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GLOBAL INSIGHT

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2018 Global Macro Outlook

Stronger for Longer

The global recovery is likely to gain momentum and breadth in 2018, supported by still accommodative monetary policy and more fiscal stimulus. With major economies at different stages of the business cycle, the risk of the global economy running too hot is limited though.

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

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The global recovery is likely to gain momentum and breadth in 2018, supported by still accommodative monetary policy and more fiscal stimulus. With major economies at different stages of the business cycle, the risk of the global economy running too hot is limited though.

Growth – solid stride in DM, faster pace in EM

The global recovery is set to continue in 2018 and it is likely to broaden further as EM gains momentum. Maturing business cycles could cause DM growth to slow in 2019, but it should still stay above potential. US and China are late-cycle already, while the euro area and Japan are mid-cycle and EM commodity exporters only early-cycle.

Inflation – moving higher, but not beyond targets

While DM headline inflation is likely moving sideways over the forecast horizon, DM core inflation is likely to pick up in 2018. However, with the exception of the UK, DM inflation is unlikely to move above central bank targets. Meanwhile, EM inflation is set to rise, led by Asia.

Policy – less monetary expansion, more fiscal stimulus

Monetary policy is set to remain expansionary in 2018. Balance sheet reduction and additional rate hikes cause the Federal Reserve to inch beyond neutral, but only in 2019. Fiscal policy is likely to become a bit more expansionary in several key DM economies, including the US.

Risks – faster inflation, tighter finances, trade protectionism

The key risk relates to estimating the remaining economic slack correctly and anticipating wage pressures as labour markets reach full employment. Overly rich asset valuations could cause tighter financial conditions. Lastly, a disruption in global trade could undermine the recent rebound in capex and productivity.

Exhibit 1:

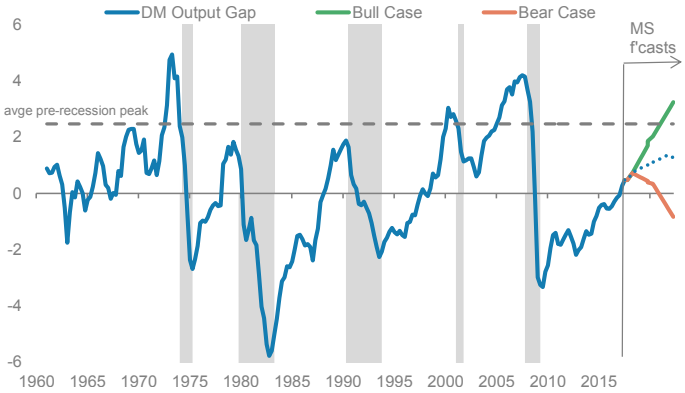
Morgan Stanley real GDP forecasts

	2017E	2018E		2019E	
	MS	MS	Cons.	MS	Cons.
GLOBAL	**3.6**	**3.8**	**3.7**	**3.7**	**3.7**
G10	**2.2**	**2.1**	**2.1**	**1.8**	**1.8**
US	**2.3**	**2.5**	2.5	**1.9**	2.1
Euro Area	**2.3**	**2.1**	1.9	**1.9**	1.6
Japan	**1.5**	**1.3**	1.3	**1.5**	0.9
UK	**1.5**	**1.1**	1.4	**0.8**	1.6
EM	**4.7**	**5.0**	**4.9**	**5.0**	**4.9**
China	**6.8**	**6.5**	6.4	**6.3**	6.2
India	**6.4**	**7.5**	7.5	**7.7**	7.4
Brazil	**0.7**	**3.1**	2.4	**3.4**	2.5
Russia	**1.8**	**2.3**	1.8	**1.8**	1.8
MW Global*	**3.1**	**3.2**	**3.1**	**3.1**	**3.0**

Source: Bloomberg, Morgan Stanley Research forecasts; Note: Aggregates are PPP-weighted. MW Global* is weighted by long-term market exchange rates and is given here for comparison. Cons = consensus.

Exhibit 2:

DM to still stay far below overheating territory in our base case



Source: OECD, Morgan Stanley Research forecasts; Note: Shaded areas denote past global recessions.

Stronger for longer

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Our 2018 outlook at a glance

A broader, not a shorter recovery

On our updated forecasts, the global economy will gain a little more momentum in 2018, reflecting strong and steady DM growth and a pick-up in EM GDP growth despite a moderate slowdown in China. We expect global GDP growth to push above its long-term average of 3.5%Y to 3.8%Y next year, the strongest growth rate since 2011. The acceleration is driven by a pick-up in growth in EM to 5%Y (masking a slowdown in China and faster growth elsewhere in EM). Solid global growth is also supported by steady growth momentum in DM of around 2%Y (masking stronger US growth and slightly weaker growth elsewhere in DM).

Still not running hot

While the global recovery remains a synchronous one, it is important to remember that major economies are at very different stages of the business cycle. This unusual amount of cyclical dispersion is key to preventing global growth – which has only recently been running above potential again – from running too hot (**Exhibit 2**). While unemployment rates continue to fall and output gaps keep closing, key capacity utilisation metrics should remain way below their typical cyclical peaks, even in the US. As a result, we only see a very limited risk of a global recession in starting in 2018. In our view, the global economy is simply not running hot enough yet to require cooling down.

Inflation unlikely to move beyond targets

While DM headline inflation is likely to broadly move sideways, DM core inflation should pick up visibly over the course of 2018. But both the US and the euro area should see inflation dynamics picking up materially between February and August next year. But, with the exception of the UK, DM inflation is unlikely to move above central bank targets on a sustained basis. Despite a steep rise in core inflation, the BoJ and, possibly, also the ECB and the Fed will struggle to hit their 2%Y targets. Meanwhile, EM inflation is set to rise visibly next year, led by AXJ, as both China and India are likely to experience material increases in their inflation rates. Inflation pressures in LatAm, by contrast, are likely to moderate, led by Mexico, notwithstanding a rise in Brazil.

Exhibit 3:

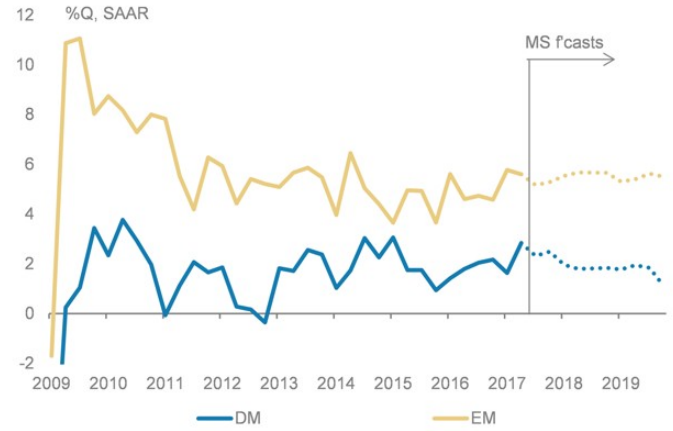
Morgan Stanley real GDP forecasts: base, bull and bear case

	2017E	2018E			2019E			2020-22
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
GLOBAL	**3.6**	**2.8**	**3.8**	**4.6**	**2.4**	**3.7**	**4.7**	**3.4**
G10	**2.2**	**1.1**	**2.1**	**2.8**	**0.3**	**1.8**	**2.7**	**1.3**
US	2.3	1.3	2.5	2.9	0.1	1.9	2.5	1.2
EA	2.3	1.3	2.1	2.9	0.6	1.9	3.3	1.2
Japan	1.5	0.4	1.3	2.0	0.4	1.5	2.4	1.1
UK	1.5	0.3	1.1	1.9	-0.5	0.8	1.6	1.4
EM	**4.7**	**3.9**	**5.0**	**5.9**	**3.8**	**5.0**	**6.1**	**4.8**
China	6.8	6.0	6.5	6.9	5.7	6.3	6.8	5.6
India	6.4	6.3	7.5	8.8	6.1	7.7	8.8	7.3
Brazil	0.7	2.0	3.1	3.9	2.0	3.4	4.3	2.3
Russia	1.8	0.0	2.3	4.3	-1.0	1.8	4.2	1.8

Source: Morgan Stanley Research forecasts; Note: The above aggregates are PPP-weighted.

Exhibit 4:

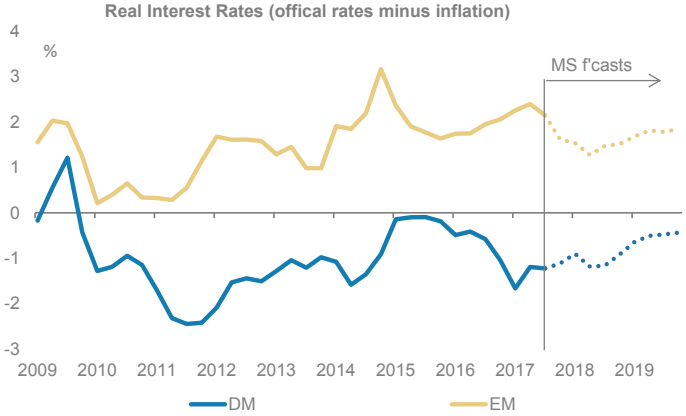
Real GDP growth to hold steady at an above-trend pace in 2018



Source: IMF, National sources, Morgan Stanley Research forecasts

Exhibit 5:

DM real rates to stay negative, EM rates will likely moderate



Source: IMF, National sources, Morgan Stanley Research forecasts

Expansionary policies to support the economy

Monetary policy should still continue to support easy financial conditions in 2018. On our forecasts, the Fed will only inch beyond neutral in 2019, while the ECB and BoJ continue their QE, albeit at a slower pace next year. As a result, DM real interest rates should stay deeply negative and well below their natural equilibrium levels. However, shadow short rate estimates might show a more material increase as unconventional policies are reduced and forward guidance gets adjusted. Our fiscal policy projections, which are subject to considerable uncertainty, given the ongoing budget deliberations in many countries, including the US, show that DM fiscal policy is likely to only become a bit more expansionary in 2018. All in all, the risk of a material late-cycle fiscal stimulus causing an early end to the current cycle seems remote.

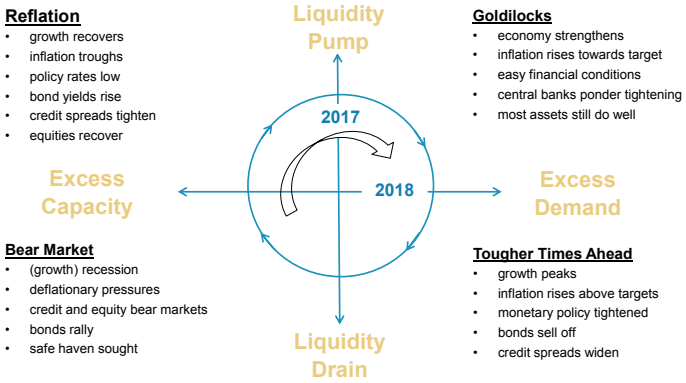
The runway to the end of the cycle

The interaction between the financial and the economic cycle

In our view, the macro debate in 2018 will likely focus on the remaining runway for the current recovery, especially in the US. Looking beyond subjective or model-derived recession probabilities, we think that this issue is best discussed in the context of the global financial cycle (defined via either excess liquidity dynamics or global central bank policy rates) and its interaction with the global business cycle. While the global liquidity cycle indicates how much support the global economy receives from central banks via either liquidity provision or policy rates, the global growth cycle determines whether there is still excess capacity available in the economy. Subdued inflation pressures in the face of continued strong growth, considerable underemployment and an only recent revival in capex and productivity suggest that the danger of excess demand is still far off.

Exhibit 6:

Framework for interaction between financial and business cycles



Source: Morgan Stanley Research

Still believing in Goldilocks

Over the last two years, the global economy has moved from the reflation phase into the Goldilocks phase (see Global Economics: From Deflation Scare to Reflation Run, June 13, 2015). Of course, over time, higher inflation and stronger activity will absorb a rising share of the excess liquidity that thus far has mostly been sloshing around the financial system. In addition, central banks look set to slow the creation of excess liquidity if they are not, like the Fed, already starting to drain it gradually. Once a combination of tighter monetary policy and visible capacity pressures materialises, tougher times, maybe even a full-blown bear market, will likely lie ahead for asset markets. From a fundamental point of view, however, this will likely only become an issue in late 2019, if not 2020.

Keeping a watchful eye

Notwithstanding the positive fundamentals, financial markets will likely doubt the continuation of the recovery at some point over the forecast horizon. Especially once the growth momentum starts to moderate, risk asset markets could get increasingly nervous. To help investors to navigate this debate, we have developed several metrics beyond our traditional recession probability estimates (see the accompanying box for details). These metrics gauge the likelihood of latest high-frequency data reliably indicating a cyclical peak and the probability of a downturn now and in a year's time based on the size of the output gap and the credit gap. In addition, we summarise the stylised pattern in our broad-based financial conditions indices ahead of past downturns. Finally, we try to assess whether the recovery is sufficiently resilient to withstand a major market correction.

Recovery to strengthen and broaden

Raising our global growth forecasts

As we peer into 2018, we are raising our global growth forecast further to 3.8%Y next year. Upward revisions to the 2018 estimates are concentrated in the DM space, where we are raising our US, euro area and Japanese GDP forecasts. In the EM space, we are raising our China GDP forecasts for 2017 and 2018, but we are also cutting our India estimates materially. We are also raising our forecasts for commodity-exporting EMs on the back of the impressive rebound in the commodity sector and resulting terms of trade improvements. The forecast upgrade leaves our estimates above consensus at the global level and in most countries we cover.

Mapping a marathon recovery run

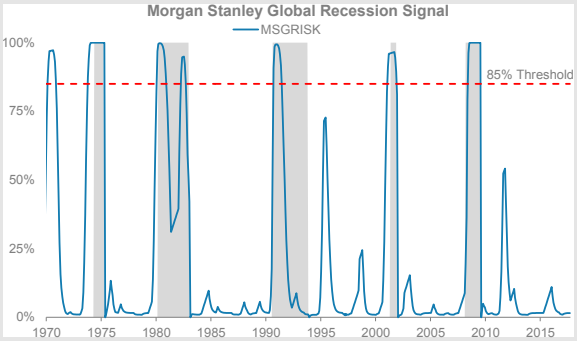
Elga Bartsch & Jan Kozak

How far to the end of the cycle?

Apart from potential exogenous shocks – such as geopolitical tensions, financial accidents or political turbulence – we do not see an endogenous reason for an end to the current recovery materialising in 2018. In our view, the risk of the global economy or any of its major constituents running too hot over the next 12 months is contained. Hence, the original call the Morgan Stanley global macro team made in 2014 that this recovery would likely run until 2020 still seems intact (see Lower But Longer). But as the recovery progresses and moves into the later stages of the cycle, end-of-cycle risks such as broad-based economic overheating, excess credit creation and overly generous asset valuations need to be monitored closely. We outline our preferred metrics to monitor the late-cycle risks at a global level below.

Exhibit 7:

MSGRISK not pointing to recession risk



Source: OECD, Morgan Stanley Research. MSGRISK is computed using the algorithm in Chauvet, M and Hamilton, J (2007). Dating Business Cycle Turning Points. MSGRISK signals a imminent recession when it crosses the 85% threshold. A reading near zero corresponds to the unconditional recession probability of 19%.

These three new indicators complement our traditional recession probability estimate, MSGRISK, which uses a simple Bayesian model based on the OECD Composite Leading Indicator to calibrate the risks of moving towards a global recession. At the time of writing, **MSGRISK does not indicate an elevated risk of recession** (**Exhibit 7**). Hence, we would deem the risk of a global recession to still be near the unconditional probability of ~20%. But based on past patterns, sharp and sudden surges – a common feature of many regime-switching models – cannot be ruled out in future.

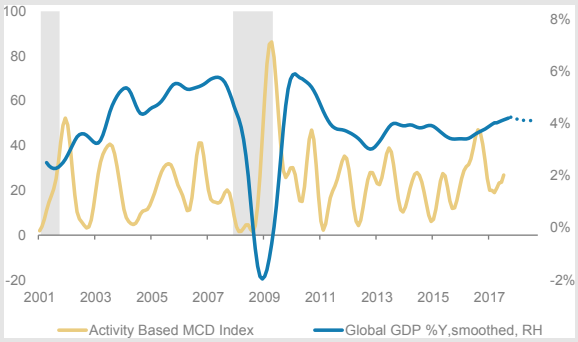
MCD index not pointing to a peak in growth

According to our global turning point indicator, which is based on high-frequency activity data, there are currently no signs of growth rolling over. On the contrary, the recent pick-up in our turning point indicator could point to faster growth ahead. Our preferred turning point indicator summarises the noise-to-signal ratios across the key global activity indicators we track (see When the Tide Is Turning). It separates the underlying cyclical dynamics from the idiosyncratic one-off factors and statistical noise for each indicator.

Taking into consideration how persistent a change in the direction for each indicator was in the past, we calculate which activity indicators currently signal a cyclical peak by estimating a Months-to-Cyclical-Dominance (MCD) Index (**Exhibit 8**) and calculate the share of indicators signalling a cyclical turning point. This MCD index currently does not point to a downturn. On the contrary, the pick up in the MCD Index could hint at faster growth as we head into 2018.

Exhibit 8:

MSMCD Index not indicating a downturn



Source: National data, Morgan Stanley Research

Recession risk likely to rise over the medium term

But even if the recession risk is limited in the near term, we still want to assess how the recession risk is likely to evolve over the medium term. In our view, it makes sense to gauge the risk of a downturn through a heat-map summarising the probabilities of key metrics moving beyond a threshold that historically implied a substantial recession risk. Academic literature points to variables such as the credit-to-GDP gap or the output gap as indicators that can warn of material economic and financial imbalances building up.

In the spirit of the work done by the BIS regarding credit gaps and financial crises, we derive critical thresholds for the output gap, which historically have been reliable signals

for recessions within the next two years. We define the recession signalling threshold (RST). If the RST is surpassed a recession should become our base case over a two-year forecast horizon. We assess the likelihood of reaching the recession threshold by averaging over two distinct quantitative methods*. The results of this algorithm are summarised in Exhibit 9. They suggest that the **probability of reaching the recession threshold before the end of 2018 is limited.** Where this probability is more elevated, bear in mind that the signal refers to a recession becoming the base case over the next two years, i.e., in 2019/20 if the RST was breached by the end of 2018. Traditionally, we have attached a 60% probability to the base case in our bull-bear framework.

Exhibit 9:

Calibrating overheating risk followed by cooling

Region	Distance to Recession Signalling Threshold (MS RST)	Probability to Pass MS RST Based on 3Q17		Probability to Pass MS RST Based on 4Q18E	
		Until 4Q18	Until 4Q19	In 2019	In 2019 or 2020
Global	0.6	55%	85%	80%	90%
US	0.2	65%	90%	75%	85%
Euro Area	2.7	30%	45%	50%	65%
China	0.9	70%	85%	70%	85%

Note: For China RST reflects a growth recession, which we define as periods with growth rates at least 100bp lower than trend growth. *The first method is based on a joint probability density estimation approach, and the second on an extensive set of Monte Carlo simulations of the output gap path. A similar methodology could be applied to obtain a probabilistic assessment of a equity market drawdown or financial crisis. Source: Morgan Stanley Research.

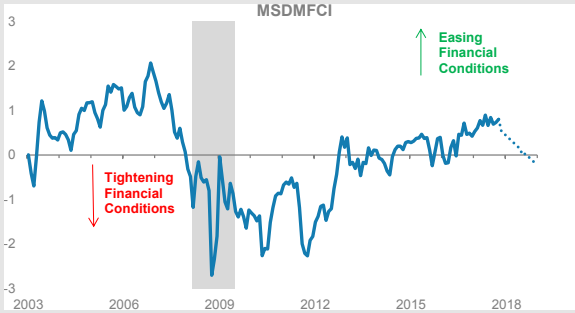
As you would expect, the **probability increases substantially if we look further ahead and assume that the recovery continues** according to our baseline forecasts until the end of 2019. At that point, our algorithm would suggest that the probability of getting a recession signal for the coming two years becomes elevated. The differences across regions stand out, consistent with our assessment that economies are at different stages of the cycle. For the euro area, the probability to reach the critical threshold in the next two years appears very muted, while for the US, the risk seems more elevated. But even in the US, the threshold would probably only be hit at the end of 2019 (implying a significant recession risk over 2020/21).

Financial market shock to tighten financial conditions? In addition to the recovery running into roadblocks, our benign outlook could also be challenged by an abrupt tightening in financial conditions, say, because market volatility starts to normalise from its current unusually low levels.

At the current juncture, **easy financial conditions across developed markets bode well** for economic growth and risk assets. In order to gauge how quickly financial conditions could deteriorate and how such a change would compare to past pre-recession patterns, we project the path of our MS Developed Market Financial Conditions Index (MSDMFCI) until December 2018, based on an assumption of a normalisation in market volatility, measured by the VIX (see Tracking Global Financial Cycles and Financial Conditions). Specifically, we assume that the VIX corrects two-thirds of its current distance to the long-term average. Exhibit 10 illustrates the projected MSDMFCI path. It highlights a tightening of financial conditions all the way below the long-term average, implying tighter financial conditions than we normally would have at this stage of the cycle. Such a move would be significant, given the leading indicator properties of the MSDMFCI. But the **MSDMFCI should still stay above its typical recession level of below -0.5% S.D even in the case of a significant VIX correction.**

Exhibit 10:

MSDMFCI not dipping into danger zone



Source: National data, Morgan Stanley Research forecasts.

Indicators investors should keep an eye on to map out the remaining runway of the recovery include standard models indicating a regime switch towards recession, indicators hinting at turning points or at recession thresholds for widely used measures of economic and financial imbalances such as the output gap. Resilience to tighter financial conditions also matters. Historically, an FCI reading of -0.5 has been consistent with a recession probability of 1 in 3.

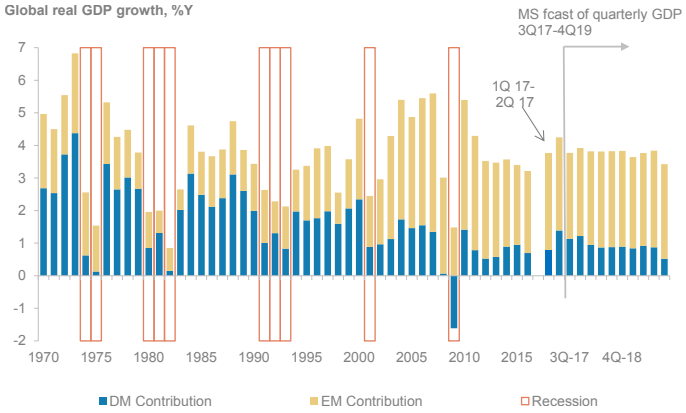
But bear in mind that the start of a global recession typically coincides with that of a US recession. So, all eyes on the US in 2018.

DM growth cruising, EM growth speeding

All in all, we are projecting DM GDP growth to hold steady at 2.1%Y in 2018 and expect EM GDP growth to pick up pace from 4.7%Y this year to 5.0%Y next year. While DM GDP growth likely peaked in 2Q17, we expect it to oscillate around 2-2.5% in quarterly annualised terms over the winter. From next summer onwards, DM GDP growth will likely slow to ~1.75%. We would stress that this slowdown would still leave DM GDP growth well above potential, allowing a further erosion of slack in DM. But arguably the perception of growth peaking out might make for a more challenging backdrop for financial markets. Meanwhile, EM GDP growth will likely move from around 4.5%Y in 1H17 towards a 5%Y pace in 2018 and beyond. On balance, our forecasts are more bullish than the consensus in the mid- and early-cycle economies (e.g., the euro area and Japan in DM and Brazil and Russia in EM) and broadly in line with the consensus in the late-cycle ones.

Exhibit 11:

Continued recovery ahead – driven by EM, supported by DM



Source: IMF, Morgan Stanley Research forecasts; Note, red boxes represent global recession periods.

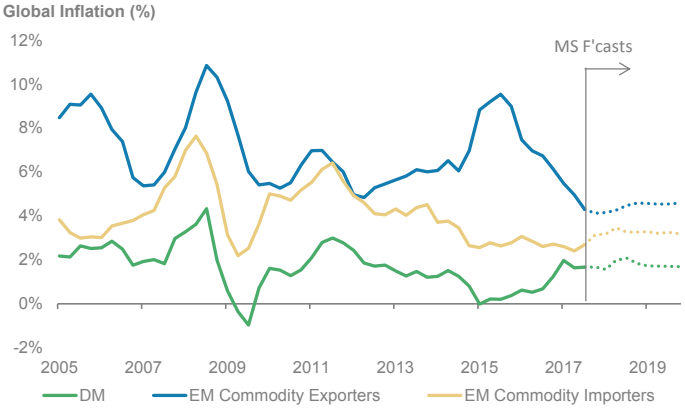
Inflation moves higher, stays within limits

Core inflation to catch up with headline…

While headline inflation is likely to move sideways on both sides of the Atlantic, DM core inflation is likely to pick up in 2018 both in the US and the euro area. Contrary to the UK, which will likely experience an ongoing material inflation overshoot due to surging import prices, DM inflation is unlikely to move beyond central bank targets on a sustained basis. In Japan, underlying core inflation will likely even struggle to move materially above 1%Y before 2019. In the US and in euro area, underlying inflation is likely to stay a touch below central bank objectives. While overall EM inflation is broadly steady over the forecast horizon, this masks material increases in global bellwethers such as China, India and Brazil. We will therefore keep a close eye on inflation dynamics in EM to gauge any pipeline pressure building along global supply chains.

Exhibit 12:

Inflation to move higher in DM in 1H18, but not beyond targets



Source: National sources, Morgan Stanley Research forecasts

…but to stay below central bank inflation targets

In our view, the absence of meaningful inflation and wage pressures in conjunction with strong growth dynamics and falling unemployment leave the economy still firmly in the Goldilocks phase of the global financial cycle. For that to change, we would need to see some serious signs of underlying wage pressures building and of corporate pricing power improving further. With a considerable share of part-timers still aiming to work more hours, temporary workers hoping to land a permanent contract, and part of the population only marginally attached to the labour market, official unemployment rates are likely to understate the degree of labour market slack. Years of low-flation and their impact on expectation formation will also likely limit the risk of a sudden rise in wage inflation. All in all, the Phillips curves are therefore likely to at most re-steepen moderately as economies push beyond full employment.

Exhibit 13:

Morgan Stanley global inflation forecasts

	2017E	2018E		2019E	
	MS	MS	Cons.	MS	Cons.
GLOBAL*	**2.5**	**2.9**	**2.7**	**2.8**	**2.8**
G10	**1.8**	**1.9**	**1.7**	**1.7**	**1.9**
US	**2.1**	**2.1**	2.1	**1.8**	2.2
Euro Area	**1.5**	**1.7**	1.4	**1.6**	1.6
Japan	**0.5**	**1.2**	0.8	**0.9**	1.1
UK	**2.7**	**2.6**	2.5	**2.2**	2.2
EM*	**3.1**	**3.6**	**3.4**	**3.5**	**3.4**
China	**1.6**	**2.5**	2.2	**2.6**	2.2
India	**3.2**	**4.6**	4.6	**4.4**	4.5
Brazil	**3.5**	**3.9**	4.0	**4.2**	4.2
Russia	**3.7**	**3.8**	4.0	**4.1**	4.0

Source: Morgan Stanley Research forecasts; *Global/EM aggregates exclude Argentina and Venezuela.

Where we differ from consensus

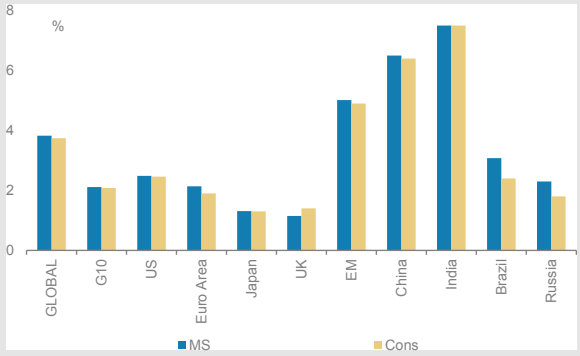
Global: We are one-tenth above consensus on global growth in 2018 at 3.8%Y, being slightly more bullish on EM. We are in line with consensus in expecting growth of 3.7%Y in 2019. We are two-tenths above consensus on global inflation in 2018 and in line in 2019.

Developed markets: We are in line with consensus on growth at 2.1%Y in 2018 and 1.8%Y in 2019. We are two-tenths above consensus on the euro area in 2018, but in line on the US and Japan. We are more bullish on the euro area and particularly Japan in 2019, but are two-tenths below consensus on the US and almost a percentage point lower on the UK. Meanwhile, we are two-tenths above consensus on 2018 inflation, driven by material above-consensus calls on the euro area and Japan. In contrast, we are two-tenths below consensus in 2019, driven primarily by the US. On monetary policy, we forecast more rate hikes than is priced by the market. We forecast three rate hikes in 2018 and another two in 2019. The market is discounting 1.5 hikes in 2018 and just over a 50% probability of another hike in 2019.

Emerging markets: We are one-tenth above consensus on EM growth in both 2018 and 2019, with a similar stance on China. We are significantly above consensus on Brazil in both years and materially above consensus on Russia in 2018. On inflation, we are two-tenths above consensus in 2018 and one-tenth above in 2019, with China being a key driver in both years. On monetary policy, our forecast for 25bp increases in benchmark interest rates in 3Q18 and 1Q19 from the PBOC stands in contrast to consensus estimates of no change through end-1Q19.

Exhibit 14:

2018 growth forecasts – Morgan Stanley versus consensus



Source: Bloomberg, Morgan Stanley Research forecasts; 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.

Central banks to support growth, watch financial stability risks

Monetary policy to stay easy

At the global level, monetary policy will likely stay expansionary in 2018. DM central bank balance sheets are still set to expand through 3Q18 and real interest rates will likely remain deep in negative territory. In addition, global excess liquidity is still expanding and financial conditions are considerably easier than they usually would be at this stage of the cycle. Only the Federal Reserve will actually shrink its balance sheet and engage in active quantitative tightening. All other key central banks – the ECB, the BoJ and the PBOC – will likely expand their balance sheets, but at a slower pace. While we expect the PBOC to raise interest rates in 3Q18, the ECB and the BoJ are unlikely raise their traditional policy rates in 2018. However, the BoJ will likely raise its 10-year JGB yield target by 25bp in 2H18 and also allow for wider deviations from the target than before.

Exhibit 15:

Our key monetary policy calls

US	Balance sheet drawdown to continue on schedule, three Fed hikes expected in 2018 and two in 2019.
EA	QE to be discontinued after September 2018. First depo rate hike in March 2019, but on hold for the rest of year.
UK	Two rate hikes in 2019, following a 25bp hike in May 2018. QE unwind to begin in August 2019.
Japan	BoJ will raise its 10-year JGB yield target in 2H18 vs. 1H previously and will only raise it once through forecast horizon.
China	Expecting two 25bp benchmark rate hikes, in 3Q18 and 1Q19.
Brazil	Further easing in Brazil before year-end, but 150bp of rate hikes expected over 4Q18-1Q19.
Russia	Will continue to cut interest rates gradually through forecast horizon until end-2019.

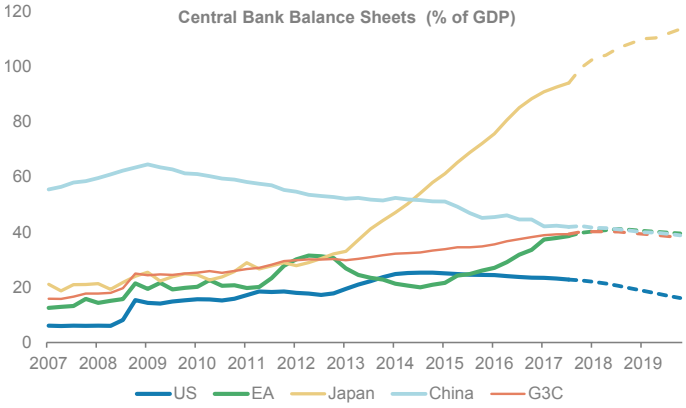
Source: Morgan Stanley Research forecasts

All eyes on the Fed

With the Federal Reserve being the central bank that is most advanced in normalising its policy stance, all eyes are likely to be on it in 2018. The designated Fed Chair Jerome Powell looks likely to continue on the course set out under Janet Yellen. We therefore expect the Fed to reduce its balance sheet in line with its long-standing official guidance. In addition, we forecast three more Fed rate hikes in 2018, in line with median of the Summary of Economic Projections, but above current market expectations. Much of the debate on Fed policies should be on the impact of the measures rather than the measures themselves. With its QE wind-down the Fed is entering uncharted territory. There is a further factor to consider though:

Exhibit 16:

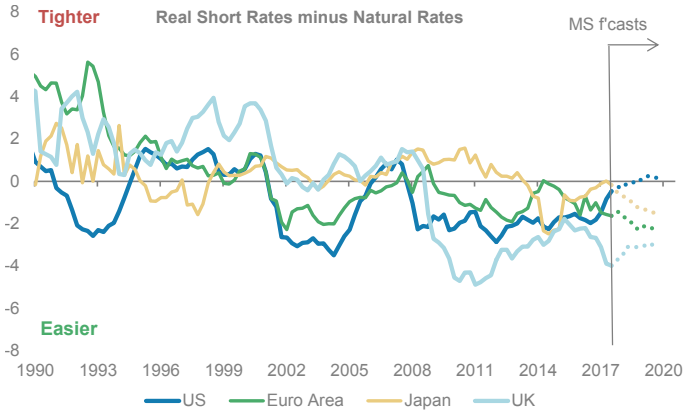
Fed to wind down QE, ECB and BoJ to slow down QE in 2018



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

Exhibit 17:

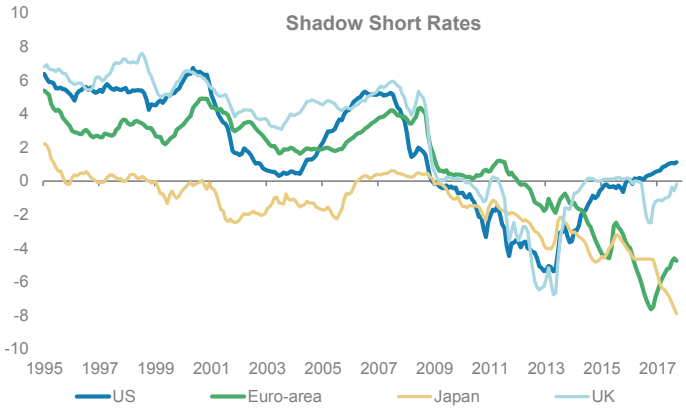
G4 real rates stay below their natural levels in easy policy territory



Note: Natural interest rate estimates are from Holston, Laubach and Williams (2016) for the UK, US and the EA. Japan estimates from the BoJ.
Source: ECB, FRB, BoE, IMF, ACDC, OECD, BEA, MIC, Morgan Stanley Research forecasts

Exhibit 18:

Shadow rates have been rising in the US more recently also euro area and the UK



To gauge the impact of unconventional monetary policies such as asset purchases or forward guidance at the zero lower bound, shadow short rates (SSRs) estimate a term structure model that backs out the hypothetical short rate needed to replicate the observed term structure. While SSR estimates can be sensitive to the model specifications, data periods, and estimation methods they provide interesting cross-country comparisons.
Source: RBNZ, Morgan Stanley Research

While a prolonged period of exceptionally low interest rates has weighed on financial intermediaries' business models, financial deregulation even if only at the operational rather than the legislative level should boost the availability of financing.

Not much dry powder left

Looking further ahead to the next economic downturn or the next financial accident, it is clear that central banks don't have much dry powder left, given how close policy rates are to the zero lower bound. Based on our current forecasts, central banks are also unlikely to rebuild their policy arsenals quickly. While the next monetary policy easing cycle might still be a long way away, given that we are just embarking on a gradual tightening cycle, it is important to bear in mind the legal and institutional constraints many central banks are facing, e.g., the Fed with respect to private sector assets and the ECB with respect to public sector assets (capital key, issuer limits). The hurdle to mobilising another dose of central bank support might therefore be relatively high. If full-blown monetary financing of government deficits became necessary, increasingly fragmented parliaments would likely complicate matters further, as the current budget debates show.

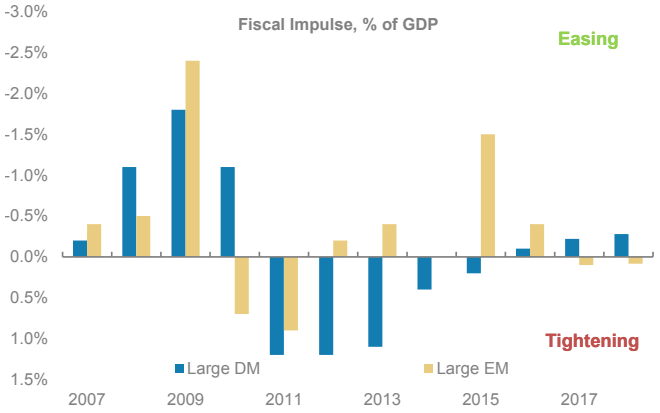
Taking up fiscal space

Turning up DM fiscal stimulus

On balance, fiscal policy will likely become more expansionary in 2018. While a number of key countries are still in the process of drafting their 2018 budgets, we project a small fiscal stimulus to be implemented in DM next year. However, many of the countries mulling a more expansionary fiscal policy at the moment, including the US, the UK, Japan and Germany, are already at or close to full employment. As a result, fiscal stimulus is likely to have only a very limited effect on aggregate demand, even if the impact on the budget balance is more meaningful.

Exhibit 19:

Fiscal impulse likely to get bigger in 2018



Source: IMF, Morgan Stanley Research forecasts

Rise in debt not restricting fiscal space

Since the start of the Global Financial Crisis (GFC), government debt has increased materially. In DM, debt increased from 85.7% in 2007 to 114.6% of GDP on the latest data. In EM, it increased from 35.7% to 46.9% of GDP at the end of 2016. In light of the much higher debt at present and the material future commitments already made via pension systems and healthcare provisions, some observers have wondered how much fiscal space governments still have left before they get too close to the cliff. Given that for most G20 countries interest rates on government debt are well below nominal trend growth (on average by around 200bp), we don't deem debt sustainability a factor limiting fiscal policy action at the current juncture.

Exhibit 20:

Overview of fiscal policy assumptions

US	Expecting delivery of mildly expansionary tax package in 1H18, ~0.5% of GDP in deficit expansion over first four quarters.
EA	Discretionary stimulus to rise from 0.3% of GDP in 2017 to 0.5% in 2018, amid a combination of tax cuts/spending rises.
Japan	Fiscal policy moderately tighter in 2018, broadly neutral in 2019.
UK	Government to keep easing planned fiscal squeeze amid pressure on public services and for higher investment.
China	Fiscal policy broadly neutral over 2018 and 2019.
India	Fiscal policy largely neutral in 2018.
Brazil	Policy should become looser in cyclically adjusted terms in 2018, but will tighten from 2019 as the primary balance improves.

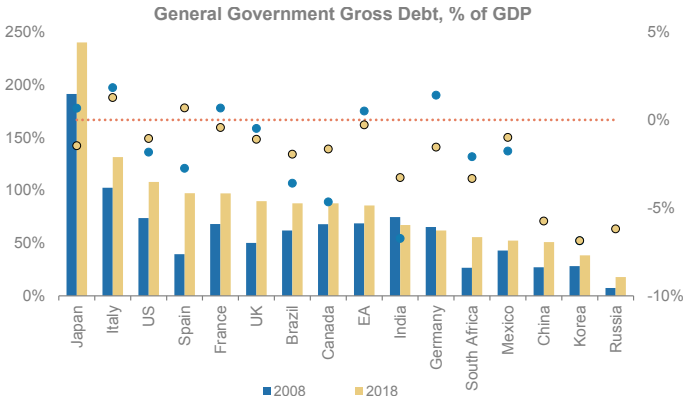
Source: Morgan Stanley Research forecasts

However, the euro area is a notable exception

There is one important exception though: the euro area. Longer term, the euro area periphery could be potentially challenged on debt sustainability through two different channels: First, even in the current low interest rate environment, a number of countries in the periphery still face interest rates on government debt that exceed trend growth rates meaningfully. Clearly, these headwinds could intensify if government bond yields and/or peripheral spreads start to rise in future. Second, individual euro area countries are not borrowing in their national currency. While the region can rely on the ECB to act as a lender of last resort, for an individual country such support would only be available with controversial conditionality.

Exhibit 21:

Debt levels surged, but interest dropped below growth



Source: IMF, OECD, National sources, Morgan Stanley Research; Note: The dots show the difference between the implied interest rate on government debt (r) and nominal trend growth (g) for 2008 (blue) and for 2018 (yellow). We use OECD, central bank or MS estimates for trend growth and the 5YMA growth in the GDP deflator for trend inflation.

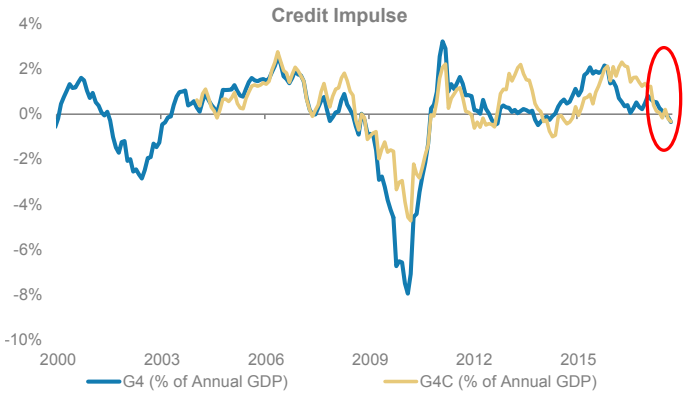
Transition from consumers to capex

Consumer spending to pass on the baton…

After consumer spending accelerated materially in 2017, we forecast steady but strong consumer spending growth in 2018 on the back of continued job creation, elevated consumer confidence and higher consumer price inflation. In some countries, rising house prices could support consumer spending dynamics further. Overall, consumers have remained relatively cautious with their borrowing decisions, with a few notable exceptions such as car loans in the US and unsecured borrowing in the UK. A further strengthening in domestic demand dynamics will likely need to come from investment spending.

Exhibit 22:

Global credit impulse not pointing to credit-fuelled private demand recovery



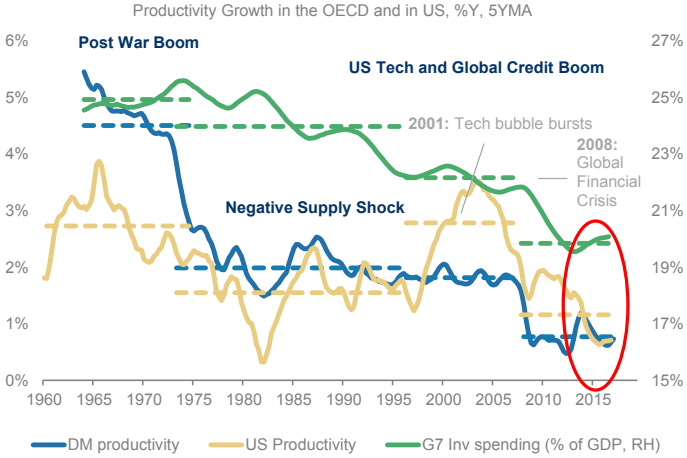
Source: National data, Morgan Stanley Research; Note: Credit impulse is the change in bank lending flows and credit issuance to the non-financial private sector. G4C comprises the US, EA, Japan, UK and China.

…to investment spending

Going forward, the investment spending recovery is mostly driven by EM economies other than China. In China, by contrast, we are likely to see a moderation in investment spending as the government is trying to rein in excesses at the local government level, in residential property markets and in state-owned production facilities. Looking through some short-term volatility, both the US and the euro area should see a steady, possibly strengthening, capex recovery. In Japan, investment spending is set to expand modestly. In the run-up to Brexit, the UK will likely see capex come to a standstill, if not see an outright contraction.

Exhibit 23:

Tentative signs of the secular slowdown in DM productivity and investment spending giving way to a rebound



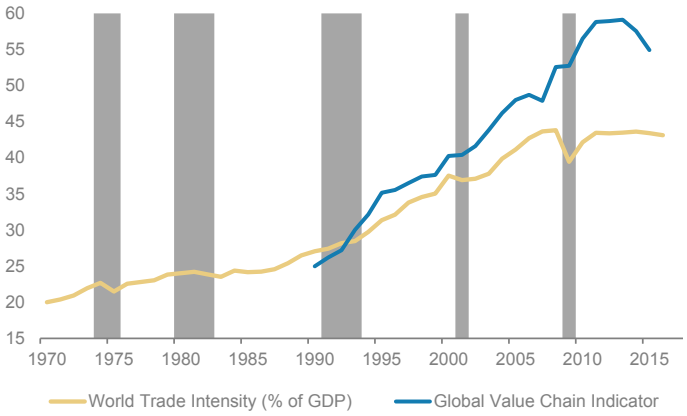
Source: BLS, OECD, Morgan Stanley Research

Capex recovery crucial for productivity revival…

In our view, a continued capex recovery is a precondition for productivity growth to break away from its post-crisis lull. There are some signs, for instance in the US, that stronger capex growth is leading to faster productivity gains (see US Economics, Quantitative & Equity Strategy Research: The Productivity Pickup: Who's Driving, November 8, 2017). Note that a continued recovery in capex also helps to alleviate potential future capacity constraints either by substituting workers for machines or by building additional production capacities. Private sector capex thus very much remains a precondition for a self-sustaining recovery. In this context, it is important to bear in mind that the investment recovery remains materially weaker than in the past, the average shortfall in DM being more than 15pp, according to OECD estimates. In DM, investment spending has yet to reach the long-term equilibrium to support potential output. Hence, there is no sign whatsoever of excessive investment spending.

Exhibit 24:

Trade intensity more than doubled since the 1970s, global value chains nearly trebled since 1990



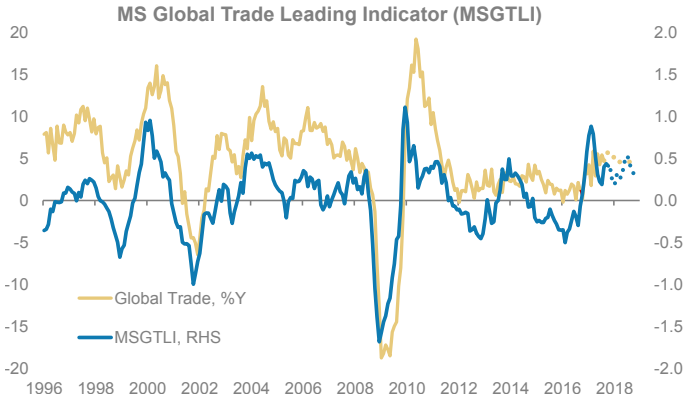
Source: OECD, Morgan Stanley Research; Note: Trade intensity is the sum of exports and imports in GDP. GVC refects the ratio of intermediate goods imports to final domestic demand.

...and the recovery in global trade

The recovery in capex around the globe has contributed to the revival in global trade dynamics seen recently. This is due to the fact that capital goods are traded much more internationally than many consumer goods or construction services. In the age of digitalisation and automation, it should not be surprising that we are also seeing a sharp rebound in the tech cycle globally. A renewed intensification of globalisation would likely also help to achieve stronger productivity growth globally. Freeing resources trapped in companies whose earnings don't cover even interest by addressing remaining non-performing loans (NPL) issues and through further structural reforms could boost productivity growth further.

Exhibit 25:

MSGTLI suggests that global trade likely to expand at a decent pace going forward



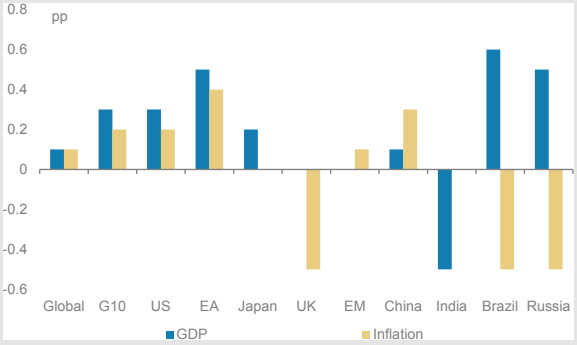
Source: CPB, Morgan Stanley Research forecasts; Note: The dashed lines represent forecasts/projections for 2018.

Our key forecast changes at a glance

Growth: We raised our global growth forecast by one-tenth to 3.8%Y for 2018 from our mid-year outlook. Upward revisions were driven by DM, with forecasts for the US and euro area raised by three and five-tenths respectively. Our forecast for Japan was also revised higher by two-tenths. In EM, we nudged our GDP forecast for China up by one-tenth to 6.5% for 2018 and made significant upward revisions to our Brazilian and Russian forecasts (six-tenths and five-tenths, respectively). This helped to offset the material downwards revision in our Indian growth forecast.

Exhibit 26:

Forecast changes for 2018 compared to the mid-year outlook



Source: Morgan Stanley Research forecasts

Inflation: We revised higher our 2018 global forecast by one-tenth to 2.9%Y from our mid-year outlook. Both DM and EM were responsible for the upgrade to varying degrees, with the US and euro area forecasts raised by two and four-tenths, respectively. In contrast, the UK CPI forecast for 2018 was cut by five-tenths. In EM, we raised our forecast for China by three-tenths, which helped to offset downward revisions of five-tenths in our Brazil and Russia forecasts.

Monetary policy: Compared with the mid-year outlook, we expect one less Fed hike in 2018 and pushed back the timing of the first ECB deposit rate hike to 1Q19 from 3Q18 previously. In Japan, we now forecast that the BoJ will raise its 10-year yield curve target in 3Q18 versus 1Q18 previously and no longer expect a second rise in the target before end-2018. In China, we now expect the PBOC to hike interest rates in 3Q18 versus an assumption of unchanged rates previously.

Key forecast profile

	Quarterly												Annual		
	2017				2018				2019				2017E	2018E	2019E
Real GDP	1Q	2Q	3QE	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global (%Q, SAAR)	**3.7**	**4.2**	**3.8**	**3.9**	**3.8**	**3.8**	**3.8**	**3.8**	**3.6**	**3.8**	**3.8**	**3.4**	**3.6**	**3.8**	**3.7**
G10 (%Q, SAAR)	**1.6**	**2.8**	**2.3**	**2.5**	**2.0**	**1.8**	**1.8**	**1.8**	**1.8**	**1.9**	**1.8**	**1.1**	**2.2**	**2.1**	**1.8**
United States	1.2	3.1	3.0	3.4	2.2	1.9	2.0	2.1	2.0	1.8	1.7	1.5	2.3	2.5	1.9
Euro Area	2.2	2.6	2.5	2.2	2.1	2.0	1.9	1.9	1.9	1.9	1.8	1.8	2.3	2.1	1.9
Japan	1.0	2.6	1.4	0.9	1.2	1.2	1.3	1.5	1.7	2.4	2.5	-3.3	1.5	1.3	1.5
UK	1.0	1.2	1.6	1.5	1.1	1.1	0.8	0.0	-0.2	2.0	1.6	1.8	1.5	1.1	0.8
EM (YoY)	**4.4**	**4.5**	**4.9**	**4.9**	**5.0**	**5.0**	**5.0**	**5.1**	**5.1**	**5.0**	**5.0**	**5.1**	**4.7**	**5.0**	**5.0**
China (YoY)	6.9	6.9	6.8	6.7	6.5	6.4	6.5	6.6	6.5	6.4	6.3	6.2	6.8	6.5	6.3
India (YoY)	6.1	5.7	6.5	7.2	7.5	7.6	7.4	7.4	7.7	7.6	7.7	7.8	6.4	7.5	7.7
Brazil (YoY)	-0.4	0.3	0.9	2.0	2.0	2.8	3.5	3.9	3.7	3.2	3.3	3.2	0.7	3.1	3.4
Russia (YoY)	0.5	2.5	1.8	2.1	2.5	2.0	2.6	2.3	1.8	1.8	1.8	1.9	1.8	2.3	1.8
Consumer Price Inflation (YoY)															
Global*	**2.7**	**2.4**	**2.4**	**2.6**	**2.6**	**3.0**	**2.9**	**2.9**	**2.8**	**2.8**	**2.8**	**2.8**	**2.5**	**2.9**	**2.8**
G10	**2.0**	**1.6**	**1.7**	**1.7**	**1.6**	**2.0**	**2.1**	**1.8**	**1.7**	**1.7**	**1.7**	**1.7**	**1.8**	**1.9**	**1.7**
United States	2.6	1.9	2.0	2.1	1.9	2.4	2.3	1.8	1.7	1.8	1.8	1.8	2.1	2.1	1.8
Euro Area	1.8	1.5	1.5	1.4	1.2	1.7	2.0	1.9	1.7	1.7	1.6	1.5	1.5	1.7	1.6
Japan	0.3	0.4	0.6	0.4	0.8	1.2	1.5	1.4	1.1	0.9	0.8	0.8	0.5	1.2	0.9
UK	2.1	2.7	2.8	3.0	2.8	2.7	2.6	2.4	2.2	2.2	2.2	2.3	2.7	2.6	2.2
EM*	**3.2**	**3.0**	**3.0**	**3.3**	**3.4**	**3.6**	**3.6**	**3.6**	**3.6**	**3.5**	**3.5**	**3.5**	**3.1**	**3.6**	**3.5**
China	1.4	1.4	1.6	2.0	2.3	2.4	2.5	2.6	2.6	2.6	2.7	2.7	1.6	2.5	2.6
India	3.6	2.2	3.0	4.2	4.3	5.3	4.3	4.4	4.5	4.2	4.4	4.4	3.2	4.6	4.4
Brazil	4.9	3.6	2.6	3.0	3.5	4.0	4.1	4.1	4.2	4.1	4.2	4.3	3.5	3.9	4.2
Russia	4.6	4.2	3.4	2.7	3.3	3.4	4.0	4.4	4.2	4.1	4.1	4.2	3.7	3.8	4.1
Core Inflation (YoY)															
Global	**2.2**	**2.1**	**2.0**	**2.1**	**2.1**	**2.3**	**2.4**	**2.5**	**2.5**	**2.5**	**2.6**	**2.5**	**2.1**	**2.3**	**2.5**
G4	**1.2**	**1.2**	**1.2**	**1.2**	**1.3**	**1.4**	**1.6**	**1.6**	**1.6**	**1.7**	**1.7**	**1.7**	**1.2**	**1.5**	**1.7**
United States^	1.8	1.5	1.3	1.5	1.5	1.7	1.8	1.7	1.7	1.8	1.8	1.7	1.5	1.7	1.7
Euro Area	0.8	1.1	1.2	0.9	1.1	1.3	1.4	1.6	1.6	1.7	1.7	1.6	1.0	1.3	1.6
Japan	0.1	0.0	0.2	0.3	0.4	0.6	0.8	1.0	1.1	1.1	1.2	1.2	0.1	0.7	1.2
UK	1.8	2.5	2.6	2.6	2.4	2.3	2.4	2.4	2.4	2.5	2.6	2.8	2.4	2.4	2.6
BRIC	**3.2**	**2.9**	**2.9**	**3.0**	**3.0**	**3.2**	**3.3**	**3.3**	**3.3**	**3.3**	**3.4**	**3.3**	**3.0**	**3.2**	**3.3**
China	2.0	2.1	2.2	2.3	2.3	2.3	2.4	2.5	2.5	2.6	2.6	2.6	2.2	2.4	2.5
India	4.9	4.2	4.3	4.7	4.7	5.1	4.7	4.5	4.7	4.7	4.7	4.3	4.5	4.7	4.6
Brazil	4.5	3.8	3.1	3.2	3.5	3.9	4.1	4.3	4.3	4.3	4.3	4.3	3.6	3.9	4.3
Russia	5.2	3.9	3.0	2.2	2.7	3.5	4.1	4.6	4.2	4.0	4.2	4.2	3.6	3.7	4.1
Monetary Policy Rate (% p.a.)															
Global	**3.2**	**3.2**	**3.1**	**3.1**	**3.1**	**3.2**	**3.3**	**3.3**	**3.5**	**3.6**	**3.6**	**3.7**	**3.1**	**3.3**	**3.7**
G10	**0.3**	**0.4**	**0.4**	**0.6**	**0.7**	**0.8**	**0.9**	**0.9**	**1.1**	**1.2**	**1.2**	**1.3**	**0.6**	**0.9**	**1.3**
United States	0.875	1.125	1.125	1.375	1.625	1.875	2.125	2.125	2.375	2.625	2.625	2.625	1.375	2.125	2.625
Euro Area	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	-0.25	-0.25	-0.25	-0.40	-0.40	-0.25
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	0.25	0.25	0.25	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.25	0.50	0.75	1.25
EM	**5.4**	**5.3**	**5.0**	**4.9**	**4.9**	**4.9**	**5.0**	**5.1**	**5.3**	**5.3**	**5.3**	**5.4**	**4.9**	**5.1**	**5.4**
China	4.35	4.35	4.35	4.35	4.35	4.35	4.60	4.60	4.85	4.85	4.85	4.85	4.35	4.60	4.85
India	6.25	6.25	6.00	6.00	6.00	6.00	6.00	6.25	6.25	6.50	6.50	6.75	6.00	6.25	6.75
Brazil	12.25	10.25	8.25	7.00	7.00	7.00	7.00	7.50	8.50	8.50	8.50	8.50	7.00	7.50	8.50
Russia	9.75	9.00	8.50	8.00	7.75	7.50	7.25	7.00	7.00	6.75	6.75	6.50	8.00	7.00	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 average. Global* and EM* Consumer Price Inflation Aggregates exclude Venezuela and Argentina. The global core inflation aggregate consist of G4+BRiCS. ^The US core inflation number is core PCE. Source: IMF, Morgan Stanley Research forecasts

Exploring the bull and bear cases

Global growth risks are skewed towards the downside in both 2018 and 2019. This is driven by both DM and EM in 2018, but primarily DM in 2019. The US stands out with marked downward skews in the GDP forecasts for both 2018 and 2019. Global trade, financial conditions and productivity/labour force growth are the key risk drivers of our bull-bear scenarios. The risks to the global inflation outlook are moderately skewed to the downside in both 2018 and 2019.

Bear case: Our bear case is a combination of a disruption to global trade and value chains (causing global trade to be 1.5pp lower in 2018 and 2.5pp lower in 2019 than in our base case), a material correction in risk assets fuelling a significant tightening in financial conditions (financial conditions tightening by more than 125bp than in our base case in 2018 and 150bp in 2019) and anaemic productivity and labour force growth (with productivity growth flat and the labour force shrinking modestly). In the US, failure to reach an agreement on fiscal reform/stimulus is a key downside risk, as is the Fed's balance sheet drawdown, which could potentially have a more malign impact on risk assets than generally assumed. In the euro area, political risk resurfaces, fuelling a negative feedback loop across the region from financial markets. Moreover, trade talks with the UK break down and the UK crashes into a WTO relationship with the euro area from March 2019. In China, faster policy tightening leads to a sharper slowdown in domestic demand.

Bull case: Our bull case is a combination of a rebound in globalisation (causing global trade to be 1.5pp higher in 2018 and 2.5pp higher in 2019 than in our base case), financial deregulation and continued repair of the banking system, fuelling a significant easing in financial conditions (financial conditions easing by 100bp compared with our base case in both 2018 and 2019) and stronger-than-expected productivity and labour force growth (with both 0.5pp higher than in the base case). In the US, holdout budget hawks abandon caution and there is a larger-than-expected fiscal stimulus. In the euro area, further European integration lifts sentiment and the fiscal impulse becomes more expansionary. The euro area and the UK reach early agreement on a modest/no change outcome. In China, a stronger-than-expected global recovery and slower-than-expected domestic tightening lift exports and capex.

Exhibit 27:

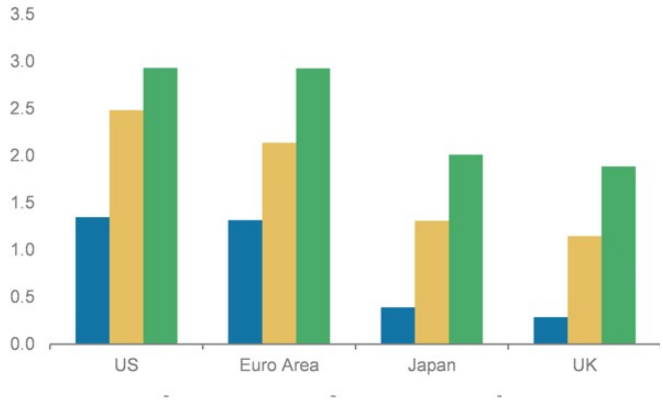
Growth risks: Skewed to the downside

	2017E		2018E			2019E		2020-22
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
GLOBAL	**3.6**	**2.8**	**3.8**	**4.6**	**2.4**	**3.7**	**4.7**	**3.4**
G10	**2.2**	**1.1**	**2.1**	**2.8**	**0.3**	**1.8**	**2.7**	**1.3**
US	**2.3**	1.3	**2.5**	2.9	0.1	**1.9**	2.5	**1.2**
EA	**2.3**	1.3	**2.1**	2.9	0.6	**1.9**	3.3	**1.2**
Japan	**1.5**	0.4	**1.3**	2.0	0.4	**1.5**	2.4	**1.1**
UK	**1.5**	0.3	**1.1**	1.9	-0.4	**0.8**	1.7	**1.4**
EM	**4.7**	**3.9**	**5.0**	**5.9**	**3.8**	**5.0**	**6.1**	**4.8**
China	**6.8**	6.0	**6.5**	6.9	5.7	**6.3**	6.8	**5.6**
India	**6.4**	6.3	**7.5**	8.8	6.1	**7.7**	8.8	**7.3**
Brazil	**0.7**	2.0	**3.1**	3.9	2.0	**3.4**	4.3	**2.3**
Russia	**1.8**	0.0	**2.3**	4.3	-1.0	**1.8**	4.2	**1.8**

Source: Morgan Stanley Research forecasts

Exhibit 28:

Risks to 2018 growth skewed to the downside in G4



Source: Morgan Stanley Research forecasts

Exhibit 29:

Inflation risks: Skewed slightly to the downside

	2017E		2018E			2019E		2020-22
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
GLOBAL	**2.5**	**2.6**	**2.9**	**3.0**	**2.5**	**2.8**	**3.0**	**2.8**
G10	**1.8**	**1.2**	**1.9**	**2.3**	**1.1**	**1.7**	**2.2**	**1.9**
US	**2.1**	1.4	**2.1**	2.6	1.6	**1.8**	2.2	**2.1**
EA	**1.5**	1.0	**1.7**	2.0	0.4	**1.6**	2.2	**1.7**
Japan	**0.5**	0.5	**1.2**	1.7	0.1	**0.9**	1.6	**1.5**
UK	**2.7**	3.0	**2.6**	2.5	3.0	**2.2**	2.0	**2.2**
EM	**3.1**	**3.6**	**3.6**	**3.5**	**3.5**	**3.5**	**3.5**	**3.4**
China	**1.6**	1.9	**2.5**	2.7	1.9	**2.6**	2.9	**2.5**
India	**3.2**	5.0	**4.6**	4.4	5.1	**4.4**	4.3	**4.0**
Brazil	**3.5**	4.4	**3.9**	3.4	5.2	**4.2**	3.2	**4.0**
Russia	**3.7**	6.5	**3.8**	2.0	7.0	**4.1**	2.1	**4.2**

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

Bull-base-bear scenarios – DM

Bear	Base	Bull
US: Ellen Zentner, US Economics Team		
Includes a **recession**, and comes not only with a dose of fiscal failure, but more importantly the Fed's **balance sheet drawdown** hits **credit spreads**, then equities hard as a mountain of corporate bond issuance in 2018 competes with US Treasuries for global liquidity. Additionally, the synchronous global recovery runs out of steam. The **Fed is late to recognise** that not only has growth stalled, but r* never really made it off zero and continues to hike into mid-2018.	In 2019, the business expansion ties the longest on record, elongated by a latent **pick-up in productivity** and **contained inflation**. We are revising growth in 2018 upward to 2.5%Y (vs. 2.2%Y previously) on **stronger investment** and a **larger fiscal deficit**. We initiate 2019 at 1.9%Y as the Fed pushes past neutral to slow the economy back toward its potential.	Holdout budget hawks abandon caution and **embrace larger stimulus.** With unemployment around 4% and growth above potential, the Fed responds aggressively with four hikes in 2018. Seeing little dent to financial conditions, the Fed shifts to raising rates at every meeting in 2019, ultimately leading to a **boom/bust cycle** that ends in recession in 2019 as restrictive monetary policy and a fading impulse from tax policy combine.
Euro area: Daniele Antonucci, EA Economics Team		
Political risk becomes a focus again, with **Italy's election** perceived by the markets as a binary event of moderate vs. anti-euro parties, and **Catalonia's 'Spexit'** resurfacing. This fuels a **negative feedback loop across the region from financial markets:** a spike in interest rates and a general tightening in financial conditions.	Following a raised estimate of 2.3%Y for 2017, we further lift our 2018 GDP growth forecast to 2.1%Y, and our first stab at 2019 puts growth at 1.9%Y. A **broadening of the domestic momentum, lower bond yields** and a **weaker FX path** are the key drivers behind this forecast change. With **core inflation rising** above the long-term average, the **ECB QE** comes to an end in September 2018, and the first **depo rate hike** happens in March 2019.	**Prospects of extra European integration** lift sentiment. The **fiscal impulse** becomes more expansionary and boosts growth. **Productivity** accelerates, driven by a **faster recovery in capex** in reaction to the stronger incentive to invest, given better economic conditions.
Japan: Takeshi Yamaguchi, Shoki Omori		
Weaker external demand including a US recession hurts Japan's exports and capex. PM Abe may resign if he **loses a constitutional referendum**, which may end reflationary Abenomics earlier than assumed. Other downside risks include **higher oil prices** worsening Japan's terms of trade and a disorderly resolution of **North Korean tensions**.	Japan is making a **gradual exit from deflation**. For 2018, we revise up our real GDP forecast mainly on **stronger exports and private capex**, while we expect slower nominal GDP growth, reflecting higher oil prices with slow adjustments in domestic prices in the near term. That said, we expect both real and nominal GDP growth to reaccelerate in 2019.	Japan's exports and capex gain from a stronger-than-expected global recovery. We see a risk of **more expansionary fiscal policy** in 2H18 and 1H19 ahead of a constitutional referendum, possibly in July 2019. We also see a risk (30-40% chance) of PM Abe **postponing the c-tax hike** ahead of the referendum, as it is very unpopular among the public.
UK: Jacob Nell, Melanie Baker		
Trade talks break down ('no deal') and the UK moves to a **WTO relationship** with the EU in March 2019, pushing the economy into a recession, and keeping the MPC on hold through the forecast horizon.	We see heightened political and market uncertainty in the endgame on **Brexit** and as the **UK leaves the EU**, with growth slowing to a standstill in 4Q18/1Q19, before a last-minute deal which avoids a hard Brexit opens the door to a modest 2019 recovery, reflecting greater certainty about the **UK's trading relationship** with the EU.	**Early agreement with EU** on a modest/no change outcome, and a government which holds together and **avoids early elections,** would drive a better outcome in which growth continues at current levels through the riskiest period of the Brexit talks and transition. In this scenario, we would expect more aggressive tightening from the MPC.

Bull-base-bear scenarios – EM

Bear	Base	Bull
China: Robin Xing, Jenny Zheng, Zhipeng Cai		
Faster **monetary tightening** leads to a sharper slowdown in domestic demand. In particular, more aggressive **property tightening** (such as stricter housing sales restrictions and earlier implementation of nationwide property tax) leads to slower-than-expected housing sales. Meanwhile, an escalation in **US-China trade friction** or a US recession could drag down China's export growth. In the bear case, GDP growth could decelerate to 6.0%Y in 2018 and 5.7%Y in 2019.	We expect a **policy-induced growth moderation** in 2018-19, led by slower public and housing investment, but the **growth quality** will continue to improve with **robust consumption** and external demand. Inflation dynamics will remain healthy, while debt/GDP will achieve a near-stabilisation by 2H19 amid incrementally tighter financial conditions.	**A stronger-than-expected global recovery** and a slower-than-expected pace of **domestic monetary tightening** lift exports and capex. As a result, real GDP growth can remain resilient at 6.9%Y in 2018 and 6.8%Y in 2019.
India: Derrick Kam, Chetan Ahya, Aayushi Kukreja		
In 2018, the anticipated **capex recovery** does not come to fruition and external factors weigh on growth. For 2019, the key downside risk would be the **general election** in May. **Policy uncertainty** prevails in the run-up and post the election, which, coupled with weaker trade and tighter financial conditions globally, results in businesses holding back on spending.	The economy is poised for a **growth acceleration** from 3Q17 onwards as a number of significant headwinds (currency replacement programme, implementation of GST) are now firmly in the rear-view mirror. We see a clear runway for growth, with both consumption and exports picking up. The continued recovery in demand will lift capacity utilisation rates and improving corporate balance sheets will lead to a private capex recovery by 2018.	In the bull case, the **capex recovery** happens at a quicker and stronger pace, strengthening the growth momentum. While election risks in 2019 are largely on the downside, in a bull case, a strong outturn of fiscal spending ahead of the elections, coupled with a **win for the incumbent government**, bolsters confidence further and leads to a sharper rise in investment.
Russia: Alina Slyusarchuk		
External demand weakens, oil prices decline. Relations with the West stay tense and **new sanctions** are imposed, given no change in foreign policy. In the bear scenario, we see the government failing to deliver on the **reform agenda** after the elections, increasing control over the economy. Domestic instability after elections keeps **uncertainty high** and investment depressed. External pressures weaken RUB, fuel inflation and erode household incomes.	In our base case, in 2018 we expect growth to accelerate to 2.3%Y. We see support coming from **higher oil prices**, as we now assume it at US$62/barrel in 2018 versus US$53 previously. We expect **public sector workers' wages indexation** ahead of elections and a more pronounced **CPI slowdown** to support household incomes and consumption. Fixed investment should benefit from better sentiment, delayed renewal of equipment and **construction growth** related to the 2018 FIFA World Cup.	In our bull case, we see the ambitious pro-reform government agenda fully implemented, including measures such as **infrastructure investment** and **labour market reforms.** This should boost investment and total factor productivity. In the bull case we would also see Western sanctions being eased gradually after the elections, supporting growth further.
Brazil: Arthur Carvalho, Thiago Machado		
The bear case is related to **politics,** where not only does the election outcome lead to uncertainty around the macroeconomic balance for Brazil, but also the balance sheet recovery which is under way proves to be more challenging than previously expected. This would mean a weaker recovery. We would also assume not only a weaker currency leading to **higher inflation** but also price pressures in electricity prices due to poor hydrology.	Brazil has left its 2.5-year-long recession and is in the early stages of its ongoing recovery. This recovery is mainly driven by the **consumer,** aided by historically low inflation and cash transfers from the social security workers fund. We expect that over the next 12 months the **monetary policy impulse** will be an important driver for the consumer, where the 675bp of rate cuts so far will reduce the cost of servicing of debt by 1.4pp of GDP for households. The corporate sector should accelerate capex spending into 2018.	If the current **reform agenda** remains in place after the October 2018 election, we believe that Brazil can have a prolonged growth cycle. The bull case would include a **business-friendly candidate** leading in the polls next year, which would boost **confidence** and accelerate the investment recovery. It would also assume a stronger currency, which would keep **inflation low**. This would lead to easier monetary policy.

US: Ringing in year ten

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A latent pick-up in productivity and contained inflation help to elongate the cycle. We are revising growth in 2018 upward to 2.5%Y (versus 2.2%Y previously) due primarily to a stronger domestic backdrop.

Growth: Midway through 2018, the US will ring in its tenth year of expansion. Though signs such as ultra-low unemployment, a positive output gap and rising interest rates continue to suggest that the US is late-cycle, a general lack of overheating in key sectors such as housing and rising productivity suggest that this late-cycle phase has more room to run.

We are ending the year with a stronger-than-expected domestic backdrop that puts 2017 GDP growth on track for 2.3%Y (2.7% 4Q/4Q), and has also led us to **revise higher 2018 GDP by 0.3pp to 2.5%Y (2.1% 4Q/4Q).** In 2018 the unemployment rate moves down to a three-handle, the lowest since 2000. Rising labour costs associated with a tightening labour market have pressured corporate profits, incentivising capex over labour. On the back of a lengthy period of higher investment, productivity is now rising.

In 1H18 we expect the delivery of a mildly expansionary tax package worth US$1 trillion over 10 years. This amounts to a moderate ~0.5% of GDP in deficit expansion over the first four quarters of enactment, and about a 0.1pp of boost to GDP growth. Looking further ahead, **we initiate 2019 GDP growth at 1.9%Y (1.7% 4Q/4Q).** While this appears to be fairly stable growth, the devil is in the quarterly details, where 4Q growth slips to just 1.5% SAAR, well below the Fed's estimate of the economy's potential.

Supporting 1H growth is the 2019 tax filing season, which will bring about a jump in refunds, providing a renewed lift to demand, but a more aggressive Fed and hole in economic activity on the other side of tax relief threaten to set in motion end-of-cycle outcomes. Risks to the outlook are to the downside. We place the 12-month recession probability at 25%. We forecast longer-term GDP growth (2020-22) at 1.2%Y, which includes an implicit assumption that the US is in recession at some point within that time frame.

Inflation: A combination of temporary factors depressing core inflation now, such as the lagged impact of previous USD appreciation, slowing rents and other transitory factors such as price resets in telecom contracts will abate over the forecast horizon. Moreover, with the unemployment rate moving down to a 3-handle, the Phillips curve-sensitive components of domestic service inflation respond, while personal income tax cuts lead to a more price-tolerant consumer in early 2019. Still, longer-term structural forces, such as those from technological change and adoption, continue to exert downward pressure. **After ending 2017 at 1.5% 4Q/4Q, we see core PCE inflation rising to 1.7% by end-2018, and remaining roughly flat from there.** We also forecast longer-term growth (2020-22) in PCE averaging 1.7%Y. Applying the 'wedge' to PCE, we see longer-term growth in CPI at 2.1%Y.

Monetary policy: Following a December hike, the Fed raises rates three additional times in 2018 (March, June and September). This view is supported by little remaining slack in the economy and rising r*. At 2.125% by September 2018, the federal funds rate is in the range of neutral, so we expect the Fed to pause there to take stock of how its string of tightening will feed through to the outlook. Seeing the bulk of fiscal stimulus pushing the economy to new heights in early 2019, and with a further increase in r*, we expect two additional hikes – in March and June – pushing the target range past neutral and further into positive real rate territory. With a restrictive stance on policy, we look for 2H19 GDP growth to slow sharply, putting upward pressure on the unemployment rate. This is likely where the hiking cycle ends in this expansion.

We expect no change to the FOMC's explicit guidance on balance sheet policy. With no "material deterioration" in the outlook that results in a "sizable reduction" in the target range of the federal funds rate, balance sheet run-off continues on schedule.

United States: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	1.5	2.3	2.5	1.9
Private consumption	2.7	2.7	2.4	2.1
Government consumption	0.4	-0.1	0.4	0.4
Gross fixed investment	0.6	2.9	2.8	2.6
Contribution to GDP (pp)				
Final domestic demand	2.1	2.5	2.4	2.1
Net exports	-0.2	-0.1	0.0	-0.2
Inventories	-0.4	-0.1	0.1	0.0
Unemp. rate (eop, % labour force)	4.7	4.0	3.8	3.8
CPI (%Y)	1.3	2.1	2.1	1.8
Core PCE (%Y)	1.8	1.5	1.7	1.7
Policy rate (eop, %)	0.625	1.375	2.125	2.625
General govt. balance (% GDP)	-3.1	-3.2	-3.6	-3.8
Gross govt. debt (% GDP)	106	106	107	107
Current account (% GDP)	-2.4%	-2.6%	-2.2%	-2.2%

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Morgan Stanley Research forecasts

Euro area: Regime changes

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In the context of an upwardly revised growth path, 2018 will likely mark the beginning of three key shifts – from negative to positive output gap, from below- to above-average core inflation and from ECB QE to the end of it. For the first time in quite a while, political risk shouldn't be a systemically disruptive factor.

Recovery continues unabated: Following a raised estimate of 2.3%Y for 2017, we lift our 2018 GDP growth forecast further to 2.1%Y, 20bp higher relative to our latest update piece in August and an extra 50bp higher compared with our mid-year outlook. A broadening of the domestic momentum across EMU countries and sectors – with some of the laggards beginning to catch up – and stronger global demand, lower projected bond yields and a weaker near-term FX trajectory are the key drivers behind this forecast change. Our first stab at 2019 puts growth at 1.9%Y, a broadly similar pace of *sequential* expansion relative to the previous year.

Output gap turns positive: Three key trends that have characterised the economy since the euro crisis will likely start to shift next year. The first change in regime has to do with spare capacity. The unemployment rate is approaching the 8.5% mid-point of the range of NAIRU estimates, and will be at less than 8% at the end of the forecast horizon. With growth having expanded markedly above its potential rate of 1.3%Y for three years in a row, and likely to continue to do so for at least the next couple of years, we expect the output gap to become positive, to the tune of 0.3% in 2018 and 0.6% in 2019.

Core inflation rises above average: The second change has to do with the inflation outlook, with the core metric exceeding its long-term average of 1.5%Y in 2H18, after having undershot it significantly. We project a rise from ~1%Y on average this year to 1.3%Y next year and then 1.6%Y in 2019. This is because spare capacity, even in the context of more labour underutilisation than captured by the unemployment rate, should diminish further, and so wage growth is likely to accelerate moderately – also pushed up by the wage-bargaining and indexation mechanisms in the region, which have historically reacted to rising headline inflation.

QE ends: The third regime shift has to do with monetary policy, as the ECB will likely move away from the emergency toolkit. We think that QE will be discontinued after September 2018, with a risk that the ECB extends a bit further with a short taper at a much reduced pace. We believe that, given the reinvestment policy, the stock of QE assets on the central bank's balance sheet will remain unchanged over the forecast horizon. The first depo rate hike will likely be in March 2019 – a one-off move to 'less negative', rather than the beginning of a hiking cycle. The refi rate will likely stay unchanged at zero throughout.

Fiscal policy adds to growth: The change in the cyclically adjusted primary balance, a measure of discretionary changes in the budget, is likely to get slightly bigger. We think that, from an estimated 0.3% of GDP this year, it will likely get to 0.5% next and then ~0.4%, with all large countries running an expansionary fiscal stance – with a combination of tax cuts and/or spending increases. However, the impact on growth may be relatively limited, in our view, as a positive output gap would argue for a smaller fiscal multiplier relative to the crisis years.

Political risk stays subdued: The only major 2018 political event is the Italian election – probably between March and May. It's *not* a binary event. We expect the outcome to be one where, ultimately, a moderate Prime Minister is elected. But the three largest political blocs are in a tight race – with the centre-right possibly slightly ahead if it was to form a coalition. So, we also expect the process to be very volatile, thus making the likelihood of sweeping reforms rather low. By and large, this leaves Italy's economic fabric, along with the debt path, vulnerable to macro shocks.

Euro area: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	1.8	2.3	2.1	1.9
Private consumption	2.0	1.8	1.8	1.6
Government consumption	1.7	1.2	1.4	1.3
Gross fixed investment	4.5	3.7	3.6	3.9
Contribution to GDP (pp)				
Final domestic demand	2.3	2.0	2.0	2.0
Net exports	-0.5	0.2	0.1	0.0
Inventories	-0.1	0.1	0.0	-0.1
Unemp. rate (eop, % labour force)	9.7	8.8	8.4	7.9
HICP (%Y)	0.2	1.5	1.7	1.6
Core HICP (%Y)	0.9	1.0	1.3	1.6
Policy rate (eop, %)	-0.40	-0.40	-0.40	-0.25
General govt. balance (% GDP)	-1.5	-1.2	-1.4	-1.6
Gross govt. debt (% GDP)	88.9	87.5	86.2	85.5
Current account (% GDP)	3.3	2.8	2.7	2.7

Source: ECB, Eurostat, Morgan Stanley Research forecasts

Japan: Gradual exit from deflation

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Japan is making a gradual exit from deflation. We raise our real GDP forecast for 2018 on exports and capex, while we expect a moderate recovery in private consumption and inflation in the near term.

Growth: For 2018, we revise up our real GDP forecast to 1.3%Y from 1.1%Y, mainly on stronger exports and private capex, while we revise down our nominal growth forecast to 1.6%Y from 2.2%Y, reflecting higher oil prices with slow adjustments in domestic prices in the near term. That said, we expect both real and nominal GDP growth to reaccelerate to 1.5%Y and 2.6%Y, respectively in 2019. Japan's exports should continue to benefit from the ongoing synchronous global recovery. Domestic capex should remain solid thanks to higher capacity utilisation rates, a better business outlook, labour shortages and inbound consumption ahead of the 2020 Tokyo Olympics. Meanwhile, we expect private consumption to grow only moderately in the near term before starting to accelerate from 2H18 via solid income growth and front-loaded spending ahead of the consumption tax hike.

Prices: We think that Japan's underlying inflation has already bottomed. That said, we lower our core-core CPI (ex. energy and fresh food) outlook, especially for 1H18, mainly from recent sluggish consumption and slower-than-expected wage growth for regular workers. We still expect the core-core to reach 1.0%Y in Oct-Dec 2018, which will likely remain above the market consensus. For 2019, our FX team expects sharp yen appreciation, which will likely delay CPI approaching the 2%Y target.

BoJ: Monetary policy will remain dependent on inflation developments. Our forecast of the policy sequencing remains that the BoJ: i) Raises the long-term interest rate (10yr JGB yields) target (when the core-core approaches 1%Y); ii) Adjusts the pace of its equity ETF buying (from JPY 6 trillion/year to a JPY 3-6 trillion/year range target, any time after the core-core exceeds 1%Y, depending on equity prices); and iii) Raises the short-term policy rate and abolishes NIRP (when the core-core exceeds 1.5%Y and approaches 2%Y).

We push back the timing of the first hike of the long-term rate target to "3Q18" from "as early as in 1Q18", given our updated inflation forecast. We continue to expect the midpoint target to be raised from "around 0%" to "around 0.25%" with a wider band of +/- 25bp (0-50bp range), although we see a small risk of the BoJ shortening its target duration. We expect the BoJ to remain on hold after the first adjustment until end-2019. We do not expect it to raise the short-term policy rate from -0.1%. For ETFs, we believe that the BoJ would extend low or zero interest loans to firms to buy back their shares should the BoJ reduce its annual pace of buying.

Fiscal policy: Public investment will be a drag in the near term, as formulation of the F3/18 supplementary budget was delayed due to the October 2017 snap election. We expect the Diet to approve a supplementary budget of a few trillion yen in 1Q18, but its economic impact will likely be limited. That said, we expect public investment to contribute positively to GDP growth in 1H19 due to a F3/19 supplementary budget that we expect to be formulated in autumn 2018, ahead of major political events and the next consumption tax hike in 2019.

Five risk factors: i) **Fiscal policy:** We see risk of fiscal policy being more expansionary in 2H18 and 2019. We also see a 30-40% chance of PM Abe announcing a delay on the consumption tax hike ahead of a potential constitutional referendum. ii) **Constitutional referendum:** PM Abe may start to focus on constitutional reform issues, and we see risk that a national referendum may be held with the Upper House elections in July 2019. iii) **Oil prices:** Higher oil prices would worsen Japan's terms of trade. The GDP deflator, one of the four 'deflation-exit' indicators, could turn temporarily negative YoY again with higher oil prices. iv) **BoJ governor selection:** Reappointment of Governor Kuroda is our base case, while Mr. Etsuro Honda still is a possibility. v) **North Korea.**

Japan: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	1.0	1.5	1.3	1.5
Private consumption	0.4	1.0	1.0	1.2
Government consumption	1.3	0.2	0.4	0.3
Gross fixed investment	0.9	2.4	1.0	2.0
Contribution to GDP (pp)				
Final domestic demand	0.7	1.3	0.9	1.2
Net exports	0.6	0.5	0.3	0.1
Inventories	-0.3	-0.3	0.1	0.1
Unemp. rate (eop, % labour force)	3.1	2.6	2.5	2.4
CPI (%Y, ex. VAT)	-0.1	0.5	1.2	0.9
Core-core CPI (%Y, ex. VAT)	0.6	0.1	0.7	1.2
Policy rate (eop, %)	-0.1	-0.1	-0.1	-0.1
General govt. balance (% GDP)	-4.2	-4.1	-3.5	-3.6
Gross govt. debt (% GDP)	239	241	240	238
Current account (% GDP)	3.8	3.9	3.7	4.0

Note: Forecast table show calendar years, not fiscal year
Source: Bank of Japan, Cabinet Office, Ministry of Internal Affairs and Communications, Ministry of Finance, Morgan Stanley Research forecasts

UK: Decision time

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2018 should decide the outcome of Brexit. Uncertainty around the talks and the associated political uncertainty drives growth to a standstill by year-end and pauses the MPC's hiking, before a last-minute deal paves the way for a modest 2019 recovery and a resumption of tightening.

Brexit: The main game in town: We expect the Brexit talks to drive UK politics, the economy and markets. We expect rising uncertainty as the talks approach a conclusion, likely towards the end of 2018, as the looming March 2019 Brexit date forces decisions. In the end, we expect an 11th hour deal – including on a transition – buying time for further, more detailed trade talks.

Growth: Sub-par to standstill to step-up: With investment deterred by uncertainty and real consumption squeezed by inflation, we see growth continuing to run at a sub-par rate of around 0.3%Q through 1H18. We then expect rising uncertainty about the outcome of the Brexit talks and associated domestic political uncertainty to drive growth to a standstill in late 2018, before a deal on transition and further trade talks reduce uncertainty and support a modest recovery through 2019.

Inflation: Peaking now: Inflation is at its peak, as FX pass-through starts to drop out of the data and goods inflation falls back. But it will be a long journey back to target, as the tight labour market drives a gradual build-up in wages and domestic inflationary pressure, reflected in rising services and core inflation. We expect house prices to fall modestly next year, given flat real incomes, driving a larger fall in RPI inflation.

Monetary policy: Hike-pause-tighten: With unemployment holding below the Bank of England's estimate of full employment, and some upward movement in wage growth, we expect an MPC majority for a second hike in May 2018. We then expect the MPC to remain on hold until after Brexit: The growth standstill that we expect, as Brexit talks approach the conclusion, will likely nudge unemployment above equilibrium and push growth below potential, widening the output gap. Beyond a March 2019 Brexit, with core and services inflation pointing to rising domestic inflationary risks, we expect the MPC to resume tightening with further hikes in May 2019 and November 2019, pushing Bank Rate to 1.25% by end-2019, with a QE unwind launched in August 2019 under a new BoE governor.

Fiscal policy: From austerity to neutral: We expect the government to keep easing the planned fiscal squeeze. This reflects public services under pressure; investment to help the economy adjust to Brexit; and a fiscal deficit already back at average levels.

Risk: At the mercy of markets? Given the UK's wide current account deficit and lingering fiscal deficit, and consequent dependence on investor sentiment, we see scope for political uncertainty to temporarily impact markets. Such market moves would themselves impact politics and the economy. Absent a shock, we expect the UK's current account deficit to keep shrinking, with robust global growth and income earned on the UK's foreign assets narrowing the external deficit.

Bull-bear scenarios: In our bull case, the parties reach early agreement on a transition deal, triggering a 2018 rebound in investment and consumption, and a more aggressive hiking cycle from the MPC, with Bank Rate reaching 1.75% by end-2019. In our bear case of a hard Brexit, we see the UK going into a shallow recession and the MPC staying on hold at 0.5% ('one and done').

United Kingdom: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	1.8	1.5	1.1	0.8
Private consumption	2.8	1.6	0.6	0.8
Government consumption	1.1	0.5	0.3	0.7
Gross fixed investment	1.3	2.4	0.5	-0.4
Contribution to GDP (pp)				
Final domestic demand	2.3	1.5	0.5	0.6
Net exports	-0.9	0.5	0.5	0.1
Inventories	0.4	-0.5	0.2	0.1
Unemp. rate (% labour force)	4.9	4.4	4.5	4.6
CPI (%Y)	0.7	2.7	2.6	2.2
Core CPI (%Y)	1.3	2.4	2.4	2.6
Policy rate (eop, %)	0.3	0.5	0.75	1.25
General govt. balance (% GDP)	-2.9	-2.3	-2.0	-1.7
Gross govt. debt (% GDP)	88.3	86.7	86.6	86.5
Current account (% GDP)	-5.9	-5.8	-5.1	-4.3

Source: ONS, BoE, Morgan Stanley Research forecasts

Australia: Late to the party

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Australia will remain out of sync with the global expansion in 2018, with consumer weakness keeping domestic conditions subdued. A depreciating AUD should see growth and inflation pick up in 2019, with the RBA on hold through 2018, before starting a gradual tightening cycle in 2H19.

Out of sync: In contrast to most other DM countries, we expect GDP growth to slow further in 2018 (1.5%Y), after an already weak 2017 (1.9%Y). The household sector is key to our negative view, as the consumer is being squeezed by record-low income growth (with average wages falling), increasing cost-of-living pressures and tighter credit conditions as regulators continue to crack down on mortgage lending. The RBA should remain on hold through 2018 as it balances a weak domestic economy with concerns about household leverage and financial stability, which should in turn drive a substantial AUD depreciation. This will support a recovery in growth and inflation in 2019, and we see a 50bp hike in 2H19.

Government supporting growth, but plenty of risks: Public spending will be a key support to growth in 2017 and 2018 (+1.2pp and +1.1pp contribution, respectively), as state governments continue to ramp up spending on infrastructure investment. As we move closer to another federal election (likely in late 2018 or early 2019), the governing LNP Coalition could try to boost its flagging poll ratings by enacting a stimulatory budget, boosting growth in the short term. However, optimism on stimulus needs to be moderated by the risks posed by the opposition's proposed tax changes, which would impact an already softening housing market.

Housing market slowing further: MSHAUS, our proprietary housing market lead indicator, declined further in 2Q17, pointing to a continued slowing in the housing market into 2018. The largest driver has been credit supply, where regulatory action has seen limits placed on investor and interest-only lending, with banks repricing these loans higher. We expect that construction activity will decline into 2018, while tighter credit and weaker sentiment will see dwelling prices peak. Our AlphaWise survey of mortgagors suggests that the primary impact will be via weaker consumption growth (see Australia: Crunch Time: Switch and Thrift, October 3, 2017), but the risk of a significant change in sentiment and housing price correction remains, which underpins our bear case of a balance sheet recession.

Strong jobs, but disposable income still crunched: The labour market has improved in 2017, with 290k jobs added in the first three quarters and the unemployment rate falling 0.3pp to 5.5%. Despite this, income growth has continued to trend lower, with average incomes falling from the same time a year ago. Looking forward, we expect this to put pressure on consumption growth (with 'spending money' growth of just 0.7%Y for 2018), and for the unemployment rate to grind higher over 2018 (peaking at 6.1% in 4Q18). Household debt will likely remain a key concern for policy-makers, as we expect slow income growth to push leverage ratios higher than their current levels of almost 200% of income.

RBA standing pat: We expect the RBA to hold the cash rate steady over 2018, as inflation moves back into its target band but weakness in the labour market and concern over household leverage remain. The Fed increasing its policy rate above the RBA for the first time in 18 years should drive a depreciation in AUD, which would support activity and inflation into 2019 and see the RBA tentatively beginning a tightening cycle in 2H19. However, this is heavily dependent on the global economy remaining supportive and late-cycle over this time, and over 2018 the risks skew more towards cuts than hikes.

Risks: Our bull case sees the strong employment growth in 2017 to date continuing and lessening the downward pressure on income and consumption. Our bear case sees the housing market slow down by more than expected, which, in combination with the soft consumer, drags the economy into a balance sheet recession.

Australia: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	2.5	1.9	1.5	2.5
Private consumption	2.7	2.2	1.1	1.8
Government consumption	4.2	3.1	2.9	2.8
Gross fixed investment	-2.7	1.1	-0.2	1.4
Contribution to GDP (pp)				
Final domestic demand	1.6	2.1	1.1	1.9
Net exports	1.5	-0.5	0.4	0.6
Inventories	0.1	0.1	0.1	0.1
Unemp. rate (eop, % labour force)	5.7	5.6	6.0	5.4
CPI (%Y)	1.3	2.0	2.3	2.8
Core CPI (%Y)	1.5	1.8	2.1	2.7
Policy rate (eop, %)	1.5	1.5	1.5	2.0
General govt. balance (% GDP)	-2.4	-2.1	-2.0	-2.1
Gross govt. debt (% GDP)	25.4	28.7	29.9	31.5
Current account (% GDP)	-2.6	-1.9	-2.7	-3.0

Source: ABS, RBA, Morgan Stanley Research forecasts

China: Slower growth, higher quality

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We expect a policy-induced growth moderation in 2018-19, led by slower public and housing investment, but the growth quality will continue to improve with robust consumption and external demand. The inflation dynamic will remain healthy, while the debt/GDP ratio will achieve near-stabilisation by 2H19 amid incrementally tighter financial conditions.

Slower growth but high quality in sight: We revise up our 2018 GDP growth forecast to 6.5%Y (versus 6.4%Y previously) with a higher entry point (2017 YTD: 6.9%Y), and expect it to slow to 6.3%Y in 2019. The Party Congress' emphasis on growth quality instead of the GDP target means continued policy efforts on capacity management, leverage controls and housing tightening, which could weigh on public and housing investment. That said, growth is turning more self-sustaining, with robust consumption and external demand. On the quarterly trajectory, we expect growth to decelerate in the next 2-3 quarters due to environmental closures of capacity and slower credit growth, and stabilise in 2H18.

Rising core CPI, normalised PPI: We retain our constructive view on core CPI and non-commodity PPI, as downstream pricing power will be supported by the robust job market, resilient consumption and multi-year capacity adjustments. While PPI could moderate from 6.5%Y in 2017 to 3.3%Y in 2018 and 2.5%Y in 2019 amid a high base in commodity prices, non-commodity PPI could hold up relatively well at 1.6%Y in 2018 and 1.5%Y in 2019, with a larger contribution to headline PPI (32% in 2018 and 40% in 2019). Meanwhile, core CPI could rise gradually to 2.4%Y in 2018 and 2.5%Y in 2019 (versus 2.2%Y in 2017) while food CPI would likely normalise, bringing headline CPI to 2.5%Y in 2018 and 2.6%Y in 2019.

Incrementally tighter financial conditions, slower debt growth: In the face of rising inflation and upcoming Fed rate hikes, the PBOC will likely make 25bp hikes in benchmark interest rates in 3Q18 and 1Q19 and move the 7D repo rate upwards to 3.8% by end-2018 and 4.0% by end-2019 (from 3.0% currently). This, combined with continued regulatory tightening and scrutiny on local government financing, will bring broad credit growth down to 11.5%Y by end-2018 and ~11%Y by end-2019 (versus 14%Y currently). In turn, the annual average rise in the debt/GDP ratio could slow notably to 5pp in 2017-18 from 16pp in the previous five years, and achieve a near-stabilisation by 2H19.

Continued CNY stability versus the basket: We expect USDCNY to reach 6.65 by end-2017, 6.7 by end-2018 and 6.5 by end-2019. In our view, the PBOC will continue to maintain the stability in trade-weighted CNY, by keeping USDCNY largely as a function of a trade-weighted dollar. Therefore, our FX team's view of a flattened USD trajectory in 2018 and dollar weakness in 2019 indicates that CNY can be held largely stable in 2018 while appreciating in 2019 against USD. Meanwhile, capital controls will likely remain tight in the next 1-2 years to curb speculative outbound investment, but policy-makers could remain supportive of OBOR-related outbound investment as capital flows have stabilised.

Near-term risks to growth tilted to the downside: Our bull case assumes that a slower-than-expected pace of domestic credit tightening and stronger global recovery lift China's capex and exports, keeping real GDP growth resilient at 6.9%Y in 2018 and 6.8%Y in 2019. In the bear case, more aggressive monetary and housing tightening and an escalation in US-China trade friction or a US recession could push down growth to 6.0%Y in 2018 and 5.7%Y in 2019.

More confident on the long-term outlook: China's progress on managing the debt cycle and transition to a high-income society has been better than we expected in our February Blue Paper, and policy-makers' strengthened efforts in capacity cuts and leverage controls since the Party Congress solidify its commitment to prioritise the quality of growth. We are more confident that China will be able to achieve near-stabilisation of debt/GDP by 2H19 and attain high-income status by 2025, two years earlier than we expected (see China: Blue Paper Revisit: Why we are still bullish on China, Nov 14, 2017).

China: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	6.7	6.8	6.5	6.3
Private consumption	7.9	8.2	8.0	7.8
Government consumption	9.5	9.0	8.5	8.2
Gross fixed investment	6.3	5.0	4.5	4.1
Contribution to GDP (pp)				
Final domestic demand	7.2	6.7	6.4	6.1
Net exports	-0.5	0.2	0.2	0.2
Inventories	-0.1	0.0	0.0	0.0
Unemp. rate (eop, % labour force)	4.0	4.0	4.0	4.0
CPI (%Y)	2.0	1.6	2.5	2.6
Core CPI (%Y)	1.6	2.2	2.4	2.5
Policy rate (eop, %)	4.35	4.35	4.60	4.85
General govt. balance (% GDP)	-3.8	-3.8	-3.8	-3.6
Gross govt. debt (% GDP)	47	47	48	49
Current account (% GDP)	1.9	1.0	1.0	1.0

Source: CEIC, Morgan Stanley Research forecasts

India: Cleared for takeoff

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We remain constructive on the macro outlook. We expect a growth acceleration and a recovery in private capex in 2018, setting the stage for a sustained growth cycle.

Private capex to recover in 2018: We expect real GDP growth to accelerate to 7.5%Y in 2018 and further to 7.7% in 2019, from 6.4%Y in 2017. More importantly, we are confident that a recovery in private capex will be under way in 2018, for the first time in six years. The private capex cycle has been subdued due to the issues of weak profitability, trailing excess capacity and weak balance sheets of the industrial sector and state-owned banks. However, these issues have either been or will get resolved in the coming year. Indeed, our confidence in the private capex recovery is predicated on two factors:

First, from the Sep-17 quarter onwards, the economy has largely worked off the impact of idiosyncratic factors of the currency replacement programme and GST implementation. With the headwinds abating, we expect that the economy now has a clear runway for growth, with consumption and exports picking up. This continued recovery in end demand should help to lift capacity utilisation rates. As we look ahead to 2018, a supportive global trade environment should help to support exports growth for India while consumption growth should stay well-supported due to the implementation of state-wise pay commission hikes.

Second, corporate balance sheets are improving. Corporate revenue growth has now outpaced interest costs and the ratings upgrade/downgrade ratio (that is, more companies have had their ratings upgraded than downgraded) has been improving. Moreover, the government has recently announced plans to infuse US$32.5 billion of capital into state-owned banks, which should help to accelerate the NPL resolution process, improve the headroom for growth and boost investor and corporate sentiment. Taken together, these factors should lead to a recovery in private capex in 2018.

Inflation set to rise gradually: CPI inflation has been rising from its June 2017 trough of 1.5%Y to 3.6%Y in October, largely due to normalisation in food prices. Going forward, we expect inflation to continue to rise but remain within the central bank's comfort zone (with the exception of the June-18 quarter, where favourable base effects will push it up). Normalisation in food prices, rising crude oil prices and the continued impact of implementation of pay commission hikes will be the key drivers imparting upward pressures to CPI inflation. On an annual average basis, we expect headline CPI inflation to average 4.6%Y in 2018 versus 3.2%Y in 2017.

Setting the stage for the start of rate hikes: Against this backdrop of an improvement in overall growth, recovery in private capex and a gradual rise in headline inflation, we believe that the next move by the central bank will be to hike rates. As the recovery in private capex gets under way in 2018, neutral real rates would have also likely picked up from the 150-200bp that the central bank had mentioned in 2014. Currently the central bank has a neutral stance, and we expect it to stay on hold for an extended period before moving to prepare for rate hikes. We expect the central bank to begin hiking rates by 4Q18 and also pencil in two more rate hikes in 2019.

Balanced risks as external downside skew offset by domestic upside skew: With the domestic demand recovery gaining traction and the recent policy action to recapitalise the state-owned banks, the risks to the growth story would have been skewed to the upside. However, the downside skew from global factors would have offset this, resulting in evenly balanced risks for 2018. In the bull case, the capex recovery happens at a quicker and stronger pace, strengthening the growth momentum. In the bear case, the anticipated capex recovery does not come to fruition and external factors also weigh on the growth momentum.

India: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	7.9	6.4	7.5	7.7
Private consumption	9.2	6.9	7.7	8.1
Government consumption	15.1	14.5	5.9	5.7
Gross fixed investment	5.1	1.8	6.6	8.9
Contribution to GDP (pp)				
Final domestic demand	5.1	3.8	4.3	4.5
Net exports	0.7	-0.8	0.0	0.1
Inventories	0.1	0.1	0.1	0.2
Unemp. rate (% labour force)	NA	NA	NA	NA
CPI (%Y)	5.0	3.2	4.6	4.4
Core CPI (%Y)	4.8	4.5	4.7	4.6
Policy rate (eop, %)	6.3	6.0	6.3	6.8
General govt. balance (% GDP)	-7.1	-6.2	-6.3	-6.0
Gross govt. debt (% GDP)	68	67	65	63
Current account (% GDP)	-0.5	-1.8	-1.7	-2.1

Source: CSO, RBI, Morgan Stanley Research forecasts

Indonesia: Staying on a gradual recovery path

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We expect the economy to stay on a gradual recovery path. We would watch for risk factors such as elections risks, the pace of structural reforms, the global funding environment and commodity prices.

Growth has surprised somewhat to the downside as the negative fiscal impulse held back domestic demand this year: The domestic demand trajectory has been weaker than expected and we mark-to-market our 2017 GDP forecast, bringing it down a notch from 5.2%Y to 5.1%Y. A few factors have been put forward as to why this is the case (e.g., tax compliance efforts, a rise in electricity tariffs and political uncertainty), but we think that a negative fiscal impulse is what has been holding back the grassroots economy. Indeed, government expenditure has trailed government revenue this year, suggesting that policy-makers have not recycled fiscal resources back into the economy via spending.

This has led to questions about whether growth could decelerate further from here: We don't think so and believe that several factors help to put a floor on how much growth could decelerate. Macro stability has been restored, which reduces the likelihood of disruptive rate hikes. Additionally, structural fundamentals are healthy and there are no macro excesses. Furthermore, commodity exposure has fallen lower than pre-commodity supercycle days, which reduces downside risks from a further commodity price fall.

We expect a recovery path, with GDP growth coming in at 5.4%Y in 2018 and 5.5%Y in 2019: We expect the recovery to be driven by a few factors: i) Continuation of the global synchronous recovery, which would lend support to both commodities and non-commodity exports; ii) A pick-up in government spend in 4Q17; iii) A more efficient government expenditure mix, which would generate better multiplier effects; and iv) A crowding in of domestic demand on the back of the above.

How do elections usually affect the growth path? Indonesia is headed for local elections in June 2018 and national elections in April 2019. We note the following in the past three election cycles: i) Fiscal expansion around national elections tends to coincide with incumbent re-runs; ii) Private consumption showed a similar pattern to fiscal trends, suggesting that the former may have been influenced by the latter; and iii) Election cycles have not led to a lull in capex, except for in 2009 due to the GFC.

What can policy-makers do and how would elections affect the economy this time? We think that further policy rate cuts are unlikely, given the cumulative 225bp rate cut, but the fiscal deficit is likely to come in wider than the -2.2% plan once the MoF has more visibility over the government revenue stream. Should growth disappoint, we believe that capital spend (which helps to generate better multiplier effects) and social assistance spend (which would benefit lower income households with higher propensity to spend) would likely be what policy-makers focus on in order to support growth. That said, to the extent that fiscal largesse is unlikely, given the 3% fiscal deficit ceiling cap, we expect a gradual growth recovery rather than a V-shaped growth recovery in Indonesia. Meanwhile, we do not think that the election cycle will lead to a lull in capex, given that the capacity utilisation rate has been improving and that capex momentum seems to have lagged production. Beyond the near term, we reiterate our view that any growth alpha would need to be driven by structural reforms to improve competitiveness of non-commodities sectors. Sustained implementation of structural reforms beyond the 2019 elections would be required to help Indonesia lift its growth potential and drive further growth alpha.

Where are the risks? On the domestic front, we would keep an eye on election risk and the pace of structural reforms. A sustained rise in political/policy uncertainty ahead of the elections could be a drag on sentiment and depress domestic demand. On the external front, global demand, commodity prices and the funding environment (US 10Y yield) are factors to watch.

Indonesia: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	5.0	5.1	5.4	5.5
Private consumption	5.0	5.0	5.3	5.4
Government consumption	-0.1	1.9	3.5	3.5
Gross fixed investment	4.5	5.6	6.0	6.2
Contribution to GDP (pp)				
Final domestic demand	4.2	4.7	5.1	5.3
Net exports	0.1	0.5	0.0	-0.1
Inventories	0.3	-0.1	0.2	0.2
Unemp. rate (eop, % labour force)	5.6	5.6	5.4	5.1
CPI (%Y)	3.5	3.8	3.5	3.8
Core CPI (%Y)	3.4	3.2	2.9	3.1
Policy rate (eop, %)	4.8	4.3	4.8	4.8
Fiscal balance (% GDP)	-2.5	-2.4	-2.5	-2.5
Gross govt. debt (% GDP)	28	30	31	31
Current account (% GDP)	-1.8	-1.6	-1.8	-2.0

Source: CEIC, Morgan Stanley Research forecasts

Korea: Better growth, macro cross-currents

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Export recovery and the gradual spillover to domestic demand would likely be offset by the drag from the slowdown in construction capex. We do not expect policy measures to provide significant growth support.

Marking to market 2017 forecasts; upside surprise in 2017 lifts the ramp into 2018: Exports have surprised to the upside and facilities investment has benefitted. With the stronger-than-expected incoming trajectory and the ramp effect into 2018, we are marking to market our 2017 GDP growth forecast from 2.8%Y to 3.1%Y and lifting our 2018 GDP growth forecast from 2.6%Y to 3.0%Y. Meanwhile, our first stab at 2019 GDP growth stands at 2.7%Y.

Higher growth levels but decelerating trajectory: Our GDP growth forecasts reflect the following:

i) We expect Korea's export machine to continue to benefit from the global synchronous recovery: To be sure, export value %Y growth would likely decelerate on the back of base effects but we think that export volume growth would sustain at a healthy pace. Indeed, the iPhone supercycle would benefit Korea's producers of memory and displays.

ii) The export cycle would likely spill over to domestic demand but gradually: So far, facilities capex has already benefitted from the export recovery but the spillover to consumer spending has been less evident. We expect consumer spending to recover but a still over-stretched household balance sheet means that the spending pick-up is likely to be mild as income recovery is saved to pay down on debt.

iii) However, on the other hand, a slowdown in construction capex is likely to offset the positive impact from the former two: Indeed, high household debt and a rising debt-service ratio mean that macroprudential tightening has been undertaken to manage financial stability risks. Pre-sale transactions volume has slowed and points to a significant slowdown in residential construction capex in 2018 and 2019.

iv) Policy stance is likely to be conservative and unlikely to provide significant headline growth support: On the monetary policy front, we are revising our policy rate forecasts from on hold to a 25bp hike in 1Q18 and 2Q18. Heavy signalling by the BoK points to an inclination to normalise rates but we think that any rate tightening is unlikely to be aggressive as a still present negative output gap would likely put a lid on demand-pull inflationary pressures. Meanwhile, the combination of corporate tax hikes and redistributive policies means that the overall fiscal stance is not aggressive. In fact, policy-makers are looking for fiscal deficit to go from 1.7% of GDP in 2017 to 1.6% in 2018 and 1.8% in 2019.

Structural reforms still needed to lift productivity and competitiveness: The rising external tide has provided a growth cushion, masking the underlying structural challenges (of poor demographics and high indebtedness) that the economy faces and buying time for policy-makers to implement tough structural reforms. Policy reforms so far have been a relatively mixed bag. We believe that redistributive policies such as aggressive minimum wage hikes are not sustainable if not accompanied by productivity growth, but measures such as chaebol reforms and raising regular workers' share in the labour force are steps in the right direction if they can lead to higher productivity. Overall, we think that more structural reforms are required to improve competitiveness in the SME and services space (e.g., streamlining the overgenerous SME financing programmes and overhauling regulatory protection in the services space). These would help to improve efficiency in resource allocation and build a more vibrant private sector required to drive new growth sectors.

Where are the risks? Risk factors to watch include sustainability of global recovery and implications for global trade; China's macro-rebalancing process; global policy risks, such as from Fed or US government policies; geopolitical developments; and direction and momentum of policy reforms in Korea.

Korea: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	2.8	3.1	3.0	2.7
Private consumption	2.5	2.3	2.5	2.4
Government consumption	4.3	3.5	3.5	3.5
Gross fixed investment	5.2	9.4	5.3	3.1
Exports	2.1	3.5	5.5	4.0
Imports	4.5	8.5	7.5	5.2
Unemp. rate (eop, % labour force)	3.7	3.5	3.3	3.1
CPI (%Y)	1.0	2.0	1.7	1.7
Core CPI (%Y)	1.9	1.6	1.7	1.6
Policy rate (eop, %)	1.25	1.25	1.75	1.75
Fiscal balance (% GDP)	-1.4	-1.5	-1.5	-1.7
Gross govt. debt (% GDP)	38	39	39	40
Current account (% GDP)	7.0	5.8	6.5	6.7

Source: CEIC, Morgan Stanley Research forecasts

Russia: A story of stability

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In 2018, we expect growth at 2.3%Y, supported by higher oil prices, increases in public sector wages and construction ahead of the 2018 FIFA World Cup. With CPI slightly below 4%Y in 2018, we see the CBR cutting rates to only 7.00%.

Higher oil prices to lift all boats: We revise our 2017 real GDP forecast to 1.8%Y from 2.0%Y, mainly due to the downside 3Q GDP surprise. Despite a lower entry point, in 2018 we expect growth to accelerate to 2.3%Y (consensus: 1.8%Y). We see support coming from a higher oil price, as we now assume it at US$62/barrel in 2018 versus US$53 previously. We expect public sector workers' wages indexation ahead of elections and a more pronounced CPI slowdown to support household incomes, with consumption accelerating to 4.0%Y. Fixed investment (3.9%Y) should benefit from better sentiment, delayed renewal of equipment and construction growth related to the 2018 FIFA World Cup. Finally, we expect Russia to benefit from stronger external demand. In 2019 we see growth slowing down to 1.8%Y due to the effect of the high base and an oil price slowdown to US$58.

Bringing our inflation forecast down: Helped by a strong RUB and good harvest, inflation reached the 4%Y target faster than expected in July 2017, and has moved to 2.6%Y since then. A much lower entry point (2.7%Y in December 2017), a higher oil price assumption and a somewhat stronger RUB mean that we revise inflation lower. Even though we expect CPI to accelerate to 4.4%Y by end-2018 on base effects and domestic demand recovery, it will still average 3.8%Y in 2018, close to the CBR's 4%Y target. In 2019 we expect inflation to stabilise at 4.1%Y. Given that in the 2018-2020 Monetary Policy Guidelines the CBR said that it aims to anchor CPI inflation "near 4%", we see the target as broadly met.

Gradual monetary easing ahead: That said, we think that the CBR will not be in a rush to cut rates. Given that the CBR sees the economy close to potential, a growth pick-up to 2.3%Y will likely force the CBR to ease rates gradually. As before, we pencil in only four rate cuts of 25bp each next year, with the key rate at 7.00% by end-2018. In the 2018-2020 Guidelines, the CBR revised the level of the neutral interest rate to 6.00-7.00% from 6.50-7.00% previously, as it revised the long-term equilibrium rate in the US and expects a lower Russia risk premium. In 2019, we expect the key rate to be down to 6.50% but not lower, given that inflation expectations should remain elevated, the government is unlikely to fully address some bottlenecks in the economy with the structural reforms, and the labour market should remain tight.

Fiscal policy outlook: Rule-based and tight: The current 2018-20 budget plan signals fiscal tightening, with the federal budget spending shrinking from 18.3% of GDP in 2017 to 15.6% in 2020. It assumes a US$43.8/barrel oil price in 2018 and US$42 in 2019-20 and targets the federal budget deficit narrowing from 2.2% of GDP in 2017 to 1.3% in 2018 and 0.8% in 2019. On our estimates, a higher oil price would secure RUB 2 trillion or 2.1% of GDP of additional oil and gas revenues in 2018. However, we expect the Ministry of Finance to stick to the fiscal rule. It means that additional hydrocarbon revenues will be saved in the Reserve Fund, while the MinFin would be able to expand spending only by the amount of additional non-oil and gas revenues. We see the budget deficit narrowing from 2.0% of GDP this year to 1.1% in 2018 and 0.7% in 2019.

What to expect after the March elections? The pre-election stimulus is unlikely to be aggressive. However, presidential elections are worth watching because they are likely to result in some changes in policy-making. According to the statements, now that stability has been reached, the government is working on the economic reform plan to increase potential growth to 3.0%Y by 2020. Without structural reforms, we see long-term potential growth capped at 1.8%Y per annum. So far we share local expert scepticism regarding the full delivery of the proposed reforms. However, the implementation of the growth agenda presents the upside to our forecast in 2019.

Russia: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	-0.2	1.8	2.3	1.8
Private consumption	-4.5	3.9	4.0	3.3
Government consumption	-0.5	-0.2	1.9	0.5
Gross fixed investment	-1.8	4.5	3.9	3.1
Contribution to GDP (pp)				
Final domestic demand	-2.5	3.3	3.8	3.2
Net exports	1.6	-2.4	-1.8	-1.5
Inventories	0.7	0.9	0.3	0.2
Unemp. rate (eop, % labour force)	5.3	5.0	4.9	4.8
CPI (%Y)	7.1	3.7	3.8	4.1
Core CPI (%Y)	7.5	3.6	3.7	4.1
Policy rate (eop, %)	10.0	8.0	7.0	6.5
General govt. balance (% GDP)	-3.4	-2.0	-1.1	-0.7
Gross govt. debt (% GDP)	12.9	13.5	14.9	15.0
Current account (% GDP)	1.9	2.3	2.7	2.5

Source: CBR, Rosstat, MinFin, Morgan Stanley Research forecasts

Turkey: The side effects of stronger growth

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The current growth model comes with its side effects: a higher fiscal deficit (1.9% in 2017, 2.1% in 2018 and 2.7% in 2019), a higher current account deficit (4.8% in 2017, 5.3% in 2018 and 4.8% in 2019) and higher CPI. Using USDTRY 4.00 for end-2017 and 4.40 for end-2018, we see limited downside for CPI in 2018.

Growth to remain strong: We revise up our GDP growth forecasts by 1.3pp to 5.6%Y for 2017 and by 0.4pp to 3.2%Y for 2018. The upward revision especially for 2017 is mainly due to a unique combination of financial easing (the unprecedented amount and the speed of credit expansion through the credit guarantee fund), macro-prudential easing (lower RRRs, lower LTV for mortgage loans, higher duration in retail lending) and fiscal easing (budget deficit/GDP rising to c.2% from c.1%). As also confirmed by the recently released Medium-Term Programme 2018-2020, a growth and employment-friendly policy mix will be maintained in the upcoming period. However, our GDP growth forecast for 2018 remains well below that of 2017. First, different from 2017, we will have a very high base effect in 2018. Second, although we expect a similar composition of stimulus packages on the prudential and fiscal fronts, it is not likely to create similar CGF-related lending growth in 2018 due to liquidity constraints in the banking system as revealed by a very high loan/deposit ratio at 145%. The authorities have announced that repayments from the actual package will be around TRY 50 billion in 2018, and this will be used for lending on a rolling basis. That said, if a new credit guarantee package is introduced, the risks to our growth forecast for 2018 would be to the upside as each TRY 100 billion expansion in lending is impacting GDP growth by around 0.8pp according to our calculations.

But the growth-friendly policy mix is taking its toll on other macro balances: i) Higher budget deficit: We expect the budget deficit to reach 1.9% in 2017, 2.1% in 2018 and 2.7% in 2019, up from 1.2% on average in 2011-16. Accordingly, the public debt rollover ratio has increased to c.115% in 2017 (c.130% for domestic debt) from 82% on average in the previous decade (85% in domestic debt). Yet, this didn't create pressure on interest rates this year as the rising share of non-residents both in local bonds and credit has helped to keep spreads low such that their shares were up by 3pp to 20% in local bonds and 4pp to 54% in Eurobonds as of 3Q17. **ii) Higher C/A deficit:** There is a strong correlation between lending growth and the core C/A deficit, which is excluding energy and gold. This, coupled with the ongoing rise in the energy and gold deficit, is creating upside pressure on the external deficit. We expect CAD/GDP to rise by 1pp to 4.8% in 2017 and by another 0.5pp to 5.3% in 2018. **iii) Higher inflation:** The recent move in TRY and commodity prices along with the policy framework to support domestic consumption in 2018 as revealed in the recent MTP necessitate a revision to our inflation and monetary policy expectations, at least for the short term. Marking to market the October print and using current USDTRY levels, we have revised up our CPI expectation for 2018 (average) to 9.1%Y from 8.4%Y previously.

Policy rates on hold: The CBT has responded to recent volatility by providing around US$6.4 billion FX liquidity to the system. Yet, limited FX reserves (gross: US$96 billion, net: US$37 billion) limit the options on the FX liquidity front. Therefore, the CBT has recently announced its plans to implement non-deliverable forwards. This measure is intended to normalise FX demand of corporates during high volatility. Yet, if these measures are not enough to stop TRY depreciation, measured hikes in the upper bound of around 75-100bp are likely to be considered. In our base case, we expect all policy rates on hold in 2018, and only a 25-50bp cut in the blended funding rate in 2H18.

No elections until 2019: Turkey had five elections between March 2014 and April 2017, corresponding to 1.6 elections a year, creating idiosyncratic political risk. In line with our long-term view, politicians confirmed that the next elections will be on time in 2019 (local elections in March and presidential/parliamentary elections in November).

Turkey: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	3.2	5.6	3.2	3.7
Private consumption	3.7	3.6	3.5	3.8
Government consumption	9.5	3.1	4.0	4.0
Gross fixed investment	2.2	4.6	2.5	2.0
Contribution to GDP (pp)				
Final domestic demand	4.2	3.9	3.4	3.4
Net exports	-1.3	1.0	-0.3	0.0
Inventories	0.2	0.7	0.1	0.3
Unemp. rate (eop, % labour force)	12.7	12.5	12.4	12.1
CPI (%Y)	7.8	10.9	9.1	8.1
Core CPI (%Y)	8.5	9.9	8.6	7.8
Policy rate (eop, %)	8.0	8.0	8.0	8.0
General govt. balance (% GDP)	-1.1	-1.9	-2.1	-2.7
Gross govt. debt (% GDP)	30	31	32	33
Current account (% GDP)	-3.8	-4.8	-5.3	-4.8

Source: Turkstat, Central Bank of Turkey, Republic of Turkey Undersecretariat of Treasury, Morgan Stanley Research forecasts

Brazil: Growth amid uncertainty

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The consumer should lead the economic recovery, due to strong fundamentals, even in the face of political uncertainty in 2018, but the sustainability of the recovery is more policy-dependent. Inflation and rates should continue to be low.

Brazil has a critical year ahead of its 2018 presidential elections, where voters will choose between the continuation of the ongoing reform agenda or a return to populist policies: Despite this political uncertainty, we believe that there are sufficient fundamental drivers that should generate growth in 2018, while the election result will be critical in order to determine how sustainable the recovery will be in 2019. Despite stronger growth, due to a large output gap, inflation should accelerate mildly mostly due to food price normalisation after a very benign 2016. This should allow the central bank to keep rates stable for most of 2018, initiating a stimulus reduction in late 2018/early 2019.

We see two main drivers for growth in 2018 – the consumer benefitting from the looser monetary policy and some investment pick-up, albeit weak compared to historical comparisons: So far the consumer has benefitted from the remarkably low inflation and also from cash transfers from the workers' fund (FGTS). We believe that the 675bp easing cycle, which should reach 725bp by year-end, will be the main driver for the consumer in 2018, which should benefit from lower servicing costs and also the ability to releverage after two years of deleveraging. Also, we believe that labour markets will continue to improve, reaching 10.7% unemployment by end-2018. Finally, historically consumer confidence actually improves during election years, highlighting how resilient this growth engine is for 2018.

The stronger consumer backdrop should push corporates to invest at least in building inventories and brownfield investments: Although we believe that investment will swing into positive growth in 2018, it is important to note that this is a sub-par investment recovery growth when compared to previous episodes, when investment grew at a double-digit pace when exiting from a recession. We believe that while consumers are more indifferent to the political uncertainty, corporates are much more sensitive, which is the main reason why we foresee this sub-par investment recovery. If the political outcome is one favourable to the reform agenda, we believe that investment will accelerate and be the main growth driver in 2019.

Inflation should pick up, but remain below the centre of the target for 2018. After a very benign year for inflation in 2017, we forecast an acceleration from close to 3%Y at end-2017 to around 4%Y in 2018: This is mostly due to the normalisation of food prices, which have been in the deflationary camp for the past few months. Meanwhile, core inflation should remain well-behaved and close to 4%Y, given the large slack that the economy currently has.

Stronger growth should lead to a wider current account deficit, but also a slightly better fiscal result: We believe that imports will accelerate in 2018 due to stronger consumption and investment, so should profits and dividends remittances, while exports should have weaker growth than in 2017, when Brazil had one of the best soy harvests in its history and new iron ore capacity delivery. The positive side from stronger growth will be stronger tax revenues growth and the small improvement in Brazil's fiscal accounts, despite the lack of advancement in pension reforms.

Brazil's bull and bear case are dependent on the policy choices from the president that will be elected in 2018: If candidates that are leading polls throughout 2018 are not perceived to be willing to continue the reform agenda, this would add pressure on long-term interest rates and FX, not to mention lead to more cautious behaviour from banks, which would in turn hurt the ongoing recovery. Of course, a non-delivery of the pension reform in 2019 would add even more volatility and hurt growth further. On the other hand, a positive perception about further reforms could not only reduce risk premiums, especially long-term interest rates, but also unlock the investment projects that are currently being held back.

Brazil: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	-3.6	0.7	3.1	3.4
Private consumption	-4.2	1.0	4.0	2.8
Government consumption	-0.6	-1.9	-0.6	0.3
Gross fixed investment	-10.0	-3.5	6.6	9.1
Contribution to GDP (pp)				
Final domestic demand	-4.9	-0.3	3.7	3.6
Net exports	2.3	0.2	-0.3	-0.4
Inventories	-1.0	0.8	-0.3	0.2
Unemp. rate (eop, % labour force)	12.6	12.4	10.7	9.1
CPI (%Y)	8.8	3.5	3.9	4.2
Core CPI (%Y)	4.8	3.6	3.9	4.3
Policy rate (eop, %)	13.75	7.00	7.50	8.50
General govt. balance (% GDP)	-9.00	-8.60	-7.90	-6.90
Gross govt. debt (% GDP)	69.5	74.0	75.0	78.8
Current account (% GDP)	-1.30	-0.70	-1.60	-2.20

Source: IBGE, BCB, Morgan Stanley Research forecasts

Mexico: Into the unknown

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Uncertainty will dominate Mexico's outlook in the year ahead as the outcome of NAFTA talks and the presidential election could define the country's narrative for years to come.

Mexico is facing important risks that could change its narrative materially for years to come: The first challenge is the future shape of the US-Mexico trade relationship. The second, which is set to intensify, is political uncertainty ahead of the July election. Given the country's high degree of trade and financial openness, the failure of NAFTA or a shift away from prudent macro policy with a commitment to reforms would deal a blow to Mexico's economy, hurting prospects for a lifting in potential output as reforms mature. While neither of these two challenges are new, developments since our last update point to uncertainty lingering for longer, with risks skewed to the downside.

Disagreement on thorny topics of NAFTA negotiations have pushed forward the deadline to strike a deal, possibly adding noise during the campaign season: A deadline that envisaged reaching a deal by year-end has been pushed to March 2018 amid disagreements stemming from US demands that Canada and Mexico consider unacceptable. Protectionism is unlikely to yield any winners – a core element of our view in favour of a positive outcome for NAFTA – yet we underestimated the extent to which US political imperatives would get in the way of achieving consensus.

The presidential election is shaping into a contested, three-way race after the incumbent emerged strengthened from the state elections, leading to greater fragmentation among centre-right voters. Against this backdrop, we are downgrading 2018 growth to 1.8%Y from 2.3%Y previously as uncertainty takes its toll on investment, hiring and spending decisions and policy remains tight. Indeed, the uncertainty shock may be already leaving its mark: our estimates suggest that capex over the past year has been rising at roughly half the pace predicted by factors such as the industrial cycle. For 2019, we are pencilling in a rebound to 2.3%Y as uncertainty fades. Our base case assumes broad policy continuity. A bear case of protectionism and a populist shift would see activity coming to a near halt by 2019, with financial stability concerns preventing the central bank from easing; a swift, successful NAFTA resolution and reform progress would lift growth above trend to 3.3%Y by 2019.

Starting points matter and Mexico is facing a period of uncertainty in good fundamental shape: Fiscal consolidation efforts have finally put debt ratios on a downward path while helping to build modest buffers. The current account deficit is moving in the right direction thanks mainly to rising industrial exports. With the global rebound set to carry into 2018, Mexico's manufacturers should keep benefitting despite lingering protectionism fears. The central bank tightened policy aggressively and, even as inflation gradually eases over the course of 2018, policy-makers are likely to err on the side of caution by staying on hold as they prioritise financial stability considerations. Indeed, the threshold for the central bank to adjust policy either way seems quite high, even with our updated path for the peso which assumes a more depreciated currency hovering near 20.0 to the dollar during most of 2018. In 2019, the central bank should find space to lower rates to 6.00%, with the extent of easing capped by Fed tightening.

Even if uncertainty from NAFTA and politics subsides sooner, Mexico should not lose sight of the unfinished task of tackling its 'missing links', namely shortcomings related to institutions, the rule of law and insecurity: Failure to address these problematic factors has eroded the approval of the administration, and is becoming a dominant topic for next year's election amid high voter dissatisfaction. Mexico has advanced an ambitious set of reforms that is already yielding benefits; failure to embark on the politically difficult task of strengthening institutions would cap Mexico's competitiveness, limiting the upside from past reform efforts.

Mexico: Forecast summary

	2016	2017E	2018E	2019E
Real GDP (%Y)	2.9	2.1	1.8	2.3
Private consumption	3.7	2.9	2.0	2.5
Government consumption	2.4	0.4	1.4	1.2
Gross fixed investment	1.1	-0.9	1.0	3.1
Contribution to GDP (pp)				
Final domestic demand	3.0	1.9	1.8	2.6
Net exports	0.2	-0.3	0.1	-0.2
Inventories	-0.2	0.4	-0.1	-0.1
Unemp. rate (% of labour force)	3.9	3.4	3.4	3.2
CPI (%Y)	2.8	5.9	4.2	3.5
Core CPI (%)	3.0	4.7	3.8	3.2
Policy rate (eop, %)	5.75	7.00	7.00	6.00
General govt. balance (%GDP)	-2.5	-1.3	-2.0	-1.9
Gross govt. debt (%GDP)	49.4	46.6	46.5	45.1
Current account (% GDP)	-2.1	-1.7	-1.9	-2.2

Source: Banxico, INEGI, SHCP, Morgan Stanley Research forecasts

GDP forecasts: Base, bear, bull scenarios

We raised our global growth forecast by one-tenth to 3.8%Y for 2018 from our mid-year outlook. Upward revisions were driven by DM, with forecasts for the US and euro area raised by three and five-tenths respectively. Our forecast for Japan was also revised higher by two-tenths. In EM, we nudged our GDP forecast for China up by one-tenth to 6.5% for 2018 and made significant upward revisions to our Brazilian and Russian forecasts (six-tenths and five-tenths, respectively). This helped to offset the material downwards revision in our Indian growth forecast.

	2017E		2018E			2019E		2020-22E
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
Global	**3.6**	**2.8**	**3.8**	**4.6**	**2.4**	**3.7**	**4.7**	**3.4**
G10	**2.2**	**1.1**	**2.1**	**2.8**	**0.3**	**1.8**	**2.7**	**1.3**
US	2.3	1.3	2.5	2.9	0.1	1.9	2.5	1.2
Euro Area	2.3	1.3	2.1	2.9	0.6	1.9	3.3	1.2
Japan	1.5	0.4	1.3	2.0	0.4	1.5	2.4	1.1
UK	1.5	0.3	1.1	1.9	-0.5	0.8	1.6	1.4
Canada	2.6	0.8	1.8	2.5	-0.1	1.8	2.0	1.3
Norway	1.8	1.5	2.3	3.4	1.3	2.1	3.2	1.7
Sweden	3.1	1.9	2.8	3.9	0.8	2.0	3.2	2.0
Australia	1.9	-0.1	1.5	3.5	0.5	2.5	3.5	2.7
New Zealand	2.7	1.2	3.7	4.0	1.8	3.0	3.5	3.0
EM	**4.7**	**3.9**	**5.0**	**5.9**	**3.8**	**5.0**	**6.1**	**4.8**
CEEMEA	**2.5**	**0.7**	**2.7**	**4.3**	**0.5**	**2.6**	**4.6**	**2.6**
Russia	1.8	0.0	2.3	4.3	-1.0	1.8	4.2	1.8
Poland	4.2	3.1	4.4	5.7	1.6	3.8	6.1	3.3
Czech Rep	4.5	2.5	3.8	5.1	0.9	3.0	5.3	2.8
Hungary	3.7	2.2	3.5	4.8	1.1	3.2	5.5	2.5
Ukraine	2.1	-0.5	2.9	6.0	-0.5	3.4	7.5	3.5
Kazakhstan	4.0	2.0	4.3	6.5	2.0	4.0	7.0	4.0
Turkey	5.6	1.7	3.2	4.7	2.0	3.7	5.4	3.0
Israel	3.2	2.6	3.1	3.6	2.9	3.4	3.9	3.0
South Africa	0.8	-0.3	1.2	1.8	0.5	1.4	2.5	1.6
Nigeria	0.7	0.8	2.5	4.0	1.0	2.9	4.9	3.0
Saudi Arabia	0.1	-1.5	1.5	3.0	0.4	1.9	2.9	3.0
AXJ	**6.1**	**5.4**	**6.2**	**6.9**	**5.1**	**6.1**	**6.9**	**5.7**
China	6.8	6.0	6.5	6.9	5.7	6.3	6.8	5.6
India	6.4	6.3	7.5	8.8	6.1	7.7	8.8	7.3
Hong Kong	3.6	1.4	3.0	4.0	1.0	2.5	3.0	2.5
Korea	3.1	1.8	3.0	3.8	1.2	2.7	3.7	2.8
Taiwan	2.7	1.5	2.9	4.0	0.9	2.6	4.0	2.8
Singapore	3.4	1.7	3.4	4.8	1.0	3.1	4.8	3.0
Indonesia	5.1	4.7	5.4	5.9	4.6	5.5	6.1	5.7
Malaysia	5.9	4.3	5.6	6.5	3.6	5.3	6.4	5.0
Thailand	3.7	2.5	3.8	4.8	1.9	3.5	4.8	3.0
Philippines	6.6	5.6	6.6	7.2	5.4	6.6	7.4	6.8
LatAm	**0.8**	**1.1**	**2.2**	**3.1**	**1.0**	**2.6**	**3.9**	**2.8**
Brazil	0.7	2.0	3.1	3.9	2.0	3.4	4.3	2.3
Mexico	2.1	1.3	1.8	2.2	0.5	2.3	3.3	2.8
Chile	1.6	2.4	2.9	3.2	2.0	2.7	3.2	3.0
Peru	2.8	3.3	3.9	4.5	2.7	3.7	4.7	3.8
Colombia	1.6	1.5	2.3	3.2	1.7	2.8	4.5	3.3
Argentina	2.8	2.0	3.3	4.5	2.1	3.7	4.8	3.1
Venezuela	-15.6	-15.0	-9.6	-4.5	-12.0	-6.9	1.0	5.0

Source: Morgan Stanley Research forecasts

CPI forecasts: Base, bear, bull scenarios

We revised higher our 2018 global forecast by one-tenth to 2.9%Y from our mid-year outlook. Both DM and EM are responsible for the upgrade to varying degrees, with the US and euro area forecasts raised by two and four-tenths, respectively. In contrast, the UK CPI forecast for 2018 has been cut by five-tenths. In EM, we raised our forecast for China by three-tenths, which helped to offset downward revisions of five-tenths in our Brazil and Russia forecasts.

	2017E		2018E			2019E		2020-22E
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
Global*	**2.5**	**2.6**	**2.9**	**3.0**	**2.5**	**2.8**	**3.0**	**2.8**
G10	**1.8**	**1.2**	**1.9**	**2.3**	**1.1**	**1.7**	**2.2**	**1.9**
US	2.1	1.4	2.1	2.6	1.6	1.8	2.2	2.1
Euro Area	1.5	1.0	1.7	2.0	0.4	1.6	2.2	1.7
Japan	0.5	0.5	1.2	1.7	0.1	0.9	1.6	1.5
UK	2.7	3.0	2.6	2.5	3.0	2.2	2.0	2.2
Canada	1.5	1.3	1.5	2.0	1.0	2.2	2.8	1.8
Norway	1.9	1.0	1.9	2.8	0.8	2.0	3.3	2.5
Sweden	1.8	0.6	1.3	2.4	1.4	2.6	3.0	2.0
Australia	2.0	1.2	2.3	3.3	1.0	2.8	3.5	2.5
New Zealand	1.9	1.5	2.3	3.5	1.8	2.4	3.0	2.0
EM*	**3.1**	**3.6**	**3.6**	**3.5**	**3.5**	**3.5**	**3.5**	**3.4**
CEEMEA	**5.8**	**6.3**	**5.6**	**5.2**	**6.0**	**5.3**	**4.9**	**5.3**
Russia	3.7	6.5	3.8	2.0	7.0	4.1	2.1	4.2
Poland	1.9	1.3	2.2	2.6	0.6	2.5	3.4	2.5
Czech Rep	2.5	1.5	2.5	3.0	0.5	2.1	2.9	2.0
Hungary	2.4	1.7	2.9	3.5	0.8	3.0	4.2	3.0
Ukraine	14.5	14.0	11.0	7.0	12.0	7.8	5.5	7.0
Kazakhstan	7.5	9.0	7.3	5.0	8.0	6.5	5.0	7.0
Turkey	10.9	8.1	9.1	10.6	7.1	8.1	9.1	7.5
Israel	0.3	0.8	0.6	1.6	0.8	1.6	1.6	2.0
South Africa	5.3	6.3	5.2	4.4	5.9	5.3	5.0	5.2
Nigeria	16.6	15.3	13.5	12.5	14.5	13.0	11.5	13.0
Saudi Arabia	-0.1	1.9	2.9	3.9	1.5	2.5	3.5	3.0
AXJ	**2.2**	**2.7**	**3.0**	**3.1**	**2.7**	**3.0**	**3.2**	**2.8**
China	1.6	1.9	2.5	2.7	1.9	2.6	2.9	2.5
India	3.2	5.0	4.6	4.4	5.1	4.4	4.3	4.0
Hong Kong	1.7	2.1	2.7	3.5	1.4	3.1	3.5	2.5
Korea	2.0	1.0	1.7	2.1	0.9	1.7	2.3	1.8
Taiwan	0.4	0.2	0.8	1.3	0.4	1.2	1.8	1.5
Singapore	0.6	0.6	1.4	2.1	0.8	1.8	2.6	1.5
Indonesia	3.8	4.4	3.5	2.8	4.9	3.8	2.9	3.5
Malaysia	3.9	2.4	3.0	3.5	1.7	2.5	3.1	2.0
Thailand	0.6	1.1	1.9	2.4	0.3	1.3	2.0	1.5
Philippines	3.2	3.6	3.7	4.3	2.9	3.1	3.8	3.0
LatAm*	**4.3**	**4.4**	**3.7**	**3.3**	**4.4**	**3.7**	**3.1**	**3.6**
Brazil	3.5	4.4	3.9	3.4	5.2	4.2	3.2	4.0
Mexico	5.9	5.0	4.2	3.5	4.0	3.5	3.2	3.4
Chile	2.1	1.8	2.2	2.8	2.4	2.9	3.4	3.0
Peru	2.9	2.9	2.0	2.1	3.0	2.5	2.0	2.5
Colombia	4.3	4.5	3.5	3.0	4.7	3.6	3.0	3.2
Argentina	25.4	23.0	19.1	14.0	20.0	13.6	10.0	9.0
Venezuela	1049.0	7000.0	4073.5	2800.0	13000.0	10428.3	200.0	120.0

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

Monetary policy rate forecasts

Compared with the mid-year outlook, we expect one less Fed hike in 2018 and have pushed back the timing of the first ECB deposit rate hike to 1Q19 from 3Q18 previously. In Japan, we forecast that the BoJ will raise its 10-year yield curve target in 3Q18 versus 1Q18 previously and are no longer expecting a second rise in the target before end-2018. In China, we now expect the PBOC to hike interest rates in 3Q18 versus an assumption of unchanged rates previously.

	Current	4Q17E	1Q18E	2Q18E	3Q18E	4Q18E	1Q19E	2Q19E	3Q19E	4Q19E
US	1.125	1.375	1.625	1.875	2.125	2.125	2.375	2.625	2.625	2.625
Euro Area	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	-0.25	-0.25	-0.25
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United Kingdom	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.25
Canada	1.00	1.00	1.00	1.25	1.50	1.50	1.75	1.75	2.00	2.00
Norway	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25
Sweden	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.25	-0.25	0.00	0.00
Australia	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	2.00
New Zealand	1.75	1.75	1.75	1.75	2.00	2.25	2.50	2.75	3.00	3.25
Russia	8.25	8.00	7.75	7.50	7.25	7.00	7.00	6.75	6.75	6.50
Poland	1.50	1.50	1.50	1.50	1.75	2.00	2.25	2.50	2.50	2.50
Czech Republic	0.25	0.50	0.75	1.00	1.25	1.25	1.50	1.75	2.00	2.00
Hungary	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90
Romania	1.75	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.50	3.50
Turkey	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Israel	0.10	0.10	0.10	0.10	0.25	0.25	0.25	0.25	0.50	0.50
South Africa	6.75	6.75	6.50	6.50	6.50	6.50	6.50	6.75	6.75	6.75
Nigeria	14.00	14.00	14.00	13.00	13.00	13.00	13.50	14.00	14.00	14.00
Saudi Arabia	2.00	2.00	2.13	2.38	2.63	2.75	3.00	3.25	3.25	3.25
China	4.35	4.35	4.35	4.35	4.60	4.60	4.85	4.85	4.85	4.85
India	6.00	6.00	6.00	6.00	6.00	6.25	6.25	6.50	6.50	6.75
Hong Kong	1.50	1.75	2.00	2.25	2.50	2.50	2.75	3.00	3.00	3.00
S. Korea	1.25	1.25	1.50	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.375	1.375	1.375	1.500	1.625	1.750	1.750	1.750	1.750	1.750
Indonesia	4.25	4.25	4.25	4.25	4.50	4.75	4.75	4.75	4.75	4.75
Malaysia	3.00	3.00	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	2.00	2.00
Philippines	3.00	3.00	3.25	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Brazil	7.50	7.00	7.00	7.00	7.00	7.50	8.50	8.50	8.50	8.50
Mexico	7.00	7.00	7.00	7.00	7.00	7.00	6.50	6.00	6.00	6.00
Chile	2.50	2.50	2.50	2.50	2.50	2.50	3.00	3.50	3.50	3.50
Peru	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.00
Colombia	5.00	4.75	4.25	4.25	4.25	4.25	4.75	5.00	5.00	5.00
Argentina	28.75	28.75	28.75	26.00	25.00	24.00	22.00	21.00	20.00	20.00

Source: Morgan Stanley Research forecasts

Government budget balance and debt forecasts

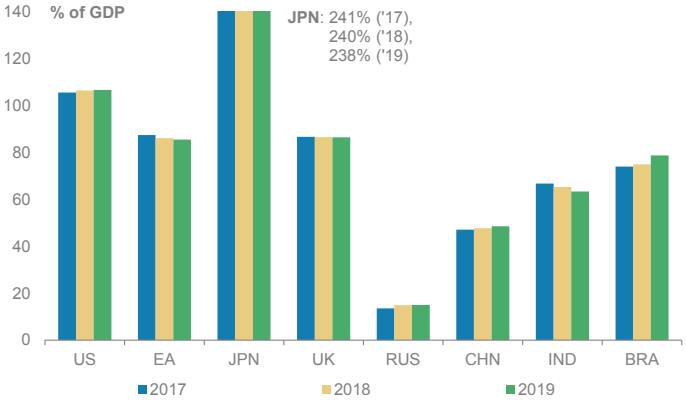
	General Gov't Budget Balance (% of GDP)				Primary General Gov't Budget Balance (% of GDP)			
	2016	2017E	2018E	2019E	2016	2017E	2018E	2019E
DM								
US	-3.1	-3.2	-3.6	-3.8	-1.8	-1.8	-2.2	-2.3
Euro Area	-1.5	-1.2	-1.4	-1.6	0.7	0.9	0.6	0.4
Japan	-4.2	-4.1	-3.5	-3.6	-4.0	-4.0	-3.6	-3.6
UK	-2.9	-2.3	-2.0	-1.7	-0.7	-0.8	-0.3	-0.1
Canada	-1.9	-2.2	-1.8	-1.6	-1.2	-1.5	-1.3	-0.9
Sweden	0.9	1.1	0.9	0.9	1.3	1.3	1.1	1.1
Australia	-2.4	-2.1	-2.0	-2.1	-1.6	-1.5	-1.3	-1.4
BRICs								
Russia	-3.4	-2.0	-1.1	-0.7	-3.1	N/A	N/A	N/A
China	-3.8	-3.8	-3.8	-3.6	-2.9	N/A	N/A	N/A
India	-7.1	-6.2	-6.3	-6.0	2.1	1.7	1.8	1.4
Brazil	-9.0	-8.6	-7.9	-6.9	-2.5	-2.4	-2.2	-1.5

	Gross General Gov't Debt (% of GDP)				Net General Gov't Debt (% of GDP)			
	2016	2017E	2018E	2019E	2016	2017E	2018E	2019E
DM								
US	106.1	105.6	106.5	106.7	77.0	76.7	78.0	78.8
Euro Area	88.9	87.5	86.2	85.5	70.6	N/A	N/A	N/A
Japan	239.3	240.7	240.4	237.8	119.8	121.2	120.9	118.3
UK	88.3	86.7	86.6	86.5	53.3	51.2	51.1	50.8
Canada	92.4	89.6	87.7	85.8	27.4	24.6	22.7	20.9
Sweden	42.2	39.1	36.4	34.1	-29.5	N/A	N/A	N/A
Australia	25.4	28.7	29.9	31.5	17.9	18.6	20.1	21.4
BRICs								
Russia	12.9	13.5	14.9	15.0	N/A	N/A	N/A	N/A
China	47.2	47.1	47.8	48.6	N/A	N/A	N/A	N/A
India	68.0	66.8	65.3	63.4	N/A	N/A	N/A	N/A
Brazil	69.5	74.0	75.0	78.8	47.5	55.3	57.6	63.6

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

Exhibit 31:

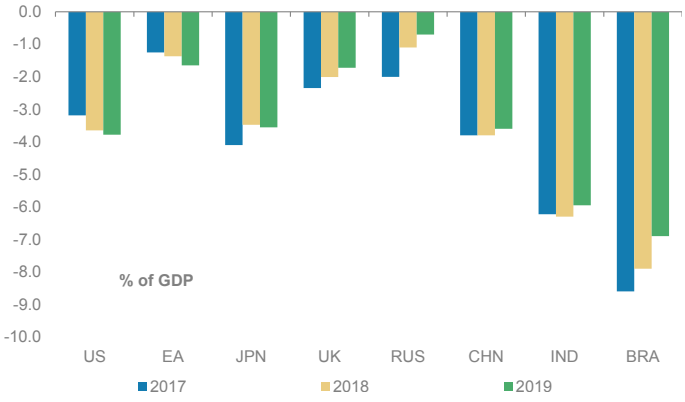
Gross general government debt



Source: Morgan Stanley Research forecasts

Exhibit 32:

General government budget balance



Source: Morgan Stanley Research forecasts

Consumer expenditure and investment spending forecasts

	Quarterly												Annual		
	2017				2018				2019				2017E	2018E	2019E
Pvt Consumption (%Q, SA)	1Q	2Q	3Q	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global*	**0.9**	**1.2**	**1.1**	**1.2**	**1.1**	**1.1**	**1.1**	**1.1**	**1.1**	**1.1**	**1.1**	**0.9**	**4.4**	**4.6**	**4.4**
G4	**0.4**	**0.7**	**0.4**	**0.6**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**	**0.4**	**0.5**	**0.0**	**2.1**	**1.9**	**1.8**
United States	0.5	0.8	0.6	0.8	0.6	0.5	0.5	0.6	0.6	0.5	0.5	0.4	2.7	2.4	2.1
Euro Area	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	1.8	1.8	1.6
Japan	0.4	0.7	-0.5	0.2	0.3	0.4	0.4	0.4	0.3	0.5	1.3	-2.8	1.0	1.0	1.2
UK	0.3	0.2	0.4	0.2	0.0	0.1	0.1	0.2	0.1	0.3	0.4	0.4	1.6	0.6	0.8
BRIC	**1.5**	**1.7**	**1.7**	**1.8**	**1.8**	**1.7**	**1.8**	**1.8**	**1.7**	**1.7**	**1.7**	**1.8**	**6.9**	**7.2**	**7.1**
China	2.0	2.0	2.0	2.0	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	8.2	8.0	7.8
India	0.4	1.5	2.0	2.1	1.6	1.7	2.2	2.0	1.9	1.8	2.1	2.2	6.9	7.7	8.1
Brazil	0.0	1.4	0.8	0.9	1.0	1.3	0.7	0.7	0.9	0.5	0.5	0.4	1.0	4.0	2.8
Russia	2.5	0.7	0.4	0.4	1.9	0.9	0.9	0.8	0.8	0.8	0.8	0.8	3.9	4.0	3.3
Pvt Consumption (%Y)	1Q	2Q	3Q	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global*	**4.3**	**4.5**	**4.5**	**4.4**	**4.6**	**4.5**	**4.6**	**4.5**	**4.5**	**4.5**	**4.5**	**4.3**	**4.4**	**4.6**	**4.4**
G4	**2.1**	**2.2**	**2.1**	**2.1**	**2.1**	**1.9**	**1.9**	**1.8**	**1.8**	**1.8**	**1.9**	**1.4**	**2.1**	**1.9**	**1.8**
United States	2.9	2.7	2.6	2.7	2.7	2.4	2.4	2.2	2.2	2.2	2.1	2.0	2.7	2.4	2.1
Euro Area	1.6	1.8	1.9	1.9	2.0	1.9	1.8	1.7	1.6	1.6	1.6	1.6	1.8	1.8	1.6
Japan	1.0	1.6	0.7	0.8	0.7	0.4	1.3	1.5	1.5	1.6	2.6	-0.7	1.0	1.0	1.2
UK	2.2	1.5	1.4	1.2	0.8	0.7	0.4	0.4	0.5	0.7	1.0	1.2	1.6	0.6	0.8
BRIC	6.5	6.9	7.1	6.8	7.2	7.2	7.3	7.2	7.2	7.1	7.0	7.0	6.9	7.2	7.1
China	8.3	8.2	8.2	8.1	8.1	8.0	8.0	7.9	7.9	7.8	7.8	7.7	8.2	8.0	7.8
India	6.9	7.1	7.3	6.1	7.4	7.7	7.9	7.8	8.1	8.1	8.0	8.2	6.9	7.7	8.1
Brazil	-1.9	0.7	1.9	3.1	4.1	4.1	4.0	3.8	3.6	2.8	2.6	2.3	1.0	4.0	2.8
Russia	2.1	3.9	4.2	4.1	3.5	3.6	4.2	4.6	3.4	3.3	3.2	3.2	3.9	4.0	3.3
Investment (%Q, SA)	1Q	2Q	3Q	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global*	**0.8**	**1.3**	**0.5**	**1.0**	**0.9**	**1.1**	**1.1**	**1.1**	**1.0**	**1.1**	**1.0**	**0.9**	**3.3**	**3.9**	**4.2**
G4	**0.9**	**1.2**	**0.2**	**0.8**	**0.7**	**0.6**	**0.7**	**0.7**	**0.6**	**0.8**	**0.8**	**0.4**	**3.1**	**2.7**	**2.8**
United States	1.8	0.5	0.0	0.9	0.8	0.7	0.8	0.8	0.5	0.7	0.6	0.6	2.9	2.8	2.6
Euro Area	-0.2	2.0	0.8	0.9	0.7	0.8	0.9	0.8	1.0	1.0	1.0	1.1	3.7	3.6	3.9
Japan	0.5	1.6	-0.5	0.1	0.2	0.3	0.3	0.6	0.8	1.0	0.8	-2.2	2.4	1.0	2.0
UK	0.5	0.6	0.4	0.1	0.0	0.1	0.0	-0.4	-1.0	0.4	0.9	0.6	2.4	0.5	-0.4
BRIC	**0.7**	**1.5**	**0.9**	**1.2**	**1.1**	**1.5**	**1.5**	**1.5**	**1.4**	**1.3**	**1.3**	**1.3**	**3.5**	**5.1**	**5.6**
China	1.2	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0	5.0	4.5	4.1
India	-0.4	2.7	0.8	1.5	0.7	2.6	2.0	2.2	2.2	1.9	2.2	2.4	1.8	6.6	8.9
Brazil	-0.9	-0.7	-0.3	1.1	2.0	2.0	3.1	2.7	2.1	2.5	1.2	1.0	-3.5	6.6	9.1
Russia	1.8	2.0	-0.2	0.6	1.4	1.2	0.9	0.8	0.7	0.7	0.7	0.7	4.5	3.9	3.1
Investment (%Y)	1Q	2Q	3Q	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global*	**2.9**	**3.2**	**3.4**	**3.6**	**3.8**	**3.5**	**4.0**	**4.2**	**4.3**	**4.3**	**4.2**	**4.0**	**3.3**	**3.9**	**4.2**
G4	**3.0**	**3.1**	**3.1**	**3.1**	**2.9**	**2.3**	**2.8**	**2.7**	**2.7**	**2.9**	**2.9**	**2.7**	**3.1**	**2.7**	**2.8**
United States	2.4	3.0	2.9	3.3	2.3	2.4	3.3	3.1	2.8	2.8	2.6	2.4	2.9	2.8	2.6
Euro Area	4.0	3.3	4.1	3.5	4.5	3.2	3.3	3.2	3.5	3.8	4.0	4.2	3.7	3.6	3.9
Japan	2.6	3.1	2.3	1.7	1.4	0.1	0.9	1.4	2.0	2.7	3.2	0.4	2.4	1.0	2.0
UK	3.7	2.4	1.9	1.6	1.1	0.7	0.3	-0.2	-1.3	-1.0	-0.2	0.9	2.4	0.5	-0.4
BRIC	**2.8**	**3.3**	**3.8**	**4.2**	**4.6**	**4.7**	**5.3**	**5.7**	**5.9**	**5.6**	**5.5**	**5.3**	**3.5**	**5.1**	**5.6**
China	5.4	5.1	4.8	4.7	4.6	4.5	4.4	4.4	4.2	4.1	4.1	4.0	5.0	4.5	4.1
India	-1.5	1.3	3.2	4.7	5.9	5.8	7.1	7.8	9.4	8.6	8.8	9.0	1.8	6.6	8.9
Brazil	-4.6	-5.7	-3.3	-0.9	2.0	4.9	8.4	10.2	10.3	10.8	8.8	7.0	-3.5	6.6	9.1
Russia	3.9	5.3	4.7	4.3	3.8	3.0	4.2	4.4	3.6	3.1	2.9	2.8	4.5	3.9	3.1

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

Source: IMF, Morgan Stanley Research forecasts

Government bond yield/spread forecasts

	10-Year			
	1Q18E	2Q18E	3Q18E	4Q18E
US	2.25	2.15	2.05	1.95
Germany	0.5	0.55	0.6	0.5
Japan	0.05	0.08	0.2	0.2
UK	1.45	1.5	1.55	1.55
Australia	2.55	2.45	2.3	2.2
Austria*	20	20	20	20
Netherlands*	15	15	15	15
France*	20	25	25	25
Belgium*	30	30	25	25
Ireland*	30	30	25	25
Spain*	110	120	95	100
Italy*	155	165	140	145
Portugal*	150	150	130	130

	10-Year			
	1Q18E	2Q18E	3Q18E	4Q18E
Russia	7.4	7.3	7.3	7.2
Poland	3.3	3.5	3.55	3.6
Hungary	2.2	2	2.1	2.2
Turkey	12.5	12.2	12.2	12
S. Africa	9.3	9.15	9	8.8
China	4.2	4.4	4.3	4.25
India	6.8	6.8	6.9	7
Hong Kong	1.85	1.9	1.85	1.75
Singapore	2.25	2.3	2.25	2.2
S. Korea	2.7	2.8	2.75	2.7
Taiwan	1.05	1.1	1.2	1.3
Indonesia	6.5	6.5	6.8	6.9
Malaysia	4.2	4.2	4.2	4.2
Thailand	2.25	2.2	2.15	2.1
Argentina	14.75	14.5	15	15.25
Brazil	9.5	10	10.5	9.5
Mexico	7.35	7.5	7.5	7.5
Chile	4.35	4.25	4.5	4.55
Peru	5.2	5.1	5.3	5.35
Colombia	6.6	6.5	6.8	6.9

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

Global currency forecasts

	4Q17	1Q18	2Q18	3Q18	4Q18
EURUSD	1.18	1.20	1.23	1.18	1.17
USDJPY	113	114	112	108	105
GBPUSD	1.30	1.25	1.30	1.27	1.24
EURCHF	1.20	1.25	1.28	1.20	1.15
EURSEK	9.90	9.80	10.00	10.10	10.00
EURNOK	9.70	9.80	9.90	10.00	10.20
USDCAD	1.30	1.28	1.27	1.33	1.38
AUDUSD	0.75	0.76	0.77	0.72	0.67
NZDUSD	0.67	0.68	0.68	0.64	0.61
USDCHF	1.02	1.04	1.04	1.02	0.98
USDSEK	8.39	8.17	8.13	8.56	8.55
USDNOK	8.22	8.17	8.05	8.47	8.72
EURJPY	133	137	138	127	123
EURGBP	0.91	0.96	0.95	0.93	0.94
AxJ					
USDCNY	6.65	6.63	6.62	6.68	6.70
USDHKD	7.80	7.80	7.80	7.80	7.80
USDIDR	13475	13350	13280	13450	13600
USDINR	65	65	64	65	66
USDKRW	1095	1085	1070	1080	1095
USDMYR	4.12	4.07	4.00	4.08	4.11
USDPHP	51.0	51.5	51.5	52.0	53.0
USDSGD	1.36	1.35	1.34	1.36	1.37
USDTHB	32.8	32.6	32.3	32.8	33.1
USDTWD	30.0	29.7	29.4	29.7	29.9
LatAm					
USDBRL	3.20	3.20	3.30	3.50	3.25
USDMXN	19.00	18.40	20.00	20.00	20.00
USDARS	17.8	18.3	19.3	19.9	20.6
USDCLP	630	620	610	620	635
USDCOP	3030	3000	2975	2990	3020
USDPEN	3.24	3.24	3.24	3.25	3.27
CEEMEA					
USDZAR	14.3	14.1	14.0	14.3	14.5
USDILS	3.47	3.40	3.35	3.40	3.40
USDTRY	4.10	4.10	3.95	4.20	4.40
USDRUB	58	57	55	58	61
EURCZK	25.5	25.3	25.0	25.0	25.0
EURHUF	315	320	315	315	315
EURPLN	4.2	4.2	4.1	4.1	4.1
EURRON	4.7	4.6	4.6	4.7	4.7
DXY	94.0	94.0	92.0	94.0	95.0
ECB EUR TWI	99.6	101.3	102.3	99.5	99.0
Broad USD (Fed)	120.0	119.0	119.0	122.0	123.0

Source: Morgan Stanley Global FX Strategy forecasts

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