WORLD KALEIDOSCOPE

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IIFL
INVESTMENT MANAGERS
WEALTH MANAGEMENT

World Kaleidoscope

Mixed bag of geo-politics, legislative gridlock and policy norm spree

What's behind the North Korean nuclear threat?

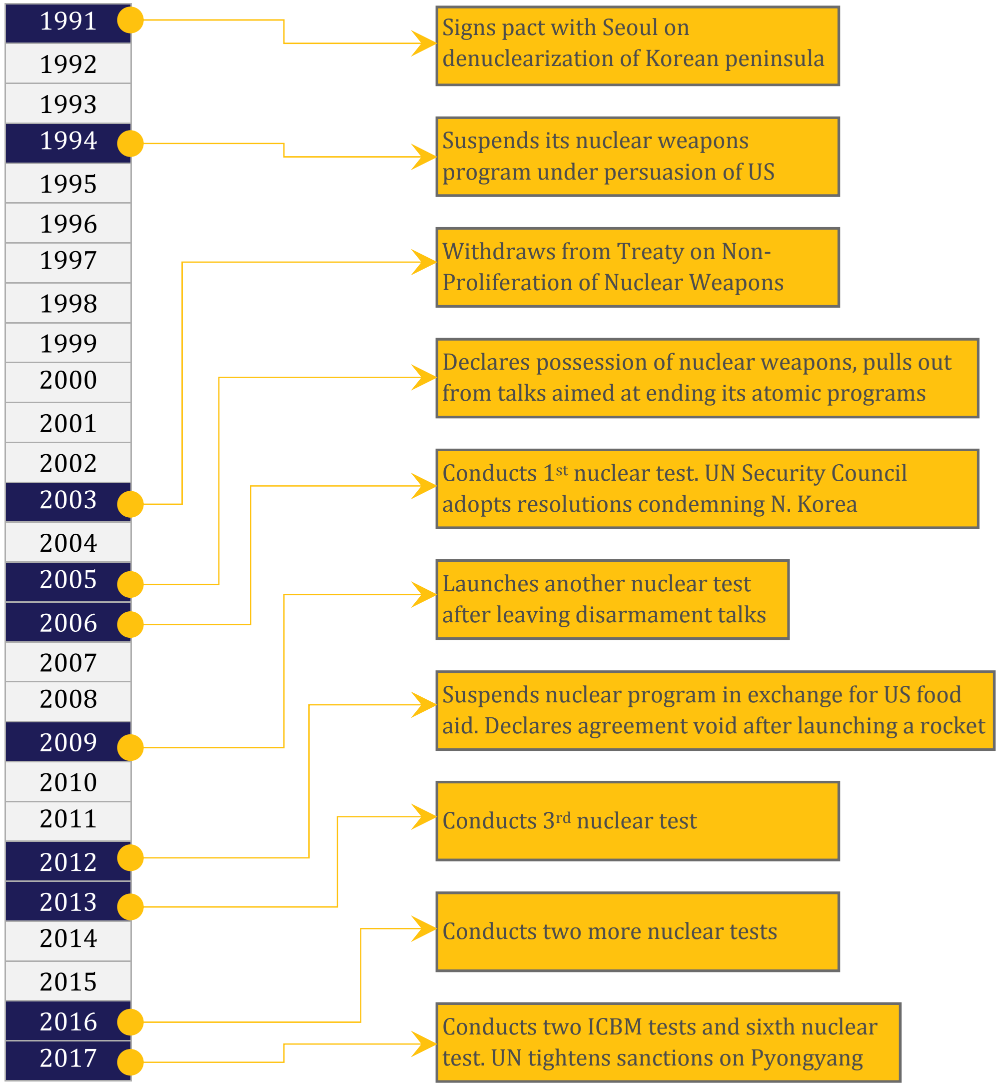
Lot of water has flown under the bridge in the context of the US-North Korea strife. That Pyongyang has tested intercontinental ballistic missiles and a lethal hydrogen bomb has incensed US and its allies who are proximal to the Korean Peninsula. If this was not enough, North Korean has now threatened to unleash a nuclear attack on Japan and directing a missile on island territory of Guam. To counter the North Korean belligerence, UN (at behest of US) recently imposed sanctions on Pyongyang, including a ban on textile imports and restrictions on oil sales. Earlier, Washington imposed new sanctions on Chinese and Russian entities for aiding North Korea's weapon expansion. The degree of punitive action could escalate, given Trump's statement that North Korea deserves even more harsh measures. US Treasury Secretary has threatened to impose financial sanctions on China if it does not abide by UN curbs on North Korea. Despite the backlash, North Korea remains indifferent, persisting with its belligerent tone and the threat of more ballistic missiles. Apparently, the situation is nothing but tense.

Any trivial issue can seemingly rub the capricious Kim Jong-un (North Korean leader) the wrong way. However, we feel North Korea's bellicose tone and conduct is a mere form of posturing. It is highly unlikely that the saber-rattling will transform into a full-fledged war. North Korea knows well that it cannot afford a war against South Korea and Japan, forget combating the US, unless of course it has suicide on its mind.

Pyongyang's war-mongering seems an endeavor to gain economic aid from the West. History is replete with instances, where the mercurial nation has played the game of brinkmanship to gain benefits and concessions. It escalated nuclear tensions in early 1990s, only to end up negotiating with US on suspending its nuclear weapons program in 1994.

Analyst: Hitesh Jain

Figure 1: North Korea's Nuclear Chronology



Source: Bloomberg, IIFL Research

Similarly, after withdrawal from non-proliferation of nuclear weapons treaty in 2003, it conducted nuclear tests in 2006 and 2009 and then eventually agreed to freeze nuclear facilities in 2012, a clear quid pro quo for US food and energy aid. However, the staying power of such agreements is a big question mark, with Pyongyang launching several more nuclear tests thereon.

We sense a possibility of a series of back door negotiations between US and North Korea. With China mute on this issue, it seems it's not endorsing North Korea's transgression and possibly working to broker a deal. Release of several American hostages from North Korea proves that informal channel is more efficacious than the perceptible formal channel. With no military action on the ground by US or North Korea (apart from posturing) and a dialogue process definitely in the works, there is less likelihood of the conflict deteriorating into a disaster. US President Trump seems desperate about gaining some mileage on foreign policy, and he would certainly strive to tame Kim Jong-un through cheque book diplomacy or through the bait of sanctions softening

Nurturing National Wealth: Intangibles crucial, tangibles indispensable

Information Technology and allied services provide an impetus to the economy but do not ensure inclusive growth for all. Traditionally, it was believed manufacturing and agriculture contributed to a country's wealth. However, the disruptive advent of computers and internet has changed the dimensions of economy. Services (tertiary sector) contribute major chunk of western economies. Pervasion of information technology and modern practices lay more weightage to intangible assets, rather than physical capital like roads, infrastructure, real estate and machinery. Intellectual property, equity valuations, brand value, technological know-how are now of paramount significance, with financial and IT companies accounting for a large part of stock market capitalization and in fact, assumed to indicate the economic health of the country.

Social media and data service companies are considered money-spinners, as they bring the entire world on one platform. However, the way of gauging real national wealth needs a serious re-assessment. Technology and digitization have equipped the rich and middle-class with a plethora of information and social leisure, but it does not cater to the poor who yet struggle for food security, housing, healthcare and transportation. Technology itself cannot improve the standard of living. The focus has to be equally accentuated on building nation's physical infrastructure.

Doing it the Mittelstand way - German lesson for India

India can take a leaf from the books of Germany, where more than 99% of the manufacturing companies in Germany are small and medium enterprises (SMEs). There's a lot to learn from the Mittelstand model (famous term for SME companies) given PM Narendra Modi's thrust on augmenting domestic manufacturing. SMEs are the backbone of Germany's economy, unlike other capitalist economies, where large multinationals account for a large chunk of economic activity. The small town-based Mittelstand companies tend to have a razor-sharp focus on quality, innovation and technology. They specialize in fabrication of equipment and components which is indispensable for various engineering and manufacturing processes. High end manufacturing has played a key role in making the German economy immune to vagaries of the global cycle.

In fact, Mittelstand model is deemed to overcome the shortcomings of capitalism, where it ensures economic activity not skewed in favour of giant conglomerates, ensuring inclusive participation and negating the threat of oligopoly. With many opportunities prevalent across the country, there is relatively low level of youth unemployment rate and migration. Profound focus on training employee with technical skill sets inculcates a culture of loyalty and low attrition, which mutually benefits employers and workers. There are thousands of family-owned Mittelstand companies efficiently running the same business for generations.

Mittelstand is no silver bullet and there's a list of perquisites for this model to flourish. Presence of well-equipped vocational education system, investment on human capital, healthy labour laws and easy access to capital are a must to replicate the German success. With changing times and a globalized world, there is also a need to be open to foreign talent in order to cater to ever- evolving consumer needs.

Figure 2: German SMEs – Fulcrum of the economy

Source: IfM Bonn, IIFL Research

Figure 3: Global snapshot

Country	GDP YoY	Interest rate	Inflation rate	Jobless rate	Export yoy (%)	Import yoy (%)	CA balance	Govt Debt % of GDP	Money Supply (M3)	Mfg PMI	Industrial Production yoy (%)
US	3.00	1.25	1.90	4.40	4.90	5.10	(2.36)	73.80	5.3#	52.80	1.54
Euro Zone	2.30	0.00	1.50	9.10	4.25	-	3.13	89.50	4.50	57.40	3.20
China	6.90	4.35	1.80	3.95	5.50	13.30	1.35	16.10	8.9#	51.70	6.00
Japan	1.40	(0.10)	0.40	2.80	13.40	16.30	3.78	234.70	3.40	52.20	4.70
Germany	0.80	0.00	1.80	3.90	7.80	9.40	7.88	68.20	4.50	59.30	4.00
UK	1.70	0.25	2.90	4.30	9.60	7.45	(3.86)	92.20	4.40^	56.90	0.40
France	1.70	0.00	0.90	9.50	4.90	9.20	(1.16)	96.00	4.50	55.80	3.70
India	5.70	6.00	3.36	8.40	10.29	21.02	(1.24)	52.30	6.60	51.20	1.20
Italy	1.53	0.00	1.20	11.30	5.13	10.54	2.73	132.50	4.50	56.30	4.40
Brazil	0.26	8.25	2.46	12.80	14.63	7.99	(0.71)	73.50	8.30^	50.90	2.50
Canada*	4.30	1.00	1.20	6.20	2.20	4.00	(2.86)	98.80	4.43	54.60	-
South Korea	2.70	1.25	2.60	3.80	17.40	14.20	5.66	36.10	6.50	49.90	0.09
Australia	1.80	1.50	1.90	5.60	15.60	6.90	(2.10)	46.10	6.91	59.80	-
Russia	2.50	8.50	3.30	5.10	10.20	28.10	2.20	13.70	9.00#	51.60	1.50
Spain	3.10	0.00	1.60	17.22	5.72	4.99	1.93	99.60	4.50	52.40	2.00
Mexico	1.77	7.00	6.66	3.41	8.03	6.61	(2.23)	56.30	7.60^	52.20	(1.59)
South Africa	1.10	6.75	4.60	27.70	12.52	6.59	(2.48)	43.30	6.81	-	-
Saudi Arabia	(0.53)	2.00	(0.30)	11.50	-	-	(9.50)	31.00	2.70	-	-

Source: Bloomberg, IIFL Research

Notes:
**Canada GDP monthly*
#Russia, China & US M2 Money Supply
^Mexico, Brazil & UK M4 Money Supply

UNITED STATES

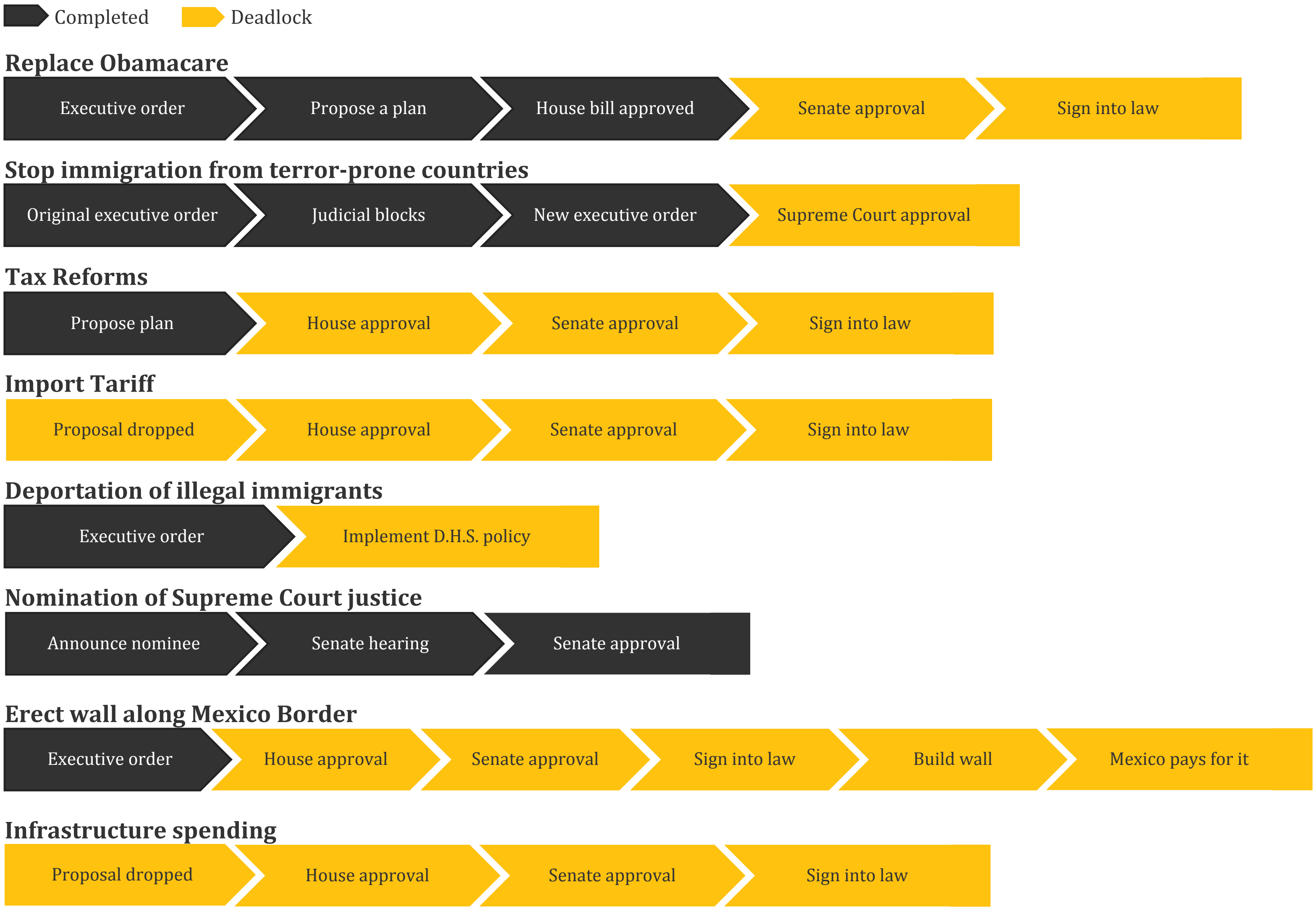
- *IMF trims US growth forecasts to 2.1% for both 2017 and 2018 in light of legislative deadlock*
- *Although Q2 US GDP expanded at the fastest pace (3% q/q) in more than two years, Q3 growth is seen around just 2%*
- *Economy has created an average 175,000 jobs per month this year, slightly lower than the last year trend*
- *Dot plot indicates an additional rate hike this year and three more in 2018. Fed will also start trimming its balance sheet by US$10bn of securities per month, beginning from October*
- *Several members of Fed endorse patience on hiking interest rates*

Legislative uncertainty in the US has almost assumed paralytic proportions, with no clue on how the much-hyped relation narrative will materialize. Political hue and cry has knowingly or unknowingly has pushed key reforms to cold storage. Although Trump portrays arrogance and confidence over the legislative prospects, this is symptomatic of a phantom twitching of an amputated limb. Controversies compounded by Trump's diminishing popularity have turned out to be daily disruption, making life difficult for Republican legislators. US Congress has been embroiled in investigations, with President Trump earlier accused of obstructing the inquiry of ex-National Security Adviser. Meanwhile, a grand jury is commissioned to investigate whether Russia meddled in the recent US national elections. The deadlock on legislative agenda has compelled IMF to trim US growth forecasts to 2.1% for both 2017 and 2018, when compared with earlier projections of 2.3% and 2.5%.

Republicans are losing time and lagging well behind the legislative timetable. President is having a tough time with an obstinate Congress and still in hunt for any major legislative achievement, barring the argumentative pullout from Paris Climate accord, Trans-Pacific Partnership and implementing stringent immigration norms. So far, Trump has failed to abide by the propriety befitting the President of the world's largest economy. His tirade against media and blatant remarks on legislators have only reinforced his fast evolving 'rebel without a cause' image. Post healthcare bill debacle, the million dollar question remains that when will Trump administration start working on other important legislative agenda (much awaited by the markets) like tax reforms and infrastructure spending.

Although US House of Representatives passed the new health-care bill by a whisker, Senate has not approved the health-care bill in its current form. Several members of the Senate (including Republicans) are neither endorsing the new measures, nor supporting the vote to repeal Affordable care Act altogether. On tax reforms, US President plans hefty cut in corporate taxes for dissuading companies from shifting operations to overseas, while also intends simplifying tax codes for the households in order to boost consumption and growth. Trump has promised to cut the corporate tax rate to 15% from the current level of 35% percent and intends to slash the current number of tax slabs for households from 7 to 3. However, Trump so far has just presented a ludicrous one page bill on tax proposal to Congress which is utterly short on substance. Proposal for erecting wall along the US-Mexican border is also struggling while the import tax (Border tax) remains contentious given the country's dependence on imports.

Figure 4: US Legislative Bill Tracker



Source: New York Times, IIFL Research

Legislative paralysis can also be epitomized by the fact that more members of the administration are turning to be dissidents of President. Trump has dissolved two of his business councils after several CEOs resigned in protest over Charlottesville incident. Security advisor Steve Bannon (right wing and hawkish strategist) has been fired on ground of contradicting Trump on the issue of North Korea.

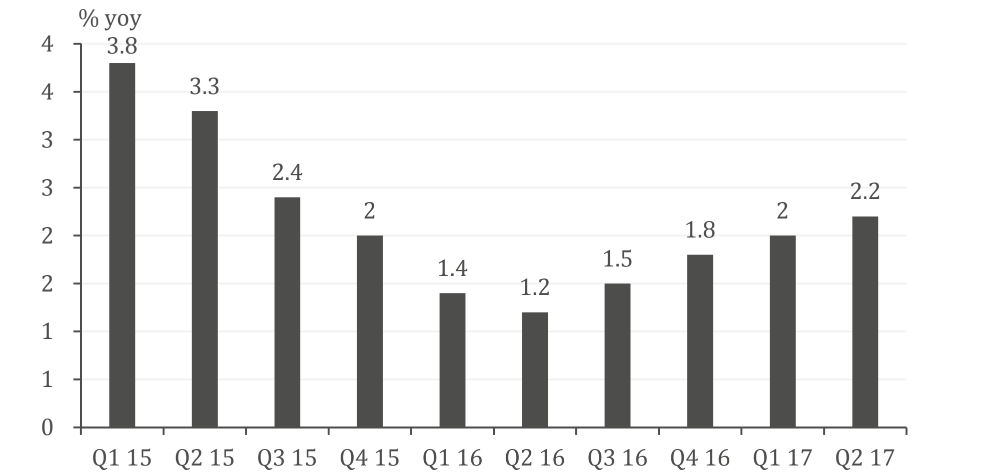
Tax reform seems to be the only issue which unites Republicans, when compared with differences among them on host of issues including import tariff, Mexico border wall and immigration policies. Lower tax cuts for higher income group can easily get the capitalist Republicans on the same page and enable President to gain some political and legislative mileage. To pull it off, Trump's team has to sincerely offer more concrete details about tax cuts and provide counterbalancing rise in fiscal revenues. It seems that Republican Senators have to diligently reconcile the budget in a manner which circumvents resistance from Democrats. There is also a possibility of changing the rules of the game by scrapping the requirement for filibuster majority of 60 (out of 100) in the Senate and amending it to 51. Trump is reported to have termed filibuster as a bureaucratic antiquity which is unnecessarily hindering the legislative agenda. However, such move can be blatantly seen as manipulation of the constitutional framework, negating the counterbalancing influences and stoking centralization of decision making.

Meanwhile, concerns regarding potential shutdown of US government function has been averted for the time being after President Trump and Congressional leaders have concurred on extending the debt ceiling and fund the government till December 15th. However, several Republicans were not in favor of a short-term fix to this problem, in fact arguing for a longer-term increase on the debt limit.

On macro numbers, Q2 US GDP was upwardly revised to 3% (q/q) from the prior estimate of 2.6%, the fastest pace of growth in more than two years. On yoy basis, the economy grew 2.2% during the quarter. While higher consumer spending have lent impetus, the economy is showing signs of slowing down in past 2 months, with a meagre 156,000 new jobs added in August, and June & July job creation numbers downwardly revised. The economy has created an average 175,000 jobs per month this year, lower than the last year trend (186,000). Meanwhile, it remains to be seen how the economy copes with the after-effects of calamitous Hurricane Harvey and Irma which has crippled activity in the energy-rich Texas region and west coast of Florida. Already, retail sales and industrial production has taken a hit during August, declining 0.2% and 0.9% respectively on mom basis. There is a sense that the catastrophe can dent headline Q3 GDP number, with Federal Reserve Bank of Atlanta and New York substantially trimming growth projections to around 2% (q/q).

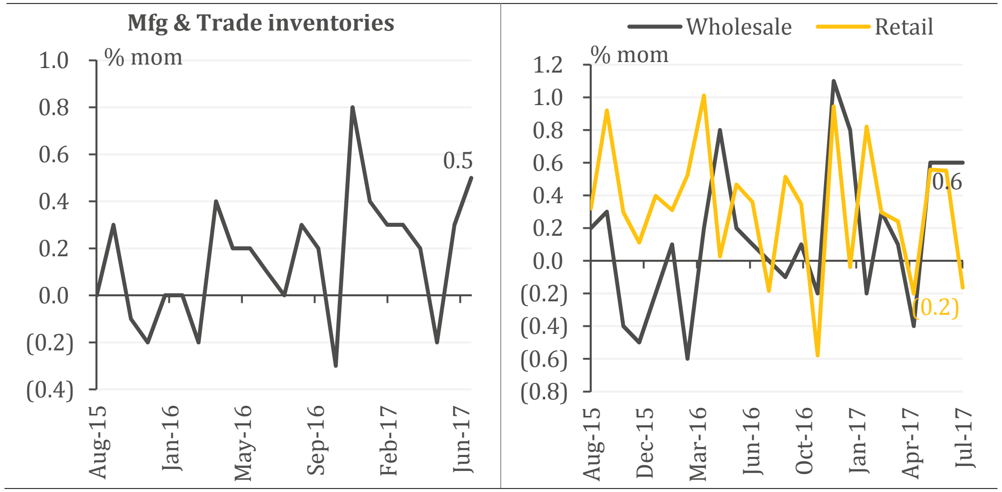
On inflation, August CPI witnessed a rise of 1.9% (yoy) on account of higher gasoline prices, however core PCE (Fed's favorite inflation gauge) is still lagging well behind the target of 2%. Yet Fed struck a hawkish tone at the September FOMC meeting, bolstering expectations of a rate hike in December. Interest rate futures now factoring in 73% probability of a rate hike. The dot plot (interest rate projections) remains unchanged, corroborating prospects for an additional rate increase this year and three more in 2018. The central bank will also start trimming its balance sheet by US$10bn of securities per month, beginning from October. Nevertheless, Janet Yellen reassured the markets, stating that tapering of the balance sheet will be data driven. Statements from several Fed members convey support for trimming the US$4.5 trillion balance sheet, though they advocate patience on hiking interest rates.

Figure 5: GDP: Growth gained momentum during Q2



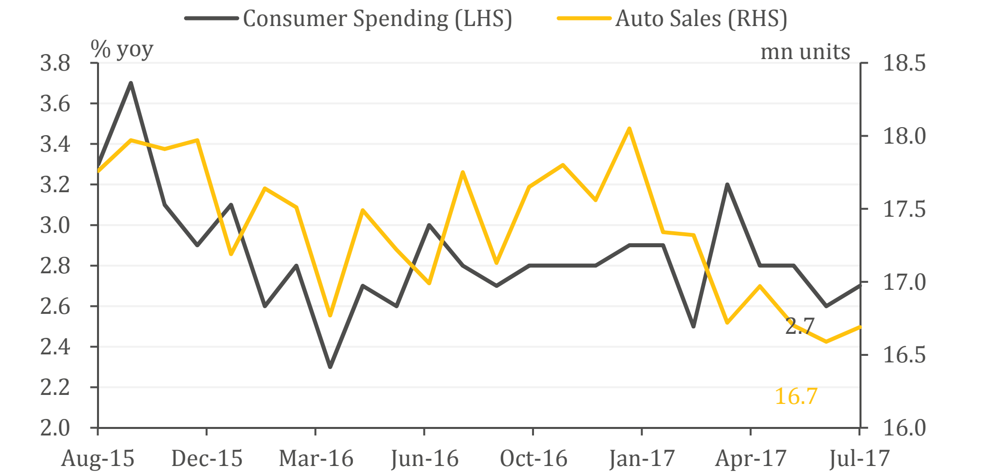
Source: Bloomberg, IIFL Research

Figure 6: Business inventory stockpiling activity showed strength during last quarter



Source: Bloomberg, IIFL Research

Figure 7: Consumer spending relatively remains stable, however, auto sales losing traction



Source: Bloomberg, IIFL Research, Note: Annualised US auto sales

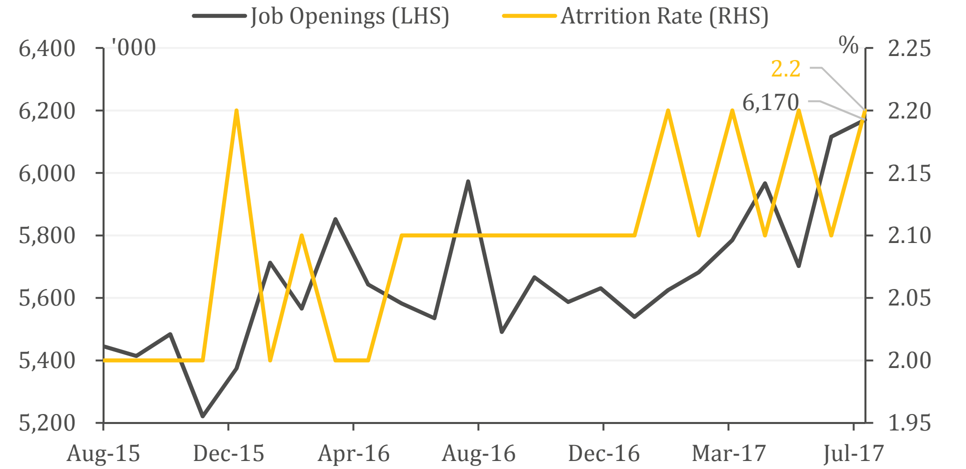
Figure 8: Q3 GDP forecasts are downgraded in light of hurricanes impacting economic activity in Texas and Florida

Source: Bloomberg, IIFL Research

Figure 9: Job creation has slowed down in past 3 months

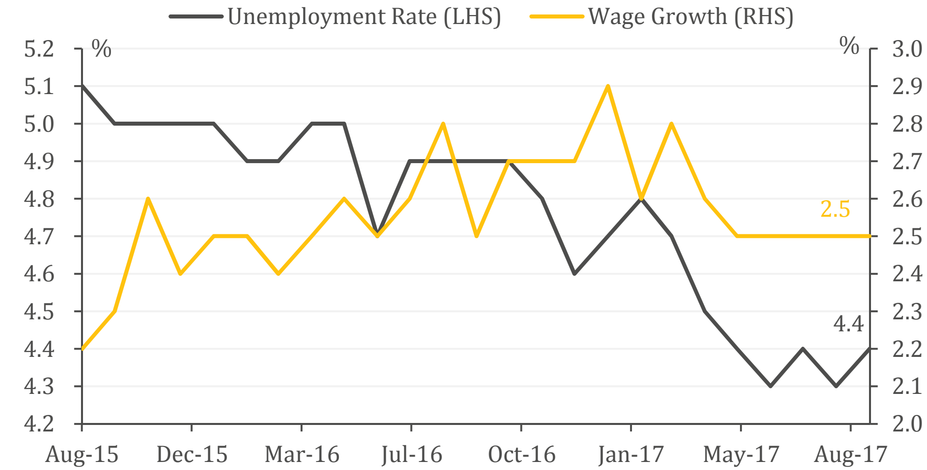
Source: Bloomberg, IIFL Research

Figure 11: Similarly, job turnover rate is very low despite rise in job openings



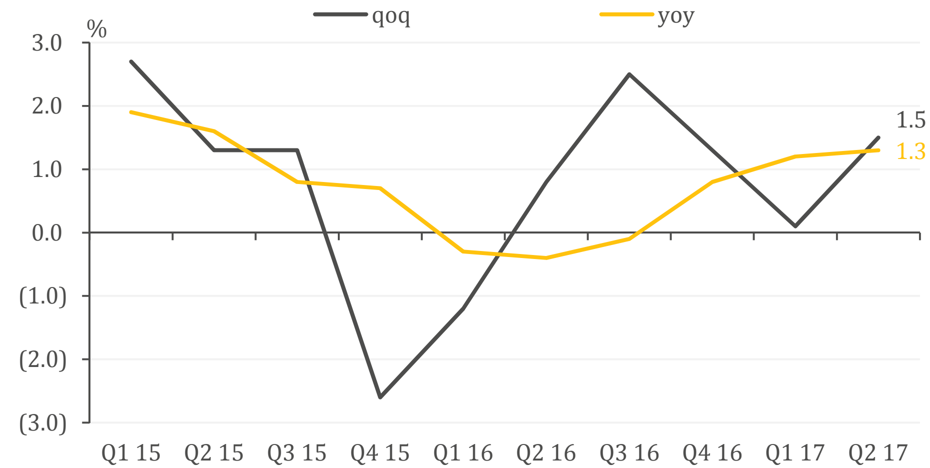
Source: Bloomberg, IIFL Research

Figure 10: Although official unemployment levels have dipped, wage growth remains dismal



Source: Bloomberg, IIFL Research

Figure 12: Nonfarm business productivity has improved in Q2

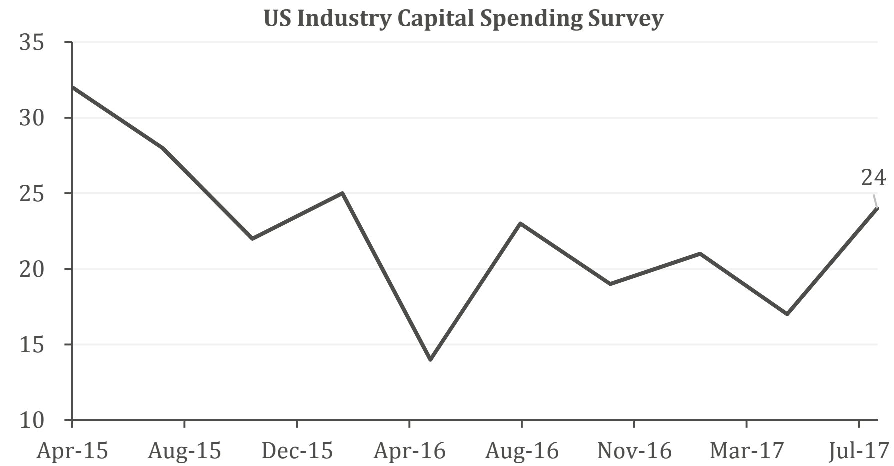


Source: Bloomberg, IIFL Research

Figure 13: US Corporate profits looking north

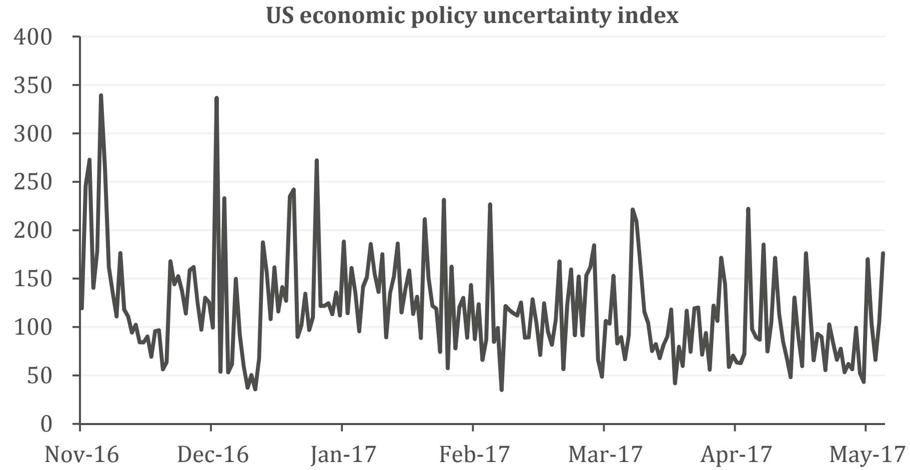
Source: Bloomberg, IIFL Research

Figure 14: Survey suggests higher Capital spending…



Source: Bloomberg, IIFL Research

Figure 15: ….However, legislative paralysis in Washington repudiates optimistic capital spending surveys

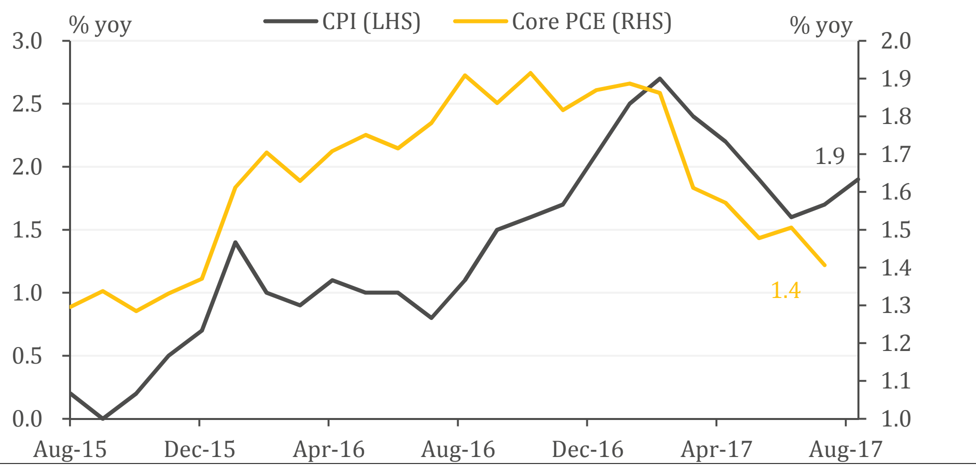


Source: Bloomberg, IIFL Research

Figure 16: US dollar in doldrums

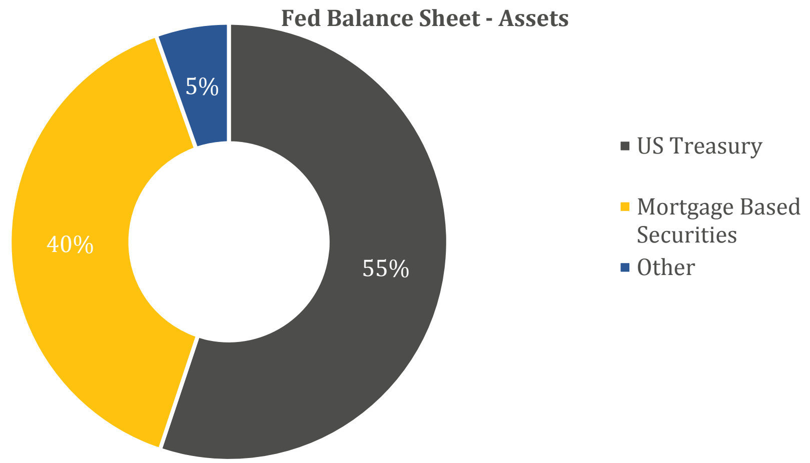
Source: Bloomberg, IIFL Research

Figure 17: Inflation scaled higher during August in light of surge in gasoline prices, however, core PCE still lags behind Fed's target



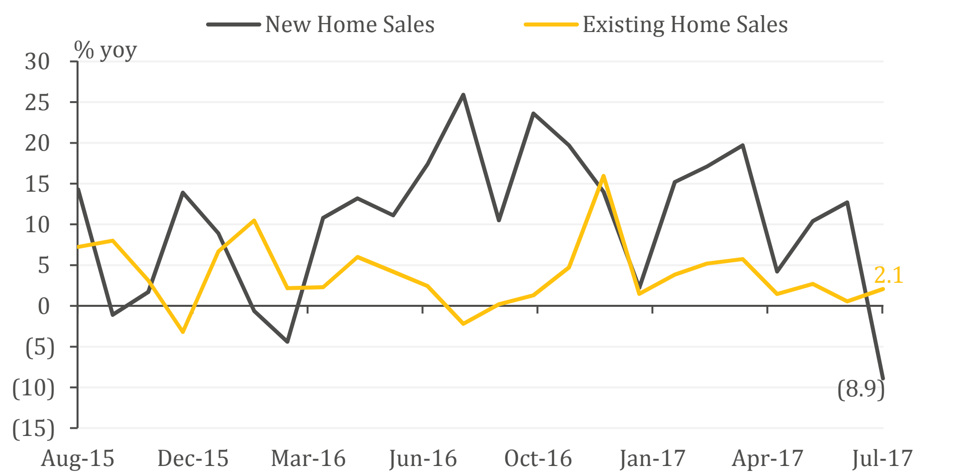
Source: Bloomberg, IIFL Research

Figure 19: Strong likelihood of Fed tapering the US$4.5 trillion balance sheet



Source: Bloomberg, IIFL Research

Figure 18: US housing markets have slowed significantly this year



Source: Bloomberg, IIFL Research

EURO ZONE

- *ECB has dropped long-standing reference to "downside risks" from the policy statement and now sees risks to be "broadly balanced*
- *Inflation scaled higher to 1.5 %(yoy) in August, but still below the April peak of 1.9%*
- *Q2 Wage growth at 2% (yoy)*
- *ECB likely to taper its bond purchases*
- *European Commission projects GDP growth of 2% this year and next year as well*

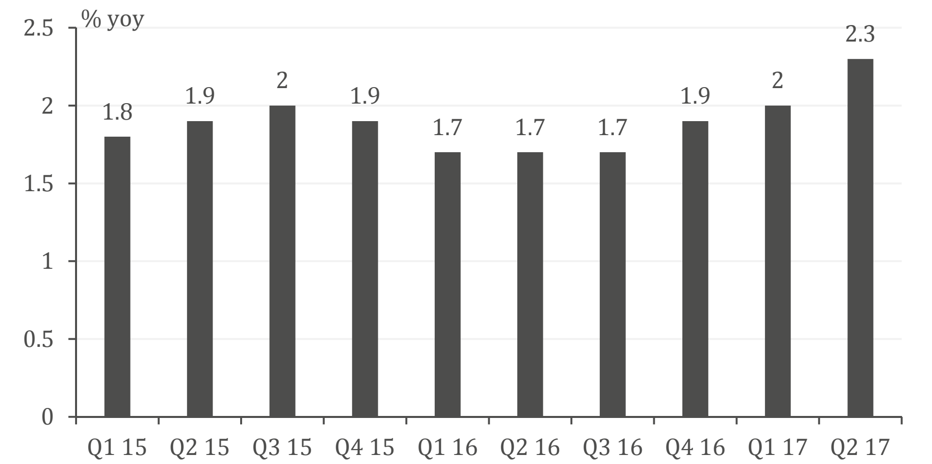
Economic recovery in Euro area is gaining significant traction, with robust PMI readings suggesting strong manufacturing growth in both Germany and France. Meanwhile, the situation in Italy is also improving with recent PMI at a 6 & 1/2 year high, and employment rising to the highest level since 2008 financial crisis. Estimates state that should PMI readings sustain in the mid-to-high-50's, GDP growth can scale higher towards 3%, compared with the correlation of current 2%-2.3% GDP growth with PMI levels in the low 50's. Nevertheless, European Commission stays realistic, projecting Eurozone to grow by 2% this year and next year as well. The economy grew by 2.1% on yoy basis during Q2'17, higher than the growth of 1.9% in the prior quarter. Meanwhile, Ifo Institute has upgraded its outlook for 2017 Germany GDP to 1.8% and 2.0% for 2018, up from 1.5% and 1.8% respectively. ECB has acknowledged modest improvement in growth prospects, wherein the long-standing reference to "downside risks" has been dropped from the policy statement and instead risks are now deemed to be "broadly balanced". The central bank sees sustained momentum in the economy, with unemployment rate projected to dip further to 8.6% in 2018 and 8.1% in 2019. Recent wage growth has also been solid, rising 2% (yoy) during Q2, the fastest pace since Q1 of 2015. Although growth in Europe has done exceedingly well than UK despite inconclusive Brexit negotiations, the region has to resolve key issues like high taxes and rigid labor laws.

Inflation scaled higher to 1.5 %(yoy) in August, compared with 1.3% in July, but still below the April peak of 1.9%. ECB Chief at the recent Jackson Hole summit stated that loose monetary policy has worked, manifested by steady economic recovery, though pick-up in inflation will take some time. ECB is not contemplating any move on rates for a foreseeable span, thought bond purchase tapering remains on the table. Clamor for trimming monthly bond buying from various ECB officials is getting louder in light of relatively stable macro numbers and end of political uncertainty post French elections. At the recent policy meeting, ECB indicated that it is gradually gearing up to taper its asset purchase programme. Mario Draghi reiterated that policy makers will make a decision on fate of bond purchases by this autumn, implying an announcement on the same during next month. October seems to be an appropriate time for such move given that German national elections will conclude by end of this month and Chancellor Angela Merkel on track for a comfortable win.

Nevertheless, the central bank expressed caution on persistent strength in Euro (against US dollar and Sterling) which is now jeopardizing inflation targets and potentially dent export growth. Effectively, ECB has lowered inflation forecasts, with price growth now seen at 1.2% next year, when compared with the earlier estimate of 1.3%. Inflation for 2019 is projected at 1.5%, well below the target rate of 2%. There is a sense that although ECB will initiate process of scaling back the monthly bond purchases (currently 60bn euros per month) next year, it would be a very gradual process.

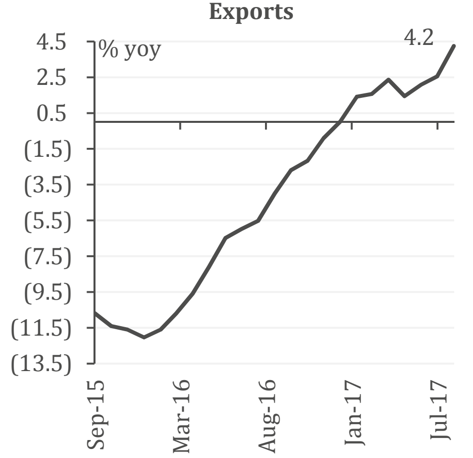
We reckon that the central bank must handle scaling down of asset purchase programme in a calibrated manner in order to avert any sharp spike in yields and borrowing costs. ECB can learn from the episode of 'taper tantrum' in US during 2013 after Fed announced reduction in bond purchases.

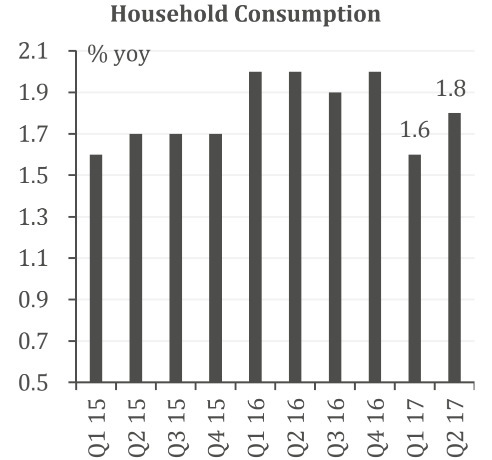
Figure 20: GDP: Sustained recovery in growth



Source: Bloomberg, IIFL Research

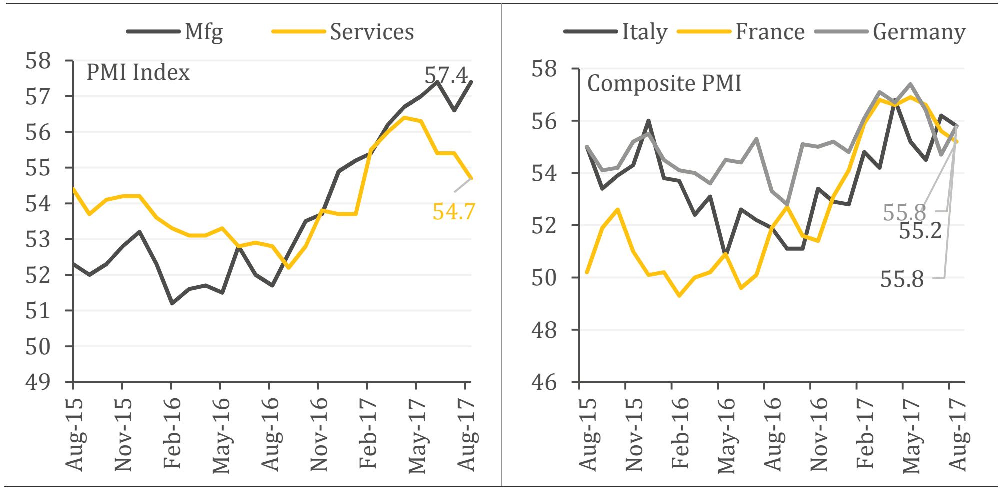
Figure 21: Exports and Household consumption providing the impetus





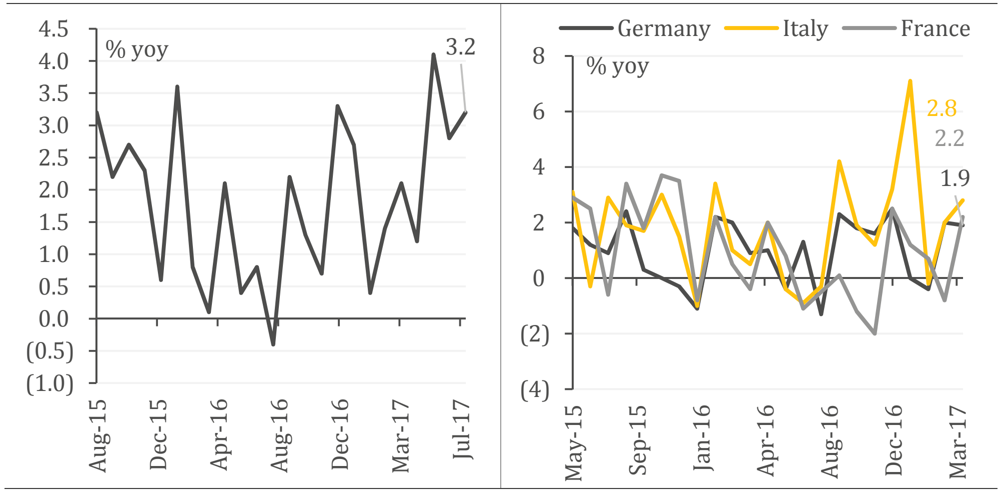
Source: Bloomberg, IIFL Research

Figure 22: PMI corroborates expansion in economic activity



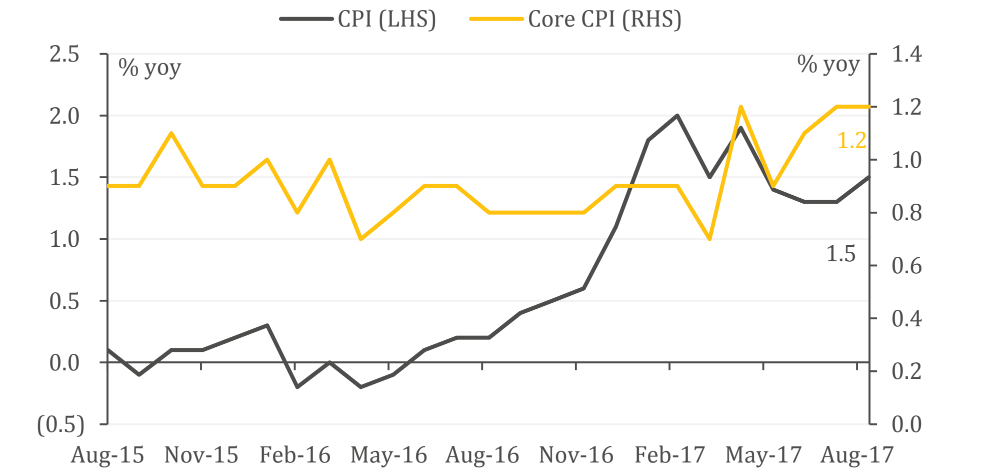
Source: Bloomberg, IIFL Research

Figure 23: Industrial Production on strong footing



Source: Bloomberg, IIFL Research

Figure 24: Inflation still below the target rate, though signs of price pressure bottoming out evident



Source: Bloomberg, IIFL Research

Figure 25: Solid wage growth during Q2 provides confidence to ECB to taper bond purchases

Source: Bloomberg, IIFL Research

UNITED KINGDOM

- *Contentious issues, primarily immigration and divorce bill are hampering progress of Brexit negotiations*
- *BOE sees GDP growth of 1.7% for this year and 1.6% for 2018*
- *Higher inflation and lower wage growth is eroding household incomes*
- *BOE is ready to hike interest rates in next few months*

Frustrating pace of the yet indecisive Brexit negotiations casts a dark shadow over UK's economic growth prospects. It seems PM Theresa May is as perplexed as the masses who don't understand the repercussions of Brexit yet, especially given their muddled understanding of the situation when they voted for the referendum in the first place. Although British are hopeful of clinching a deal before March 2019 deadline, there's a sense of exasperation in the EU camp. Contentious issues, primarily immigration and divorce bill are hampering progress of Brexit negotiations. British negotiators have outlined their stance on certain policies, but EU officials first want clarity and commitment on what amount UK will pay for its present and past commitments to EU's budget. UK has rejected the divorce bill instead, disputing the legality of such financial obligation. To make matters worse, a leaked British draft immigration proposal reveal that free movement of people will end post Brexit. EU citizens in Britain would be subjected to stringent rules, including registration on arrival. There seems a clear demarcation between low-skilled and high-skilled labour, where the sojourn of low-skilled could be restricted in terms of duration, while high-skilled workers would be provided long term permits.

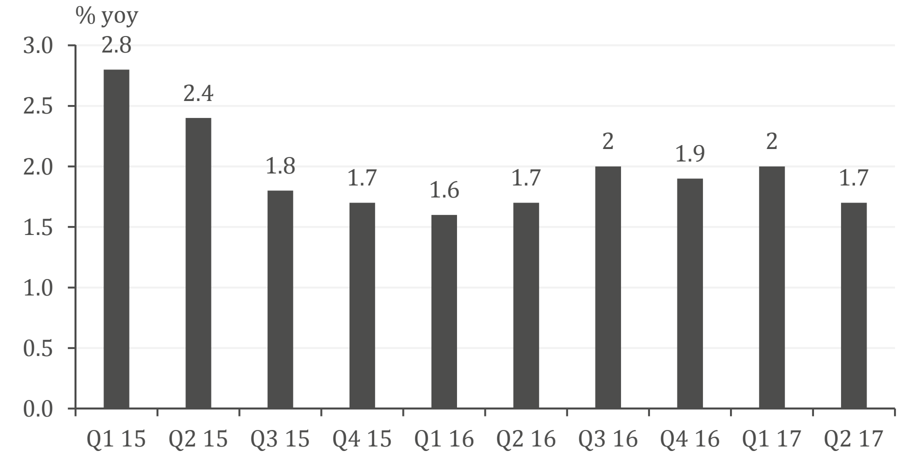
Given the lack of progress, negotiations are unlikely to advance to the next phase soon. Time is certainly ticking and Britons will lose access to EU single market post March 2019, if it fails to make opportune headway on the talks. A half-baked Brexit will prove more disastrous for the British economy rather than a hard Brexit. Some Britons reckon UK will not oblige to the irrational European demands, eventually opting for a hard Brexit. Admittedly, it is too early to jump the gun given that negotiations will be a roller-coaster ride, entailing various twists in stance over next two years. Meanwhile, a shocking loss of a majority for the ruling Conservative party and sharp slide in popularity of PM May has also aggravated the uncertainty.

Transparency and flexibility on negotiations is must to restore business confidence and spur investments. Recruitment and Employment Confederation survey report conveys that British employers are now less inclined to hire and invest as there's no clarity on transition from EU after March 2019. On similar lines, the British finance industry has asked for a detailed outline from the government on sanctity of the contracts involving financial transactions after Brexit. The situation doesn't look too good in London property markets as well, as various banks and institutions plan to shift operations to other European centers like Frankfurt and Dublin.

Ambiguity over Brexit is also shaping actions of Bank of England, where it is straitjacketed to move on the interest rates despite inflation outpacing wage growth. BOE has now lowered growth & wage forecasts. It sees GDP growth of 1.7% for this year, down from the earlier estimate of 1.9%. For 2018, growth forecasts have been downwardly revised to 1.6%, from 1.7%. Wages projections are down by

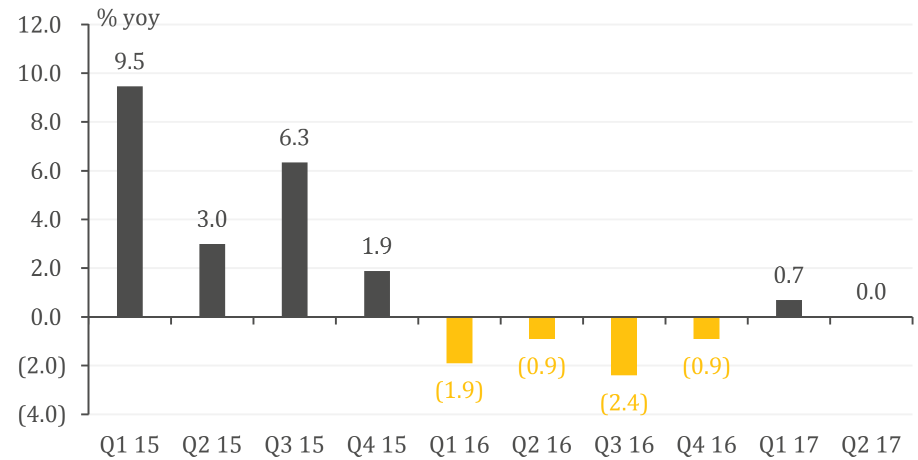
50bps for both 2017 and 2018, expected to grow 3% and 3.25% respectively. Meanwhile, inflation is expected to remain above BOE's target rate of 2% for three years. CPI inflation spiked to 2.9% in July, while wage growth continues to lag around 2.1%, eroding household real incomes. If this trend prevails, it will be difficult for BOE to kick the can down the road on normalizing the policy. Effectively, the central bank at September policy meeting showed readiness to hike interest rates in next few months if inflation persistently remains high. Although BOE governor mentioned that the rate hikes will be gradual and limited, some banks like HSBC & Barclays are already projecting UK interest rates to hike as early as November.

Figure 26: GDP: Indecisive Brexit negotiations hampering growth



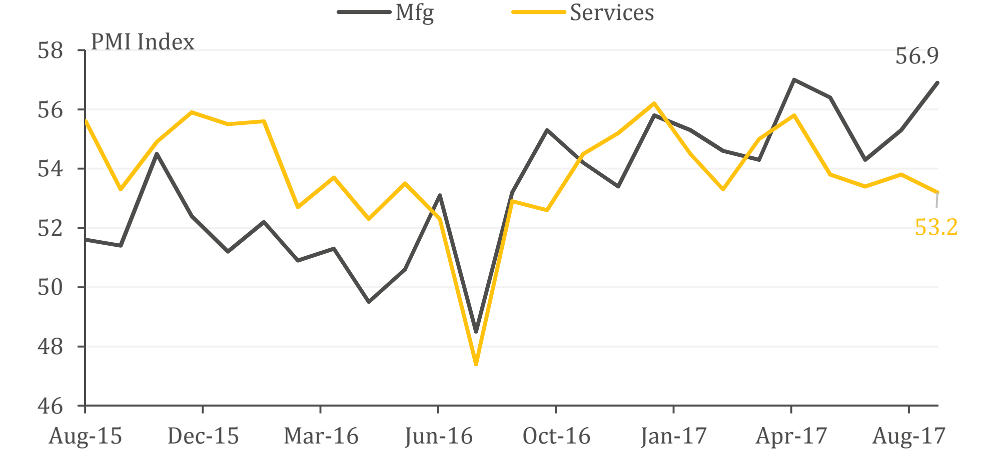
Source: Bloomberg, IIFL Research

Figure 27: Business investments remain dismally low



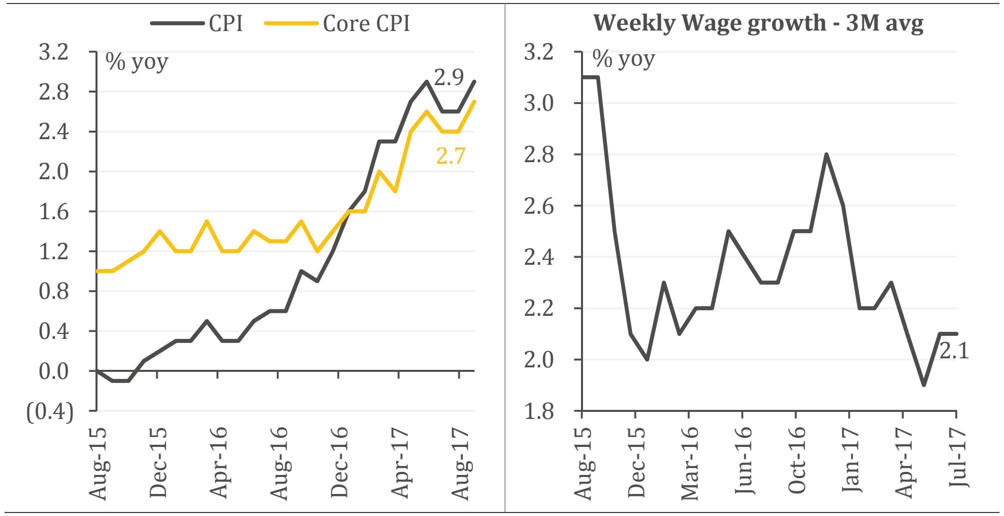
Source: Bloomberg, IIFL Research

Figure 28: PMI: Uncertainty over passporting rights cast dark cloud over the Financial Services



Source: Bloomberg, IIFL Research

Figure 30: Inflation exceeding wage growth, hampering real incomes

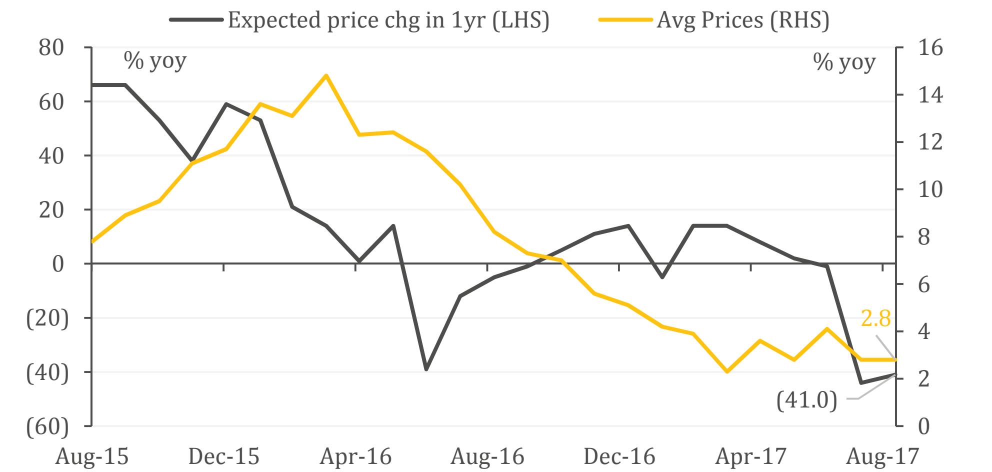


Source: Bloomberg, IIFL Research

Figure 29: Consumer spending depressed amid high inflation…

Source: Bloomberg, IIFL Research

Figure 31: London property markets in distress



Source: RICS Housing Market Survey, Bloomberg, IIFL Research

JAPAN

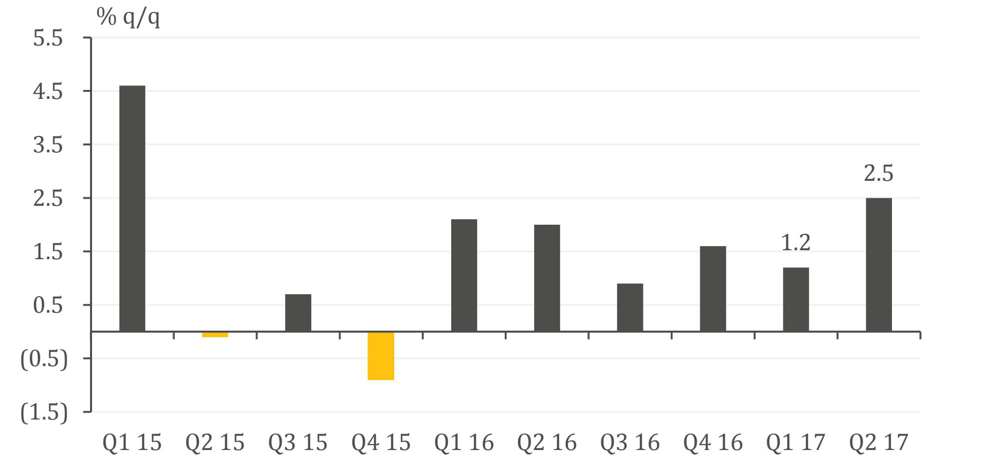
- *Growth in consumer and capital spending is at a three-year high, while corporate profits have been buoyant*
- *Core CPI in deflation for six months in a row*
- *BOJ has postponed the time frame for attaining its inflation target of 2%, the sixth time since asset purchase programme was launched in 2013.*
- *Strong Yen amid geopolitical tensions*
- *Possibility of snap national elections*

Japan's Q2 GDP expanded 2% (q/q), with the final number downwardly revised from the earlier estimate of a whopping 4%. Although the downgrade is disappointing, the economy is growing for six consecutive quarters, this has happened for the first time in 11 years. Growth in consumer and capital spending is at a three-year high, with private final consumption expenditure growing at 1.7% (yoy) during Q217, while gross fixed capital formation expanding at 3.4%. Corporate profits have also remained buoyant, growing at an average 25% during the first half of this year. This has ushered in a wave of optimism for BOJ which has been toiling hard to revive the economy. The moot point remains whether such buoyancy will sustain given Japan's weak demographic profile. Nevertheless, BOJ remains optimistic, expecting the economy to grow 1.8% this year, an upgrade from the earlier projection of 1.6%. For 2018, GDP growth is seen at 1.4%.

Inflation still remains below the target rate of 2% target, with CPI for July at 0.4%, while Core CPI in deflation for six months in a row. Effectively, BOJ has postponed the time frame for attaining its inflation target of 2%, the sixth time since asset purchase programme was launched in 2013. It seems the central bank is gradually acknowledging that it is miles behind the 2% target. Core inflation for this year is seen at 1.1%, 1.5% for 2018 and 1.8% for 2019, still an over-optimistic number. Recent policy statement indicates the central bank will stay put on ultra-easy monetary policy as any twist on the same can trigger further upside in Yen and in the process endanger growth prospects. On currency cues, Yen is ruling the roost in FX markets, quite paradoxical given the geographical proximity of Japan to mercurial North Korea. It seems investors are betting on the fact that Japan remains the second largest creditor nation to the world and will unlikely default in times of geopolitical crisis. On trade side, the country's exports continue to grow at an average of 10% during first seven months of this year despite a strong Yen.

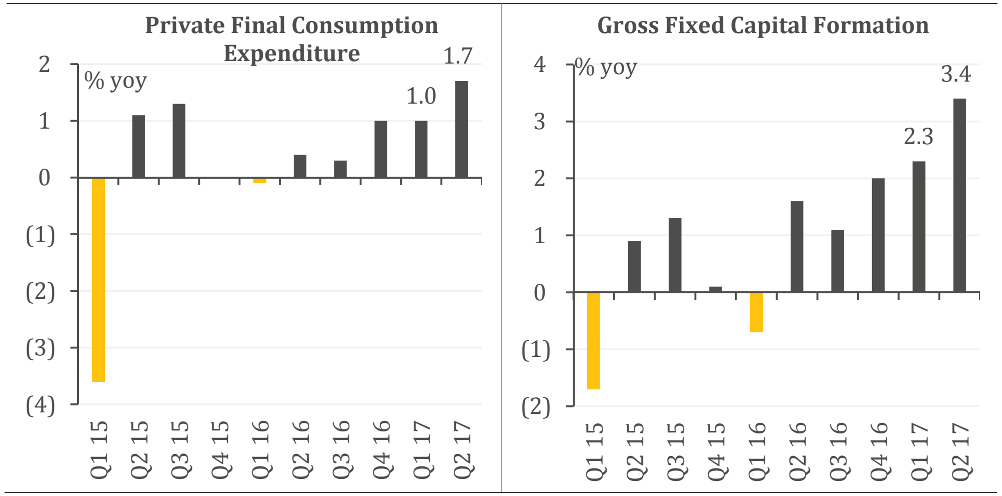
On political front, PM Abe's popularity is diminishing amid brewing business scandal, manifested by massive defeat of Liberal Democratic Party in local elections. However, political pundits opine that it is not going to change the fortunes for the incumbent regime at national level given the lack of strong opposition. PM Abe endeavors to turn the tide through a cabinet rejig. PM Abe is also considering snap elections in order to take capitalize on the prevalent rift within the main opposition party.

Figure 32: GDP: Momentum in growth during Q2



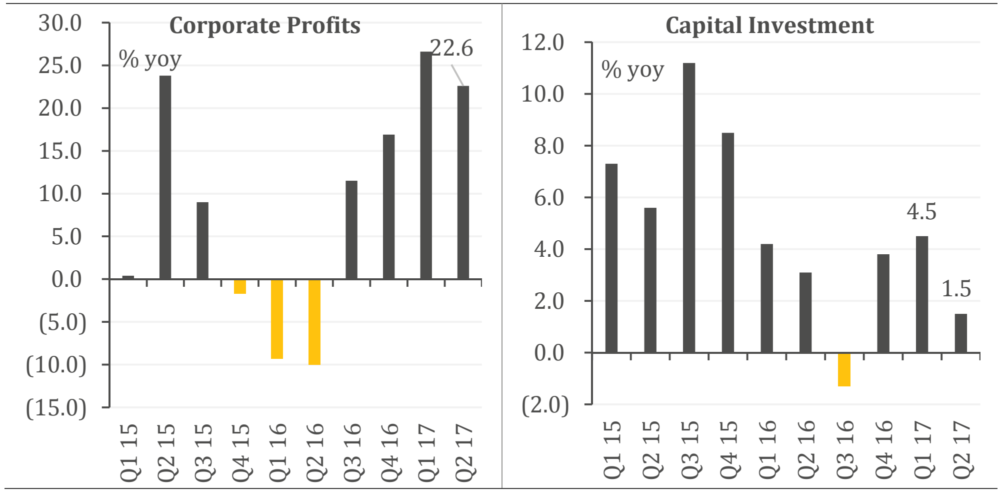
Source: Bloomberg, IIFL Research

Figure 33: Recovery in Private consumption and Fixed asset spending



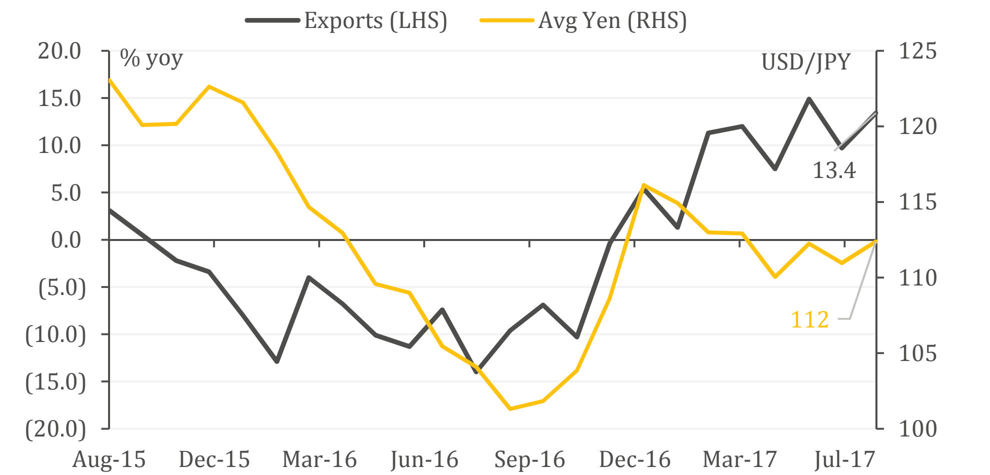
Source: Bloomberg, IIFL Research

Figure 34: Strong growth in Corporate profits, however, business investments lagged during Q2



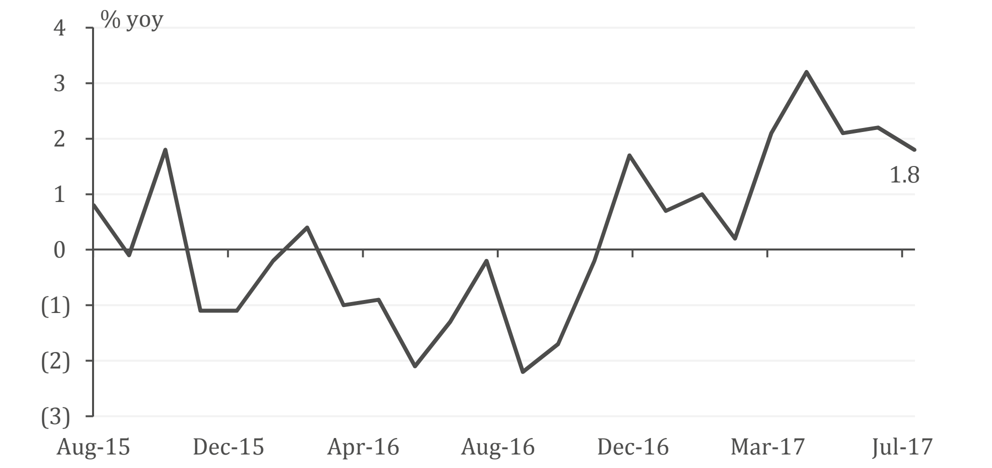
Source: Bloomberg, IIFL Research

Figure 35: Export growth remains intact despite strength in Yen



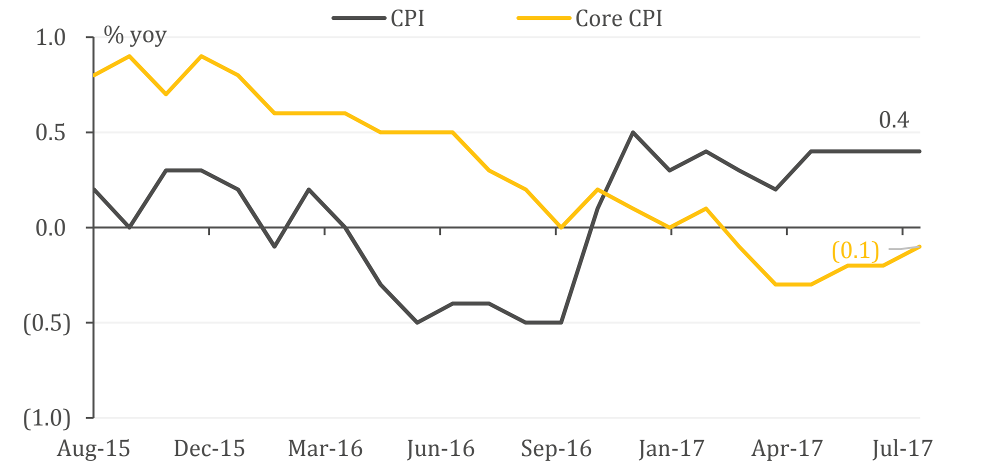
Source: Bloomberg, IIFL Research

Figure 36: Retail sales in positive territory for consecutive 9 months…



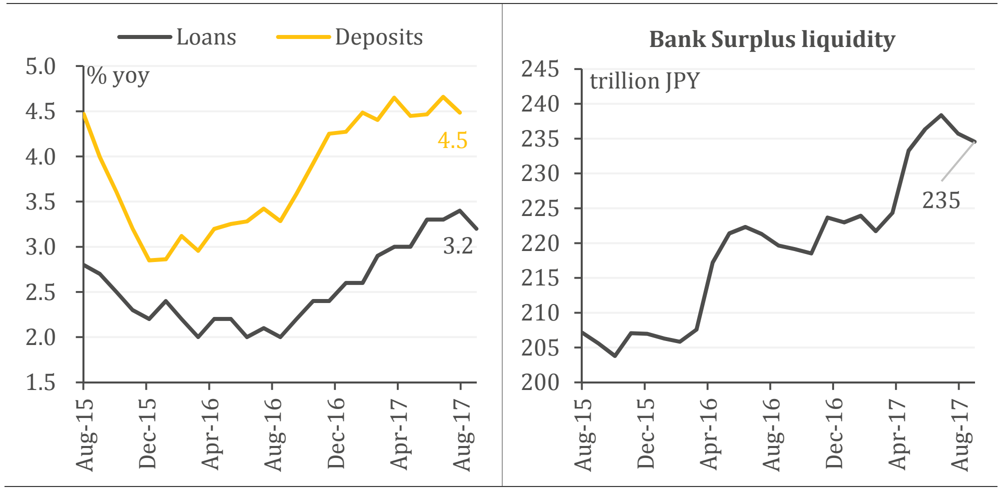
Source: Bloomberg, IIFL Research

Figure 38: BOJ has procrastinated inflation target, with CPI not seen around 2% till 2019



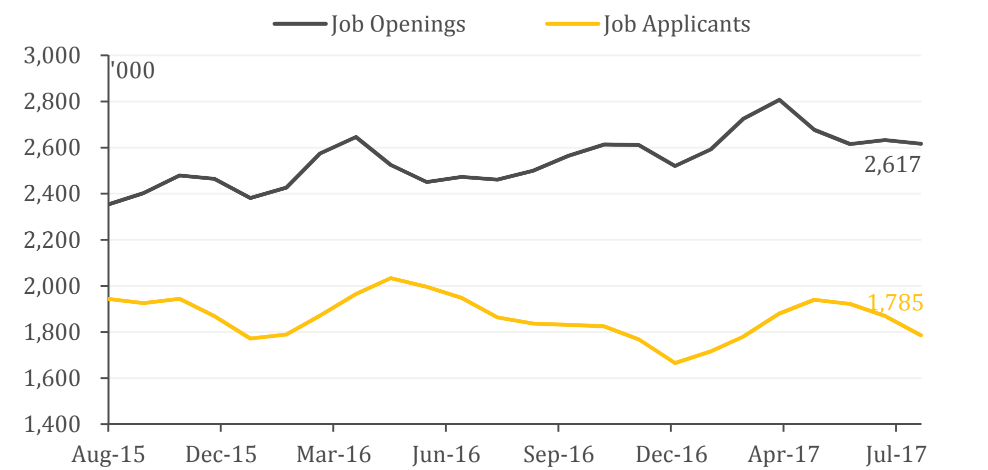
Source: Bloomberg, IIFL Research

Figure 37: …However, surplus liquidity in Banking system suggests higher saving and lower spending



Source: Bloomberg, IIFL Research

Figure 39: Weak Demographics: More jobs than job seekers



Source: Bloomberg, IIFL Research

CHINA

- *Slowdown in August macroeconomic readings, though no concrete signs of hard landing*
- *Overheated Real estate markets, PBOC sees Chinese property market as a big financial risk*
- *Regime contemplating at financial liberalization measures amid moderating capital outflows*
- *IMF and Moody's upgrade economic growth forecasts*
- *Structural problem of high debt*

Chinese economy remained stable during Q2, thought recent numbers indicate slowdown creeping in August, with industrial production, fixed-asset investment and retail sales hitting a multi-month low. Nevertheless, one cannot gauge the economy on a monthly reading, and to be fair, there is yet no concrete signals of distress or a hard landing despite high debt levels. Real estate markets continue to hold ground, with fixed asset investments in the sector rising by 5.1% during the first 8 months of this year. Residential prices of newly built units in 70 cities have risen by an average 9-10% during this year. There are no signs of slump, quite a fly in the face of experts who projected the momentum to fade during the second half of this year. Several cities have imposed curbs to restrict price appreciation, however, the results still remain mixed. In fact, a large proportion of Chinese households still expect housing prices to keep rising. Astoundingly, home prices exceed the household income levels. For instance, a two-bedroom new apartment in Beijing now costs around US $870,000, about 69 times the average per capita income in the city and much higher than the ratio of roughly 25 times for New York. Although the Chinese regime wants to cool the overheating in property markets, the overall stance still seems accommodative, with no intention of rocking the boat in terms of policy.

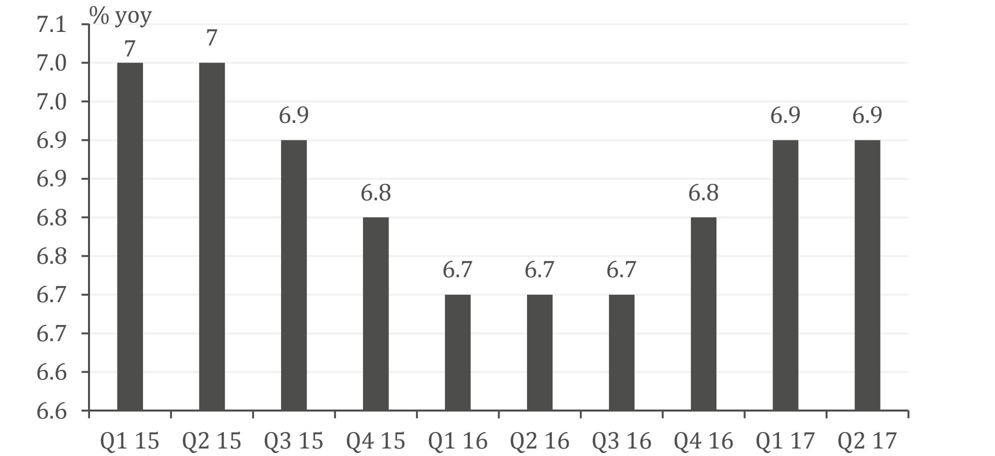
On trade front, China's outbound shipments remain steady, helped by positive economic momentum in China's trading partners. Imports have also been strong mainly due to rising commodity prices. In terms of trade balance, the country enjoyed a surplus of healthy US$274bn so far this year. Meanwhile, Yuan has remained remarkably strong, in line with the broad based weakness in US dollar against the basket of currencies. Most importantly, it's quite unprecedented to see no resistance from Chinese regime towards appreciating Yuan. This certainly seems a departure from history where the government deliberately undervalued the currency in order to boost exports.

Nevertheless, the Chinese regime has recently taken some measures to ease the appreciation in Yuan. PBOC has parted away with the reserve requirements which foreign banks and financial institutions had to maintain for settling offshore Yuan forward positions. This has now eased restrictions on purchasing and holding US dollars. Moderating capital outflows has encouraged the central bank to take such move. FX reserves now stand at a nine month high of US$3.09 trillion from US$2.99 trillion in January this year. PBOC is also considering various liberalization measures, which allows foreign investors more access to Chinese financial services.

Overall resilience in Chinese economy has triggered an upgrade in GDP growth forecast by IMF, while Moody's now sees the economy growing at 6.8% this year from the earlier estimate 6.6%. Earlier, Chinese Premier Li Keqiang stated that the country will attain GDP growth target of 6.5% and will manage systemic risks despite ongoing challenges. Conversely, PBOC remains cautious, stating that

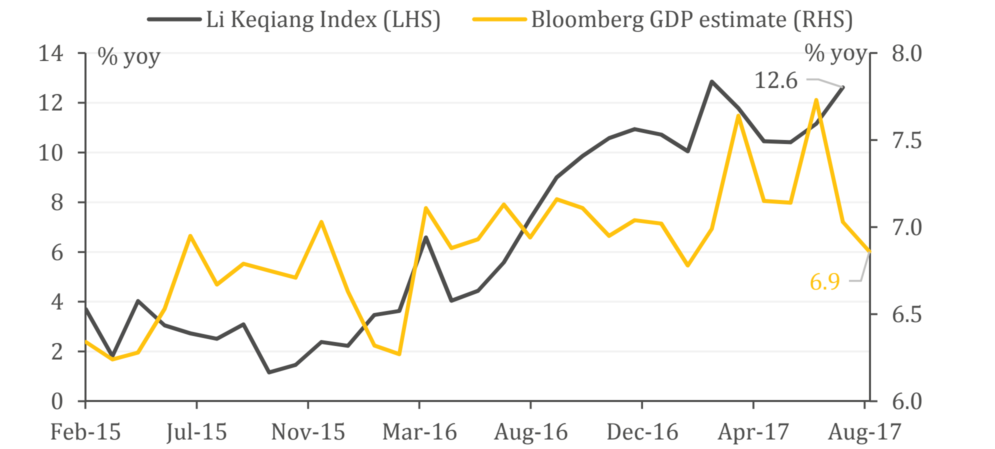
Chinese property market poses as big financial risk which cannot be contained by conventional monetary policy. Some experts still reckon that current buoyancy in growth is transient, stating that slower credit growth will eventually lead to slowdown. The country's debt now stands an alarming 300% of GDP, which can compel the government to put a brake on rise in private borrowing.

Figure 40: GDP: No signs of distress in economy despite high debt levels…



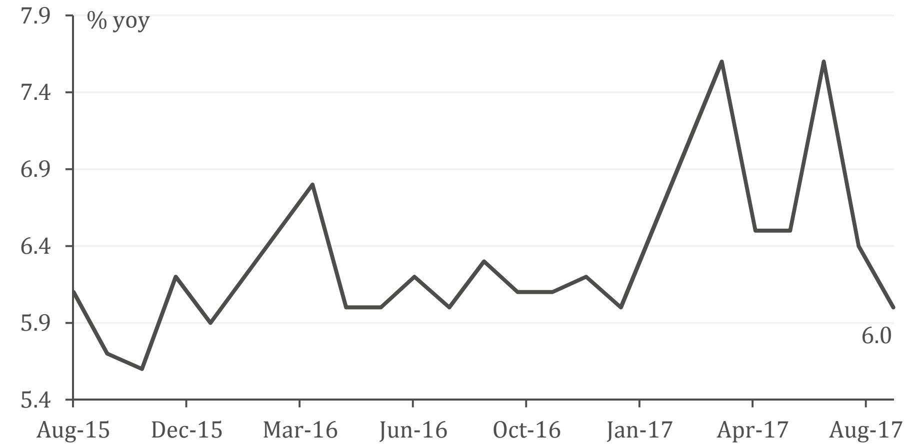
Source: Bloomberg, IIFL Research

Figure 41: …Though other indicators reveal economy slowed in August



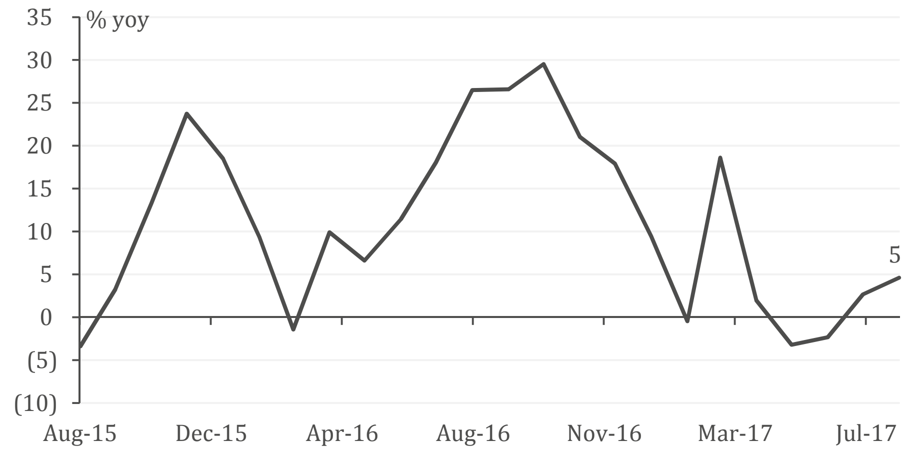
Source: Bloomberg, IIFL Research

Figure 42: Industrial Production growth in August at nine month low



Source: Bloomberg, IIFL Research

Figure 44: Slower passenger car sales

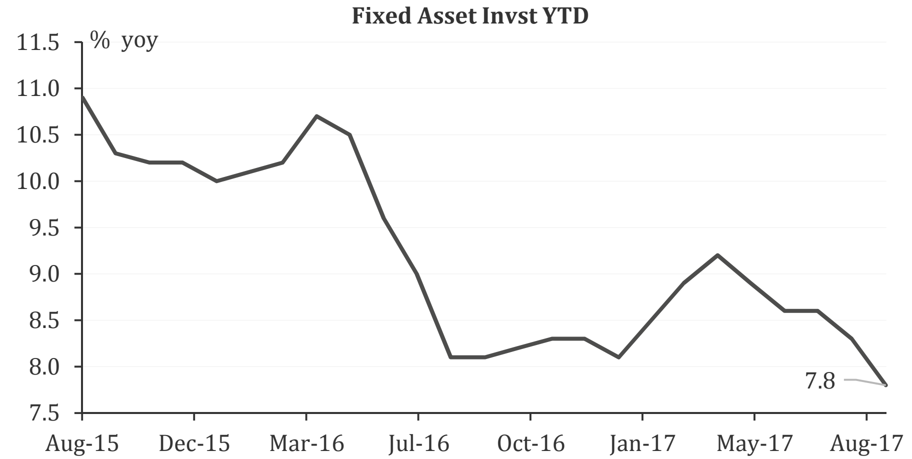


Source: Bloomberg, IIFL Research

Figure 43: Retail sales growth at six month low

Source: Bloomberg, IIFL Research

Figure 45: Fixed asset investment during first eight months of this year witnessed the slowest growth since 1999

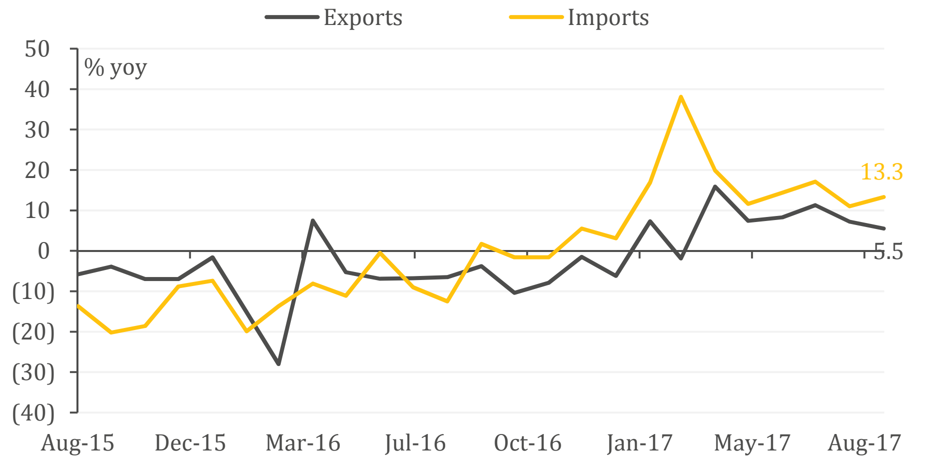


Source: Bloomberg, IIFL Research

Figure 46: Local governments are scaling down investments, as Chinese fiscal policy becomes less supportive amid high debt

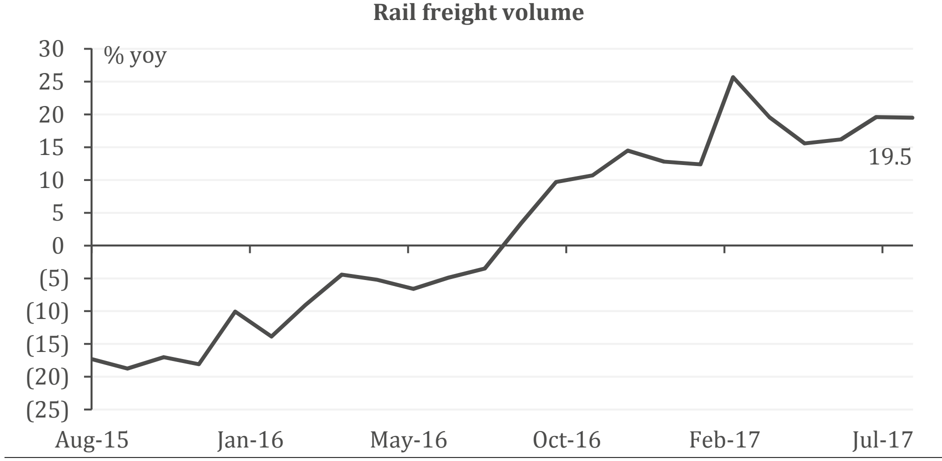
Source: Bloomberg, IIFL Research

Figure 47: Nevertheless, Chinese trade remains relatively resilient…



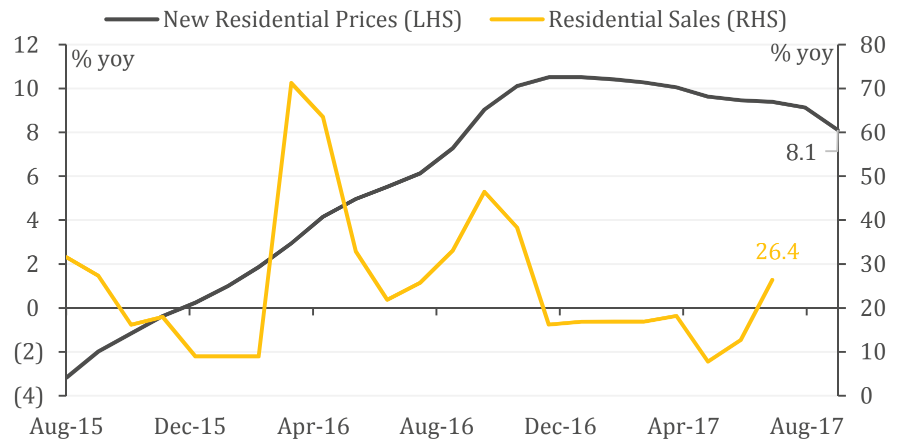
Source: Bloomberg, IIFL Research

Figure 48: …Chinese rail freight volumes also corroborate the same



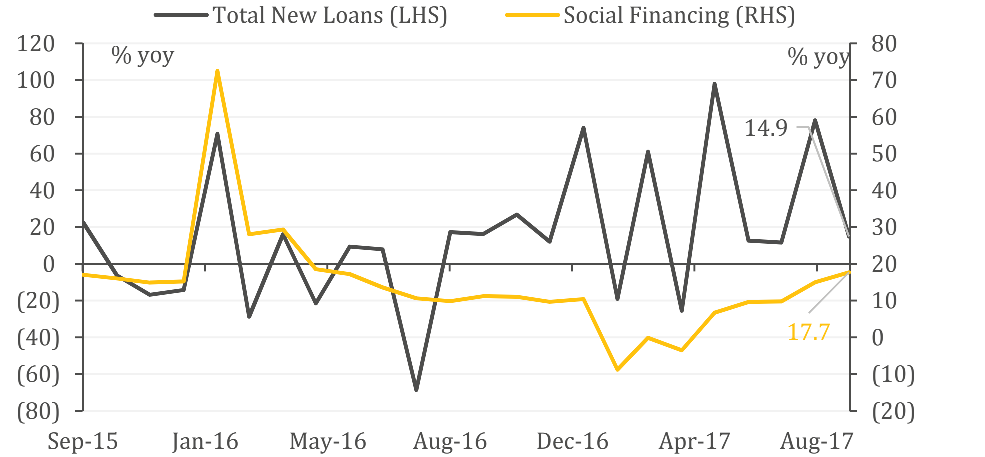
Source: Bloomberg, IIFL Research

Figure 49: Real estate sector continues to hold ground, with residential prices hitting the roof



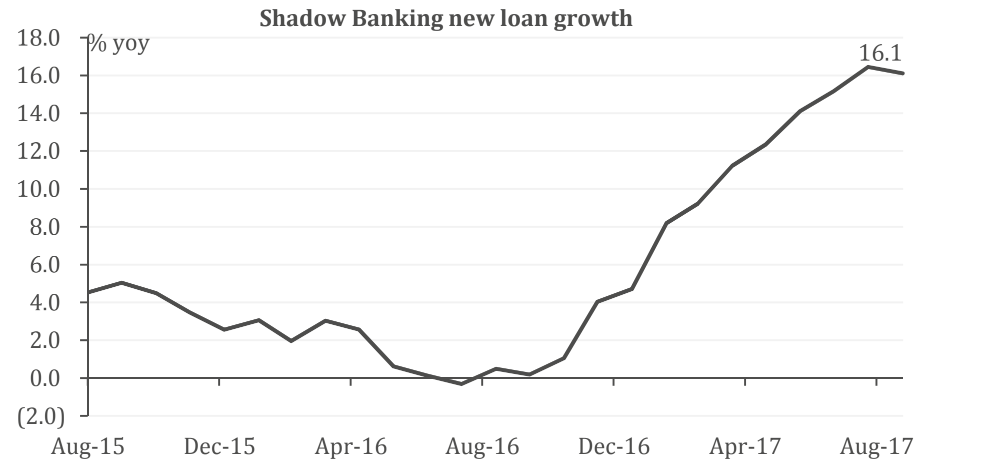
Source: Bloomberg, IIFL Research

Figure 50: Bank lending may slow down during balance of this year after a long period of credit binge…



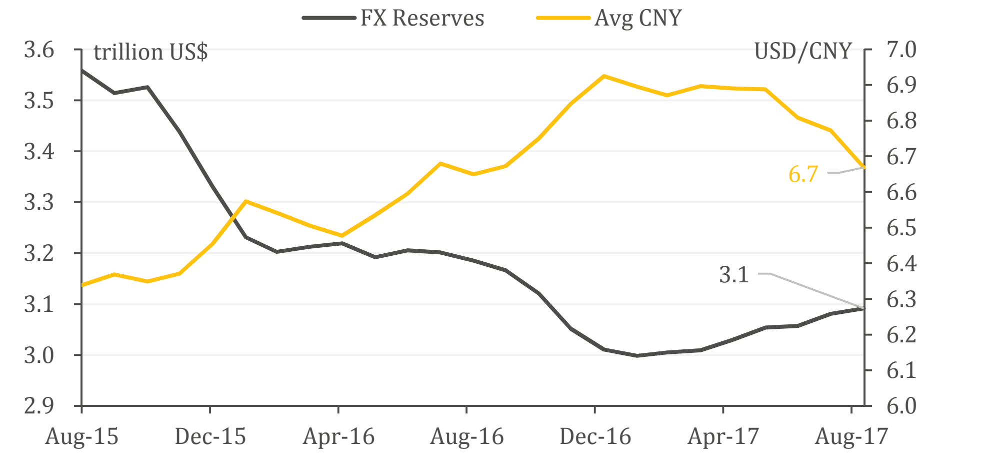
Source: Bloomberg, IIFL Research

Figure 51: …However, Shadow banking a grave concern



Source: Bloomberg, IIFL Research

Figure 52: Abating Capital outflows has resulted into strong Yuan



Source: Bloomberg, IIFL Research

INDIA

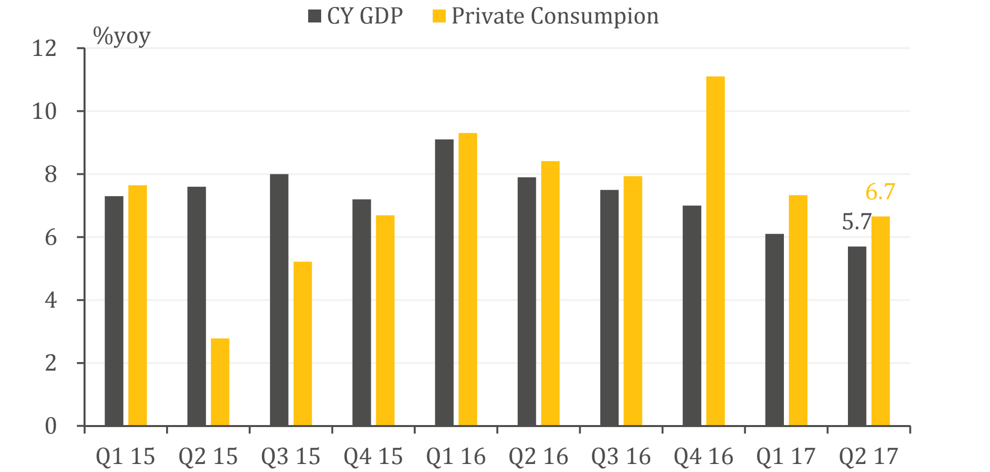
- *Transition to a new tax regime has taken a toll on growth momentum*
- *Private final consumption expenditure during Q1FY18 expanded at the slowest pace in six quarters*
- *Food inflation which constitutes literally half of the consumer price index has rebounded sharply*
- *Foreign capital inflows (equity & debt) at a cumulative US$27bn so far this year*

Indian economy lost further momentum during Q1 of this fiscal year, with GDP growing at a meagre 5.7% (yoy), way lower than the reading of 7.1% for FY17. This was a major disappointment when compared with expectations of resilience from broader sectors of the economy. Transition to a new tax regime (GST) and partial impact of demonetization obviously took a toll, with manufacturing bearing the maximum impact. Slowdown was evident in agriculture and mining, while the services segment fared well. On expenditure front, household spending lost steam after being surprisingly buoyant during H2 of FY17. Private final consumption expenditure during Q1FY18 expanded 6.8%, the slowest pace of growth in six quarters. Meanwhile, persistent government spending continues to play the economic savior, culminating into a healthy 17.2% growth. Central government's July end Gross fiscal deficit already stands at 92.4% of actuals to budgeted estimates for FY18. It seems the incumbent regime is garnering courage from projections of higher tax revenues. Gross fixed capital formation expanded 1.6%, rebounding from 2.1% contraction in the last quarter of FY17. However, doubts remain whether such recovery would sustain given the slowdown in manufacturing, mining and other sectors. It seems lower interest rates are yet to translate into a meaningful shift in private investment cycle.

On inflation, consumer prices during August rose 3.36%, when compared with 2.36% in the prior month. Price pressure in food commodities is quite evident, with Consumer food price index reported at 1.52%, a sharp rise when compared with deflationary trend during past three months. Food inflation which constitutes literally half of the consumer price index has rebounded sharply. Waning of base effect across the food basket and supply disruption in some perishable commodities (due to monsoon) indicates that price pressure is going to sustain for next few months. The overall trend in headline reading is in line with RBI projections, where the central bank expects CPI inflation to average 3.5-4.5% during the second half of this fiscal year. It seems RBI rightly remains familiar of possible inflationary pressures emanating from farm loan waivers, strengthening global commodity prices (excluding oil) and reversal of transient disinflationary factors. RBI's resolute commitment towards keeping inflation close to 4% on sustainable basis and expected policy normalization by global central banks has ruled out any policy move during the calendar year.

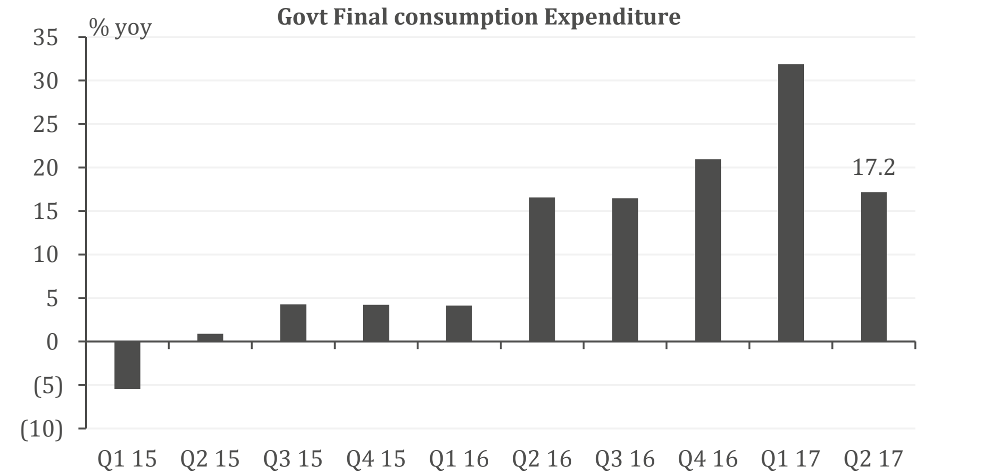
Meanwhile, foreign capital inflows into the economy remains healthy, with investors pouring in US$27bn cumulatively so far this year in debt and equity markets. Although a rate cut lowers the appeal for investments in sovereign debt, the interest rate differentials between India and US & other developed economies still remains too high. Favorable real Interest rates, reform-oriented government and relatively stable currency has also lured investments.

Figure 53: Transition to new tax regime has dented economic momentum



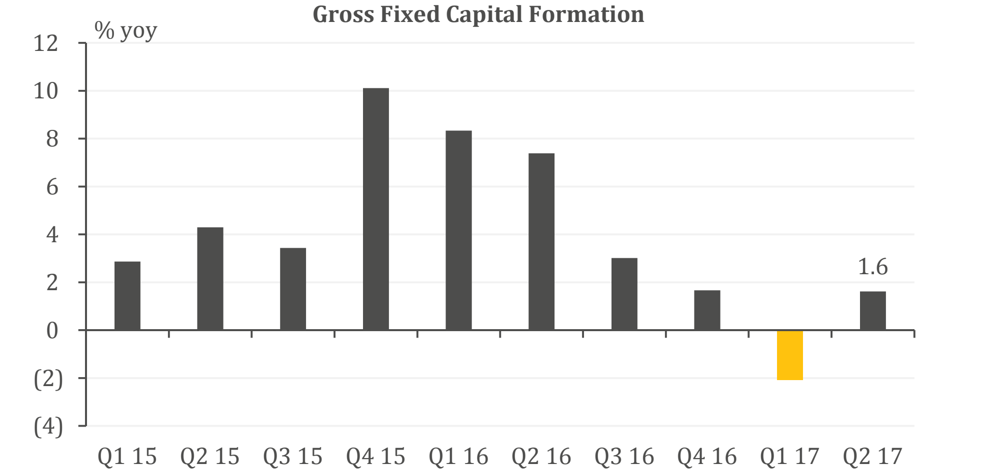
Source: Bloomberg, IIFL Research

Figure 54: Government spending remains strong in light of projections of higher tax revenues



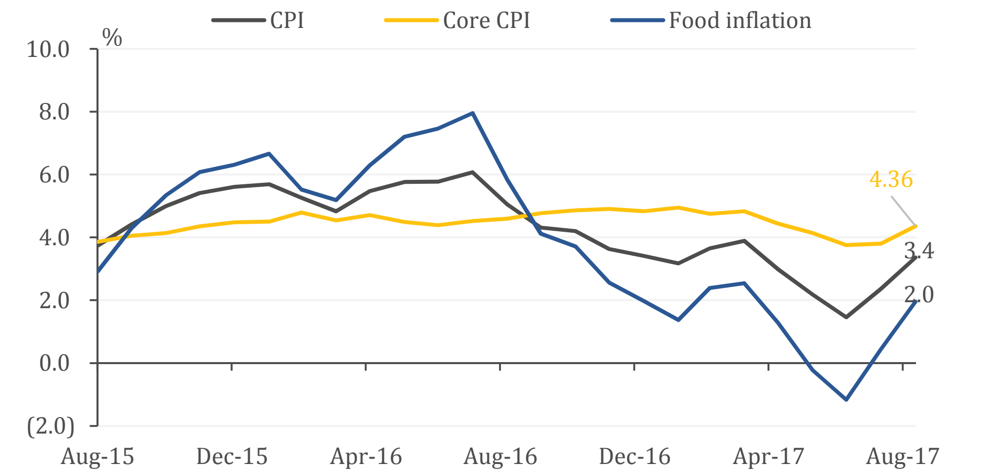
Source: Bloomberg, IIFL Research. Note; Data is for Calendar Year

Figure 55: Investment cycle witnessed moderate recovery during CY17Q2, however sustainability remains a question



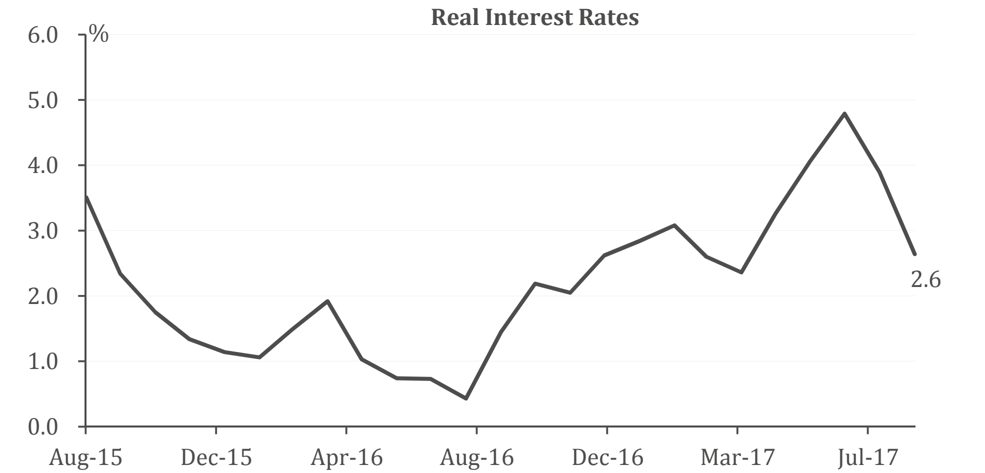
Source: Bloomberg, IIFL Research. Note; Data is for Calendar Year

Figure 56: Headline inflation scaling higher…



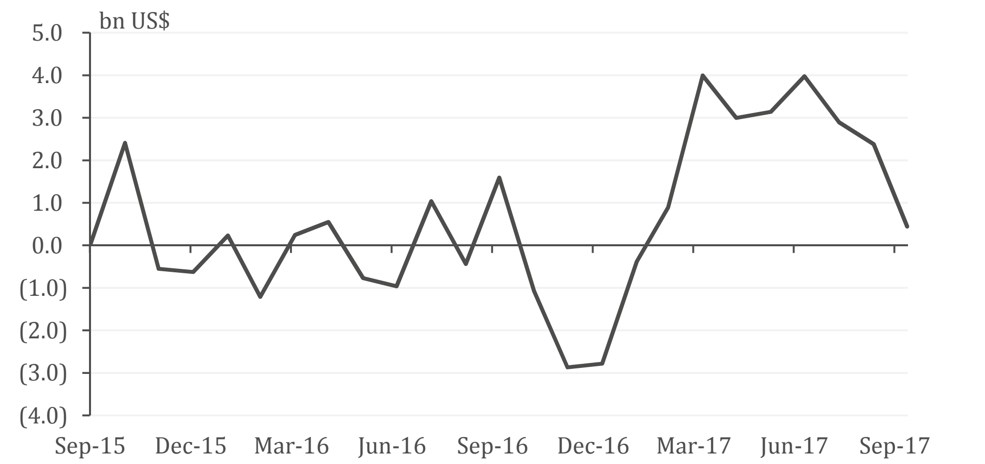
Source: Bloomberg, IIFL Research

Figure 57: …However, real interest rates still remain attractive



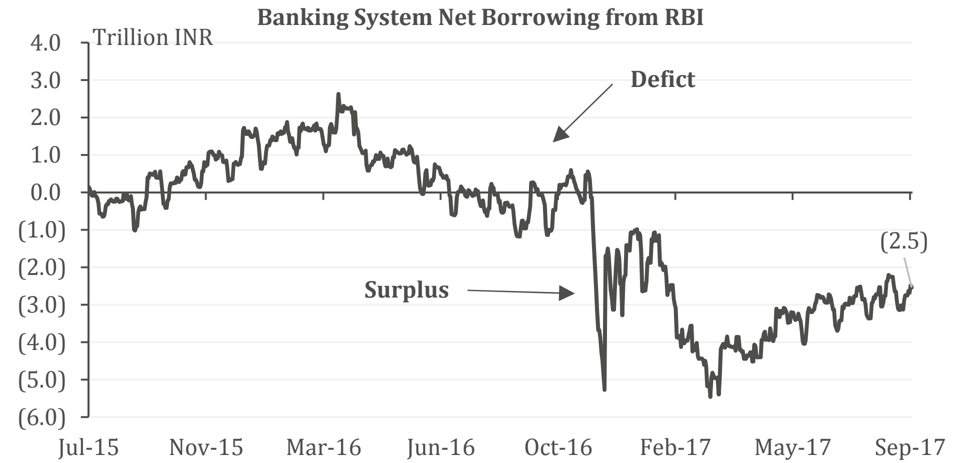
Source: Bloomberg, IIFL Research

Figure 58: No wonder, cumulative foreign capital inflows in debt markets over US$20.3bn so far this calendar year



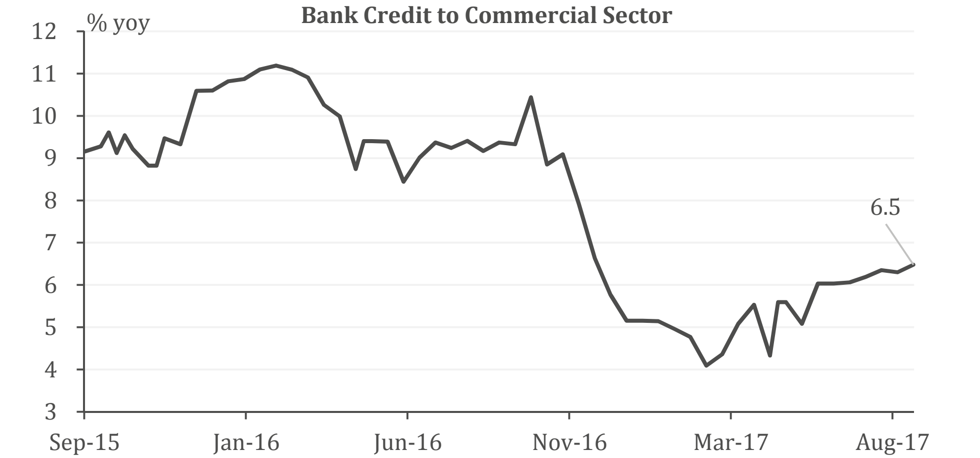
Source: Bloomberg, IIFL Research

Figure 59: Surplus liquidity prevails in the banking system



Source: Bloomberg, IIFL Research. Note: A positive borrowing amount implies liquidity deficit, while a negative amount implies surplus

Figure 60: Recent rate cuts by RBI gradually taking shape of higher credit growth



Source: Bloomberg, IIFL Research

BRAZIL

- *Political strife dominate headlines*
- *Economy has recovered from twelve consecutive quarters of contraction*
- *Brazil's central bank has trimmed interest rates by 600bps since October last year*
- *Government on a massive reform agenda, entailing US$14bn privatization of highways, ports, and airports and electricity generation*

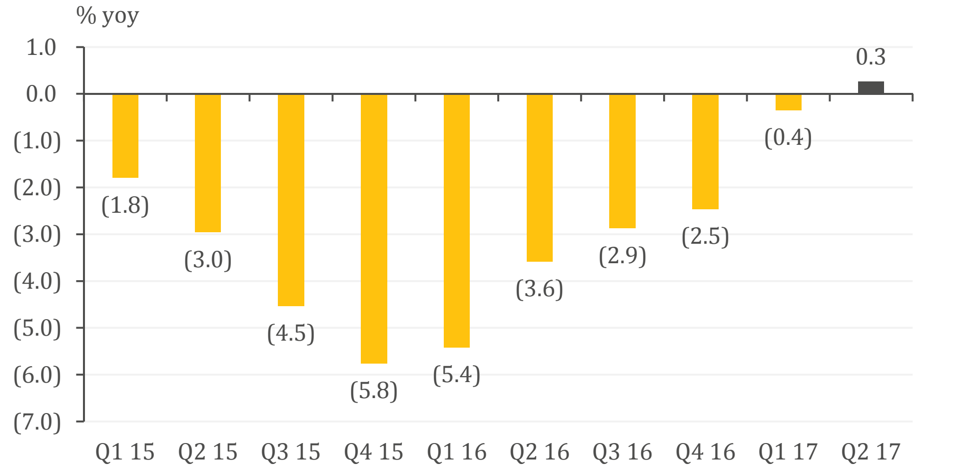
With political drama making headlines for past few months, there was some respite on the macroeconomic front. The economy has emerged from a prolonged recession after Q217 GDP grew 0.26% (yoy), snapping twelve consecutive quarters of contraction. Rise in household consumption after a gap of nine quarters has played an instrumental role in reviving the economy. Retail sales (a gauge for consumer spending) has also exhibited strength, rising an average 2.3% (yoy) during Q2, much better than the average decline of 2.7% and 6% during Q1 and 2016 respectively.

Lower interest rates seems to be helping consumer spending, however the impact is not yet evident on the investment cycle, with gross fixed capital formation declining yet again in Q2. Brazil's central bank has aggressively pruned interest rates to a four-year low of 8.25%, a cut of 600bps, spanning over eight moves since October last year. Plummeting inflation has provided the much needed space for central bank action. Healthy agricultural output has particularly curbed food inflation. There's scope for more easing given the benign inflationary trends. Price pressure is close to a two decade low, with July CPI reported at 2.46%.

Meanwhile, the economy needs slew of reforms to sustain the recovery. In this regard, President Temer has embarked on an ambitious reform agenda, entailing US$14bn privatization of highways, ports, and airports and electricity generation. Disinvestments will certainly ease the fiscal stress, however, experts reckon that it can also lead to a new episode of political dishonesty and bribery. After passing the labour reforms, the government is having difficult time on resetting the munificent pension system, especially after corruption charged were leveled against Temer. Government's intent and appetite for austerity is laudable and important for sustainable economic growth, however, these measures have already translated into political repercussions, with popularity of incumbent President dipping critically low. Meanwhile, credit S&P is not too confident on fiscal reforms, maintaining a "BB" rating and negative outlook on Brazil's sovereign debt. The rating agency cites the prevalent political turmoil as a major impediment in the fiscal road map. Erstwhile Brazilian President Lula da Silva has been sentenced to 10 years in prison on corruption charges. Although he has appealed against the sentence in order to contest general elections in October 2018, the process of appeal will literally consume more than one year.

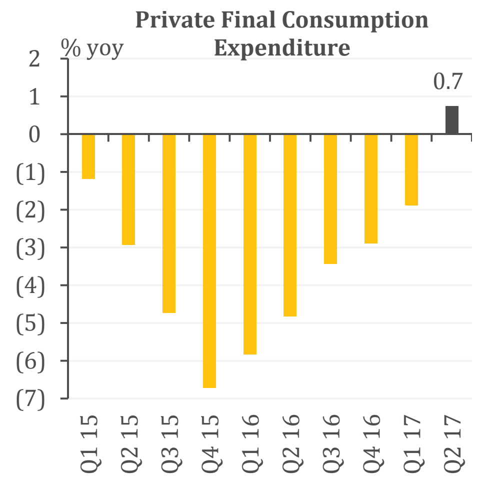
IIFL INVESTMENT MANAGERS WEALTH MANAGEMENT

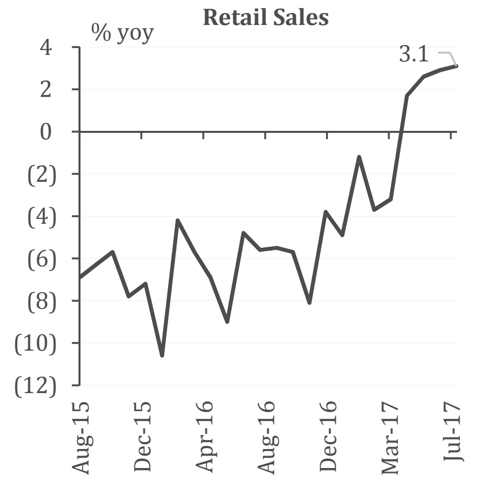
Figure 61: GDP: The economy in growth mode after nine years of contraction



Source: Bloomberg, IIFL Research

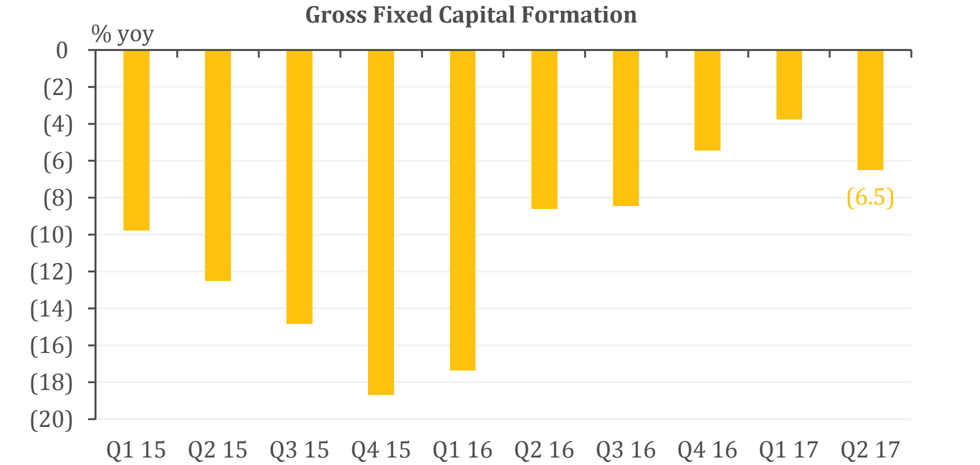
Figure 62: Private Consumption witnessing green shoots…





Source: Bloomberg, IIFL Research

Figure 63: However, fixed asset spending still struggles

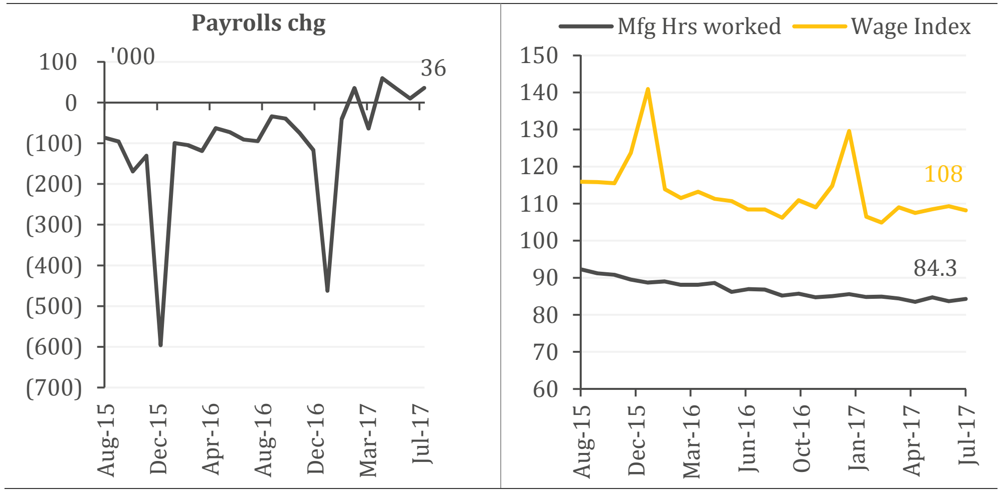


Source: Bloomberg, IIFL Research

Figure 64: Foreign direct investments still remain low

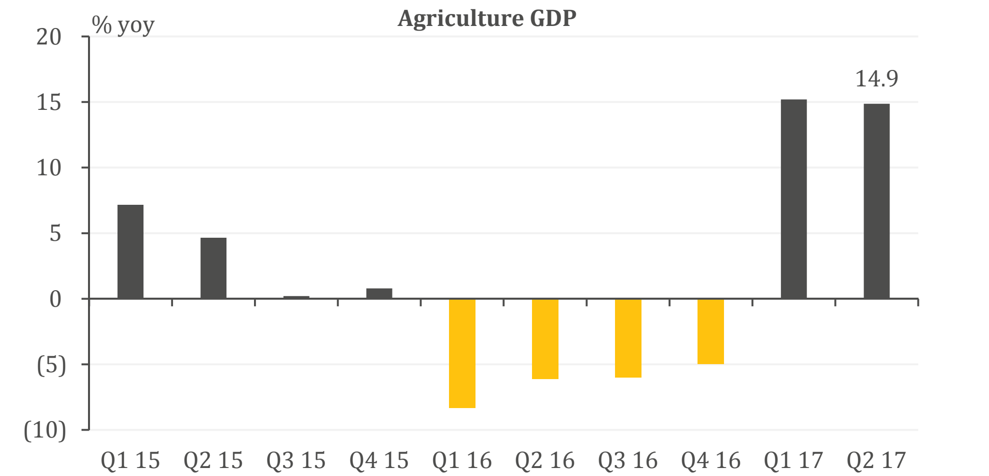
Source: Bloomberg, IIFL Research

Figure 65: The economy have created 71,000 jobs so far this year, snapping the trend of persistent declines



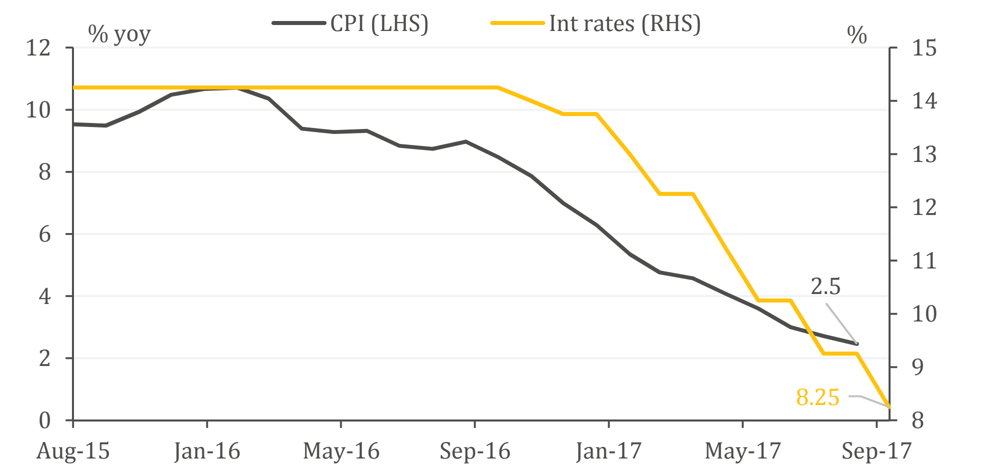
Source: Bloomberg, IIFL Research

Figure 67: Higher Agricultural output has played a major role in softening inflation



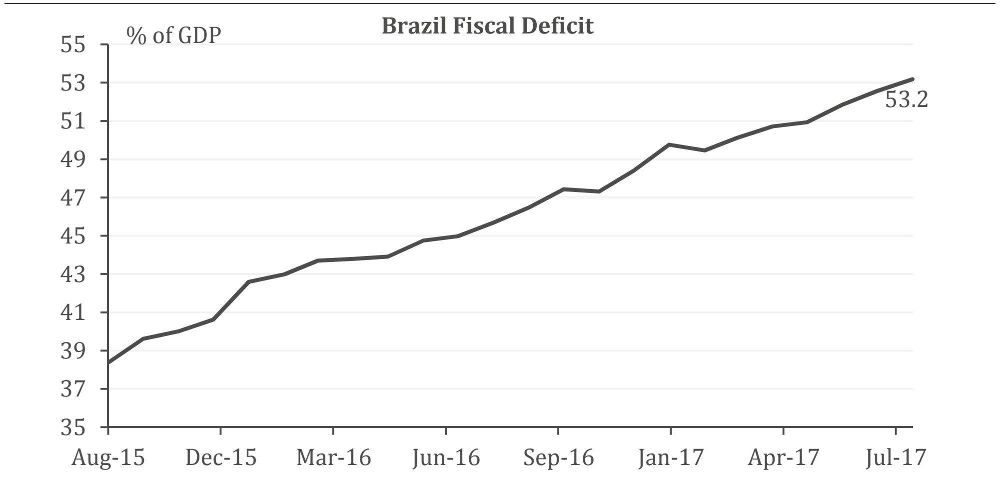
Source: Bloomberg, IIFL Research

Figure 66: With inflation well below target rate, the central bank has aggressively trimmed interest rates



Source: Bloomberg, IIFL Research

Figure 68: Rising fiscal stress



Source: Bloomberg, IIFL Research

RUSSIA

- *Russia-US relations have deteriorated further after Washington imposed new sanctions*
- *After two years of contraction in 2015 and 2016, the economy is treading on the path of growth.*
- *Economic ministry expects GDP to grow 2% this year*
- *With headline inflation at two decade low, central bank delivered a rate cut of 50bps in September and may trim more in next few months*

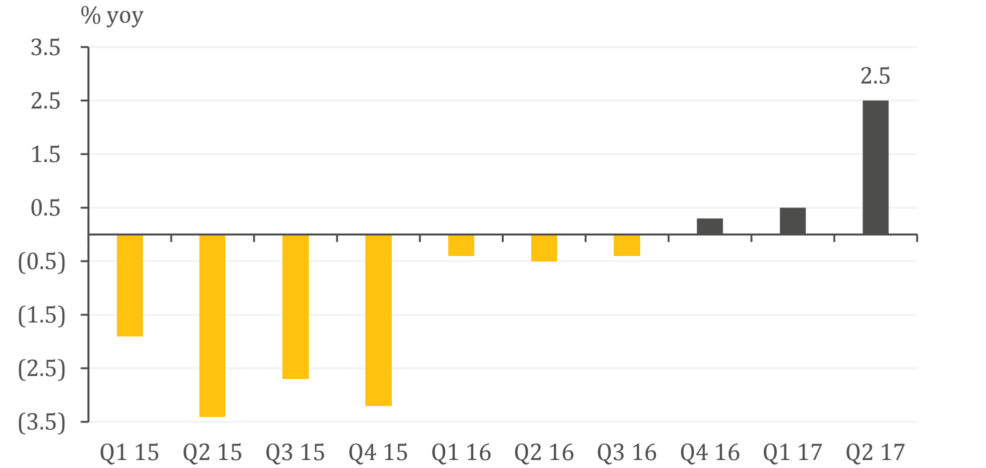
With relations between Washington and Kremlin straining further, Russia risks being burdened with further economic isolation from the Western World. There are already various sanctions on Russia and if this is not enough, US Senate recently imposed new curbs on Russia, hard-pressing President Trump to adopt a reluctant stern stance on Moscow. New sanctions on Russian entities for aiding North Korea's weapon expansion has shattered hopes of improvement in ties between the two nations. Meanwhile, Russia is being communicated to shut its consulate in San Francisco along with two annex buildings in Washington and New York. This is followed by Russia's earlier decision to snap diplomatic ties with US. Needless to mention, alleged links of US President Trump with Russian agencies continue to dominate the headlines.

After two years of contraction in 2015 and 2016, the economy is treading on the path of growth. However, it is very unlikely to see Russia replicating growth of above 5%, which prevailed during the last decade. Need of the hour is structural reforms which will ensure sustainable economic growth and defy threat of sanctions and low oil prices. The government is already contemplating at divesting stake in a shipping company. There is also a sense that Kremlin needs to amply convey that its policy and demeanor will no more invite further sanctions. For investments to pick up, there needs to be a certainty about Russia's ability to do business with West.

On recent macro numbers, the economy expanded 2.5% (yoy) during the second quarter, the best rate of growth since the last quarter of 2013. Relative stability in oil prices and broad based pick-up in manufacturing, transport, construction, industrial sector and retail sales contributed to growth. The country's economic ministry estimates GDP to have expanded by 1.7% during the first half of this year. For 2017 as a whole, the economy ministry expects growth of 2%. Meanwhile, the central bank of Russia is more optimistic, projecting growth of 2.2% for this year.

On monetary policy, stable domestic currency and low inflation has provided central bank the leeway to trim interest rates. Headline inflation remains at the lowest level in more than two decades, with CPI for August reported at 3.3%. The central bank delivered a rate cut of 50bps at September policy meeting and probably may trim additional 50bps during the balance of this year.

Figure 69: Economy witnessed broad based recovery in Q2

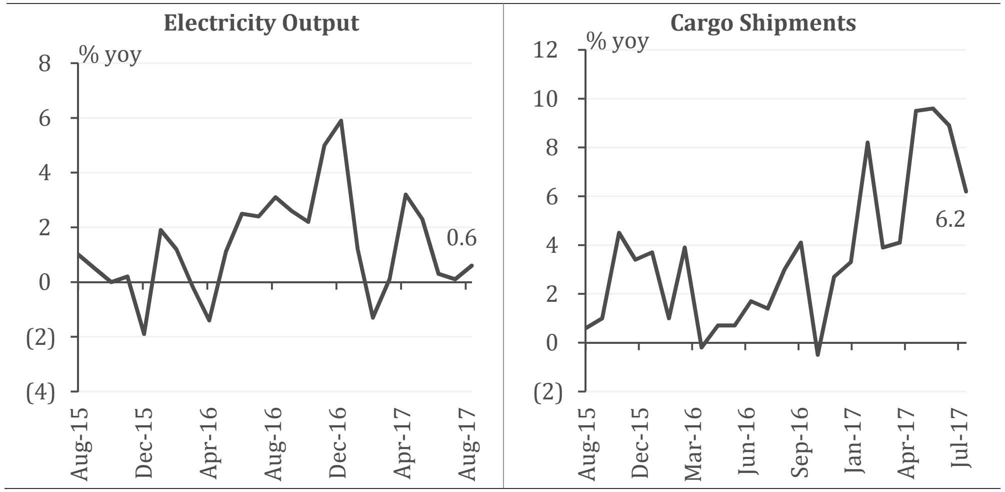


Source: Bloomberg, IIFL Research

Figure 71: Consumer Demand garnering momentum

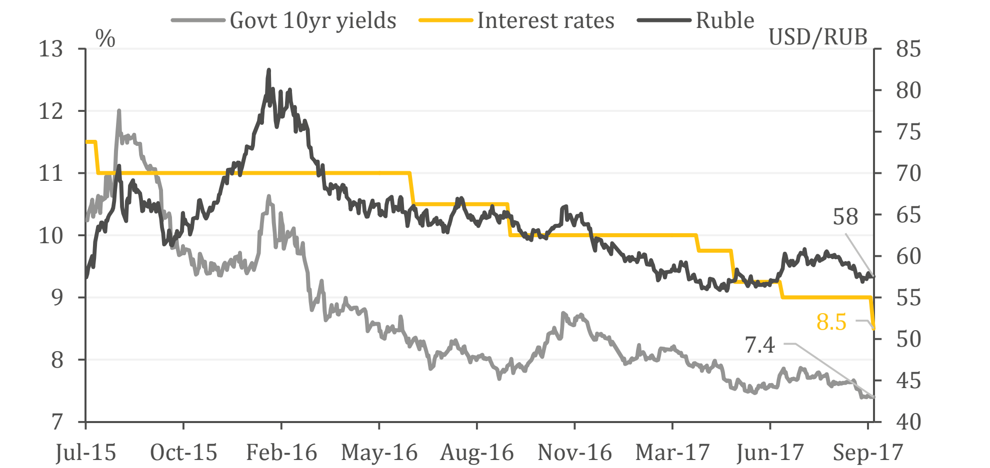
Source: Bloomberg, IIFL Research

Figure 70: Various indicators show economy embarking on growth mode



Source: Bloomberg, IIFL Research

Figure 72: Stable Ruble and cut in interest rates is helping the economy

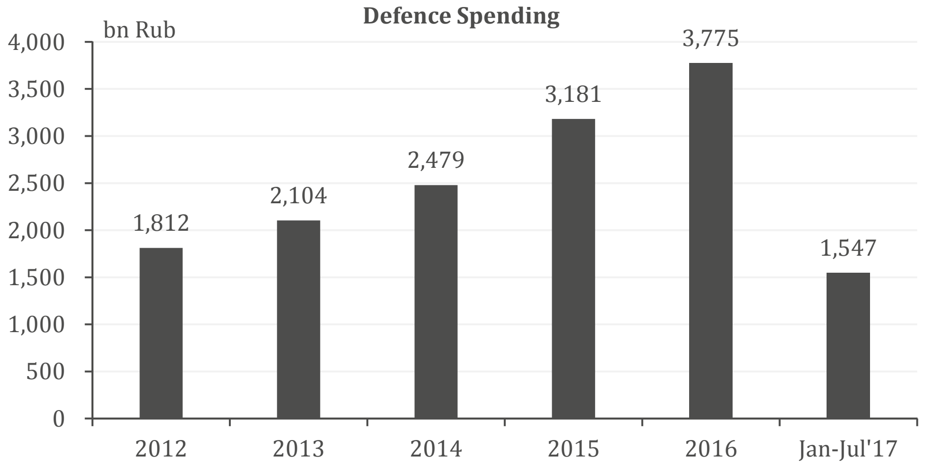


Source: Bloomberg, IIFL Research

Figure 73: Slowing capital outflows can be manifested by recovery in Forex reserves

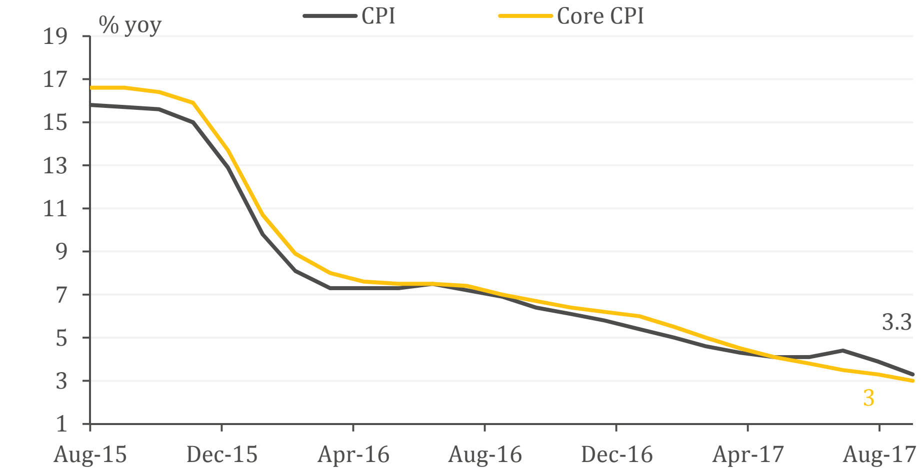
Source: Bloomberg, IIFL Research

Figure 74: Government plans lower budget on weapons next year in order to augment social spending



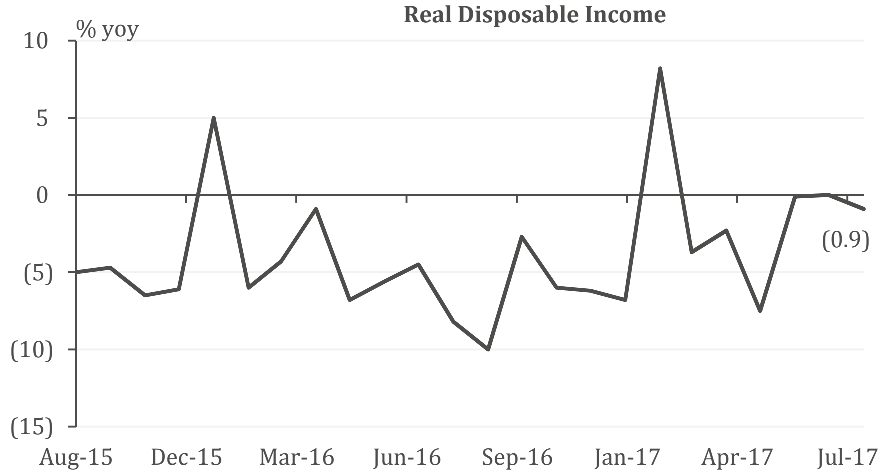
Source: Bloomberg, IIFL Research

Figure 75: Sharp retracement in inflation



Source: Bloomberg, IIFL Research

Figure 76: However, household income growth remains a concern



Source: Bloomberg, IIFL Research

CANADA

- *Bank of Canada initiates policy normalization, delivers two rate hikes this year*
- *Q2 GDP expanded at the fastest pace in several years, thanks to household consumption*
- *Household debt above 100% of GDP and 176% of disposable income*
- *Unfavorable outcome of NAFTA negotiations can impact Canada's trade*

Stronger economic growth and rising core inflation levels have already persuaded Bank of Canada to embark on the path of policy normalization. The central bank delivered yet another rate hike in September, the second move in three months. It seems that the central bank is serious about policy normalization process given the strong GDP numbers. In this regard, the economy during Q2 expanded 3.7% on y/y basis, the fastest pace of growth in several years. On inflation front, BOC governor expects price pressure to scale higher during the balance of the year, with core inflation for July reported at 1.5%. There is a growing probability of yet another rate hike in December.

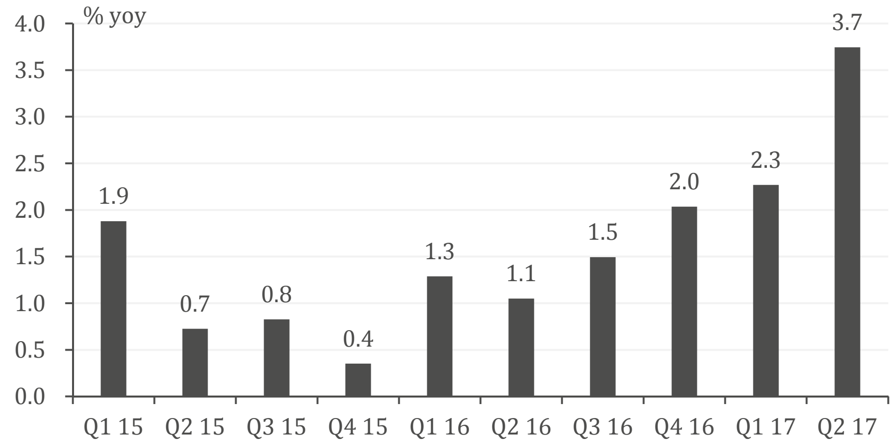
Meanwhile, consumer spending remains very strong, with retail sales surging consistently around 7% (yoy) so far this year. Auto sales have also remained buoyant, with YTD units registering gain of 5.3%. This is in slight contrast to the recent slowdown in neighboring US auto markets. On broader numbers, household consumption has also exhibited strength, rising 3.6% during the first half of 2017. Wage growth has also gained traction, with average hourly pay during August rising 1.7% (yoy), the fastest rise in ten months. Sharp fall in unemployment rate and steady monthly payrolls has also played a key role in boosting consumer spending.

However, structural risks prevail, as household debt has surged above 100% of GDP and running at about 170% of disposable income. Moreover, home prices in major cities have been swelling for past few years. Canadian government has already introduced several measures to cool down overheating in property markets of Vancouver and Toronto including stringent mortgage lending and levy of a foreign buyer's tax.

On trade front, deficit has widened during the current quarter, mainly due to slower growth in exports of merchandise and petroleum products. This is no surprise given the looming uncertainty over talks over North American Free Trade Agreement (NAFTA). Although representatives from US, Canada and Mexico have reported progress on the second round of NAFTA negotiations, there are lot of unresolved and contentious issues which needs to be dealt with. To begin with, Trump administration wants a much higher share of autos and auto parts to be produced in US to qualify for duty-free shipment. This has logically given birth to resistance from Canada and Mexico. No wonder, US automobile companies also disapprove of such measures given their dependence on cheaper imported parts from across the border. But US President Trump remains stubborn on his demand, in fact reiterating his threat to dismantle NAFTA, if the reformed trade pact does not benefit American economy.

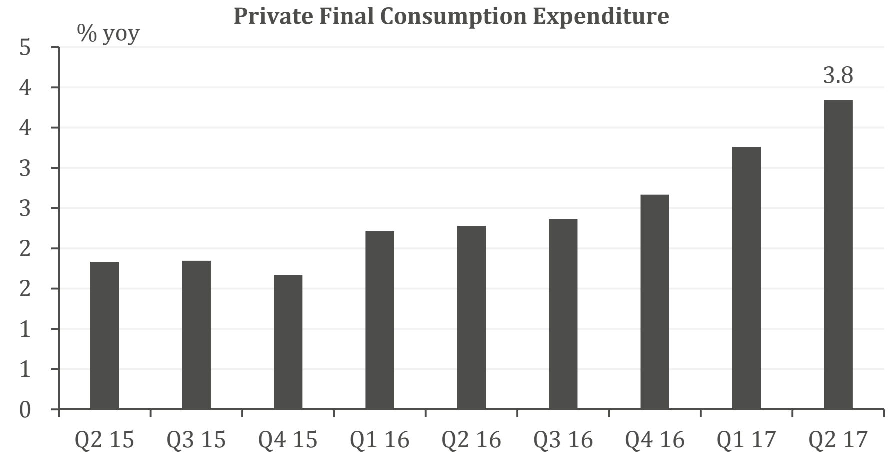
Any unfavorable outcome on NAFTA can impact Canada's trade given that 74% of its outbound shipments head towards US. The three North American countries now advance to the third round of NAFTA negotiations, scheduled in Canada later this month to review mechanisms on resolving trade disputes and decide on wage hikes of Mexican laborers. The three nations aim to reform the trade pact by the end of this year.

Figure 77: GDP: Strong economic momentum



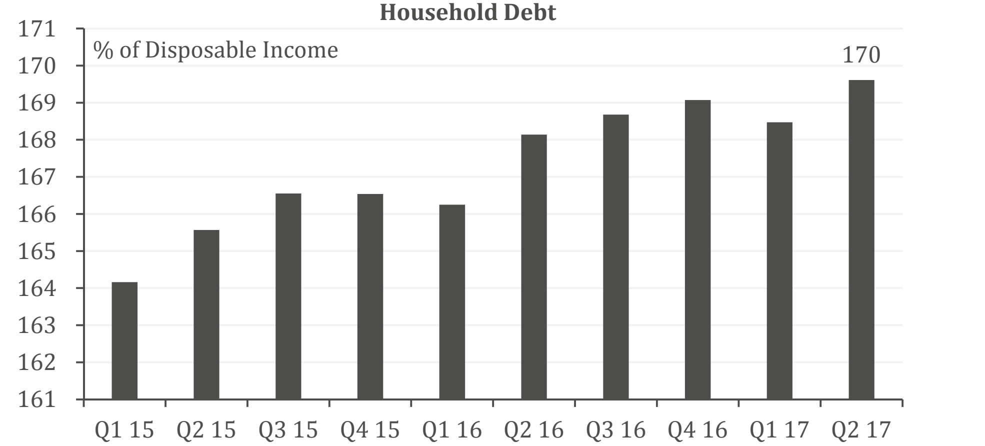
Source: Bloomberg, IIFL Research

Figure 78: Household consumption plays a pivot..



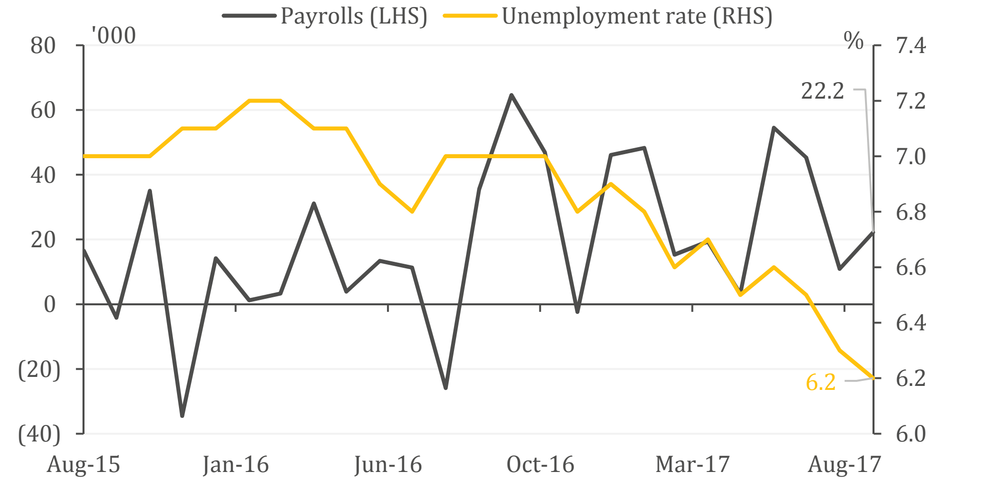
Source: Bloomberg, IIFL Research

Figure 79: …However, rising household debt a concern



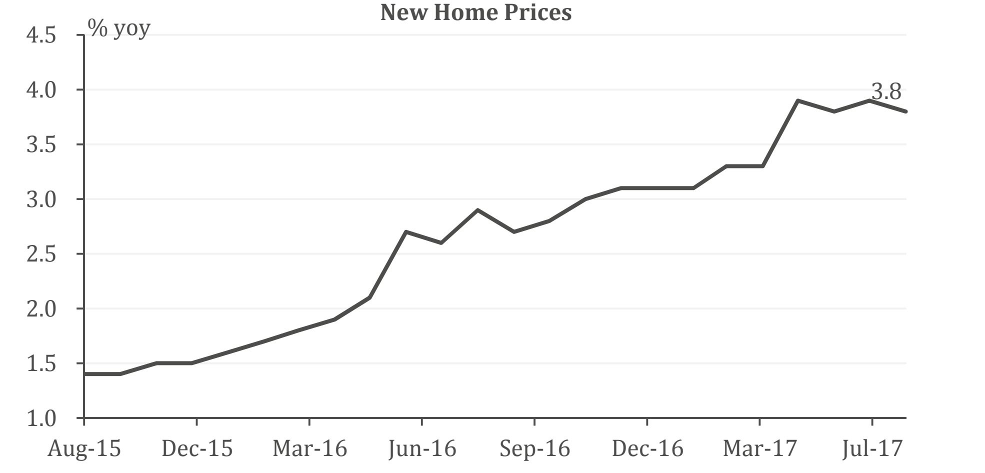
Source: Bloomberg, IIFL Research

Figure 80: Economy creating decent quantum of jobs



Source: Bloomberg, IIFL Research

Figure 81: Overheated housing markets



Source: Bloomberg, IIFL Research

AUSTRALIA

- *Government spending on infrastructure, including roads, rail and hospitals*
- *Australians spending more and saving less, high debt levels*
- *Subdued business investments*

Australia's economy showed momentum during second quarter, with traction evident in consumer and government spending. The economy expanded 0.8% on q/q basis, a sharp jump when compared with the subdued growth of 0.2% during the prior quarter. On yoy basis, the economy expanded 1.8% during the quarter. Government spending on infrastructure, including roads, rail and hospitals provided the much needed thrust to the economy. Public expenditure expanded 1.2% (q/q basis), the fastest pace of growth in four quarters. Meanwhile, household spending on clothes, food and other merchandise remained buoyant, with retail sales expanding on an average 3.2% (yoy) during this year.

On trade front, exports remained upbeat during the second quarter given the sharp rise in metal prices and strong demand from China for most of the industrial commodities. However, there are signs of some slowdown in outbound shipments in the current quarter.

On broader issues, falling savings rate and rising household debt poses as a canary in a coal mine. Household debt is at a risky 105% of GDP and 190% of disposable income, while the savings rate has halved dramatically to 4.6%, when compared with 9% four years back. Moreover, wage growth continues to remain subdued, while unemployment rate stubborn around 6%. Reserve Bank of Australia sees jobless rate to remain around 5.5% till the end of 2019. It is difficult to see the spending spree sustain amidst a deteriorating debt situation and listless private business investments that have been contracting for sixteen consecutive quarters.

Nevertheless, the central bank remains optimistic, estimating the economy to grow around 2% this year and 3% in 2018. However, there is some caution on inflation trajectory, which prices pressure remaining tepid, in line with the trend in most western economies. As a result, RBA is maintaining a status quo on monetary policy for more than a year and there are no signals that it will move on the rates this year as well.

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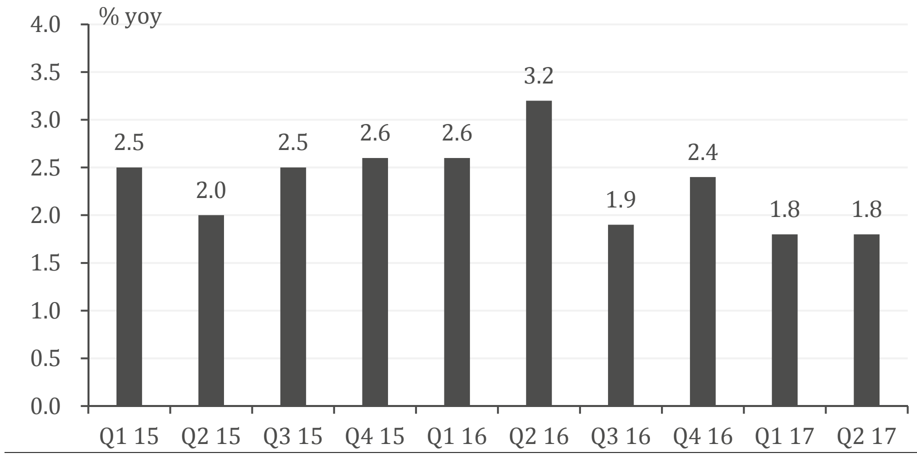
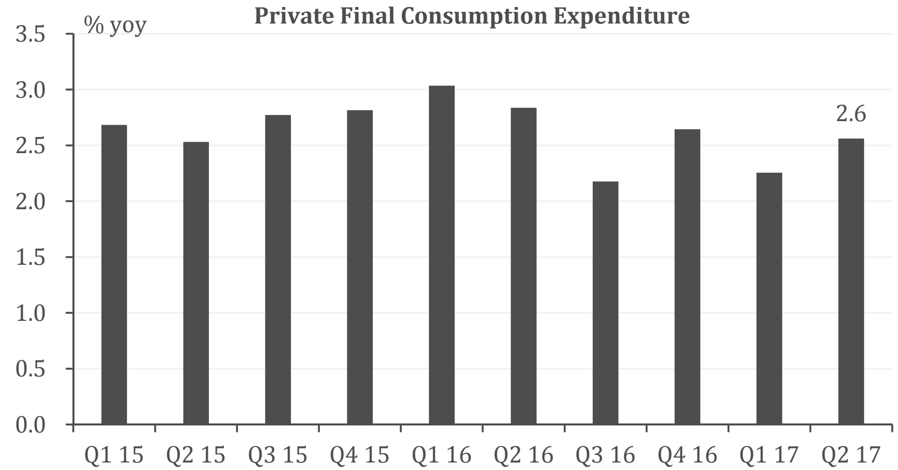
Figure 82: GDP: Government Spending on infrastructure provided the momentum during Q2



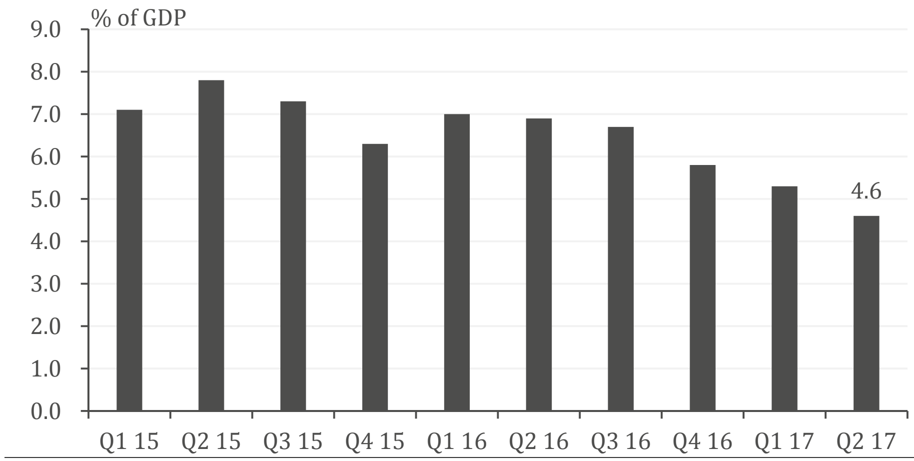
Source: Bloomberg, IIFL Research

Figure 83: Household consumption remains strong as Australians are saving less…



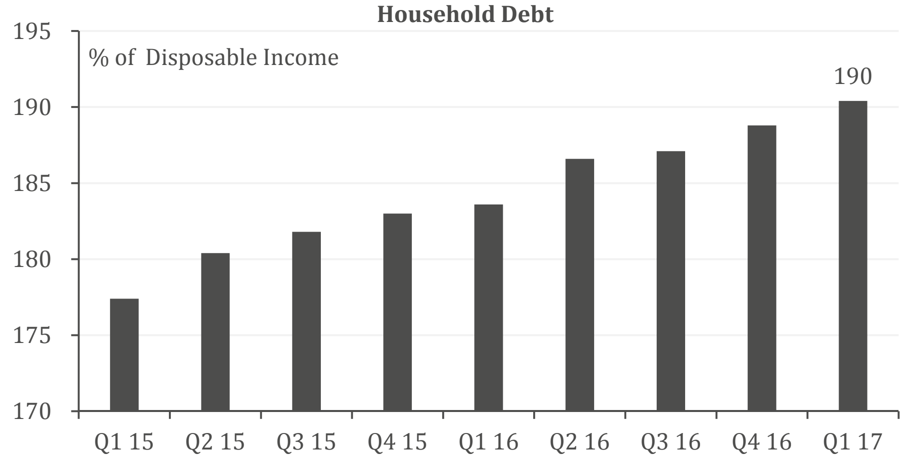
Source: Bloomberg, IIFL Research

Figure 84: …Dipping savings…



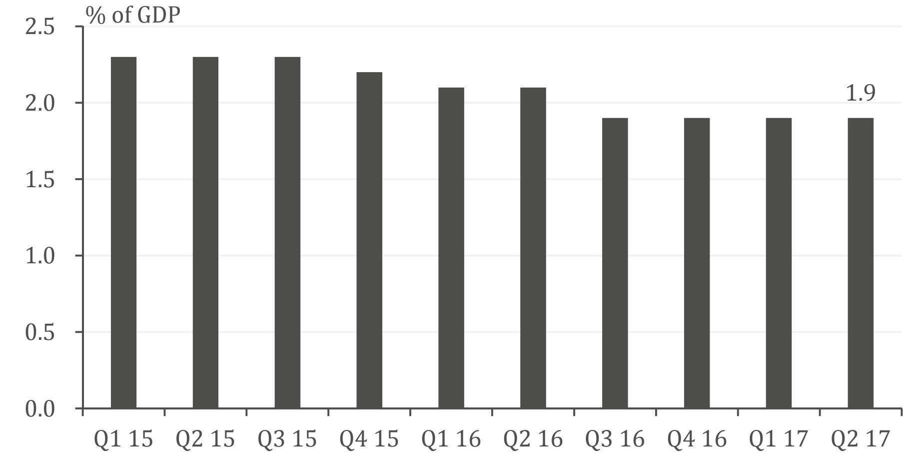
Source: Bloomberg, IIFL Research

Figure 85: …And swelling Household debt



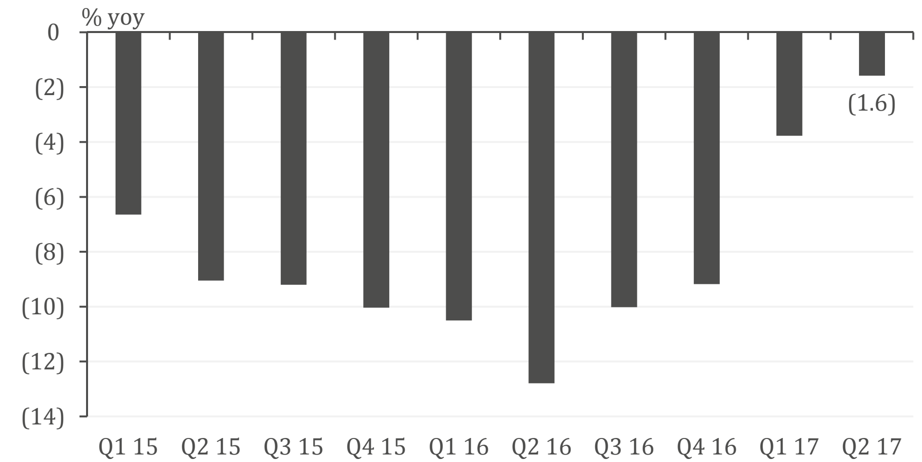
Source: Bloomberg, IIFL Research

Figure 86: Slower wage growth also remains a concern



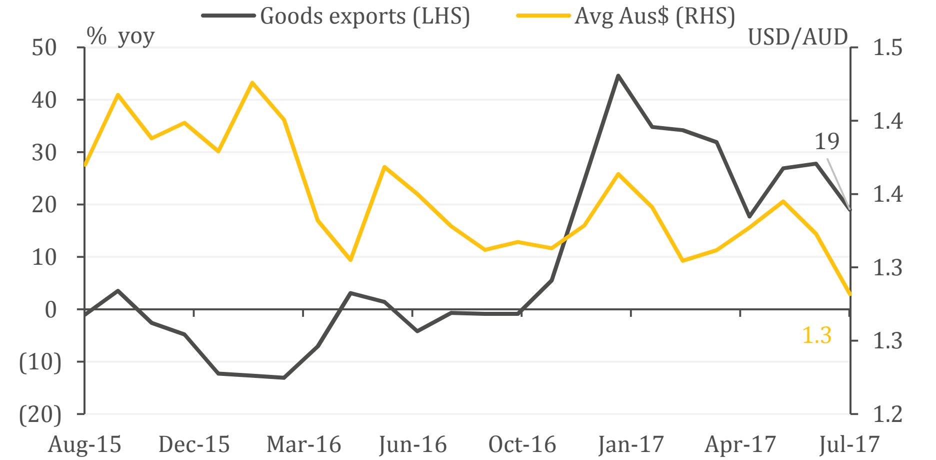
Source: Bloomberg, IIFL Research

Figure 87: Contraction in Private Business investments for 16 consecutive quarters



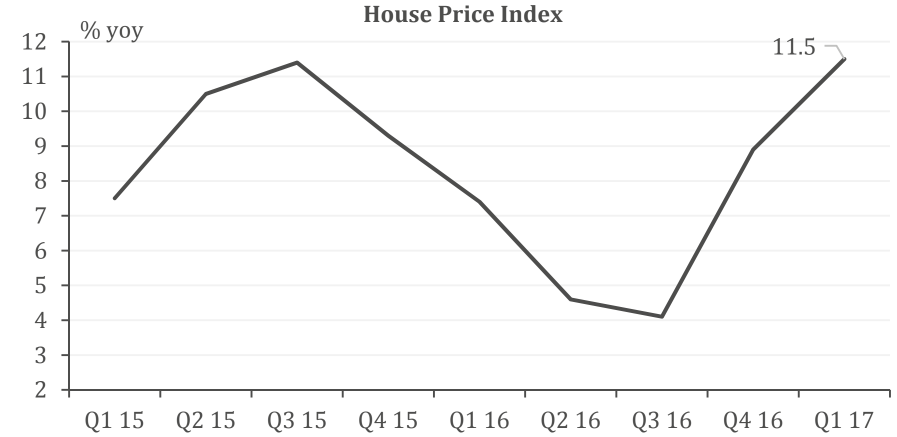
Source: Bloomberg, IIFL Research

Figure 88: Australian exports have done reasonably well in light of strong demand for industrial commodities



Source: Bloomberg, IIFL Research

Figure 89: House prices remains sky high despite several measures taken by government



Source: Bloomberg, IIFL Research

SOUTH KOREA

- *High tensions in Korean Peninsula*
- *Strained ties with China*
- *Threat of US pulling out of free trade pact*
- *Government estimates GDP growth of 3% this year, driven by rising export demand for memory chips, automobiles and petrochemicals*

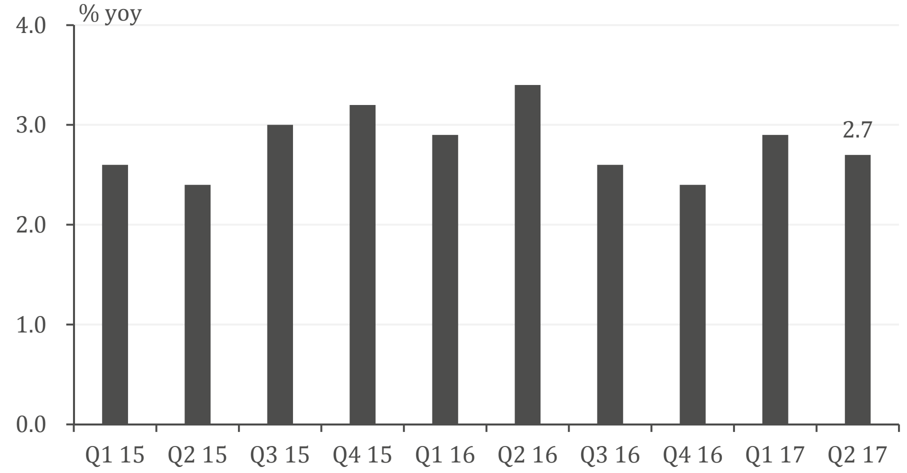
The country is facing a difficult time given the belligerent neighbor (Pyongyang) and strained bi-lateral ties with China. South Korean economy is already paying a price for deploying US anti-ballistic missile defense system, popularly known as THAAD (Terminal High Altitude Area Defense). Deployment of THAAD in order to avert any attack by North Korea has made China livid, with Beijing suspecting it as a foul play by US to espionage into its territory. Chinese authorities have already confronted the same by imposing curbs on various companies, which were transacting with South Korea. Contentious THAAD has also led to Chinese embargo on South Korean television soaps and merchandise. Most importantly, lull is palpable at shopping centers in Seoul, deprived of Chinese tourists. China has discreetly restricted travel organizations to operate tours to South Korea. Chinese cruises have parted away with Korean ports from their itineraries, while flights to Korean destinations have reduced. Koreans cannot afford to outrage Chinese given their heavy dependence on them for their exports. Korean exports contribute about 40% to the economy.

Another headache for South Korea is threat of US pulling out of free trade deal. President Donald Trump is keen on revisiting the existing trade pact, considering America's wide trade deficit with Seoul. It seems that South Korean government has to put forward a palatable overhaul of trade agreement, which pacify its biggest ally and a key trade partner.

On macroeconomic front, South Korea's economy slowed moderately during Apr-Jun period, with GDP expanding 2.7%, when compared with growth of 2.9% during first quarter of this year. Slowdown in construction activity and exports led to loss in momentum during last quarter. Exports which contribute 40% to the economy, registered no growth during Q2 (yoy) after a splendid performance in Q1. Nevertheless, outbound shipments of IT products (semi-conductor chips and electronic display devices) continue to remain steady. On other positives, household spending and fixed capital formation has been resilient this year.

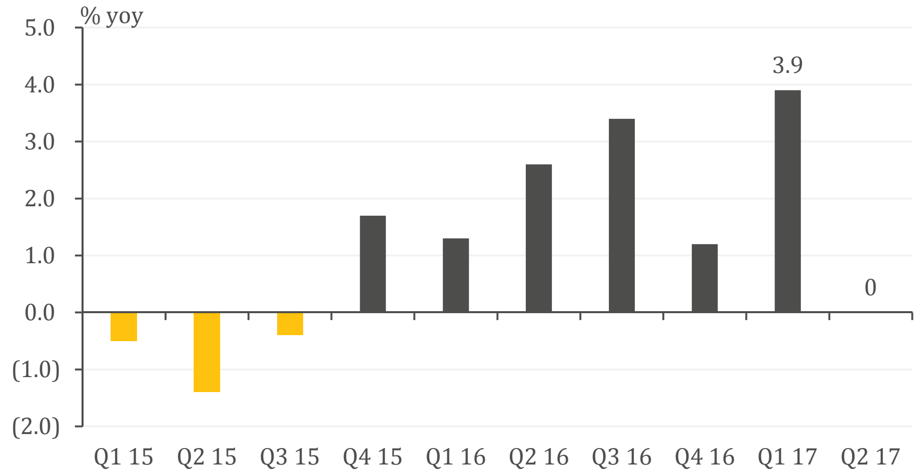
On growth projections, the central bank expects the economy to expand 2.8% this year, while the government's estimates growth of 3%. Korean officials are banking on prospects of sustained growth in exports given the rising demand for memory chips, automobiles and petrochemicals.

Figure 90: GDP: Slower growth in Q2'17



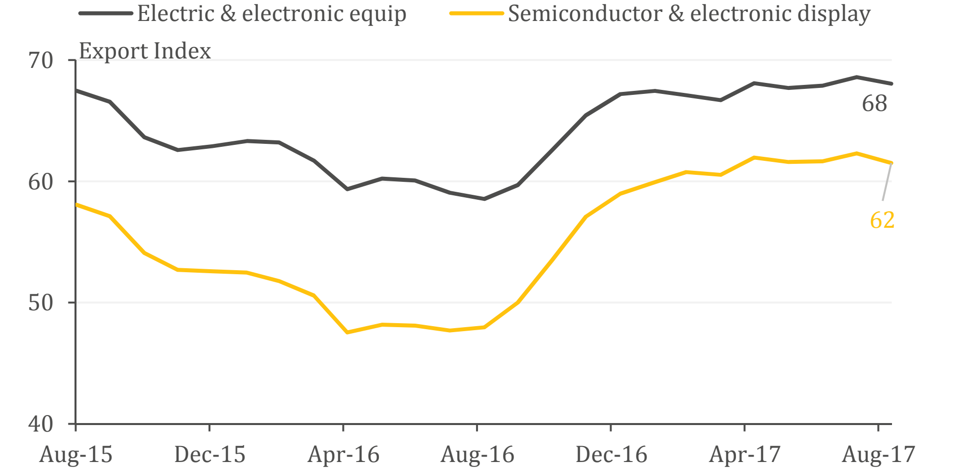
Source: Bloomberg, IIFL Research

Figure 91: Overall Exports have witnessed no growth during Q2



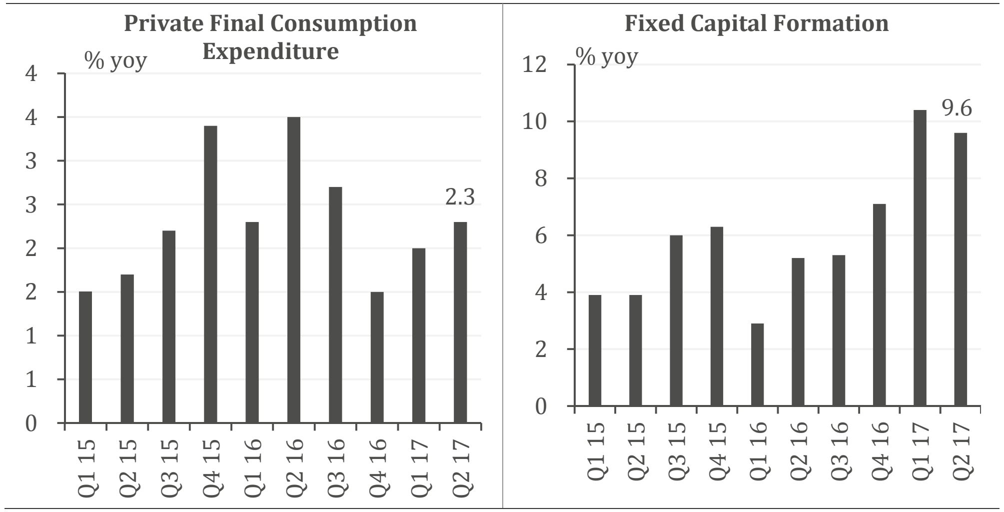
Source: Bloomberg, IIFL Research

Figure 92: However, outbound shipments of semiconductor chips are strong



Source: Bloomberg, IIFL Research

Figure 93: Household consumption and fixed capital formation on a firm footing



Source: Bloomberg, IIFL Research

MEXICO

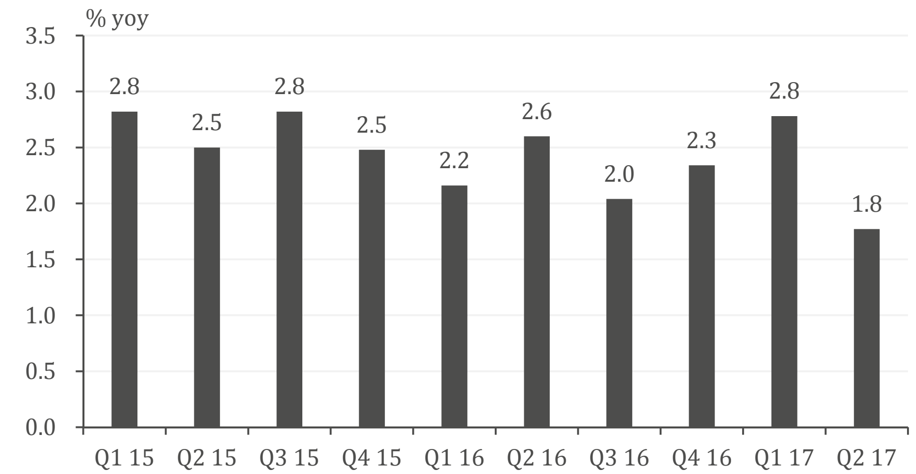
- *Economy relatively resilient to threat of US protectionism*
- *Finance ministry upgrades growth projections for 2017 and next year*
- *Inflation has remained stubborn around 6% due to rise in petrol prices early this year*

The economy is relatively resilient to the threat of protectionist policies from US. This is in quite contrast to the earlier perception that exports and investments will suffer a huge blow after election of President Trump. Although uncertainty over NAFTA still prevails, the second round of negotiations has witnessed representatives from US and Mexico reaching common ground on some issues, including the energy sector. Moreover, US administration has soften their reservations on American investments in Mexico. There is a hope that a new tripartite (US, Canada & Mexico) trade agreement will be in place before the onset of Mexican Presidential elections.

A sense of economic optimism prevails, with the Finance ministry upgrading growth projections for 2017 and next year as well. Mexican economy is now estimated to grow between 2.0-2.6% this year, when compared with the initial estimate of 1.5-2.5%. For 2018, forecasts call for GDP growth of 2-3%.

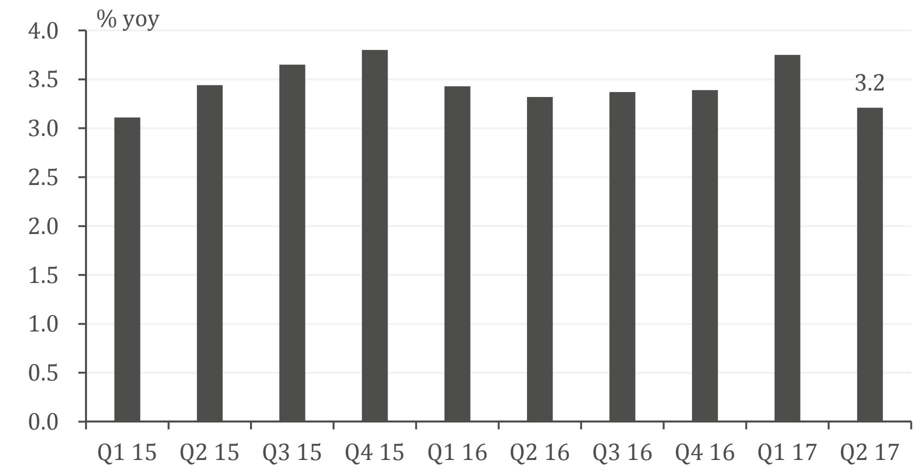
On recent macro indicators, Q2 GDP expanded 1.8%, much slower than the reading of 2.8% during the first quarter of this year. The slowdown is attributed to contraction in energy sector and lower agricultural output. Meanwhile, inflation has remained stubborn around 6% due to rise in petrol prices early this year. However, the central bank expects price pressure to moderate in the medium term, projecting CPI inflation of 3% (+/- 1%) by September 2018. On currency front, Mexican Peso has rebounded sharply against US dollar, helped by receding fears of disruption from US trade policy and stable flow of remittances from overseas.

Figure 94: GDP: The economy slowed in Q2, however, 2017 growth trajectory is revised higher



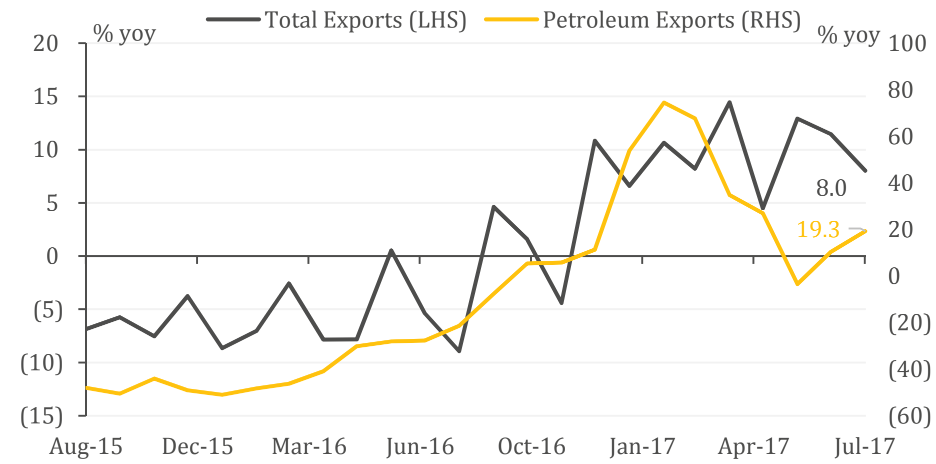
Source: Bloomberg, IIFL Research

Figure 96: Growth in Services sector also remains steady



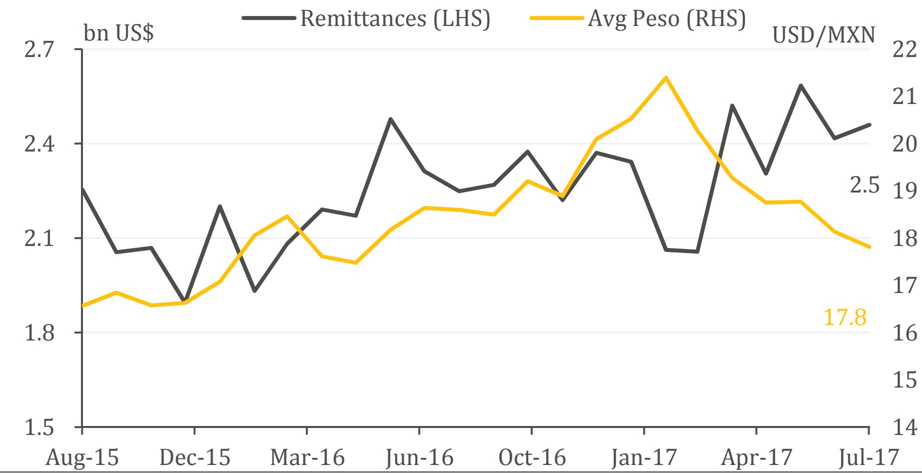
Source: Bloomberg, IIFL Research

Figure 95: Exports have remained resilient to protectionist stance of US



Source: Bloomberg, IIFL Research

Figure 97: Overseas remittances from US remain high despite Mexican workers in crosshairs of President Trump



Source: Bloomberg, IIFL Research

SOUTH AFRICA

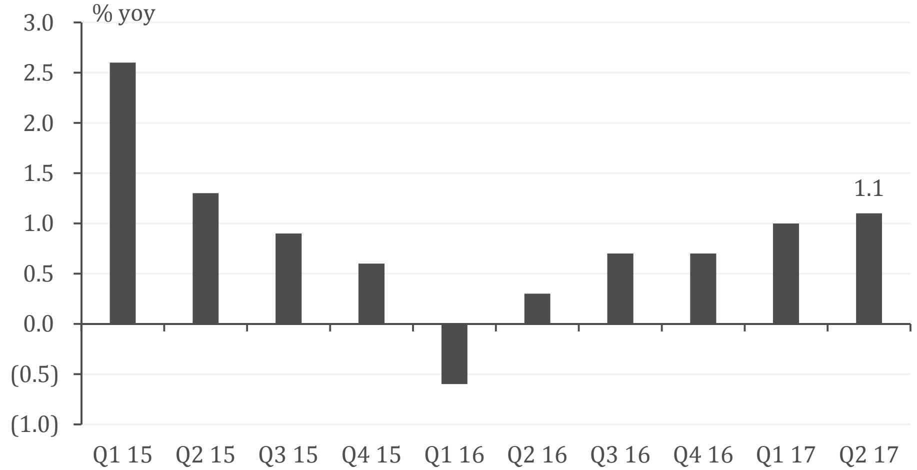
- *Political uncertainty cast a dark cloud on sovereign credit ratings*
- *Fiscal prudence is need of the hour*
- *Economic growth below the government's target rate*
- *Unemployment rate at 28%*

Political uncertainty continues to dampen economic fortunes of the nation. Internal fighting within the incumbent regime and rising uproar to expel President Jacob Zuma (on account of corruption charges) has dented business confidence and investment climate. Political turmoil remains intensified after reform-oriented Finance minister Pravin Gordhan was fired early this year. Subsequently, several credit rating agencies have cut South Africa's sovereign credit ratings, citing domestic chaos and diminishing prospects of economic recovery.

The onus is now on the current Finance Minister Malusi Gigaba to frame measures to attain fiscal prudence and facilitate economic recovery. Failure to do so will certainly prompt further downgrade in investment outlook. The situation is already in dire straits, with Mr. Gigaba recently stating that the country will be compelled to seek outside financial assistance, if the situation does not improve. This government has already announced US$176bn bailout of state-owned South African Airways, and there could be several in the line who are dependent on government aid, which can put lot of stress on the fiscal situation. Earlier this year, erstwhile Finance Minister Pravin Gordhan hiked taxes for the high income group in order to lower the budgetary deficit to 2.6% of GDP by 2019-20. Fiscal deficit stood around 3.95% at the end of Q2. With economic growth below the government target rate of 1.3%, high unemployment rate and disappointing tax revenues, it seems very unlikely that the government will able to make any progress on the fiscal road map.

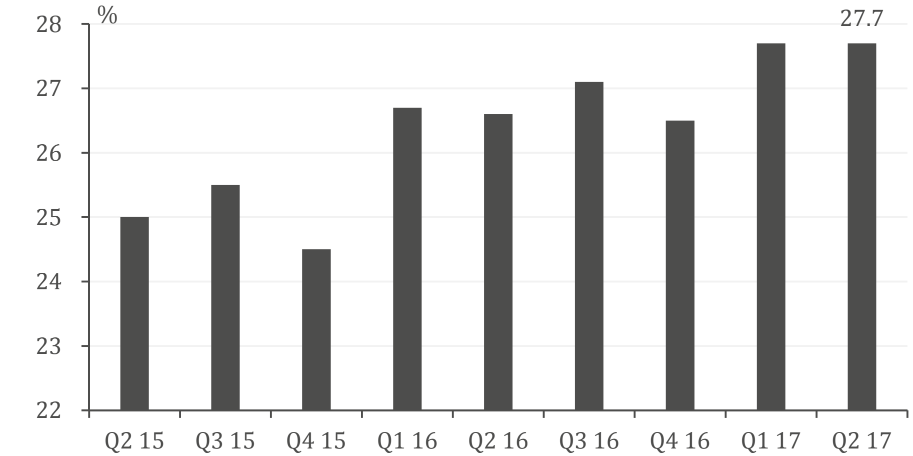
IMF has expressed caution on health of economy, stating susceptibility to external shocks and fiscal stress. Nevertheless, the body expects the economy to grow 1% this year, quite optimistic when compared with Moody's forecast of 0.5% growth. For 2018, both IMF and Moody's are on the same page, projecting 1.2% growth.

Figure 98: GDP: Growth hampered by political turmoil



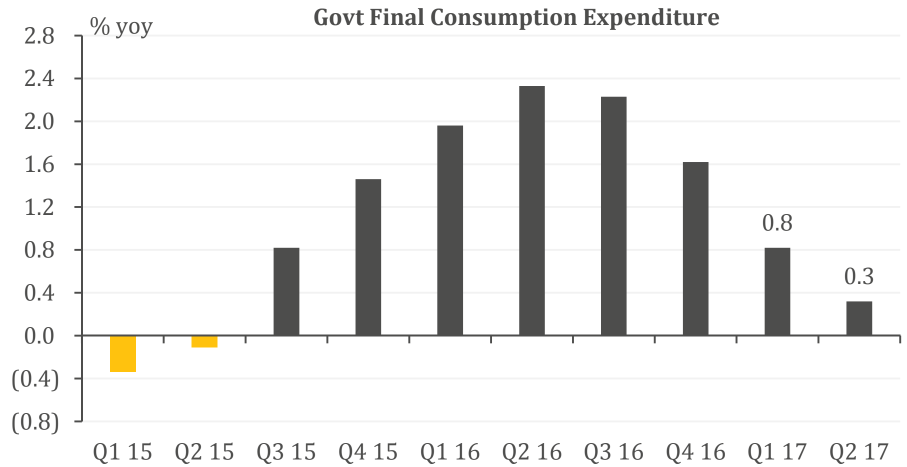
Source: Bloomberg, IIFL Research

Figure 100: Unemployment rate stubbornly high



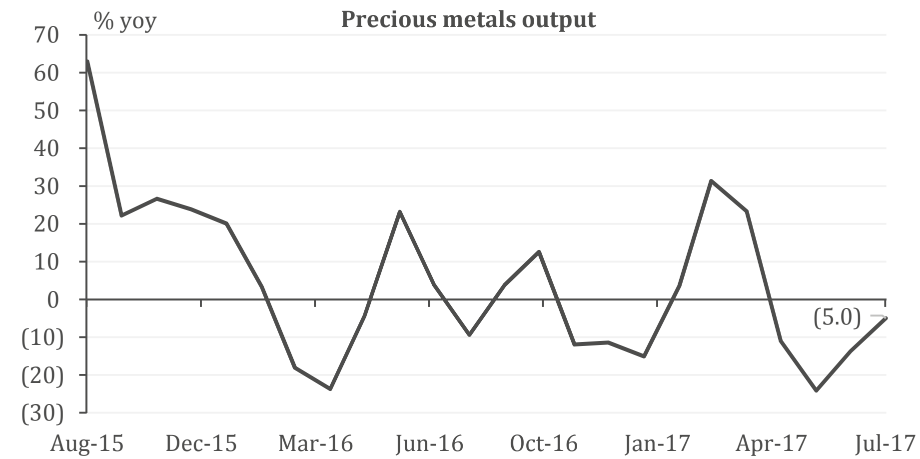
Source: Bloomberg, IIFL Research

Figure 99: Government Spending has slowed, quite explicable given the compulsion of lowering fiscal deficit



Source: Bloomberg, IIFL Research

Figure 101: Persistent contraction in mining output



Source: Bloomberg, IIFL Research

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SAUDI ARABIA

- *Rebalancing of budget, reducing dependence on oil revenues*
- *Saudi Aramco on the privatization list*
- *Government encouraging private investments*
- *Lower fiscal deficit this year*
- *Economy contracted during Q1*

Saudis continue to work on the road map of balancing it budget by 2020, where the endeavor is directed at mitigating reliance on oil revenues and diversify sources of growth. Meanwhile, the country has also embarked on various austerity measures, including gradual reduction in subsidy on energy prices, plans of introduction of 5% value-added tax in 2018. Higher residence fees for expatriates is also on the anvil. Meanwhile, the country has kept a strict ceiling on government spending. Nevertheless, the government recently has eased some of its austerity, considering the need to support consumption. In this regard, financial allowances to public sector employees have been reinstated.

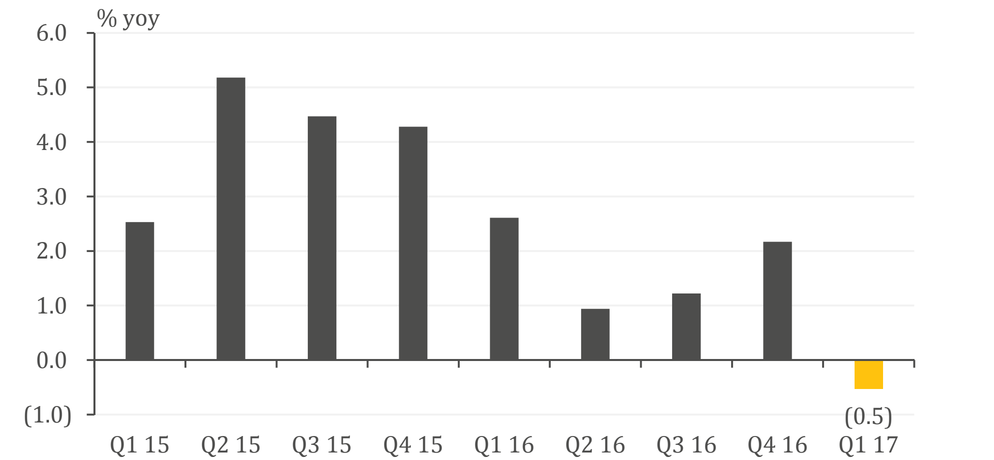
On big reforms, the Kingdom looks forward to disinvestment of state-owned enterprises from broad range of sectors, covering oil, healthcare, education and airports. The privatization plan is expected to raise around US$200bn over the next few years, out of which US100bn is going to come from the sale of 5% stake in the oil giant Saudi Aramco. Saudis value the company around US$2 trillion, however, it seems the prevalent environment will not fetch them the desired realization given the turmoil in energy markets and structural questions on the long term prospects of oil demand. Sale in Aramco is expected to conclude by the early 2019. Money raised from privatization measures is planned to be parked through sovereign wealth funds into non-oil sectors.

The government also intends to encourage private investments in the economy through cheap financing. The administration has already dedicated US$53bn for the cause, though there is lack of detail on how funds will be channelized across various sectors. It is reported that some funds have been allotted to Saudi Industrial Development Fund, which finances to strategic and infrastructure projects.

The country is doing well on budgetary road map, with fiscal deficit expected to mitigate to 9.1% of GDP by end of 2017, compared to 12.8% in 2016. The million dollar question is how it would set the ball rolling as far as growth is concerned. The economy contracted 0.5% (yoy) during Q1 this year, the first decline since 2009. With oil output expected to remain low due to OPEC production accord, there are no signals of any economic impetus at least in the short-run.

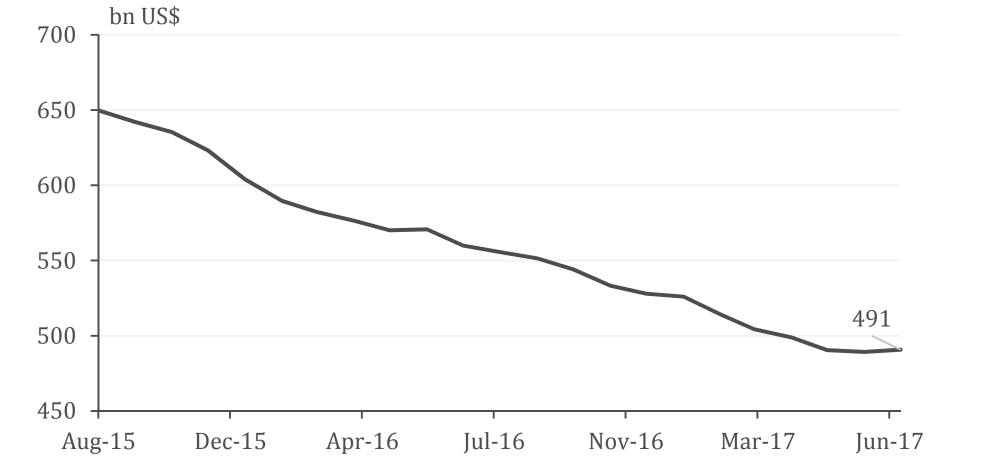
On political front, increasing strife is evident given the crackdown on activists and intellectuals who have exhibited resistance to the conservative royal family. This comes after rising speculation that King Salman intends to renounce his throne and pass the baton to his son Mohammed Bin Salman, who is already calling the shots on economic and foreign policy.

Figure 102: GDP: A contraction in first quarter this year, the first since financial crisis



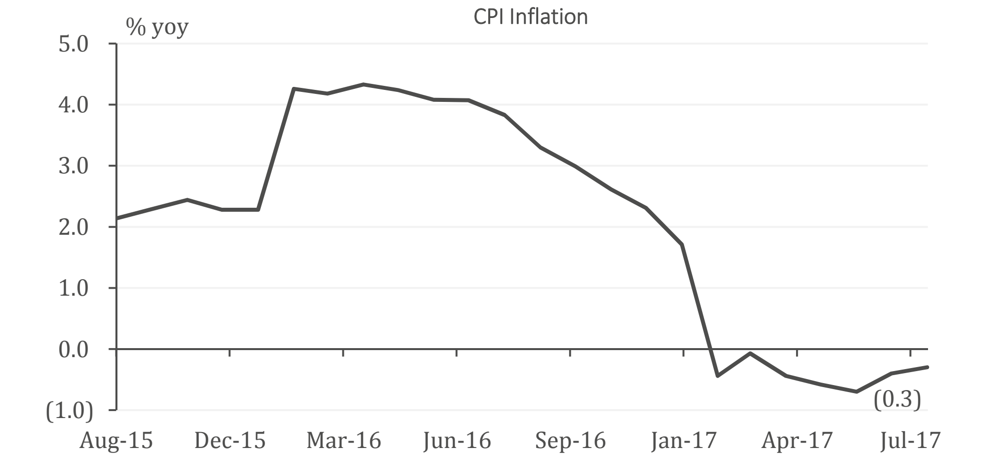
Source: Bloomberg, IIFL Research

Figure 104: Saudis have liquidated a big chunk of their FX reserves to finance its fiscal spending



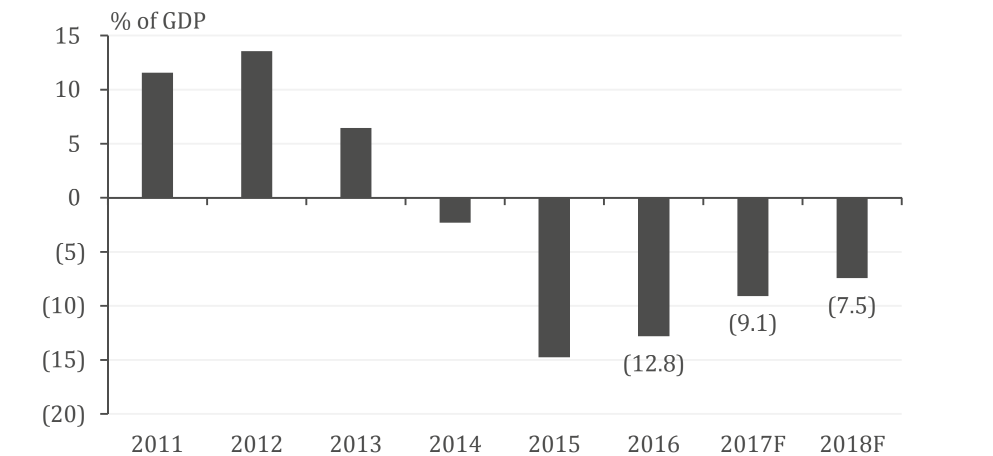
Source: Bloomberg, IIFL Research

Figure 103: Slower economic activity and lower energy prices has led to deflationary environment



Source: IMF, Bloomberg, IIFL Research

Figure 105: Saudi's balancing the budget to reduce fiscal deficit



Source: Bloomberg, IIFL Research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IIFL Wealth Research bags 2 Best Analyst Awards

IIFL Wealth Research has bagged two prestigious awards at the ***Zee Business Market Excellence Awards 2016***.

Prayesh Jain was conferred the Best Analyst Award for Auto sector and **Bhavesh Gandhi** bagged the Best Analyst Award for Pharma sector.

Besides the twin awards, IIFL Wealth Research was also nominated in the categories of Oil/Gas, Banking and Industrials.

IIFL Wealth Research, as you know, has always prided itself on its unique value proposition in a swarming market space of cut-throat competition, among other things, on our wealth of actionable ideas, tailored portfolio approach and thorough research in line with client needs and priorities, distinctive practice of following up with Call Success post recommendations and a vast coverage universe of as many as 300 companies (comprising 70% of India's equity mcap).

In the past, the research team has won Zee Biz Awards under different categories; Bloomberg has rated our research as the most accurate, while we have twice been winners of Business Standard Smart Portfolios, having received awards at the hands of luminaries including President Pranab Mukherjee, Prime Minister Narendra Modi and Minister of State Piyush Goyal.

Recommendation parameters for fundamental reports:

Buy = >15%+

Accumulate = 5% to 15%

Reduce = -10% to 5%

Sell = >-10%

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