Morgan Stanley

MORGAN STANLEY RESEARCH

Global Economics Team

Coordinators of this publication

Joachim Fels
Joachim.Fels@morganstanley.com
+44 (0)20 7425 6138

Manoj Pradhan
Manoj.Pradhan@morganstanley.com
+44 (0)20 7425 3805

Patryk Drozdzik
Patryk.Drozdzik@morganstanley.com
+44 (0)20 7425 7483

Sung Woen Kang
Sung.Woen.Kang@morganstanley.com
+852 2848 5652

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Global

Outlook

The Global Macro Analyst

Commodity Exporters Biggest Beneficiaries of Lower Commodity Prices

Yes, commodity exporters face a difficult transition, some a recession, and even after that, a few could lapse back into mediocre growth and low productivity.

What is less obvious is the synchronous adjustment that commodity price declines are driving gives commodity exporters the best chance in decades to rebalance their economies without relying on the ability and willingness of policy-makers to enforce change.

The really crucial part of the story is that commodity price falls of this magnitude can completely change the structure of commodity-exporting economies towards more productive activities, which is not what will happen to commodity importers (who already tend to be engaged in manufacturing). **The potential for the increase in productivity among exporters therefore outstrips what lower commodity prices will do for importers.**

To understand these cathartic dynamics, we ask:

- Can the US housing boom and bust that created sectoral misallocation and deindustrialisation provide commodity exporters some lessons?
- What exactly is the Dutch Disease?
- How do you cure it?
- Who is most likely to benefit, and how soon will the second derivative of adjustment turn positive?

Spotlight: Euro Area: Sovereign QE and How to Do it
Despite political and legal concerns, we now expect the ECB to embark on sovereign QE of €500 billion (plus other assets of €100 billion). But mind the political limitations, legal uncertainties and complex execution.
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The Morgan Stanley Global Economics View p 8

Global Economics Forecasts

	Real GDP (%)			CPI inflation (%)		
	2014E	2015E	2016E	2014E	2015E	2016E
Global Economy	3.2	3.5	3.9	3.5	3.3	3.7
G10	1.6	2.0	2.0	1.3	0.4	1.9
Emerging Markets	4.5	4.6	5.2	5.2	5.5	5.0

Source: Morgan Stanley Research forecasts

Global Macro Watch

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Commodity Exporters Biggest Beneficiaries of Lower Commodity Prices

Manoj Pradhan (44 20) 7425 3805
Joachim Fels (44 20) 7425 6138
Patryk Drozdzik (44 20) 7425 7483

It seems strange to suggest that commodity exporters will be the biggest beneficiaries of this precipitous decline in commodity prices. Yet this is exactly what we argue.

Why? Because large commodity exporters – Russia, Brazil, Indonesia, Malaysia as well as Australia and Canada – developed varying degrees of affliction of the Dutch Disease as commodity prices rose for many years (see *Emerging Issues: Can the Broken EM Growth Models Be Fixed?* September 24, 2012), while others stood at risk of following that path too (the US, Mexico, Colombia, and a relapse in Brazil from its oil exploration). Even Norway and Chile, two economies with efficiently functioning commodity funds designed to insulate the economy, have not been able to avoid picking up elements of the Dutch Disease.

The Dutch Disease creates an over-allocation of capital to the commodity and non-tradeable sectors, leading to strong consumption growth, at the expense of the manufacturing sector. If left uncured, the net effect is usually a decline in productivity that tends to hurt growth over longer periods.

Commodity price falls of this magnitude can completely change the structure of commodity-exporting economies, while no such dramatic transformation occurs among commodity importers. The delta of productivity increases is therefore much higher for commodity exporters than importers.

The transformation of commodity-exporting economies implies that growth can come from more productive activities like manufacturing rather than commodities and consumption. Commodity importers, on the other hand, already tend to be engaged in manufacturing, so that lower commodity prices do help to raise productivity and profitability, but do not create a similarly dramatic transformation of the economy.

What's more, we believe commodity prices are more suited to carrying out this rebalancing than macroeconomic policies are.

The sectoral imbalance that the Dutch Disease creates can be better rebalanced via '*expenditure-switching*' tools that will allocate resources *between* sectors to reduce imbalances than through '*expenditure-changing*' policies that will reduce resource allocation *across* all sectors.

Over shorter horizons, we know full well that the adjustment will almost certainly be a very difficult one for markets to deal with. Our FX team has written consistently about the Dutch Disease unwind creating downside risks for BRL, ZAR, AUD, NZD and CAD (see *FX Spring Outlook: Strong USD, Weak EM*, March 17, 2014), while a recent series of notes on oil and Russia highlight near-term losers (see *Emerging Issues: Oil Spills: Contagion versus the Oil Dividend*, December 18, 2014, and *Economics and Strategy Insights: Russia - Untangling the Russia Complex*, December 18, 2014).

To examine the dynamics of such a catharsis, we ask:

- Are there any historical precedents of sectoral misallocation and deindustrialisation?
- What is the Dutch Disease?
- How do you cure it?
- Who is most likely to benefit, and how soon will the second derivative of adjustment turn positive (which is what investors looking for fundamental support for markets should care about)?

The US Housing Boom and the Dutch Disease – Not So Different

Rising house prices acted as an internal terms-of-trade (ToT) shock within the US economy, as labour and capital (financial and also physical) were increasingly absorbed by the housing sector. House prices and a tight labour market created strong household wealth and income effects and the US became increasingly consumption-driven while manufacturing production continued to fall and manufacturing employment fell sharply (though only in part, because China played a large role in this decline too – see *Emerging Issues: Could Sustainable US Growth Be Bad News for EM?* March 6, 2013).

As house prices turned down, it was the driver of the housing boom that also unwound the housing bubble and generated a recession (not the other way around) – a sectoral misallocation problem was being solved by a negative relative price shock rather than a macro policy. That a recession resulted is a function of two things: i) The financial sector was heavily entrenched in the housing market by then; and ii) Of all the components of GDP, residential investment is by far the most likely to generate a recession (see *Housing IS the Business Cycle*, Edward Leamer, 2007) – see Exhibits 4-7 on page 6.

Three lessons from the US housing boom and bust: i) The *duration and severity of the downturn* will depend on both the size of the price shock and the severity of the problem created during the upswing; ii) It is the *second derivative of the adjustment that is important to markets*. The period of greatest turbulence for markets lasted from 3Q07 to 1Q09, anticipating the beginning and the end of the recession between December 2007 to June 2009, while the deleveraging adjustment continues even today; and iii) Trend growth after the bust will be lower, but will likely come from a *more sustainable driver than before*, investment rather than consumption. In turn, this implies more upside for productivity growth than would have been likely in a consumption-driven economy.

What Is the Dutch Disease?

The onset of the Dutch Disease usually takes hold in the following series of steps: Rising commodity prices (or finding a new natural resource) lead to a ToT shock. The boom in the commodity sectors attracts labour and capital from around the economy, making labour markets tight and raising wage growth. The non-tradeable sectors (housing, services) run higher inflation to counter higher wage costs, and in turn benefit from strong retail demand from fully employed households whose incomes are rising, as well as from strong credit growth resulting from the ToT shock. However, the manufacturing/non-tradeable sector is unable to generate inflation because it competes globally, and the macro economy usually sees falling investment and productivity due to the deindustrialisation that sets in.

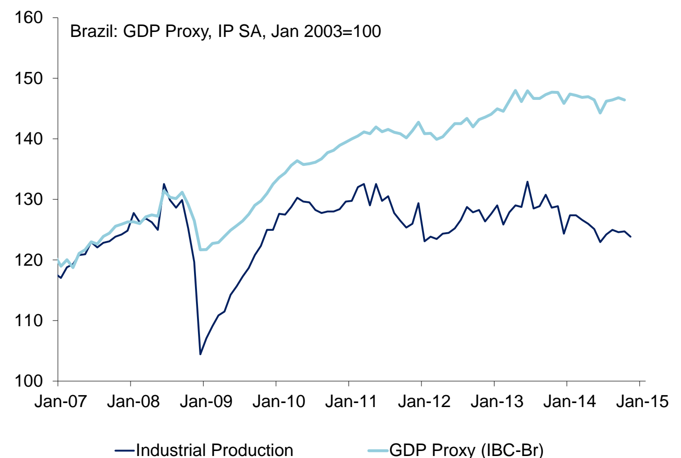
To summarise a bit more neatly, economies suffering from Dutch Disease present an ambivalent set of dynamics: i) A set of leading (commodities, retail/non-tradeable) and lagging (manufacturing/tradeable) sectors; ii) Tight labour markets, falling labour productivity and high wage growth; and iii) Inflation in the services/non-tradeable sectors along with strong retail demand from households and credit growth.

Hard to represent in a macroeconomic model: This presents an existential problem for macro-economists. We so badly want to depict most things as a macro problem, but fitting this one into a macro framework is very difficult. Let's try and use your Econ 101 tools of aggregate supply and aggregate demand curves to try to depict a commodity-oriented economy where commodity prices have risen and are still high (see Exhibits 1 and 2).

If we try to show strong credit growth, retail sales as well as high inflation, we might be tempted to shift the AD curve to the right. However, the AD curve would then suggest that the economy should be running growth above potential when growth was actually falling thanks to the decline in manufacturing and productivity. If we argued that it was the AS curve shifting upwards to depict high inflation and weak growth, then we can't explain the strength of the labour market and the consistency in retail strength. In fact, most macro depictions of the Dutch Disease don't do terribly well.

Exhibit 1

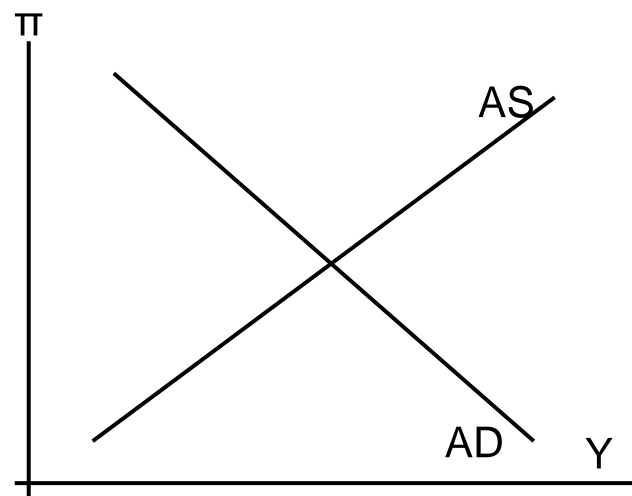
Brazil's 'Growth Mismatch' – Depicting the Dutch Disease…



Source: Haver Analytics

Exhibit 2

…Is Hard to Depict in a Macroeconomic Framework



Source: Morgan Stanley Research

Often diagnosed as a macroeconomic problem of over-heating: The picture of tight labour markets and strong real wage growth, credit growth, high inflation and real exchange rate appreciation often paints a picture of over-heating. Even though most commodity-oriented economies are closer to a recession than a boom today, the medicine being recommended is the classical response to overheating – a conservative mix of prudent policies including tighter monetary policy to reduce inflation. While a firmly and long-enough applied prudent policy mix often cures most ills, it only does so in a roundabout way and relies heavily on the willingness of policy-makers to push strong enough medicine down the throat of the economy.

How Do You Cure the Dutch Disease?

The roundabout macro cure: Before commodity prices had a precipitous fall, the macro cure was the only one at hand even though it was second-best. Prudent fiscal and monetary policy would have shifted the AD curve to the left, creating a downturn/recession, softening the labour market and bringing down any excessive credit growth. If policy-makers are willing to consistently inflict pain, a downturn that is deep enough can bring the exchange rate, inflation and wage growth to levels where the manufacturing sector becomes competitive again. Just how much pain is needed naturally depends on the severity of the Dutch Disease affliction.

A macro-adjustment creates greater downside risks: Since macro-adjustment leads to a reduction in expenditure across all sectors, including the beleaguered manufacturing sector, it creates a greater downside risk for growth. In the current context, a macro adjustment over and above the fall in the terms of trade (which Brazil is undertaking and Russia has been forced into) increases the overall adjustment that the domestic economy has to face. The external risks that exist today (the risk of rising US real rates, downside risks to China's growth, further downside in commodity prices) could amplify the domestic pain of adjustment (see *Emerging Issues: Will Brazil Determine the Fate of EM in 2015?* January 12, 2015).

What about a policy of exchange rate depreciation? Exchange rate depreciation is an expenditure-switching mechanism, but a policy of depreciating the exchange rate (abstracting from the depreciation resulting from falling terms of trade) does not lead to an unambiguous improvement. Why? True, the manufacturing/tradeable sector does see improving competitiveness, but the depreciation also protects commodity exporters and creates upside risks for inflation. In economies where labour markets remain tight, currency depreciation could exacerbate wage growth and actually hurt domestic producers.

A first-best cure – the negative terms-of-trade shock: Commodity price declines can do a much better job. If the exchange rate adjustment is part of the adjustment process brought on by a decline in commodity prices, then everything works well from an adjustment point of view, and it is the real exchange rate that depreciates (in exactly the right way). As the negative ToT shock adversely affects the commodities and non-tradeables sectors, they release labour and help to soften the labour market. The exchange rate weakens as overall growth slows down. However, the manufacturing sector finds itself doing better, thanks to a softer labour market, weaker nominal exchange rates (implying a real exchange rate depreciation) and cheaper commodity inputs, making it competitive again. Commodity price declines will thus unwind much of what we described in the onset of the Dutch Disease.

Critically, the manufacturing sector will start seeing benefits just as the negative ToT shock hurts the commodity and non-tradeables sectors.

Who Is Most Likely to Benefit, and How Soon?

Who is most likely to benefit? The economies most likely to benefit are the ones where a nascent manufacturing sector stands ready to revive itself if competitiveness returns.

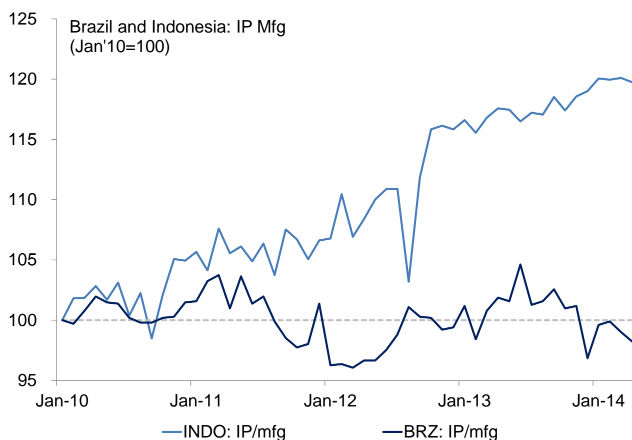
Indonesia, Malaysia and Brazil stand to benefit as soon as the second derivative from the reversal of the Dutch Disease turns positive. All three economies have manufacturing sectors that stand ready to reap the benefits of improved competitiveness. **Russia's** manufacturing base has eroded dramatically over the last two decades, but it retains the human capital and infrastructure that could house a manufacturing sector.

However, the likes of **Chile, Peru** and much of the **Middle East** have never really had a manufacturing base, and creating one from scratch could be challenging. Even then there is some scope for upside. Both Chile and many of the Middle East economies have accumulated enough wealth to be able to support the creation of a manufacturing base, while Peru starts without a Dutch Disease problem because it hasn't indulged heavily in copper-related investment so far. It could now do so in a prudent manner, while encouraging development of a small manufacturing base there.

How soon will the second derivative turn positive? Rather obviously, the second derivative of the adjustment process will come sooner if the strain of the Dutch Disease afflicting the economy is a relatively mild one:

- **Indonesia:** We have argued for a while now that Indonesia has the mildest case of the Dutch Disease among EM economies facing a similar problem (see Exhibit 3), and it has begun its domestic and external adjustment at a slow pace but very early on. What's more, Indonesia is an oil importer, and hence actually sees some benefit along with pain. It will hence likely be the earliest to see the benefits of the return of manufacturing and higher productivity growth, as early as the next few quarters (see *Emerging Issues: Will Brazil Determine the Fate of EM in 2015?* January 12, 2015, and *Indonesia Economics: Asia Insight: Is a Manufacturing Resurgence at Hand?* January 7, 2015).

Exhibit 3
The Dutch Disease Creates a Smaller Structural Drag on Indonesia than Brazil



Source: Haver Analytics, Morgan Stanley Research

- **Malaysia** lies further behind in the story for three reasons: i) It has a stronger variant of the Dutch Disease than Indonesia, having lost more manufacturing market share globally; ii) it is an exporter of oil which implies a deeper correction than Indonesia; and iii) its macro adjustment is relatively recent compared to Indonesia's.

- **Russia and Brazil:** Both have a more serious affliction and will need more time as well as greater attrition before a return to productive investment can be expected. What's more, a really serious adjustment in the terms of trade and in domestic policies has only just started to materialise in both economies, unlike in the case of Indonesia.

- **Brazil:** As it turns out, Brazil's self-imposed prospective path of fiscal austerity and the macro adjustment forced upon Russia by markets does provide an adjustment over and above that being imposed by falling commodity prices. Brazil could see a return to investment once the bulk of that adjustment has taken place. Without external headwinds (it's an ask, but worth considering – see *Emerging Issues: Will Brazil Determine the Fate of EM in 2015?* January 12, 2015), the worst parts of the adjustment process could last a year or so before the second derivative of the macro adjustment turns positive. On the other side of the adjustment, Brazil's manufacturing sector stands to regain quite a lot of the drive that it possessed

- **Russia:** Russia's more difficult mix of the Dutch Disease (like Brazil) and the dominance of SOEs (like China) creates the worst of both worlds – a structural problem and a corporate sector that does not lend itself to reform or revamps. Sanctions make it harder for Russia to access foreign funds for investment, so funds accrued from oil sales will have to be drawn down, or savings will need to be generated at home by demand destruction in consumption and unproductive investment spending. While this makes us more cautious, Russia's human capital via its high level of education, its high per capita GDP and its infrastructure can all combine to make the prospective adjustment cathartic.

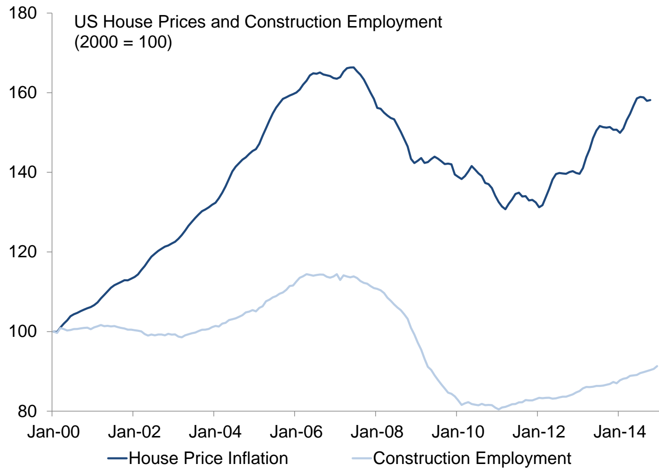
Summary

Yes, commodity exporters are going to face a difficult transition. Yes, many of them could face a recession. And yes, even when they come through this period, some could easily lapse back into a period of mediocre growth and low productivity.

However, the synchronous adjustment that commodity price declines are driving is giving commodity exporters the best chance in decades to rebalance their economies without relying on reforms, or prudent policies, or just the ability and willingness of policy-makers to enforce change.

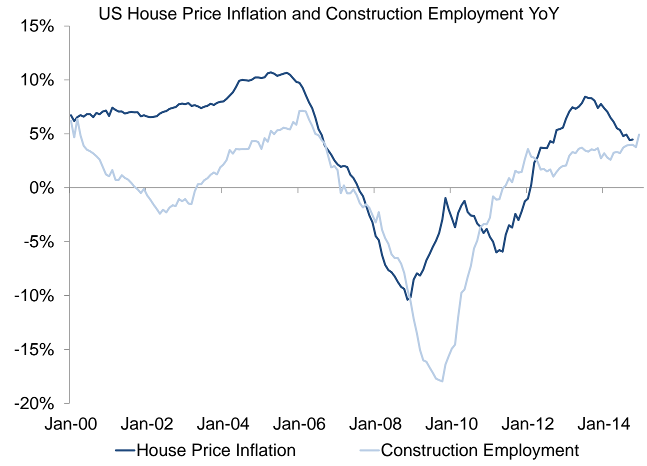
The really crucial part of the story is that commodity price falls of this magnitude can completely change the structure of commodity-exporting economies towards more productive activities, which is not what will happen to commodity importers (who already tend to be engaged in manufacturing). The potential for the increase in productivity among exporters therefore outstrips what lower commodity prices will do for importers.

Exhibit 4
US House Prices and Construction Employment



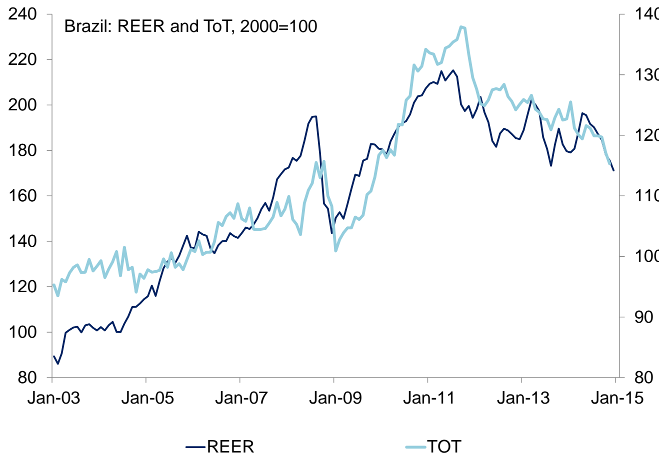
Source: Haver Analytics

Exhibit 5
US House Price Inflation and Construction Employment YoY



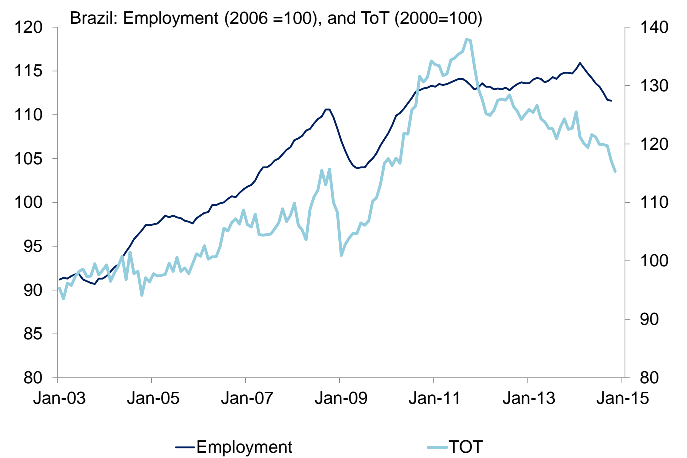
Source: IMF, Morgan Stanley Research forecasts

Exhibit 6
Brazil: REER Followed the ToT Higher…



Source: Haver Analytics

Exhibit 7
Brazil: Employment Followed the ToT Higher Too



Source: Haver Analytics

Spotlight: Euro Area: Sovereign QE and How to Do it

Elga Bartsch (44 20) 7425 5434

For a long time, we had thought the ECB would try to shy away from purchasing government bonds as part of its unconventional policies for as long as possible, given the political and legal complications of a multi-national currency union. We had argued that the decision on sovereign QE was on a knife-edge and that the ECB would only resort to buying sovereign debt after it had exhausted other options such as additional private sector asset purchases (*see* *Muted Growth, Lowflation and Divided Policy Makers*, November 30, 2014).

Based on specific ECB comments, it turns out that we were wrong and that the Governing Council will likely approve purchases of government bonds in 1Q15: While preparations are getting under way across the Eurosystem, our best guess is that the sovereign bond purchases will initially be capped at €500 billion for sovereign debt and at €100 billion for additional private sector purchases. For the sovereign part, we deem a hybrid programme with a core component, where financial risk is shared across the Eurosystem, and an optional component, which is national central bank risk, to be a workable compromise. Notwithstanding our change in view on whether sovereign QE will happen or not, **we maintain our cautious stance relative to market expectations when it comes to QE.**

There are several reasons for us to stay sceptical on sovereign QE: i) We are aware of considerable opposition to such an unprecedented step among a significant minority of Governing Council members; ii) The design of a programme will be a compromise and a conservative execution might be a way to avoid a further alienation of the Governing Council members opposing the QE decision as well as evade a political backlash from core creditor countries; iii) We would expect the political noise to pick up materially once the ECB announces a sovereign QE programme; and iv) The legal uncertainties around the admissibility of sovereign bond purchases will likely linger for some time.

Overall, we fear that the ultimate impact of QE on growth and inflation could be rather limited, possibly negligible: Last May, we simulated the impact of a €1 trillion QE programme and found it to boost growth and inflation by about 0.4pp (see *What if the ECB Did QE?* May 12, 2014). Since then, euro area bond yields and the trade-weighted exchange rate have fallen further than we projected in our QE scenario, making a further material easing in financial conditions much more difficult to manufacture. In addition, our simulation did not allow for a negative deposit rate, which we fear could be undermining the impact of QE, by imposing a QE tax on the banking system.

Modelling the impact of QE is fraught with difficulties as most standard macroeconometric models do not explicitly allow for any balance sheet effects. As a stop-gap measure, one can try to gauge the impact via the changes in asset prices QE is estimated to achieve. However, ECB research finds that there are important differences between conventional and unconventional monetary policy measures, with the time-lag with which the measures affect GDP being considerably longer for QE, where it take about six quarters to reach the maximum impact versus four quarters for interest rate changes (see *ECB WP 1397-2011*). However, the overall impact on growth and inflation is broadly comparable. A 10% increase in the balance sheet should have roughly the same effect as a 25bp rate cut.

As we outlined before, there are essentially **two ways to allocate the purchases by country – either by ECB capital key or by market size:** In the case of a combined programme, the core QE programme would probably be capital key. The list of countries being bought by the ECB can be defined simply by euro membership, by the sovereign credit ratings, or by compliance with the requirements of the EU treaty (notably the SGP). On balance, we would expect the ECB not be keen to buy bonds with negative yields. But we are not sure that this would be stated upfront or whether it would only become evident in the QE execution.

When it comes to the eligibility to a sovereign QE programme, we would expect the **ECB to follow the same logic it applies to the eligibility criteria for the collateral** required in its refi operations and in the ABS and the covered bond purchase programmes. This would put the spotlight on Greece, where the current programme expires at the end of February. In our view, countries that are not rated investment grade by at least one ratings agency will have to be under a programme to be eligible for any purchase programme.

In addition, we would not rule out that the **ECB could tighten the eligibility criteria further and demand that countries meet their obligations under the EU Treaty, notably under the SGP,** in order to prevent any whiff of debt monetisation and limit potential moral hazard on much-needed economic reforms. In our view, it is conceivable that the ECB would insist on such full EU treaty compliance.

For full details, see *ECB Watch: Sovereign QE and How to Do it*, January 12, 2015.

The Morgan Stanley Global Economics View

Our Core Global Views

The BBB out-of-sync global expansion continues: Global growth continues to be bumpy, below-par and brittle as Europe and Japan keep struggling to generate self-sustaining growth, and large EM economies such as China, Brazil and Russia are experiencing sputtering transitions to new growth models, and is expected to maintain an average pace of around 3.5%Q SAAR during 2015. Although we cut our growth forecasts slightly, our forecasts for 2016 and beyond suggest that the more muted, globally un-synchronised global expansion could turn into one of the longest on record.

Revising down both DM and EM: In the DM world, we have further cut our 2015 forecasts for the euro area and Japan, while pushing the US slightly higher. Growth appears to bottom out in EM in 4Q14, but we expect it to remain sluggish by historical comparison. Within the EM world, we expect decent reform-driven growth recovery in India and Indonesia, but China and Korea growth to face headwinds, while we forecast outright recession s in Brazil and Russia. With the risk of higher US rates and USD still present, we remain cautions on EM especially if Brazil macro adjustment happens at the same time as one of the external headwinds manifest itself. Should an EM shock materialise, DM may not be as resilient as it was in the late 1990s.

The battle against lowflation: In our base case, global 'lowflation' is pervasive, persistent and pernicious. The drop in oil prices has pushed headline inflation and expectations lower, while lack of domestic wage pressure continues to be the main domestic factor keeping inflation low. Exchange rate appreciation in the US, China and Korea are also key factors. Lowflation is pernicious, in particular for those with high debts or who are at or close to the zero lower bound, and threatens the credibility of central bank inflation targets.

Central banks to prevail: We expect major central banks to keep monetary policy accommodative as inflation remains low. We expect the Fed to be patient in hiking its rate and the ECB to embark on sovereign QE. Some EM central banks will likely cut rates in their push against lowflation (PBOC, BoK), or react to faster deceleration in highflation thanks to the oil price declines. We expect inflation to creep higher in 2H15 and in 2016, as growth improves further.

Key Macro Risk Events

February 2015
Greece presidential elections

March 2015
US debt-ceiling suspension ends

May 2015
UK general elections

June 2015
OPEC next meeting

June 2015
Turkey parliamentary elections

June 2015
Poland presidential elections

September 2015
Japan LDP president elections

September 30 2015
US budget or CR must be passed

October 2015
Canada federal election

EM Regional Themes

Despite some near-term stabilisation, there is much more adjustment due in EM to progress recovery towards a more sustainable one and/or improve macro-stability.

Asia ex-Japan: China needs more policy easing to support the mini cycle and to focus on pro-market reforms, economic rebalancing and deleveraging to improve the medium-term outlook, which might come at the expense of short-term performance. India is transitioning away from stagflation conditions, thanks to the combination of the much-needed higher real rates in a more friendly investment environment along with structural reforms which seem to be accelerating as well.

Latin America: Fiscal austerity is pushing Brazil into a mild recession as the new administration makes a policy shift and takes on 'The Growth Mismatch'. With better cyclical growth in Mexico, the passing of energy-related legislation should help with structural tailwinds as well.

CEEMEA: Russia needs to deal with a Dutch Disease problem which ironically the recent oil and commodity price declines could help alleviate, as we argue today. Turkey and South Africa are also large beneficiaries of cheaper oil.

For our global forecasts, see *2015 Global Macro Outlook: The Battle Against Lowflation*, November 30, 2014.
For our cross-asset views, see 2015 *Global Strategy Outlook: Onwards and Upwards*, November 30, 2014.

Key Forecast Profile

Global Economics Team

	Quarterly												Annual		
	2014				2015				2016				2014E	2015E	2016E
Real GDP (%Q, SAAR)	1Q	2Q	3Q	4QE	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global*	2.2	3.5	3.8	**3.2**	**3.5**	**3.0**	**3.5**	**3.5**	**3.6**	**3.7**	**3.9**	**3.8**	**3.2**	**3.5**	**3.9**
G10	**0.5**	**1.7**	**2.5**	**1.9**	**2.5**	**1.7**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.1**	**1.6**	**1.9**	**2.0**
US	-2.1	4.6	5.0	2.9*	4.1*	1.8	2.6	2.5	2.3	2.2	2.1	2.1	2.2	2.9	2.3
Euro Area	1.2	0.3	0.6	0.6	0.9	1.2	1.6	1.6	1.7	1.8	1.8	1.6	0.8	1.0	1.7
Japan	5.8	-6.7	-1.9	1.1	1.6	2.3	0.9	1.6	1.9	2.0	2.1	3.0	0.0	0.6	1.8
UK	3.0	3.7	2.8	2.6	2.5	2.0	2.5	2.0	2.0	1.2	1.6	2.1	3.0	2.5	1.9
EM (%Y)	**4.7**	**4.6**	**4.5**	**4.3**	**4.7**	**4.6**	**4.7**	**4.9**	**5.0**	**5.3**	**5.4**	**5.5**	**4.5**	**4.6**	**5.3**
China	7.4	7.5	7.3	7.2	7.4	7.1	6.9	6.8	6.8	7.0	7.3	7.5	7.3	7.0	7.2
India	4.6	5.7	5.3	5.6	6.0	6.1	6.5	6.6	6.8	6.8	6.9	6.9	5.3	6.3	6.8
Brazil	1.9	-0.9	0.1	-0.2	-0.5	-0.5	-0.3	0.0	0.7	1.5	1.6	1.6	0.2	-0.3	1.3
Russia	0.9	0.8	0.7	-0.6	-1.2	-2.0	-2.4	-1.3	-0.5	0.5	1.3	1.5	0.4	-1.7	0.8
Consumer price inflation (%Y)															
Global	**3.4**	**3.8**	**3.6**	**3.3**	**3.2**	**3.1**	**3.2**	**3.4**	**3.6**	**3.6**	**3.7**	**3.8**	**3.5**	**3.3**	**3.7**
G10	**1.2**	**1.8**	**1.5**	**1.1**	**0.0**	**-0.1**	**0.1**	**0.6**	**1.7**	**1.9**	**1.9**	**2.0**	**1.3**	**0.4**	**1.9**
US	1.4	2.1	1.8	1.2	-0.6	-0.5	-0.3	0.3	1.9	2.1	2.2	2.4	1.3	-0.3	2.2
Euro Area	0.7	0.6	0.4	0.2	-0.5	-0.2	-0.1	0.5	1.4	1.5	1.6	1.6	0.5	0.9	1.4
Japan	1.3	3.3	3.2	2.8	2.8	0.9	0.9	1.3	1.5	1.5	1.6	1.8	2.7	1.5	1.6
UK	1.7	1.7	1.5	0.9	0.2	0.3	0.7	1.1	1.9	1.9	1.9	1.9	1.5	0.6	1.9
EM	**5.2**	**5.4**	**5.2**	**5.0**	**5.6**	**5.6**	**5.6**	**5.5**	**5.0**	**4.9**	**5.0**	**5.1**	**5.2**	**5.5**	**5.0**
China	2.3	2.2	2.0	1.5	1.8	1.9	2.0	2.1	2.1	2.3	2.5	2.9	2.0	2.0	2.4
India	8.4	8.1	7.4	5.0	5.7	5.5	4.8	5.9	6.0	5.9	5.4	5.2	7.3	5.5	5.5
Brazil	5.8	6.4	6.6	6.5	6.8	6.3	6.5	6.3	6.0	6.1	5.9	6.0	6.3	6.5	6.0
Russia	6.4	7.6	7.7	9.6	14.4	14.6	13.8	12.2	7.8	6.7	7.4	7.3	7.8	13.7	7.3
Monetary policy rate (% p.a.)															
Global	**3.4**	**3.4**	**3.4**	**3.7**	**3.7**	**3.6**	**3.5**	**3.4**	**3.4**	**3.4**	**3.6**	**3.7**	**3.7**	**3.4**	**3.7**
G10	**0.3**	**0.3**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.5**	**0.7**	**1.0**	**1.2**	**0.2**	**0.2**	**1.2**
US	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.625	1.125	1.625	2.125	0.125	0.125	2.125
Euro Area	0.25	0.15	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	0.50	0.75	1.25
EM	**6.1**	**6.1**	**6.1**	**6.7**	**6.6**	**6.5**	**6.3**	**6.1**	**6.0**	**5.8**	**5.8**	**5.8**	**6.7**	**6.1**	**5.8**
China	6.00	6.00	6.00	5.60	5.35	5.10	5.10	5.10	5.10	5.10	5.10	5.10	5.60	5.10	5.10
India	8.00	8.00	8.00	8.00	7.75	7.50	7.50	7.50	7.50	7.50	7.50	7.50	8.00	7.50	7.50
Brazil	10.75	11.00	11.00	11.75	12.50	12.50	12.00	11.00	10.00	10.00	10.00	10.00	11.75	11.00	10.00
Russia	7.00	7.50	8.00	17.00	17.00	17.00	15.50	13.50	12.00	8.50	8.50	8.50	17.00	13.50	8.50

Note: Global and regional aggregates are GDP-weighted averages, using PPPs; as of this report, they are based on new PPP weights and are not comparable to the aggregates published in the September *Back-to-School*. Japan CPI includes VAT; Japan policy rate is the interest rate on excess reserves; CPI numbers are period averages. *G10+BRICs+Korea. *tracking estimates.
Source: Morgan Stanley Research forecasts

Global Macro Watch

US: The Search for Wage Growth

Ellen Zentner (1 212) 296 4882

Strong job gains: Job gains wrapped up 2014 as the best year since 1999, with 2.95 million new jobs added and a 246K average monthly payroll gain. The unemployment rate fell another 0.1pp to 5.6% in December, from 6.7% at end -2013.

Wage growth still sluggish: Despite how far unemployment has fallen, there are no signs of sustained wage pressures. Average hourly earnings fell 0.2% in December following a downwardly revised gain of 0.2% in November (versus the previously reported gain of 0.4%), which left year-on-year average hourly earnings growth at 1.7%, near a historical low. The pullback in average hourly earnings appears to confirm that the originally reported jump in November was influenced by a statistical quirk. This puts the spotlight on the January 30 release of the 4Q Employment Cost Index (ECI) to help sort out the wage inflation picture. We look for a 2.16%Y increase in the 4Q ECI (versus 2.26%Y in 3Q) – still well below what we've seen going into past Fed tightening cycles.

Rising real wages: We expect that a sufficient tightening of labour markets will provide the impetus for wage growth to climb gradually in 2015, rising by an average 2.5%Y compared with a touch below 2%Y in 2014.

While nominal wage gains remain historically muted, lower inflation alone will boost *real* wages this year: As a result of lower energy prices, we expect year-on-year headline inflation to turn negative starting in January, and deepen into the summer months. But this is a transitory effect, and we expect inflation will rise back towards 2%Y once we've lapped the annual base effect. Assuming a steady 0.2% monthly increase in average hourly earnings this year, inflation-adjusted wage growth should get a boost through the first half of the year, and then normalise in the second half.

Examining earnings: There is a disconnect between wages and unemployment. Even with the unemployment rate falling near levels consistent with the FOMC's projections of full employment, wage growth has yet to pick up, suggesting that the natural rate of unemployment may be lower than currently estimated – something the Fed may have to acknowledge when it updates its long-run projections in March. Recent research from the San Francisco Fed examined this disconnect and concluded that "pent-up wage cuts" may be an important explanation. Regardless of the reason, wage gains remain far from normal. Even with the help of lower gasoline prices, Fed Chair Yellen and the FOMC are unlikely to be confident enough that wages can weather higher interest rates this year.

For full details, see *US Economics: The Search for Wage Growth*, January 9, 2015.

UK: Flirting with Deflation

Melanie Baker, CFA (44 20) 7425 8607
Jonathan Ashworth (44 20) 7425 1820
Jacob Nell (44 20) 7425 8724

UK CPI inflation fell to 0.5%Y in December, a downside surprise. While good news for the consumer, this increases the risk of deflation and a delay to our call for the first rate hike in 4Q15.

Impact on our views: CPI inflation fell by 0.5pp to 0.5%Y in December, 0.2pp below our and consensus expectations. The main downward contributions came from transport and housing/household services, largely reflecting energy prices. However, most major components were broadly unchanged in terms of year-on-year inflation. We assume that the downward surprise is not unwound next month and, given lower oil prices too, make downward revisions to our near-term inflation forecasts. This lowers our 2015 CPI forecast by 0.5pp to only 0.6%Y. Overall, there remains no urgency for a rate rise coming from the current inflation data. These lower forecasts suggest additional upside risk to our consumer spending forecasts for 2015 though.

Will inflation fall further from here? We expect CPI inflation to decline to 0.3%Y in January and to only 0.1%Y in February amid sharp further downward pressure from energy components. The picture for underlying near-term inflationary pressure remains subdued. Energy prices and supermarket price pressures continue to imply downside risks for headline inflation in the near term and disinflationary pressures appear evident across several sectors. However, pay growth has continued to pick up and our measures of underlying services inflation don't look markedly lower than they were at the start of 2014. We still forecast a pick-up in headline inflation at the end of 2015 as some of these downward pressures unwind and as domestically generated inflation picks up.

Implications for the MPC: The 4Q 0.9%Y reading on CPI is already 0.3pp below the MPC's November Inflation Report forecast and Governor Carney will need to write an open letter to the Chancellor in February explaining why inflation has fallen below 1%Y and what action will be taken to address this (he may have to write a couple more letters after that one too, on our forecasts). We continue to expect a first rate rise in 4Q15 but, with headline inflation low and some inflation expectations measures having drifted lower too, risks are growing for a later first rate rise.

For full details, see *UK Economics: Inflation: Flirting with Deflation*, January 13, 2015.

Global Macro Watch

Canada: Sands Through the Hourglass

Robert Rosener (1 212) 296 5614

The fall in oil is undisputedly negative for Canada's economy. We believe that the Bank of Canada is likely to revise down its growth forecasts when it releases its Monetary Policy Review on January 21, which would have significant implications for USD/CAD.

Growth: Considering the second-round effects of lower oil prices, we've downwardly revised our growth forecasts for Canada. We now forecast that real GDP growth will slow from 2.4%Y in 2014 to 1.8%Y in 2015 and 1.5%Y in 2016.

We expect that the Bank of Canada will also need to downwardly revise its growth forecasts in its Monetary Policy Report on January 21.

Monetary policy: Our lower growth forecasts imply that it will take longer for Canada's output gap to close, and already dovish rate hike expectations could be priced out to 2017. Consistent with our expectations for lower growth and moderating inflation, we do not expect the first rate hike from the Bank of Canada until 2017.

Moreover, we see *downside* risks to our growth and inflation forecasts from potential further cuts to capex and slowing domestic activity, and we place a subjective probability of 1 in 3 that the Bank of Canada ***cuts*** interest rates in 2015; the market is pricing in only a slim chance of a 25bp easing this year. While the Bank of Canada is reluctant to aggravate household imbalances, a more severe widening of the output gap would increase the pressure to cut rates.

For full details, see *Economics & Strategy Insights: Canada Outlook: Sands Through the Hourglass*, January 14, 2015.

EM: Will Brazil Determine the Fate of EM in 2015?

Manoj Pradhan (44 20) 7425 3805
Patryk Drozdzik (44 20) 7425 7483

2014 versus 2015: Last December, we upgraded India and downgraded Russia as our key call for 2014, also arguing that economies in the 'Double Deficit Club' would continue to remain under pressure (thanks to the Great EM Unwind – a triple unwind of US real rates, high leverage in China and excessive credit growth in EM). While the headwinds remain the same for 2015, we believe that the key economy to follow is Brazil.

As goes Brazil, so should EM: Should Brazil pass through the most painful parts of its macro adjustment before any external headwinds to EM have a serious flare-up, the EM complex as a whole will likely be far more resilient to external headwinds. The bear case is not that Brazil doesn't go through with its macro adjustment, but that it does at the same time as one of many external headwinds manifests itself. Asset prices buoyed by fiscal downside suggest that investors seem to have forgotten the lessons of fiscal austerity in Europe, and the mix of austerity and external headwinds could combine to deliver a body blow to EM markets and economies.

In our 2015 outlook, we ask:

1. Why Brazil, why not other economies? Brazil is one of only two large EM economies (the other being China) where we believe policy-led domestic adjustment could be disruptive, making it a potential exporter of contagion. It is one of four economies, along with Russia, South Africa and less so Turkey, that we see as both 'most structurally challenged' (China features here too) and 'most externally exposed', implying a greater tendency to import contagion.

2. What are the hot spots and bright spots in EM in 2015? We examine Russia, China, South Africa, India, Mexico, Indonesia, Taiwan and CE3 economies, and agonise over where to place Turkey. We also scrutinise where the biggest risks of exporting and importing contagion to the rest of EM reside among the structurally challenged and externally exposed economies.

3. What surprises could 2015 have in store? We look at: i) Korea's reaction if China becomes an exporter of deflation again in 2015; ii) Why commodity-sensitive Indonesia and Mexico could do better than their commodity exposure would suggest; and iii) A return of external headwinds – the Great EM Unwind – interacting badly with Russia's market-enforced adjustment and Brazil's fiscal austerity programme.

For full details, see *Emerging Issues: Will Brazil Determine the Fate of EM in 2015?* January 12, 2015.

Global Macro Watch

CEEMEA: Oil at $50: Inflation Implications

CEEMEA Economics Team

How's life at US$50/bbl? In this note, we update our analysis on the impact of oil price movements on CEEMEA inflation. We find that a 10% move in oil prices changes inflation by 10-40bp, with **Israel** and the **Czech Republic** at the lower end of that range and **Turkey** and **South Africa** at the higher end. We also find that pass-through is particularly high and rapid in **South Africa,** where up to three-quarters of the long-term impact may be transmitted within three months.

Second-round effects could make the pass-through even higher: As our model works on narrow energy components, we do not explicitly account for second-round effects. Also, we leave out administered energy prices and other components of the CPI basket where energy is a significant input cost. Therefore, by construction, our estimates may be somewhat downwardly biased.

Do oil prices matter for CEEMEA central banks?

In **South Africa,** ongoing oil price weakness puts our call for the SARB to hike rates in 2Q at risk, as the lower the inflation outcome, the less the need for policy normalisation in what is still a relatively weak growth environment.

In **Turkey,** the CBT should look favourably upon the oil price move, which will likely help to push inflation close to 5%Y by summer 2015, and pave the way for at least 100bp of rate cuts in the coming months.

In **Poland,** the oil move should only exacerbate the tensions on the MPC between doves and hawks; the market's verdict is that the doves will prevail, but we are not so sure and stick to our view that rates will remain unchanged in 2015.

In **Hungary,** the NBH is likely to once again have to downgrade its inflation forecast in March, which would increase risks of further easing (not our current view).

In the **Czech Republic,** inflation hovering dangerously close to zero will likely reignite speculation that the CNB will devalue CZK again.

By contrast, in **Russia,** the inflationary impact of RUB weakness dwarfs the disinflationary impact of lower energy prices. We expect rates on hold at 17% in 1H15 and a rate-cutting cycle starting in 2H only, when the CBR is comfortable that inflation is on a downward track.

For full details, see *CEEMEA Macro Focus: Oil at $50: Inflation Implications*, January 12, 2015.

Asia-Pacific: Disinflation to Deflation Risk?

Chetan Ahya (852) 2239 7812
Derrick Kam (852) 2239 7826
Jenny Zheng (852) 3963 4015
Nupur Gupta (91 22) 6118 2245

From PPI deflation to CPI deflation? While PPI has been in deflation for some time, we are now increasingly witnessing the deflationary pressures spreading quickly to CPI and the GDP deflator. Even without the full effect of the recent collapse in energy prices, the GDP deflator in the region ex-India, Indonesia and Philippines is estimated to have slipped to 0.3%Y in the quarter ended Dec-14 from 1.6%Y in Dec-13. We believe that weaker aggregate demand is at the heart of this generalised deflationary pressure.

Persistent deflationary pressure in the context of high debt is our key concern: The deflationary trend has meant that real rates are rising across the region. This development is particularly challenging considering that seven out of 10 countries in the region now have debt to GDP at close to 200% or above. Rising real rates and slowing nominal GDP growth mean that debt to GDP will likely continue to rise.

Monetary easing is the answer, but central banks continue to be hesitant as they are concerned about the misallocation of financial resources and deterioration in productivity. Moreover, six countries in the region are experiencing a shift in demographics, which has lessened the pressures for job creation.

Rising risks of broad-based deflation: Policy-makers are concerned that a sharp cut in real rates would encourage further misallocation and hence place greater emphasis on reforms over monetary easing as the means to kick-start a productive growth cycle. However, keeping real rates at elevated levels will risk a withdrawal of the private sector, which will instead increase the challenges of kick-starting a productive growth cycle, in our view. While structural reforms are much needed and will be important in lifting productive growth, we believe that setting the right level of real interest rates will be even more critical as it will create a conducive environment in which a new productive and sustainable growth cycle can emerge.

For full details, see *Asia Pacific Economics: Disinflation to Deflation Risk?* January 13, 2015.

Global Macro Watch

China: Risk from Lowflation Calls for More Easing

Helen Qiao (852) 2848 6511
Junwei Sun (852) 2848 5200
Yin Zhang (852) 2239 7818

December CPI inflation inched up to 1.5%Y, in line with market expectations (+1.5%Y) and versus our +1.7%Y. This was due mainly to higher food price inflation (up 0.6pp to +2.9%Y) thanks to a low base a year ago and the seasonal rise in fresh vegetable prices against cold weather. Meanwhile, non-food CPI inflation dipped to a five-year low of +0.8%Y, reflecting a sequential contraction in fuel and utility prices on the back of falling crude oil prices.

PPI deflation widened to -3.3%Y in December (versus -2.7%Y in November), slightly below market expectations (-3.1%Y) and our -3.2%Y. The sequential contraction widened to -7.6%M SAAR in December (versus -6.1%M SAAR in November), on our estimates. Similar to the previous month, this reflected the sharper fall in fuel and power prices on the back of falling oil prices and the weaker sequential growth of building materials prices and non-ferrous metal prices amid still sluggish industrial demand growth.

Outlook and policy implications: Domestic demand growth likely remains sluggish, as reflected in the entrenched lowflation in CPI and deeper PPI deflation. Despite the notable drag from falling oil prices, the faster sequential fall in non-ferrous metal prices and building materials prices implies that the source of more entrenched PPI deflation is from weak domestic investment. It will take time for PPI deflation to flip into positive territory, and CPI is likely to remain range-bound around 2%Y in the coming quarters.

Sluggish demand growth and the risk from lowflation warrant further policy easing. In the near term, the PBOC is likely to continue to rely on quantitative tools, such as targeted easing measures, open market operation and RRR cuts, to improve liquidity conditions, lower interbank rates and drive down funding costs. The risk from entrenched lowflation amid weaker growth data should strengthen the case for another rate cut in the upcoming months.

For full details, see *China Economics: Risk from Lowflation Calls for More Easing*, January 9, 2015.

India: CPI Inflation – Another Month of Positive Surprise

Upasana Chachra (91 22) 6118 2246
Chetan Ahya (852) 2239 7812

Headline CPI inflation accelerated in December but was lower than expected: CPI inflation accelerated to 5%Y in December 2014 from 4.4%Y in November. This was below our 5.5%Y estimate and consensus of 5.35%Y. The acceleration was expected, mainly in view of the unwinding of the supportive base effect. However, the pick-up was lower than expected, mainly because food inflation was less than expected.

Core inflation decelerated in December, with muted sequential momentum: Ex-food and fuel, (core) CPI inflation decelerated to a new low of 5.2%Y in December from 5.5%Y in November and 5.9%Y in October. On a three-month trailing average basis, core CPI moderated to 5.5%Y for the three months ending December from 5.7%Y for the three months ending November. Indeed, the trend in core inflation has shown sustained moderation on a year-on-year basis from April 2014 onwards with a broad-based moderation in prices. Price rises for housing, transport & communication and clothing moderated; recreation & amusement decelerated on a year-on-year basis.

Food inflation accelerated in December on a year-on-year basis, mainly because base effect support waned: Food inflation accelerated to 4.78%Y in December 2014 from 3.1%Y in November and 5.6%Y in October. On a monthly sequential basis, the food index declined by 1.3%M in December versus a decline of 0.1%M in November. The sequential decline mainly reflected declines in the prices of vegetables (-7.9%M), cereals (-0.2%M), sugar (-1.4%M) and fruits and oils (-0.1%M each).

High-frequency data indicate that food prices have risen on a year-on-year basis in January (month to date): We track high-frequency food prices released by the Department of Consumer Affairs to assess the underlying food inflation pressures in a timely manner. High-frequency food items we are tracking account for approximately 38% of the overall CPI index. The high-frequency retail food prices in January (month to date) indicate that food prices have risen in January on a year-on-year basis, mainly led by vegetable prices (partly due to the base effect).

For full details, see *India Economics: CPI Inflation – Another Month of Positive Surprise*, January 12, 2015.

Global Macro Watch

Korea: The Impact of Lower Oil Prices

Sharon Lam (852) 2848 8927
Sung Woen Kang (852) 2848 5652

Given the importance of oil to the Korean economy, it stands to be a beneficiary of low oil prices: However, such a positive impact may come through at a slow pace, in particular if overall sentiment, both at home and abroad, remains depressed.

Global oil prices have continued to slide: They're leaning towards the bear case laid out in our commodity strategists' 2015 outlook (see *Crude Oil 2015: It Likely Gets Worse Before It Gets Better*, December 5, 2014). Brent is down to US$50/barrel, a decline of >50% since mid-2014, and WTI has plunged below the US$50 level.

If global oil prices were to be sustained at such low levels, this would deviate meaningfully from the US$88 average that we assumed for our 2015 outlook (see *Korea Economics: 2015 Outlook: Crawling Back to Trend Growth*, December 1, 2014). Korea's consumption of oil relative to total energy use is 40%. Its overall oil balance is approximately -5.5% of GDP, making it one of the larger net oil importers in AXJ.

Savings from lower fuel prices point to a potentially positive impact on the economy: Lower oil prices support consumer spending in two ways: i) Directly, via lower spending on fuel products; and ii) Indirectly, via cheaper consumer goods and services that benefit from fuel as an input of production.

Impact of oil prices on the current account: As a large net oil importer, lower oil prices would help Korea's terms of trade and improve its current account balance.

Impact of oil prices on inflation: The floating fuel price mechanism in Korea means that global energy prices translate into domestic prices fairly quickly. Recent trends in global energy prices would therefore intensify the environment of low inflation. Lower inflation may in turn further weigh on domestic activity by pushing real rates higher.

As such, the BoK would face more easing pressures in addition to the 25bp rate cut we already assume in 1Q15. However, we stick to our base case that the BoK will cut the policy rate once by 25bp in 1Q15, to 1.75%.

For full details, see *Korea Economics: Impact of Lower Oil Prices on Korea*, January 7, 2015.

Indonesia: Is a Manufacturing Resurgence at Hand?

Deyi Tan (65) 6834 6703
Zhixiang Su (65) 6834 6739
Ju Ye Lee (65) 6834 6743

For two years, the Street debated what lower commodity prices meant for Indonesia: Going forward, we think that the debate will centre on whether it can re-industrialise and improve non-commodity competitiveness to offset commodities. We delve into manufacturing for a better sense. Our view? Manufacturing has picked up and will continue to do so – but the pace is unlikely to return GDP growth to 6.0-6.5%Y in 2015 just yet. Faster-than-expected reforms would mean upside growth risk which is back-ended to 2016.

Re-industrialisation needed to restore growth: The impact from reversal of the commodity supercycle is well-flagged. Lesser known is how high commodity prices had earlier inflicted Dutch Disease and weakened manufacturing, leading to a double whammy when commodity prices fell. We believe that manufacturing will have to pick up from a 10-year CAGR of 4.7% to 7-8% for GDP growth to return to 6.0-6.5%Y.

Manufacturing has picked up… The good news: manufacturing has picked up in recent years. This is not limited to autos; it is also visible in food, chemicals/ pharmaceuticals and metal/machinery/electronics, where investment was relatively stronger. The latter coincided with these segments outperforming the overall IPI. Indonesia's global export share in autos, chemicals and pharmaceuticals has also improved.

…but will have to get into full swing via reforms: This manufacturing pick-up is insufficient to offset the commodity impact, though; the industrialisation tales of Asian tigers suggest that more reforms are needed. Re-industrialising by adding value to commodities and import substitution appears to be the policy stance – but we think that non-commodities manufacturing is a more sustainable strategy. Import substitution could work, but only if it enables domestic producers ultimately to become globally competitive. Meanwhile, infrastructure improvement is necessary; keeping external and internal prices competitive would help.

For full details, see *Indonesia Economics: Asia Insight: Is a Manufacturing Resurgence at Hand?* January 7, 2015.

Global Macro Watch

Brazil: Policy-Makers Getting Serious?

Arthur Carvalho (55 11) 3048 6272

Brazil has advanced from signalling tighter fiscal and quasi-fiscal policy to the first steps of implementing it: Since the new economic team was announced, markets have expected that Brazil's policy mix would change. After several years of lax fiscal policy, the most recent signals point to a dramatically different stance, not only on spending and taxes, but also on the quasi fiscal policy that has boosted public banks' lending in the past couple of years.

Subsidised credit has taken its first hit already: The monetary council announced a 50bp hike in the development bank's base interest rate (TJLP), taking it to 5.5%, the first hike since April 2003. This is a key pillar in the effort to reduce the cost to the government of subsidised credit, which soared in the past few years as the development bank received R$390 billion to lend at the TJLP. Officials have also stressed that further capital injections into the development bank are unlikely, sending a clear message that one should expect not only higher costs, but also lower volumes. Indeed, we expect that the TJLP will be hiked to at least 7% before end-2015.

Spending cuts have already been announced in the form of changes to the regulations for social benefits: Although the government has not changed the amount of benefits, it made it materially harder for people to access some of them. To obtain unemployment insurance, workers will now need to have worked for 18 months, up from six previously. Also, in order to qualify for the minimum wage bonus paid by the government to workers who hold up to two minimum wage jobs, workers now need to work for at least six months versus just one previously. The new economic team estimated that these changes, together with some further changes on pensions, will save around R$18 billion annually, or 30bp of GDP.

Even education, which continues to be a top priority for the government, has undergone some change: The minimum grade a student needs to achieve in order to receive a loan will be higher.

Finally, the administration announced a preliminary R$22 billion budget cut: Given that the official budget law has not yet been approved by Congress, technically the economic team cannot announce final budget cuts. Instead, the team has announced preliminary cuts that would not become official until the final budget law is approved. Indeed, these cuts could even increase once the team has access to the full new budget law.

For full details, see *Brazil and Mexico: While You Were Away: Week Ahead in Latin America*, January 9, 2015.

Mexico: Growth Is Firming

Luis Arcentales (1 212) 761 4913

Mexico's story of positive yet moderate economic growth has continued to play out: October's IGAE activity index posted the strongest sequential gain (+0.6%) since April, putting GDP growth in 4Q on track to expand near 3% annualised – 1pp faster than in 3Q. Consistent with the welcome acceleration in formal job creation in October and November to almost 6% annualised, November's seasonally adjusted unemployment rate declined to a fresh one-year low (4.7%) – good news even though lower participation accounted for part of the improvement. There was also good news from remittances, credit and autos. In contrast, the latest trade data were mixed. On the negative side, manufacturing and services PMIs declined in December, dipping below the 50 neutral threshold. Mexico watchers may rightfully be doubtful of the sustainability of the late-year momentum – after all, in the past two years of sluggish growth there have been plenty of green shoots that quickly faded – but at least the latest batch of data clearly points to firming growth.

For all the generally supportive data reports of late, concerns over oil prices and politics are still dominating the news flow: Protests have subsided and legislators have indicated that the anti-corruption reform is likely to be a priority in the next session that starts in February. Beyond this, it remains to be seen if Mexican policy-makers can take advantage of the recent turmoil to push bolder actions to address the challenges to the rule of law and transparency.

Progress with energy reform implementation has been challenged by uncertainty over the impact of lower oil prices on potential investment: Indeed, policy-makers have already suggested that some unconventional and deep water projects may be postponed until market conditions improve. Yet, as much as lower oil is squeezing capex budgets, one has to ask if the government will risk early failure by not providing proper incentives to invest in light of the recent plunge in oil.

For inflation watchers, the turn of the year brought positive news in the form of a fuel price hike of just 1.9%, well below the move consistent with expected inflation (3-4%) previously suggested by policy-makers. Starting in 2015, domestic fuel prices will see only one adjustment at the start of the year instead of regular hikes on the first Saturday of each month. This decrease in the rates of domestic fuel price hikes, which over the past four years have averaged close to 11%, along with decreases in some electricity tariffs, should surely prove welcome relief for consumers' pockets in 2015.

For full details, see *Brazil and Mexico: While You Were Away: Week Ahead in Latin America*, January 9, 2015.

Inflation Target Monitor & Next Rate Move

Global Economics Team. Contact: Manoj.Pradhan@morganstanley.com

	Inflation target	Latest month	12M MS fcast	Next rate decision	Current rate	Market expects (bp)	MS expects (bp)	Risks to our call
US	2.0% PCE Price Index	1.2%	1.7%	28 Jan	0.125	0	0	No risks, same through mid-2015
Euro Area	< 2% HICP (u)	-0.2%	0.9%	22 Jan	0.05	5	0	Potential announcement of sovereign QE
Japan	2% CPI (u)	0.7%	1.0%	21 Jan	0.10	0	0	-
UK	2%	0.5%	1.4%	05 Feb	0.50	1	0	Risk has risen of no rate rise until 2016
Canada	1-3%	1.0%	2.0%	22 Jan	1.00	0	0	Data-dependent
Switzerland	<2% CPI (u)	0.0%	0.2%	19 Mar	0.00	-10	0	-
Sweden	2.0% CPI	-0.3%	0.8%	12 Feb	0.00	-5	0	Unconventional measures become viable
Australia	2-3% over the cycle	2.3%	2.2%	02 Feb	2.50	-4	0	We put additional 50bp rate cuts over 2015 as 45% likelihood
New Zealand	1-3% CPI	1.0%	-	29 Jan	3.50	1	0	-
Russia	5% CPI	11.3%	10.6%	30 Jan	17.00	-	0	-
Poland	2.5% (+/- 1%) CPI	-0.6%	1.4%	04 Feb	2.00	-	0	-
Czech Rep.	2.0% (+/-1%) CPI	0.1%	1.5%	05 Feb	0.05	-2	0	-
Hungary	3.0% CPI	-0.9%	2.4%	27 Jan	2.10	-1	0	-
Romania	2.5% (+/-1%) CPI	0.8%	2.2%	04 Feb	2.50	-	-25	-
Turkey	5%	8.2%	6.2%	20 Jan	8.25	-15	0	-
Israel	1-3%	-0.1%	1.1%	26 Jan	0.25	0	0	-
S. Africa	3-6%	5.8%	5.2%	29 Jan	5.75	11	0	Oil drops below US$30/bbl, SARB debates cuts
Nigeria	-	8.0%	8.5%	20 Jan	13.00	-	-	CBN hikes the MPR aggressively
Ghana	9% +/-2%	17.0%	11.0%	18 Feb	21.00	-	0	-
Kenya	5% +/-2.5%	6.0%	7.2%	12 Mar	8.50	-	0	-
China	-	1.5%		N/A	5.60	-	-	-
India	-	5.0%	5.5%	03 Feb	8.00	-	-25	-
Hong Kong	-	5.1%	3.6%	28 Jan	0.50	-	0	-
S. Korea	2.5-3.5%	0.8%	1.9%	15 Jan	2.00	0	0	Rate cut due to lower inflation caused by decline in oil prices
Taiwan	-	0.6%	1.9%	25 Mar	1.875	29	0	-
Indonesia	4.5% +/- 1.0%	8.4%	5.7%	15 Jan	7.75	-	0	Evenly balanced
Malaysia	-	3.0%	4.1%	28 Jan	3.25	10	0	Evenly balanced
Thailand	0.5-3.0% core CPI	0.6%	2.4%	28 Jan	2.00	-4	0	-
Philippines	4% +/-1% CPI	2.7%	4.0%	12 Feb	2.50	-	25	-
Brazil	4.5% +/-2.0% IPCA	6.6%	6.3%	21 Jan	11.75	59	25	-
Mexico	3% +/-1% CPI	4.1%	3.4%	29 Jan	3.00	1	0	FX weakness could prompt earlier hikes
Argentina	15.5-24.2% M2 growth	24.2%	27.9%	NA	NA	-	-	-
Chile	3% +/-1% CPI	4.6%	3.3%	15 Jan	3.00	-6	0	-
Peru	2% +/-1% CPI	3.1%	2.8%	15 Jan	3.50	-	0	-
Colombia	3% +/-1% CPI	2.9%	3.3%	30 Jan	4.50	-4	0	-

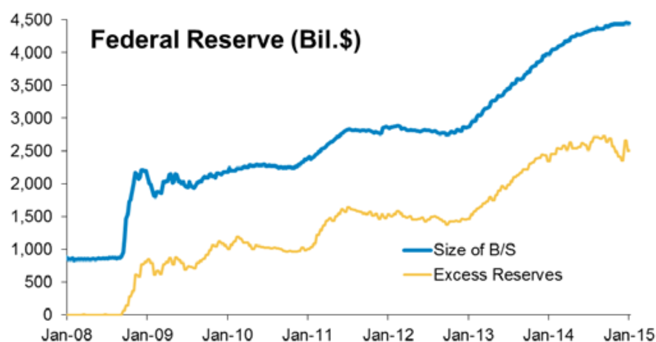
(u) = unofficial
Notes: Inflation numbers in red indicate values above target, green below; MS expectations in red (green) indicate our rate forecasts are above (below) market expectations. Japan policy rate is the interest rate on excess reserves. Japan latest month CPI is ex fresh food and VAT impact.
Source: National central banks, Morgan Stanley Research forecast

Global Monetary Policy Rate Forecasts

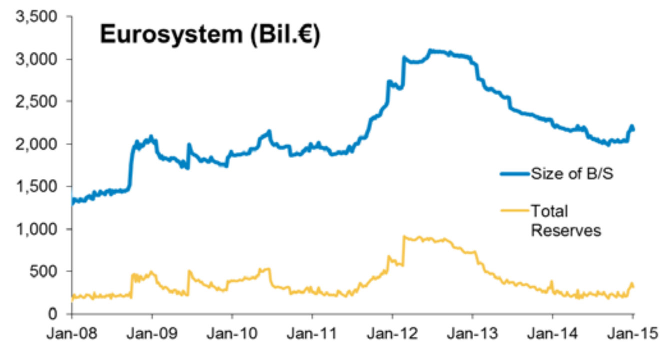
	Current	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16
US	0.125	0.125	0.125	0.125	0.125	0.625	1.125	1.625	2.125
Euro Area	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25
Canada	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Switzerland	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Sweden	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.50
Australia	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25	3.25
New Zealand	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.25	4.50
Russia	17.00	17.00	17.00	15.50	13.50	12.00	8.50	8.50	8.50
Poland	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.25	2.50
Czech Rep.	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.25	0.50
Hungary	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.25	2.50
Romania	2.75	2.25	2.25	2.25	2.25	2.25	2.50	2.75	3.00
Turkey	8.25	7.75	7.00	7.00	7.00	7.25	7.50	7.50	7.50
Israel	0.25	0.25	0.25	0.25	0.50	1.25	1.50	1.75	2.25
S. Africa	5.75	5.75	6.00	6.00	6.25	6.75	6.75	7.25	7.25
Nigeria	13.00	13.00	13.00	13.00	13.00	12.50	11.50	11.50	11.50
Ghana	21.00	21.00	21.00	21.00	20.00	20.00	19.00	19.00	19.00
Kenya	8.50	8.50	8.50	8.50	8.50	8.00	8.00	8.00	8.00
China	5.60	5.35	5.10	5.10	5.10	5.10	5.10	5.10	5.10
India	8.00	7.75	7.50	7.50	7.50	7.50	7.50	7.50	7.50
Hong Kong	0.50	0.50	0.50	0.50	0.50	1.00	1.50	2.00	2.50
S. Korea	2.00	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.875	1.875	1.875	1.875	1.875	1.875	2.000	2.125	2.125
Indonesia	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.75
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Thailand	2.00	2.00	2.00	2.00	2.50	2.75	2.75	2.75	2.75
Philippines	2.50	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75
Brazil	11.75	12.50	12.50	12.00	11.00	10.00	10.00	10.00	10.00
Mexico	3.00	3.00	3.00	3.00	3.50	4.00	4.25	4.50	4.50
Chile	3.00	2.75	2.75	2.75	2.75	2.75	3.25	3.50	4.00
Peru	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.25	4.50
Colombia	4.50	4.50	4.50	4.50	4.50	4.75	5.00	5.00	5.00

Source: National Central Banks, Morgan Stanley Research forecasts; Note: Japan policy rate is the interest rate on excess reserves. Red font highlights rate hikes; green font highlights rate cuts.

Fed and Eurosystem Balance Sheet Monitor



Source: Haver Analytics



Source: Haver Analytics

Global GDP and Inflation Forecasts

	Real GDP (%)				CPI inflation (%)			
	2013	2014E	2015E	2016E	2013	2014E	2015E	2016E
Global Economy	**3.3**	**3.2**	**3.5**	**3.9**	**3.5**	**3.5**	**3.3**	**3.7**
G10	**1.3**	**1.6**	**2.0**	**2.0**	**1.4**	**1.3**	**0.4**	**1.9**
US	2.2	2.2	2.9	2.3	1.5	1.3	-0.3	2.2
Euro Area	-0.4	0.8	1.0	1.7	1.4	0.5	0.9	1.4
Japan	1.6	0.0	0.6	1.8	0.4	2.7	1.5	1.6
UK	1.7	3.0	2.5	1.9	2.6	1.5	0.6	1.8
Canada	2.0	2.4	1.8	1.5	3.5	3.5	3.3	2.1
Sweden	1.3	1.7	2.4	3.1	0.0	-0.2	0.1	1.4
Australia	2.1	2.7	1.5	2.2	2.4	2.5	2.0	2.4
Emerging Markets	**4.8**	**4.5**	**4.6**	**5.3**	**5.2**	**5.2**	**5.5**	**5.0**
CEEMEA	**2.3**	**1.9**	**1.4**	**2.9**	**5.6**	**6.8**	**8.9**	**6.3**
Russia	1.3	0.4	-1.7	0.8	6.8	7.8	13.7	7.3
Poland	1.6	3.3	3.1	3.7	0.9	0.0	0.8	2.0
Czech Rep	-0.7	2.3	2.3	2.6	1.4	0.4	1.5	2.0
Hungary	1.5	3.5	2.9	2.3	1.7	-0.1	1.4	2.8
Ukraine	0.0	-6.8	-4.3	4.0	-0.3	12.0	20.9	9.8
Kazakhstan	6.0	3.2	2.8	5.0	5.7	6.7	7.4	6.8
Turkey	4.0	3.3	3.4	3.4	7.5	8.9	6.0	5.9
South Africa	1.9	1.3	2.5	3.0	5.8	6.1	4.3	6.0
Nigeria	5.4	6.2	6.6	6.7	8.5	8.1	8.6	8.2
Ghana	7.1	6.5	5.0	7.0	11.4	15.4	13.0	10.0
Kenya	5.7	5.2	5.8	6.0	5.7	7.1	6.5	6.5
Asia ex-Japan	**6.1**	**6.0**	**6.2**	**6.4**	**4.4**	**3.5**	**3.2**	**3.4**
China	7.7	7.3	7.0	7.2	2.6	2.0	2.0	2.4
India	4.7	5.3	6.3	6.8	10.1	7.3	5.5	5.5
Hong Kong	2.9	2.1	2.3	2.5	4.3	4.2	3.6	2.5
Korea	3.0	3.5	3.7	3.7	1.3	1.3	1.9	2.3
Taiwan	2.1	3.7	3.7	4.0	0.8	1.2	1.9	2.3
Singapore	3.9	3.0	3.2	3.4	2.4	1.3	1.0	1.2
Indonesia	5.8	5.1	5.3	5.5	6.4	6.4	7.2	5.6
Malaysia	4.7	5.8	5.3	5.4	2.1	3.2	4.1	3.1
Thailand	2.9	0.6	3.6	4.0	2.2	1.9	1.7	2.4
Philippines	7.2	5.9	6.3	6.3	2.9	4.2	4.0	4.0
Latin America	**2.5**	**0.9**	**1.4**	**2.6**	**7.5**	**10.3**	**11.3**	**10.7**
Brazil	2.5	0.2	-0.3	1.3	6.2	6.3	6.5	6.0
Mexico	1.1	2.1	3.8	4.1	3.8	4.0	3.6	3.3
Chile	4.1	1.7	2.9	3.8	1.9	4.4	4.3	2.9
Peru	5.0	3.3	4.5	4.0	2.8	3.3	3.0	2.7
Colombia	4.7	4.7	4.2	4.5	2.0	2.9	3.4	3.1
Argentina	3.0	-1.5	-1.0	1.6	10.6	22.4	30.8	26.7
Venezuela	1.3	-3.0	-2.5	0.1	40.6	60.8	66.0	71.9

Source: IMF, Morgan Stanley Research forecasts

Global Economics Team

Global Economics

Joachim Fels	Global	Joachim.Fels@morganstanley.com	+44 (0)20 7425 6138
Manoj Pradhan	Global	Manoj.Pradhan@morganstanley.com	+44 (0)20 7425 3805
Patryk Drozdzik	Global	Patryk.Drozdzik@morganstanley.com	+44 (0)20 7425 7483
Sung Woen Kang	Global, Korea, New Zealand	Sung.Woen.Kang@morganstanley.com	+852 2848 5652

Americas

Ellen Zentner	US	Ellen.Zentner@morganstanley.com	+1 212 296 4822
Ted Wieseman	US	Ted.Wieseman@morganstanley.com	+1 212 761 3407
Robert Rosener	US	Robert.Rosener@morganstanley.com	+1 212 296 5614
Luis Arcentales	Latam, Chile, Mexico	Luis.Arcentales@morganstanley.com	+1 212 761 4913
Arthur Carvalho	Latam, Brazil	Arthur.Carvalho@morganstanley.com	+55 11 3048 6272
Maria Bendana	Latam	Maria.Bendana@morganstanley.com	+1 212 296 5220
Thiago Machado	Brazil	Thiago.Machado@morganstanley.com	+55 11 3048 6249

Europe & Africa

Elga Bartsch	Euro Area, ECB, Germany	Elga.Bartsch@morganstanley.com	+44 (0)20 7425 5434
Daniele Antonucci	Italy, Spain, Greece, Portugal	Daniele.Antonucci@morganstanley.com	+44 (0)20 7425 8943
Marcus Gedai	Germany, Sweden, Austria	Marcus.Gedai@morganstanley.com	+44 (0)20 7425 9668
Jacob Nell	UK	Jacob.Nell@morganstanley.com	+44 (0)20 7425 8724
Melanie Baker	UK	Melanie.Baker@morganstanley.com	+44 (0)20 7425 8607
Jonathan Ashworth	UK	Jonathan.Ashworth@morganstanley.com	+44 (0)20 7425 1820
Pasquale Diana	Poland, Hungary, Czech, Romania	Pasquale.Diana@morganstanley.com	+44 (0)20 7677 4183
Michael Kafe	South Africa, Ghana, Nigeria, Kenya	Michael.Kafe@morganstanley.com	+27 11 587 0806
Andrea Masia	South Africa, Nigeria	Andrea.Masia@rmbmorganstanley.com	+27 11 282 1593
Alina Slyusarchuk	Russia, Kazakhstan, Ukraine	Alina.Slyusarchuk@morganstanley.com	+44 (0)20 7677 6869

Asia

Robert Feldman	Japan	Robert.Tokyo.Feldman@morganstanleymufg.com	+81 3 6836 8400
Takeshi Yamaguchi	Japan	Takeshi.Yamaguchi@morganstanleymufg.com	+81 3 6836 5404
Shoki Omori	Japan	Shoki.Omori@morganstanleymufg.com	+81 3 6836 5466
Chetan Ahya	Asia ex-Japan, India	Chetan.Ahya@morganstanley.com	+852 2239 7812
Derrick Kam	Asia ex-Japan, Hong Kong	Derrick.Kam@morganstanley.com	+852 2239 7826
Jenny Zheng	Asia ex-Japan	Jenny.L.Zheng@morganstanley.com	+852 3963 4015
Nupur Gupta	Asia ex-Japan	Nupur.Gupta@morganstanley.com	+91 22 6118 2245
Upasana Chachra	India	Upasana.Chachra@morganstanley.com	+91 22 6118 2246
Sharon Lam	Korea, Taiwan	Sharon.Lam@morganstanley.com	+852 2848 8927
Jason Liu	Korea, Taiwan	Jason.JL.Liu@morganstanley.com	+852 2848 6882
Helen Qiao	China	Helen.Qiao@morganstanley.com	+852 2848 6511
Junwei Sun	China	Junwei.Sun@morganstanley.com	+852 2239 7820
Yin Zhang	China	Yin.Zhang@morganstanley.com	+852 2239 7818
Deyi Tan	ASEAN	Deyi.Tan@morganstanley.com	+65 6834 6703
Zhixiang Su	ASEAN	Zhixiang.Su@morganstanley.com	+65 6834 6739
Ju Ye Lee	ASEAN	Ju.Ye.Lee@morganstanley.com	+65 6834 6743
Daniel Blake	Australia	Daniel.Blake@morganstanley.com	+61 2 9770 1579

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The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1)212 761 4000

Europe
20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0)20 7425 8000

Japan
1-9-7 Otemachi,
Chiyoda-ku,
Tokyo 100-8104, Japan
Tel: +81 (0)3 6836 5000

Asia/Pacific
1 Austin Road West
Kowloon
Hong Kong
Tel: +852 2848 5200

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