MACROECONOMIC OUTLOOK 2017

Growth and Inflation: A New Narrative
Modest, but Persistent Growth

Fiscal policy is expected to be more stimulative in response to social discontent... and the ECB remains supportive in order to improve inflation expectations and stimulate growth.

New Stimulus Ahead

A new wave of fiscal and monetary policy measures are under way... to support the inflation outlook, profits and exports.

Economy to Slow (With No Drama)

Overcapacity cut, rebalanced towards domestic sectors leading to softer growth... counterbalanced by more infrastructure spending.

US Economic Acceleration

Sound economic conditions (labour market strength, confidence pick up) and fiscal boost... are consistent with the Fed raising rates three times in 2017.

Resilience could be Tested

Foundations for EMs have strengthened, helped by a more favourable commodity cycle... but winners will be those ones with more fiscal and monetary room.

Source: Pioneer Investments, as of December 31, 2016. ECB means European Central Banks.
Key Global Themes

Macroeconomic Outlook 2017

GEOPOLITICAL EQUILIBRIUM
- Middle East, Russia, China and EMs

US FISCAL BOOST
- $3-6tn tax cut/$1tn infrastructure spending

POPULISM IN EUROZONE
- **72% of GDP “voting” in 2017

Source: Pioneer Investments, as of December 31, 2016. *Fiscal boost data are estimates based on President-elect campaign by 2026. **IMF estimates on 2016 Eurozone GDP data.

Reflation

Inflation 2017 Forecast

<table>
<thead>
<tr>
<th>Country</th>
<th>2016 Inflation</th>
<th>2017 Forecast</th>
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<tbody>
<tr>
<td>Japan</td>
<td>-0.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Eurozone</td>
<td>-0.3</td>
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<tr>
<td>U.S.</td>
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<tr>
<td>UK</td>
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Main Inflation Drivers

1. Reflation: More pro-growth fiscal policies leading to higher inflation
2. Commodity Cycle: Rebound in commodity cycle with oil prices* expected at $57 per barrel by the end of 2017
3. Monetary Policy: Central Banks in Japan and Eurozone continue to act to achieve inflation targets

Global Triggers and Risks

- Fiscal boost
- Structural reforms
- Supportive Central Banks
- Global Catalysts

- Fed policy mistakes
- Trump disappointment
- Voting EU elections

Important Information

Unless otherwise stated, all information contained in this document is from Pioneer Investments and as of December 31, 2016. The views expressed regarding market and economic trends are those of the author and not necessarily Pioneer Investments, and are subject to change at any time based on market and other conditions and there can be no assurances that countries, markets or sectors will perform as expected. These views should not be relied upon as investment advice, as securities recommendations, or as an indication of trading on behalf of any Pioneer Investments product. There is no guarantee that market forecasts discussed will be realized or that these trends will continue. Investments involve certain risks, including political and currency risks. Investment return and principal value may go down as well as up and could result in the loss of all capital invested. This material does not constitute an offer to buy or a solicitation to sell any units of any investment fund or any services.

Date of First Use: January 9, 2017.
Main Scenario

High Conviction Ideas regarding the Global Economy

- Looking for growth engine beyond short-term rebound.
- Inflation is coming back, finally.
- Burden shifting from Central Banks (CBs), in short-term, to fiscal accommodation; public debt dynamics will be closely watched.

Global Themes

In the second half of 2016, the growth premium favoured Developed Markets (DMs) vs Emerging Markets (EMs) – with DMs regaining the macro momentum lost in the first part of 2016. We now expect DMs and EMs to display similar, moderately paced GDP growth going forward.

The US, Eurozone and Japanese economies have been accelerating while the UK has shown a certain degree of resiliency, so far, in the wake of the UK Referendum. At the same time, China’s growth is holding up well and the commodity space has steadied, allowing EM economies to maintain their overall momentum.

The growth outlook for 2017 is constructive, but still lacks a structural engine to make growth sustainable and inclusive over the long term, with a proper increase in productivity rates. Monetary and fiscal levers will be necessary to keep economies moving forward. Household consumption, together with exports, are leading the way as there is the right mix of exported products and country exposures, but private capex continues to struggle.

Inflation dynamics are finally creeping upward as base effects kick in. In 2017, inflation rates will be driven by the cost side more than demand pressure. Only in the US will an inflation rise be supported by some overheating in the economy, with pressure coming from a labour market in full employment and increased fiscal stimulus coming from the newly elected President. In Europe and Japan, inflation levels should increase mildly, while likely remaining well below CB targets. In EMs, the inflation outlook is very benign, with levels expected to approach or to stay within CB targets.

In the case of China, risks to the inflation outlook are to the upside. Producer price indices are rising, but are expected to remain under control absent another strong year for global commodity prices.
Central Banks
Considering its domestic macroeconomic conditions, the US Federal Reserve faces no particular constraint as it pursues the normalization of monetary policy. In fact, the effort might be slightly accelerated by the incoming President’s economic policy. The rest of the DM space is expected to keep a very accommodative monetary policy stance for the time being: inflation in Europe and Japan is still low or very low, while in the UK, although inflation is expected to go above target soon, an easing stance is supported by possible economic deterioration related to Brexit implementation.

The Federal Reserve’s stance is acting as a constraint on easing within the EM space. In most EM countries, GDP is growing below potential and inflation is heading towards CB targets. These domestic macro conditions are conducive to a certain degree of monetary easing; however, tighter global financial conditions will prevent this much needed policy shift, in our view.

Fiscal Policy
2017 looks to us like the year when the emphasis will shift from monetary to fiscal policy. As noted earlier, global monetary policy is becoming slightly less accommodative as the Federal Reserve pursues normalization, but the overall stance will likely remain accommodative. On the fiscal side the stance will become easier, to widely varying degrees country-by-country. However, the path to fiscal easing will not be an easy one. Debt has piled up since the Great Financial Crisis and, for the sake of stability and to preserve future growth, monetary policy has carried the burden so far.

The newly elected US President appears to be acting as a further catalyst for the ongoing global debate on fiscal policy. While the outlook on fiscal policy implementation in the US is uncertain, the focus is expected to be on tax rationalization and reduction, in the short-term, rather than on direct expenditures. As a result, we expect any near-term rise in GDP growth to be only marginally tied to addressing productivity.

In Europe, expectations remain very low with respect to any broad and significant easing on the fiscal side. Although, in some countries we have seen less reliance on fiscal policy due to continued weak macro conditions. Japan continues to implement the ambitious fiscal package announced last August: a decent Second Supplementary Budget (around 0.6% of GDP) was approved in 2016, with some impact expected in 2017.

In EMs, the principal constraint is represented by the outlook of Rating Agencies on fiscal sustainability for each country. However, conditions are very heterogeneous; those countries that can afford it, being less fragile, are ready to use the fiscal lever.
Commodity performance is a useful parameter to evaluate winners and losers among exporters and importers. In China, fiscal easing will remain strong and supportive, especially if signs of a slowdown return.

Regional Themes

- **US:**
  - Current cycle can extend further; longer-term issues remain.
  - Inflation heading up, sustained by cost side and some demand pressure.
  - Policies on the fiscal side are likely to lift GDP growth in the short run, but longer-run productivity growth issues are only marginally addressed.
  - Monetary policy normalization is likely to be accelerated if Trump’s policies overheat the economy.

- **Eurozone:**
  - A dense calendar of political events is scheduled in 2017.
  - The economy has proven to be resilient to shocks, business and consumer surveys are accelerating, while price pressures are still very low.
  - The European Central Bank (ECB) extended its QE programme maintaining a very accommodative attitude, despite the announced reduction in the monthly pace of purchases.

- **Japan:**
  - Sound domestic fundamentals and support from JPY improve the Japanese outlook for 2017.
  - In our view, inflation will not achieve the Bank of Japan (BoJ) target, let alone overshoot it, unless a boom year for global commodity prices materializes.
  - Extremely accommodative monetary policy and less fiscal consolidation ahead.

- **EMs:**
  - After a year of persistent improvement, our EM macroeconomic outlook for 2017 is stable or mildly positive.
  - Inflation is expected to approach or stay within CB targets.
  - On the monetary policy side, we see little room for easing except in countries on a significant and clear deflationary path.
  - In a “new” environment of higher rates, fiscal stimulus is becoming harder to sustain.

- **China:**
  - China’s economy is likely to slow again, although it will be less painful.
  - Recent pickup of capital outflows was mainly a result of the strong dollar rather than Renminbi (RMB) devaluation. Looking ahead, the key will be how to manage expectations while seeking to achieve greater RMB flexibility without triggering systemic risks.
  - Some common concerns about China’s potential growth are probably overdone, with increasing lifespans, improved labour quality, rural reforms and relatively strong R&D spending ready to offset weakness in demographics.
  - China has already made meaningful moves on a wide range of reforms, although progress has not been linear or evenly paced across areas.

Global Risks

- Fed normalization path and a stronger USD.
- US policies on geopolitics/trade war.
- Eurozone politics.
- China mismanagement of transition and reforms.
US: Economic Acceleration

Key Points
- Growth cycle has been very long, but expansion can last as signaled by mid-cycle situation of housing market and limited leverage of private operators.
- Trump’s expected fiscal policy is likely to boost the economy in the short run, especially via corporate tax cuts, but long-run impact might be harmful. Need to address long-term flaws, notably weak investment and productivity, and it is not clear if Trump’s policies will help in this regard.
- The positive impact of fiscal expansion is likely to be limited because the economy is already at full employment and the risk of overheating could increase the odds of a hawkish Fed in 2017.

Economic Conditions
After a weak first half of 2016 (+1% annualized GDP growth), the US economy has been accelerating. With the labour market near full employment, new jobs have continued to grow by 180k per month and wages have started to rise. Growth is sustained mainly by consumer spending, thanks to disposable income gains and a steady increase in consumer confidence. Manufacturing, weakened by the huge oil price decline and the strength of the USD in the last two years, is slowly but steadily recovering, with ISM\(^1\) figures improving slightly. In addition, we still have not observed excessive leverage of private agents and a booming housing market, which are typical signs of overstretched economic cycles. This picture is confirmed by our macroeconomic models: the probability of the US economy entering a recession in the coming six months, after spiking to a degree during the summer months, is now estimated to be below 10%.

However, the real medium-term challenge is low productivity growth, partially caused by low investment spending in machinery and equipment. Therefore, in evaluating the sustainability of Trump’s proposed economic policies, it is crucial to consider their potential to boost investment and improve productivity and potential output growth as a consequence.

\(^1\) Institute of Supply Management (ISM) manufacturing index.
Finally, our forecasts for GDP growth are around 2.3% for both 2017 and 2018, and for inflation they are around 2.2% and 2.1% in 2017 and 2018, respectively.

**Trumpomics**  
The main feature characterizing policies proposed by President-elect Trump during the campaign, at the moment, is uncertainty about how and whether they will be implemented. In the following, we analyse the economic and budgetary implications of the four most likely measures proposed. It is clear that Trump’s proposed policies could have long-term negative consequences, particularly with reference to climate change, social cohesion and global growth, but those are not taken into account here. We have elaborated on Congressional Budget Office (CBO) projections (released back in August 2016) and on analysis from the Tax Foundation, a non-partisan organization that studies tax policy in the US; hence, the base case is represented by the CBO projections, the static case computes the revenue-expenditures impact without considering the feedback on economic growth, while the dynamic case includes the retroaction of these measures on economic indicators.

1. **Tax Reform.** The reform of personal income taxation would consolidate the current seven tax brackets into three, with the lowest tax rate rising to 12% and the highest falling to 33% (they are, currently, at 10% and 39.6% respectively). On the corporate side, the tax rate would be reduced from 35% to 15% and manufacturing firms could choose between fully expensing capital investments and deducting interest paid. According to the Tax Foundation, personal income tax cuts would reduce federal revenues by around $1.75 trillion over 2017-2026 ($3 trillion if policy does not positively affect GDP and there’s no feedback effect on the budget) and corporate income tax cuts would decrease Government revenues by $1.9 trillion over 2017-2026. Combined, the tax measures would stimulate the economy, bringing additional employment and increasing payroll tax revenues by around $600 billion. The Tax Foundation also estimates that fiscal expansion would increase GDP by between 6.9% and 8.2% at the 2026 horizon.

2. **Investments.** On the spending side, if Trump’s $1 trillion investment plan is entirely borne by the public, the budget impact will be meaningful. However, longer-run economic returns may be better, since these investments will be
directed to items of little appeal to the private sector, such as maintenance and pure infrastructures. On the other hand, were the spending to be carried out in Private Public Partnership (PPP), the impact on the budget would be lower ($170 billion of additional outlays), but the return on longer-run productivity growth will be lower as well. PPP implies investment in projects that have a stable and certain flow of returns (like the toll of a bridge) and, hence, a much narrower field than the possible spending on infrastructure of public interest (an obvious example is high-speed internet connections).

3. **Obamacare.** A study of the Congressional Budget Office (2015) sketches the economic and budget impact of repealing so-called Obamacare. In the time window 2017-2026 the deficit would deteriorate slightly (+$140 billion). In particular, CBO estimates higher GDP growth of around 0.7% per year over 2022-2026, resulting from greater incentive to enter the job market and from increased capital stock.

4. **Trade policy.** As to trade policy, we considered a 45% tariff on Chinese imports and a 35% tariff on non-oil Mexican imports. We assume, over 2017-2026, a reduction of $600 billion of GDP due to lower exports which would mean a 15% reduction annually of exports to the two above-mentioned countries.

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**Figure 4. Effect of Trump Proposal on US Debt**

![Graph showing the effect of Trump Proposal on US Debt](image)

**The impact on debt/GDP ratio is not expected to be disruptive should the economy point to additional growth.**

Were all policies to be implemented, average nominal GDP growth would increase, in the period 2017-2026, from 3.9% (baseline level of CBO projections) to 5.0%.

In addition, the average deficit would increase to 5.2% and debt held by the public would be 89% of GDP in 2026 (compared to 85.5% of the baseline projection) in a dynamic scenario.

The static case is much worse: the average yearly deficit would be 7.2% and end-year 2026 debt would be 109.6% of GDP. As to the timing, while the investment programme will take time, especially if carried out in Private Public Partnership, the tax cuts can be implemented quite quickly.

We estimate a potential increase of GDP growth, mainly as a consequence of the corporate tax cuts, from 2.3% to around 2.7%-2.8%.
Overall, these proposed policies could be positive in that:
1. A period of economic overheating may help repair the hysteresis\(^2\) caused by the deep and prolonged recession.
2. The investments allowance, corporate tax cuts and infrastructure investments can potentially boost investments and help productivity growth.
3. With negative real interest rates, increasing debt is currently not a major issue.

On the other hand, previous massive supply-side episodes were not very effective, productivity growth is not explicitly targeted, especially if investments are carried out in Private Public Partnership, and fiscal multipliers (i.e., the impact on GDP of a change in taxes) are usually very small for an economy already running above potential.

**Monetary Policy**

After the 25 basis point hike of December 2016, the Fed signaled, via the dot plot, three additional hikes in 2017.

**Figure 5. Why the Fed Decided to Rise Rates in December**

![Graph showing Core and Headline Inflations and Fed Funds and Unit Labour Cost](image)


It justified the December move by noting that the labour market had strengthened, moderate economic growth was continuing and there were some signs of higher inflation.

The market was somewhat surprised by the uptick from two to three hikes in 2017 in the dot plot. Yellen in the press conference indicated that this was due to the changed forecast of “only some FOMC participants” and is only a “very modest adjustment”; she reminded markets that “Fed policy isn’t on a pre-set course”.

Given the positive situation of the economy, the Fed faces no particular constraint in pursuing the normalization path. On the contrary, it might be slightly accelerated by President-elect Trump’s economic policy. Indeed, according to Yellen’s speech, fiscal stimulus is not needed to bring the economy to full employment and the Fed will adjust its course as future policies are put in place.

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\(^2\) In economics, hysteresis arises when a single disturbance affects the course of the economy and its effects persist after the initial causes giving rise to the effects are removed.
Eurozone: Noisy Politics, Steady Economics

**Key Points**
- Political noise is high and will possibly increase ahead of a dense electoral schedule: general elections in the Netherlands and France in spring and in Germany in autumn are adding to uncertainty in Italy, while the Greek issue has resurfaced.
- National concerns interact with European-wide questions, particularly the Brexit negotiations and the migrants issue.
- Despite this noise, the economy is robust and while growth maybe unspectacular, the pace is steady and (slightly) above potential.

**Economic Conditions**
After Brexit and the US presidential election, a third ballot nightmare materialized in December when the Italian constitutional referendum ended in a wide defeat for Renzi’s government, with his resignation being the initial consequence. These episodes gave further voice to the centrifugal forces in Europe and a success for the euro-skeptics in France would be particularly critical, as would a general election in Italy.

There are also a number of Euro or European-wide themes and issues: the issue of migrants is still a source of debate, as is the attitude towards the UK and the Brexit negotiations; the position towards Russia and sanctions is also in focus, particularly if the US administration changes its posture towards Russia and NATO support.

Despite all of these variables, the economy is improving after a soft period in the summer of 2016. Eurozone GDP grew by 0.3% QoQ, 1.7% YoY in Q3 2016, with a good contribution coming from domestic demand (particularly private consumption) and a mildly negative one from net exports. It is likely that growth in 2016 will be at 1.6% even though a more favourable rounding to 1.7% (as in ECB December forecasts) cannot be excluded. In fact, our leading indicator has been rising mildly recently, hence we expect a 0.4% average pace in Q4 2016 and Q1 2017. We expect this pace to be maintained over the foreseeable future with growth at around 1.5% until 2018.

**Figure 6. European Economic Outlook**

Source: Pioneer Investments on Datastream data, Bank of Italy and CEPR (Eurocoin, a coincident indicator of Eurozone business cycle), Bloomberg. Data as of December 15, 2016. PMI is the purchasing managers' index. A reading above 50 indicates an expansion of the manufacturing sector.
In fact, business surveys are pointing up, starting with PMIs now firmly above 50 for all the four biggest Eurozone countries. EU Commission surveys results are also on the rise (albeit, more on the business than consumer side). Looking at the underlying survey questions, the positive factors behind the rise consistently point to improved “employment expectations” and “price expectations”. It is possible to interpret these results with some degree of optimism, as the former signals a tendency towards an improving business environment (easier to hire) and the latter suggests somewhat firmer demand would allow some margin increases (but not in the retail sector).

It is not clear the extent to which the improvements in manufacturing PMI indices are also linked to an upgrade in external demand, but there is a suggestion in this direction. On prices, with the recovery in commodity and energy prices, it is clear that there is a base effect due to the sharp decline in December-January last year that will bring headline inflation above 1%. But headline figures are still anchored to a very low level. Our econometric model projects an inflation rate at 0.2% in 2016, rising to 1.4% in 2017 and 1.7% in 2018, with core rates lagging a bit behind for the entire period, arriving at 1.3% in 2018. Hence, we agree entirely with the ECB analysis suggesting the need to continue accommodative monetary policy (see below).

**Figure 7. Eurozone Inflation**


**Monetary Policy**

At its December 2016 meeting, the ECB further extended its Asset Purchase programme (APP) while leaving interest rates unchanged. From April 2017 until at least December 2017 purchases will continue at a €60 billion monthly, adding a further €540 billion of purchases on top of the already planned €1.76 trillion of asset purchases, which are now expected to total €2.3 trillion up to the end of 2017. The ECB also adjusted the parameters of its APP to accommodate the further purchases, with the changes taking effect from January 2017. Specifically, the shortest maturity of purchases, allowed at the time of purchase, was reduced from 2 years to 1 year; in addition, purchases of assets yielding less than -40bps yield of the deposit facility will be allowed if necessary to meet the monetary policy objectives. Despite announcing a reduction in the pace of purchases, the ECB sounded the same relatively dovish tone and appears ready to maintain its very accommodative stance as long as necessary.
On the fiscal side, we note a mildly accommodative tone, but we don’t expect too much activity from the Eurozone in 2017.

**Fiscal Policy**

If one chooses to assess the stance of policy in the Eurozone, the graph below clearly indicates a mild tendency towards easing and even the countries that are still in Excessive Deficit Procedure (like Spain and France) are not enacting tough policies. The EU Commission proposed to define a “number” to describe the aggregate fiscal stance and then, in its European Semester Autumn Package, it also stated that in 2017 fiscal expansion by at least 0.5% is recommended for the Eurozone (particular via expansionary actions from countries not at risk of non-compliance, namely, Germany). This proposal has not been well received by the Eurogroup. Hence, nothing particularly tough will be implemented in addition to what the below graph shows.

**Figure 8. Change in Structural Budget Balance**

Japan: Thank you Trump!

Key Points

- External conditions remain crucial to a better outlook in 2017. A weaker yen is a positive driver for growth.
- Inflation is not overshooting the target; risk to the upside.
- Less fiscal consolidation ahead.
- Bank of Japan on hold for the time being – no changes to its extremely accommodative stance.

Economic Conditions

Two factors resulted in Japan ending 2016 in a better macroeconomic condition than expected at beginning of the year: strong support from the external side together with a significant revision of national accounts released with final Q3 2016 GDP.

With respect to the first factor, in H2 2016, net trade contribution to GDP growth started to pick up as highlighted in corporate profitability figures that in Q3 2016 displayed a significant increase, led by large cap exporters.

With regard to the second factor, the Cabinet is now reporting recent economic performance that is much sounder than that previously registered. Private final domestic demand (consumption, investment) has been broadly stronger than anticipated in the last three years. Overall, the recession triggered by the 2014 consumption tax increase from 5% to 8% has been less painful than expected, although household consumption has declined as previously reported.

On the back of those factors, we have been revising our Japanese outlook upward for the time being: GDP is expected to grow at around 1.0% per year in 2016-17-18. That means Japan is growing at a mildly stronger pace than its potential and the output gap is essentially closed.

Looking at growth drivers:

- Wages have been increasing slightly since Abenomics started, supporting a decent path for household consumption.
- Profits have deteriorated in the recent past but are now picking up. We expect resilient residential investment (low rates and credit growth have not been impacted by negative rates policy so far) and a mild recovery in capital expenditure.

Although the inflation outlook remains far from the BoJ target on the forecasting horizon, and even further from overshooting 2.0% YoY, the revised growth performance is conducive of higher inflation going forward. Core inflation is comfortably heading towards 1.0% YoY (ex-fresh food, BoJ target) and the risk to the base case is to the upside (oil and yen).

If we include the new US President-elect in the picture, we add a couple of additional positive factors:

1. JPY depreciation as consequence of USD strengthening is, in many ways, supportive of the Japanese outlook on the growth/profits side and on inflation.
2. The shift from monetary policy, as the only player in town, to a more balanced mix incorporating fiscal policy is gaining traction with Trump coming to office. That should support other leaders, such as Prime Minister Abe, in pushing on the fiscal lever a bit more heavily.
However, in Trump’s overall rhetoric we have to consider the negative comments related to anti-trade initiatives (tariffs and so on) that were mentioned so many times during his campaign. Japan doesn’t appear to be a target, but would be impacted by a broad deterioration of trade dynamics. While we do not believe these initiatives will be implemented to any serious degree, we have run an analysis on the sensitivity of Japanese growth to a weaker trade outlook and to a weaker JPY. What we find is that sensitivity of growth to the JPY is more significant than to world trade. The outcome of the analysis is that even in a case of world trade deterioration, the Japanese corporate sector is quite resilient and a weak JPY will help to smooth any negative impact.

Figure 9. Japan GDP Growth & Contributions

![Figure 9](image)


**Monetary Policy**

After the introduction of Quantitative and Qualitative Easing (QQE) with negative interest rates and, more recently, yield curve control with the aim of fixing 10-year government rates at 0%, we believe that the BoJ will remain extremely accommodative going forward because of its strong commitment to achieving a 2% inflation target or, even better, overshooting it. We believe further monetary policy measures could be enacted in 2017 if there are no signs of a rise in inflation or inflation again heads towards negative territory. The current BoJ seems to be less independent from the desires of the government, increasing the odds for action going forward. The BoJ has been highly unpredictable in recent years, so there are no guarantees on when or how it will act, but warning has been given, this time, of the potential for further action. The political situation in the rest of the world (Brexit, US policy uncertainty, political unease in the Eurozone) may affect Japan’s economy going forward and may therefore influence the future policy path enacted by the BoJ.

**Fiscal Policy**

Since a significant fiscal package of about JPY 28 trillion, via multi-year steps, was announced in the August 2016, the Abe administration has reinforced this stance with the recent release of a Second Supplementary Budget for the current fiscal year. The size of this supplementary budget is more than JPY 3 trillion and is targeted at supporting small and medium enterprises, 21st century infrastructure projects and reconstruction and preventions. The budget has mainly been funded by Government Construction Bonds, alongside an existing fiscal surplus and marginally higher revenues.
The two relevant focuses are as follows:

1. Although the Ministry of Finance hasn’t abandoned its fiscal targets for upcoming years (such as the Primary Budget at zero plus by 2020), the policy mix has started to become more balanced. Yet, due to the stretched debt position, the balance is still strongly biased towards monetary policy even though a slight shift has begun.

2. Debt monetization, or Helicopter Money, initiatives are being debated, but are far from implementation. However, if macroeconomic conditions significantly diverge from our base case, stronger action by monetary and fiscal authorities will be warranted. The case for these initiatives in 2017 is not ruled out.

**Foreign Policy**

In the event of a US disengagement from Asia, amid a new era of foreign policy adopted by the incoming Trump administration, geopolitical tensions in the region will escalate. A new equilibrium has to be found and an increase in China’s power will not make countries such as Japan happy. Although the passage from the TPP (Trans-Pacific Partnership) to the RCEP (Regional Comprehensive Economic Partnership) should be easier, as the second doesn’t involve regulations and ways of doing business rather simply deals with tariffs, TPP was functional to Japanese Government to pass more comfortably some critical reforms. Moreover, RCEP sees China as pivot power in the area. While ease of doing business will likely remain the ultimate target for all countries involved, a new equilibrium will not be achieved without tension.

**Figure 10. Inflation and Fiscal Policy**

![Inflation and Fiscal Policy](image)

EM: Trump, Jump, Pump or Dump?

Key Points
- Macroeconomic conditions moving into 2017 will, in our view, slightly improve.
- External contributions to growth remain resilient, capital expenditure (Capex) moderate and consumption robust.
- Output gap still open, although narrowing.
- Inflation at CBs’ targets.
- Needs for Monetary Policy easing mitigated by global financial conditions.
- Few countries can afford fiscal stimulus.
- “South to South” trade agreements enforcement to be watched.

Economic Conditions
Macroeconomic conditions in EMs are much better today than they were at the end of 2015 or the beginning of 2016. In line with our 2016 Outlook, macroeconomic conditions kept improving, supported by a benign external environment led by increasing commodity prices and a very accommodative Federal Reserve. For 2017, we expect EMs to exhibit a very mild improvement from current macroeconomic conditions. The outlook is stable/positive overall with the usual significant divergences among countries.

In terms of GDP growth, a slight improvement at the aggregate level is mainly driven by higher growth expectations in Brazil and Russia after the deep recessions they have experienced. Other countries are not expected to improve their GDP growth by much, while Mexico and Turkey are expected to see significant deterioration. On the domestic side, the fiscal lever will be slightly more supportive than in 2016 and Asian countries are better positioned to use it because they are generally less fragile (except Malaysia). On the back of our constructive outlook for the commodity space, commodity exporters may decide to loosen their stance sometime during the year if necessary, trimming or delaying their fiscal consolidation plans (e.g., Russia). Although monetary policy easing is needed in most countries, according to metrics based on output and inflation gaps, room to ease will be limited by the “normalization” process undertaken by the Federal Reserve with respect to US rates. In some cases, notably Mexico, the need for easing in view of increasingly poor economic performance is completely overshadowed by the focus the Central Bank has on currency weakness and its pass-through impact on inflation, prompting the CB to actually hike rates and continue to tighten.

On the external side, we are constructive on the commodity space and on the trade of manufacturing goods in 2017. Regarding the latter, our positive outlook comes from the recent upward revision of growth expectations for 2017 and positive macro momentum among DMs. Overall, the returns expected in energy and metals sectors are higher than for agriculture and manufacturing goods. Oil and metals exporters (Russia, South Africa, Chile and Peru) are the largest beneficiaries in our outlook.

On the inflation side, we see a clear convergence of inflation towards CBs target either from the upside (Brazil, Russia and Colombia) or from the downside (Thailand, Poland, Hungary, South Korea and Taiwan).
We do not see any pressure coming from demand next year; rather, the output gap in aggregate terms is still open, although narrowing. However, if we do not see pressure on the demand side some pressure could come from the cost side, either because of a stronger-than-expected increase in oil prices or because of a further devaluation of EM currencies passing through to inflation.

In recent years, many EM Central Banks have done an excellent job of managing policy. Exchange rate pass-through\(^3\) has been declining mainly in countries with a stable and predictable monetary policy that are anchoring expectations with an inflation targeting framework, letting currencies float and avoiding the use of capital controls.

However, recent producer price index figures are showing some early signals of overheating that, in our view, should not be underestimated (China, Mexico). The case of a stronger USD together with higher-than-expected oil prices (both aspects coherent with Trump’s strategy) could turn benign inflation into a disruptive dynamic, causing concern for EM monetary policy.

**Figure 11. EM Inflation Outlook**

![EM Inflation Outlook](image)

Source: Pioneer Investments, CEIC, IMF. Data as of December 15, 2016.

**Monetary Policy**

As noted, monetary policy easing needs to remain in place in 2017 for most EM economies. EM countries are broadly growing below their potential rate, with a few exceptions (Philippines above all), and inflation doesn’t represent a constraint, with the exception of Turkey. High inflation countries are witnessing a declining path in the cost of living, converging towards CB targets and, for most of them, inflation is well under control, meaning below or at target.

However, while domestic macroeconomic conditions are supported by monetary policy easing, external financial conditions have been tighter and tighter since the election of the new US President: a stronger dollar and higher rates have been anticipating what Trump could do on the fiscal side and what the Federal Reserve could do on the monetary side.

In the few countries where C\(s\) were behind the curve in 2016 (Brazil, Russia and even Colombia), and where inflation rates have reversed and easing is far from being completed, we still see room for easing in 2017. However, for most EMs we do not see much room to ease going forward and what little room there is will be offset by tight global financial conditions.

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\(^3\)Exchange rate pass-through is defined as the effect of exchange rate changes on domestic inflation.
In line with the risk that we see on the inflation side, some CBs could be forced to adopt a tighter monetary policy stance to defend their currencies and their mandate on inflation.

Inflation dynamics more than monetary policy will be the driver of real interest rate changes in 2017, in contrast with 2016. Real rates are not expected to change dramatically in 2017, except in countries with very low inflation today, where real rates will decrease due to higher inflation.

**Figure 12. EM Monetary Policy Room**

X axis: External Vulnerability Indicator. The countries more vulnerable are the ones with higher external unbalances and more stressed external financial positions.

Y axis: Country Taylor Rule stances (change in nominal rates due to inflation change) according to the composite indicator made up by domestic output and inflation gap projected in 2016.

Sources: Pioneer Investments, Bloomberg, CEIC. Data as of December 15, 2016.

**Fiscal Policy**

The deployment of the fiscal lever last year was higher than anticipated in our 2016 outlook. We do expect at least the same support coming from the fiscal side in 2017, although in a “new” environment of higher rates, fiscal sustainability is becoming more difficult to achieve. On paper, Asian countries appear the least fragile today and the most likely to be comfortable in using fiscal lever. However, we believe that other countries, like Russia, Chile, South Korea and Czech Republic, will join thanks to low government debt positions, low interest payments as a percentage of revenue and accommodative rates in comparison with growth dynamics (fiscal sustainability law). Notwithstanding that interest payments are almost 10% of revenue, Turkey will continue with fiscal easing to counterbalance its deteriorating economic outlook.
Since the 2013 taper tantrum episode, EM external vulnerability has decreased. However, EMs are hardly free of concern.

Stability Conditions
External vulnerability is crucial for determining next year’s outlook. Since the “taper tantrum” episode in 2013, EM vulnerability has decreased in aggregate terms, but we can’t say that EMs are free of concern. Aggregate basic current accounts (Current Account balance plus Foreign Direct investments, Ex-China) have become positive since the end of 2014, thanks to some adjustments made by the so called Fragile Five (in particular India, Indonesia and Brazil). However, vulnerability conditions, measured by a group of indicators including balance of payments, external debt and reserve ratio adequacy, remain quite heterogeneous, with India appearing to be the safest country in the EM universe and Turkey the riskiest one.

As observed, Trump’s election has brought a focus on a strong USD and higher rates. Accordingly, we have added two factors to our classical framework used to measure a country’s vulnerability. The first new input is the level of USD denominated external debt (either sovereign or corporate), and in this vein we see Latin America (except Brazil) as the most fragile area together with Turkey, Hungary, Philippines, Malaysia and Indonesia.
The second new factor is sensitivity to interest rates and we are able to identify, in Figure 15, which countries are most at risk from any major tightening of monetary policy. Brazil is the loser here; India’s issue relates to its very low level of tax burden rather than the level of interest expenditures.

Considering a number of variables (macroeconomic conditions, fiscal and monetary policy, debt and leverage, external vulnerability measures) we can see the 2017 rank for EMs in Figure 16. India continues to be the most appealing country, followed by Indonesia and Russia.
### Figure 16. EM Heat Map

<table>
<thead>
<tr>
<th></th>
<th>Macro Momentum 2017</th>
<th>Monetary Policy 2017</th>
<th>Fiscal Room 2017</th>
<th>Leverage</th>
<th>USD Debt Denominated Vulnerability</th>
<th>External Vulnerability</th>
<th>Final Score</th>
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</table>

Source: Pioneer Investments. Data as of December 15, 2016. The final score is calculated as sum of single items.
China: How to Grow Towards 2020

**Key Points**
- The economy is expected to slow again, but the slowdown will probably be less painful.
- Policy focus has shifted from monetary easing towards fiscal support, through relatively more effective channels.
- Recent pickup of capital outflows is largely the result of a strong US dollar rather than RMB devaluation. How to manage expectations will be the key.
- Looking beyond the short term, the best solution when faced with US policy uncertainty, in our assessment, is to look more for internal growth engines.
- Some common concerns about China’s medium-term growth are probably overdone. If reforms continue, the current pace of growth is perhaps not far from the floor.

**Economic Conditions**
China’s economy has held up relatively well so far, after strong concerns one year ago. We expect some slowdown in 2017, but this should be less painful than in 2015. There has been a more visible recovery in nominal growth, with PPI (Producer Price Index) inflation back to positive territory after declining continually for nearly five years. This has been supported by rising global commodity prices in the wake of China’s reduction in overcapacity. CPI inflation has remained in a relatively comfortable range. A stabilized real estate sector has also helped. Property sales started to cool recently following targeted policy tightening in some large cities to prevent potential asset bubbles. That said, downside risks in property investments should be manageable given already meaningful destocking. Meanwhile, affordability has largely improved over the last few years with relatively solid income growth. Meanwhile, the impact of policy support has become more visible, with a shift of focus from monetary easing towards fiscal spending. The effects of fiscal policy were relatively muted in 2015, due to controls imposed on local government financing. That said, the fiscal side appears to have become more effective in 2016, with more infrastructure spending through budget deficit, an expansion of the policy banks’ balance sheets, and the recent acceleration of Public-Private Partnership (PPP) projects. This implies that if any downside risks emerge, China could still use fiscal measures to soften the pain.

**Figure 17. China Budget Fiscal Balance (12m Rolling)**

Sources: Pioneer Investments, CEIC. Data as of December 15, 2016.
Monetary conditions look to remain roughly stable going forward. The People’s Bank of China (PBOC) seems reluctant to ease further, given concerns around asset bubbles and capital outflows, and will likely remain wary of tightening, given underlying economic conditions still look fragile, with relatively high uncertainty from overseas.

**Stability Conditions**

While a hard-landing for the economy is less of a concern, worries about capital outflows have resumed recently. Such risks could still be manageable in the near term, but the challenge is how to manage the ongoing transition to a more flexible RMB regime in a strong dollar environment.

We continue to think expectations are the key, rather than the country’s fundamentals. The recent pickup of capital outflows seems to be principally due to a stronger US dollar rather than RMB devaluation. Expectations of global investors have been relatively anchored, with CNY being kept relatively stable against its currency basket. But locals appear to watch the dollar closely and have become more nervous.

Looking ahead, a risk would be if the dollar strengthened again at a fast pace. Further tightening in capital account management could help. That said, if the dollar’s strengthening moderates, outflow pressures could ease.

Beyond RMB levels, a more important focus would be when and how the PBOC could achieve greater RMB flexibility without triggering systematic risks, which would be a major step in financial liberalization.

**Looking Beyond the Short Term**

Probably a bigger concern would be the relatively high uncertainty of US policy targeting China. While we think a trade war can be avoided, a better solution for China is probably to look for more internal growth engines.

We have looked into the causes behind China’s slowdown in recent years and it appears that some common concerns about the country’s potential growth are perhaps overdone. If China can continue to push structural reform, the current pace of growth is perhaps near its floor for this multi-year transition.

- First, the concern about the country’s demographics is probably overstated. Admittedly, China’s working-age population has peaked, but employment has continued to grow, though at a slightly slower pace. This is partially due to a steady increase in Chinese lifespans. China has a relatively early retirement age, and allowing people to work longer could help offset some negative impact from demographics in coming years.

- Second, productivity gains reflecting the shift of labour from agriculture to other sectors are ongoing. The agriculture sector is still far less productive than other parts of the economy and other countries, with nearly 30% of employment producing less than 10% of GDP. Increased productivity in agriculture, with more imports of agricultural products, could continue to help release more labours from rural areas. The latest move was that China has officially clarified rural land transfer rights, which should facilitate the growth of modern farmers.

- Third, labour quality is steadily improving. While few Chinese went to college before the 1980s, there are currently around 8 million graduates per year, representing roughly 1% of the labour pool. The gains look to become more meaningful with the economy shifting from low-end manufacturing to higher-end products and services.

- Fourth, China has continued to increase R&D spending, which is already higher than its peers in a similar development stage, such as South Korea and Taiwan. Its R&D spending as share of GDP has already reached around the average level of EU economies.

*The recent pickup of capital outflows was mainly the result of a strong US dollar rather than RMB devaluation. The key ahead is how to manage expectations and to achieve greater RMB flexibility without triggering systematic risks.*

*Some common concerns about China’s potential growth are probably overdone, with an increase of lifespan, improved labour quality, rural reform and relatively strong R&D spending offsetting weakness in demographics.*
Meanwhile, despite decades of relatively fast growth, China’s labour productivity is still only around one-fifth of US levels. If we take US productivity as a standard of the productivity frontier, this implies China has more than enough potential space to catch up.

**Figure 18. China Employment and Education**

![China Employment and Education Graph](chart)

Sources: Pioneer Investments, CEIC. Data as of December 15, 2016.

Finally, while the above factors are relatively certain elements supporting China’s medium-term growth, a key variable is structural reform, which could help improve system efficiency.

Overall, it appears that it will be a challenge for China to return to 7% or above growth if the recent de-globalization trend lasts, but the 6% growth range remains achievable over the rest of this decade, based on our evaluation matrix on reform progress.

**Figure 19. Contribution to China GDP Growth 2016-2020 (Purchasing Prices)**

![Contribution to China GDP Growth Graph](chart)

Sources: Pioneer Investments, GAAR forecasts, CEIC. Data as of December 15, 2016.
**Focus on Reform**

Regarding reform, we believe that most market commentary has either been too subjective or focused on narrow areas. By contrast, we have tried to list all of the reform measures that we thought China should pursue and have been tracking their progress in a systematic way.

Our reform tracker suggests that:

- China has made relatively good progress in financial reform and some fiscal reform over the last 2-3 years, while the focus has shifted towards those areas to help shift income and rebalance the economy over the past year.
- Reform measures have been accelerating since the summer, following more convincing signs of the economy stabilizing, while progress was relatively slow in early 2016 when growth was a top concern.
- Important structural measures in 2016 included the opening of interbank bond markets; the launch of the Shenzhen-Hong Kong Stock Connect; a stronger push of the Hukou reforms and the "People-centred" urbanization; a strengthening of financial regulations; some pilots for Stated Owned Enterprise reform; and recent rural land reforms, in addition to ongoing exchange regime transition and measures to speed up overcapacity cuts.
- Regarding recent tightening of capital management in some areas, we think they are largely focused on short-term risk management; targeting short-term and speculative flows, rather than signaling a change of long-term direction.

**Figure 20. China’s Reform Progress**

In our view, the success of the China reform process will be crucial in determining the growth outlook for the next few years.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>GDP Growth Outlook</th>
<th>2020</th>
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<tbody>
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<td>Worst - 25% reforms</td>
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<td>4.5</td>
</tr>
<tr>
<td>Base - 50% reforms</td>
<td>6.1</td>
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</tr>
<tr>
<td>Best - 100% reforms</td>
<td>6.8</td>
<td>6.8</td>
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</table>

Source: Pioneer Investments analysis, as of December 15, 2016.
Important Information

Unless otherwise stated, all information contained in this document is from Pioneer Investments and is as of December 16, 2016.

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