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GLOBAL INSIGHT

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2019 Global Macro Outlook

Emerging Markets Retake the Lead

We see global growth moderating towards trend. DMs slow but EMs hold up well, supported by a favourable policy mix. A Fed pause, weaker USD and softer oil prices reduce external pressures for EMs – a reversal of 2018. Risks are to the downside – watch US corporate credit and trade tensions.

Contents

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We see global growth moderating towards trend. DMs slow but EMs hold up well, supported by a favourable policy mix. A Fed pause, weaker USD and softer oil prices reduce external pressures for EMs – a reversal of 2018. Risks are to the downside – watch US corporate credit and trade tensions.

We see global growth moderating towards trend in 2019: We expect global growth to slow to 3.6%Y in 2019 from 3.8%Y in 2018. The 2019 macro outlook is likely to be shaped and supported by the following three divergences:

1) Growth – DMs slow, EMs stabilise: The growth differential will swing back in favour of emerging markets (EM). Developed markets (DM) growth slows in 2019, mainly driven by the US, as tighter resources and less supportive policy weigh on growth. Easing measures work and stabilise growth in China. Receding external headwinds allow growth to hold up in EM ex China, enabling EMs to retake the lead in driving global growth.

2) Core inflation – making new highs in DM, staying low in EM: Tighter labour markets continue to lift wage growth, bringing core inflation gradually higher in DM. In the US and euro area, core inflation makes new cycle highs in 2019. In contrast, a still favourable domestic policy mix keeps core inflation in EM well-anchored at relatively low levels.

3) Central banks – the Fed pauses while others hike: The Fed pauses after reaching neutral and ends balance sheet run-off in 3Q19. The ECB and BoJ embark on the next stage of policy normalisation and hike rates. Real rates do not rise meaningfully in EM, while China's easing measures help to take broad credit growth modestly higher.

Risks – US corporate credit risks, trade tensions, USD strength and policy uncertainty: Given that the cycle is maturing, we see risks skewed to the downside, with a possibility of a global recession in our bear case. We view US corporate credit as the key risk to watch while trade tensions could be the most immediate risk to play out pending the outcome of potential negotiations between the US and China.

Exhibit 1:

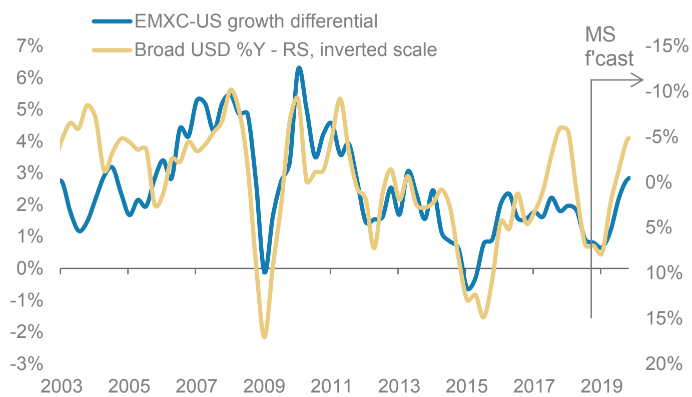
Morgan Stanley real GDP growth forecasts

	2018E	2019E		2020E	
	MS	MS	Cons.	MS	Cons.
GLOBAL	**3.8**	**3.6**	**3.6**	**3.5**	**3.6**
G10	**2.2**	**1.9**	**2.0**	**1.6**	**1.7**
US	2.9	2.3	2.6	1.9	2.0
Euro Area	1.9	1.6	1.6	1.5	1.5
Japan	0.8	1.3	1.0	0.6	0.4
UK	1.2	1.3	1.5	1.6	1.6
EM	**4.8**	**4.7**	**4.7**	**4.8**	**4.8**
China	6.6	6.3	6.2	6.1	6.0
India	7.7	7.6	7.3	7.5	7.5
Brazil	1.3	2.3	2.3	2.5	2.5
Russia	1.6	1.5	1.5	1.6	1.7

Source: Bloomberg, IMF, Morgan Stanley Research forecasts; Note: Aggregates are PPP-weighted. Cons = consensus.

Exhibit 2:

Growth differential to swing back in favour of EM



Source: Haver Analytics, IMF, Morgan Stanley Research forecasts; Note: EMXC includes EM countries under Morgan Stanley coverage excluding Argentina, Venezuela, Nigeria, Saudi Arabia and Kazakhstan.

Emerging markets retake the lead

Three key divergences to watch for in 2019

2019 outlook – three key divergences... Looking back, 2018 was a year of two halves, as global growth clocked at 4%Y in the first half before decelerating to 3.6%Y in the second. Our forecast for 2019 is that global growth will slow towards trend, with risks skewed to the downside. As usual, this aggregate headline figure does not do justice to the underlying dynamics. Save for the single year of synchronous growth in 2017, the global cycle has been marked and supported by divergent trends. We think that the following three divergences will define the 2019 macro outlook and will actually lend support to the economic cycle:

1) Growth: DMs slow, EMs stabilise

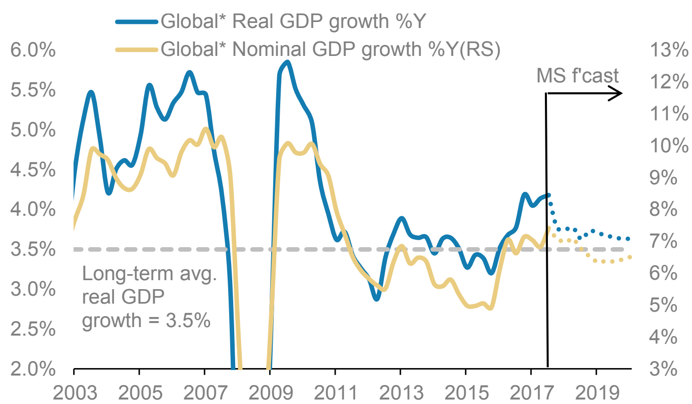
2) Core inflation: Making new highs in DM, staying low in EM

3) Central banks: The Fed pauses while others hike

...and how they actually support the cycle: Relatively robust EM growth keeps global growth oscillating around trend despite weaker DM growth momentum. Meanwhile, DM core inflation is supported by stronger wage growth and will rise gradually, allowing a gradual removal of monetary accommodation by central banks. Stable core inflation in EM and the pause by the Fed mean that EM central banks do not have to lift real interest rates and tighten financial conditions.

Exhibit 3:

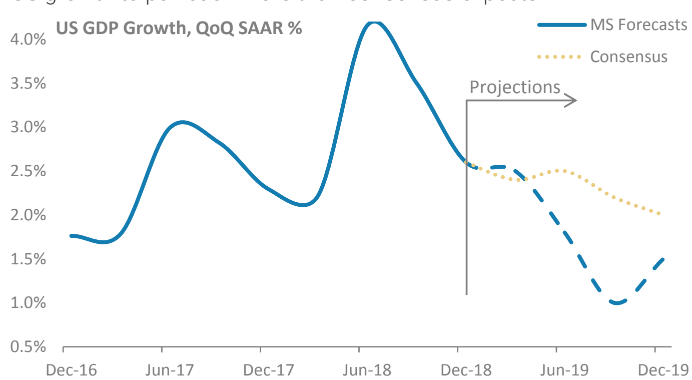
Global growth is slowing towards trend



Source: Haver Analytics, Morgan Stanley Research forecasts; *Global GDP includes countries under Morgan Stanley coverage excluding Argentina, Venezuela, Nigeria, Saudi Arabia and Kazakhstan. Aggregates are PPP-based GDP-weighted averages.

Exhibit 4:

US growth to pull back more than consensus expects...



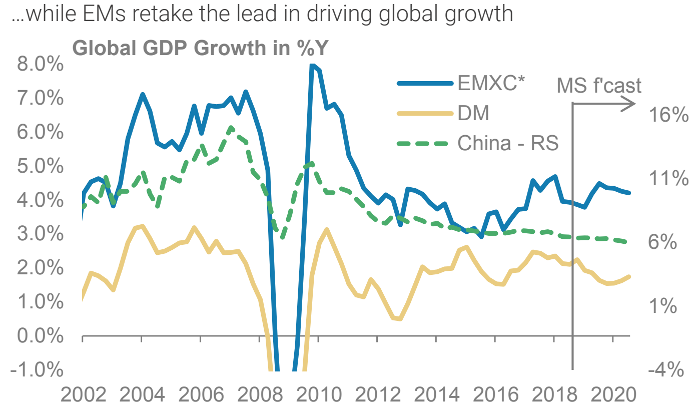
Source: Bloomberg, Morgan Stanley Research forecasts

1) EMs moving back into the lead

The growth differential should swing back in favour of EMs. DM growth slows materially in 2019, mainly driven by our below-consensus view on US growth, as tighter resources and less supportive policy weigh on growth. Easing measures work and stabilise growth in China, while receding external headwinds allow growth to hold up in EM ex China.

Exhibit 5:

...while EMs retake the lead in driving global growth



Source: Haver Analytics, IMF, Morgan Stanley Research forecasts; *EM ex China includes EM countries under Morgan Stanley coverage excluding Argentina,Venezuela, Nigeria, Saudi Arabia and Kazakhstan.

2018 – a bad year for EMs especially: Following the synchronised upswing in global growth in 2017, the US economy continued to power ahead in 2018 while growth faltered in the rest of the world. However, the pain was a lot more pronounced and persistent for emerging markets. Interest rates moving higher in the US and a stronger US dollar led to a tightening of financial conditions in EM. At the same time, with oil production in the US making new record highs, the rise in oil prices provided another fillip to the US dollar relative to large oil importers' currencies. This, coupled with trade tensions, rendered EM economies nearly defenseless against the barrage of negative external headwinds and ultimately resulted in slower growth in 2H18.

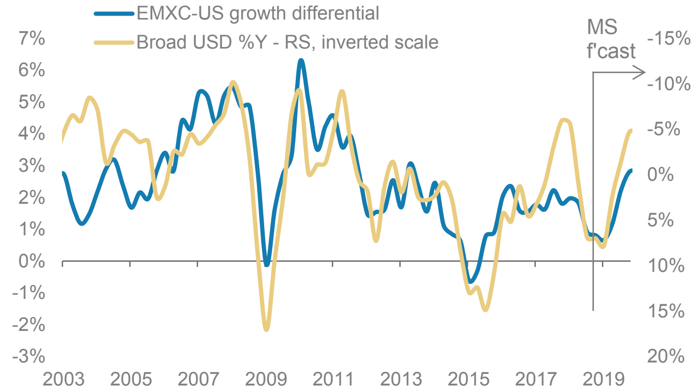
2019 – a reversal with the US pulling back, EMs pulling ahead: In 2019, we expect this dynamic to reverse. Growth slows in DM and we are below consensus on the US growth outlook. Temporary factors will support DM growth in 4Q18-1Q19 before fading. In 4Q18, we expect a short-term bounce in growth in the euro area and Japan after a temporary disruption (due to changes in emission standards impacting car production and the impact of natural disasters, respectively) in 3Q18. In 1Q19, a record-high tax-refund season boosts consumption growth in the US and supports overall GDP growth. However, we expect DM growth to slow as we move through the year, given tighter labour markets, fading fiscal stimulus (in the US) and also the impact from withdrawal of monetary accommodation. In EMs, growth will hold up relatively well as external headwinds recede. The growth differential will swing back in favour of EMs, which will resume the mantle of growth leadership.

Tough external environment pushed EMs to build up more buffers… As external pressures mounted, most EMs have maintained a prudent and favourable policy mix, keeping macro-stability risks at bay while fostering continued recovery. If anything, the harsher external environment in 2018 actually pushed EMs to build up buffers. Major EMs (save Argentina and Turkey) maintained adequate real interest rate buffers, stayed on a path of fiscal consolidation and kept real wage growth trends broadly in line with real GDP growth. Macro-stability indicators such as inflation and current account deficits have thus remained relatively contained in EM as a whole, with inflation in most EMs not overshooting the central banks' comfort zone.

…which puts them in a good position as external headwinds ease: A Fed pause and weaker outlook for the US dollar should bring some respite for EM financial conditions and support their growth momentum. In 2019, growth in the US is likely to moderate due to tighter factor markets constraining growth, the fading impact from

Exhibit 6:

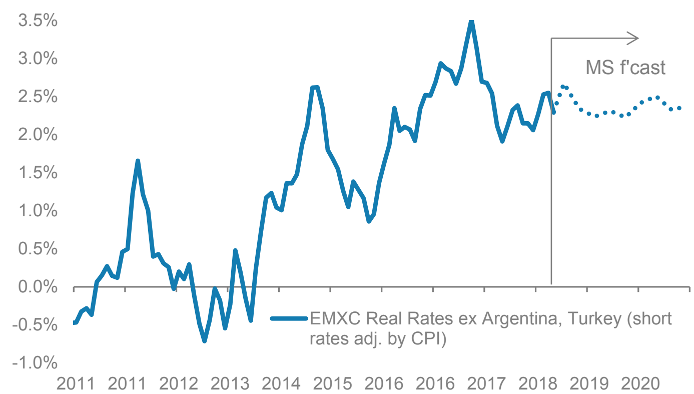
Growth differential to swing in favour of EMs, USD to depreciate



Source: Haver Analytics, Morgan Stanley Research forecasts; Note: EMXC includes EM countries under Morgan Stanley coverage excluding Argentina, Venezuela, Nigeria, Saudi Arabia and Kazakhstan.

Exhibit 7:

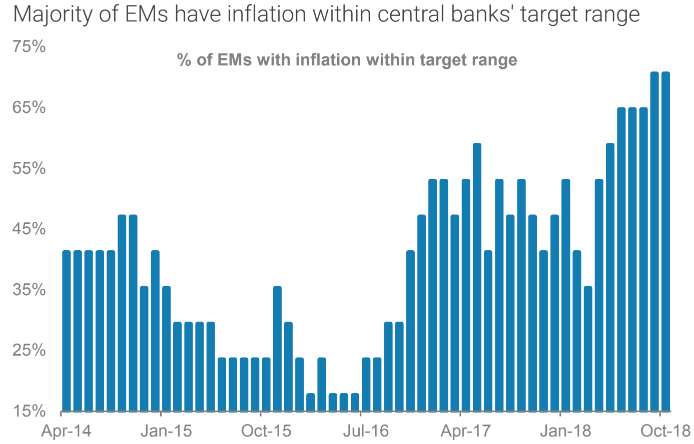
EM ex China maintaining adequate real rate buffers



Source: Bloomberg, Haver Analytics, IMF, Morgan Stanley Research forecasts; Note: EMXC here includes Brazil, India, Indonesia, Mexico, Poland, Russia, South Africa, South Korea, Taiwan and Thailand.

Exhibit 8:

Majority of EMs have inflation within central banks' target range



Source: Bloomberg, Haver Analytics, Morgan Stanley Research forecasts; Note: EMs includes EM countries under Morgan Stanley coverage ex Argentina, Hong Kong, Taiwan, Malaysia, Singapore, Czech Rep., Hungary, Kazakhstan, Ukraine, S. Arabia, Nigeria.

fiscal measures and the cumulative impact of trailing rate hikes. We also expect the Fed to pause in the rate hike cycle in 3Q19. This backdrop, according to our strategists, will keep the US 10-year bond yield closer to 3% and lead to a weaker dollar. The pressures from higher oil prices should also recede in 2019, contributing to a much more favourable external backdrop for EMs.

What about China?

We think that defensive easing measures will stabilise growth in the coming quarters: China's growth momentum has been impacted by policy tightening in the past and escalating trade tensions in 2H18, which compounded concerns about the wider EM universe. Broad credit growth, which we view as the most important measure of policy stance, decelerated from ~14%Y in December 2017 to 11%Y in October 2018. Since June, however, policy-makers in China have shifted to a defensive easing path, and we think that they will succeed in lifting broad credit growth to 12.5%Y by end-2019 and stabilising growth.

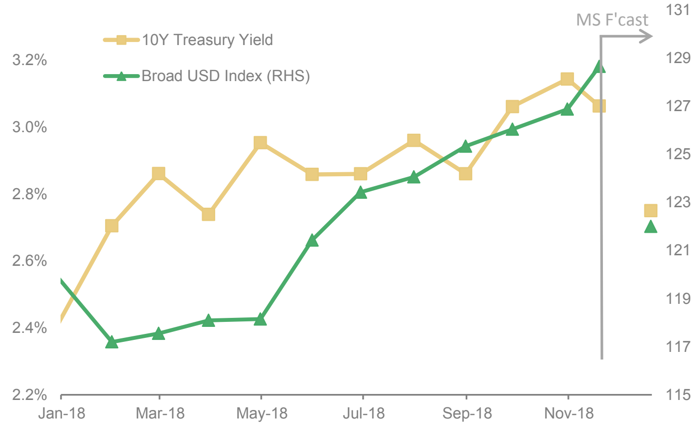
This easing cycle is different: The intensity of its easing measures will be calibrated to the evolution of trade tensions. Moreover, the focus has shifted towards supporting sentiment for private capex and boosting private consumption, and less on encouraging large infrastructure and real estate spending. The measures we expect include: 1) 2-3% VAT cuts (in the 16% bracket); 2) A wider on-budget deficit (4.0% of GDP in 2019 versus 3.3% in 2018); 3) A higher local government special bond issuance quota; and 4) A lower social insurance contribution ratio. Policy-makers will likely focus on the quality of growth and avoid creating risks to financial stability.

Our base case: Global growth oscillates around trend

We project that global growth will oscillate around trend in 2019: Risks are skewed to the downside, with US corporate credit risks being the most prominent one (see Box B for a detailed discussion). As the cycle matures, growth moderates in the US and euro area in 2019 while Japan's growth path will be influenced by the imposition of the consumption tax hike. Meanwhile, we expect a more favourable external backdrop for EMs to pave the way for relatively robust growth, allowing EMs to retake the lead in driving global growth.

Exhibit 9:

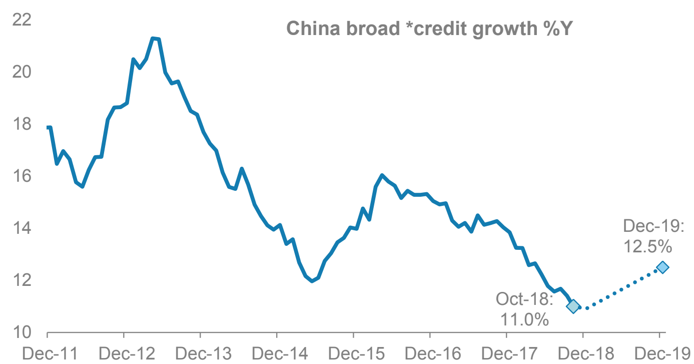
External headwinds to EM growth are receding in 2019



Source: Bloomberg, Morgan Stanley Research forecasts; Note that forecasts are referring to end-2019.

Exhibit 10:

Modest acceleration in China's broad credit growth



Source: CEIC, PBOC, Morgan Stanley Research forecasts; *Broad credit growth refers to total social financing including net issuance of central government bonds, local government general bonds and local government special bonds.

2) Core inflation making new highs in DM, staying low in EM

Tighter labour markets lift wage growth, gradually taking core inflation higher in DM. In contrast, a still favourable domestic policy mix keeps core inflation in EM well-anchored at relatively low levels.

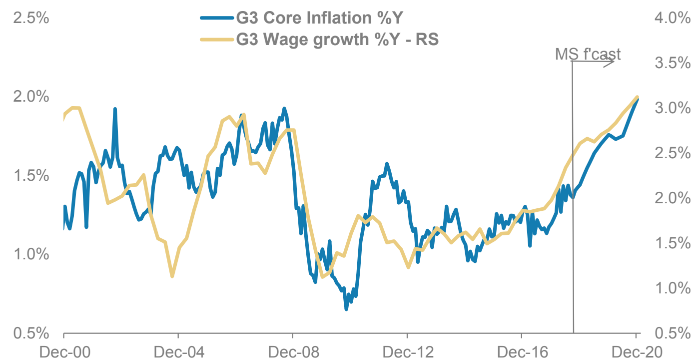
Reducing slack, stronger wage growth, higher G3 core inflation: Core inflation in the G3 has been rising and has broken out of the post-crisis range. DM core inflation is being driven higher by a continued drawdown of economic resources, higher capacity utilisation rates and stronger wage growth. Specifically, wage growth is picking up synchronously across the G3, closing the gap with 'normal' wage growth (defined as productivity growth plus central banks' inflation goal) and exerting upward pressure on inflation. Rising wage growth is the confirmatory signal that resources in the economy are stretched, which increases our conviction that the risks to G3 core inflation are no longer skewed to the downside.

US core inflation to move above 2%Y, moving towards the long-term average in the euro area: We expect core inflation in both the US and euro area to rise by 40bp over the course of 2019, reaching 2.3%Y and 1.5%Y, respectively by 4Q19. In the US, the rise in tariffs from 10% to 25% on US$200 billion of imports from China in January 2019 is an additional driver pushing up core inflation in the US. In the euro area, above-trend growth and diminishing signs of slack in labour markets mean that unit labour cost growth should feed through more visibly to core inflation. In Japan, the underlying trend in core inflation pressures remains on an upward trajectory though the actual outturn will likely be impacted by the imposition of the consumption tax hike, provision of free education for primary school children and cuts in cell phone charges.

Prudent policy mix anchoring EM core inflation to a 15-year low: In contrast, we believe that the benign trends we have observed in EM core inflation will continue into 2019. This persistent and well-behaved inflation is systematically different compared to the past. In our view, EM inflation is more dependent on domestic than external factors. The prudent policy mix, as discussed above, has meant that domestic factors will keep core inflation in check. As a case in point, in this cycle, currency weakness has not translated into higher EM inflation. EM central banks did not have to hike interest rates aggressively in response to recent currency depreciation.

Exhibit 11:

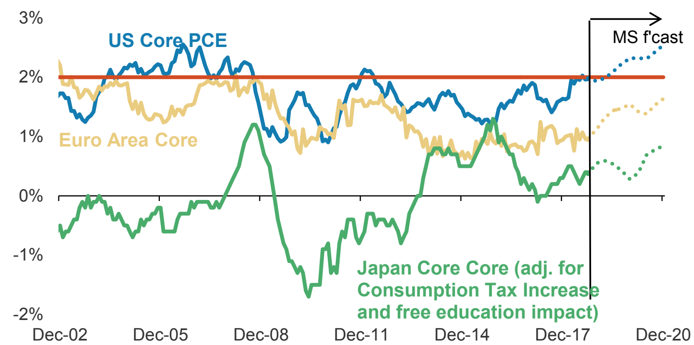
Stronger G3 wage growth, stronger core inflation



Source: Haver Analytics, IMF, Morgan Stanley Research forecasts; Note: Aggregates are PPP-based GDP-weighted averages. US core inflation refers to core PCE. Japan core CPI refers to 'core core' ex fresh food and energy, ex VAT and free child education impact.

Exhibit 12:

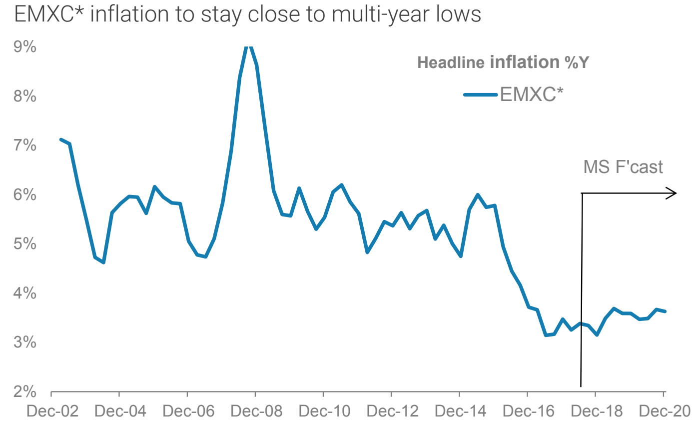
G3 core inflation making new highs



Source: Haver Analytics, IMF, Morgan Stanley Research forecasts; Note: 2% line in red refers to the inflation goal in the US. US core inflation refers to core PCE. Japan core CPI refers to 'core core' ex fresh food and energy, ex VAT and free child education impact.

Exhibit 13:

EMXC* inflation to stay close to multi-year lows



Source: Haver Analytics, IMF, Morgan Stanley Research; Note: Aggregates are PPP-based GDP-weighted averages. *EMs under Morgan Stanley coverage ex. China, Argentina, Turkey, Venezuela, Nigeria, Saudi Arabia and Kazakhstan.

3) Central banks: The Fed pauses while others hike

The Fed pauses after reaching neutral and ends balance sheet run-off in 3Q19, while the ECB and BoJ embark on the next stage of policy normalisation and hike rates. Real rates do not rise meaningfully in EM, while China's easing measures help to stabilise growth.

Changing trade-offs keep central banks on a hiking path: Central banks have played a key role in this cycle in managing the downside risks to growth and inflation in 2012-16. Their trade-offs and role have evolved since then as growth moved above trend in 2017, driven by private sector demand, labour markets have tightened meaningfully and wage growth has picked up. At this stage in the cycle, central banks have to ensure that the pace of tightening does not disrupt the recovery and that the cycle can be extended. Our base case is that central banks will normalise monetary policy gradually.

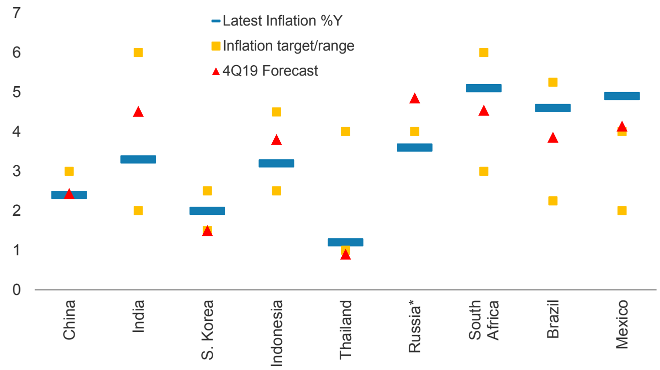
The Fed will pause after neutral... In this context, we expect that the Fed, having embarked on the tightening cycle far ahead of other central banks, will hike three more times in December, March and June. As it would have likely reached neutral territory by then, we expect the Fed to then pause in its hiking cycle. Recent Fedspeak has reaffirmed our expectation of a pause as policy-makers are now putting more emphasis on data dependence and signalling some flexibility on policy management after reaching the neutral rate, a subtle shift in tone relative to a few weeks ago (see Box A for details).

...while central banks in the rest of G4 take another step towards normalisation: Elsewhere in the world, we think that other central banks will also move to normalise monetary policy, with the BoJ ending its negative interest rate policy in 2Q19, the BoE resuming rate hikes from 2Q19 and the ECB hiking in 4Q19 (depo rate in 4Q19 and refi rate in 1Q20).

G4 central banks' balance sheet to shrink in aggregate: We think that 2019 will be the first year that G4 central banks' balance sheet shrinks in the post-Global Financial Crisis era. However, we forecast that the Fed will end balance sheet run-off in 3Q19 while the ECB and BoE embark on this process. The ECB, having stopped QE at end-2018, will continue with reinvestments and 'operation twist' to mitigate the rise in long-term interest rates. The BoE unwinds QE starting from 4Q19. The BoJ will continue to expand its balance sheet and will maintain its current wording of the policy for asset purchases including ETFs.

Exhibit 14:

EM inflation to stay within central bank target ranges

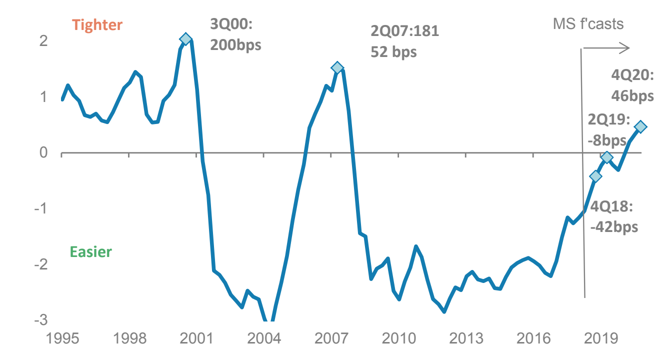


Source: Haver Analytics, Morgan Stanley Research forecasts; *Note that the Russian inflation forecast is impacted by a VAT increase.

Exhibit 16:

US real rates approaching natural* level

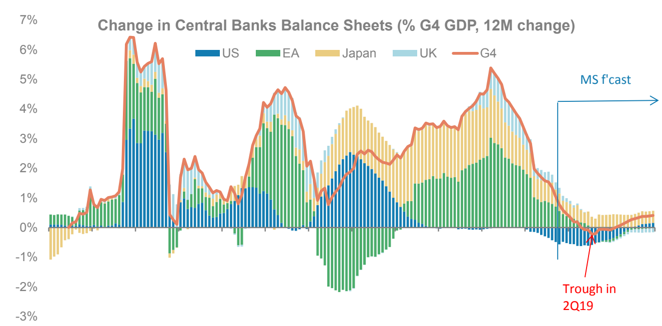
US Real Short Rates minus Natural Rate*



Source: Haver Analytics, Morgan Stanley Research forecasts; *See Kiley (2015); Johannsen and Mertens (2016); Holston, Laubach, and Williams (2017); Laubach and Williams (2003) (current estimates available on the Federal Reserve Bank of New York's website.

Exhibit 17:

G4 central banks' balance sheet to decline in 2019



Source: FRB, ECB, BoJ, Morgan Stanley Research forecasts; Note: Exchange rate conversions made at average historical exchange rates with USD since 2007.

Modest hikes in EM, China staying on a defensive easing path: EM central banks are also hiking interest rates in 2019, though by a smaller magnitude as compared to the Fed (about two-thirds of the EM central banks we cover fall into this category). In China, as noted, we expect policy-makers to stay on a defensive easing path, calibrating the intensity of their easing measures to how trade tensions evolve. We expect that the impact of China's easing measures will lift broad credit growth to 12.5%Y by end-2019 versus 11%Y now.

Exhibit 15:

G4 monetary policy forecasts in detail

	2019	2020
Fed – pausing at neutral	• Two hikes of 25bp each in 1Q and 2Q • Balance sheet run-off ends by September 2019, with announcement at the March FOMC meeting	• Resumes hiking – four hikes of 25bp each to bring the terminal rate to 3.875% by the end of 2020 • Balance sheet to increase slightly by ~US$100 billion in order to stabilise bank reserves in the system
ECB – heading towards the exit	• One hike of depo rate in October 2019 by 15bp	• Two hikes of depo and refi rates: 25bp for the depo and the refi rates in March, and another one of the same magnitude for both rates in September • ECB to keep the stock of QE assets unchanged with reinvestments to continue throughout, but does not renew the long-term refinancing operations when they expire. Shorter-term facilities to avoid central bank liquidity declining
BoJ – from NIRP to ZIRP	• BoJ to adjust NIRP in 1H19 (base case: April 2019) by raising policy rate by 10bp to 0%	• Policy rates to remain unchanged
BoE – hawkish amid soft Brexit	• Two hikes by 25bp each in May and November (once there is more clarity on Brexit) • We expect an early start to QE unwind in 4Q19, once MPC is firmly on a steeper tightening path	• Three hikes of 25bp each from 2Q20 onwards, guiding towards a terminal rate at the bottom end of its neutral range of 2-3%

Source: Morgan Stanley Research forecasts

Risks – skewed to the downside, high risk of recession in 2020

Risks skewed to the downside: With the expansion moving even further into late-cycle, risks are skewed towards the downside in 2019 and will likely become more pronounced in 2020, with the risk of a recession increasing significantly, particularly in the US.

Expecting a global recession in our bear case scenario: In our bear case, we expect the global economy to enter recession in 2019-20. Global growth would slow significantly to 2.5%Y in 2019 and further to 2.0%Y in 2020, its slowest pace since the Global Financial Crisis (Exhibit 18).

Exhibit 18:

Morgan Stanley bull-bear GDP growth forecasts: Risks to global GDP growth are increasingly skewed to the downside

	2018E	2019E			2020E			2021-23E
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
GLOBAL	**3.8**	**2.5**	**3.6**	**4.2**	**2.0**	**3.5**	**4.4**	**3.4**
G10	**2.2**	**1.1**	**1.9**	**2.4**	**-0.1**	**1.6**	**2.4**	**1.2**
US	2.9	1.6	2.3	2.6	-0.2	1.9	2.7	1.1
EA	1.9	0.6	1.6	2.4	0.0	1.5	2.5	1.0
Japan	0.8	0.3	1.3	1.5	-0.9	0.6	0.9	1.3
UK	1.2	0.9	1.3	1.8	1.0	1.6	2.0	1.3
EM	**4.8**	**3.5**	**4.7**	**5.5**	**3.4**	**4.8**	**5.7**	**4.7**
China	6.6	5.6	6.3	6.7	5.3	6.1	6.5	5.5
India	7.7	6.8	7.6	8.2	6.5	7.5	8.3	7.3
Brazil	1.3	0.9	2.3	3.4	0.8	2.5	3.8	2.4
Russia	1.6	-0.2	1.5	2.9	-0.5	1.6	3.2	1.8

Source: Bloomberg, IMF, Morgan Stanley Research forecasts; Note: Aggregates are PPP-based GDP-weighted averages.

We view the following as the key risks to the global economy: Corporate credit risks in the US, the impact of trade tensions, potential strength in USD driving tightening financial conditions in EM and idiosyncratic political and policy risks. Among these risks, we view US corporate credit as the key risk to watch while trade tensions could be the most immediate risk to play out pending the outcome of potential negotiations between the US and China.

1) US corporate credit risks: Corporates (particularly the riskier ones) have levered up in this cycle. The corporate sector is also likely to face pressures from both rising unit labour costs and higher real interest rates. We think that the risks could emerge from 2H19 as wage growth should continue to rise while productivity growth is expected to moderate then (see Box B for details).

2) Trade tensions: The outlook on trade tensions between the US and China remains uncertain, notwithstanding the recent talks. Trade tensions will undoubtedly impact business confidence (and capex decisions) and could disrupt supply chains. Given how tightly linked the global economy is today, economic shocks have a tendency to reverberate across the world. We estimate that if the US moves to impose 25% tariffs on all remaining imports from China, China will likewise impose 25% tariffs on all US goods. This will impact global GDP growth by an incremental 15bp, on our estimates. However, these estimates do not reflect the feedback from a potential widening of US corporate credit spreads, tightening of financial conditions and policy uncertainty impacting business investment.

3) Continued USD strength which tightens EM financial conditions: As outlined earlier, our base case is that US GDP and productivity growth moderate. However, if US capex and productivity growth and/or oil production remain strong, the Fed can and will tighten further, and USD could stay stronger for longer. In this scenario, EM central banks will eventually have to tighten more than underlying growth and inflation fundamentals warrant, bringing about a tightening of their financial conditions and leading to downside risks to growth.

4) Idiosyncratic risks such as Italy's fiscal situation and potential political uncertainty in Germany. Meanwhile, political and policy uncertainty could weigh on corporate and consumer confidence in EM, given elections in India and Indonesia and policy uncertainty post new governments in Brazil and Mexico.

In our bull case, global growth accelerates further above its 2018 pace. Such a scenario could be driven by stronger capex and productivity growth as well as larger-than-expected slack in labour markets which keeps inflationary pressures contained. In addition, it could be driven by easier fiscal policy and a higher fiscal multiplier in DM, a faster de-escalation of trade tensions between the US and China or more market-friendly outcomes of political events such as Brexit negotiations and elections in major EMs.

Exhibit 19:

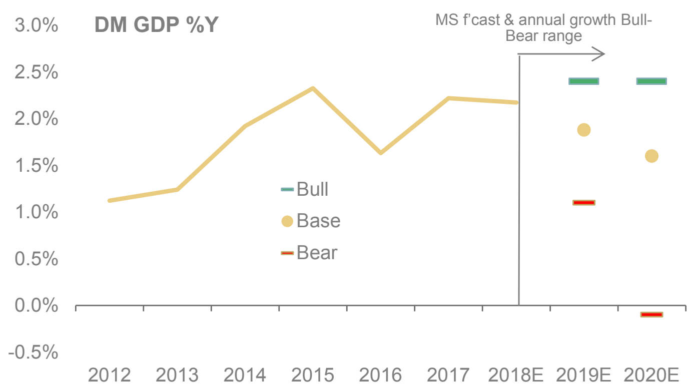
Growth impact from existing and potential new tariff measures

	Impact on GDP		
	Global	US	China
Existing tariff measures – initial impact	-19bp	-9bp	-60bp
Existing tariff measures – final impact incl. policy responses	-14bp	-9bp	-20bp
Tariff measures on all goods – initial impact	-38bp	-20bp	-130bp
Tariff measures on all goods – final impact incl. policy response	-29bp	-20bp	-70bp

Source: Morgan Stanley Research forecasts; *The initial modelled growth impact is derived from the simulation results from the global input-output model. We expect that the initial growth impact will result in a policy response from China, where policy-makers will lift broad credit growth and fiscal deficit to cushion the impact on growth, which results in a lower final impact. See Trade Tensions: Chipping Away at Growth, September 3, 2018, for details on policy responses.

Exhibit 20:

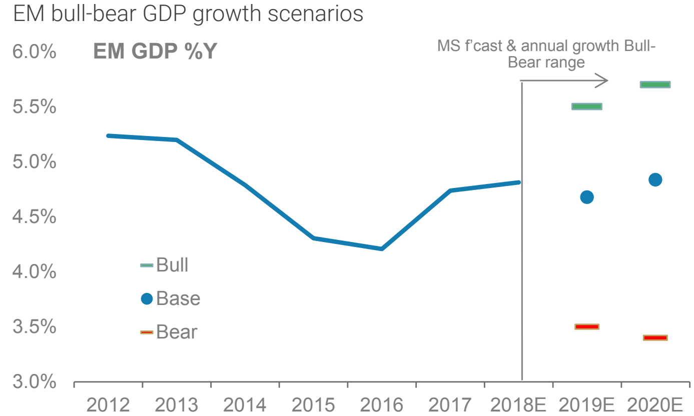
DM bull-bear GDP growth scenarios



Source: Bloomberg, IMF, Morgan Stanley Research forecasts; Note: Aggregates are PPP-based GDP-weighted averages. Forecasts are annual averages.

Exhibit 21:

EM bull-bear GDP growth scenarios



Source: Bloomberg, IMF, Morgan Stanley Research forecasts; Note: Aggregates are PPP-based GDP-weighted averages. Forecasts are annual averages.

Box A: The Fed pause: Your questions, our answers

1) What is the Fed's thinking on policy management?

Recent speeches by the Chair and Vice Chair have sent a consistent message which is signalling some flexibility on policy management after reaching neutral, with comments indicating a subtle shift towards increased data dependence as policy rates enter the neutral range of 2.5-3.5%. Indeed, the Fed's median projection of the September summary of economic projections implies 2-3 hikes in 2019, which hints at a pause too at some point during 2019. In terms of how the Fed evaluates the impact of its policy, Chair Powell alluded that the FOMC would look "really carefully" at "how the markets and the economy and business contacts will be reacting". We thus think that the Fed will be particularly watchful of three factors: 1) Economic growth and inflation indicators; 2) Financial conditions; and 3) Feedback from business contacts.

2) What will lead the Fed to pause in 2019?

We believe that by 3Q19 GDP growth will have slowed below trend and rates will have reached close to neutral. Core PCE inflation will have risen above 2%Y in 2Q19 but we think that the FOMC will judge the mild overshoot as mostly driven by temporary factors (such as tariffs) and expect below-trend sequential growth to keep inflation risks contained. (Note that our inflation path builds in the increase in tariffs on US$250 billion of imports from China to 25% starting from January 2019, but not on the remaining US$267 billion.) At that point, we believe that the FOMC will have moved into what NY Fed President Williams has called the 'third phase' of policy-making, managing policy around neutral (after 'lift-off' and 'normalisation'). We thus think that 'wait-and-see' will become the dominant conversation in the back half of 2019 as the Fed sits on rates. Note that around the same time we expect the Fed to end balance sheet normalisation as well.

3) How does this compare to the past two cycles?

The late 1990s may be a more comparable period, using the state of labour markets as a guide.

***a) Mid and late 1990s** – the Fed paused and restarted rate hikes.* In both the mid and late 1990s the Fed had paused policy tightening, cut rates and then started hiking again. In May 1997 the Fed had decided to keep rates on hold as there were signs of consumption growth and jobs growth slowing following a strong first quarter (GDP growth was expected to have slowed from 6%Q saar to 1.8% in 2Q and to average 2.2% over the next four quarters). Underlying inflationary pressure seemed contained, despite some acceleration in wage growth. The Fed traced this back to strong productivity growth (judging from high corporate profit growth) and the impact from a strong dollar. While economic activity turned out to be much stronger than the Fed had predicted during the rest of the year, it kept rates unchanged in the absence of major inflationary pressure and eventually cut rates by a cumulative 75bp in 4Q98 due to adverse developments abroad, before restarting the hiking cycle for another year in June 1999. Domestic demand in 1999 proved to be much stronger than expected and eventually led the Fed to restart the hiking cycle in June 1999.

***b) 2000s** – the Fed paused but never restarted tightening as rates were in highly restrictive territory already.* In August 2006 the Fed also paused amid a sharp slowdown in economic growth (from 5.6%Q saar in 1Q to 2.3% in 2Q) as housing investment contracted, domestic demand slowed and payrolls moderated, but the Fed never restarted tightening. Inflation was above 2%Y at the time, but with rates already in restrictive territory and rates-sensitive sectors slowing, the Fed seemed less concerned about inflation risks. In fact, inflation expectations and unit labour costs remained well contained. In hindsight, we estimate that rates were already in highly restrictive territory.

Box B: Increased recession risks – the role of US corporate credit

Our framework for the cycle has been that DMs are further along the business cycle than EMs and, within DMs, the US is the furthest. As financial imbalances (rather than inflation) have been the key factor which brought an end to the past two US cycles, via a significant tightening of financial conditions, we are monitoring the potential emergence of such risks closely.

Corporate credit is the key risk in the current cycle

Household balance sheets are not the key risk this cycle. Rather, the corporate sector has been levering up. Overall corporate debt levels have risen to 72.5% of GDP in 2Q18 from a trough of 64.6% in 2Q12. The rise in corporate debt has also been driven more by riskier companies and their share in total corporate bond issuance has risen. While the deleveraging in the energy sector in 2017/18 helped to stabilise corporate debt levels somewhat in late 2017, debt growth has continued to pick up in 2Q18.

A more challenging backdrop in 2019

So far, the corporate sector has been able to absorb higher interest rates despite an increase in leverage. In 2018, tax reforms and an acceleration in productivity growth have helped to lift corporate profits. Corporate credit spreads widened only modestly, and mainly among bonds of higher credit quality. Overall financial conditions have also remained largely accommodative.

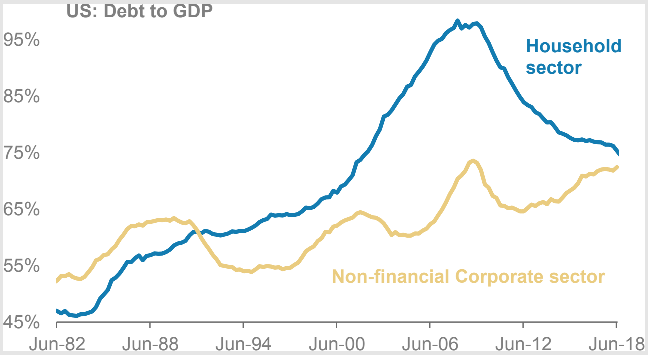
However, as we move further into the cycle, the US corporate sector could face increasing pressures from both accelerating wage growth and a higher cost of capital. In fact, our US economics team sees average hourly earnings growth rising from an average 3.2%Y in 2Q19 to 4.0%Y by 4Q20, the fastest pace since 3Q06. At the same time, productivity growth should slow from an average 1.5%Y (4QMA) in 2Q19 to 0.7%Y in 4Q20. Against this backdrop, our credit strategy team expects credit spreads to widen, particularly in lower-rated bond segments, and sees a modest rise in defaults in the high yield and leveraged loan space. Our US economics team estimates that a 100bp sustained widening in BBB credit spreads over four quarters would be the equivalent of a 62bp increase in the fed funds rate.

Our bear case assumes a shallow, 2001-like recession

We are not anticipating a recession in 2020 in our base case as we expect the Fed to pause after raising rates towards neutral territory, which will allow for growth to rebound. However, we see a material rise in recession risks as we approach 2020. In our bear case we expect a mild 2001-like recession. In this scenario, the higher cost of capital wins the tug of war with productivity. The US economy enters recession by late 2019 and continues to contract until mid-2020. The depth of the recession (we forecast a contraction of 0.2%Y in our 2020 bear case) would be more comparable with the 2001 recession since the rise in debt has been more manageable relative to the 2003-07 cycle, with both household and financial sector balance sheets in better shape. As financial conditions tighten materially (our US credit team sees high yield credit spreads widening the most since the Global Financial Crisis), productivity growth decelerates and default rates among weaker debtors accelerate.

Exhibit 22:

US corporate sector leverage has increased, while households have delevered



Source: Haver Analytics, Morgan Stanley Research

Exhibit 23:

BBB rated debt at an all-time high

Source: Bloomberg, S&P Capital IQ, the Citigroup Index LLC, Morgan Stanley Research

Country snapshots

US – pausing at neutral: In 2019, a record-high tax refund season front-loads consumer spending, investment remains modest, while net trade and housing are a drag. By mid-2019 growth slows below trend as fiscal stimulus fades and earlier rate hikes result in tighter financial conditions. As real interest rates reach 'neutral', the Fed pauses and moves into wait-and-see mode in 2H19.

Euro area – heading towards the exit: While growth moderates, it stays above trend in 2019. Inflationary pressures are likely to rise. The ECB will no longer expand its balance sheet, and hikes rates three times. The political environment is likely to result in a push for region-wide fiscal tools.

Japan – from NIRP to ZIRP: The consumption tax hike will likely cause swings in growth and prices, and also affect fiscal and monetary policy. Growth in the first half of the year should be boosted by front-loaded consumer spending, but slow to below potential after implementation. On the fiscal side, a large-scale second supplementary budget proposal could surface by year-end. The BoJ will likely lift NIRP in 1H19 (April in our base case) to enhance the sustainability of the current policy.

UK – soft Brexit, hawkish MPC: We expect a difficult Brexit endgame. However, in our base case of a soft Brexit we see a modest recovery. With an economy at potential, inflation above target, rising pay and fiscal stimulus, we expect a hawkish MPC to deliver a cumulative five hikes, taking rates to the MPC's neutral range by end-2020.

China – a different easing cycle: Different from past cycles, China's current easing efforts focus on the private sector and fiscal policy to ensure not to disrupt its journey to high-quality growth. We expect growth to stabilise starting from 2Q19 at a pace which is slightly above consensus expectations.

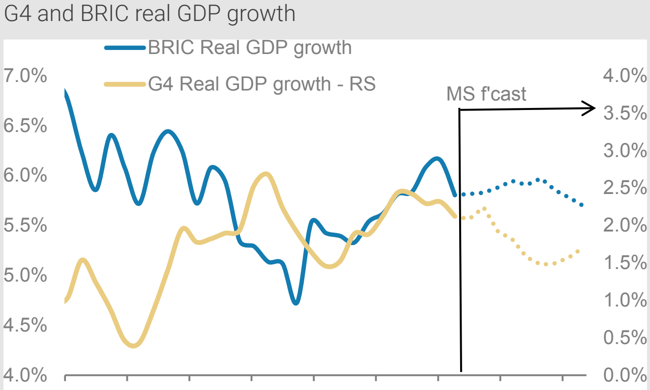
India – staying on track: The growth recovery should stay on track as policy decisions remain supportive of improving the productivity dynamic, with no evident signs of misallocation in the form of higher inflation or deficits. External pressures in the form of higher oil prices and a stronger US dollar should recede but still represent a key risk to the outlook.

Brazil – recovering amid some policy uncertainty: We believe that the Brazilian economy will accelerate, without generating inflationary pressures, even amid uncertainties about the approval of pension reform, which is required to stabilise Brazil's debt dynamics. Our base case assumes that a watered-down version of the pension reform will be approved by the end of 2019.

Russia – fiscal rules and sanctions constraining growth upside: Economic growth should stay broadly stable with oil not providing much additional support, and both the fiscal rule and sanctions limiting any upside. We see average CPI at 5.0%Y in 2019 on the back of the VAT increase and partial FX pass-through. We expect a higher country risk premium and CPI acceleration to force the CBR to hike rates twice more to 8.00% by 1Q19.

Exhibit 24:

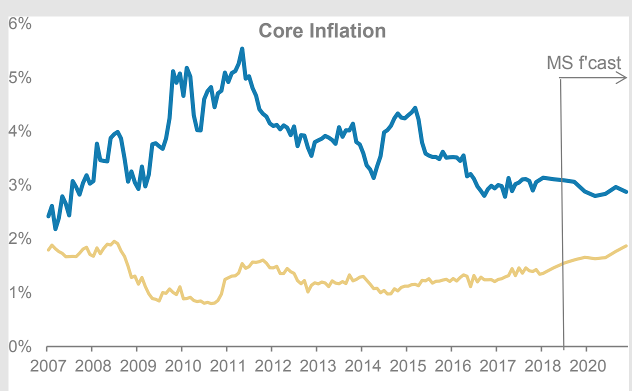
G4 and BRIC real GDP growth



Source: Haver Analytics, Morgan Stanley Research forecasts; Note: Aggregates are PPP-based GDP-weighted averages.

Exhibit 25:

G4 and BRIC core inflation



Source: Haver Analytics, Morgan Stanley Research forecasts; Note: Aggregates are PPP-based GDP-weighted averages.

Key forecast tables

	Quarterly												Annual		
	2018				2019				2020				2018E	2019E	2020E
Real GDP	1Q	2Q	3QE	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global (YoY)	**4.0**	**4.0**	**3.6**	**3.5**	**3.6**	**3.5**	**3.6**	**3.6**	**3.6**	**3.6**	**3.5**	**3.5**	**3.8**	**3.6**	**3.5**
G10 (YoY)	**2.3**	**2.3**	**2.1**	**2.1**	**2.3**	**1.9**	**1.9**	**1.6**	**1.5**	**1.6**	**1.6**	**1.7**	**2.2**	**1.9**	**1.6**
United States	2.6	2.9	3.0	3.1	3.2	2.6	2.0	1.7	1.6	1.7	2.1	2.3	2.9	2.3	1.9
Euro Area	2.4	2.2	1.7	1.4	1.5	1.4	1.7	1.7	1.6	1.5	1.4	1.3	1.9	1.6	1.5
Japan	1.1	1.4	0.3	0.6	1.4	1.0	2.0	1.0	0.6	0.6	0.1	1.0	0.8	1.3	0.6
UK	1.1	1.2	1.5	1.2	1.3	1.4	1.2	1.5	1.8	1.6	1.5	1.4	1.2	1.3	1.6
EM (YoY)	**5.1**	**5.1**	**4.6**	**4.5**	**4.5**	**4.5**	**4.8**	**5.0**	**5.0**	**4.9**	**4.8**	**4.7**	**4.8**	**4.7**	**4.8**
China	6.8	6.7	6.5	6.4	6.3	6.4	6.4	6.3	6.3	6.2	6.1	6.0	6.6	6.3	6.1
India	7.7	8.2	7.5	7.4	7.5	7.5	7.6	7.6	7.6	7.5	7.5	7.5	7.7	7.6	7.5
Brazil	1.2	1.0	1.3	1.7	2.0	2.6	2.4	2.2	2.4	2.3	2.5	2.6	1.3	2.3	2.5
Russia	1.3	1.9	1.3	1.6	1.3	1.2	1.8	2.0	2.1	1.8	1.4	1.2	1.6	1.5	1.6
Global (%Q, SAAR)	**3.8**	**4.1**	**3.4**	**3.5**	**3.8**	**4.0**	**3.5**	**3.3**	**3.7**	**3.8**	**3.6**	**3.4**	**3.8**	**3.6**	**3.5**
G10 (%Q, SAAR)	**1.5**	**3.0**	**1.8**	**2.1**	**2.0**	**1.8**	**1.5**	**1.2**	**1.6**	**1.9**	**1.9**	**1.6**	**2.2**	**1.9**	**1.6**
United States	2.2	4.2	3.5	2.6	2.5	1.8	1.0	1.5	2.1	2.4	2.5	2.0	2.9	2.3	1.9
Euro Area	1.6	1.8	0.7	1.6	1.8	1.7	1.6	1.6	1.4	1.4	1.2	1.1	1.9	1.6	1.5
Japan	-1.1	3.0	-1.2	1.9	1.5	1.9	2.9	-2.1	0.1	1.6	1.0	1.3	0.8	1.3	0.6
UK	0.4	1.6	2.5	0.4	0.6	2.0	1.8	1.8	1.4	1.4	1.4	1.4	1.2	1.3	1.6
Consumer Price Inflation (YoY)															
Global*	**2.7**	**2.8**	**3.1**	**3.1**	**3.1**	**3.2**	**3.0**	**2.8**	**3.0**	**3.0**	**3.0**	**3.0**	**2.9**	**3.0**	**3.0**
G10	**1.8**	**2.1**	**2.2**	**2.1**	**1.8**	**1.9**	**1.8**	**1.7**	**1.9**	**1.9**	**2.1**	**2.2**	**2.1**	**1.8**	**2.0**
United States	2.3	2.6	2.6	2.3	1.5	1.8	2.0	2.0	2.5	2.6	2.6	2.7	2.4	1.8	2.6
Euro Area	1.3	1.7	2.1	2.2	2.3	2.1	1.8	1.5	1.4	1.5	1.8	2.0	1.8	1.9	1.7
Japan**	1.3	0.7	1.1	1.3	0.9	1.3	0.7	0.2	0.2	0.5	0.6	0.6	1.1	0.8	0.5
UK	2.7	2.4	2.5	2.3	2.0	2.1	2.0	2.1	2.3	2.1	2.1	2.0	2.5	2.1	2.1
EM*	**3.3**	**3.3**	**3.6**	**3.8**	**4.0**	**4.1**	**3.8**	**3.7**	**3.7**	**3.6**	**3.7**	**3.6**	**3.5**	**3.9**	**3.6**
China	2.2	1.8	2.3	2.6	2.7	2.8	2.7	2.4	2.5	2.5	2.3	2.1	2.2	2.6	2.4
India	4.6	4.8	3.9	3.0	4.0	4.4	4.2	4.5	4.2	4.4	5.0	4.8	4.1	4.3	4.6
Brazil	2.8	3.3	4.4	4.2	4.3	4.6	3.8	3.9	4.1	4.1	4.2	4.3	3.7	4.1	4.2
Russia	2.3	2.4	3.0	3.9	4.9	5.2	5.1	4.9	4.2	4.0	3.9	4.0	2.9	5.0	4.0
Core Inflation (YoY)															
Global (G4 & BRIC)	**2.1**	**2.2**	**2.2**	**2.3**	**2.3**	**2.4**	**2.4**	**2.4**	**2.3**	**2.3**	**2.5**	**2.5**	**2.2**	**2.4**	**2.4**
G4	**1.4**	**1.4**	**1.4**	**1.5**	**1.6**	**1.7**	**1.8**	**1.8**	**1.8**	**1.8**	**1.9**	**2.0**	**1.4**	**1.7**	**1.9**
G3	**1.3**	**1.4**	**1.4**	**1.4**	**1.6**	**1.6**	**1.7**	**1.8**	**1.7**	**1.8**	**1.9**	**2.0**	**1.4**	**1.7**	**1.8**
United States^	1.7	1.9	2.0	1.9	2.0	2.1	2.2	2.3	2.3	2.3	2.4	2.5	1.9	2.2	2.4
Euro Area	1.0	0.9	1.0	1.1	1.3	1.4	1.5	1.5	1.4	1.4	1.5	1.6	1.0	1.4	1.5
Japan**	0.5	0.3	0.4	0.6	0.6	0.5	0.4	0.3	0.4	0.7	0.8	0.8	0.4	0.5	0.7
UK	2.5	2.0	2.0	1.8	1.9	2.2	2.3	2.6	2.6	2.5	2.5	2.5	2.1	2.2	2.5
BRIC	**2.9**	**3.0**	**3.0**	**3.1**	**3.1**	**3.1**	**3.1**	**2.9**	**2.8**	**2.8**	**3.0**	**2.9**	**3.0**	**3.0**	**2.9**
China	2.1	1.9	1.9	1.9	1.9	2.0	1.9	1.9	1.8	1.8	1.9	1.8	2.0	1.9	1.8
India	5.2	6.2	6.0	5.9	5.3	4.8	4.7	4.3	4.5	4.7	4.8	4.5	5.8	4.8	4.6
Brazil	2.8	2.7	2.9	2.7	2.8	3.5	3.9	3.9	3.8	3.9	4.0	4.2	2.8	3.5	4.0
Russia	1.9	2.1	2.7	3.9	4.9	5.4	5.3	4.7	3.9	3.7	4.1	4.2	2.6	5.1	4.0
Monetary Policy Rate (% p.a.)															
Global	**2.9**	**3.1**	**3.3**	**3.4**	**3.5**	**3.5**	**3.5**	**3.5**	**3.7**	**3.8**	**3.8**	**3.9**	**3.4**	**3.5**	**3.9**
G10	**0.7**	**0.8**	**0.9**	**1.0**	**1.1**	**1.3**	**1.3**	**1.4**	**1.6**	**1.7**	**1.9**	**2.0**	**1.0**	**1.4**	**2.0**
United States	1.625	1.875	2.125	2.375	2.625	2.875	2.875	2.875	3.125	3.375	3.625	3.875	2.375	2.875	3.875
Euro Area#	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	0.00	0.00	0.25	0.25	-0.40	-0.25	0.25
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.10	0.00	0.00
UK	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00	0.75	1.25	2.00
EM	**4.6**	**4.8**	**5.1**	**5.1**	**5.1**	**5.1**	**5.1**	**5.0**	**5.1**	**5.2**	**5.2**	**5.2**	**5.1**	**5.0**	**5.2**
China^^	3.10	3.01	2.80	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
India	6.00	6.25	6.50	6.50	6.50	6.75	7.00	7.00	7.25	7.50	7.50	7.50	6.50	7.00	7.50
Brazil	6.50	6.50	6.50	6.50	6.50	6.50	6.50	7.50	8.50	9.00	9.00	9.00	6.50	7.50	9.00
Russia	7.25	7.25	7.50	7.75	8.00	8.00	8.00	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75

Source: IMF, Morgan Stanley Research forecasts; Note: Global and regional aggregates for GDP growth are GDP-weighted averages, using PPP weights; 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. ^^ 7-day repo rate. ** Japan CPI excludes VAT and free child education impact. #Euro area policy rate refers to depo rate.

Consumption and investment spending forecasts

	Quarterly												Annual		
	2018				2019				2020				2018E	2019E	2020E
Pvt Consumption (%Q, SAAR)	1Q	2Q	3QE	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global (G4 BRIC)	**3.6**	**5.2**	**4.5**	**4.3**	**4.2**	**4.6**	**4.2**	**3.7**	**4.2**	**4.5**	**4.2**	**4.4**	**4.4**	**4.3**	**4.2**
G4	**0.9**	**2.5**	**2.1**	**1.7**	**2.1**	**1.7**	**1.9**	**0.7**	**1.6**	**1.8**	**1.7**	**1.7**	**1.8**	**1.9**	**1.5**
United States	0.5	3.8	4.0	1.8	3.0	1.8	1.2	2.0	2.2	2.5	2.6	2.4	2.6	2.5	2.1
Euro Area	2.2	0.8	0.6	1.4	1.6	1.6	1.6	1.6	1.4	1.3	1.2	1.0	1.4	1.4	1.4
Japan	-0.9	2.6	-0.5	1.7	1.0	2.0	5.8	-7.2	0.2	1.4	0.1	1.4	0.4	1.3	-0.2
UK	0.0	1.9	1.3	2.0	0.4	0.4	1.4	1.4	1.4	1.2	1.2	1.0	1.4	1.0	1.2
BRIC	**6.4**	**7.9**	**7.0**	**7.0**	**6.3**	**7.4**	**6.5**	**6.7**	**6.6**	**7.1**	**6.5**	**6.9**	**7.0**	**6.8**	**6.7**
China	8.0	8.0	8.0	8.0	7.7	7.7	7.7	7.7	7.5	7.5	7.5	7.5	8.0	7.7	7.5
India	6.2	12.1	7.2	7.9	6.0	10.2	6.2	7.4	7.1	8.9	6.7	8.4	8.0	7.7	7.6
Brazil	1.4	0.3	2.8	1.6	2.4	3.2	3.2	2.0	2.8	3.2	2.4	2.4	1.8	2.4	2.7
Russia	1.3	2.6	3.2	2.8	1.2	1.4	2.0	2.0	2.4	2.2	2.2	2.2	2.6	2.0	2.2
Pvt Consumption (%Y)															
Global (G4 BRIC)	**4.2**	**4.4**	**4.4**	**4.4**	**4.6**	**4.4**	**4.3**	**4.1**	**4.2**	**4.2**	**4.1**	**4.3**	**4.4**	**4.3**	**4.2**
G4	**1.8**	**1.8**	**1.9**	**1.8**	**2.1**	**1.9**	**1.9**	**1.6**	**1.5**	**1.5**	**1.5**	**1.7**	**1.8**	**1.9**	**1.5**
United States	2.4	2.6	3.0	2.5	3.2	2.7	2.0	2.0	1.8	2.0	2.3	2.4	2.6	2.5	2.1
Euro Area	1.7	1.4	1.1	1.2	1.1	1.3	1.6	1.6	1.6	1.5	1.4	1.2	1.4	1.4	1.4
Japan	0.2	0.1	0.6	0.7	1.2	1.1	2.6	0.3	0.1	0.0	-1.4	0.8	0.4	1.3	-0.2
UK	0.9	1.4	0.8	1.3	1.4	1.0	1.0	0.9	1.2	1.4	1.3	1.2	1.4	1.0	1.2
BRIC	**6.6**	**7.0**	**7.0**	**7.0**	**7.0**	**6.9**	**6.7**	**6.7**	**6.8**	**6.7**	**6.7**	**6.7**	**7.0**	**6.8**	**6.7**
China	7.5	7.8	8.0	8.0	7.9	7.8	7.7	7.7	7.6	7.6	7.5	7.5	8.0	7.7	7.5
India	7.0	8.4	8.0	8.4	8.3	7.8	7.6	7.4	7.7	7.4	7.5	7.8	8.0	7.7	7.6
Brazil	2.9	1.7	1.1	1.5	1.8	2.5	2.6	2.7	2.8	2.8	2.6	2.7	1.8	2.4	2.7
Russia	2.9	2.8	2.5	2.5	2.5	2.2	1.9	1.7	2.0	2.2	2.2	2.3	2.6	2.0	2.2
Investment (%Q, SAAR)															
Global (G4 BRIC)	**4.1**	**4.1**	**3.5**	**4.4**	**4.2**	**3.9**	**4.1**	**3.7**	**4.2**	**4.3**	**4.1**	**4.0**	**4.4**	**4.1**	**4.0**
G4	**3.3**	**5.6**	**2.4**	**3.2**	**2.6**	**2.7**	**2.7**	**1.7**	**2.8**	**3.4**	**3.4**	**2.6**	**3.7**	**2.9**	**2.7**
United States	6.9	6.2	1.1	3.3	1.8	1.7	0.6	1.2	2.3	3.3	4.0	2.6	4.8	2.0	2.3
Euro Area	0.3	5.9	6.7	3.2	4.1	4.0	4.2	3.9	3.5	3.4	3.2	3.0	3.8	4.4	3.6
Japan	0.6	7.4	-1.8	2.7	4.1	5.1	5.7	-3.3	2.5	4.1	2.3	1.9	1.8	3.2	2.2
UK	-1.2	-3.9	-1.8	3.4	-1.9	-0.8	4.1	3.3	3.1	2.7	2.4	2.2	0.0	1.1	2.8
BRIC	**4.9**	**2.7**	**4.5**	**5.7**	**5.8**	**5.0**	**5.4**	**5.7**	**5.6**	**5.1**	**4.8**	**5.2**	**5.1**	**5.3**	**5.3**
China	4.1	4.1	4.1	4.1	4.4	4.4	4.4	4.4	4.2	4.2	4.2	4.2	4.1	4.4	4.2
India	9.7	3.0	6.6	10.7	10.5	6.5	7.6	9.5	9.6	7.4	6.1	8.6	9.8	8.4	8.3
Brazil	1.1	-7.2	6.1	7.4	5.3	6.1	7.4	6.1	7.4	7.4	7.8	4.9	2.6	5.5	7.0
Russia	0.6	0.8	0.4	1.2	2.4	3.6	4.1	3.2	2.8	2.8	2.8	2.8	1.0	2.6	3.0
Investment (%Y)															
Global (G4 BRIC)	**5.0**	**4.4**	**4.3**	**4.0**	**4.1**	**4.0**	**4.2**	**3.9**	**4.0**	**4.1**	**4.1**	**4.1**	**4.4**	**4.1**	**4.0**
G4	**3.7**	**3.7**	**4.1**	**3.6**	**3.4**	**2.7**	**2.8**	**2.4**	**2.5**	**2.6**	**2.8**	**3.1**	**3.7**	**2.9**	**2.7**
United States	4.6	5.2	5.1	4.3	3.1	1.9	1.8	1.3	1.4	1.8	2.7	3.0	4.8	2.0	2.3
Euro Area	3.5	2.8	4.8	4.0	5.0	4.5	3.9	4.1	3.9	3.8	3.5	3.3	3.8	4.4	3.6
Japan	1.7	2.1	1.4	2.1	3.0	2.5	4.4	2.8	2.4	2.2	1.4	2.7	1.8	3.2	2.2
UK	2.9	0.3	-1.0	-0.9	-1.1	-0.3	1.1	1.1	2.4	3.3	2.9	2.6	0.0	1.1	2.8
BRIC	**6.4**	**5.1**	**4.6**	**4.5**	**4.7**	**5.3**	**5.5**	**5.4**	**5.4**	**5.4**	**5.3**	**5.1**	**5.1**	**5.3**	**5.3**
China	4.1	4.1	4.1	4.2	4.3	4.4	4.4	4.4	4.3	4.2	4.2	4.1	4.1	4.4	4.2
India	14.0	10.1	7.9	7.4	7.6	8.5	8.8	8.5	8.3	8.5	8.2	7.9	9.8	8.4	8.3
Brazil	5.1	2.2	1.7	1.7	2.7	6.2	6.6	6.2	6.8	7.1	7.2	6.9	2.6	5.5	7.0
Russia	2.4	0.8	0.9	0.7	1.2	1.9	2.8	3.3	3.4	3.2	2.9	2.8	1.0	2.6	3.0

Source: Morgan Stanley Research forecasts; *Global includes G4 and BRIC, PPP-weighted. Note that the %Y quarterly number for China is based on interpolations of the annual forecast and does not represent our official quarterly forecast.

Bull-base-bear scenarios – DM

Bear	Base	Bull
US: Ellen Zentner & US Economics Team		
Full-blown trade escalation leads to a decline in investment, while volatile markets and a **material widening in corporate credit spreads** add further restraint to the economy through a **significant and sustained tightening of financial conditions.** With incoming data pointing to **negative GDP growth in 2H19,** the **Fed begins to cut rates and halts balance sheet drawdown. Rate cuts accelerate in 2020,** falling back to zero **as the US recession deepens.**	A record-high tax refund season sends consumption higher in early 2019. Thereafter the hole is larger as demand has been pulled forward and the hangover from stimulus is taking hold. **By the September 2019 FOMC meeting the Fed sees the economy slowing to below potential** and takes this as evidence that rates must be around neutral, therefore **pausing on rate hikes.** In 2020, easing financial conditions, rising inflation and growth regaining momentum prompt the Fed to restart hikes.	The economy continues to grow well above trend. **Productivity remains higher and labour force participation picks up notably, buying time on the supply side of the economy.** Eventually, the economy runs hot though as a non-linear Phillips curve comes through. prompting the Fed to raise rates at every meeting by 2H20. Highly restrictive monetary policy leads to fading growth momentum as the year ends with the economy very clearly entering the stall/overheating phase.
Euro area: Daniele Antonucci & EA Economics Team		
Trade relations deteriorate and the **global economy slows,** causing euro area growth to stagnate. **Political risks in Italy and Germany** become more prominent and **generate policy and broader market uncertainty.** A weaker macro outlook and **more restrictive financial conditions keep the ECB on hold** throughout.	**GDP growth moderates towards trend. Capex remains a bright spot,** but is offset by less supportive exports and the lack of fiscal stimulus in 2020. The **labour market continues to tighten,** wage growth accelerates and **core inflation rises gradually to move above its long-term average.** The **ECB normalises policy slowly,** with a first depo rate hike in October 2019 followed by two more in 2020.	**Fiscal policy becomes more expansionary,** while **improved prospects for European fiscal integration boost sentiment,** keeping GDP growth above trend. **Wage growth accelerates more quickly,** boosting consumer spending but also generating inflationary pressure. Stronger wage growth means the **ECB hikes rates more aggressively,** twice in 2019 and three times in 2020.
Japan: Takeshi Yamaguchi & Hiromu Uezato		
Weaker external demand including a **US recession hurt Japan's exports and capex.** The BoJ **maintains existing policy, while fiscal policy becomes more expansionary** in a reactive manner. The government **postpones the next consumption tax hike** in the case of tightening in global financial conditions in anticipation of a US recession in 2H19.	We retain our view that the **late-cycle economic expansion will continue** until the next consumption tax hike in October 2019, led by domestic demand. We expect a **slowdown after the tax hike,** mainly in private consumption, but we do not expect a recession in our base case. We expect the **BoJ to lift NIRP in 1H19 (base case: April 2019) ahead of the c-tax hike.**	Japan's **exports and capex gain from a stronger-than-expected global recovery.** A weaker yen trajectory supports Japan's exports and corporate profits. Other upside risks include **more expansionary fiscal policy,** either by sustained fiscal spending or postponement of the next c-tax hike. The **BoJ may lift NIRP early in 1Q19, but we do not expect further rate hikes.**
UK: Jacob Nell & Bruna Skarica		
With **Brexit talks deadlocked, a disruptive no deal Brexit looms.** To avoid it, the sides agree a bare bones withdrawal agreement and for the UK to enter a transition period without clarity on the future UK-EU relationship. We project that **growth would average 1%Y amid weak investment and protracted uncertainty.** Domestically generated inflation would be weaker – partially offset by stronger imported inflation from a weaker GBP – and the **BoE would hike only** once a year.	We see heightened volatility in the Brexit endgame, which causes growth to slow in 4Q18/1Q19. In the end, we expect a **transition period which lasts until January 1, 2022, and an ultimate soft Brexit.** This opens the door to a **modest 2019 recovery.** With the economy at full employment, inflation above target and easier fiscal policy, the **BoE picks up the pace of tightening once Brexit has been navigated, with the first hike in May 2019**, and a cumulative five hikes by end-2020.	After a period of heightened uncertainty, reflecting the lack of political consensus in the UK on relations with Europe, the UK decides **ultimately on a softer Brexit than the base case.** In this scenario, we would **expect a stronger recovery with higher growth than in the base case,** and a **more aggressive tightening by the BoE** – likely a hike once a quarter when the Inflation Report is released – with a cumulative six rate hikes by end-2020.

Bull-base-bear scenarios – EM

Bear	Base	Bull
China: Robin Xing, Jenny Zheng & Zhipeng Cai		
A **25% US tariff on all Chinese goods drags** down **China's growth by 1.3pp,** leading to **more meaningful policy stimulus** – a **rebound in broad credit growth to 14-15%Y, the fiscal deficit widening to 4.5% of GDP** and the local government special bond issuance quota more than doubling. In turn, real GDP growth could reach 5.6%Y in 2019 and 5.3%Y in 2020. Meanwhile, **CPI could reach 3.3%Y in 2019 due to China's 25% tariff on all American goods and widespread swine flu.**	**GDP growth moderates** to 6.3%Y in 2019 (vs. 6.6%Y in 2018) with **policy support to private sector and infrastructure partly offsetting drags from trade tensions.** CPI rises to 2.6%Y in 2019 (vs. 2.2%Y in 2018) on supply-side factors, but core CPI likely remains soft. We expect a **~1pp rebound in broad credit growth, a wider fiscal deficit** (4.0% of GDP in 2019 vs. 3.3% in 2018), and **higher local government bond issuance quota** (Rmb2.0trn in 2019 vs. Rmb1.35trn in 2018).	**A US-China trade deal** and **removal of implemented/proposed tariffs** could alleviate the overhang for China's exports and **improve the outlook for manufacturing capex**. Meanwhile, policy-makers could implement a modest cut in tax rates to restore business confidence. In turn, GDP growth could hold up at 6.7%Y in 2019. Meanwhile, we expect a modest CPI reflation, to 2.3%Y in 2019-20, as slightly stronger core CPI could offset eased supply-side pressures from tariff removal and well-contained swine flu.
India: Upasana Chachra & Avni Jain		
We build in a **weaker growth trend due to global factors** (higher oil prices, trade escalation and financial conditions tightening) **and deteriorating macro stability.** On the domestic side, policy uncertainty post elections in May 2019 along with tighter-than-expected liquidity conditions impact growth adversely. We estimate **growth to decelerate to 6.8%Y in our bear case, with a faster pace of rate hikes from the RBI in response** to weaker macro stability.	**Economic growth remains healthy,** even though we build in a marginal growth deceleration of 10bp in 2019 taking into account some adverse impact of higher interest rates, oil prices and currency depreciation. However, the underlying trend remains **supported, driven by consumption, exports and incipient signs of a broadening capex recovery.** The RBI resumes hikes in 2Q19, real rates remain largely range-bound and fiscal policy consolidation stays on track.	In the bull case, the **private capex turnaround is stronger** due to a greater pick-up in external and domestic demand. The **global environment is benign,** with positive spillovers for global capital market flows to India. Domestically, **stronger fiscal spending ahead of the elections,** coupled with a win for the incumbent government, provides support. **Macro-stability indicators remain strong and stable,** which allows the **RBI to reduce the pace of rate hikes.**
Russia: Alina Slyusarchuk		
We see **weaker external demand and new geopolitical tensions** resulting in the **US imposing additional sanctions on Russia.** The state increases control over the economy and **fails to deliver micro reforms to boost growth.** This keeps uncertainty high and investment depressed. External pressures **weaken RUB and fuel inflation,** which erodes household incomes and **forces the CBR to hike rates** more aggressively.	**Tight fiscal and monetary policy result in growth slowing down** to 1.5%Y in 2019. The VAT increase should put **upward pressure on inflation and weigh on consumption**. Assuming only partial FX pass-through, we expect 2019 CPI to average 5.0%Y, which should **force the CBR to hike the key rate to 8.00% in 1Q19.** The fiscal rule preserves budget discipline and results in a budget surplus at 2.5% of GDP.	The **pro-reform government agenda** goes beyond increasing expenditure on infrastructure, education and healthcare, and **includes public service reform,** reducing the share of the state in the economy and raising productivity. The measures **remove bottlenecks, support investment and total factor productivity** and increase potential growth. We also see **Western sanctions being eased gradually,** supporting business confidence and growth further.
Brazil: Arthur Carvalho & Thiago Machado		
The approval of important structural reforms, mainly the pension reform, is delayed, while global growth also weakens more visibly. In the absence of such measures, growth is impacted negatively mainly through the confidence channel, while putting significant downward **pressure on the currency and generating inflation in 2019 and 2020.** This forces the **central bank to hike rates earlier than expected in 2019.**	Regarding the reforms, we think that a **watered down version of the pension reform is approved in late 2019**. A **stable currency, low rates and large slack allow the economy to recover, without material inflationary pressures.** With inflation at target, we don't think the **central bank will be forced to hike rates any time soon.** Only when faced with the prospect of inflation rising somewhat above the centre of the new target (4%Y) do we expect it to start a hiking cycle (4Q19).	We see **a more comprehensive version of the pension reform** and other initiatives approved. This has a very positive impact on growth in 2019 and 2020, boosting investment and productivity. At the same time, inflationary pressures remain absent, since there is a lot of slack in the economy and the currency remains supported. As a result, the **central bank leaves rates unchanged for longer than expected.**

US: Managing neutral

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The Fed manages policy around neutral. A record-high tax refund season front-loads consumer spending, investment remains modest, while net trade and housing are a drag. In 2020 growth re-accelerates and inflation is higher. The Fed sees the need to do more.

Back below trend in 2019: Combined tax stimulus and increased government spending provided significant tailwinds to economic growth in 2018 that are now fading. From a contribution of roughly 0.8pp in 2018 to just 0.2pp in 2019, diminishing government support accounts for a good deal of the **slowdown in headline GDP growth we expect from 3.1% 4Q/4Q in 2018 (2.9%Y) to 1.7% 4Q/4Q in 2019 (2.3%Y)**.

Following a high-water mark of 4.2%Q SAAR in 2Q18, growth slows sequentially with the exception of a pop in consumer spending in 1Q19 on a one-off record-high tax refund season. Thereafter the hole in spending is larger as demand has been pulled forward, particularly for consumer durable goods. By mid-2019, the hangover from stimulus is taking hold as fading fiscal support, coupled with Fed rate hikes, bite and are reflected in tighter financial conditions. The economy slows in 2Q-3Q19 to just 1.4%Q SAAR on average, akin to a growth correction.

Business investment is constrained as larger firms continue to digest the effects of tariffs on margins and supply chains while small-to-medium businesses settle into a glide path post-tax cuts. Interest rate-sensitive sectors such as housing and autos make no contributions to growth as Fed rate hikes work their way through credit markets. The labour market tightens further with the unemployment rate falling to 3.4% in 2019, helping to drive up prime-age labour force participation. Wage growth accelerates to 3.5%Y in 2019 following 3.1%Y growth in 2018.

Further ahead, a responsive Fed results in an easing of financial conditions in 2H19 and growth recovers back to above-potential in 2020 at a pace of 2.3% 4Q/4Q (1.9%Y). Strong growth sends the unemployment rate lower to 3.2%, while wages accelerate further to 4.0%Y. The Fed is caught playing catch-up to an overheating economy.

Overshoot in 2019 is modest, rising inflation becomes a problem in 2020: Core PCE inflation ends 2019 higher at 2.3%Y, in part from tariffs on Chinese imports passing through to consumer prices and upward pressure from accelerating wages in a tight labour market. Further declines in the unemployment rate move the economy onto the steep portion of the non-linear Phillips curve. Year-on-year core PCE inflation accelerates further to 2.5%Y by end-2020.

The Fed pauses after June, then accelerates in 2020: While it searches for neutral, the Committee hikes in December, March and June, but by the September 2019 meeting it sees the economy slowing to below potential growth and takes this as evidence that rates must be around neutral (2.875%). The Committee moves into what New York Fed President Williams has called the "third phase" of policy-making – managing policy around neutral. We believe that this 'wait-and-see' approach will become the dominant conversation in the back half of 2019 as the Fed sits on rates. In 2020, with growth back above potential and core PCE inflation rising further, it feels the need to move rates into restrictive territory – prompting the FOMC to raise the fed funds rate four additional times, bringing the terminal rate to 3.875% by year-end.

Recession probability is low in 2019, but jumps in 2020: In 2019 the probability of recession remains low at 15%, but naturally rises in 2H around the growth correction. By 2H20, the economy shows clear signs that it has entered the last stage of the expansion, the stall/overheating phase of the business cycle where we see the probability of recession rising to 30%.

United States: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**2.2**	**2.9**	**2.3**	**1.9**
Private consumption	2.5	2.6	2.5	2.1
Government consumption	-0.1	1.9	2.7	1.0
Gross fixed investment	4.0	4.8	2.0	2.3
Contribution to GDP (pp)				
Final domestic demand	2.6	3.1	2.5	2.1
Net exports	-0.4	-0.3	-0.3	-0.2
Inventories	0.0	0.0	0.2	0.0
Unemp. rate (eop, % labour force)	4.1	3.7	3.4	3.2
CPI (%Y)	2.1	2.4	1.8	2.6
Core PCE (%Y)	1.6	1.9	2.2	2.4
Policy rate (eop, %)	1.375	2.375	2.875	3.875
General govt. balance (% GDP)	-3.5	-3.7	-4.1	-3.9
Gross govt. debt (% GDP)	105	106	107	107
Current account balance (% GDP)	-2.3	-2.4	-2.6	-2.9

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

Euro area: Heading for the exit

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Growth should moderate towards trend. Inflationary pressures are likely to rise. The ECB will no longer expand its balance sheet, and hikes rates three times. The political environment is likely to result in a push for region-wide fiscal tools.

Cyclical momentum loses steam: The economy looks relatively solid domestically, with a moderate deceleration driven partly by transitory factors, e.g., weakness in the car industry following new EU emission standards. Following a short-term rebound once these temporary effects peter out, tighter capacity constraints and a worsening export outlook suggest that economic growth will likely continue to slow towards its potential rate. The expansion looks endogenously sustainable, with neither overheating requiring a sharp policy tightening nor major imbalances that are about to unwind. Productivity growth looks set to rise, but should remain structurally weak and below pre-crisis levels.

Core inflation makes a comeback: Price pressures will likely continue to rise as long as the economy expands above trend – our base case for 2019. The output gap is now positive, capacity utilisation rates are elevated across sectors, the unemployment rate is at NAIRU and broader measures of labour underutilisation are diminishing. As economic slack declines further, both wage and unit labour cost growth should feed through more visibly. In the context of widespread mechanisms of wage bargaining and backward indexation, these dynamics should self-reinforce, thus pushing core inflation higher – eventually back to its long-term average. The lagged effect of past currency weakness should offset some of the recent softness in commodity prices.

Central bank begins to tighten: We continue to expect the first depo rate hike, by 15bp to -0.25%, in October 2019. With less spare capacity and higher core inflation, a more hawkish ECB will want to rebuild a cushion of rates, to eventually lower it when the next downturn comes. We expect the second rate hike, of 25bp for the depo and the refi rates, in March 2020, and a third one of the same magnitude for both rates in September. While QE stops at end-2018, reinvestments should continue throughout, with 'operation twist' to mitigate the rise in long-term interest rates. Shorter-term facilities to avoid central bank liquidity to the banking system declining sharply when the four-year TLTROs expire are likely, though they'll probably be at less favourable borrowing rates.

Common fiscal tools become a priority: As the ECB has very limited room to cut rates and its balance sheet has already expanded considerably, core countries are looking for ways to supplement its remaining monetary policy tools. We expect that the debate on a 'federal' budget for the region as a whole will progress. Possible proposals range from an unemployment insurance fund and cash for reform to a facility to backstop public investment and turning the ESM rescue fund into a sort of European Monetary Fund. We think that the political landscape in Germany is supporting some of these changes, as they build shock absorbers with little or no risk-sharing. To us, this seems true for Italy too, as these tools are the only ones capable of engineering a fiscal boost without raising funding costs.

Continued uncertainty doesn't rock the boat: The European Parliament election in May 2019 may raise political volatility. But we believe that the end result, given the prevalence of absolute majority voting, is more likely to be a push towards a fiscal expansion rather than a more permanent fracture in the EU. The German and Italian situations are in a state of flux, although a policy shift at some point may reinforce the effort of fiscal integration, rather than hinder it. Rising trade tensions and tighter financial conditions are key downside risks, in part offset by a weaker currency in the short term and a potentially bigger fiscal impulse in the long term.

Euro area: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**2.5**	**1.9**	**1.6**	**1.5**
Private consumption	1.7	1.4	1.4	1.4
Government consumption	1.2	1.0	1.3	1.3
Gross fixed investment	2.9	3.8	4.4	3.6
Contribution to GDP (pp)				
Final domestic demand	1.8	1.7	1.9	1.8
Net exports	0.8	0.2	-0.3	-0.3
Inventories	-0.1	0.0	-0.1	-0.1
Unemp. rate (eop, % labour force)	8.7	7.9	7.6	7.5
HICP (%Y)	1.5	1.8	1.9	1.7
Core HICP (%Y)	1.0	1.0	1.4	1.5
Policy rate (eop, %)	-0.40	-0.40	-0.25	0.25
General govt. balance (% GDP)	-0.9	-0.8	-0.9	-0.4
Gross govt. debt (% GDP)	86.7	84.7	83.1	81.2
Current account balance (% GDP)	3.2	3.3	3.1	3.0

Source: ECB, Eurostat, Morgan Stanley Research forecasts

Japan: From NIRP to ZIRP

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The consumption tax hike will likely cause swings in growth and prices, and also affect fiscal and monetary policy. Fiscal spending along with tax revenue is on an expansion path. Unless the BoJ tweaks policy in 1H19, its hands are likely to be tied thereafter.

Growth to swing on consumption tax hike: We trim our 2019 growth forecast from 1.5%Y to 1.3%Y, but we retain our view of a domestic demand-led expansion until the October 2019 consumption tax hike. We expect private consumption to remain solid until the tax hike. Employee income should continue to rise amid low levels of unemployment. In addition to front-loaded spending, we expect replacement demand for goods purchased under the eco-points programme during 2009-11, and events such as the new emperor's enthronement and Rugby World Cup can also buoy consumer sentiment. We have lowered our forecast for exports, but expect productivity-enhancing capex to remain solid on demographics-driven labour shortages and low real interest rates.

Slowdown after the consumption tax hike appears inevitable: We expect growth to slow to 0.6%Y in 2020, below the potential trend of about 1%Y. Consumption should moderate not only due to a payback from front-loaded spending but also on perceived lower levels of permanent disposable income. However, in our base case, we are not expecting a recession, given that the upcoming consumption tax increase is smaller than last time in 2014, the reduced rate applied to food, and the likelihood that the government will adopt a range of measures to cushion the economic impact.

Special factors to affect prices: We expect the underlying inflation trend to pick up gradually in 1H19, but it will likely decelerate after the tax hike, reflecting slower growth. The Japan-style core CPI will be affected by special factors such as free preschool education and cuts in mobile phone charges. Core-core CPI (ex. consumption tax) could turn negative temporarily year on year, affected by the special factors. Yet, we think the underlying trend excluding these factors, while slowing, will maintain positive growth, with no return to deflation.

No change in our out-of-consensus BoJ call: We think that the BoJ's reaction function shifted away from an approach that prioritises prices under simple inflation targeting, in favour of one that gives greater consideration to the financial system and market functions. We still expect the BoJ to lift NIRP in 1H19 (April 2019 in our base case). The wording of "around 0%" on the long-term policy rate will likely be maintained, but we think that its effective upper limit is already set at around 25bp. We also expect the current wording of the policy for asset purchasing including ETFs to be maintained.

Headline risk of a big supplementary budget: A large-scale second F3/19 (FY 2018) supplementary budget proposal could surface by year-end, and we need to be alert to headline risk in the media. The announced figures will likely be inflated by fiscal loan programmes. That said, we currently expect the 'real-water' portion affecting GDP to be about JPY 3-5 trillion spread over several years. In addition to free preschool education, possible measures to alleviate the tax hike impact include rebate points for cashless payments in small/medium-sized stores, means-tested gift vouchers, temporary suspension of automobile fuel tax and extending tax breaks on mortgages, but none of these would likely offset the negative tax impact completely.

Risks skewed to the downside: With the economy in a late-cycle stage, the risks are skewed towards the downside. Deceleration of the overseas economy on the back of US-China trade tension and higher US interest rates poses the biggest risk. Although this is not our base case, we see a risk of the economy falling into a shallow recession after the consumption tax hike. If global financial conditions tighten in 1H19, chances of tax hike postponement would rise.

Japan: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**1.7**	**0.8**	**1.3**	**0.6**
Private consumption	1.0	0.4	1.3	-0.2
Government consumption	0.4	0.5	0.5	0.4
Gross fixed investment	2.5	1.8	3.2	2.2
Contribution to GDP (pp)				
Final domestic demand	1.3	0.7	1.6	0.6
Net exports	0.5	0.1	-0.3	0.0
Inventories	-0.1	0.1	0.0	0.0
Unemp. rate (eop, % labour force)	2.8	2.4	2.3	2.4
CPI (%Y, ex. VAT)	0.5	1.1	0.6	-0.1
Core-core CPI (%Y, ex. VAT)	0.1	0.4	0.3	0.1
Policy rate (eop, %)	-0.1	-0.1	0.0	0.0
General govt. balance (% GDP)	-4.3	-3.9	-3.4	-3.2
Gross govt. debt (% GDP)	237	239	237	239
Current account balance (% GDP)	4.0	3.6	3.6	3.4

Source: Bank of Japan, Cabinet Office, Ministry of Internal Affairs and Communications, Ministry of Finance, Morgan Stanley Research forecasts; Note: Forecast table show calendar years, not fiscal year. CPI figures include free child education impact.

UK: Soft Brexit, hawkish MPC

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We expect a difficult Brexit endgame. In our base case which is a soft Brexit, we see a modest recovery. With an economy at potential, inflation above target, rising pay and fiscal stimulus, we expect a hawkish MPC to deliver a cumulative five hikes, taking rates to the MPC's neutral range by end-2020.

Endgame slowdown, modest post-Brexit recovery: Near term, through a period of enhanced volatility in the Brexit endgame, we expect growth to slow sharply. But from 2Q19, we see a recovery in growth as the tail risk of a hard Brexit is removed, and greater certainty triggers a rebound in investment. However, we see the recovery as muted, given considerable residual uncertainty, pending conclusion of the detailed trade talks, a stretched consumer and fading support from trade, as GBP strengthens. Still, with weak productivity and low immigration, we expect growth to outpace potential, which we now peg at around 1.3%Y.

Rising homemade inflation: We see rising cost pressures from the tight labour market, which drives pay up towards 4% 3M/Y in 2020. In the absence of a robust recovery in productivity, this in turn drives core and services inflation higher, and holds headline inflation above target, offsetting the impact of a stronger GBP. We see the CPI-RPI wedge troughing at around 50bp at end-2019 on lower energy prices and our below-consensus call for flat house prices.

Hiking to the neutral range: With the output gap closed, inflation above target, pay growth running above a level consistent with hitting the inflation target and significant fiscal stimulus in the pipeline, we think that the MPC will be keen to pick up the pace of tightening once the UK is firmly on the path to a soft Brexit. We expect two hikes in 2019, and a further three in 2020, taking rates to the bottom end of the MPC's neutral range of 2-3% by end-2020. We also expect an early start to QE unwind in late 2019, once the MPC is firmly on a steeper tightening path. Against the backdrop of high levels of gilt issuance by the DMO in 2019/20 and 2020/21, we expect the early focus to be on reducing the BoE's funding of commercial banks rather than the stock of gilt holdings.

Late-cycle fiscal stimulus: Chancellor Hammond delivered a 0.6% of GDP 2019 loosening in fiscal policy in the 2018 budget, and has promised further loosening as a "Brexit deal dividend". We expect this loosening – largely in the form of increased current spending – to be delivered in 2020. This drives a modest widening of the deficit.

External deficit widens modestly: The combination of a weaker GBP and stronger external demand growth has been effective in halving the UK's current account deficit since 2015. However, with a stronger GBP forecast and a UK recovery, we see a modest reopening of the current account over the forecast period.

Bear and bull: Our bear case assumes that the UK fails to achieve a political consensus around its preferred form of Brexit. Assuming a shared interest in avoiding a disruptive no deal outcome, we see the UK exiting into a temporary transition period from March 2019 in advance of providing clarity on its preferred future EU-UK relationship. In this scenario, we expect the uncertainty and continuing risk of a hard Brexit to weigh on growth and limit MPC hikes to one a year. In our bull case, the UK decides on a softer Brexit than the base case, triggering stronger growth from mid-2019 and six hikes by end-2020.

United Kingdom: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**1.7**	**1.2**	**1.3**	**1.6**
Private consumption	1.8	1.4	1.0	1.2
Government consumption	-0.1	0.5	1.9	2.8
Gross fixed investment	3.3	0.0	1.1	2.8
Contribution to GDP (pp)				
Final domestic demand	1.7	1.0	1.2	1.8
Net exports	0.7	0.4	0.2	-0.2
Inventories	-0.6	-0.1	0.0	0.0
Unemployment rate	4.4	4.1	4.2	3.9
CPI	2.7	2.5	2.1	2.1
Core CPI	2.4	2.1	2.2	2.5
Policy rate	0.50	0.75	1.25	2.00
General govt. balance (% GDP)	-1.8	-1.4	-1.4	-1.7
Gross govt. debt (% GDP)	87.4	83.7	82.7	81.9
Current account balance (% GDP)	-3.7	-2.8	-3.3	-3.5

Source: ONS, BoE, Morgan Stanley Research forecasts

Australia: Navigating cross-currents

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A deteriorating housing market will keep the consumer under pressure and see growth ease back below trend for 2019 and 2020. Debt concerns and policy uncertainty will see the RBA stand pat for 2019, before hiking twice in early 2020 on a lower AUD and gradual wage and price increases.

Headwinds and tailwinds: We expect GDP growth to slow back below trend in 2019 to 2.5%Y after a strong 2018 (3.3%Y). The deteriorating housing market is the key headwind, weighing on consumption and construction, while government spending, business investment and the lower AUD provide important supports. The RBA should navigate these cross-currents by holding rates over 2019, before the slow build of inflation and wage pressures sees two hikes from 1Q20.

Housing market the key driver: We expect real house prices to decline 10-15% peak-to-trough, which will be the key headwind facing the economy in 2019 and 2020. The wealth effects of falling house prices should see consumption moderate even as incomes improve somewhat, leaving the savings rate higher at 2-3%. Solid global growth and the non-household sector should assist a benign deleveraging and avoid a sharper pullback in spending. The pipeline of housing under construction remains large and should support activity in the near term, but work should decline from early 2019, especially on apartments, helping to close the supply gap in 2020.

Government an important offset into an election year: Despite this significant headwind to the economy, non-household spending looks like it will remain robust. Government spending should continue to provide important support, both through infrastructure and regular spending (the planned 3Q19 tax rebate should also provide a short boost to consumption). The upcoming federal election (expected May 2019) presents some policy risks, with the opposition Labor party proposing significant tax policy changes that we expect will be a net negative for housing prices and turnover.

More jobs to come: We expect the run of strong jobs growth we have seen over the past two years to continue into 2019 and 2020, albeit at a slightly slower pace of 1.6%Y (+200k jobs). Unemployment should hold above 5% for most of the year, before dipping to 4.9% in 4Q19 and dropping to 4.7% in 2020. The declines in unemployment to date, and its continuation, should see an improvement in wage growth – although this will be extremely gradual (we expect the WPI at 2.6%Y for 2019 and 2.8%Y for 2020). This suggests an improving income picture for households, although growth in disposable income should remain below its decade-average.

Improving inflation sees tentative RBA hikes: We expect a gradual increase in inflation over the next few years, moving definitively into the RBA's 2-3%Y target band in late 2019. In the near term, this is driven by tradables inflation helped by AUD depreciation (both moves to date and its expected continuation), before the building labour cost pressures begin to feed into prices. The RBA should remain patient despite this, given the uncertainty around housing and the federal election, holding rates throughout 2019. With more certainty in 2020, we expect rate hikes in 1Q and 2Q, before the cash flow impacts on the subdued consumer and slowing momentum in inflation should see it on hold for the rest of the year.

Risks: Our bull case sees housing prices trough, limiting the consumer pullback, keeping growth above trend and accelerating RBA rate hikes. Our bear case sees consumer deleveraging slowing growth substantially, impacting the labour market and pushing the economy into a balance sheet recession in 2020.

Australia: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**2.2**	**3.3**	**2.5**	**2.6**
Private consumption	2.7	2.6	1.7	2.2
Government consumption	3.6	5.1	3.7	3.6
Gross fixed investment	3.2	2.7	0.7	1.2
Contribution to GDP (pp)				
Final domestic demand	3.0	3.3	1.8	2.3
Net exports	-1.0	-0.1	0.7	0.3
Inventories	-0.1	0.1	-0.1	0.0
Unemp. rate (eop, % labour force)	5.5	5.1	4.9	4.7
CPI (%Y)	2.0	1.9	2.0	2.4
Core CPI (%Y)	1.9	1.8	2.1	2.5
Policy rate (eop, %)	1.50	1.50	1.50	2.00
General govt. balance (% GDP)	-2.1	-1.0	-0.8	0.1
Gross govt. debt (% GDP)	28.7	29.3	29.8	29.7
Current account balance (% GDP)	-2.6	-3.0	-3.7	-3.5

Source: ABS, RBA, Morgan Stanley Research forecasts

China: A different easing cycle

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Unlike past cycles, China's current easing efforts focus on the private sector and fiscal policy to ensure its journey to high-quality growth is not disrupted. We expect growth to stabilise starting from 2Q19 at slightly above consensus expectations.

We expect GDP growth to slow from 6.6%Y in 2018 to 6.3%Y in 2019, slightly above consensus expectations. Most of the slow-down occurs in 3Q18-1Q19 as the lagged effects of deleveraging and trade tensions weigh on consumption and business confidence. We think that policy easing will kick in fully by 2Q19 to support private sector and infrastructure, stabilising growth onwards. Over the longer term, we maintain our view that China will stay on the path of a soft landing and journey to high-income, with GDP growth slowing to 6.1%Y in 2020 and 5.5%Y in 2021-23.

Higher inflation not a policy constraint: CPI inflation will likely rise to 2.6%Y in 2019 (versus 2.2%Y in 2018) on tariff hikes and swine flu, and moderate to 2.4%Y in 2020 after these supply-side factors fade. That said, core CPI could edge down to 1.9%Y in 2019 and 1.8%Y in 2020 (versus 2.0%Y in 2018) and PPI could normalise gradually to 2.7%Y in 2019 and 2.0%Y in 2020 (versus 3.8%Y in 2018) amid a slowdown in economic growth. This means that a higher inflation trajectory would not necessarily constrain policy flexibility.

A different policy easing approach... Unlike the previous episodes (2008-09, 2011-12, 2014-15), policy-makers have focused more on growth quality over quantity since late 2016. The current policy may thus focus more on the private sector and fiscal easing, while not reversing achievements related to financial clean-up. We expect 2-3% VAT cuts (on the 16% bracket) with a wider actual on-budget deficit (4.0% of GDP in 2019 versus 3.3% in 2018), a higher local government special bond issuance quota (Rmb 2.0 trillion in 2019 versus Rmb 1.35 trillion in 2018) and a lower social insurance contribution ratio. Policy-makers could also reduce the RRR by 100bp per quarter.

...to ensure more sustained productivity growth: The policy easing measures could lead to a modest rebound in broad credit growth, to 12.5%Y by end-2019 (versus 11.0%Y now), significantly milder than an average rise of 8pp in previous easing cycles. This, combined with a policy pledge on supply-side reform, could help to contain the risk of triggering another debt/disinflation cycle like in 2012-16 due to debt-fuelled overinvestment. Meanwhile, policy-makers will likely continue to attract FDI by loosening the foreign ownership restriction in JVs and widening market access. We thus expect productivity growth to hold up at 2.1-2.2%Y in 2019-20 (versus 2.3-2.5%Y in 2017-18).

Currency outlook: We expect further CNY depreciation in 4Q18-1Q19, as our base case assumes a 25% US tariff on US$200 billion of Chinese goods (versus 10% now) from January. Yet, the nature of domestic policy easing (more fiscal than monetary) and potential rise of passive stock/bond inflows due to global indices inclusion could offset a modest current account deficit (-0.3% of GDP in 2019 and -0.6% in 2020 versus 0.3% in 2018), preventing disruptive depreciation. If the dollar index weakens as our global FX team projects next year, USDCNY could stabilise from 2Q19 and reach 6.85 by end-2019.

Risks tilted to the downside: In our bear case, further escalation in trade tensions with a 25% universal tariff on all Chinese goods could drag down growth by 1.3pp, leading to more meaningful policy stimulus – a rebound in broad credit growth to 14-15%Y, the budget deficit widening to 4.5% and the local government special bond issuance quota more than doubling. In turn, real GDP growth could reach 5.6%Y in 2019 and 5.3%Y in 2020. In our bull case, a US-China trade deal and removal of implemented/proposed tariffs could alleviate the overhang for China's exports and improve the outlook for manufacturing capex, with growth at 6.7%Y in 2019 and 6.5%Y in 2020.

China: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**6.9**	**6.6**	**6.3**	**6.1**
Private consumption	7.0	8.0	7.7	7.5
Government consumption	9.6	11.7	12.0	11.2
Gross fixed investment	4.0	4.1	4.4	4.2
Contribution to GDP (pp)				
Final domestic demand	5.9	6.7	6.8	6.5
Net exports	0.6	-0.5	-0.9	-0.7
Inventories	0.4	0.4	0.4	0.3
Unemp. rate (eop, % labour force)^	5.1	4.9	5.2	5.3
CPI (%Y)	1.6	2.2	2.6	2.4
Core CPI (%Y)	2.2	2.0	1.9	1.8
Policy rate (eop, %)*	3.1	2.6	2.6	2.6
General govt. balance (% GDP)	-3.7	-3.3	-4.0	-4.0
Gross govt. debt (% GDP)	52	53	55	55
Current account balance (% GDP)	1.3	0.3	-0.3	-0.6

Source: CEIC, Morgan Stanley Research forecasts; ^Survey-based urban unemployment rate, available from 2017; *7-day interbank repo rate. We expect the rate to remain stable at the range of 2.45-2.75% throughout the forecast horizon.

India: Still on track despite speed bumps

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The growth recovery should stay on track as policy decisions remain supportive of improving the productivity dynamic, with no evident signs of misallocation in the form of higher inflation or deficits. External pressures in the form of higher oil prices and a stronger US dollar should recede but still represent a key risk to the outlook.

We remain constructive on the outlook: In our view, the key anchor for the macro outlook is the government's policy action to improve the productivity dynamic (trend in fiscal policy, stance on real rates and trend in labour markets) which has been moving in the right direction. We believe that a continued prudent policy mix and a pick-up in capex spending will likely make the cycle more durable as it will help to sustain growth without stoking macro-stability risks. From a cyclical perspective, external pressures from strong US growth/US dollar strength and higher oil prices should also recede in 2019.

Recovery expected to remain on track: Since mid-year, growth indicators have largely evolved along expected lines, with some softening in year-on-year readings as support from the base effect wanes. Consumption growth remains healthy, export growth remains supportive and incoming data on capacity utilisation, commercial vehicle sales and engineering and construction companies' order books suggest a nascent recovery in capex spending. **We expect 2018 growth to remain on track at 7.7%Y.** We believe that prudent policy mix will keep growth at healthy levels and as such we expect **growth at 7.6%Y in 2018 and 7.5%Y in 2020.**

We expect macro stability indicators to remain in check in 2019: Retail inflation has thus far surprised on the downside due to subdued food prices. While we take into account the upside from factors such as higher minimum support prices, an increase in retail fuel prices and INR depreciation, we expect the inflation trajectory to remain benign. Indeed, we see CPI staying well within the RBI's target range at **4.3%Y in 2019 and 4.6%Y in 2020 (4.1%Y in 2018).**

Current account deficit should narrow a tad in 2019: In 2019 we estimate a modest narrowing in the deficit to 2.3% of GDP (from 2.5% in 2018) as oil prices (as per futures curves) remain benign and a correction in the real effective exchange rate closer to the fair value will likely help to address some of the trade imbalance. However, as long as India runs a current account deficit, it remains exposed to external funding risks – though the degree of vulnerability is lower.

Policy rate hikes to continue after a pause: We expect policy rates to be on hold until 1Q19 as inflation remains sub-4%Y. We expect the RBI to resume the hiking cycle in 2Q19 and build in two rate hikes in 2019 and a further two in 2020, as inflation rises from the low of 2018 and the Fed continues with its rate hike cycle in 2020. We believe that maintaining an adequate real rate buffer in an environment of tighter global liquidity conditions will be essential in the context of India's external funding needs.

Risks tilted to the downside: In our view, the risks to the outlook are tilted to the downside, mainly stemming from external factors. The key swing factors from the global side will be strength of the US dollar/rates, potential spillovers from the global capital market environment and the extent of trade tensions impacting global growth. From the domestic perspective, the key swing factors will be the outcome of general elections in 2019, domestic credit conditions and the pace of capex spending.

India: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**6.2**	**7.7**	**7.6**	**7.5**
Private consumption	5.9	8.0	7.7	7.6
Government consumption	11.7	9.8	7.5	7.0
Gross fixed investment	5.4	9.8	8.4	8.3
Contribution to GDP (pp)				
Final domestic demand	6.8	8.7	8.0	7.8
Net exports	-1.1	-1.3	-0.6	-0.3
Inventories	-0.3	0.1	0.1	0.1
CPI (%Y)	3.3	4.1	4.3	4.6
Core CPI (%Y)	4.6	5.8	4.8	4.6
Policy rate (eop, %)	6.0	6.5	7.0	7.5
General govt. balance (% GDP)	-6.7	-6.4	-6.2	-5.8
Gross govt. debt (% GDP)	68.7	68.1	67.8	67.4
Current account (% GDP)	-1.5	-2.5	-2.3	-2.2

Source: RBI, CEIC, Budget documents, Morgan Stanley Research forecasts

Indonesia: Going against the tide

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We see Indonesia's growth rising slightly despite the growth moderation expected in most of Asia. External funding pressure should abate and it is less exposed to trade tension and a China slowdown. Social assistance and infrastructure spending ahead of the election should help to drive better multiplier effects.

Unlike most of the rest of Asia which should see growth moderation, we think that Indonesia can go against the global tide in 2019 due to three factors: External funding pressures, which have put the currency on the backfoot, should abate; Indonesia is less exposed to global growth gyrations and a China slowdown than appears at first glance; and domestic factors such as fiscal spending ahead of elections should also provide some support.

Funding pressures to abate: Indeed, external funding pressure had been a key concern for Indonesia this year, leading to a 175bp hike and currency depreciation. However, we think that the economy can weather this. Improving growth momentum means the economy has some ability to absorb the hikes. Moreover, imperfect monetary policy transmission suggests that lending rates are unlikely to rise by a similar magnitude, blunting the hike impact. There have been concerns that a high level of dollarisation would impart macro-stability and growth risks when the currency depreciates but our analysis suggests that Indonesia has de-dollarised compared to before and the collateral impact of currency volatility has also reduced correspondingly. Indeed, de-dollarisation signs can be seen from the following: External debt/GDP has declined. The share of USD external debt has fallen. The FX loans/GDP and FX deposits/GDP ratios have come off and hedge ratios have gone up. We also see external funding pressure abating into 2019 as the US 10Y yield edges down and USD weakens amid US growth decelerating.

Less exposed to global growth moderation and China slowdown: Global trade is another factor being watched. Indonesia's export momentum will likely moderate, as the global cycle matures and trade tensions linger. However, its low level of trade orientation (exports are 17% of GDP, 12-month trailing sum, as of September 2018) means that it is less exposed to trade risks. Investors have also been concerned about what China's slowdown may mean for Indonesia, particularly through commodity linkages. However, supply-side reforms mean that the causal relationship between China's growth and commodity prices has changed from before. Indeed, supply-side cutbacks have led coal prices to rise despite China's slowdown. In any case, downside risks to commodity prices would not impose the same negative terms of trade as before as Indonesia's commodity trade surplus (as a % of GDP) has fallen to levels lower than pre-2003/04, which is before the commodity supercycle began.

Fiscal spending in election run-up provides support: The presidential and legislative elections are taking place in April 2019, and we expect some fiscal loosening in the run-up to elections. To be sure, fiscal policy is unlikely to be aggressive, given the 3% fiscal deficit ceiling and the need to protect macro stability, but we think that a focus on social assistance and infrastructure will help to generate better multiplier effects and provide growth support to help Indonesia go against the global tide. Over the medium term, structural reforms to improve non-commodities competitiveness would be needed to help Indonesia go on a higher sustainable growth path and at the same time narrow the external funding gap.

Where are the risks? On the domestic demand front, we watch for political/policy risks and what this means for domestic demand, reform momentum and policy direction post-elections. On the external front, the sustainability of global demand, China's macro-rebalancing process, commodity prices and the funding environment are factors to watch.

Indonesia: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**5.1**	**5.2**	**5.3**	**5.3**
Private consumption	5.0	5.1	5.4	5.4
Government consumption	2.1	5.0	5.0	4.0
Gross fixed investment	6.2	6.9	6.0	6.5
Contribution to GDP (pp)				
Final domestic demand	4.9	5.5	5.4	5.5
Net exports	0.3	-1.1	0.0	-0.1
Inventories	-0.2	0.5	-0.1	-0.1
Unemp. rate (eop, % labour force)	5.5	5.3	5.1	4.9
CPI (%Y)	3.8	3.2	3.4	4.3
Core CPI (%Y)	3.1	2.8	3.2	3.9
Policy rate (eop, %)	4.25	6.00	6.00	6.25
General govt. balance (% GDP)	-2.5	-2.0	-2.1	-2.3
Gross govt. debt (% GDP)	29.4	30.3	31.2	31.9
Current account balance (% GDP)	-1.7	-2.9	-2.6	-2.6

Source: CEIC, Morgan Stanley Research forecasts

Korea: External and domestic headwinds converge

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Growth momentum is likely to drift lower as trade growth moderates amid a maturing growth cycle and lingering trade tension. Domestic factors such as slowing capex and uneven labour market conditions add to the headwinds. Fiscal policy is not aggressive enough to provide an offset.

Growth moderation under way: We revise downwards our GDP growth forecasts from 2.9%Y to 2.6% for 2018 and 2.7%Y to 2.5%Y for 2019 and we roll out our 2020 forecast at 2.4%Y. Our numbers are somewhat below consensus and reflect the moderation in external demand and the growing headwinds on the domestic front.

Exports to moderate to still healthy levels: We assume some moderation in 2019 as the global growth cycle matures and global growth slows towards trend and 25% tariffs (up from 10%) are imposed on another US$200 billion of Chinese exports to the US. Korea's export momentum to October shows no obvious signs of being impacted by trade tension, but as a risk to watch, its economy remains one of the most exposed, given relatively high export orientation and high export market concentration risk to China.

Domestic demand is the weaker part of the growth equation: So far, the spillover of exports to domestic demand has been relatively patchy. Facilities capex, which picked up earlier, is now showing signs of pullback as high-frequency indicators such as the equipment investment index contract in 3Q18. In 2H15-2017, construction capex was contributing as much as 45% of headline GDP growth but ongoing macroprudential tightening exerts a drag on the real estate sector, which will increasingly show up in the numbers. Indeed, tighter macroprudential measures are here to stay. The measures implemented so far have led property prices in non-Seoul metropolitan areas to fall but those in Seoul have stayed on an uptrend. Besides, while household credit growth has decelerated, it has not fallen below nominal GDP growth and household debt/GDP has edged higher.

Labour market measures such as a minimum wage hike and employment support schemes not helping consumers to stage a recovery: Retail sales momentum has softened as organic drivers of consumer spending have not picked up uniformly. Indeed, labour market conditions have been patchy despite policy efforts. Job elasticity relative to growth has fallen and employment growth is subdued at 0.1%Y in 3Q18. Wage growth may be better at 5.3%Y in July-August but this recovery has been uneven – stronger for high-income households and weaker for low-income households where the marginal propensity to spend is higher.

Fiscal policy is unlikely to be aggressive enough to offset the moderation even though 2019 government expenditure is expected to see the fastest rise since 2009, as policy-makers are planning for the fiscal deficit to be only slightly more expansionary at -1.8% of GDP (versus the planned -1.7% in 2018). Meanwhile, the BoK could hike once more by 25bp in November 2018 in what is a shallow rate hike cycle, but we do not see it staying on the Fed's normalisation path. Overall, beyond fiscal policy providing any form of near-term support, fulfilling the government's agenda of income redistribution, along with income-led and innovation-led growth on a sustainable basis will take more policy work. We still think it would require policy-makers to go beyond just tackling the symptoms, to improve the underlying productivity and competitiveness of the Korean economy. That, in turn, would likely be achieved by revamping the educational system, pursuing active labour market policies and correcting practices which may have impeded competitiveness before.

Where are the risks? On the external front, global demand, trade tension and China's macro-rebalancing process would be key to watch. On the domestic front, the pace and type of the policy reforms are factors which could affect longer-term productivity and the structural outlook of the economy.

Korea: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**3.1**	**2.6**	**2.5**	**2.4**
Private consumption	2.6	2.8	2.6	2.4
Government consumption	3.4	4.5	5.0	5.0
Gross fixed investment	8.6	-1.5	-1.7	-1.2
Contribution to GDP (pp)				
Final domestic demand	4.4	1.6	1.5	1.6
Net exports	-1.7	0.8	0.9	0.8
Inventories	0.4	0.1	0.0	-0.1
Unemp. rate (eop, % labour force)	3.7	3.9	4.0	4.0
CPI (%Y)	1.9	1.6	1.6	1.5
Core CPI (%Y)	1.5	1.3	1.3	1.2
Policy rate (eop, %)	1.50	1.75	1.75	1.75
General govt. balance (% GDP)	-1.1	-1.2	-1.5	-1.7
Gross govt. debt (% GDP)	38.2	39.0	40.1	41.4
Current account balance (% GDP)	5.1	4.7	5.6	5.6

Source: CEIC, Morgan Stanley Research forecasts

Russia: More monetary tightening ahead

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The fiscal rule and sanctions are likely to keep the economy stagnant in 2019-20. We see average CPI at 5.0%Y in 2019 on the back of the VAT increase and partial FX pass-through. We expect a higher country risk premium and CPI acceleration to force the CBR to hike rates to 8.00% in 2019.

Tight fiscal policy and sanctions to weigh on growth: Presidential elections in 1Q18 and the World Cup in 2Q18 supported growth this year. In 2019 we expect sequential growth to remain broadly stable, while annual growth is set to slow down to 1.5%Y from 1.6%Y in 2018 on the base effect. Since the introduction of the fiscal rule in 2017, the importance of oil prices as a growth driver has diminished and the economy is still struggling to find a new driver. Looking at the domestic factors, in line with President Putin's May orders, budget spending will be redistributed more towards infrastructure spending, healthcare and education from 2019. While we expect this measure to accelerate fixed investment to 2.6%Y next year, an inflation pick-up would weigh on household consumption. Also, adverse external conditions, including sanctions weighing on business confidence, trade tensions and tighter financial conditions, would offset the positive impact of pro-growth measures going forward, so we see GDP growth at 1.6%Y in 2020.

In terms of sanctions, besides the second round of sanctions under the Chemical and Biological Weapons Control and Warfare Elimination Act, there are several Russian sanctions bills which will likely be considered by Congress in early 2019. We assume mild measures avoiding sanctions on new government debt, oil or banking sector.

External and fiscal balances are set to remain solid: In 2018, an oil recovery combined with RUB weakness is likely to secure a 3.4pp of GDP fiscal improvement with the federal budget surplus expected at 2.0%. In terms of external accounts, surging energy exports and an imports slowdown suppressed by RUB weakness should result in a 4.5pp of current account improvement, to US$103 billion or a 6.6% surplus in 2018. In 2019, given the MinFin's conservative oil price assumption, we expect a 2.5% of GDP budget surplus. Also, we expect the C/A surplus to remain solid at US$100 billion or 5.7% of GDP in 2019.

VAT increase in January 2019 and partial FX pass-through are set to accelerate inflation to average 5.0%Y in 2019 from 2.9%Y in 2018. We expect CPI to peak at 5.1%Y in March-May and slow down to 4.7%Y by end-2019. In September the CBR delivered a 25bp rate hike to 7.50%, emphasising that the decision is not the beginning of a hiking cycle. However, more recently in November CBR Governor Nabiullina commented that the CBR would "evaluate the viability of a further rate increase". Inflation has been only somewhat faster than expected recently while core inflation has been well behaved. However, producer prices, broad money supply and short-term inflation expectations have been on the rise. **We see a 25bp rate hike in December, ahead of the VAT hike, and another 25bp hike to 8.00% in 1Q19** to keep monetary policy moderately tight amid rising inflation. As inflation starts to slow down on base effects at end-2019, we see a 25bp cut back to 7.75%, although tightening financial conditions won't let the CBR cut rates below 7.75% in 2020. In terms of **on-market FX purchases,** we expect a gradual return of the CBR to the FX market in early 2019 with a chance of on-market FX purchases being postponed.

In case of more severe US sanctions which is part of our bear case, potentially banning the new sovereign debt, we expect the CBR to hike rates more aggressively in response to RUB weakness and the MinFin to increase the cut-off oil price in the fiscal rule, eliminating the necessity to issue OFZs (government bonds) amid a budget surplus in the coming years.

Russia: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**1.5**	**1.6**	**1.5**	**1.6**
Private consumption	3.4	2.6	2.0	2.2
Government consumption	0.4	0.6	0.9	0.4
Gross fixed investment	4.3	1.0	2.6	3.0
Contribution to GDP (pp)				
Final domestic demand	2.7	1.7	1.8	1.9
Net exports	-2.3	0.2	-0.7	-0.9
Inventories	1.0	-0.3	0.4	0.6
Unemp. rate (eop, % labour force)	5.1	4.9	4.8	4.9
CPI (%Y)	3.7	2.9	5.0	4.0
Core CPI (%Y)	3.5	2.6	5.1	4.0
Policy rate (eop, %)	7.75	7.75	7.75	7.75
General govt. balance (% GDP)	-1.4	2.0	2.5	1.9
Gross govt. debt (% GDP)	12.6	13.6	14.5	15.1
Current account balance (% GDP)	2.1	6.6	5.7	4.5

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

Turkey: Fiscal policy to stay in the spotlight

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Our base case is a major economic slowdown at year-end and a recession in 2019, a further contraction in the CAD and the CBT remaining on hold until there is a gradual fall in CPI starting from 2Q19. The biggest risk to our scenario is a major fiscal policy slippage ahead of elections.

Soft landing ahead: Following ongoing normalisation in geopolitical risks and a significant policy rate hike, TRY appreciated by around 25% and 10Y local bond yields declined by around 580bp compared to their weakest levels in August. Yet, financial conditions are still very tight compared to 1H18. For example, TRY lending rates for household and corporate loans are up by 20pp and 14pp in the last 12 months to 36% and 29%, respectively. The initial impact of higher interest rates and the weaker currency is starting to be seen in the leading growth indicators, including weekly loan growth data, PMI and confidence indices. TRY loans (in TRY) and FX loans (in USD) are down by 3% and 2%, respectively in nominal terms in the last three months. We expect the slowdown in economic activity to become more pronounced from 4Q18 and forecast a recession in 2019 with quarterly economic growth to turn positive from 3Q19. We revise our growth forecast for 2019 to -0.7%Y from +0.8%Y.

500bp rate cut in 2019: Our strategy team is expecting a 13.3%Y depreciation in TRY in 2019. Coupled with slower economic growth, we expect this to bring CPI down to 19.4%Y in 2Q19 and 13.7%Y in 3Q19. Against the backdrop of this CPI forecast profile, we expect the CBT to cut policy rates by 500bp in total in 2019 (200bp in 2Q and 3Q and 100bp in 4Q). Risks to our CPI forecasts are balanced. On the one hand, we have the 10% price discount campaign, sharp economic slowdown and sharp TRY appreciation in recent months. On the other hand, it is still not possible to feel complacent about inflation due to an ongoing deterioration in pricing behaviour and PPI being over 45%Y, increasing the risk of pass-through.

All expansionary fiscal policies are not the same: Looking at similar financial shocks followed by economic slowdowns in the past, the initial impact on the fiscal front is seen in tax revenues, which start to fall (in CPI-adjusted terms) very quickly as around two-thirds of total tax revenues are driven by consumption. Moreover, it is normal for a country with very low public debt/GDP to implement some countercyclical stimulus measures against an economic slowdown, like the announcement of recent tax cuts on some durable goods. In this regard, our budget deficit/GDP forecast for 2019 at 3.7% is well above the official target at 1.8%. That said, the main risk on the fiscal front is not a cyclical expansion in the budget deficit. Based on our recent client interactions, risks such as the introduction of quasi-fiscal measures (like the credit guarantee fund) and/or recurring expenditures (like the TRY2K/year bonus payment to all pensioners introduced before the June 2018 elections) remain the biggest worries on the policy front.

External deficit to contract further: We expect the lagged impact of the weaker currency and economic slowdown to lead to a major correction in the C/A balance to GDP to -2.2% (or US$17 billion) in December 2019.

Downside and upside risks: Downside risks to the soft landing scenario we described above include a fiscal policy slippage, idiosyncratic geopolitical risks and premature easing in the policy rate. On the flip side, attempts to structure a credible bad bank or asset management company (credibility is a function of transparency, fairness and international participation, in our view) may help to ease asset quality concerns in the banking system sooner than expected and impact growth more positively, especially in the medium term as a strong recovery from the economic slowdown is not a foregone conclusion until lending practices return to normal.

Turkey: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**7.4**	**3.0**	**-0.7**	**1.9**
Private consumption	6.1	2.9	-1.8	2.5
Government consumption	5.0	3.1	2.4	1.9
Gross fixed investment	7.8	0.6	-13.1	-1.8
Contribution to GDP (pp)				
Final domestic demand	6.5	2.3	-4.4	1.3
Net exports	0.1	0.6	3.8	0.4
Inventories	0.7	0.1	-0.1	0.2
Unemp. rate (eop, % labour force)	10.9	11.0	13.4	13.1
CPI (%Y)	11.1	16.7	17.3	15.1
Core CPI (%Y)	10.1	16.2	15.7	16.1
Policy rate (eop, %)	12.8	24.0	19.0	18.0
General govt. balance (% GDP)	-1.5	-2.3	-3.7	-3.0
Gross govt. debt (% GDP)	28.2	30.2	33.4	35.6
Current account (% GDP)	-5.6	-5.4	-2.2	-3.4

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

Brazil: Recovering amid some uncertainty

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We believe that the Brazilian economy will accelerate, without generating inflationary pressures, even amid uncertainties about the approval of pension reform, which is required to stabilise Brazil's debt dynamics.

We expect the private sector to drive the recovery: Households should be the main beneficiaries of a clean balance sheet, low inflation and a gradually improving labour market, which should continue to drive real wage mass growth and consumption. We believe that the corporate sector will accelerate investment, but at a much slower pace than in previous recoveries, partially due to the tighter monetary conditions, but more specifically due to domestic conditions resulting from restricted funding from the state development bank BNDES. While we believe that the economy should accelerate further in 2020, this remains highly dependent on approval of pension reform and whether a confidence boost results from that. If a strong pension reform is approved, investment could accelerate further than our current forecast, but the first signs that we are seeing have not been encouraging. Indeed, business confidence has fallen in the past few months by 7%, although it is still 30% higher than the 2015 lows.

Stronger growth should not generate inflation because there is plenty of slack in the Brazilian economy: The unemployment rate is still close to 12%, and we believe that, given the recent changes in labour laws that have made the labour market more flexible, corporates are more likely to first spend on hiring rather than on capex. However, we do not believe that the level of hiring would be enough to create a tight labour market. Indeed, we believe that NAIRU is close to 8%, while we forecast that unemployment will close 2019 at 10.4%. Finally, capacity utilisation is close to an all-time low, which is yet another important indicator of slack in the economy. The biggest risk of inflationary pressure would be a weaker FX, which is not part of our base case. While we do expect the currency to weaken from here when tensions about pension reform approval intensify, we do not expect it to weaken enough to generate inflationary pressures that would derail the inflation path.

In our base case scenario of well-behaved inflation and a gradual recovery, we believe that the central bank would not be forced to hike rates any time soon: Indeed, we believe that only when faced with 2020 inflation somewhat above the centre of the new target (4%Y) would it start to reduce the stimulus, and this would require a small hiking cycle in 4Q19, taking rates to 9.0% by 2Q20. In this scenario, thanks to the weaker US dollar and less expansionary monetary policy, our FX strategists believe that BRL would appreciate a little over time in real terms.

This relatively benign story assumes that a version of pension reform, although likely watered down, is approved by the end of 2019: We believe that the incoming administration understands the need to reform the pension system, but we also believe that political considerations will be taken into account in the final version. Finally, approving a constitutional amendment is a complex political process that needs a strong coalition as it requires a 60% majority, and we believe that achieving this in Congress will be challenging at best.

Our bull and bear cases, in addition to external assumptions, are based upon whether there is pension reform: Our bear case includes either no reform or a version too weak to stabilise Brazil's debt dynamics. Our bull case is not only for a strong version of pension reform but also one that is approved relatively quickly, allowing the administration to move on to tax reform.

Brazil: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**1.0**	**1.3**	**2.3**	**2.5**
Private consumption	1.0	1.8	2.4	2.7
Government consumption	-0.6	-0.1	0.2	0.4
Gross fixed investment	-1.6	2.6	5.5	7.0
Contribution to GDP (pp)				
Final domestic demand	0.3	1.6	2.6	3.2
Net exports	0.0	-0.8	-0.6	-1.0
Inventories	0.8	0.5	0.3	0.3
Unemp. rate (eop, % labour force)	12.4	12.0	10.4	9.3
CPI (%Y)	3.5	3.7	4.1	4.2
Core CPI (%Y)	3.6	2.8	3.5	4.0
Policy rate (eop, %)	7.0	6.5	7.5	9.0
General govt. balance (% GDP)	-7.8	-7.5	-6.9	-5.7
Gross govt. debt (% GDP)	74.0	78.0	80.0	81.3
Current account balance (% GDP)	-0.5	-0.8	-1.7	-2.1

Source: IBGE, BCB, Morgan Stanley Research forecasts

Mexico: Mapping the new course

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Questions over policy continuity will likely dominate Mexico's outlook in 2019, with recent actions by the incoming administration hinting at a new course. Against this uncertain backdrop, we see growth at 1.7%Y in 2019, with activity struggling below trend over the forecast horizon.

New policy course, renewed uncertainty: Armed with a strong mandate, early signs of pragmatism and continuity by the incoming administration – such as allowing NAFTA talks to advance and pledging fiscal austerity – have given way to decisions hinting at a new, unorthodox policy course. The decision to scrap a new airport will likely weigh on investment, with the associated increase in funding costs an additional drag. Proposals for added regulation on miners, to scrap bank fees and a willingness to rely on public consultations to advance policy measures have increased uncertainty regarding the fiscal path, the institutional framework and sustainability. These question marks come at a time of slowing external demand and tighter financial conditions, pointing to downside risks over the forecast horizon.

Shifting below trend in 2019: The starting point for the economy is a healthy one – external accounts are in good shape, public debt ratios have stabilised and inflation, though still elevated, is drifting lower. Against this backdrop, activity has been expanding at a moderate pace, propped up by record exports and resilient consumers benefitting from firm labour markets. For 2019, several headwinds should drag activity to a below-consensus 1.7%Y from 2.2%Y this year. First, the transition should act as a barrier to timely budget execution, reminiscent of 2013 when the public sector became a major drag. Second, the uncertainty generated by recent policy decisions will likely limit any recovery in investment derived from optimism about USMCA and the export cycle. Indeed, we now see an anaemic 1.3%Y capex uptick, off from a call of 3.0%Y previously. Lastly, tighter external funding conditions, exacerbated by pressures related to perceptions of a deteriorating domestic environment, will likely take their toll on activity. Stable household consumption and still positive external demand should prevent a deeper slump in 2019. In 2020, as both public spending and capex normalise, the economy sees a pick-up to a below-trend 2.3%Y pace.

Stability concerns and the Fed mean a tight monetary stance: Monetary policy is already restrictive but Banxico may have more work to do. The airport decision and moves away from the orthodox status quo have triggered an increase in risk premia, signalling that the neutral rate may be higher than before – something that Banxico is likely to validate by lifting rates to 8.25% by year-end. Further disinflation (4.4%Y in 2019 from a 16-year high of 6.0%Y in 2017) and the expected mid-year Fed pause open the door for Banxico to ease, but the cycle is cut short when rates reach 7.50% – above estimates of neutral (5.5-6.0%) – as the Fed resumes policy rate hikes in 2020.

Risks to outlook biased to the downside: If confirmed by the 2019 budget bill and other initiatives, the new policy course runs the risk of undermining the pillars of Mexico's narrative – such as prudent fiscal management and structural reform progress – that have succeeded in delivering broad macro stability. Such a policy U-turn scenario would hurt confidence and the ability to attract capital, with associated growth downside – thus the negative skew shaping our bear (0.5%Y) and bull (2.2%Y) scenarios for 2019. In a bull case, the next administration takes advantage of its strong mandate to tackle Mexico's productivity challenge; such an agenda would include building stronger institutions as a prerequisite to improve security and transparency, while creating conditions that incentivise formalisation and investment. The policy priorities advanced so far – focused on redistribution and greater state intervention – have put little focus on how to tackle the root causes of the low productivity challenge.

Mexico: Forecast summary

	2017	2018E	2019E	2020E
Real GDP (%Y)	**2.0**	**2.2**	**1.7**	**2.3**
Private consumption	3.0	2.8	2.5	2.6
Government consumption	0.1	2.3	0.0	2.2
Gross fixed investment	-1.5	2.9	1.3	3.1
Contribution to GDP (pp)				
Final domestic demand	1.7	2.8	1.9	2.7
Net exports	-0.8	0.2	-0.1	-0.3
Inventories	1.1	-0.6	-0.1	-0.1
Unemp. rate (% of labour force)	3.4	3.3	3.5	3.6
CPI (%Y)	6.0	4.9	4.4	4.0
Policy rate (eop, %)	7.25	8.25	7.50	7.50
Fiscal balance (% GDP)	-1.1	-2.0	-1.8	-2.5
Gross govt. debt (% GDP)	47.2	47.9	47.3	47.3
Current account balance (% GDP)	-1.7	-1.7	-1.9	-2.3

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

GDP forecasts: Base, bear, bull scenarios

We lower our global GDP forecast by 10bp in 2019 compared to our last published forecasts in October 2018 and 20bp compared to our 2018 Global Macro Mid-Year Outlook, driven by downward revisions in both DM and EM. While downward revisions are broad-based across larger and smaller economies in DM, they are more concentrated among smaller economies in EM. Among G4 and BRIC economies, we lower our 2019 growth forecasts for the US, euro area, Japan, India and China, keep Russia unchanged and make upward revisions to 2019 forecasts for the UK and Brazil.

	2018E	2019E			2020E			2021-23E
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
Global	**3.8**	**2.5**	**3.6**	**4.2**	**2.0**	**3.5**	**4.4**	**3.4**
G10	**2.2**	**1.1**	**1.9**	**2.4**	**-0.1**	**1.6**	**2.4**	**1.2**
United States	2.9	1.6	2.3	2.6	-0.2	1.9	2.7	1.1
Euro Area	1.9	0.6	1.6	2.4	0.0	1.5	2.5	1.0
Japan	0.8	0.3	1.3	1.5	-0.9	0.6	0.9	1.3
United Kingdom	1.2	0.9	1.3	1.8	1.0	1.6	2.0	1.3
Canada	1.9	0.9	1.9	2.8	0.0	1.7	2.8	1.2
Norway	2.1	0.9	2.3	3.4	0.0	2.1	3.6	1.6
Sweden	2.4	1.0	2.0	3.1	0.5	2.0	3.0	2.0
Australia	3.3	1.5	2.5	3.6	-0.5	2.6	3.3	2.7
New Zealand	2.8	2.2	3.1	3.5	1.8	2.9	3.7	2.8
EM	**4.8**	**3.5**	**4.7**	**5.5**	**3.4**	**4.8**	**5.7**	**4.7**
CEEMEA	**2.4**	**-0.4**	**1.8**	**3.4**	**-0.1**	**2.3**	**4.1**	**2.7**
Russia	1.6	-0.2	1.5	2.9	-0.5	1.6	3.2	1.8
Poland	5.1	2.1	3.8	5.1	1.1	3.6	5.3	3.0
Czech Republic	2.8	1.9	3.4	4.6	1.0	3.3	4.8	2.8
Hungary	4.6	2.1	3.8	5.1	0.7	3.2	4.8	2.8
Ukraine	3.2	0.0	2.7	5.0	-0.7	2.6	5.5	3.0
Kazakhstan	3.9	2.0	3.5	5.0	1.4	3.2	5.0	3.5
Turkey	3.0	-5.7	-0.7	1.8	-2.4	1.9	5.2	3.0
Israel	3.6	2.0	3.3	3.9	2.0	3.6	4.2	3.2
South Africa	0.7	0.7	2.0	2.5	0.8	1.5	2.3	2.5
Nigeria	1.8	1.7	2.9	3.8	1.6	3.2	4.3	3.5
Saudi Arabia	1.8	0.1	2.1	3.8	0.1	2.3	4.1	3.5
AXJ	**6.2**	**5.2**	**6.0**	**6.6**	**4.9**	**6.0**	**6.5**	**5.6**
China	6.6	5.6	6.3	6.7	5.3	6.1	6.5	5.5
India	7.7	6.8	7.6	8.2	6.5	7.5	8.3	7.3
Hong Kong	3.3	1.0	2.4	3.5	0.8	2.2	3.3	2.5
Korea	2.6	1.1	2.5	3.4	0.5	2.4	3.2	2.5
Taiwan	2.8	1.1	2.6	3.6	0.4	2.5	3.4	2.5
Singapore	3.4	1.1	3.0	4.3	0.3	2.9	4.0	3.0
Indonesia	5.2	4.6	5.3	5.9	4.3	5.3	5.8	5.7
Malaysia	4.8	3.2	4.6	5.5	2.8	4.7	5.5	5.0
Thailand	4.1	2.9	3.9	4.7	2.4	3.8	4.6	3.0
Philippines	6.2	4.6	5.7	6.4	4.1	5.6	6.2	6.3
LatAm	**0.9**	**-0.2**	**1.5**	**2.5**	**0.0**	**2.3**	**3.4**	**2.6**
Brazil	1.3	0.9	2.3	3.4	0.8	2.5	3.8	2.4
Mexico	2.2	0.5	1.7	2.2	0.2	2.3	2.8	2.2
Chile	3.9	1.5	3.3	4.0	1.3	3.1	3.9	3.0
Peru	3.8	1.6	3.4	4.0	1.1	3.3	4.2	3.6
Colombia	2.6	1.7	3.0	4.0	1.8	3.3	4.4	3.2
Argentina	-2.3	-3.2	-1.0	0.5	-1.0	2.7	4.0	3.0
Venezuela	-18.3	-20.0	-12.1	-8.0	-18.0	-7.5	-2.0	5.0

Source: Bloomberg, IMF, Morgan Stanley Research forecasts. Note: Global and regional aggregates for GDP growth are GDP-weighted averages, using PPPs.

CPI forecasts: Base, bear, bull scenarios

We lower our global CPI forecast for 2019 by 20bp relative to our last published forecasts in October 2018. The change is driven by DM and to a lesser extent by EM. Among G4 and BRIC, major downward revisions occur in the US, Japan and Brazil.

	2018E		2019E			2020E		2021-23E
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
Global*	**2.9**		**3.0**			**3.0**		**2.8**
G10	**2.1**	**1.7**	**1.8**	**2.4**	**1.2**	**2.0**	**2.6**	**1.8**
United States	2.4	2.2	1.8	2.7	1.3	2.6	3.3	2.1
Euro Area	1.8	1.6	1.9	2.3	1.1	1.7	2.3	1.5
Japan^^	1.1	0.3	0.8	1.3	-0.2	0.5	1.2	1.5
United Kingdom	2.5	2.1	2.1	2.3	2.0	2.1	2.4	2.2
Canada	2.4	1.7	2.0	2.6	2.1	2.0	2.4	1.9
Norway	2.7	2.1	2.6	3.2	1.5	2.3	3.2	2.0
Sweden	2.0	2.0	2.4	2.8	2.1	2.7	3.3	2.0
Australia	1.9	1.7	2.0	2.5	1.5	2.4	2.8	2.5
New Zealand	1.7	1.8	2.6	3.0	1.6	2.2	2.8	2.0
EM*	**3.5**	**4.2**	**3.9**	**3.8**	**4.1**	**3.6**	**3.5**	**3.4**
CEEMEA	**6.3**	**6.8**	**7.1**	**7.7**	**6.7**	**6.3**	**6.3**	**6.2**
Russia	2.9	6.5	5.0	3.8	5.8	4.0	2.6	4.0
Poland	1.8	2.2	2.6	3.2	1.7	2.6	3.5	2.5
Czech Republic	2.2	2.0	2.3	2.8	1.4	2.2	2.9	2.0
Hungary	3.0	2.9	3.5	4.2	1.9	2.9	4.0	3.0
Ukraine	11.0	12.5	9.2	7.7	11.0	6.6	5.0	6.0
Kazakhstan	6.1	7.5	5.4	4.8	7.3	4.8	3.8	4.5
Turkey	16.7	11.3	17.3	23.3	13.1	15.1	18.1	14.0
Israel	0.8	0.8	1.3	1.8	1.1	1.6	2.1	2.3
South Africa	4.6	5.5	4.8	4.1	6.3	5.1	3.8	5.2
Nigeria	12.3	14.9	13.5	11.5	14.5	12.9	11.7	12.8
Saudi Arabia	2.4	1.7	2.2	2.7	1.6	2.1	2.6	3.0
AXJ	**2.6**	**3.4**	**2.9**	**2.7**	**3.3**	**2.9**	**2.8**	**2.7**
China	2.2	3.3	2.6	2.3	2.8	2.4	2.3	2.3
India	4.1	5.0	4.3	4.0	5.5	4.6	4.0	4.0
Hong Kong	2.4	1.6	2.2	2.6	1.3	1.8	2.2	2.0
Korea	1.6	0.9	1.6	2.0	0.6	1.5	1.9	1.5
Taiwan	1.5	0.4	1.1	1.5	0.4	1.3	1.7	1.0
Singapore	0.6	0.1	1.1	1.7	0.2	1.2	1.6	1.3
Indonesia	3.2	4.6	3.4	2.6	6.0	4.3	3.6	3.5
Malaysia	1.1	1.6	2.3	2.8	0.8	1.8	2.2	2.0
Thailand	1.2	0.2	1.0	1.5	-0.2	0.9	1.4	1.3
Philippines	5.4	4.0	4.6	5.5	3.4	4.2	5.2	3.8
LatAm*	**3.8**	**4.8**	**4.1**	**3.8**	**4.7**	**3.8**	**3.6**	**3.5**
Brazil	3.7	5.0	4.1	3.5	5.7	4.2	3.9	4.0
Mexico	4.9	5.2	4.4	4.0	4.5	4.0	3.7	3.3
Chile	2.4	2.4	2.9	3.1	2.3	3.0	3.2	3.0
Peru	1.4	1.8	2.2	2.6	1.4	1.9	2.4	2.5
Colombia	3.3	6.0	5.2	5.7	4.6	3.5	3.1	3.2
Argentina	34.2	42.0	38.8	35.0	26.0	22.1	19.5	12.0

Source: Morgan Stanley Research forecasts.Note: Global and regional aggregates for inflation are GDP-weighted averages, using PPPs; CPI numbers are period average. Global* and EM* Consumer Price Inflation Aggregates exclude Venezuela and Argentina; ^^ Japan CPI excludes impact of VAT and free child education.

Monetary policy rate forecasts

Our monetary policy forecasts for 2019 remain largely unchanged relative to our last published forecasts in October 2018. In Russia, we now expect one more rate hike in 1Q19, compared with no rate hike earlier. In India and Brazil, we expect rate hikes in 2019 to occur somewhat later (in 2Q19 for India and in 4Q19 for Brazil).

	Current	4Q18E	1Q19E	2Q19E	3Q19E	4Q19E	1Q20E	2Q20E	3Q20E	4Q20E
US	2.125	2.375	2.625	2.875	2.875	2.875	3.125	3.375	3.625	3.875
Euro Area^	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	0.00	0.00	0.25	0.25
Japan	-0.10	-0.10	-0.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00
UK	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00
Canada	1.75	1.75	2.00	2.25	2.50	2.50	2.75	3.00	3.00	3.00
Norway	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	2.00
Sweden	-0.50	-0.25	-0.25	-0.25	0.00	0.00	0.25	0.25	0.50	0.75
Australia	1.50	1.50	1.50	1.50	1.50	1.50	1.75	2.00	2.00	2.00
New Zealand	1.75	1.75	1.75	1.75	1.75	2.00	2.25	2.50	2.75	2.75
Russia	7.50	7.75	8.00	8.00	8.00	7.75	7.75	7.75	7.75	7.75
Poland	1.50	1.50	1.50	1.50	1.50	1.50	1.75	1.75	2.00	2.00
Czech Republic	1.75	1.75	2.00	2.25	2.50	2.50	2.75	2.75	2.75	2.75
Hungary	0.90	0.90	0.90	0.90	0.90	1.00	1.25	1.25	1.50	1.50
Romania	2.50	2.50	2.50	2.75	2.75	3.00	3.00	3.25	3.25	3.50
Turkey*	24.00	24.00	24.00	22.00	20.00	19.00	19.00	19.00	18.00	18.00
Israel	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50
South Africa	6.75	6.75	7.00	7.00	7.00	7.00	7.00	7.00	7.25	7.50
Nigeria	14.00	14.00	15.00	15.00	15.00	14.50	14.00	14.00	14.00	14.00
Saudi Arabia	2.75	3.00	3.25	3.50	3.50	3.50	3.75	4.00	4.25	4.50
China**	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
India	6.50	6.50	6.50	6.75	7.00	7.00	7.25	7.50	7.50	7.50
Hong Kong	2.50	2.75	3.00	3.25	3.25	3.25	3.50	3.75	4.00	4.25
S. Korea	1.50	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.375	1.375	1.375	1.375	1.375	1.375	1.375	1.375	1.375	1.375
Indonesia	6.00	6.00	6.00	6.00	6.00	6.00	6.25	6.25	6.25	6.25
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Thailand	1.50	1.75	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Philippines	4.75	4.75	5.00	5.25	5.25	5.25	5.25	5.25	5.25	5.25
Brazil	6.50	6.50	6.50	6.50	6.50	7.50	8.50	9.00	9.00	9.00
Mexico	8.00	8.25	8.25	8.25	8.00	7.50	7.50	7.50	7.50	7.50
Chile	2.75	2.75	3.25	3.50	3.50	3.50	3.75	4.00	4.00	4.00
Peru	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	3.25
Colombia	4.25	4.25	4.75	5.25	5.50	5.50	5.50	5.50	5.50	5.50
Argentina^^	62.11	60.00	57.00	51.00	44.50	41.00	37.00	30.00	26.00	24.00

Source: Bloomberg, Morgan Stanley Research forecasts. Note: *For Turkey, we use the blended funding rate which is the effective policy rate; it is the weighted average rate of three different lending rates: Weekly repo rate, the O/N repo rate and the late liquidity window rate. **7-day repo rate. ^Euro area policy rate refers to depo rate. ^^Argentina does not follow inflation targeting anymore, but has moved to a monetary aggregate targeting scheme.

Government budget balance and debt forecasts

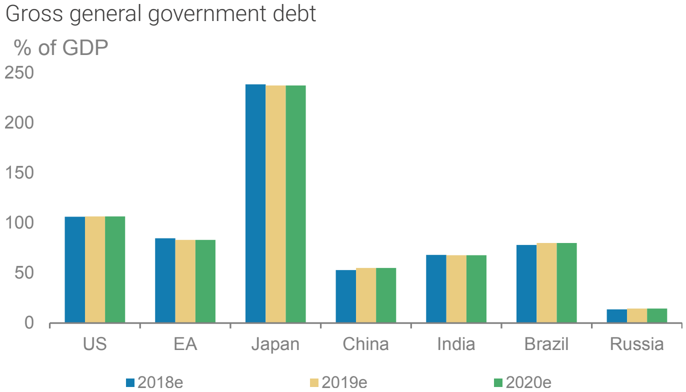
	General Gov't Budget Balance (% of GDP)				Primary General Gov't Budget Balance (% of GDP)			
	2017	2018E	2019E	2020E	2017	2018E	2019E	2020E
DM								
US	-3.5	-3.7	-4.1	-3.9	-2.1	-2.1	-2.2	-1.8
Euro Area	-0.9	-0.8	-0.9	-0.4	1.1	1.1	0.9	1.3
Japan	-4.3	-3.9	-3.4	-3.2	-3.8	-3.5	-3.2	-3.0
UK	-1.8	-1.4	-1.4	-1.7	0.9	1.1	1.0	0.7
Canada	-1.1	-1.2	-1.1	-1.0	-0.8	-0.9	-0.6	-0.5
Sweden	1.6	1.5	1.4	1.2	1.9	1.7	2.0	1.9
Australia	-2.1	-1.0	-0.8	0.1	-1.8	-0.7	-0.1	0.4
BRICs								
Russia	-1.4	2.0	2.5	1.9	-1.0	2.6	2.9	2.3
China	-3.7	-3.3	-4.0	-4.0	-2.9	-2.5	-3.2	-3.1
India	-6.7	-6.4	-6.2	-5.8	-1.8	-1.3	-1.2	-1.0
Brazil	-7.8	-7.5	-6.9	-5.7	-1.7	-1.1	-0.9	-0.5

	Gross General Gov't Debt (% of GDP)				Net General Gov't Debt (% of GDP)			
	2017	2018E	2019E	2020E	2017	2018E	2019E	2020E
DM								
US	105	106	107	107	77	78	79	81
Euro Area	87	85	83	81	67	N/A	N/A	N/A
Japan	237	239	237	239	154	156	155	156
UK	87	84	83	82	51	47	46	45
Canada	90	87	85	83	28	28	27	27
Sweden	41	38	35	32	-33	N/A	N/A	N/A
Australia	29	29	30	30	18	19	18	17
BRICs								
Russia	13	14	15	15	N/A	N/A	N/A	N/A
China	52	53	55	55	N/A	N/A	N/A	N/A
India	69	68	68	67	N/A	N/A	N/A	N/A
Brazil	74	78	80	81	53	57	61	63

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

Exhibit 26:

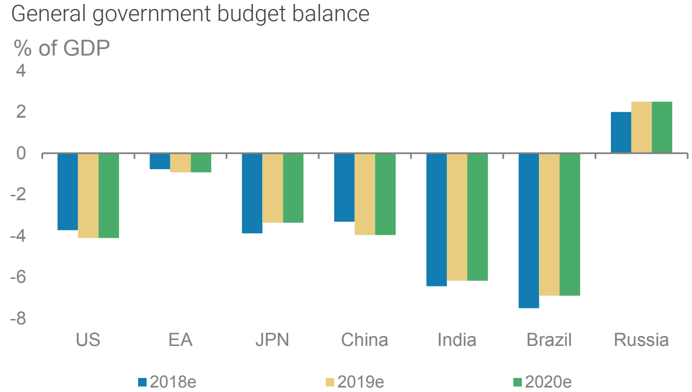
Gross general government debt



Source: Morgan Stanley Research forecasts

Exhibit 27:

General government budget balance



Source: Morgan Stanley Research forecasts

Global currency forecasts

	4Q18E	1Q19E	2Q19E	3Q19E	4Q19E	1Q20E	2Q20E	3Q20E	4Q20E
DM									
EURUSD	1.15	1.17	1.20	1.26	1.31	1.34	1.36	1.37	1.38
USDJPY	112	109	106	104	102	100	98	96	94
GBPUSD	1.30	1.34	1.40	1.45	1.50	1.54	1.58	1.59	1.60
EURCHF	1.15	1.17	1.19	1.22	1.23	1.25	1.26	1.27	1.28
EURSEK	10.15	10.00	9.90	9.70	9.50	9.50	9.60	9.70	9.80
EURNOK	9.7	9.7	9.6	9.4	9.3	9.3	9.4	9.5	9.6
USDCAD	1.31	1.33	1.35	1.33	1.32	1.31	1.30	1.29	1.28
AUDUSD	0.72	0.70	0.67	0.70	0.71	0.72	0.73	0.74	0.75
NZDUSD	0.67	0.65	0.62	0.66	0.67	0.68	0.69	0.70	0.71
DXY	96	94	92	88	85	84	82	82	81
ECB EUR TWI	98.8	99.8	100.6	102.8	104.5	105.5	105.9	106.2	106.4
Broad USD (Fed)	128	127	126	124	122	120	119	119	118
AxJ									
USDCNY	6.97	7.05	7.03	6.92	6.85	6.81	6.78	6.77	6.75
USDHKD	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8	7.8
USDIDR	14700	14400	14200	14100	14000	13900	13800	13700	13600
USDINR	72.0	71.0	69.5	68.5	68.0	67.5	67.0	66.5	66.0
USDKRW	1115	1110	1105	1100	1095	1090	1085	1080	1075
USDMYR	4.25	4.20	4.18	4.15	4.12	4.10	4.08	4.05	4.02
USDPHP	52.5	52.4	52.3	52.2	52.1	52.0	52.0	52.0	52.0
USDSGD	1.37	1.34	1.32	1.29	1.28	1.28	1.27	1.26	1.26
USDTHB	32.8	32.5	32.2	31.8	31.4	31.0	30.5	30.0	30.0
USDTWD	30.6	30.4	30.2	30	29.8	29.7	29.7	29.6	29.5
LatAm									
USDBRL	3.65	3.55	3.85	3.65	3.50	3.50	3.55	3.60	3.60
USDMXN	21.00	21.00	21.00	21.00	21.00	20.75	20.50	20.50	20.50
USDARS	37.00	39.50	41.25	42.50	43.50	44.15	44.75	46.00	42.00
USDCLP	675	660	645	630	620	610	600	590	580
USDCOP	3135	3100	3060	3030	3010	3010	3000	2975	2975
USDPEN	3.35	3.32	3.29	3.26	3.23	3.22	3.21	3.20	3.20
CEEMEA									
USDZAR	14.0	13.8	13.5	13.2	13.0	13.3	13.6	13.9	14.2
USDILS	3.65	3.60	3.55	3.50	3.45	3.40	3.40	3.40	3.40
USDTRY	5.5	5.5	5.6	5.7	5.8	5.9	6.0	6.1	6.2
USDRUB	66	65	64	63	62	61	60	60	60
EURCZK	25.9	25.5	25.3	25.2	25.0	25.0	24.8	24.5	24.3
EURHUF	325	330	325	320	315	315	315	315	315
EURPLN	4.30	4.35	4.30	4.25	4.20	4.15	4.10	4.10	4.10
EURRON	4.67	4.70	4.67	4.65	4.60	4.60	4.60	4.60	4.60

Source: Morgan Stanley Global FX forecasts

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