Exhibit 21
Revisions to Our Key Monetary Policy Calls

US	More gradual hiking cycle (75bp of hikes in '16, 100bp in '17 vs. 100bp previously in both years)
EA	More QE and staying on hold in 2017 vs. 45bp of hikes previously
UK	The hiking cycle starts in 2Q16 vs. 1Q16 previously
China	50bp of extra cuts in 2016
Taiwan	One more cut in December 2015 (12.5bp)
Turkey	More dovish in '15 (eop 8% vs. 8.50%) and '16 (eop 9.50%, vs. 11%)
Russia	More cuts in '16 (eop 8% vs. 9.50%), slightly less in '17 (eop 6.50% vs. 6%)
Brazil	Hiking cycle gets restarted in '16 (eop 15.25% vs. 12%)
Mexico	Dovish slant in '16 (75bp vs. 125bp of hikes)

Source: Morgan Stanley Research forecasts; green = easier policy; red = tighter policy

Exhibit 22

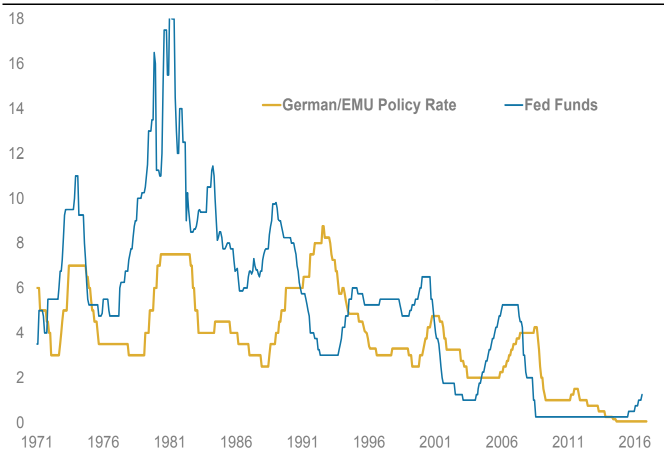
Fed Balance Sheet to Stagnate, ECB & BoJ Growing



Source: Federal Reserve, BoJ, ECB, BoE, Morgan Stanley Research forecasts

Exhibit 23

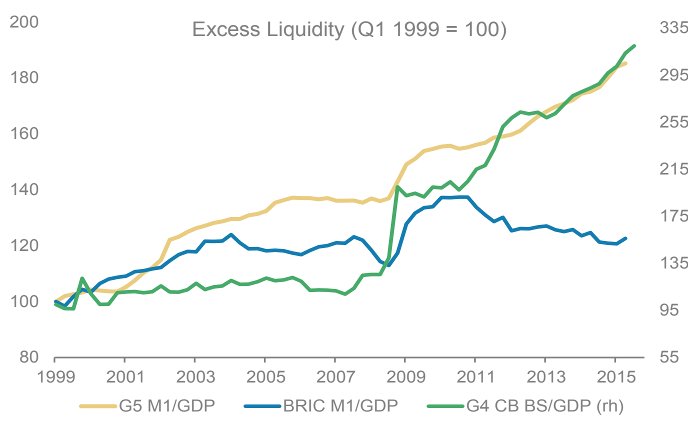
Fed to Raise Rates, ECB to Cut Depo Rate



Source: Federal Reserve, Bundesbank, ECB, Morgan Stanley Research forecasts

Exhibit 24

Excess Liquidity Peaking in DM, Troughing in EM



Source: Haver Analytics, Morgan Stanley Research forecasts

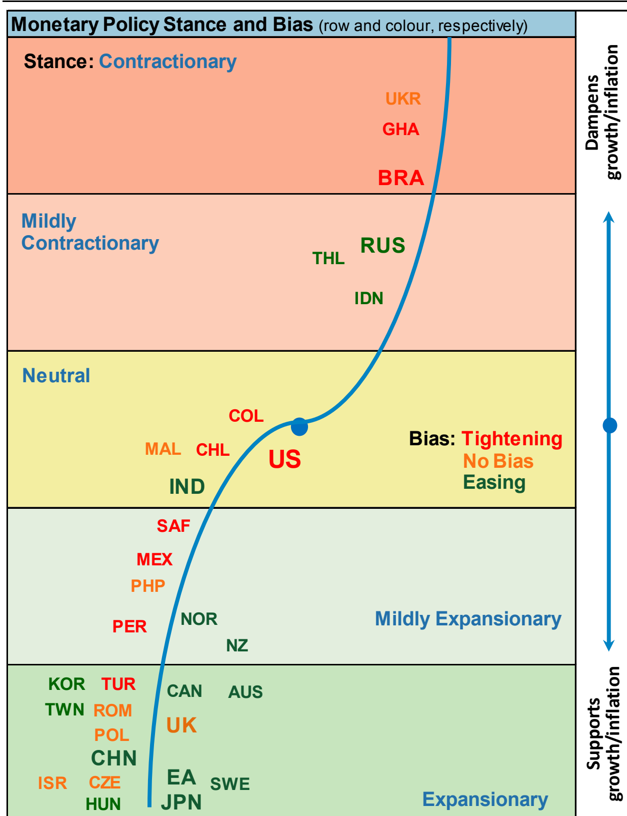
Fed and BoE Tighten Gradually, ECB Adds to QE
In the US, while we are maintaining our long-standing call for Fed lift-off in December, we expect it to pause in 1Q16 and only resume hiking in 2Q16. As a result, we are removing one rate hike from the 2016 cycle. In the UK, we expect later lift-off in 2Q16 instead of 1Q16, but still expect a total of 50bp of policy rate hikes for the year. The ECB is expected to embark on further easing in December by cutting the depo rate by 10bp and boosting its QE programme by €585 billion (~6% of GDP) through a faster pace and a longer duration of the purchase programme. Last but not least, the BoJ is no longer expected to taper in October 2016 and instead could contemplate a shift in its monetary policy regime from targeting its balance sheet towards a new regime such as targeting bond yields.

Even EM Monetary Policy Likely to Become Supportive
Relative to our previous forecasts, we are expecting more accommodative monetary policy in EM, especially in AXJ. With the exception of Brazil and Colombia (where we are now pencilling in more hikes in 2016), the majority of the EM central banks we cover are expected to either lower policy rates further or to hike by a lesser extent than previously expected. In China, monetary policy easing continues, bringing the total easing in the current cycle to 4.35% (or down by 165bp) for the policy rate (1Y lending rate) and to 17% (or down by 250bp) for the reserve requirement ratio. Going forward, we expect two more policy rate cuts in the first half of next year and see several more cuts in the required reserve ratio (RRR) in order to boost liquidity conditions. In our view, RRR is the most important policy tool that the PBOC has to hand and, with a current level of 17%, also one that has considerable firepower. On our estimates, every 1pp reduction in the RRR will release US$209 billion of liquidity into the banking system.

Easing Does it in Asia, but Not in Latin America
Across AXJ, where disinflationary, if not deflationary, pressures still prevail, we expect the central banks of Korea and India to cut interest rates by 25bp in early 2016. In Indonesia, we see two more rate cuts in 1H16 and an unchanged policy rate thereafter. Among the EM commodity exporters, Brazil will likely be forced to raise rates by another 100bp from present levels while Russia is already in a position to ease policy and could do so by slashing rates by 300bp between now and the end of 2016. Further easing over the next 12 months is also projected in Nigeria (150bp) Poland (50bp) and Hungary (35bp) while other LatAm and CEEMEA central banks are likely to raise rates (e.g., Mexico by 100bp, Turkey by 200bp and South Africa by 50bp).

Bottom Line: The Money Tide Is Turning but Only Slowly
While the new Fed tightening cycle will eventually cause the tides to turn in terms of monetary policy, **the gradual pace of tightening should help to maintain an accommodative monetary stance globally.** In 2016, investors will see a hard decoupling between the US and the euro area, with monetary policy heading into different directions. In addition, there will likely be a very soft form of decoupling between the US and China as a result of the new RMB regime introduced over the summer. The ultra-low policy rates imposed by the ECB and the change by the PBOC to now target a stable trade-weighted exchange rate created new policy challenges for the smaller central banks in the respective regions who needed to lean forcefully against an unwanted strengthening of their respective currencies. On balance, we estimate the additional asset purchases of the ECB and the BoJ to be able to broadly offset the fact that the Fed and BoE are no longer adding to their balance sheets (see *Global Economics Playbook*, October 19, 2015). While global excess liquidity is still expanding, the pace of its expansion is losing momentum – in DM more so than in EM.

Exhibit 25
Monetary Policy Remains Accommodative



Source: Morgan Stanley Research; Note: Colour corresponds to monetary bias, where 'red' stands for tightening bias, 'orange' for no bias and 'green' for easing.

Risks: Fed Rate Hikes, China Deflation, EU/EM Politics

As ever, the **global economy faces a number of risks that could undermine the still sluggish recovery.** The risks to our global growth outlook are skewed towards the downside. In the year ahead, we are watching out for three risk factors in particular: Top of our list is the **Fed's tightening cycle and its repercussion for financial conditions** globally but especially in the US and dollar-indebted EM economies. Right behind the Fed is the **risk of deflation in China** and potential spillovers onto its trade partners, Finally, we are keeping a close eye on **political developments in Europe and in EM.** In Europe, we are concerned by the pressure put on the European Union by protest parties ousting established incumbents in national elections, by an unprecedented number of refugees applying for humanitarian support and by an increasingly unpredictable outcome of the UK's vote on EU membership.

Nothing normal about the Fed's policy normalisation: The back and forth about lift-off in the US over the past year underlines how challenging the normalisation of monetary policy in the US is. Not only does the Fed start from an ultra-loose policy stance, but it also does so against the backdrop of bond yields, term premia and risk premia that are low by historical standards and debt levels, notably leverage in the corporate sector, that are high by historical standards. Furthermore, the great recession has likely caused the natural rate to move much lower than in past cycles, increasing the risk of wrongly calibrating the monetary policy stance. The risk is that the start of a new Fed tightening cycle negatively affects risk attitudes globally, causing material corrections in asset prices and reversals in capital flows.

Less worried about China hard landing, more concerned about deflation risk: For many forecasters, a potential growth hard landing in China remains a key risk to their global growth outlook. For us, this has been less of a concern. We believe that China's policy-makers have enough policy wiggle room in the form of monetary and fiscal easing to manage a soft landing. However, we are more concerned about the slow adjustment in cutting excess capacity and recognition of NPLs leading to a more persistent disinflationary trend morphing into deflation risks. For instance, in the case of the steel sector, China currently has excess capacity of about 350 million tonnes, but the pace at which policy-makers are taking up shutdown is around 25 million tonnes per annum. If China faces more generalised deflationary pressures, it will increase the risk of spillover onto the other economies as China remains the largest trading partner for most major countries.

Political developments in Europe and in EM: There are several key political risk events in Europe in the coming year, which could challenge the current political consensus. The risk events include a series of national elections in the periphery, the unprecedented influx of refugees and UK vote on EU exit in 2016, whose outcome is a very close call. In EM, the main political risk we are watching is in Brazil, where our baseline forecasts assume that the current political stalemate cannot be resolved until 2Q16, given the political calendar and the ongoing investigations. In both cases, the risk is that political complications cause sovereign spreads to widen materially, leading to a sharp tightening in financial conditions, derailing the domestic demand recovery.

An Alternative Metric of Global GDP Growth

We also present our country forecasts in another global growth aggregate. In addition to the traditional aggregation, using purchasing power-adjusted exchange rates, we use **the market-based exchange rates** prevailing over a 10-year period. On this metric, **global growth is quite a bit lower at 2.3%Y in 2015 and 2.1%Y in 2016 than on the PPP-based metric** (see Exhibit 26).

This is for two reasons: For starters, the aggregate growth dynamics in EM are lower. Second, the weight of EM in the global aggregate is also lower. The smaller weights are due to fact that the national income levels (which define the purchasing power) are no longer levelled across countries.

While both methods are valid, which one is more appropriate to use depends on the question at hand. The aggregation based on market exchange rates might be **more relevant for investors interested in financial flows or global sales dynamics than the PPP-based one.**

Exhibit 26

Morgan Stanley Growth Forecasts: PPP vs. MW

	2015		2016		2017	
	MW	PPP	MW	PPP	MW	PPP
Global	2.3	3.1	2.1	3.3	2.7	3.7
G10	1.8	1.8	1.8	1.8	1.8	1.8
EM	2.9	4.0	2.5	4.4	3.6	5.0

Note: MW = 10y FX market exchange rate-weighted, PPP = purchasing power parity-weighted; Actuals and Morgan Stanley FX forecasts used to obtain MW.
Source: Bloomberg, Morgan Stanley Research forecasts

Exploring the Bull and Bear Cases

EM and DM growth risks skewed towards the downside: We view global trade, financial conditions and policy actions as the key anchors to our bull-bear scenarios. The skew of our global growth forecasts is to the downside for both 2016 and 2017. This is true for both DM and EM aggregates over the forecast horizon. For 2016, we view the risks as skewed to the upside for the UK and Russia, balanced for the euro area and India and skewed to the downside for the US, Japan, China and Brazil. Globally, the risks to the **inflation outlook are towards lowflation prevailing for longer** for DM economies and China. For Brazil and Russia, we see lower inflation in the bull case, as the effects from negative terms of trade shock and currency depreciation endured by commodity exporters dissipates.

Bear case: G3 recession + EM shock = global recession: Our bear case is a combination of less favourable global trade, tighter financial conditions and idiosyncratic policy mistakes. In the US, a poor communication of the Fed to the market after its first hike in December 2015 leads to a rapid tightening of financial conditions, sending the economy to a recession in 2H16. In the euro area, unfavourable global conditions and increased political uncertainties in some countries also push the economy into a short-lived recession in late 2016/early 2017. In China, the issues of excess capacity and deflationary pressures intensify, deterring private corporate capex. In Brazil and Russia, higher inflation expectations (due to a larger fiscal deficit in Brazil and negative terms of trade shock in Russia) force central banks to keep rates higher for longer. **In sum, these conditions trigger a global recession for both 2016 and 2017.**

Bull case: Goldilocks returns to the global economy: Our bull case features a combination of a benign global environment and positive policy developments, which improve productivity in both DM and EM. In US, better global growth boosts exports and spurs a rebound in energy investment. In the euro area, an extra belt-loosening of 0.5pp in 2016 due to the refugee crisis and the shift to pro-cyclical budgets in some countries will likely fuel domestic demand growth. In China, a faster-than-expected pass-through of policy easing and a firmer recovery in external demand lead to a GDP growth stabilisation. A swift improvement in the political environment in Brazil and improved terms of trade in Russia lead to lower inflation, leaving room for a faster pace of policy rate cuts to boost domestic demand. Reflation in major DM countries (the US, the euro area and the UK) allows a normalisation of policy rates from ultra-low levels, while lower inflation pressures in EM countries that had highflation problems (India, Brazi, and Russia) creates room for a faster pace of policy rate cuts to boost domestic demand. **Globally our bull case GDP growth comes to 4.1%Y in 2016 and 4.5%Y in 2017.**

Exhibit 27

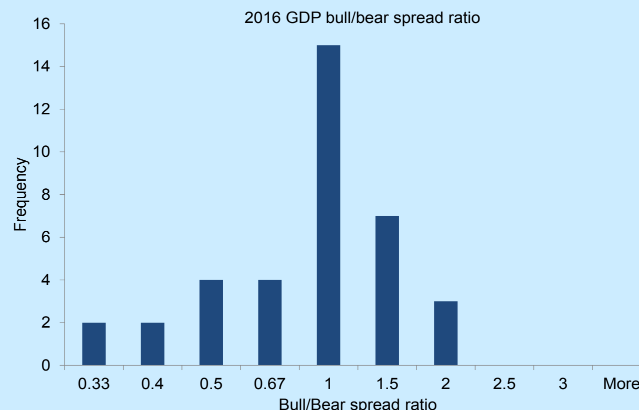
Growth Risks: Global Recession Looms Large

Real GDP (%Y)	2016E			2017E		
	Bear	Base	Bull	Bear	Base	Bull
Global	**2.2**	**3.3**	**4.1**	**2.4**	**3.7**	**4.5**
G10	**0.8**	**1.8**	**2.5**	**0.4**	**1.8**	**2.5**
US	0.8	**1.9**	2.5	0.4	**1.8**	2.7
Euro Area	0.9	**1.8**	2.7	0.6	**1.8**	2.3
Japan	0.2	**1.2**	1.8	-0.2	**0.8**	1.2
UK	1.5	**2.0**	3.0	1.0	**2.3**	2.9
EM	**3.3**	**4.4**	**5.2**	**3.8**	**5.0**	**5.9**
China	6.0	**6.7**	7.0	5.8	**6.6**	6.9
India	6.8	**7.9**	9.0	6.5	**8.0**	9.5
Brazil	-4.1	**-3.0**	-2.1	-0.2	**1.2**	2.1
Russia	-2.5	**-0.8**	1.2	0.5	**1.7**	3.0

Source: Morgan Stanley Research forecasts

Exhibit 28

Risks to Growth Are Skewed to the Downside



Source: Morgan Stanley Research forecasts

Exhibit 29

Inflation Risks: Lowflation for Longer in DM/China

CPI (%Y)	2016E			2017E		
	Bear	Base	Bull	Bear	Base	Bull
Global*	**2.6**	**2.7**	**2.8**	**2.6**	**2.8**	**2.9**
G10	**1.2**	**1.5**	**1.7**	**1.5**	**2.1**	**2.5**
US	1.5	**1.7**	1.9	1.8	**2.3**	2.7
Euro Area	1.0	**1.3**	1.3	1.1	**1.8**	2.1
Japan	0.2	**1.0**	1.6	1.3	**2.5**	2.8
UK	1.2	**1.3**	1.4	1.2	**1.5**	2.0
EM*	**3.8**	**3.7**	**3.6**	**3.5**	**3.2**	**3.2**
China	0.5	**1.1**	1.6	0.2	**1.1**	1.5
India	6.0	**4.9**	4.0	6.0	**4.5**	4.0
Brazil	9.5	**8.2**	6.5	11.0	**6.0**	4.5
Russia	9.5	**7.8**	6.5	7.4	**6.4**	5.5

Source: Morgan Stanley Research forecasts. Note: Global*, EM* aggregates are calculated excluding Argentina and Venezuela

Bull-Base-Bear Scenarios – Key Countries

	Bear	Base	Bull
US	• The Fed hikes in December, but does a poor job of communicating its gradual intent to financial markets. Financial conditions tighten rapidly, cracks appear in the soundness of the domestic economy and a short-lived recession in 2H16 ensues. • Fed reverses the only rate hike it had executed.	• The Fed delivers a rate hike in December and signals that more will depend on both realised and expected increases in inflation. A policy of gradualism helps extend the growth cycle.	• Global growth accelerates, boosting exports and spurring a rebound in energy investment. Full employment is realised sooner than expected, wage growth takes off and household spending increases. • Fed tightens gradually at first, then plays catch-up, reaching 3.625% by end-2017.
EA	• Financial conditions tighten on the back of both global factors and increased uncertainty in EU politics. With a weak economic structure, limited policy room and sluggish external demand, the economy first decelerates and then shrinks for two quarters. • The ECB expands QE to the whole of 2017.	• Gradual pick-up in growth in 2016 with inflation beginning to normalise. ECB continues with its QE programme until March 2017, but 'exits' thereafter. Fiscal policy turns outright expansionary, partly because of extra spending due to the refugee crisis, and partly because some countries' budgets become more pro-cyclical.	• Fiscal policy adds an extra 0.5pp to GDP growth, as the region's spending for the refugee crisis gets aligned to the more substantial spending of Germany. Tax cuts are implemented more broadly in the region, and reforms continue. • Stronger growth and higher inflation make the ECB stop QE in March 2017 and then hike three times starting from 2Q.
Japan	• Stagnant exports to hurt both corporate profits and wage growth. Combined with slower employment growth, consumption growth stalls, adversely affecting inflation. Reforms slow, consumption tax might be postponed. • The BoJ eases further, by expanding both the scope and quantity of asset purchases.	• A moderate pick-up in personal consumption due to gradual recovery in real income and economic stimulus measures. The BoJ's new core CPI (ex energy and fresh food) may remain range-bound in the near term. • We expect no further easing from the BoJ.	• Strong exports improve capacity utilisation rates and firms' demand outlook, raising capex and IP as well. On the policy front, we get an accelerated pace of various reforms. • The BoJ will change its monetary regime towards a yield-targeting regime, linked to further progress in exit from deflation.
UK	• Brexit – a vote to exit to the EU in 3Q16 – adversely impacts investment. Together with weaker trade growth and tighter global financial conditions, this slows the recovery and the already gradual pace of rate normalisation. • BoE hikes in early 2016 but reverses it in 2017.	• Policy tightening and muted wage growth leave inflation struggling to return to target and help the MPC to keep rate normalisation at a gradual and steady 50bp a year throughout the forecast period. • The UK votes to stay in the EU.	• Stronger global trade and looser global financial conditions drive an earlier and stronger pick-up in pay growth, helping to trigger earlier and sharper rate rises. • The UK votes to stay in the EU, with a strong vote in favour of remaining.
China	• Excess capacity and deflationary pressures intensify and elevated property inventory levels deter private corporate and real estate investment, which drags. • PBOC responds more aggressively with another four rate cuts (100bp) and aggressive RRR cuts.	• With policy-makers still adopting an approach of gradual adjustment, disinflationary pressures will persist and GDP growth will remain in a downward channel, marked by mini-cycles. • Policy-makers to continue defensive easing in monetary and fiscal policies.	• Stronger global growth supports exports, past policy easing filters through faster than expected, supporting property sectors and a pick-up in infrastructure investment growth, stabilising growth at around 7.0%Y in 2016. • PBOC stays on hold.
India	• Slower pace of policy reforms, weaker export growth and slowdown in global capital flows adversely impact private capex. • Inflation stays at the higher end of the RBI's target, pushing it to hike policy rates.	• Steady pace of policy reforms, normalised export growth and benign capital market environment support gradual capex recovery. Pace of job creation picks up, supporting urban consumption.	• Stronger-than-expected pace of policy reforms, sharper acceleration in exports. • Inflation decelerates more than expected, providing room for the RBI to cut by 50bp more than the base case.
Brazil	• Efforts to consolidate fiscal deficit are even weaker than expected, pressuring the currency and long-term rates further. The economy sinks into an even deeper recession and capital outflows start002E • Given the already very high fiscal expenditure on interest payments, the central bank cannot hike rates due to fiscal dominance and inflation picks up further.	• Weaker economy due to a combination of tight monetary policy and insufficient fiscal consolidation to lower long-term cost of capital. An even weaker currency pushes policy-makers into approving some measures to boost fiscal policy, but inflation expectations being higher still forces the central bank to hike rates to help inflation down in 2017.	• As a result of a successful fiscal adjustment including a potential agreement on pension reform, confidence and investment rebound, giving room for looser monetary policy.
Russia	• Weak exports and volatile oil prices result in RUB weakness and keep inflation elevated. A tighter 2016 budget, falling household incomes and increased uncertainty around Syria and Ukraine keep business sentiment downbeat and investment stagnant. • CBR keeps rates higher for longer. Banking sector risks emerge.	• Inflation stays on a decelerating path helped by a base effect, a negative output gap and a stronger RUB, which softens the contraction of household consumption. • A quieter situation in Eastern Ukraine improves business sentiment and allows the CBR to cut rates by 250bp in 2016 and 150bp in 2017.	• Implementation of Minsk agreements results in the sanctions withdrawal in early 2017 while the government comes up with a more ambitious privatisation programme in 2016 and increases the pension age in 2017. • Stronger exports and RUB along with lower inflation soften the contraction of household incomes and support consumption. This allows the CBR to cut rates faster.

Source: Morgan Stanley Research

Key Forecast Profile

Global Economics Team

	Quarterly												Annual		
	2015				2016				2017				2015E	2016E	2017E
Real GDP (%Q, SAAR)	**1Q**	**2Q**	**3QE**	**4QE**	**1QE**	**2QE**	**3QE**	**4QE**	**1QE**	**2QE**	**3QE**	**4QE**			
Global*	**2.9**	**3.0**	**3.2**	**2.9**	**3.0**	**3.4**	**3.5**	**3.6**	**3.6**	**3.4**	**3.6**	**3.6**	**3.1**	**3.3**	**3.7**
G10	**1.6**	**2.3**	**1.4**	**1.4**	**1.9**	**1.9**	**1.8**	**2.0**	**2.0**	**1.2**	**1.6**	**1.7**	**1.8**	**1.8**	**1.8**
US	0.6	3.9	2.1	1.3**	1.9	1.8	1.8	1.9	1.8	1.8	1.8	1.7	2.4	1.9	1.8
Euro Area	2.1	1.4	1.2	1.7	2.0	2.0	2.0	2.0	1.8	1.6	1.6	1.6	1.5	1.8	1.8
Japan	4.6	-0.7	-0.8	0.7	1.7	1.8	1.7	2.2	2.8	-3.8	0.1	1.2	0.5	1.2	0.8
UK	1.5	2.6	2.1	2.3	1.8	2.0	0.9	2.5	2.5	2.8	2.5	2.4	2.4	2.0	2.3
EM (%Y)	**4.4**	**4.0**	**3.8**	**3.9**	**4.0**	**4.4**	**4.4**	**4.7**	**4.9**	**5.0**	**5.0**	**5.1**	**4.0**	**4.4**	**5.0**
China	7.0	7.0	6.9	7.0	7.0	6.9	6.7	6.5	6.6	6.6	6.5	6.4	7.0	6.7	6.6
India	7.5	7.0	7.4	7.6	7.7	7.9	8.0	8.1	8.2	8.0	7.9	8.1	7.4	7.9	8.0
Brazil	-1.6	-2.6	-4.1	-4.4	-5.3	-4.4	-2.7	0.1	0.0	1.3	1.7	1.7	-3.2	-3.0	1.2
Russia	-2.2	-4.6	-4.4	-4.1	-2.8	-0.7	-0.5	0.2	1.0	1.4	1.9	2.2	-3.9	-0.8	1.7
Consumer Price Inflation (%Y)															
Global*	**2.4**	**2.6**	**2.5**	**2.7**	**2.9**	**2.6**	**2.7**	**2.8**	**2.7**	**2.8**	**2.8**	**2.8**	**2.6**	**2.7**	**2.8**
G10	**0.2**	**0.2**	**0.2**	**0.5**	**1.3**	**1.3**	**1.6**	**1.8**	**1.9**	**2.1**	**2.2**	**2.2**	**0.3**	**1.5**	**2.1**
US	-0.1	0.0	0.1	0.5	1.6	1.6	1.8	1.9	2.2	2.2	2.3	2.4	0.2	1.7	2.3
Euro Area	-0.3	0.2	0.1	0.3	1.0	0.9	1.4	1.7	1.7	1.8	1.8	1.8	0.1	1.3	1.8
Japan	2.1	0.1	-0.1	0.2	0.6	0.5	1.1	1.5	1.6	3.0	3.0	2.9	0.9	1.0	2.5
UK	0.1	0.0	0.0	0.1	0.9	1.1	1.4	1.7	1.5	1.5	1.6	1.6	0.0	1.3	1.5
EM*	**4.2**	**4.4**	**4.4**	**4.5**	**4.1**	**3.7**	**3.6**	**3.5**	**3.3**	**3.3**	**3.2**	**3.2**	**4.4**	**3.7**	**3.2**
China	1.2	1.4	1.7	1.6	1.6	1.2	0.9	0.9	1.0	1.1	1.1	1.1	1.5	1.1	1.1
India	5.3	5.1	3.9	4.9	4.8	4.8	5.1	4.9	4.7	4.4	4.4	4.3	4.8	4.9	4.5
Brazil	7.7	8.5	9.5	10.1	9.3	8.4	7.8	7.3	6.6	6.1	5.7	5.5	8.9	8.2	6.0
Russia	16.2	15.8	15.7	14.5	8.4	8.0	7.9	7.4	6.9	6.4	6.3	6.0	15.5	7.8	6.4
Core Inflation (%Y)															
Global	**2.5**	**2.6**	**2.7**	**2.7**	**2.5**	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**2.4**	**2.7**	**2.4**	**1.0**
G10	**1.2**	**1.3**	**1.4**	**1.5**	**1.6**	**1.6**	**1.7**	**1.7**	**1.8**	**1.8**	**1.9**	**2.0**	**1.3**	**1.7**	**1.9**
US	1.7	1.8	1.8	2.0	2.1	1.9	2.0	2.0	2.1	2.1	2.2	2.4	1.8	2.0	2.2
Euro Area	0.7	0.8	0.9	1.0	1.1	1.1	1.1	1.2	1.3	1.4	1.4	1.5	0.8	1.1	1.4
Japan	0.4	0.4	0.8	0.6	0.8	1.1	1.4	1.6	1.6	1.5	1.5	1.5	0.6	1.4	1.4
UK	1.2	0.8	1.1	1.3	1.7	2.0	2.0	2.1	2.0	2.1	2.3	2.3	1.1	1.9	2.2
EM	**3.5**	**3.7**	**3.7**	**3.7**	**3.2**	**3.0**	**3.0**	**3.0**	**2.8**	**2.8**	**2.8**	**2.7**	**3.7**	**3.0**	**1.0**
China	1.4	1.6	1.7	1.7	1.5	1.3	1.2	1.1	1.0	1.0	1.0	0.9	1.6	1.3	1.0
India	3.9	4.3	4.0	4.1	4.1	3.7	4.1	4.4	4.5	4.3	4.3	4.2	4.1	4.1	4.3
Brazil	6.1	5.8	6.2	6.6	6.6	6.3	6.2	6.0	5.6	5.5	5.2	5.2	6.2	6.3	5.4
Russia	16.3	17.1	16.5	15.3	9.2	8.2	8.2	7.9	7.2	6.8	6.8	6.5	16.3	8.4	6.8
Monetary policy rate (% p.a.)															
Global	**3.51**	**3.31**	**3.21**	**3.21**	**3.12**	**3.13**	**3.17**	**3.22**	**3.23**	**3.26**	**3.32**	**3.38**	**3.21**	**3.22**	**3.38**
G10	**0.21**	**0.21**	**0.19**	**0.30**	**0.29**	**0.41**	**0.52**	**0.64**	**0.75**	**0.88**	**0.99**	**1.11**	**0.30**	**0.64**	**1.11**
US	0.125	0.125	0.125	0.375	0.375	0.625	0.875	1.125	1.375	1.625	1.875	2.125	0.375	1.125	2.125
Euro Area	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	0.50	1.00	1.50
EM	**6.28**	**5.92**	**5.75**	**5.66**	**5.49**	**5.42**	**5.40**	**5.38**	**5.30**	**5.26**	**5.29**	**5.28**	**5.66**	**5.38**	**5.28**
China	5.35	4.85	4.60	4.35	4.10	3.85	3.85	3.85	3.85	3.85	3.85	3.85	4.35	3.85	3.85
India	7.50	7.25	6.75	6.75	6.50	6.50	6.50	6.50	6.50	6.50	6.75	6.75	6.75	6.50	6.75
Brazil	12.75	13.75	14.25	14.25	14.50	15.25	15.25	15.25	14.25	13.75	13.25	13.25	14.25	15.25	13.25
Russia	14.00	11.50	11.00	10.50	10.00	9.50	8.75	8.00	7.50	7.00	6.75	6.50	10.50	8.00	6.50

Note: Global and regional aggregates for GDP growth are GDP-weighted averages, using PPPs; Japan CPI includes VAT; Japan policy rate is the interest rate on excess reserves; CPI numbers are period averages. *G10+BRICs+Korea. Global* and EM* Consumer Price Inflation Aggregates exclude Venezuela and Argentina. Global and EM core inflation aggregates exclude Ukraine, Kazakhstan, Ghana, Venezuela and Argentina. **US tracking estimate
Source: IMF, Morgan Stanley Research forecasts

Country Focus

US: Testing the Waters

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US Economics Team

Key message: The Fed delivers a rate hike in December and the economy takes higher interest rates in its stride. A policy of gradualism helps to extend the growth cycle.

In 2016, offsetting factors have kept our Autumn Outlook growth forecasts intact at 1.8% 4Q/4Q (1.9%Y) – the result of slower export growth that has been countered by a two-year budget deal with extension of the debt ceiling that delivers more fiscal support. Our well-below-consensus expectation owes to what we see as structural challenges that have depressed the economy's medium-term growth potential (~1.5%) over the next several years.

In December, our long-standing Fed call comes to fruition as policy-makers finally leave zero interest rates behind. The key debate then turns to what we believe will be **an unprecedented policy tightening cycle.** We now look for one less rate hike in 2016 **as the Fed delivers a snail's pace of normalisation with 25bp rate hikes at its June, September and December meetings next year.** This pegs the mid-point of the Fed's target range at 1.125% by end-2016. Four additional hikes in 2017 bring the target range to 2.125% by end-2017.

We expect the Fed to start the year as it has in the past, having overestimated growth. As those growth forecasts are lowered, **sluggish core inflation does not pressure the Fed to act more aggressively.** Moreover, the lack of broadly accelerating wage growth sees the median expectation for NAIRU drift lower, which further informs a shallow stance on monetary policy tightening.

Interest rate-sensitive sectors will face the headwinds that rising interest rates present, but the economy takes higher rates in its stride as corporate debt rollover is largely a 2018 story and the household balance sheet is not particularly exposed to a variable rate. Housing demand is supported by rising household formation rates while further home price appreciation continues to whittle away at negative equity and support spending on home improvements.

Record levels of consumer liquidity funded by income versus debt, alongside energy savings and the improved buying power of the dollar, have supported consumer fundamentals. In the year ahead, energy stabilises and the pace of job gains slows while wage growth strengthens, resulting in **slower but better-balanced growth in consumer spending.**

We expect little contribution to growth from inventory building next year as consumer spending slows and business investment remains sluggish. With no additional collapse in oil prices, **energy investment becomes net neutral for growth next year.** Lastly, transitory external headwinds fade as the pace of appreciation in the broad nominal trade-weighted dollar moves into a slower upward trajectory, but the lagged effects of past appreciation continue to weigh on external demand, with net trade shaving 0.3pp from growth in 2016.

Risks to the outlook: In our bull case, global growth accelerates, boosting exports and energy investment. Global central banks come off an easing bias and the dollar loses steam. Full employment is reached more quickly and wage growth takes off. Households pick up the pace of spending and business investment follows suit. An optimal control policy informs the Fed to embark on a path of tightening that is gradual at first, and then plays catch-up with the Fed's target, reaching 3.625% by end-2017.

In our bear case, the Fed hikes rates in December but does a poor job of communicating its gradual intent to financial markets. The result is an extreme tightening of global financial conditions on the expectation of an aggressive path for Fed policy. The global economy weakens further while cracks appear in the soundness of the US domestic economy. On signs of a more material weakening, the Fed backs out the only rate hike it had executed, but a short-lived recession is locked in.

Forecast Summary

(4Q/4Q % change)	2014	2015E	2016E	2017E
Real GDP	2.5	2.0	1.8	1.8
Final sales	2.6	2.1	1.9	1.8
Final domestic demand	3.0	2.5	2.3	1.7
PCE	3.2	2.7	1.9	1.8
Business fixed investment	5.5	2.0	3.3	2.7
Residential fixed investment	5.1	8.0	8.6	2.6
Exports	2.4	-0.3	1.2	4.3
Imports	5.4	2.5	3.9	3.7
Government	0.4	1.2	1.6	0.6
CPI	1.2	0.5	1.9	2.4
Core PCEPI	1.4	1.3	1.5	1.8
Unemployment*	5.7	5.0	4.8	4.7

Source: Bureau of Economic Analysis, Morgan Stanley Research forecasts; *4Q average

Country Focus

Euro Area: It's the Policy, Stupid

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Key message: Politics will dominate the macro debate in Europe. Above-trend growth can only be maintained if consumer spending holds up. Here easier fiscal and monetary policy should help to offset higher inflation.

Politics and policies in the driving seat in Europe: In 1992, Bill Clinton's campaign strategist, James Carville, coined the phrase "it is the economy, stupid". Instead of the economy driving politics, it will likely be policy driving the euro area economy in 2016. There are a number of political events that will likely shape Europe in the coming year. For starters, Europe will be completing a series of national elections in the periphery when Ireland heads to the polls in the spring. If the elections in Greece and Portugal are anything to go by, incumbents could be ousted in Spain and Ireland. In addition, Europe needs to deal with an unprecedented refugee crisis at the national and the Union level as well as a serious terror threat – for which France has invoked the mutual defence clause enshrined in Article 42.7 of the EU Treaty. Finally, in the coming months the UK aims to renegotiate its position in the EU and will likely hold a referendum, whose outcome is a very close call, in 2016.

Towards more monetary and fiscal policy easing: The upshot of these political events is likely to be a fiscal policy stance that swings from austerity towards stimulus and a monetary policy remaining ready to act even after adding to the existing accommodation in early December. Against a backdrop of a more accommodative policy mix, we expect euro area GDP to still expand at an above-trend rate of 1.8%Y in 2016. Already in 2015, the euro area economy has proven to be rather resilient against external factors such as slower EM growth, a stronger euro and financial market volatility. As a result, average GDP growth for 2015 will likely come in at a higher than projected 1.5%Y. Despite the small reduction in our 2016 forecast from 1.9%Y to 1.8%Y, we remain a shade above the consensus of 1.7%Y. For 2017, our forecast is unchanged.

Eyes on consumers, who might be in for testing times: In 2015, the consumer was the backbone of growth in the euro area, while net exports and investment spending proved to be more fickle. In the year ahead, we expect both foreign demand and corporate spending to improve. We view these components as the icing on the cake. For our growth forecast to become true, we need consumer spending to hold up. Given the political uncertainties mentioned above as well as the likely increase in inflation in the course of the year, which will likely dent real disposable income growth, consumers will be more challenged than in 2015 when they benefitted from a sharp fall in energy prices, continued job creation and faster wage growth. Contrary to their US counterparts, euro area consumers will not have to worry about rising interest rates though. On balance, we expect consumer spending to expand at a broadly unchanged rate of 1.6%Y in 2016.

Headline inflation slowly moving higher: After lower oil prices and a stronger EUR have been pulling headline inflation lower again recently, base effects should start to push it materially higher in the near term before moving sideways and probably even a little lower again over the spring. Hence, it might be more instructive to look through the near-term gyrations in headline inflation and focus on core inflation instead, which we expect to move higher in gradual fashion. Despite the headwinds for headline inflation this past year, HICP inflation has likely troughed. Looking ahead, a small rise in oil prices implied by the futures, an ongoing economic recovery and a renewed weakening of the euro should push headline inflation back towards the ECB's inflation objective of below but close to 2%Y by late 2016. A large part of this turnaround will likely be down to a big swing in energy prices.

ECB to cut the depo rate and add to its QE programme: On balance, we believe that the ECB will lower its deposit rate by 10bp at the December meeting, increase the pace of monthly purchases by €15 billion to €75 billion from January 2016, and extend the duration of the purchase programme by six months to March 2017. Taken together, the latter two measures would add about €585 billion to the size of the ECB's balance sheet. After this further policy easing, we expect the ECB to maintain an easing bias for a while. But in the end, we see it keeping policy unchanged over the forecast horizon.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	0.9	1.5	1.8	1.8
Private consumption	0.9	1.8	1.6	1.6
Government consumption	0.8	1.2	0.8	0.8
Gross fixed investment	1.3	2.1	3.0	3.3
Contribution to GDP (pp)				
Final domestic demand	0.9	1.6	1.6	1.7
Net exports	0.1	0.1	0.2	0.3
Inventories	-0.1	-0.3	-0.1	-0.2
Unemp. rate (% labour force)	11.6	11.1	11.0	10.7
Current account (% GDP)	2.5	3.0	2.6	2.5
HICP (%Y)	0.4	0.1	1.3	1.8
Policy rate (eop, %)	0.05	0.05	0.05	0.05
Genl. govt. balance (% GDP)	-2.6	-2.5	-2.2	-2.0
Genl. govt. debt (% GDP)	92.1	91.8	90.7	89.4

Source: Eurostat, ECB, Morgan Stanley Research forecasts

Country Focus

Japan: Better Economy Triggers Late 2016 BoJ Regime Change

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Key message: In autumn 2016, we foresee a potential BoJ regime change towards a different easing framework, such as bond yield targeting.

Economy: Real GDP growth was slightly negative in 3Q15, but mostly due to inventory correction. Consumption and housing were unexpectedly firm, while capex remained weak. Over the next two quarters, a modest rebound is likely, due to recovering growth in China and Asia (54% of exports), and a pick-up of the diffusion of low oil prices into consumption. Tourism continues to surge – the pace so far this year is JPY 3.5 trillion annualised, compared to about JPY 2.0 trillion at this stage last year.

For 2016, we see improved growth, but only to 1.2%Y (downwardly revised from 1.6%Y): The improvement is based on rebounds in consumption and residential investment and a modest rise in business investment. We expect the key drivers to be continued low oil prices, better conditions in major export markets and a modest capex rebound due to both growth policies and substitution of capital for increasingly scarce labour. In addition, more growth will likely come from the impact of a supplementary budget (see below) and rush demand ahead of the April 2017 consumption tax hike.

For 2017, we see a reversion to slowdown, at 0.8%Y growth (no change): The consumption tax hike will reduce disposable income, in addition to the payback for extra demand growth in 2016. Nevertheless, we do expect the labour shortage to raise wages enough to keep consumption going, and to spur more labour substitution investment.

Prices: Traditional price measures remain sluggish for now, but we expect them to re-accelerate. We see Japan core CPI (ex fresh food, ex VAT) at 0.0%Y in 2015, rising to 0.9%Y in 2016 and 1.6%Y in 2017. This acceleration is based on: i) An end to the downward impact of oil prices; and ii) Wages acceleration due to the demographically induced labour shortage. Already, the signs of this acceleration are evident: For example, the Japan new core CPI (which excludes both fresh food and energy) has accelerated from 0.6%Y at the trough after the 2014 consumption tax hike to 1.2%Y now.

Policy: Japan differs from most other industrial countries in one crucial aspect – Japan has coordinated government policy. Hence, the entire burden of support for the economy does not fall on monetary policy; indeed, at this juncture, there is scepticism in the government that extra monetary policy measures would spur growth. Rather, the focus is on a supplementary budget, likely to be formulated in November and enacted in January, valued at JPY 3-4 trillion. This amount is about the same as the tax revenue overshoot (versus budget) for the year, and thus may not impact the borrowing requirement.

Our base case sees no further BoJ easing, in light of likely fiscal moves. The BoJ may decide to select a new price index as the main policy target, in light of the disruptions that energy prices have brought to the old benchmark, the Japan core; this has gone from 1.6%Y in July 2014 to -0.1%Y in August this year, as the landed price of oil in yen has fallen from JPY 10,000/bbl to only JPY 5,600 most recently. The most likely candidate is the BoJ's new core index.

For 2016, we transform our call for tapering of quantitative easing in October 2016. Instead, we foresee a regime change towards a different easing framework, such as bond yield targeting. This would happen if PM Abe declares an end to deflation in the run-up to the Upper House election in summer 2016, or if low availability of bonds renders implementation of quantitative easing impossible.

Forecast Summary (Calendar Years)

	2014	2015E	2016E	2017E
Real GDP (%Y)	-0.1	0.5	1.2	0.8
Private consumption	-1.3	-0.6	1.3	0.7
Private capital expenditure	4.0	-0.1	2.3	4.0
Public investment	3.8	0.7	0.1	-1.8
Net exports (cont.)	0.3	0.4	0.2	0.1
Nominal GDP (%Y)	1.6	2.8	1.8	2.5
CPI (ex. fresh food)	2.6	0.6	0.9	2.6
CPI (ex. fresh food, ex. VAT)	1.1	0.0	0.9	1.6
CPI (ex. food, energy & VAT)	0.6	0.6	1.0	1.5
Current account (% GDP)	0.5	3.3	3.3	3.1
Unemployment rate (%, e.o.p)	3.5	3.4	3.1	3.1
Policy rate (eop, %)	0.1	0.1	0.1	0.1
For reference:				
Fiscal year real GDP (%Y)	-0.9	0.8	1.7	0.2

Source: Cabinet Office, Morgan Stanley Research forecasts

UK: A Policy Slowdown

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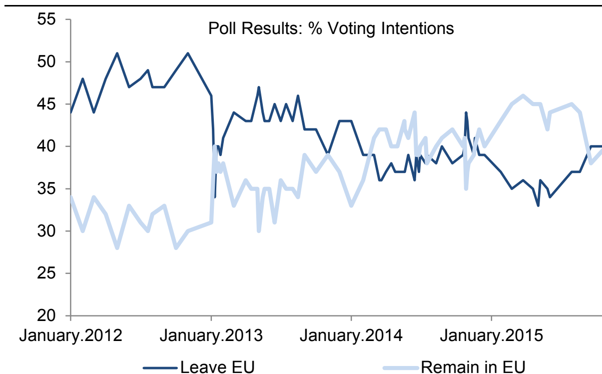
Key message: We expect a mid-year growth trough, driven by austerity, rate lift-off and Brexit uncertainty, before a vote to stay triggers a 4Q rebound.

Tighter policy and Brexit uncertainty slow 2016 growth: With the economy near full employment, rising real wages and growth running above trend, the UK recovery looks secure. Consensus forecasts growth continuing at current levels. By contrast, we expect a 2016 slowdown as the impact of tighter fiscal policy and the first rate hike starts to bite. We think the slowdown will be amplified by the impact of the UK's in/out referendum on EU membership, which we pencil in for September 2016. We expect it to be a close call, and that the significant risk of a Brexit will hit growth and drive market volatility (see *UK Economics & Strategy | EU Referendum: Insight: A Close Call*, November 4, 2015).

Exiting lowflation, but holding below target: As the 2H14 fall in oil prices drops out of the annual comparison, we see inflation rising sharply to 1%Y in 1Q16. However, we lower our forecast slightly to reflect expected falls in power and gas prices – a lagged impact of lower oil prices – which keeps inflation well below the 2%Y target through the forecast horizon. We think the UK reflation story of a tighter labour market driving rising pay and domestic inflation is working – but it will be a slow burn. Ample supply from migration and the rising retirement age, recovering productivity and growth next year running below trend will likely mute domestic reflation, keeping pay growth below the pre-crisis 4%Y level.

May 2016 lift-off: We move back the expected date of the first hike from February to May, reflecting our weaker inflation forecast. We expect the timing of the first hike to be data-dependent, and in particular driven by the evolution of pay and inflation data.

Brexit Will Be a Close Call, We Think



Source: Yougov, Morgan Stanley Research

We expect additional external members, including Weale and Forbes, to join the vote for a hike first. However, a majority for a hike will depend on the behaviour of the core group of bank officials, including Governor Carney. On balance, with the economy close to full employment, we see a bias to act if the data don't prevent it, and expect a first hike in May, once headline inflation has pushed above 1%Y.

Hike in May and go away? Directionally, with slower growth and subdued inflation, we expect a gradual pace of tightening – running at just two 25bp hikes per annum over our forecast period. But we see a specific 2016 risk that the mid-year growth trough may postpone the second hike to 2017. Still, on balance, with Brexit risk removed and the global recovery under way, we would expect a second hike in November.

Bear and bull: In our bear case, as well as weaker global trade growth and a sharp tightening in financial conditions, the UK votes to exit the EU. In this case, we would expect a sharp slowdown in growth, reflecting economic uncertainty over the future of the trading relationship with the EU, as well as political risks over a possible acceleration in the succession to PM Cameron and a second Scottish independence referendum. Inflation would rise to 2%Y on a weaker GBP, but the MPC would stay on hold, given the weak economy. In our bull case, with stronger global trade, looser financial conditions and a clear victory for remaining in the EU, the economy continues to expand at above-trend rates, leading to stronger inflation and a faster pace of rate hikes in 2017.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	2.9	2.4	2.0	2.3
Private consumption	2.6	2.9	1.9	1.9
Government consumption	1.9	1.4	0.1	0.0
Gross fixed investment	7.5	3.6	3.0	3.0
Contribution to GDP (pp)				
Final domestic demand	3.3	2.8	1.7	1.7
Net exports	-0.4	0.2	0.2	0.4
Inventories	0.0	-0.6	0.0	0.2
Unemp. rate (% labour force)	6.2	5.4	5.2	5.0
Current account (% GDP)	-5.1	-4.7	-3.7	-3.0
CPI (%Y)	1.5	0.0	1.3	1.5
Policy rate (eop, %)	0.50	0.50	1.00	1.50
Genl. govt. balance (% GDP)	-5.1	-4.1	-2.6	-1.9
Genl. govt. debt (% GDP)	87.3	86.6	86.7	85.7

Source: ONS, BoE, Morgan Stanley Research forecasts

Country Focus

Australia: Housing Joins Resources Unwind, but Hope on Fiscal?

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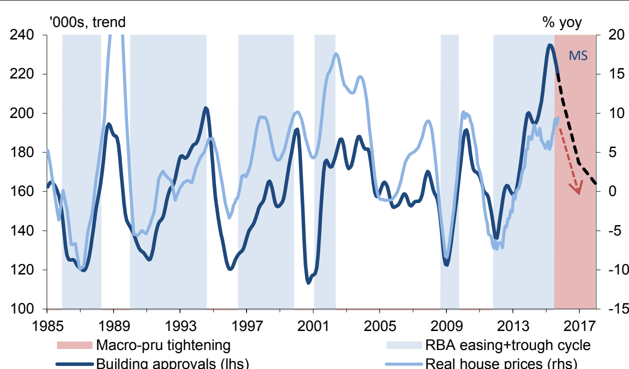
Finding post-housing growth: A policy-induced housing boom led Australia's transition away from the resources capex unwind, but the macroprudential tightening cycle looks to be reining in conditions, just as we forecast in the *Autumn Macro Outlook*. And with the RBA refraining from another rate cut in November, we reiterate our view that the cooling-off period for housing activity will take overall growth momentum lower, lift recession risks and amplify the need for easier fiscal policy (see *Australia's Housing Boom…Now Subject to Finance*, September 21, 2015). We retain our forecast 50bp of rate cuts over 1H16 as the RBA works to soft-land the housing market.

Key changes: Our growth forecasts have only seen minor MTM adjustments and we remain bottom-of-consensus at GDP growth of 1.9%Y for 2016 and 2.4%Y for 2017. We are monitoring agriculture through this El Niño event, with risk of around -0.3pp to 2016 GDP in a repeat of 2006/07.

New leadership, new hope: PM Turnbull's assumption of the federal leadership has created a sense of optimism, which may help to mitigate some of the initial impact of the housing adjustment. However, the honeymoon phase will quickly give way to contentious policy debate, with the government promising to take a substantial tax reform package to an election in Sep/Oct 2016. We also expect an 'innovation package' to be launched in December, but the more important question for our macro forecasts is whether this is paired with a public infrastructure stimulus. We see a sizeable programme (>A$40 billion or 2.5% of GDP) as necessary to mitigate the resources capex drag (-1.6pp to GDP in 2016) and a slowing housing sector, and have previously noted Australia's scope under a AAA credit rating of up to 5% of GDP. Confirmation will likely come with a 'mini-Budget', most likely in December.

The Macro-Prudential Tightening Cycle Has Begun



Source: ABS, RBA, Morgan Stanley Research forecasts

Key message: Australia will see a housing slowdown join the ongoing resources capex unwind over 2016, driving our bottom-of-consensus 1.9%Y GDP forecast. While risks are elevated, a key upside catalyst would be a sizeable infrastructure stimulus alongside flagged tax reform from the new Turnbull government. More clarity will come in a December 2015 'mini-Budget'.

Labour market still weak: Headline unemployment has been more sticky than we expected at around 6.25%, but this reflects an ongoing fall in net migration and population growth. Indeed, we lower our population growth forecast to 1.3% per annum, which leaves break-even jobs growth at just 11k/mth and would weigh on demand growth more broadly. As a result, we have trimmed our peak unemployment rate forecast to 6.6% (end-2016). However, with just 0.7%Y demand growth next year, we think that the risks to jobs and wages remain to the downside.

Lowflation club: We have also cut our underlying inflation forecast by 0.2-0.3pp to 2.0%Y in 2016 and 2.1%Y in 2017, with the year-end rate likely to dip below the RBA's 2-3%Y flexible target over summer. Domestic private inflation has fallen even further with increased supermarket competition, while AUD pass-through has been slower than we thought.

RBA optimistic, but likely forced to cut in 1H16: The bank continues to forecast a strengthening economy over 2016-17 and Governor Stevens has sounded circumspect on the net benefits of further easing. Despite this, we think the housing slowdown and tightening financial conditions will see the RBA need to cut rates 50bp over 1H16 to a trough rate of 1.50%.

Bottom of consensus, but risks still balanced: We see an even balance of risks from our below-consensus forecast. Our bull case hinges on a public infrastructure stimulus. The bear case sees the housing unwind drag Australia into recession.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	2.7	2.0	1.9	2.4
Private consumption	2.4	2.4	1.4	1.8
Government consumption	2.0	3.1	2.5	2.7
Gross fixed investment	-2.1	-2.7	-1.8	0.7
Contribution to GDP (pp)				
Domestic demand	1.1	1.2	0.7	1.7
Net exports	1.6	0.8	1.2	0.7
Inventories	0.0	0.1	0.0	0.0
Unemp. rate (% labour force)	6.1	6.2	6.5	6.4
Current account (% GDP)	-3.0	-4.2	-4.1	-3.8
Headline CPI (%Y)	2.5	1.5	2.2	2.3
Policy rate (eop, %)	2.50	2.00	1.50	1.50
AUD/USD (eop)	0.82	0.69	0.62	0.66
Fiscal deficit (% GDP)	-2.2	-2.6	-2.4	-1.9
Net govt. debt (% GDP)	13.3	16.3	18.5	19.4

Source: ABS, RBA, Commonwealth Treasury, Morgan Stanley Research forecasts

Country Focus

China: Gradual Slowdown, Persistent Disinflation

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Overall GDP growth to remain in a downward channel, marked by mini-cycles: China's economy is facing the headwinds posed by weaker demographics, high levels of debt and disinflationary pressures. We believe that policy-makers are still adopting a gradual approach in dealing with the issue of excess capacity due to concerns over social stability. This is therefore keeping the disinflationary pressures and the headwinds to growth alive.

We revise our GDP growth forecast down to 6.7%Y in 2016 and 6.6%Y in 2017: Over the past five months, as growth had reached the bottom end of the channel, policy-makers have accelerated easing efforts in both fiscal and monetary policy. These actions are likely to stabilise growth in the near term, but the effects of the mini-stimulus should wear off due to the structural headwinds. More specifically, we expect investment growth to decelerate more than consumption amid the excess capacity elimination and structurally weaker export growth. While we expect policy-makers to lift infrastructure spending to support growth, this is unlikely to offset the weakness in private investment in manufacturing and real estate sectors, especially given the ongoing unwinding of property inventory. Consumption growth faces downward pressures, given the moderation in real income growth, but will likely be supported somewhat thanks to the still stable labour market conditions, lower real mortgage rates due to monetary easing and fiscal transfers to households.

Managing disinflationary pressures remains our key macro concern for China: We expect disinflationary pressures to persist over our forecast horizon. We expect PPI, which has already been in deflation for 44 months, to remain in deflationary territory as policy-makers are opting for a very gradual pace of adjustment in shutting excess capacity. Disinflationary pressures are transmitting to households in the form of weaker wage growth. We expect CPI inflation to moderate further to around 1.1%Y in 2016 and the GDP deflator to remain in deflation in 2016.

Defensive easing in both monetary and fiscal policy: We expect policy-makers to continue to take up defensive easing. The stable labour market and need for growth rebalancing mean an aggressive stimulus is unlikely. **On the monetary front, we expect two more interest rate cuts in our base case.** To keep liquidity growth broadly stable, the central bank will likely also take up further RRR cuts.

Key message: With policy-makers still adopting an approach of gradual adjustment, we expect disinflationary pressures to persist and GDP growth to remain in a downward channel, marked by mini-cycles. We expect policy-makers to continue to take up defensive easing in monetary and fiscal policy.

We believe that the PBOC will use more relending tools to manage liquidity and improve the interest rate transmission mechanism. **On the fiscal front,** policy-makers will likely keep fiscal policy relatively expansionary. An extension of the local debt swap in 2016-17 and room for tax cuts/faster expenditure to cushion the impact of cutting excess capacity will likely be among the options under consideration. The central government should continue to take the lead in fiscal easing, with special financial bond issuance and/or special Treasury bond issuance a potential option.

A largely stable RMB NEER in 2016: Following the SDR decision, we maintain our view that the PBOC is likely to manage a largely stable trade-weighted RMB and allow more flexibility in the currency. Reflecting our FX team's view of a continued appreciation in the trade-weighed USD, **we expect USD/CNY to depreciate to 6.80 at end-2016 and 7.07 at end-2017.**

Risks to our GDP growth forecast tilted to the downside: In our bear case, we foresee a notable growth slowdown dragged by further deceleration in investment growth, and expect GDP growth to slip to 6.0%Y in 2016. We would also expect the PBOC to be more aggressive, with another four rate cuts (100bp). In the bull case, the filter-through of policy easing supports property sectors and a pick-up in infrastructure investment growth, stabilising growth at around 7.0%Y in 2016, and we expect the PBOC to be on hold.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	7.3	7.0	6.7	6.6
Consumption	7.2	7.5	7.3	7.0
GCF	7.2	5.6	5.1	5.0
Contribution to GDP (pp)				
Consumption	3.8	3.9	3.8	3.7
GCF	3.4	2.7	2.4	2.3
Net exports	0.1	0.4	0.5	0.5
Current account (% of GDP)	2.1	3.3	3.7	4.1
CPI (%Y)	2.0	1.5	1.1	1.1
Policy rate (eop)	5.60	4.35	3.85	3.85
USD/CNY (eop)	6.21	6.43	6.80	7.07
Fiscal deficit (% of GDP)	-2.1	-3.1	-3.5	-4.0

Source: NBS, CEIC, Morgan Stanley Research forecasts

Country Focus

India: Adjustment Phase Over, Gradual Recovery in Growth Ahead

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Key message: We expect a gradual recovery in growth as the macro adjustment process is complete. We expect a domestic demand-led recovery, led by capex (mainly public capex) and foreign investment, followed by a rise in discretionary consumption.

India remains one of the few bright spots in Asia: India is one of the few EM economies which has completed its macro adjustment phase and also one of the few Asian economies which is not facing issues of a high level of debt and unfavourable demographics. We expect the gradual recovery in growth to continue to pick up pace and remain above AXJ and EM growth in 2016 and 2017. We see the recovery being domestic demand-led, supported by a pick-up in capex (mainly public) and discretionary consumption.

Adjustment period over, gradual acceleration in growth expected: We reiterate our view of a gradual recovery in growth going ahead and keep our real GDP growth estimates unchanged from the *Autumn Macro Outlook*. We are building in a gradual acceleration in growth from 7.4%Y in 2015 to 7.9%Y in 2016 and 8.0%Y in 2017. We expect the growth recovery to be domestic demand-led, driven by a capex revival (supported by public capex and foreign private investment), followed by discretionary spending.

Recovery to be led by capex, mainly public… We expect the recovery in growth to be driven by a pick-up in the capex cycle, in particular public capex. We are already seeing initial signs of improvement here, due to the government's policy focus on increasing capex directly through the budget and SOEs. The government has been taking policy action in order to improve the investment climate by increasing the ease of doing business. We expect the private capex recovery to be relatively slow due to weakness in external demand and PPI deflation affecting corporate sector profitability

…and foreign private investment: We see additional support for the capex cycle recovery from private foreign investment. Gross FDI inflows are now significant and are running at US$48 billion on a 12-month trailing basis. The government has focused on policy measures to attract more foreign investment inflows by raising foreign investment caps in certain sectors and quickening the pace of approvals.

Discretionary consumption growth to pick up pace: We expect private consumption to pick up pace once the capex cycle and employment creation gather momentum. We see discretionary consumption picking up with the rise in real disposable income due to a moderation in inflation and a steady improvement in organised sector jobs growth. Rural consumption growth is likely to remain weak due to the poor summer crop outlook and low rural wage growth.

Government fiscal policy – no longer a drag on growth: Over the last three years, fiscal consolidation that was much needed from a macro adjustment standpoint has been a drag on growth due to the severe compression in government spending. Going forward, we expect fiscal policy to become supportive of domestic demand recovery with a delay in fiscal consolidation due to implementation of pay commission recommendations. Following the near-term delay in fiscal consolidation due to the one-time hike in wages, we expect the government to resume a gradual pace of deficit reduction.

Inflation to remain on moderation path – we expect another 25-50bp of policy rate cuts until March 2016: We expect CPI inflation to remain on a moderation path, reaching 4.8%Y by QE-Mar 16 and 4.75%Y by QE-Mar 17 versus 5.3%Y in QE-Mar 15. We expect the moderation to continue due to supportive factors such as lower global commodity prices, low rural wage growth, moderate government expenditure and a deceleration in property prices. We don't expect the increase in government expenditure due to pay commission recommendations to create inflationary pressures as other inflation drivers remain supportive. Given our inflation expectations and the RBI target of real rates of 1.5-2%, we expect 25-50bp of rate cuts until QE-Mar 16, implying cumulative rate cuts of 150-175bp since January 2015.

Risks to growth: We see risk to our forecasts from: i) The pace of policy actions to revive the productivity dynamic; and ii) The strength of the external demand recovery and global capital markets.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y) (old base)*	5.3	5.9	6.4	6.5
Real GDP (%Y) (new base)	7.1	7.4	7.9	8.0
Consumption	6.2	6.3	7.2	7.4
GCF	2.4	5.9	7.2	8.8
Exports (%Y, US$ terms)	3.1	-17.1	4.9	12.1
Imports (%Y, US$ terms)	-2.0	-12.6	7.3	13.9
Trade balance (US$ bn)	-143	-140	-157	-184
Current account (% of GDP)	-1.4	-1.1	-1.5	-1.8
CPI (%Y)	6.7	4.8	4.9	4.5
Policy rate (eop)	8.00	6.75	6.50	6.75
Fiscal deficit (% of GDP)	-6.4	-5.8	-6.2	-6.0

Source: CSO, RBI, Morgan Stanley Research forecasts; *Real GDP is at factor cost

Korea: Lacklustre Growth in 2016

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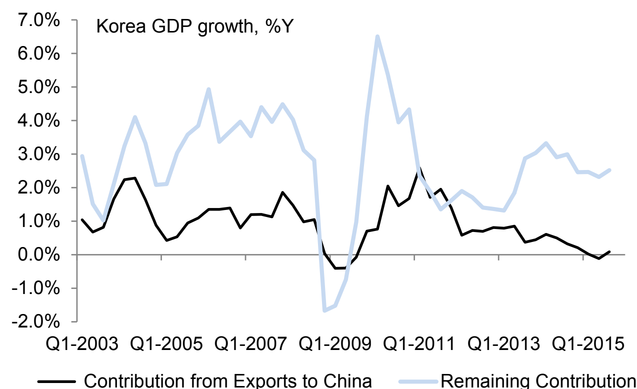
In *Korea Economic Autumn Outlook – Low Growth for Longer*, September 1, 2015, we pointed out that Korea suffers from structural issues that may keep export growth low for longer, which would in turn test the strength of the domestic recovery. We marginally lift Korea's 2015 GDP growth forecast to reflect the upward surprise in 3Q, although we continue to see a weak net export contribution. We keep our growth forecasts unchanged at 2.2%Y for 2016 and 2.9%Y for 2017 – persistently below potential growth.

Sluggish exports thesis remains intact: The reasons we presented for a structurally weaker export outlook still hold, in our view. Korea's export dependency on China will continue to be a net negative, notwithstanding the slight stabilisation our China team has pencilled in over the short term. Indeed, China's GDP growth stands at a lower 6.7%Y in 2016 and 6.6%Y in 2017. RMB depreciation throughout the forecast horizon will also be a lingering concern, in our view.

The negative structural reasons can be summarised as follows: i) Slower investment-led growth in China means less demand for Korea's exports; ii) 'Made in 2025' reforms mean China's dependence on imports should reduce further; and iii) Korean exporters will continue to feel the heat of Chinese competition, we think. Meanwhile, we no longer think JPY represents a competitiveness threat, as our FX forecasts have pencilled in some JPY strengthening over the forecast horizon. Instead, the weaker EUR, on the back of intensified ECB QE policy, will likely be more of a problem for demand for Korean exports.

Some Stabilisation, but China Growth Still on a Structural Downturn



Source: CEIC, Morgan Stanley Research

Key message: Our outlook remains largely unchanged. Structural issues weigh on export growth for longer, which in turn could have negative ramifications on the domestic economic recovery. We still expect one more rate cut of 25bp in 1Q16.

Domestic demand the main source of growth in 2016: Korea's domestic demand bounced back from the MERS episode in 3Q, aided by government initiatives. We think that domestic demand will continue to be the main driver of growth in 2016. To be clear, we still see both private consumption and fixed investment (in particular machinery and equipment investment) growth remaining subdued in 2016, as sluggish exports spill over via lower business and consumer sentiment. We expect government consumption to be stronger in 2016 than 2015, which would help to offset some of the weakness we expect to see in domestic demand.

Safe from capital outflows: One bright spot of the economy is that the property market recovery trend should be on track in 2016, lifting construction investment with it. Since Korea saw little speculative inflows into the property market in the aftermath of global QE, the downside impact from capital outflows should be lower than for other countries in the region. Similarly, destabilising effects of capital outflows from the stock market should also be relatively limited compared to other countries. In terms of capital outflows, Korea will look like an outperformer among its EM peers as the Fed hiking cycle proceeds: Ultimately, a record-high current account surplus means the economy is able to defend such outflows.

One more rate cut of 25bp in 1Q16: Although we expect a slight dip in core inflation in 2016 on weaker domestic demand, it is likely to stay relatively resilient above 2%Y. Since we see growth disappointing next year, we continue to expect the BoK to cut rates once again in 1Q16. Meanwhile, we see more KRW depreciation on the cards.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	3.3	2.4	2.2	2.9
Private consumption	1.8	1.8	1.6	2.2
Government consumption	2.8	3.4	4.0	4.0
Facility investment	5.8	5.5	1.2	5.0
Construction investment	1.0	2.4	2.5	3.0
Exports	2.8	0.2	-0.2	2.1
Imports	2.1	1.6	0.1	1.6
Contribution to GDP (pp)				
Final domestic demand	2.8	3.0	2.3	2.5
Net exports	0.5	-0.6	-0.2	0.4
Inventories	0.0	0.4	0.2	-0.3
Current account (% GDP)	6.3	9.2	7.5	7.1
CPI (%Y)	1.3	0.7	1.5	2.0
Policy rate (eop, %)	2.00	1.50	1.25	1.25

Source: CEIC, Morgan Stanley Research forecasts

Country Focus

Indonesia: What Kind of Growth Recovery Will We See?

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Key message: A growth floor appears to have been established with 3Q15 data, and so our focus turns to the growth drivers for 2016 and the type of growth pick-up we will see. We expect a mild growth recovery, driven by non-commodity exports and government capex spend. However, an acceleration in structural reforms is required to help Indonesia break out from the lower growth channel.

Tweaking our growth forecasts: We are revising upwards our GDP growth forecasts from 4.6%Y to 4.7%Y in 2015, 4.8%Y to 5.0% in 2016 and 5.1%Y to 5.2% in 2017. The mild upward revision takes into account a growth trough that has come in earlier than expected amid some signs of stabilisation in 3Q15, as well as the continued mild growth recovery that we expect thereafter.

The better part of this year had been about establishing the floor to growth: Amid the downside surprise in growth this year, investors have asked if growth could continue to edge lower and if Indonesia could see a growth hard landing. Indeed, it is only if a growth floor is established that one can get more comfortable about macro prospects in Indonesia. Our view is that, barring a large negative external shock, Indonesia is unlikely to see a growth hard landing to 3%Y territory due to a few factors. First, Indonesia does not have policy or leverage excesses, which would have necessitated a sharp policy tightening and compounded the growth slowdown. Second, macro adjustment has already been made since 2013 via higher interest rates and currency depreciation. This has gotten the current account deficit to a more sustainable equilibrium. As a result, the likelihood of a disorderly tightening in liquidity conditions leading to an abrupt brake on domestic demand has been mitigated. Third, the manufacturing sector has not been hollowed out, thus helping to provide a cushion to growth even as commodity prices fall.

Meanwhile, Indonesia's growth trough of 4.1%Y in 2Q09 amid the Global Financial Crisis when commodity prices were soft and when the global economy did not grow and its 2002/03 GDP growth of 4.5%Y/4.8%Y, which was achieved without any commodity price support, also provide hints on how low growth can go in various circumstances. At this point, 3Q15 data, which see GDP growth stabilising at 4.7%Y, appear to corroborate the view that a hard landing looks unlikely.

If growth has stabilised, what will drive the growth recovery going forward? How strong is this growth recovery likely to be? With the floor to growth established, the focus then turns to what the drivers of growth are likely to be and how strong the growth recovery will look. We believe the following factors are likely to provide support for a mild growth recovery in 2016/17: i) A gradual pick-up in global growth will provide support for non-commodity exports. Moreover, the adjustment in IDR REER which has now weakened close to 2003 pre-commodity supercycle levels would also help to bolster export price competitiveness, in our view; and ii) Autonomous domestic demand momentum is also likely to come from government capex spending. Indeed, monthly indicators suggest that government capex spend has already picked up from low levels in 1H15. In addition, to the extent that investment efficiency has not been eroded, a pick-up in government capex spending should generate favourable multiplier effects.

To be sure, the commodity price fall means that Indonesia has ground down from a peak of 6.2%Y growth to a lower growth channel. The negative terms of trade will likely remain a drag and the mild growth recovery we envisage for 2016/17 is unlikely to see it break out from this lower growth channel. In order to go back to previous growth levels, structural reforms to improve competitiveness in non-commodities (via infrastructure, attracting more FDI, keeping internal/external prices competitive) will need to be accelerated, in our view.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	5.0	4.7	5.0	5.2
Private consumption (%Y)	5.3	4.8	5.1	5.3
Public consumption (%Y)	2.0	4.1	4.3	4.5
Gross capital formation	4.4	2.4	4.4	5.5
Gross fixed capital formation (%Y)	4.1	4.0	4.6	5.0
Exports (%Y)	1.0	-0.2	2.4	4.0
Imports (%Y)	2.2	-4.6	1.2	4.0
Domestic demand (%Y)	4.7	3.9	4.8	5.3
Current account (% of GDP)	-3.1	-1.9	-2.2	-2.2
CPI (%Y)	6.4	6.4	4.9	5.0
Policy rate (eop)*	7.75	7.50	7.00	7.00
Fiscal deficit (% of GDP	-2.2	-2.4	-2.4	-2.2

Source: CEIC, Morgan Stanley Research forecasts; *We think that BI has scope to cut the policy rate by 50-75bp. The figures in the table here show a 50bp cut.

Country Focus

Russia: Still in Adjustment Mode

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Key message: We expect tight fiscal policy and downbeat business sentiment to keep growth in negative territory at -0.8%Y in 2016. Weak domestic demand should secure an inflation slowdown from an average 15.5%Y in 2015 to 7.8%Y in 2016 and allow the CBR to cut rates by 250bp to 8.00% by end-2016.

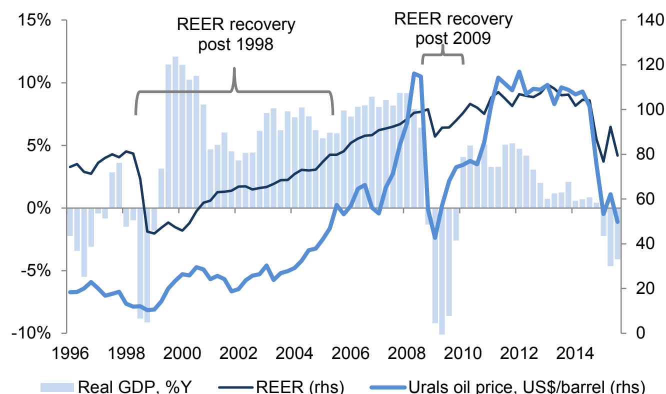
We revise our growth forecasts up to -3.9%Y from -4.2%Y in 2015 and to -0.8%Y from -1.3%Y in 2016: In particular, the 3Q preliminary GDP estimate came at -4.1%Y, stronger than expected. It was down only 0.2%Q sa, compared to -2.0%Q sa in 2Q15. We see support from government procurement orders and potentially from inventories, but this also points to **earlier stabilisation.** Nonetheless, while the Russian economy has moved away from crisis-management mode in early 2015, it is **still in the process of adjustment to lower oil prices.** Our Urals oil assumption, based on the forward curve, falls only marginally to average US$50/barrel in 2016 and US$55 in 2017 from US$55 and US$60, previously.

REER depreciation – key tool of adjustment for external shock: A 20% REER RUB depreciation has been effective in external rebalancing, despite the 45% decline in the oil price. Nominal imports are set to decline by 38%Y this year and we expect the **current account to improve to US$69 billion or 5.6% of GDP** from US$58.4 billion or 3.1% of GDP in 2014.

Fiscal rebalancing is still a challenge and requires more efforts, we argue. The weaker RUB, double-digit inflation and tight social spending limit deterioration of the budget. Still, oil and gas budget revenues are set to decline by over 20%Y or 2.3% of GDP in 2015. We expect a 2015 general budget deficit at 3.7% of GDP compared to a 1.2% deficit in 2014. In 2016, despite parliamentary elections in September, we think that the government will manage to narrow the budget deficit further to 3.3% of GDP, at the expense of growth.

Tight budget to weigh on consumer growth: We expect household consumption to fall by 2.8%Y in 2016 as public sector workers' wages are set to be frozen for another year and pensions are indexed by less than 3% on average (below inflation). We also expect a belated labour market adjustment as the unemployment rate starts to rise. We also see investment contraction protracted into 2016 (down 1.8%Y), overshadowed by weak domestic demand, economic uncertainty and lack of financing.

REER Allowed to Plunge Together with Oil Prices



Source: Rosstat, CBR, Morgan Stanley Research

Monetary policy: Back to easing mode: We expect inflation to slow down from an average 15.5%Y in 2015 to 7.8%Y in 2016, helped by tight fiscal policy and weak domestic demand. This will allow the CBR to cut rates by 250bp to 8.00% by end-2016. We also see the CBR resuming FX interventions in 2016 of a similar scale to May-July 2015.

Bull and bear: We see **upside risks** to our forecast in case of a higher oil price, as **oil prices above US$60/barrel could push growth into positive territory** already in 2016. Earlier resolution of the Ukraine crisis and sanctions withdrawal would improve access to long-term lending, while **structural reforms** can improve business sentiment, investment and medium-term growth prospects, which we currently see restricted to 1-1.5%. In contrast, we see **downside risks** coming from a fall in oil prices. With weaker FX, the CBR would keep rates higher for longer and we would expect risks to emerge in the banking sector as the **quality of lending** deteriorates. Also, **a growing role for the state** in the economy, lack of reforms and uncertainty related to Russian involvement in **Syria and Ukraine conflicts** would keep business sentiment downbeat and investment stagnant.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	0.6	-3.9	-0.8	1.7
Private consumption	1.3	-10.0	-2.8	2.1
Government consumption	-0.1	-2.5	-1.5	0.0
Gross fixed investment	-2.0	-8.7	-1.8	2.9
Exports	-0.1	2.0	0.4	1.1
Imports	-7.9	-25.5	-1.0	3.2
Unemp. rate (% labour force)	5.3	5.9	6.5	6.1
Current account (% GDP)	3.1	5.6	4.1	4.0
CPI (%Y)	7.8	15.5	7.8	6.4
Policy rate (eop, %)	17.0	10.5	8.0	6.5
Genl. govt. balance (% GDP)	-1.2	-3.7	-3.3	-2.7
Genl. govt. debt (% GDP)	10.5	11.5	12.7	14.0

Source: Rosstat, CBR, Haver Analytics, Morgan Stanley Research forecasts

Country Focus

Turkey: Back to Basics or Business as Usual?

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Investors are cautious this time: Following four elections within the last two years, there will not be any election under normal circumstances until 2019. This is indeed a good opportunity for the ruling AKP to focus on economic problems, implement long-awaited structural reforms, decrease institutional independence concerns and progress on the Kurdish peace process. Regarding these issues, we got mixed signals from AKP in the first three weeks following the election results. However, we believe that the first three months following the establishment of a new AKP government will give strong clues about the direction of these issues. At this stage, we can only say that financial markets did not give the benefit of doubt to AKP this time, as witnessed by relatively stable local markets in November despite market-friendly election results.

GDP growth likely to accelerate slightly in 2016: Following 3.1%Y in 1H15, we expect GDP growth to fall sharply to 2.2%Y in 2H15 as leading indicators are showing a slowdown in consumption and production figures with no major change in the external balance. However, we expect economic growth to reach its new normal at 3.0%Y in 2016 as it should get more support from rising domestic consumption on the back of planned fiscal easing in line with election promises.

But election promises will also take their toll on inflation and budget performance: Despite a relatively stable currency and oil price assumptions, we expect average CPI for 2016 to rise to 7.8%Y from 7.6%Y in 2015. Some part of this could be explained by the lagging contribution coming from TRY depreciation, especially until the end of 1Q16. Yet, the main contribution is likely to come from the expected 30% hike in net minimum wage to TRY 1,300 (~US$450) by the beginning of 2016. With the assumptions that the government will not subsidise the real sector for the increase in labour costs and there will not be an additional hike in the minimum wage in 2H16, we expect the minimum wage increase to add 0.7pp to headline inflation in 2016.

In the last ten years, the main characteristic of the Turkish economy was to balance an external deficit with disciplined public finances. Despite four critical elections in a row in the last two years, the budget deficit/GDP was kept below 1.5%. Although the interim government previously announced a budget deficit/GDP target for 2016 at 0.7%, it is likely to be revised up slightly following the establishment of a new government. Our budget deficit forecast for the next year is 1.5%, with risks to the upside, as 1pp of GDP will likely come from additional expenditures for election promises.

Key message: From an economic perspective, 2016 is likely to be very similar to this year; we expect small increases in all main indicators: GDP, CPI, CAD/GDP and budget deficit/GDP.

CAD/GDP to fluctuate around current levels: We expect a sharp correction in the current account deficit figures in 4Q15 and CAD/GDP to decelerate further to 5.0% from 5.5% in 3Q15. We foresee a slight increase in the external deficit in 2016 as increasing domestic consumption is likely to worsen the current account deficit, while some part of this deterioration is likely to be offset by the lagging contribution coming from lower energy prices.

Gradual normalisation from the CBT: The Central Bank of Turkey (CBT) is likely to complete monetary policy normalisation in 2016. Its ultimate aim is to create a narrower and symmetrical interest rate band. Then, the CBT will be able to use a single policy rate. In this normalisation process, the CBT is likely to increase the lower band (currently 7.25%) and the main policy rate (weekly repo; 7.50%) but keep the upper band (10.75%) stable. As previously announced by the CBT, the normalisation process will start with the first Fed hike, and is likely to follow the Fed's additional moves. In line with this, we basically take our US team's forecast of 25bp hikes on a quarterly basis (except 1Q16) and expect the CBT to follow the Fed with gradual hikes of 50bp. It should be noted that 200bp of hikes in 2015 and 2016 in total does not necessarily mean a real hike of 200bp, as the current weighted average cost of funding is around 8.70%. There are four risk factors to our call: i) The pace of Fed tightening; ii) Sharp TRY depreciation or appreciation; iii) Fiscal easing and minimum wage hike creating a more inflationary environment than we forecast; and iv) Modifications to the CBT's normalisation strategy due to possible changes in central bank mandate and/or governor changes.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	2.9	2.7	3.0	2.8
Private consumption	1.4	4.0	3.1	2.8
Government consumption	4.7	4.8	3.0	3.0
Gross fixed investment	-1.3	2.9	2.0	2.9
Exports	6.8	-1.8	3.6	0.9
Imports	-0.2	-0.5	4.5	3.8
Unemp. rate (% labour force)	10.9	11.2	11.1	11.0
Current account (% GDP)	-5.7	-4.8	-5.0	-5.2
CPI (avg,%Y)	8.9	7.6	7.8	6.4
Policy rate (eop, %)	8.25	8.0	9.5	11.0
Cent. govt. balance (% GDP)	-1.4	-1.2	-1.5	-1.3
Genl. govt. debt (% GDP)	35	34	34	33

Source: CBT, Turkstat, Haver Analytics, Morgan Stanley Research forecasts

Brazil: Uncertainty Leads to Pain

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Brazil continues to face a challenging economic environment: The combination of external and domestic factors is to blame for the recessionary and inflationary environment. The fall in commodity prices, the political stalemate between congress and an administration that continues to push out a resolution to the fiscal crisis and the ongoing corruption investigation around Brazil's largest construction companies are the main drags on growth. The uncertainty around not only politics but also the future debt path has resulted in a significant increase in Brazil's risk premium, hurting growth even further than we previously anticipated.

This has led us to cut our GDP forecast from -2.4%Y to -3.2%Y in 2015 and from -1.2%Y to -3.0%Y in 2016: Given the uncertainly, we believe that the main drag on growth will continue to be investment. We expect GFCF to contract by 14.2%Y in 2015 and 11.7%Y in 2016. Although the weaker currency means industrial sector competitiveness has been restored somewhat, idle capacity at record-high levels means that investment should only materialise in late 2016, which is not enough to help growth. We believe that the only positive growth driver will be the external sector, and this is mostly due to the sharp fall in imports we expect.

The consumer struggle that started in 2015 should intensify in 2016: A weak labour market, tight monetary conditions and high inflation have hurt the consumer in 2015. We believe that not only will unemployment continue to rise, reaching 10.5% by end-2016, but this will lead to higher delinquencies. This will generate a feedback loop effect that should tighten monetary conditions even further. Real income, currently falling by 4.2%Y, should recover slightly due to lower inflation, but should remain in negative territory.

Despite the deep recession, we are revising up inflation for the next three years: Brazil's economy is highly indexed to past inflation, so past inflation shocks also influence future inflation. In addition, the continued weaker currency should have a bigger pass-through in 2016 as inventories are run down and firms try to preserve margins. Finally, the lax fiscal policy should continue to de-anchor inflation expectations, which in turn feed into higher current inflation. This inflationary path should force the central bank to resume hiking rates. We believe that the Selic rate will peak at 15.25% by end-2016 and thereafter there will be rate cuts due to not only the recession but also tighter fiscal policy.

Key message: The political uncertainty and the consequent fiscal deterioration lead to an even deeper recession, but the lax fiscal policy keeps inflation still too high.

We believe that the resolution to Brazil's political stalemate will come from the markets applying pressure on policy-makers: Currently, neither the administration nor congress seem to grasp the need to push on aggressively with the fiscal adjustment. Hence, we believe that maybe more investors will have to price in a scenario close to our base case in order to enhance the politicians' sense of urgency and at least approve the financial transaction tax that would bring the primary result close to stability in 2017, and provide some relief for Brazil's debt path.

The difference between our bull and bear case lies in the approval of important structural fiscal reforms: In our bear case, the political stalemate continues and no meaningful tax is hiked or expenditure is cut. This leads to even higher deficits and this, combined with lower growth, creates an unsustainable debt path. In such a case, probably the central bank reaches fiscal dominance – when raising rates deteriorates the fiscal path so much that the currency actually depreciates, creating more inflationary pressures. Hence, inflation drifts higher as the central bank is constrained from using rates to fight inflation.

On the other hand, in our bull case there is an improvement in the political scenario and the approval of new taxes and some more spending cuts, and congress makes an effort to approve more structural reforms, such as the pension reform. This would lead to a stronger currency, lower inflation and lower rates. A lower cost of capital in turn would serve as the driving force for a recovery in investment.

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	0.1	-3.2	-3.0	1.2
Private consumption	0.9	-3.7	-3.3	1.2
Government consumption	1.4	-1.4	0.4	0.9
Gross fixed investment	-4.5	-14.2	-11.7	0.4
Contribution to GDP (pp)				
Final domestic demand	-0.2	-5.7	-4.3	1.4
Net exports	0.1	4.0	1.9	-0.5
Inventories	0.3	-1.5	-0.6	-0.2
Current account (% GDP)	-3.9	-3.3	-1.9	-2.0
CPI (%Y)	6.3	8.9	8.2	6.0
Policy rate (eop, %)	11.75	14.25	15.25	13.25
Genl. govt. balance (% GDP)	-6.2	-10.5	-8.9	-6.3

Source: IBGE, BCB, Morgan Stanley Latam Economics forecasts

Country Focus

Mexico: Holding Steady

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Key message: Absent a pick-up in external demand, the encouraging pick-up in domestic demand may not be sustainable.

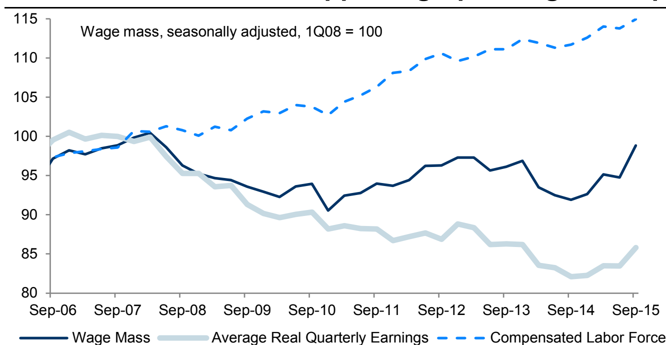
Mexico's economy has been holding steady, growing at a moderate pace over 2015: And the expansion is likely to carry on; indeed, our call for a slight improvement in 2016 (to 2.5%Y) and further acceleration in 2017 (2.9%Y) are unchanged from our Autumn Outlook. While the performance of the past three years – at just under 2.0%Y on average – has been sub-par by historical standards, this relative stability makes Mexico a standout in Latin America, a region struggling with its adjustment to a lower terms of trade, tighter financial conditions and, in some cases, deep structural headwinds (see *Latin America: Stuck in the Adjustment*, September 4, 2015). Importantly, prudent policy-making and manageable imbalances should allow Mexico to successfully navigate a challenging global environment, including the eventual start of the US tightening cycle.

Firmer domestic demand, and consumption in particular, has been instrumental in partly offsetting external headwinds from weak trade and stagnant US manufacturing, where the link to Mexico is strongest. Consumers have had a lot going for them in recent quarters – employment has been on the rise, as have real wages, the latter boosted by record-low inflation, while remittances jumped to new highs. After a year of near uninterrupted gains, our estimate of the wage mass – a broad measure of income from employment – puts it back at pre-crisis levels. Against this backdrop, consumption is on track to top 3.0%Y growth in 2015, about a point higher than in 2014. On the investment front, the bright spot has been machinery outlays, a positive trend likely to persist as it reflects better prospects for sectors such as electricity and telecom, triggered by structural reforms. Rising inflation over the course of 2016 should lead to only a mild cooling in private consumption, while low oil prices have forced a retrenchment in the public sector. Our base case for 2016 and 2017 foresees a turnaround in global trade, as well as gradual benefits from the execution of reforms, some of which are already evident in the form of lower telecom and energy costs, as well as rising investment in these sectors. Absent a pick-up in external demand, we are concerned that the encouraging growth rates in domestic demand may not be sustainable.

The risks to our outlook are to the downside, both from domestic and external factors. Falling crude output, which should knock nearly half a point off from GDP growth this year, could see further downside ahead. The drag from fiscal austerity appears to have been limited so far, but this could change in 2016 as cuts are implemented. Persistently weak global trade, which along with the stronger dollar is hurting US manufacturing, would have negative implications for Mexico's export-focused producers and associated services. A policy mistake by the Fed, as laid out in our US team's bear case, would deal a serious blow to Mexico's economy and markets. While there are no major elections until 2018, new setbacks with the rule of law and security would weigh on sentiment.

Despite low inflation and subdued growth, Banxico seems poised to lift rates in December following the Fed's first move. Record foreign holdings of local government bonds and peso weakness have led to concerns about financial stability within the central bank. Accordingly, under a 'risk management' approach, policy-makers are likely to match the Fed actions one-to-one. But this should be the case only in the early stages of the tightening cycle, after which Banxico should feel comfortable shifting its focus towards local conditions. Accordingly, we have lowered our assumption for end-2016 rates to 4.0% from 4.5%.

Firmer Labour Market Supporting Spending Pick-Up



Source: Banxico, INEGI, Morgan Stanley Latam Economics

Forecast Summary

	2014	2015E	2016E	2017E
Real GDP (%Y)	2.1	2.2	2.5	2.9
Private consumption	2.0	3.1	2.8	2.9
Government consumption	2.6	1.6	-0.6	0.7
Gross fixed investment	2.3	3.9	2.5	4.1
Contribution to GDP (pp)				
Final domestic demand	1.9	2.7	2.1	2.8
Net exports	0.3	0.9	0.2	-0.2
Inventories	-0.2	-1.4	0.2	0.2
Unemp. rate (% labour force)	4.8	4.4	4.3	4.2
Current account (% GDP)	-1.9	-2.8	-2.7	-2.5
CPI (%Y)	4.0	2.8	3.7	3.3
Policy rate (eop, %)	3.00	3.25	4.00	4.00
Fiscal balance (% GDP)	-3.2	-3.6	-3.1	-2.8
Government debt (% GDP)	40.9	45.7	48.2	49.7

Source: Banxico, INEGI, SHCP, Morgan Stanley Latam Economics forecasts

Monetary Policy Rate Forecasts

	Current	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
US	0.125	0.375	0.375	0.625	0.875	1.125	1.375	1.625	1.875	2.125
Euro Area	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50
Canada	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Norway	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
Sweden	-0.35	-0.45	-0.45	-0.45	-0.45	-0.45	-0.25	0.00	0.25	0.50
Australia	2.00	2.00	1.75	1.50	1.50	1.50	1.50	1.50	1.50	1.50
New Zealand	2.75	2.75	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
Russia	11.00	10.50	10.00	9.50	8.75	8.00	7.50	7.00	6.75	6.50
Poland	1.50	1.50	1.25	1.00	1.00	1.00	1.00	1.00	1.25	1.50
Czech Rep.	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Hungary	1.35	1.35	1.35	1.00	1.00	1.00	1.00	1.00	1.25	1.50
Romania	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25	2.50
Turkey	7.50	8.00	8.00	8.50	9.00	9.50	10.00	10.50	11.00	11.00
Israel	0.10	0.10	0.10	0.10	0.10	0.25	0.50	0.75	0.75	1.00
S. Africa	6.25	6.25	6.50	6.50	6.75	6.75	7.00	7.00	7.50	7.50
Nigeria	11.00	11.00	10.00	9.50	9.50	9.50	9.50	9.50	9.50	9.50
Ghana	26.00	26.00	26.00	26.00	26.00	26.00	24.00	23.00	23.00	23.00
Kenya	11.50	11.50	11.50	11.50	11.50	11.50	11.50	11.50	11.50	11.50
China	4.35	4.35	4.10	3.85	3.85	3.85	3.85	3.85	3.85	3.85
India	6.75	6.75	6.50	6.50	6.50	6.50	6.50	6.50	6.75	6.75
Hong Kong	0.50	0.75	0.75	1.00	1.25	1.50	1.75	2.00	2.25	2.50
S. Korea	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Taiwan	1.750	1.625	1.625	1.625	1.625	1.625	1.625	1.625	1.625	1.625
Indonesia	7.50	7.50	7.25	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Thailand	1.50	1.25	1.25	1.25	1.25	1.50	1.75	2.00	2.00	2.00
Philippines	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.00	3.00	3.00
Brazil	14.25	14.25	14.50	15.25	15.25	15.25	14.25	13.75	13.25	13.25
Mexico	3.00	3.25	3.25	3.50	3.75	4.00	4.00	4.00	4.00	4.00
Chile	3.25	3.50	3.75	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Peru	3.50	3.75	4.25	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Colombia	5.25	5.50	5.75	5.75	5.75	5.50	5.00	5.00	5.00	5.00

Source: National Central Banks, Morgan Stanley Research forecasts; Note: Japan policy rate is the interest rate on excess reserves.

GDP Forecasts: Base, Bear, Bull Scenarios

%Y	2015E	2016E			2017E			2018-20E
		Bear	Base	Bull	Bear	Base	Bull	
GLOBAL	**3.1**	**2.2**	**3.3**	**4.1**	**2.4**	**3.7**	**4.5**	**3.6**
G10	**1.8**	**0.8**	**1.8**	**2.5**	**0.4**	**1.8**	**2.5**	**1.6**
United States	2.4	0.8	1.9	2.5	0.4	1.8	2.7	1.8
Euro Area	1.5	0.9	1.8	2.7	0.6	1.8	2.3	1.4
Japan	0.5	0.2	1.2	1.8	-0.2	0.8	1.2	1.2
United Kingdom	2.4	1.5	2.0	3.0	1.0	2.3	2.9	2.1
Canada	1.0	-0.1	1.5	2.0	0.5	1.8	2.5	1.5
Norway	1.4	0.4	0.9	1.4	0.8	1.5	2.3	1.8
Sweden	3.0	1.9	2.8	3.1	1.4	2.6	3.1	2.3
Australia	2.0	0.5	1.9	3.5	1.1	2.4	3.9	2.4
Emerging Markets	**4.0**	**3.3**	**4.4**	**5.2**	**3.8**	**5.0**	**5.9**	**5.1**
CEEMEA	**-0.1**	**0.0**	**1.6**	**3.2**	**1.0**	**2.8**	**4.2**	**3.0**
Russia	-3.9	-2.5	-0.8	1.2	0.5	1.7	3.0	1.5
Poland	3.5	2.4	3.2	4.0	2.2	3.4	4.6	3.5
Czech Republic	4.3	1.7	2.5	3.1	1.8	3.0	4.0	3.0
Hungary	2.6	1.4	2.2	3.0	1.2	2.5	3.6	2.8
Ukraine	-10.5	-1.5	2.0	4.0	0.5	2.7	4.5	3.5
Kazakhstan	0.7	0.0	1.2	2.5	2.5	3.5	4.5	4.0
Turkey	2.7	1.0	3.0	4.5	-1.0	2.8	5.0	3.0
Israel	2.5	2.0	3.0	3.3	1.8	2.9	3.6	3.0
South Africa	1.4	-0.2	1.8	3.8	0.3	2.3	4.3	2.8
Nigeria	2.8	2.0	3.5	5.0	3.3	4.5	6.0	5.8
Ghana	4.0	3.5	6.0	8.5	6.0	8.5	11.0	6.0
Kenya	5.5	4.0	6.0	8.0	4.2	6.2	8.2	5.0
Asia ex Japan	**6.1**	**5.3**	**6.2**	**6.8**	**5.2**	**6.3**	**7.0**	**6.2**
China	7.0	6.0	6.7	7.0	5.8	6.6	6.9	6.0
India	7.4	6.8	7.9	9.0	6.5	8.0	9.5	7.8
Hong Kong	2.4	0.5	2.1	3.0	1.3	2.3	2.9	2.5
Korea	2.4	0.5	2.2	3.4	1.2	2.9	3.7	3.2
Taiwan	1.0	1.0	1.7	3.0	1.2	2.4	3.8	2.7
Singapore	2.1	0.7	2.3	3.7	1.1	2.7	4.1	3.8
Indonesia	4.7	4.3	5.0	5.5	4.5	5.2	5.7	5.5
Malaysia	4.5	3.1	4.5	5.5	3.4	4.8	5.8	5.0
Thailand	2.4	1.8	3.2	4.2	2.2	3.6	4.6	4.0
Philippines	5.5	5.0	5.8	6.4	5.2	6.0	6.6	6.0
Latin America	**-0.4**	**-1.9**	**-0.5**	**0.5**	**0.3**	**2.1**	**2.8**	**2.3**
Brazil	-3.2	-4.1	-3.0	-2.1	-0.2	1.2	2.1	2.0
Mexico	2.2	1.2	2.5	3.3	2.0	2.9	3.5	3.2
Chile	2.2	1.3	2.3	2.8	1.5	2.7	3.5	3.3
Peru	2.8	3.0	3.4	3.9	3.2	3.9	4.1	4.0
Colombia	2.9	1.5	2.7	3.3	1.8	3.1	3.8	3.5
Argentina	1.7	-2.8	-1.4	1.1	-1.5	3.0	4.6	3.2
Venezuela	-6.0	-12.0	-7.0	-5.0	-5.0	-0.7	-1.0	-0.8

Source: Morgan Stanley Research forecasts

CPI Forecasts: Base, Bear, Bull Scenarios

%Y	2015E	2016E			2017E			2018-20E
		Bear	Base	Bull	Bear	Base	Bull	
GLOBAL*	**2.6**	**2.6**	**2.7**	**2.8**	**2.6**	**2.8**	**2.9**	**3.0**
G10	**0.3**	**1.2**	**1.5**	**1.7**	**1.5**	**2.1**	**2.5**	**1.9**
United States	0.2	1.5	1.7	1.9	1.8	2.3	2.7	2.0
Euro Area	0.1	1.0	1.3	1.3	1.1	1.8	2.1	1.7
Japan	0.9	0.2	1.0	1.6	1.3	2.5	2.8	2.0
United Kingdom	0.0	1.2	1.3	1.4	1.2	1.5	2.0	2.0
Canada	1.4	1.7	2.1	2.2	1.5	2.4	2.9	2.0
Norway	2.2	2.4	2.9	3.4	1.5	2.0	2.5	2.5
Sweden	0.0	0.4	1.1	1.4	0.9	1.6	2.4	2.0
Australia	1.5	1.3	2.2	3.3	1.9	2.3	3.2	2.3
Emerging Markets*	**4.4**	**3.8**	**3.7**	**3.6**	**3.5**	**3.2**	**3.2**	**3.8**
CEEMEA	**10.3**	**7.5**	**7.3**	**7.0**	**5.9**	**6.0**	**5.8**	**5.7**
Russia	15.5	9.5	7.8	6.5	7.4	6.4	5.5	6.0
Poland	-0.9	0.7	1.2	1.5	1.0	1.8	2.4	2.5
Czech Republic	0.5	1.0	1.5	1.8	1.1	1.9	2.5	2.0
Hungary	0.0	1.3	1.7	2.1	1.8	2.6	3.2	3.0
Ukraine	48.3	19.0	16.0	14.5	11.0	8.5	7.0	7.0
Kazakhstan	6.6	19.0	15.7	12.0	10.0	7.9	6.0	6.0
Turkey	7.6	5.0	7.8	9.1	4.4	6.4	7.5	5.5
Israel	-0.6	-0.5	-0.1	0.5	0.8	1.3	2.2	1.6
South Africa	4.6	3.9	5.8	7.7	3.8	5.7	7.6	5.3
Nigeria	8.9	10.5	9.5	8.5	10.4	9.1	7.8	9.0
Ghana	17.0	11.8	14.5	17.2	9.3	12.0	14.7	11.0
Kenya	6.5	4.8	7.0	9.2	4.3	6.5	8.7	6.5
Asia ex Japan	**2.5**	**2.2**	**2.4**	**2.5**	**2.2**	**2.3**	**2.5**	**3.3**
China	1.5	0.5	1.1	1.6	0.2	1.1	1.5	2.6
India	4.8	6.0	4.9	4.0	6.0	4.5	4.0	4.5
Hong Kong	3.0	0.5	2.3	3.3	0.6	1.5	2.4	3.0
Korea	0.7	0.8	1.5	1.9	0.9	2.0	2.5	2.3
Taiwan	-0.3	0.0	0.5	1.0	0.4	1.0	1.5	1.5
Singapore	-0.5	-0.2	0.5	1.1	0.2	0.9	1.5	2.0
Indonesia	6.4	5.6	4.9	4.4	5.7	5.0	4.5	5.0
Malaysia	2.3	4.4	3.5	2.9	3.9	3.0	2.4	2.5
Thailand	-0.8	1.4	1.9	2.3	1.9	2.4	2.8	3.0
Philippines	1.4	1.9	2.5	3.0	2.4	3.0	3.5	3.5
Latin America	**13.2**	**23.7**	**20.6**	**18.1**	**24.5**	**14.1**	**9.8**	**3.4**
Brazil	8.9	9.5	8.2	6.5	11.0	6.0	4.5	5.5
Mexico	2.8	4.4	3.7	3.4	3.8	3.3	3.0	3.2
Chile	4.4	4.4	4.0	3.7	3.7	3.3	3.0	3.0
Peru	3.5	3.5	3.1	3.3	2.1	2.5	2.9	2.5
Colombia	4.9	5.5	4.9	4.5	4.0	3.4	3.0	3.0
Argentina	16.0	27.3	36.8	44.3	30.4	18.5	9.6	7.0
Venezuela	107.3	250.0	193.0	150.0	200.0	108.3	75.0	108.3

Source: Morgan Stanley Research forecasts; Note: Japan CPI includes VAT; Global* and EM* CPI aggregates exclude Venezuela and Argentina.

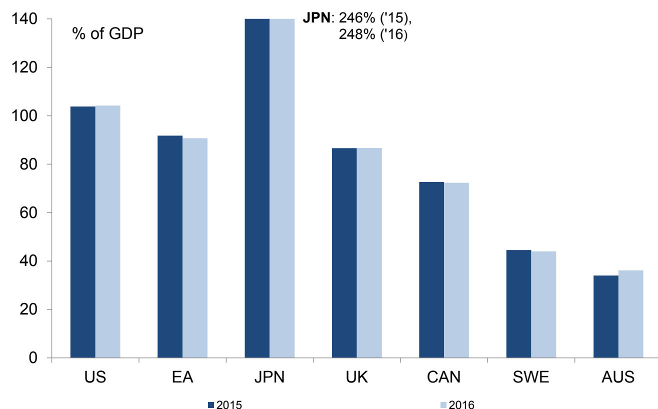
Government Budget Balance and Debt Forecasts

	General government budget balance (% of GDP)				Primary general government budget balance (% of GDP)			
	2014	2015E	2016E	2017E	2014	2015E	2016E	2017E
DM								
US	-2.8	-2.6	-3.0	-3.2	-1.5	-1.2	-1.5	-1.5
Euro Area	-2.6	-2.5	-2.2	-2.0	0.1	0.1	0.2	0.2
Japan	-6.6	-5.1	-4.5	-4.4	-6.0	-4.6	-4.0	-3.9
UK	-5.1	-4.1	-2.6	-1.9	-3.6	-2.5	-0.8	0.0
Canada	-0.2	0.1	0.5	0.7	-0.4	2.1	1.0	1.5
Sweden	-1.7	-1.5	-1.3	-1.2	-1.0	-0.5	-0.4	-0.2
Australia	-2.2	-2.6	-2.4	-1.9	-1.3	-1.7	-1.4	-0.9
BRICs								
Russia	-1.2	-3.7	-3.3	-2.7	0.1	NA	NA	NA
China*	-2.1	-3.1	-3.5	-4.0	NA	NA	NA	NA
India	-6.4	-5.8	-6.2	-6.0	-1.7	-1.4	-1.7	-1.5
Brazil	-6.2	-10.5	-8.9	-6.3	-0.6	-1.8	-1.0	0.0

	Gross general government debt (% of GDP)				Net general government debt (% of GDP)			
	2014	2015E	2016E	2017E	2013	2015E	2016E	2017E
DM								
US	104	104	104	105	73	73	73	74
Euro Area	92	92	91	89	73	NA	NA	NA
Japan	245	246	248	249	128	128	130	131
UK	87	87	87	86	51	50	50	49
Canada	67	73	72	71	34	35	33	31
Sweden	45	45	44	43	-31	NA	NA	NA
Australia	31	34	36	37	13	16	18	19
BRICs								
Russia	11	12	13	14	3	NA	NA	NA
China*	15	NA	NA	NA	NA	NA	NA	NA
India	67	65	67	66	NA	NA	NA	NA
Brazil	59	NA	NA	NA	35	NA	NA	NA

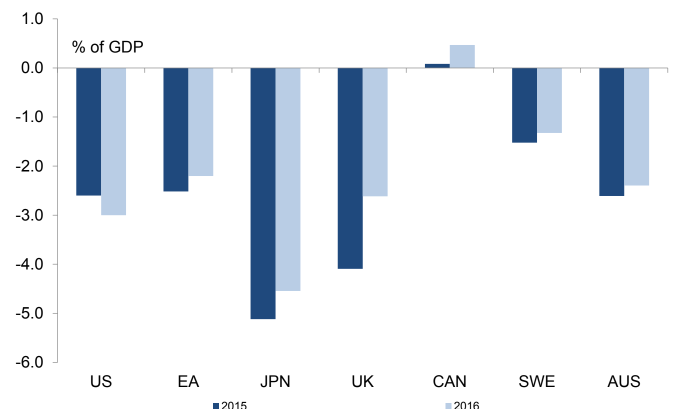
Source: IMF, Morgan Stanley Research forecasts; Note: *Central government

Gross General Government Debt



Source: Morgan Stanley Research forecasts

General Government Budget Balance



Source: Morgan Stanley Research forecasts

Consumer Expenditure and Investment Spending Forecasts

	Quarterly												Annual		
	2015				2016				2017				2015E	2016E	2017E
Private Consumption (%Q, SA)	**1Q**	**2QE**	**3QE**	**4QE**	**1QE**	**2QE**	**3QE**	**4QE**	**1QE**	**2QE**	**3QE**	**4QE**			
Global*	**0.6**	**0.8**	**0.8**	**0.8**	**1.0**	**0.8**	**0.8**	**0.9**	**1.1**	**0.8**	**0.9**	**1.0**	**3.1**	**3.5**	**3.8**
G4	**0.5**	**0.5**	**0.6**	**0.4**	**0.4**	**0.5**	**0.4**	**0.5**	**0.6**	**0.1**	**0.4**	**0.4**	**2.2**	**1.9**	**1.6**
US	0.4	0.9	0.8	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	3.1	2.3	1.8
Euro Area	0.5	0.4	0.4	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	1.8	1.6	1.6
Japan	0.4	-0.6	0.5	0.2	0.3	0.4	0.3	0.8	1.6	-2.4	0.0	0.2	-0.6	1.3	0.7
UK	0.8	0.9	0.7	0.5	0.4	0.4	0.3	0.3	0.5	0.6	0.6	0.5	2.9	1.9	1.9
BRIC	**0.7**	**1.0**	**1.0**	**1.2**	**1.5**	**1.3**	**1.2**	**1.5**	**1.6**	**1.6**	**1.5**	**1.6**	**4.5**	**5.3**	**6.2**
China	-	-	-	-	-	-	-	-	-	-	-	-	7.5	7.3	7.1
India	3.2	1.3	1.1	1.3	2.9	1.7	1.3	1.9	2.2	1.9	1.5	2.0	6.9	7.3	7.6
Brazil	-1.5	-2.1	-1.6	-1.1	-0.8	-0.6	-0.1	0.1	0.3	0.6	0.7	0.7	-3.7	-3.3	1.2
Russia	-9.0	-1.3	-0.7	-0.5	-0.9	-0.8	-0.6	0.0	0.9	1.1	1.0	0.9	-10	-2.8	2.1
Private Consumption (%Y)															
Global*	**3.4**	**3.6**	**3.2**	**3.0**	**3.4**	**3.5**	**3.5**	**3.6**	**3.8**	**3.8**	**3.9**	**3.9**	**3.1**	**3.5**	**3.8**
G4	**1.8**	**2.4**	**2.4**	**2.0**	**2.0**	**1.9**	**1.7**	**1.8**	**1.9**	**1.6**	**1.6**	**1.5**	**2.2**	**1.9**	**1.6**
US	3.3	3.3	3.2	2.6	2.7	2.3	1.9	1.9	1.9	1.9	1.9	1.8	3.1	2.3	1.8
Euro Area	1.7	1.9	1.8	1.6	1.5	1.6	1.6	1.7	1.7	1.6	1.6	1.6	1.8	1.6	1.6
Japan	-4.0	0.5	0.7	0.6	0.5	1.5	1.3	1.9	3.1	0.3	0.0	-0.7	-0.6	1.3	0.7
UK	2.8	3.0	3.0	2.9	2.5	2.0	1.6	1.4	1.5	1.7	2.0	2.2	2.9	1.9	1.9
BRIC	**5.1**	**4.8**	**4.1**	**4.3**	**5.0**	**5.2**	**5.4**	**5.7**	**5.8**	**6.1**	**6.4**	**6.6**	**4.5**	**5.3**	**6.2**
China	-	-	-	-	-	-	-	-	-	-	-	-	7.5	7.3	7.1
India	7.6	7.2	5.9	7.0	6.7	7.1	7.3	7.9	7.2	7.5	7.8	7.9	6.9	7.3	7.6
Brazil	-1.0	-2.6	-4.4	-6.2	-5.5	-4.0	-2.6	-1.4	-0.3	0.9	1.7	2.3	-3.7	-3.3	1.2
Russia	-9.0	-8.7	-11.1	-11.2	-3.3	-2.9	-2.8	-2.3	-0.5	1.4	3.0	4.0	-10	-2.8	2.1
Investment (% Q, SA)															
Global*	**0.9**	**0.4**	**0.4**	**0.7**	**1.0**	**1.0**	**1.0**	**1.1**	**1.1**	**0.8**	**0.9**	**1.0**	**2.6**	**3.3**	**4.1**
G4	**1.1**	**0.5**	**0.5**	**0.7**	**1.1**	**1.0**	**0.9**	**0.9**	**1.0**	**0.4**	**0.6**	**0.7**	**3.0**	**3.2**	**3.1**
US	0.8	1.3	0.7	0.6	1.3	1.0	1.1	0.9	0.8	0.7	0.6	0.6	4.1	4.1	3.3
Euro Area	1.4	-0.5	0.6	0.9	0.9	0.9	0.9	0.8	0.8	0.8	0.8	0.8	2.1	3.0	3.3
Japan	1.6	-0.1	-0.7	0.4	0.8	1.2	1.1	0.8	2.1	-1.9	0.1	0.8	1.0	0.5	1.6
UK	1.5	1.0	0.8	0.8	0.7	1.2	-0.4	1.4	0.9	0.6	0.8	0.5	3.6	3.0	3.0
BRIC	**0.7**	**0.2**	**0.3**	**0.8**	**0.9**	**1.0**	**1.1**	**1.3**	**1.3**	**1.3**	**1.3**	**1.3**	**2.5**	**3.5**	**5.2**
China	-	-	-	-	-	-	-	-	-	-	-	-	6.3	5.6	5.2
India	1.6	1.8	1.2	1.2	1.6	1.8	1.9	1.9	1.9	2.0	1.9	2.0	5.0	6.5	7.9
Brazil	-2.4	-8.1	-6.5	-3.1	-2.5	-2.0	-1.5	0.0	0.9	0.5	0.4	0.3	-14.2	-11.7	0.4
Russia	-3.5	-2.4	-2.1	-1.0	-0.4	0.0	0.3	0.4	0.8	0.8	1.0	1.0	-8.7	-1.8	2.9
Investment (% Y)															
Global*	**3.1**	**3.0**	**2.4**	**2.5**	**2.7**	**3.2**	**3.8**	**4.1**	**4.3**	**4.1**	**4.1**	**4.0**	**2.6**	**3.3**	**4.1**
G4	**2.7**	**3.2**	**2.6**	**2.9**	**2.8**	**3.3**	**3.7**	**3.9**	**3.8**	**3.2**	**2.9**	**2.7**	**3.0**	**3.2**	**3.1**
US	4.8	4.7	3.4	3.4	4.0	3.7	4.1	4.4	3.9	3.5	3.0	2.7	4.1	4.1	3.3
Euro Area	1.8	1.9	2.2	2.4	1.9	3.3	3.5	3.4	3.4	3.3	3.2	3.2	2.1	3.0	3.3
Japan	-3.2	1.1	0.8	1.2	0.5	1.7	3.6	4.0	5.3	2.1	1.0	1.0	1.0	0.5	1.6
UK	3.8	3.4	2.9	4.2	3.3	3.5	2.2	2.9	3.1	2.5	3.8	2.8	3.6	3.0	3.0
BRIC	**3.6**	**2.8**	**2.2**	**2.4**	**2.5**	**3.2**	**3.9**	**4.4**	**4.9**	**5.2**	**5.3**	**5.4**	**2.5**	**3.5**	**5.2**
China	-	-	-	-	-	-	-	-	-	-	-	-	6.3	5.6	5.2
India	4.3	4.5	5.2	6.0	6.0	6.0	6.7	7.4	7.8	7.9	8.0	8.0	5.0	6.5	7.9
Brazil	-7.3	-12.3	-17.6	-18.7	-18.8	-13.4	-8.8	-5.9	-2.6	-0.1	1.8	2.1	-14.2	-11.7	0.4
Russia	-6.9	-8.3	-9.6	-8.7	-5.8	-3.5	-1.1	0.3	1.5	2.3	3.0	3.6	-8.7	-1.8	2.9

Note: Global and regional aggregates GDP-weighted averages, using PPPs; *G4+BRICs. Quarterly consumption and investment data for China is unavailable; hence, there are no official forecasts.
Source: IMF, Morgan Stanley Research forecasts

Morgan Stanley Government Bond Yield/Spread Forecasts

Global Interest Rate Strategy Team

	2-Year					5-Year					10-Year				
	4Q15	1Q16	2Q16	3Q16	4Q16	4Q15	1Q16	2Q16	3Q16	4Q16	4Q15	1Q16	2Q16	3Q16	4Q16
US	1.15	1.05	1.30	1.50	1.65	2.00	1.90	2.10	2.20	2.35	2.50	2.40	2.55	2.65	2.70
Germany	-0.40	-0.40	-0.40	-0.30	-0.30	-0.20	-0.20	-0.10	0.10	0.20	0.70	0.65	0.80	1.10	1.20
Japan	0.00	0.00	0.02	0.05	0.10	0.04	0.04	0.10	0.15	0.20	0.35	0.30	0.50	0.70	0.85
UK	0.80	0.80	1.05	1.10	1.40	1.55	1.55	1.80	1.90	2.15	2.15	2.15	2.30	2.40	2.60
Australia	1.90	1.70	1.60	1.80	1.90	2.40	2.20	2.50	2.60	2.70	3.00	2.95	3.10	3.15	3.20
New Zealand	2.45	2.40	2.50	2.60	2.70	2.90	2.80	3.10	3.20	3.35	3.40	3.50	3.60	3.65	3.80
Austria*	7	6	6	6	7	9	9	10	11	12	26	27	28	29	30
Netherlands*	6	5	5	5	6	9	9	10	10	11	16	17	18	19	20
France*	10	9	9	9	10	21	20	21	22	23	30	31	32	33	36
Belgium*	8	8	8	8	9	16	16	17	18	19	30	33	33	33	34
Ireland*	20	20	20	20	20	35	35	35	35	35	50	50	50	50	50
Spain*	52	48	46	44	46	84	80	76	77	78	120	115	110	110	110
Italy*	42	38	38	38	40	70	68	67	68	69	100	100	100	100	100
Portugal*	58	55	56	58	60	145	140	130	125	120	210	200	190	180	170

	2-Year					5-Year					10-Year				
	4Q15	1Q16	2Q16	3Q16	4Q16	4Q15	1Q16	2Q16	3Q16	4Q16	4Q15	1Q16	2Q16	3Q16	4Q16
Russia	10.20	9.90	9.70	9.50	9.30	9.80	9.60	9.40	9.20	8.90	9.60	9.50	9.40	9.20	9.00
Poland	1.50	1.10	1.20	1.30	1.40	2.00	1.70	1.85	2.00	2.10	2.70	2.40	2.70	3.00	3.10
Czech Rep.	-0.35	-0.40	-0.40	-0.30	-0.30	-0.10	-0.10	-0.05	0.05	0.15	0.55	0.55	0.65	0.80	0.95
Hungary	1.80	1.50	1.60	1.70	1.70	2.40	2.10	2.30	2.50	2.50	3.20	2.90	3.20	3.40	3.20
Turkey	10.10	10.20	10.40	10.80	10.30	10.00	10.10	10.30	10.70	10.30	9.70	9.80	10.00	10.40	10.20
Israel	0.30	0.35	0.40	0.60	0.80	0.80	0.70	0.90	1.10	1.30	2.10	2.00	2.10	2.30	2.40
S. Africa	7.30	7.40	7.60	7.80	7.70	8.10	8.30	8.40	8.50	8.30	8.60	8.80	8.90	9.00	8.90
China	2.55	2.25	2.20	2.15	2.10	2.90	2.65	2.60	2.50	2.45	3.05	2.85	2.85	2.70	2.55
India	7.55	7.40	7.30	7.30	7.20	7.90	7.65	7.60	7.65	7.70	7.80	7.50	7.60	7.70	7.80
Hong Kong	0.70	0.65	0.80	0.95	1.10	1.42	1.35	1.50	1.63	1.75	1.95	1.84	2.00	2.11	2.16
S. Korea	1.70	1.45	1.60	1.70	1.75	1.95	2.05	2.10	2.15	2.20	2.40	2.45	2.50	2.55	2.70
Taiwan	0.45	0.43	0.40	0.50	0.60	0.80	0.78	0.80	0.85	1.00	1.26	1.22	1.28	1.35	1.40
Indonesia	8.30	7.80	7.60	7.70	7.80	8.50	8.00	7.80	7.90	8.05	8.60	8.30	8.00	8.10	8.30
Malaysia	3.20	3.30	3.40	3.50	3.60	3.90	4.00	4.20	4.35	4.28	4.40	4.30	4.50	4.65	4.75
Thailand	1.40	1.55	1.60	1.65	1.70	2.10	2.18	2.25	2.30	2.40	2.85	2.80	2.90	3.00	3.10
Brazil	15.42	15.62	15.92	15.82	15.77	15.42	15.70	15.77	15.60	15.55	15.40	15.75	15.50	15.50	15.50
Mexico	4.30	4.45	4.60	4.70	4.70	5.35	5.55	5.75	5.90	5.85	6.00	6.15	6.25	6.50	6.40
Chile	3.90	4.00	4.10	4.10	4.00	4.35	4.50	4.60	4.75	4.60	4.50	4.65	4.75	4.90	4.75
Peru	4.75	5.00	5.00	5.00	5.00	5.85	6.10	6.20	6.30	6.40	7.10	7.20	7.30	7.40	7.50
Colombia	6.15	6.40	6.40	6.20	5.90	6.85	7.20	7.10	6.90	6.50	8.00	8.10	8.25	8.15	8.00

Source: Morgan Stanley Global Interest Rate Strategy forecasts; *Yield spread to German Bunds

Morgan Stanley Global Currency Forecasts

Global FX Strategy Team

	2015	2016				2017			
	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
EUR/USD	1.06	1.04	1.03	1.01	1.00	0.99	0.98	0.97	0.96
USD/JPY	124	125	121	118	115	112	110	109	108
GBP/USD	1.49	1.45	1.41	1.40	1.40	1.41	1.42	1.43	1.44
USD/CHF	1.03	1.07	1.10	1.13	1.15	1.16	1.17	1.18	1.19
USD/SEK	8.77	8.89	8.93	9.01	9.00	9.04	9.08	9.12	9.17
USD/NOK	8.87	9.09	9.32	9.60	10.00	10.00	10.10	10.10	10.21
USD/CAD	1.35	1.38	1.41	1.43	1.45	1.44	1.43	1.42	1.41
AUD/USD	0.69	0.67	0.65	0.64	0.62	0.61	0.64	0.65	0.66
NZD/USD	0.63	0.61	0.59	0.57	0.56	0.57	0.58	0.59	0.60
EUR/JPY	131	130	125	119	115	111	108	106	104
EUR/GBP	0.71	0.72	0.73	0.72	0.71	0.70	0.69	0.68	0.67
EUR/CHF	1.09	1.11	1.13	1.14	1.15	1.15	1.15	1.14	1.14
EUR/SEK	9.30	9.25	9.20	9.10	9.00	8.95	8.90	8.85	8.80
EUR/NOK	9.40	9.45	9.60	9.70	10.00	9.90	9.90	9.80	9.80
USD/CNY	6.43	6.54	6.65	6.75	6.80	6.86	6.92	6.98	7.07
USD/HKD	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80
USD/IDR	14200	14400	14700	14900	15000	14800	14700	14600	14600
USD/INR	67.20	67.00	68.50	69.30	70.00	69.00	69.00	68.00	68.00
USD/KRW	1210	1230	1260	1280	1300	1280	1260	1250	1250
USD/MYR	4.56	4.66	4.80	4.90	5.00	4.90	4.90	4.80	4.80
USD/PHP	47.60	48.00	48.40	48.80	49.10	49.00	48.50	48.50	48.00
USD/SGD	1.45	1.46	1.49	1.51	1.53	1.52	1.5	1.5	1.5
USD/TWD	33.50	33.80	34.60	35.30	35.80	35.50	35.50	35.00	35.00
USD/THB	36.90	37.30	38.00	38.40	38.80	38.50	38.20	38.00	38.00
USD/BRL	4.00	4.20	4.30	4.50	4.45	4.40	4.35	4.30	4.20
USD/MXN	17.20	17.35	17.60	17.80	17.50	17.20	17.00	16.70	16.50
USD/ARS	13.70	14.96	15.88	16.61	17.36	17.89	18.43	18.99	19.57
USD/VEF	25	50	50	50	75	125	125	125	125
USD/CLP	710	725	740	750	735	730	725	720	720
USD/COP	3000	3150	3300	3200	3100	3000	2900	2900	2900
USD/PEN	3.38	3.50	3.60	3.65	3.70	3.75	3.80	3.75	3.75
USD/ZAR	14.45	14.75	15.00	15.20	15.40	15.45	15.50	15.55	15.60
USD/TRY	3.00	3.06	3.15	3.20	3.25	3.26	3.28	3.30	3.30
USD/ILS	3.96	4.05	4.10	4.10	4.08	4.06	4.02	3.98	3.90
USD/RUB	66.5	67.3	67.8	68.5	69.0	69.3	69.5	69.5	69.5
EUR/PLN	4.33	4.36	4.38	4.36	4.32	4.25	4.16	4.08	4.02
EUR/CZK	27.05	27.05	27.00	27.00	27.00	26.75	26.50	26.20	25.70
EUR/HUF	318	320	320	316	312	306	301	298	295
EUR/RON	4.49	4.51	4.52	4.51	4.50	4.45	4.40	4.35	4.30
DXY Index	100	102	103	104	105	105	105	105	106

Source: Morgan Stanley Global FX Strategy forecasts

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