

# LIVERPOOL INVESTMENT LETTER

August 2013



LIVERPOOL RESEARCH GROUP IN MACROECONOMICS

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The Julian Hodge Institute was launched in autumn 1999 in a new collaboration between the Cardiff Business School of Cardiff University and Julian Hodge Bank. The aim of the Institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. This research has been given especial relevance by the ongoing discussions on the extra powers regularly requested by the European Union and also by the recent crisis in the eurozone.

The Liverpool Investment Letter is written by Patrick Minford, with the assistance of other members of the Group; in particular the emerging markets section is written by Anupam Rastogi, and the focus on Japan is written by Francesco Perugini. The Investment Letter is published monthly.

The Liverpool Research Group in Economics is pursuing a research programme involving the estimation and use of macroeconomic models for forecasting and policy analysis. The Group is now mainly based in Cardiff Business School, Cardiff University, and is indebted to the School and to the Jane Hodge Foundation for their support. The Group's activities contribute to the programmes being pursued by the Julian Hodge Institute of Applied Macroeconomics. This Liverpool Investment Letter is typeset by David Meenagh and Bruce Webb and published on behalf of the group by Liverpool Macroeconomic Research Limited, which holds the copyright

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## THE SUN GLINTING THROUGH THE CLOUDS

The second quarter first estimate of GDP growth comes as a relief to UK economy-watchers. 0.6% is at last appreciable, if still not strong, growth. Is this a sudden onset of recovery? Not entirely as the service sector has been growth at just under 2% for a couple of years. But that growth in services was overlaid by weakness in manufacturing, collapse in construction, banking implosion and a decline in North Sea oil. Gradually those negative elements have dissipated. With North Sea oil the government has been in talks with the major companies to give proper assurances that there will be stability in the tax regime for oil; previously the North Sea was treated like a cash cow, with tax being used to collect ad hoc levies, and naturally this produced a decline in new projects. In banking there have been the two Funding for Lending Schemes and since the Budget the Mortgage support scheme for first-time buyers; this has encouraged lending, especially for housing, and in addition there seems to be more awareness among ministers that bank regulation can be excessive for the good of the economy (witness the recent outburst by Vince Cable about the ‘capital Taliban’ in the Bank). Bank profitability has risen, the Lloyds share holdings by the government are being readied for partial sale and in short banking may be turning around.

Then we turn to the housing improvement, spurred by a recent rise in house prices, apparently reflecting the mortgage subsidy scheme. This has put new life into construction prospects; and for now construction has at least stopped declining. Finally, manufacturing is picking up as the euro-zone flattens off into a slower decline and exports are being diverted elsewhere where growth is much stronger.

Looking back at the string of disappointing growth figures since the recovery from the crisis began in late 2009, it seems clear to us that a key element has been the new regulative approach to banking. This has both caused chaos in the banking sector and blocked the credit channel. It has been justified by the need to prevent future crises. But, as we have argued before, the evidence supports the view that the crisis was brought about by much wider factors than banking, even if banking problems made it worse. After 25 years of breakneck world growth there was bound to be a downturn as the world ran out of commodities. So the new bank regulation will not prevent future such crises of capitalism; but as we have seen it can be lethal to growth both by attacking the UK’s key growth industry and by killing credit growth. Fortunately the coalition politicians appear belatedly to have woken up to this — witness the outburst of Vince Cable about the ‘capital Taliban’ at the Bank of England. We may now see more backpedalling on the new regulative miasma that has swept the British establishment in the wake of the crisis, as it compensated

**Table 1: Summary of Forecast**

	2010	2011	2012	2013	2014	2015	2016
GDP Growth <sup>1</sup>	1.7	1.1	0.2	1.2	2.2	2.4	2.6
Inflation							
CPI	3.3	4.5	2.7	2.7	2.5	2.2	2.0
RPIX	4.8	5.3	3.2	2.5	3.1	2.8	2.7
Unemployment (Mill.)							
Ann. Avg. <sup>2</sup>	1.5	1.5	1.6	1.5	1.4	1.3	1.2
4th Qtr.	1.5	1.6	1.6	1.5	1.3	1.2	1.1
Exchange Rate <sup>3</sup>	80.4	80.0	83.1	82.6	83.0	82.3	82.5
3 Month Interest Rate	0.7	0.9	0.9	0.9	1.6	2.1	2.2
5 Year Interest Rate	2.4	2.0	0.9	1.3	1.8	2.1	2.4
Current Balance (£bn)	-40.0	-22.5	-59.2	-60.7	-62.9	-63.5	-62.0
PSBR (£bn)	112.6	91.0	68.4	119.7	106.0	94.6	74.5

<sup>1</sup>Expenditure estimate at factor cost

<sup>2</sup>U.K. Wholly unemployed excluding school leavers (new basis)

<sup>3</sup>Sterling effective exchange rate, Bank of England Index (2005 = 100)

for its previous regulative and monetary failure to control the economy and banking boom of the 2000s.

The trouble about the government’s approach to this backpedalling is that it is entirely ad hoc. The Mortgage support scheme has unlocked lending to housing, and mortgages are up, as are house prices. But lending to SMEs continues to crash, as banks are heavily penalised for lending to them because of the expensive extra capital they need to raise to back this up. Hence the two FLS schemes seem to have bombed out — how easy after all to ‘increase lending’ by lending you would have made anyway, so claiming the FLS subsidy, while continuing to cut back in lending to SMEs. The latest introduction by the Bank of the extra ‘leverage’ capital requirement is particularly clumsy and crass, coming as it does on top of the already cumbersome and damaging capital requirements related to risk-weighted loans.

In our opinion, what needs to be done is a severe cutting back of these new regulative capital requirements in favour of a return to a self-regulating regime with the Bank as chief monitoring agent, much as existed prior to the ‘Tripartite regime’ introduced mistakenly, as we can now clearly see, by Gordon Brown in 1997. Formulaic approaches to capital needs are crude and essentially arbitrary; also when risk-weighted as in the Basel 3 agreement they will penalise lending to SMEs even through collectively these are no more risky socially than lending to blue chips.

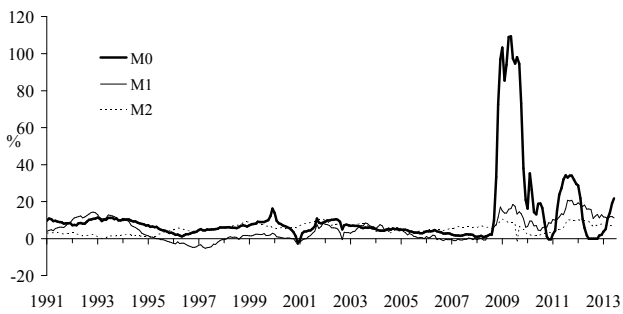
A second need is to focus monetary policy back on its old task of ‘taking away the punch bowl when the party gets merry’ (a classic description due to McChesney Martin at the Fed). This could be achieved by reintroducing money supply or credit growth targets into the conduct of monetary policy, in addition to the long-term inflation target. The problem with inflation targeting on its own has been that inflation does not respond much in the short run to excess credit growth, because of the power of belief that

it will be subject to the target. Yet as we have seen, when a credit boom takes hold, it can cause a banking problem to be super-imposed on a recession brought about by the normal forces of capitalism.

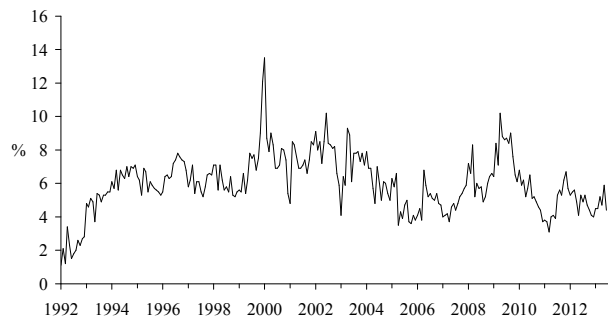
With a new Bank Governor having just arrived, who has the confidence of the Chancellor, it may be that gradually

policy will move in this direction and hence growth will be less restricted by the failure of the credit process. Our forecasts assume that something of this sort will happen and hence we have growth staying in the 2–3% range from now on.

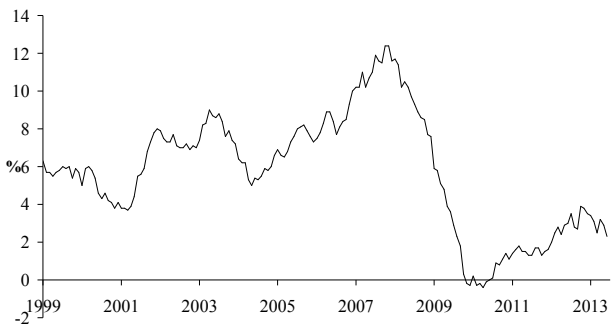
**U.S.: Growth in Monetary Aggregates (Yr - on - Yr)**



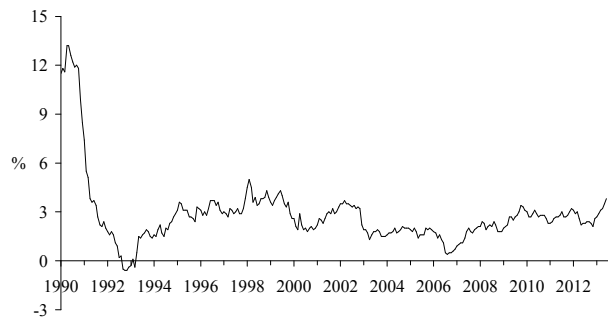
**UK: Notes and Coins in Circulation Growth**



**Eurozone M3 Growth**



**Japan: Growth of M2+CD's**



## FOCUS ON JAPAN

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Francesco Perugini

### Abe regains Upper House majority

The ruling Liberal Democratic Party (LDP) achieved a landslide victory in the July 21st election, replacing the Democratic Party of Japan (DPJ) as the dominant party in the Upper House and ending the days of the divided Diet. The LDP and its smaller partner, the New Komeito party, gained 76 of the 121 seats up for grabs. They now have a total of 135 seats in the 242-seat house, well above the threshold of 129 necessary to control all standing committees in the chamber. The result will facilitate passage of bills as the ruling bloc has an overwhelming majority in the more powerful lower house. “I must respond to people’s hopes that I will bring about (an economic recovery) that they can actually feel”, Prime Minister Shinzo Abe told reporters at a press conference after the election results. “I will make timely, speedy decisions (in the Diet) while being committed to humble debate” on crucial issues.

According to political observers, to win the election the LDP did a superb job in defining the issues. It kept the focus on Abenomics, the prime minister’s economic policy, and appealed to voters for the political stability that comes from controlling both Diet houses. The ruling coalition had the biggest advantage of being able to charge into the election with Abe’s new government barely more than six months old and its approval rating high. Last December’s Lower House election, won decisively by the LDP, followed three years of DPJ rule, which voters picked apart mercilessly. By contrast, Abe has presided over rising stock prices and corporate sentiment with no major slip-ups. He has been able to sustain expectations. This time the pendulum did not swing away from the winner of the previous election, as it has in recent years. Meanwhile, the DPJ never went beyond criticizing Abe’s government and thus failed to say exactly what it would do differently. And the opposition as a whole was unable or unwilling to form a united front.

Regaining control of the Upper House, which Abe lost in 2007 during his first stint as premier, is likely to boost political stability — no further parliamentary elections are due until 2016, unless the Lower House is dissolved — but will also serve as a golden opportunity for Abe to address key issues. “Foreign investors will be watching how fast and how hard Abe tries after the election to make big structural and regulatory changes that will really open up the economy to new kinds of domestic competition and foreign competition. Abe needs to accomplish a lot to impress foreign investors and make them think that a sustained economic improvement in Japan is possible, especially given a shrinking population”, said Scott Seaman, a senior analyst at Eurasia Group, a global leading political research company.

Two of the “three arrows” of Abenomics — big fiscal spending and aggressive monetary easing — have created the impression that Abe can revive the moribund economy, but foreign investors have doubts that Abe can achieve deregulation if he faces stiff resistance within his party and a revival of its old parochial nationalism, pork-barrel politics and protection of vested interests. In particular, observers expect Abe to implement effective economic growth strategies by dismantling the rock-solid regulations present in such fields as agriculture and medical care and to push such contentious policies as raising the consumption tax from April to restore fiscal health, restarting stalled nuclear power plants despite public concerns following the 2011 Fukushima crisis, and pursuing freer trade under the US-led Trans-Pacific Partnership in spite of protests by domestic farmers.

Observers are also looking to the consumption tax and the labour market reform issues. Regarding the first one, they expect the government to go ahead with its plan to raise the 5% sales tax to 8% next April as the first step towards funding growing social welfare costs and trimming the public debt, but they doubt the government will implement the second rise to 10% in the following year should the economic recovery fail to materialize. They also fear that should Abe delay a decision beyond October, or listen to calls from some advisers and party members to postpone or water down the initial 3 percentage-point rise, market confidence in his commitment to getting Japan’s fiscal house in order could be damaged.

On the labour market Abe says he wants a more dynamic employment system that fosters risk-taking and innovation, but there is strong opposition to moves to make it easier to fire workers. The government in April retreated from even a baby step: a proposal that companies that lose wrongful-dismissal decisions could pay off a fired worker instead of reinstatement. Abe’s government is vague on future efforts to reform Japan’s rigid labour system. Such reforms would be welcome to financial markets and firms but require the premier to take on vested interests in his own party.

With the road ahead free of past political obstacles in Parliament, Abe has now no excuse to progress with his economic agenda. We can no longer blame the ‘twisted parliament’ or the opposition for government inaction, he has said. But Japanese politics is still dominated by powerful vested interests which will resist any efforts by Abe to move towards freer and more competitive markets and restore fiscal sustainability. Nevertheless he has strong popular backing and high poll ratings, so he does have the opportunity for change if he can formulate a strategy that will mobilise public opinion behind it and also at least partially buy off the opposing interests in a time-limited way. The negotiations over the TPP may turn out to be a useful focus pushing the debate and the policies forward.

## MARKET DEVELOPMENTS

The resurgence in UK growth into the 2–3% range should underpin equity prices against an inevitable slow tightening of monetary policy both here and in the US. Both central banks have given assurances that interest rates will stay low for a long time and so guaranteed that the tightening will be very slow and gradual. Meanwhile

the downward correction in bond prices has already started as was also inevitable. It will continue. Hence our portfolios have rightly been dominated by equities and should remain so. In a multi-polar world the equities also must be spread widely across emerging markets as well as the main developed ones.

**Table 1: Market Developments**

	Market Levels		Prediction for Jul/Aug 2014	
	Jun 26	Jul 24	Previous Letter View	Current View
<b>Share Indices</b>				
UK (FT 100)	6165	6620	8835	9845
US (S&P 500)	1603	1686	2049	2138
Germany (DAX 30)	7941	8379	11078	11521
Japan (Tokyo New)	1069	1220	1516	1705
<b>Bond Yields (government long-term)</b>				
UK	2.46	2.40	1.80	1.70
US	2.54	2.59	2.10	2.10
Germany	1.77	1.66	1.50	1.50
Japan	0.88	0.78	0.70	0.70
UK Index Linked	-0.11	-0.06	-0.20	-0.30
<b>Exchange Rates</b>				
UK (\$ per £)	1.50	1.54	1.56	1.56
UK (trade weighted)	81.2	80.4	82.3	83.1
US (trade weighted)	86.8	86.5	85.5	85.5
Euro per \$	0.77	0.76	0.79	0.79
Euro per £	1.16	1.16	1.23	1.23
Japan (Yen per \$)	97.4	100.0	98.0	98.0
<b>Short Term Interest Rates (3-month deposits)</b>				
UK	0.57	0.56	1.70	1.80
US	0.33	0.30	0.70	0.70
Euro	0.15	0.15	0.50	0.50
Japan	0.15	0.08	0.70	0.70

**Table 2: Prospective Yields<sup>1</sup>**

<b>Equities: Contribution to £ yield of:</b>						
	Dividend Yield	Real Growth	Inflation	Changing Dividend Yield	Currency	Total
UK	3.70	2.2	2.5	44.00		52.40
US	1.90	2.2	1.6	23.00	-1.56	27.14
Germany	3.10	0.8	1.7	35.00	-6.27	34.33
Japan	1.80	1.6	0.0	38.00	0.47	42.07
UK indexed <sup>2</sup>	-0.06		2.5	-10.00		-7.56
Hong Kong <sup>3</sup>	2.50	7.4	1.6	15.00	-1.56	24.94
Malaysia	2.80	5.2	1.6	55.00	-1.56	63.04
Singapore	3.40	3.7	1.6	32.00	-1.56	39.14
India	1.60	6.1	1.6	19.00	-1.56	26.74
Korea	1.20	3.4	1.6	-2.00	-1.56	2.64
Indonesia	2.40	5.9	1.6	46.00	-1.56	54.34
Taiwan	2.80	3.0	1.6	31.00	-1.56	36.84
Thailand	2.90	4.7	1.6	46.00	-1.56	53.64
<b>Bonds: Contribution to £ yield of:</b>						
	Redemption Yield	Changing Nominal Rates	Currency	Total		
UK	2.40	7.00				9.40
US	2.59	4.90	-1.56			5.93
Germany	1.66	1.60	-6.27			-3.01
Japan	0.78	0.80	0.47			2.05
<b>Deposits: Contribution to £ yield of:</b>						
	Deposit Yield	Currency	Total			
UK	0.56		0.56			
US	0.30	-1.56	-1.26			
Euro	0.15	-6.27	-6.12			
Japan	0.08	0.47	0.55			

<sup>1</sup> Yields in terms of €s or \$s can be computed by adjusting the £-based yields for the expected currency change.

<sup>2</sup> UK index linked bonds All Stocks

<sup>3</sup> Output based on China.

**Table 3: Portfolio(%)**

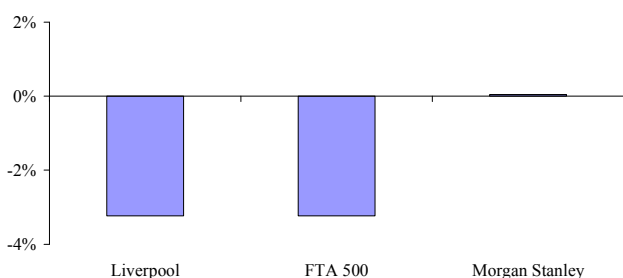
	Sterling Based Investor		Dollar Based Investor		Euro Based Investor	
	July Letter	Current View	July Letter	Current View	July Letter	Current View
UK Deposits (Cash)	5	5	5	5	1	1
US Deposits	-	-	-	-	-	-
Euro Deposits	-	-	-	-	-	-
Japanese Deposits	-	-	-	-	-	-
UK Bonds	-	-	-	-	-	-
US Bonds	-	-	-	-	-	-
German Bonds	-	-	-	-	-	-
Japanese Bonds	-	-	-	-	-	-
UK Shares	19	19	14	14	17	17
US Shares	14	14	19	19	16	16
German Shares	14	14	14	14	21	21
Japanese Shares	9	9	9	9	11	11
Hong Kong/Chinese Shares	4	4	4	4	4	4
Singaporean Shares	4	4	4	4	4	4
Indian Shares	4	4	4	4	4	4
Thai Shares	3	3	3	3	3	3
South Korean Shares	4	4	4	4	4	4
Taiwanese Shares	4	4	4	4	3	3
Brazilian Shares	4	4	4	4	3	3
Chilean Shares	4	4	4	4	3	3
Mexican Shares	4	4	4	4	3	3
Peruvian shares	4	4	4	4	3	3
Other:						
Index-linked bonds (UK)	-	-	-	-	-	-



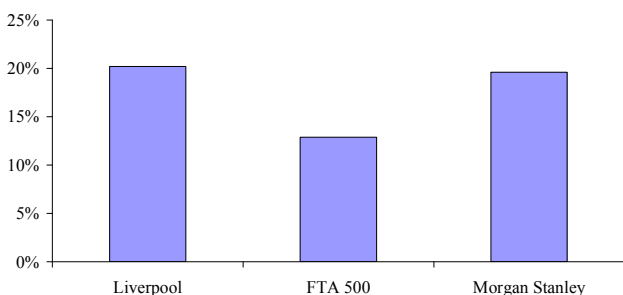
# PORTFOLIO PERFORMANCE

The charts below, and the Table opposite, measure the performance of the Liverpool Model Portfolio against the FTA Non-financials share index, and the Morgan Stanley World Capital International index, over the period from June 1992 to end-June 2013.

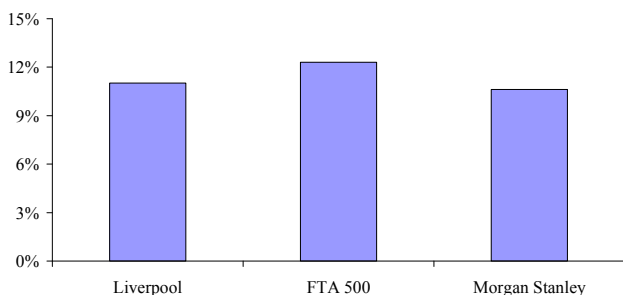
**3 Month Growth**



**12 Month Growth**



**3 Year Annualised Growth**



**Table 4: Liverpool Portfolio Evaluation  
(End-June 1992 = 100)**

Date	Index of Liverpool Portfolio	FTA Non Financials Index Total Return	Morgan Stanley World Capital International Index Total Return
2007			
1 <sup>st</sup> Jan	332.81	361.22	382.93
Apr	344.58	376.53	389.99
Jul	365.53	403.07	403.44
Oct	379.22	401.46	405.04
2008			
1 <sup>st</sup> Jan	396.02	411.25	403.19
Apr	389.00	367.01	365.34
Jul	387.93	381.90	355.90
Oct	400.53	324.99	335.11
2009			
1 <sup>st</sup> Jan	439.02	314.73	323.33
Apr	424.38	294.99	283.79
Jul	441.61	315.62	295.72
Oct	508.20	375.37	355.96
2010			
1 <sup>st</sup> Jan	526.64	408.79	365.52
Apr	564.11	436.43	399.80
Jul	531.62	382.77	351.60
Oct	572.20	435.61	378.02
2011			
1 <sup>st</sup> Jan	620.58	476.51	413.02
Apr	621.29	481.43	420.69
Jul	631.17	494.36	418.86
Oct	548.00	437.69	358.02
2012			
1 <sup>st</sup> Jan	575.91	482.11	384.40
Apr	630.65	495.88	414.96
Jul	605.43	480.40	398.13
Oct	631.88	507.18	410.42
2013			
1 <sup>st</sup> Jan	652.78	512.06	416.11
Apr-13	751.40	559.95	477.75
May-13	766.74	571.38	489.05
Jun-13	727.56	542.18	476.11

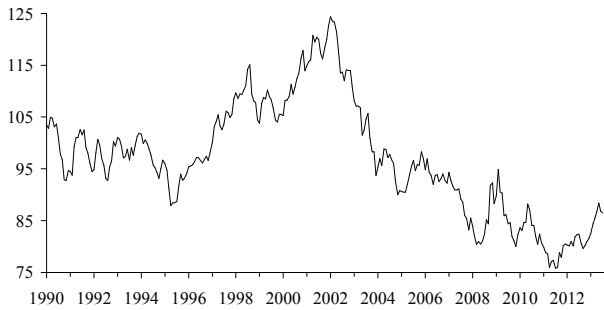
Source: Rensburg Sheppards Investment Management Limited, Liverpool Stock Exchange

# INDICATORS AND MARKET ANALYSIS

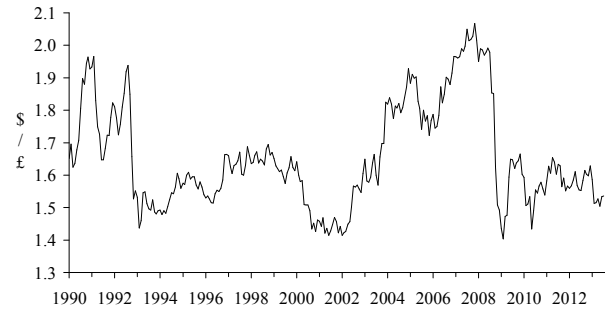
## FOREIGN EXCHANGE MARKETS

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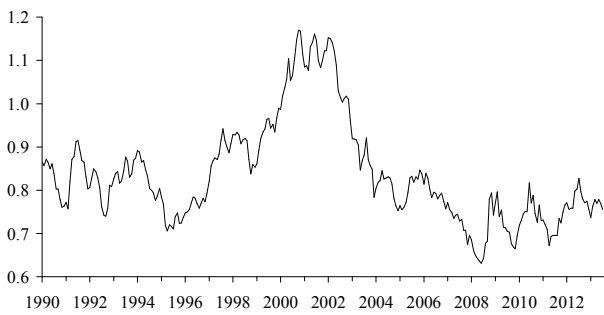
**US : Trade Weighted Index  
(Bank of England 1990 = 100)**



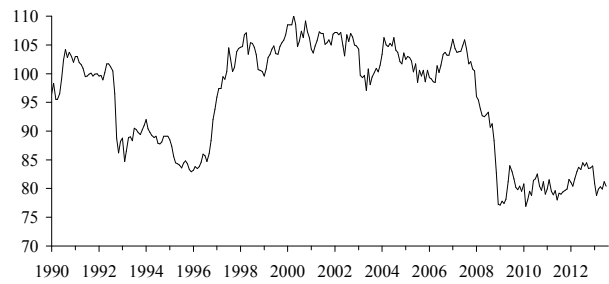
**UK: Dollars Per Pound Sterling**



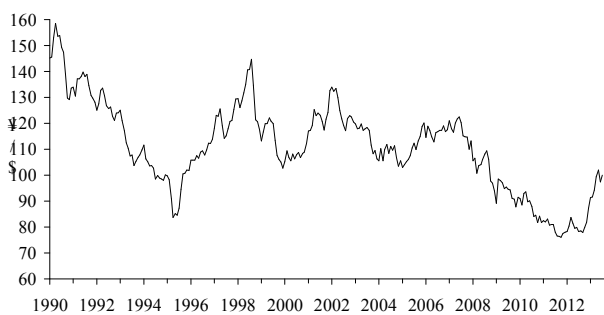
**Euro per US dollar**



**UK: Trade-Weighted Index  
(Bank of England 1990 = 100)**

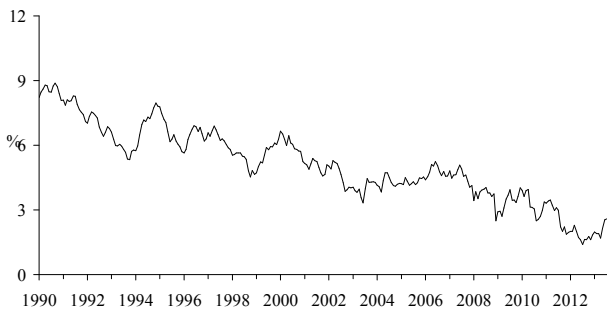


**Japan : Yen Per U.S. Dollar**

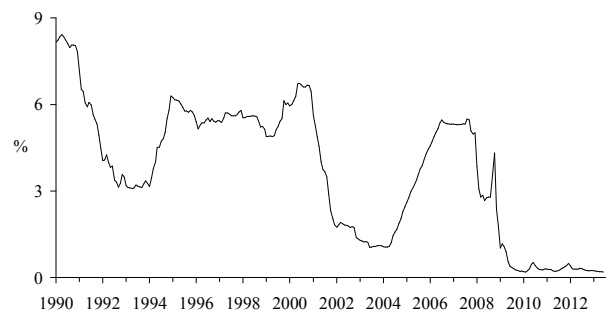


# GOVERNMENT BOND MARKETS

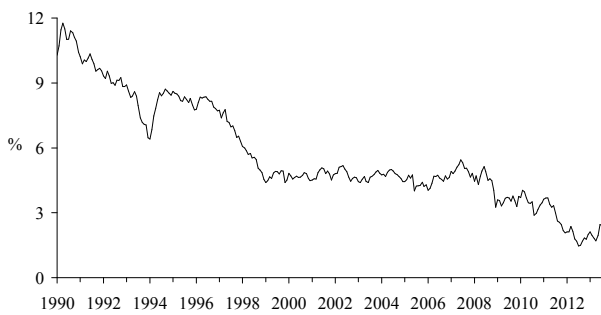
**U.S.: Yield on Long-Term Government Bonds**



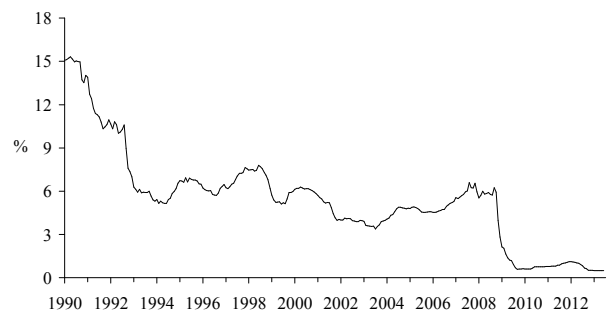
**U.S. : 3-Month Certificate of Deposit**



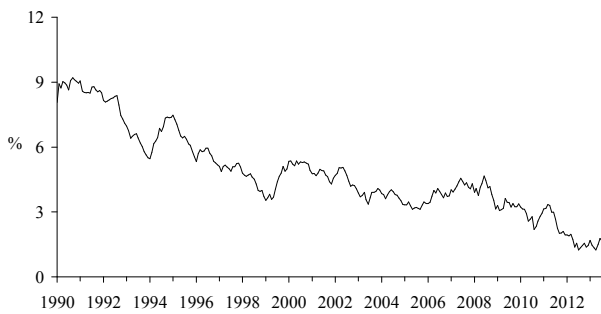
**U.K. : Yield on Long-Term Government Bonds**



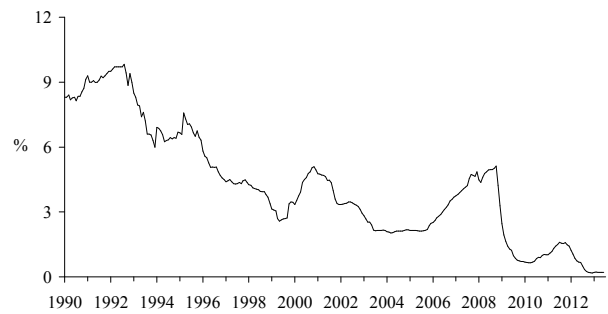
**U.K. : 3-Month Interbank Rate**



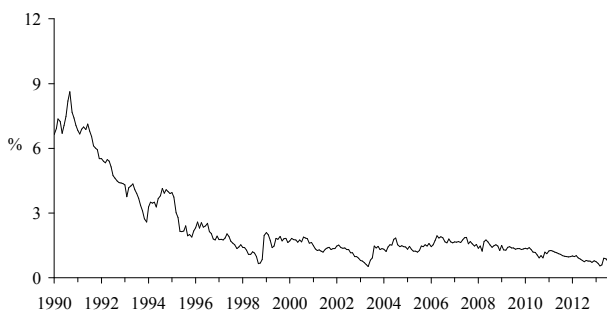
**Germany: Yield on Public Authority Bonds**



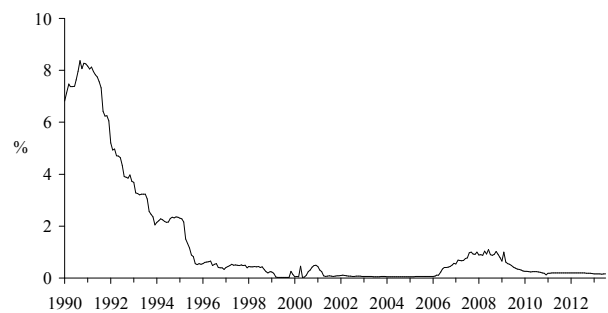
**Germany : 3-Month Interbank Deposit Rate**



**Japan: Yield on Long-Term Government Bonds**



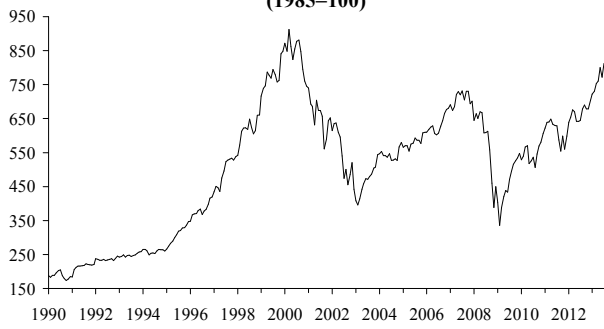
**Japan : 3 Month Money Market Rate**



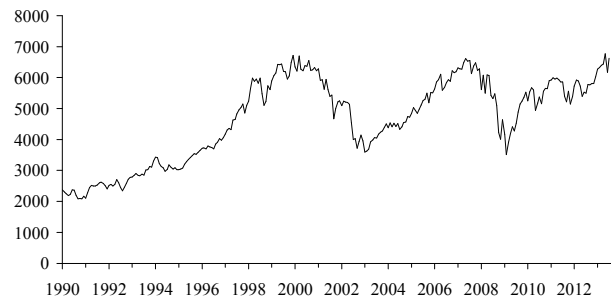
# MAJOR EQUITY MARKETS

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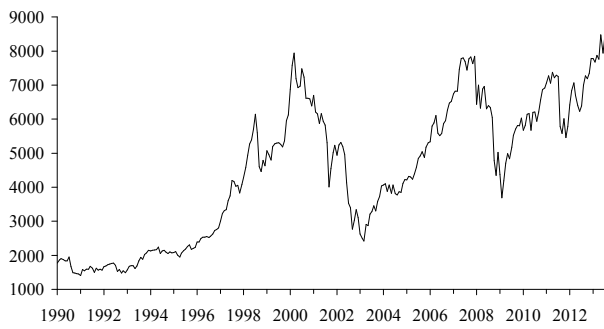
**U.S. : S & P 400 Industrial  
(1985=100)**



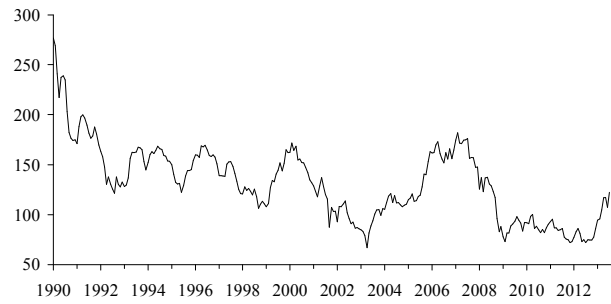
**U.K. : FTSE-100 Index  
(10 April 1962=100)**



**Germany : DAX 30**



**Japan : Tokyo S.E. New  
(1985=100)**



# EMERGING MARKETS

Anupam Rastogi

## India

India reported an unexpected fall in industrial output for May as well as a pickup in retail inflation. Weakening of the Indian rupee has left little room for authorities to take supportive measures, therefore hopes for an interest rate cut, because of the slowdown in the Indian economy, may just have to wait longer. There has been increasing pressure on the RBI to cut rates but the central bank has been in no mood to relent. And this may be the case in the coming months as well.

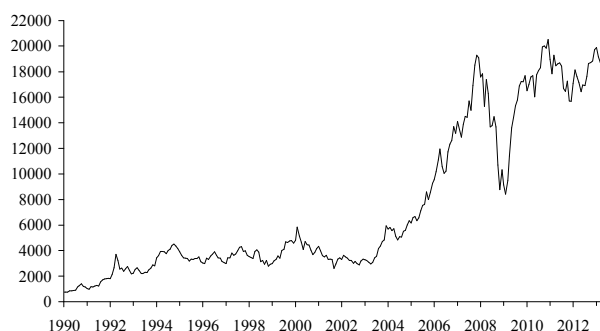
The Indian currency touched a low of Rs 61.21 against the US dollar on July 8. The falling exchange rate will have an adverse impact on food as well as fuel prices. As inflation stubbornly stays firm, the central bank will not loosen its monetary policy even though economic growth remains poor. In effect, the RBI's hands are tied. The inflation data showed consumer prices rose 9.87% from a year earlier in June, compared with 9.31% in May. India's wholesale inflation remained within the central bank's tolerance zone but accelerated to 4.86% in the month of June on the back of higher food and fuel prices. In the Reserve Bank of India's monetary policy review on July 30, we expect status quo to be maintained.

For political reasons, as the central bank is not able to raise policy rates directly, it is squeezing liquidity in the interbank market by changing banks' daily borrowing limits as well as its cost. RBI raised by 2 percentage points to 10.25% the interest it charges on borrowings beyond the cap under an emergency lending facility. The move was aimed at arresting the rupee's fall. In couple of weeks' time this will feed into the lending rate.

The International Monetary Fund has reduced forecasts of India's GDP growth to 5.8% in the year to end March 2014. Due to a better than expected Southwest monsoon and election spending boost we are maintaining growth rate and inflation rate expectations of 6% for 2013-14 and 2014-15. The rupee has fallen about 10% against the dollar since early May, which will push up import costs and feed price pressures in the coming months.

The government's efforts to reduce the fiscal deficit to 4.9% of gross domestic product last fiscal year, from 5.8% the year before, now look threatened by the huge increase in social spending under the food security bill, which is likely to be passed in the Monsoon Session of the Parliament beginning on August 5. The Bill aims to guarantee very cheap food grains to almost 70% of India's 1.2 billion population. This welfare programme will raise

India: BSE Sensitive



the subsidy bill to around \$20 billion. The food security bill, when passed, may also jeopardize the development of the agriculture sector as it would further incentivise farmers to produce low-margin grains, rather than focusing on cash crops that could help raise rural living standards and reduce dependence on imports of some staples.

The government has eased restrictions on foreign investment in telecoms and defence to attract long-term capital flows and help boost growth. But business conditions and investor confidence are at low ebb and investors, both domestic and foreign, are waiting for parliamentary elections to get over before they commit to any new investment.

Exports of gems and jewellery from India fell 40% to \$2.4 billion in June as restrictions on gold imports stifled supply. Gem and jewellery exports account for nearly 15% of India's exports. The trade gap narrowed to \$12.2 billion from \$20.1 billion.

Speculation is rife that Raghuram Rajan, former Chief Economic Adviser at the IMF, may become next governor of the RBI. Being from the Chicago School which identifies excessive credit inflation and interest rates below the "natural" rate of interest as the driver of the boom/bust cycle, one can expect a tight monetary policy to rein in inflationary expectations. Whether the political masters would like to see an independent or a pliable administrator in charge of the central bank is yet to be seen.

	10-11	11-12	12-13	13-14	14-15
GDP (%p.a.)	7.5	6.2	5.0	6.0	6.0
WPI (%p.a.)	9.0	7.5	7.0	6.0	6.0
Current A/c(US\$ bill.)	-31.0	-40.0	-80.0	-100.0	-60.0
Rs./\$(nom.)	49.0	49.5	54.5	58.0	58.0

## China

The Preliminary HSBC China manufacturing PMI fell to 47.7 in July, compared with 48.2 in June indicating that the manufacturing sector of the economy is slowing down faster than expected. Moreover, there is a serious discussion among commentators how far the Chinese leadership would allow the economic growth to whittle away. So far, China's slowdown hasn't been accompanied by signs of major job cuts.

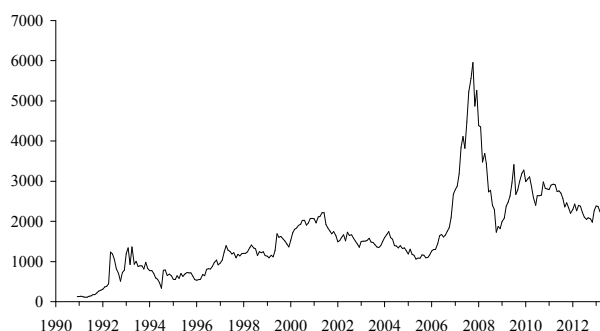
China's economy grew 7.5% year-over-year in the second quarter, down from 7.7% in the first quarter. The government has set a growth target of 7.5% for the full year. In our opinion, the government is not at risk of missing its growth target, notwithstanding a Freudian slip by Finance Minister Lou Jiwei in Washington that a 7% growth rate would not be bad. The minister has made it clear that big fiscal stimulus isn't on the agenda, and China has launched reforms to reduce the tax burden for small firms this year. The government has eliminated taxes on small businesses and reduced costs for exporters. Some funds are being provided for the construction of railways.

Premier Li Keqiang, who is in charge of the economy and administration, has said that China shouldn't squander this opportunity to restructure the economy, implying that the tried-and-tested formula of using government spending to spur growth in short term is not on agenda. China wants to boost the role of domestic consumption as a growth-driver while shifting away from the quick fix of investment. Mr. Li's statement suggests that China's leaders recognise that ever-increasing credit into infrastructure and real-estate projects is unsustainable.

More than the Chinese leadership, China's growth rate is being watched more closely by commodity producing countries and other ASEAN countries which depend on China for their exports. A Chinese economy growing at an annual rate of 7.5% contributes more to global demand growth than expansion in any other economy.

The Chinese leadership should be pleased to note that the economy is changing structurally. Consumer spending, measures by retail sales, accelerated to 13.3% in June compared with 12.9% growth in May. But disposable income growth for urban households slowed to 6.5% year-on-year in the first half, down from 9.7% growth in the first half of 2012. However, car manufacturers have seen healthy growth in car sales and expect sales growth to continue in 2014.

China: SSE Composite Index



Exports fell 3.1% in June from a year earlier, compared with a 1% increase in May. For the first half of 2013, exports grew at 10.4% on average. Imports slipped 0.7% in June from a year earlier compared with a 0.3% decline in May. In the first six months imports increased 6.7% on average. This left China with a \$27.1 billion trade surplus in June.

China is taking measured new steps to make its financial system more responsive to market forces. In July, China's central bank removed a government floor on the interest rates banks can charge their clients for credit, allowing financial institutions to price loans at whatever level they want. This is to foster competition among banks and to provide an easier access to small and private manufacturers who are shunned by big state-owned lenders. Interest rate liberalisation is regarded as a necessary precondition for eventual full convertibility of the renminbi and for China eventually to loosen its tight restrictions on cross-border capital flows. At present, the PBOC sets the one year benchmark rate for deposits at 3%, while the one-year benchmark rate for loans is 6%.

The USD/CNY pair closed at 6.1413, up from 6.1353 in the last week of July. The central bank fixed the pair higher at 6.1720, reflecting the greenback's broad strength. The yuan has risen 1.5% in 2013. The yuan is a notable gain against the resurgent US dollar. In the offshore yuan market in Hong Kong, however, where the Chinese currency floats freely, the dollar was at CNY6.1377 and offshore, one-year dollar/yuan nondeliverable forward contracts is at 6.2780/6.2830. This implies a 2.2% fall by the yuan over the next one year.

	10	11	12	13	14
GDP (%p.a.)	10.3	9.2	7.8	7.5	7.0
Inflation (%p.a.)	5.9	4.3	2.6	3.5	3.0
Trade Balance(US\$ bill.)	183	210	214	220	220
Rmb/\$ (nom.)	6.6	6.3	6.3	6.2	6.1

## South Korea

In the second quarter, the Korean economy grew a seasonally-adjusted 1.1% from the first three months of the year. Compared to the same period a year earlier, gross domestic product grew 2.3%. Weak consumer spending, sluggish industrial production and challenging outlook for exports had prompted the government to cut its annual growth forecast from 3% to 2.3% in March.

South Korea faces headwinds from a slowing Chinese economy, which dents export demand, and a weaker yen, which makes Japanese exports relatively cheaper. As South Korean products compete with Japanese products and depreciating yen provides competitive advantage to Japanese products, the Korean exports are becoming uncompetitive in many markets.

South Korea's consumer price inflation remained at the lowest level in nearly 14 years for two straight months due to the persistently stable picture of farm goods and weak oil prices. Consumer prices rose only 1% in June from a year earlier and stayed at this level for the second consecutive month.

South Korea's exports came to US\$46.7 billion in June, down 1% from the same period a year earlier. Its imports dropped 3% on-year to \$40.7 billion, according to the Korea Customs Service. This resulted in \$6 billion in trade surplus, marking the 17th straight month of a surplus since February last year. Robust export growth has helped the current-account surplus for May to \$8.64 billion.

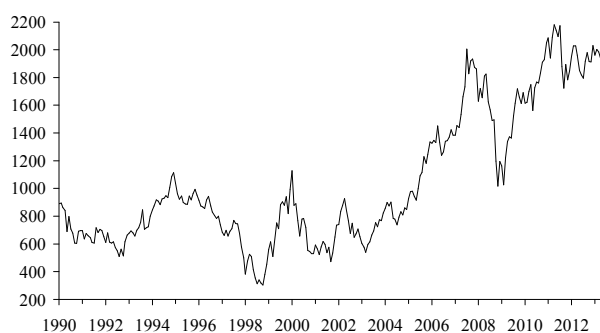
South Korean Finance Minister Hyun Oh-seok has urged the U.S. Federal Reserve to take into account the global impact of its eventual exit from stimulus measures, warning of possible "reverse spillover" effects implying that the US economy may get adversely affected due to increase in bond yields.

	10	11	12	13	14
GDP (%p.a.)	6.3	3.6	2.0	2.0	2.8
Inflation (%p.a.)	2.9	4.0	2.2	1.1	1.6
Current A/c(US\$ bill.)	28.2	27.0	44.0	28.0	28.0
Won/\$(nom.)	1150	1100	1100	1120	1150

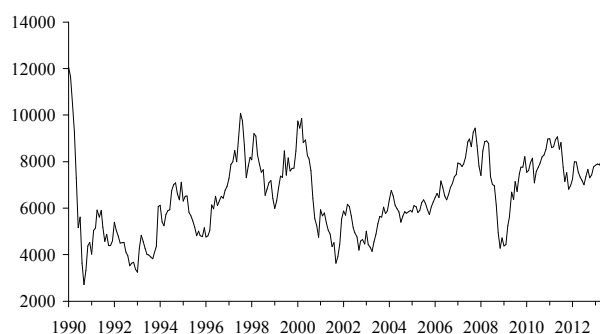
## Taiwan

Slow growth in China and in the eurozone is contributing to the slower than expected growth in Taiwan. In 2013, Taiwan may grow by 2% only and continued headwinds in China and Eurozone would not allow Taiwan to grow more than 2.5% in 2014.

Korea: Composite Index



Taiwan: Weighted TAIEX Price Index



For the first half of the year, exports totalled US\$150.48 billion, up 2.4% from the same period in 2012, and imports reached US\$135.88 billion, up 0.3% year-on-year. Taiwan's trade surplus rose 24.3% in June from a month earlier to US\$3.25 billion and was up 29.1% in the first half of 2013 from the previous year to NT\$14.61 billion.

Taiwan signed a free-trade pact with New Zealand — its first with a developed economy — in a move that will help it to reduce its dependence on mainland China. This may be an entry point into talks over the Trans-Pacific Partnership, a free-trade pact that the U.S., Japan and other countries in Asia and Latin America are exploring. Beijing seems to be comfortable with the agreement as the island is referred to as Chinese Taipei.

	10	11	12	13	14
GDP (%p.a.)	10.8	4.0	1.3	2.0	2.5
Inflation (%p.a.)	1.3	1.2	1.9	0.6	1.0
Current A/c(US\$ bill.)	16.0	18.0	20.0	22.0	23.0
NTS/\$(nom.)	31.0	30.0	29.5	30.0	29.5

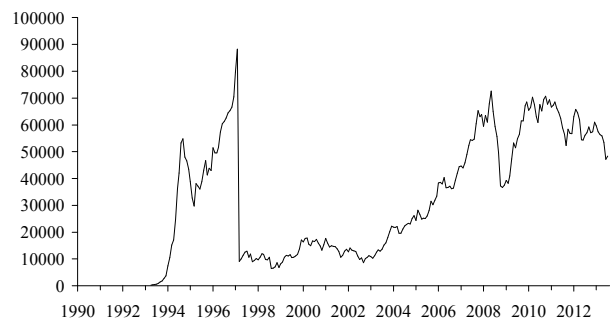
## Brazil

Growth is adversely getting affected due to persistent inflation. Inflation remains stubbornly high and above the central bank's target for the year 2013. This would be the first time in the last 10 years that inflation is above the central government target. Brazil is likely to grow just 2% this year as the fall in commodity demand and depreciation of the currency takes time to adjust in the economy. Growth in 2013 will be lower than the disappointing 2012 growth rate of 2.7%.

The 12-month inflation rate has been rising steadily in the last seven months, hitting 6.7% in May, amid widespread pressures from food and services prices. The 6.5% ceiling for the inflation set by the central bank got breached as the real has depreciated by more than 7% in the last six months. To rein in inflation the central bank is expected to raise rates to 9.25% by year-end, up from 8.5% now and two percentage points above the record low of 7.25%, where it stood before policy makers started raising rates in April. In mid-July the Brazilian Central Bank raised its base interest rate to a punishing 8.5%. It is hoped that the rate hike may curb inflation as consumer credit and business loans become more expensive. The Selic is likely to be raised by 50 basis points in the August meeting and a final 25 basis points hike at the October meeting. The expected monetary tightening is to curb inflationary expectations at the expense of economic growth. Producers are already raising their prices in accordance with inflation expectations.

The real is trading around BRL2.24 mark against the dollar and weakening steadily. This forced the central bank to step into currency markets. The central bank has been selling swap contracts regularly. The real came under pressure on expectations that the Federal Reserve would roll back its

Brazil: Bovespa



post-financial-crisis policy of buying bonds to inject money into a sluggish U.S. economy. After the Fed Chairman Ben Bernanke's assertion that the U.S. bond-buying policy is unlikely to change very soon, there is some strengthening of the real against the dollar.

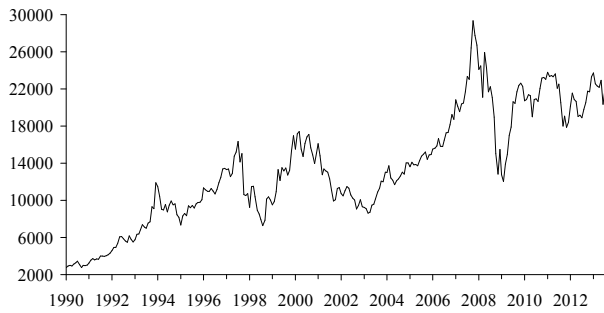
As noted in the last Letter, public support for Brazilian President Dilma Rousseff is slipping ahead of 2014 elections. A public-opinion poll showed support for the Rousseff administration at 31% compared to 54% in early June. Respondents were concerned about inflation, corruption and deteriorating public services. There is a fighting chance that former president Lula may choose to stand for the election in 2014.

	10	11	12	13	14
GDP (%p.a.)	7.5	2.7	0.9	2.0	3.5
Inflation (%p.a.)	5.9	6.5	5.8	6.5	6.0
Current A/c(US\$ bill.)	-47.3	-52.6	-60.0	-65.0	-60.0
Real/\$ (nom.)	1.7	1.5	2.0	2.2	2.2

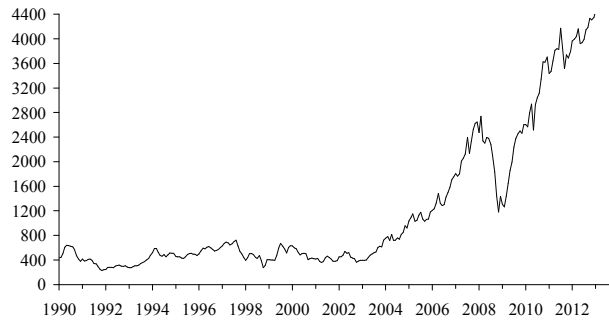


## Other Emerging Markets

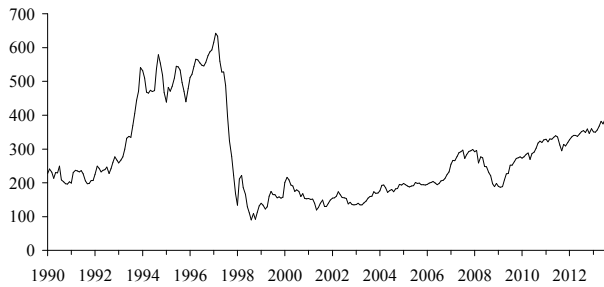
**Hong Kong: FT-Actuaries**



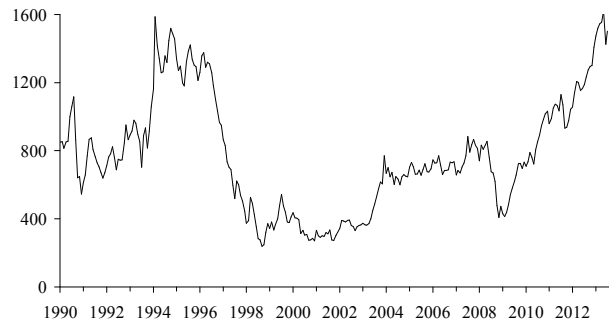
**Indonesia: Jakarta Composite**



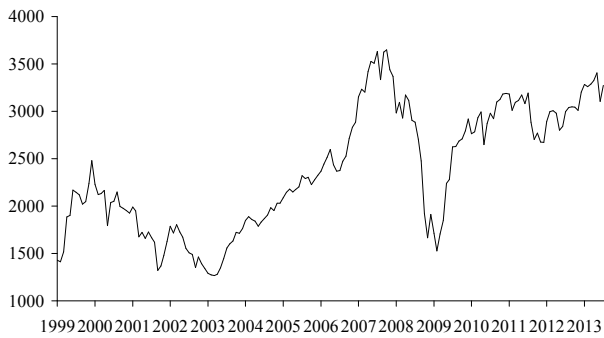
**Malaysia: FT-Actuaries  
(US\$ Index)**



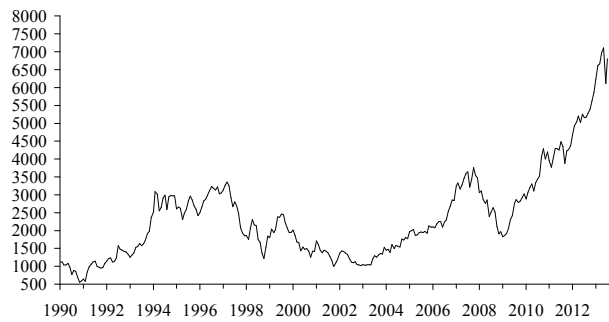
**Thailand: Composite Index**



**Singapore: Straits Times Index**



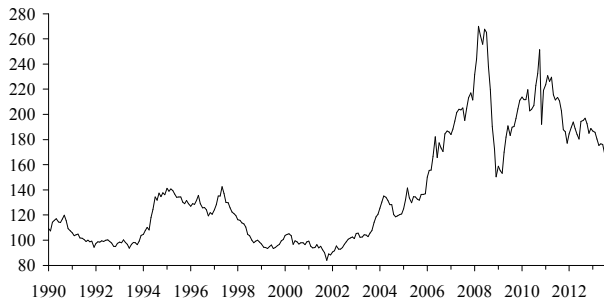
**Philippines: Manila Composite**



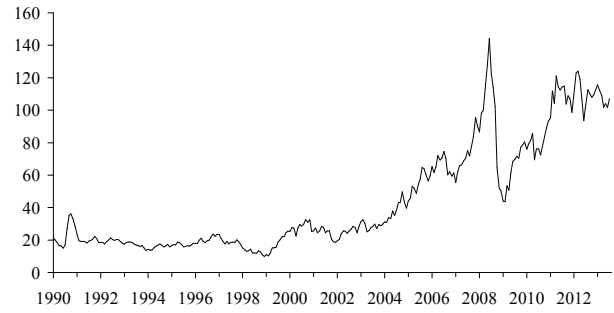
# COMMODITY MARKETS

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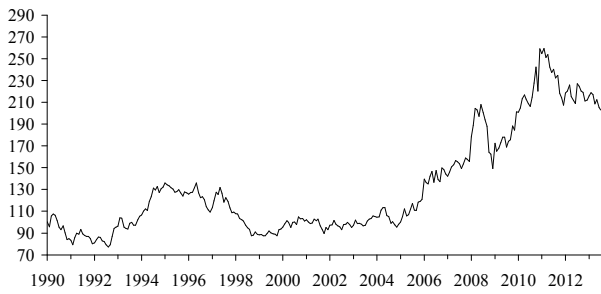
**Commodity Price Index (Dollar)**  
(Economist, 2000=100)



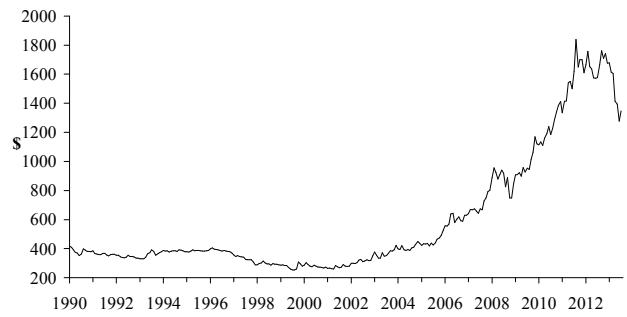
**Oil Price: North Sea Brent (in Dollars)**



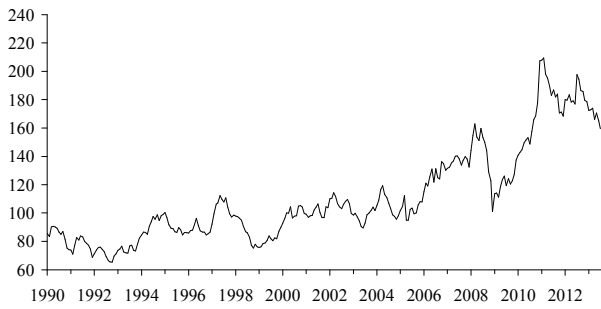
**Commodity Price Index (Sterling)**  
(Economist, 2000=100)



**Gold Price (in Dollars)**



**Commodity Price Index (Euro)**  
(Economist)



# UK FORECAST DETAIL

## Prices, Wages, Interest Rates and Exchange Rate Forecast (Seasonally Adjusted)

	Inflation % <sup>1</sup> (CPI)	Short Dated (5 Year) Interest Rates	3 Month Int. Rates	Nominal Exchange Rate (2005=100) <sup>2</sup>	Real Exchange Rate <sup>3</sup>	Real 3 Month Int. Rates % <sup>4</sup>	Inflation (RPIX)	Real Short Dated Rate of Interest <sup>5</sup>
2010	3.3	2.4	0.7	80.4	88.6	-3.5	4.8	-0.2
2011	4.5	2.0	0.9	80.0	89.8	-2.8	5.3	-0.2
2012	2.7	0.9	0.9	83.1	94.0	-1.7	3.2	-1.5
2013	2.7	1.3	0.9	82.6	94.3	-1.6	2.5	-0.9
2014	2.5	1.8	1.6	83.0	95.7	-0.6	3.1	-0.3
2015	2.2	2.1	2.1	82.3	95.4	0.1	2.8	0.1
2012:1	2.7	1.1	1.1	81.2	91.6	-1.8	3.8	-1.3
2012:2	3.0	0.9	1.1	83.2	94.3	-1.4	3.2	-1.4
2012:3	2.5	0.7	0.8	84.1	95.2	-1.7	2.9	-1.6
2012:4	2.5	0.8	0.6	83.7	94.9	-2.0	3.0	-1.5
2013:1	2.6	1.0	0.6	80.5	91.1	-2.0	0.0	-1.3
2013:2	2.8	1.3	0.9	83.2	95.2	-1.6	3.3	-0.9
2013:3	2.8	1.5	0.9	83.5	95.5	-1.6	3.3	-0.7
2013:4	2.7	1.5	1.1	83.2	95.4	-1.3	3.2	-0.6
2014:1	2.6	1.8	1.3	83.6	96.0	-1.1	3.1	-0.3
2014:2	2.5	1.8	1.6	83.0	95.8	-0.6	3.1	-0.3
2014:3	2.5	1.7	1.8	83.1	95.8	-0.3	3.1	-0.4
2014:4	2.4	1.8	1.8	82.4	95.2	-0.3	3.0	-0.2

<sup>1</sup> Consumer's Expenditure Deflator

<sup>2</sup> Sterling Effective Exchange Rate Bank of England

<sup>3</sup> Ratio of UK to other OECD consumer prices adjusted for nominal exchange rate

<sup>4</sup> Treasury Bill Rate less one year forecast of inflation

<sup>5</sup> Short Dated 5 Year Interest Rate less average of predicted 5 year ahead inflation rate

## Labour Market and Supply Factors (Seasonally Adjusted)

	Average Earnings (1990=100) <sup>1</sup>	Wage Growth <sup>2</sup>	Unemployment (New Basis) Percent <sup>3</sup>	Millions	Real Wage Rate <sup>4</sup> (1990=100)
2010	227.1	2.4	4.6	1.50	135.6
2011	232.7	2.5	4.6	1.53	133.5
2012	237.1	1.9	4.7	1.59	132.5
2013	242.3	2.2	4.5	1.53	131.8
2014	248.5	2.6	4.2	1.43	131.9
2015	256.6	3.2	3.9	1.31	133.3
2012:1	234.7	0.7	4.8	1.61	132.4
2012:2	235.8	1.8	4.8	1.59	131.9
2012:3	237.4	1.9	4.7	1.57	132.5
2012:4	240.5	3.3	4.6	1.56	133.2
2013:1	241.8	3.0	4.6	1.54	133.0
2013:2	242.1	2.7	4.6	1.55	131.7
2013:3	242.0	2.0	4.5	1.54	131.4
2013:4	243.1	1.1	4.5	1.51	131.0
2014:1	245.1	1.3	4.4	1.48	131.4
2014:2	248.1	2.5	4.3	1.45	131.7
2014:3	249.4	3.0	4.2	1.42	132.1
2014:4	251.5	3.4	4.1	1.39	132.4

<sup>1</sup> Whole Economy

<sup>2</sup> Average Earnings

<sup>3</sup> Wholly unemployed excluding school leavers as percentage of employed and unemployed, self employed and HM Forces

<sup>4</sup> Wage rate deflated by CPI

## Estimates and Projections of the Gross Domestic Product<sup>1</sup> (£ Million 1990 Prices)

	Expenditure Index	£ Million '90 prices	Non-Durable Consumption <sup>2</sup>	Private Sector Gross Investment Expenditure <sup>3</sup>	Public Authority Expenditure <sup>4</sup>	Net Exports <sup>5</sup>	AFC
2010	143.2	685816.8	412464.1	222982.1	180596.2	-35977.3	94248.2
2011	144.8	693480.0	405707.9	232196.6	179249.7	-24641.9	99032.3
2012	145.1	694662.2	405184.0	235764.3	184689.2	-30801.2	100173.9
2013	146.8	702861.9	405176.8	223498.2	188405.4	-30067.7	84149.4
2014	150.0	718141.3	408306.9	241326.9	189177.7	-31205.7	89481.4
2015	153.6	735702.5	414580.1	250992.1	193479.8	-31157.8	92210.8
2010/09	1.7		0.3	11.0	0.1		8.3
2011/10	1.1		-1.6	3.8	-0.8		4.5
2012/11	0.2		-0.1	2.5	3.0		3.0
2013/12	1.2		0.0	-5.3	2.0		-16.0
2014/13	2.2		0.8	8.6	0.4		7.3
2015/14	2.4		1.5	4.0	2.3		3.1
2012:1	145.2	173777.2	101162.8	53040.9	48062.2	-6746.9	21741.9
2012:2	144.4	172906.5	101177.7	59892.9	44993.0	-8401.7	24755.4
2012:3	145.5	174189.9	101200.0	60648.4	45617.7	-7536.4	25739.8
2012:4	145.2	173788.7	101643.4	62182.0	46016.3	-8116.2	27936.9
2013:1	145.5	174253.1	101590.2	48881.4	48201.0	-6636.6	17782.9
2013:2	146.5	175446.1	101360.9	56536.5	45914.8	-7812.6	20545.8
2013:3	147.2	176195.9	101183.7	57185.3	48587.9	-7810.2	22948.1
2013:4	147.8	176966.8	101041.9	60894.9	45701.7	-7808.3	22872.6
2014:1	148.7	177984.2	101428.2	59849.8	46404.1	-7808.4	21893.9
2014:2	149.5	179011.0	101842.3	60408.6	46695.4	-7801.3	22139.1
2014:3	150.4	180074.6	102284.4	58779.4	49462.5	-7797.5	22657.5
2014:4	151.2	181071.5	102752.0	62289.0	46615.7	-7798.5	22791.0

<sup>1</sup> GDP at factor cost. Expenditure measure; seasonally adjusted

<sup>2</sup> Consumers expenditure less expenditure on durables and housing

<sup>3</sup> Private gross domestic capital formation plus household expenditure on durables and clothing plus private sector stock building

<sup>4</sup> General government current and capital expenditure including stock building

<sup>5</sup> Exports of goods and services less imports of goods and services

## Financial Forecast

	PSBR/GDP % <sup>1</sup>	GDP <sup>1</sup> (£bn)	PSBR (£bn)	Debt Interest (£bn)	Current Account (£ bn)
	Financial Year				
2010	8.5	1319.8	112.6	36.6	-40.0
2011	6.5	1399.3	91.0	43.0	-22.5
2012	4.8	1425.0	68.4	46.9	-59.2
2013	8.1	1471.0	119.7	51.2	-60.7
2014	6.9	1541.7	106.0	56.6	-62.9
2015	5.9	1613.2	94.6	60.3	-63.5
2012:1	4.1	346.6	14.4	11.5	-12.5
2012:2	1.3	353.4	4.6	11.4	-17.8
2012:3	5.7	358.3	20.3	11.8	-15.3
2012:4	8.9	364.3	32.6	11.8	-13.6
2013:1	3.1	349.1	10.9	12.0	-14.5
2013:2	8.2	360.4	29.6	12.5	-17.1
2013:3	8.8	367.0	32.4	12.6	-15.9
2013:4	7.3	370.7	27.0	12.9	-13.2
2014:1	8.2	372.9	30.7	13.3	-16.3
2014:2	7.2	379.2	27.4	13.7	-17.3
2014:3	8.4	383.1	32.4	14.1	-16.0
2014:4	6.9	387.4	26.6	14.2	-13.3

<sup>1</sup> GDP at market prices (Financial Year)

# WORLD FORECAST DETAIL

## Growth Of Real GNP

	2009	2010	2011	2012	2013	2014
U.S.A.	-2.6	2.4	1.8	2.2	2.2	2.8
U.K.	-3.9	1.7	1.1	0.2	1.2	2.2
Japan	-6.3	4.7	-0.5	1.9	1.8	1.6
Germany	-4.7	4.2	3.0	0.7	0.6	1.5
France	-2.5	1.6	2.0	0.0	-0.4	0.7
Italy	-5.1	1.7	0.5	-2.4	-1.8	0.4

## Growth Of Consumer Prices

	2009	2010	2011	2012	2013	2014
U.S.A.	-0.3	1.6	3.1	2.1	1.6	2.0
U.K.	1.3	3.3	4.5	2.7	2.7	2.5
Japan	-1.4	-0.7	-0.3	0.0	0.0	2.0
Germany	0.4	1.2	2.0	2.0	1.7	2.0
France	0.1	1.5	2.1	2.0	1.6	1.5
Italy	0.8	1.5	2.8	3.0	2.8	1.6

## Real Short-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	-1.6	-3.0	-1.8	-1.9	-1.3	-1.2
U.K.	-0.3	-3.5	-2.8	-1.7	-1.6	-0.6
Japan	1.1	0.4	0.4	0.3	-1.6	-1.6
Germany	-0.4	-1.9	-0.5	-1.5	-1.5	-1.4
France	-0.8	-1.7	-0.5	-1.4	-1.5	-1.4
Italy	-0.8	-2.4	-1.5	-2.6	-2.0	-1.4

## Nominal Short-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	0.2	0.1	0.3	0.1	0.7	0.8
U.K.	1.1	0.7	0.9	0.9	0.9	1.6
Japan	0.1	0.1	0.4	0.3	0.4	0.4
Germany	0.7	0.4	1.5	0.2	0.5	0.6
France	0.7	0.4	1.5	0.2	0.5	0.6
Italy	0.7	0.4	1.5	0.2	0.5	0.6

## Real Long-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	1.3	1.0	0.9	-0.2	0.1	0.6
U.K.	-0.3	-0.2	-0.2	-1.5	-0.9	-0.3
Japan	1.2	0.4	-0.2	-0.8	-1.3	-1.1
Germany	2.2	1.8	-0.1	-0.4	-0.5	-0.1
France	2.2	1.9	-0.1	-0.4	-0.5	-0.1
Italy	1.5	1.2	-0.7	-0.8	-0.6	-0.1

## Nominal Long-Term Interest Rates

	2009	2010	2011	2012	2013	2014
U.S.A.	3.2	3.1	1.9	1.8	2.1	2.6
U.K.	2.8	2.4	2.0	0.9	1.3	1.8
Japan	1.3	1.1	1.0	0.8	0.7	0.9
Germany	4.0	3.8	1.8	1.5	1.5	1.9
France	4.0	3.8	1.8	1.5	1.5	1.9
Italy	4.0	3.8	1.8	1.5	1.5	1.9

## Index Of Real Exchange Rate(2000=100)<sup>1</sup>

	2009	2010	2011	2012	2013	2014
U.S.A.	88.7	87.4	85.7	90.4	97.3	99.1
U.K.	76.7	78.9	80.0	83.7	84.0	85.2
Japan	89.0	92.0	97.1	98.3	119.7	122.0
Germany	105.8	102.9	105.5	104.3	107.4	108.2
France	104.3	103.1	105.5	104.9	107.9	108.6
Italy	105.4	103.6	106.9	107.4	111.8	113.2

## Nominal Exchange Rate

(Number of Units of Local Currency To \$1)						
	2009	2010	2011	2012	2013	2014
U.S.A. <sup>1</sup>	85.98	83.73	78.08	80.90	85.50	85.40
U.K.	1.57	1.55	1.61	1.59	1.56	1.56
Japan	93.54	87.48	79.36	80.51	98.00	98.00
Eurozone	0.72	0.75	0.71	0.78	0.79	0.78

<sup>1</sup> The real exchange rate is the domestic price level relative to the foreign price level converted into domestic currency. A rise in the index implies an appreciation in the real exchange rate.

<sup>1</sup> The series for the USA is a trade weighted index (1990=100); the series for the UK is \$ per £

\* Forecasts based on the Liverpool World Model