NCB CAPITAL MARKETS LIMITED

2014 Economic Outlook: Tess-ting Times Ahead?

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Introduction

2013 was the year of many voices. One of the most memorable was that of Tessanne Chin who sang her way into the hearts of many. Talent shows aside, many other voices reverberated as the global economy continued to work through the kinks of a slow and unsteady recovery. There was the voice of the Central Banks whose actions and policies reassured the markets that they would continue to do whatever was necessary to support their respective economic recoveries. The US Federal Reserves, Bank of England and European Central Bank were among those maintaining record low interest rates while injecting liquidity into the respective financial markets through asset purchases. There was also the voice of the IMF, which continued to caution the developed economies on the dangers of prematurely winding up their accommodative monetary policy programs, while reiterating downside risks associated with developing and emerging economies due to weak domestic demand. For countries like Jamaica which re-entered a borrowing relationship with the Fund, the presence of the IMF was felt in virtually every sphere of the economy as steps to improve the fiscal situation and remove structural impediments to growth impacted all sectors. Even outside of an IMF program, various governments provided the voice of reasoning as there was a strong focus on prudent fiscal management to maintain/improve creditworthiness.

2014 is expected to be characterized by many themes, some of which can be summed up by the selections heard not too long ago when Tessanne Chin gave Jamaica its own Voice on the international stage. Like the IMF, we envisage that the global economy will be *stronger* in 2014 as developed economies help set the stage, and economic data generally become more convincing. While this should help to spur activity in the developing economies, through export growth, it will not be smooth sailing as headwinds from weak domestic demand will provide *many rivers for them to cross* before they can sing their *redemption song*.

Variables		Expectations
Economic Growth		0.5% - 1.5%
Fiscal		
	Deficit to GDP	0.8%
	Primary Balance to GDP	7.2%
Foreign Exchange		7.5% Depreciation (J$114.36:US$1)
Inflation		8% - 9.5%
Interest Rates		
Stock Market		

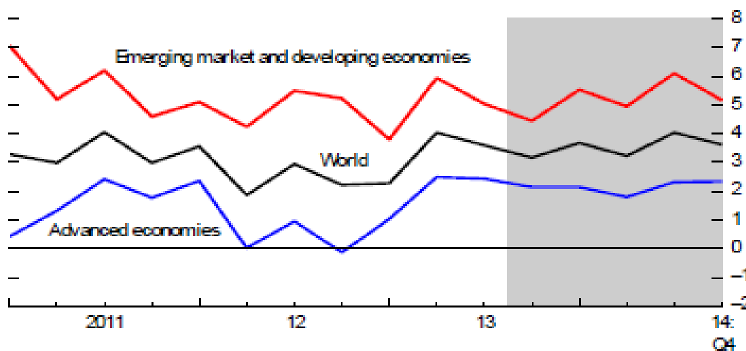
The International Stage

According to the IMF, the world economy is expected to expand by 3.7% in 2014 up from the projected growth rate of 3.0% in 2013 and 3.2% in 2012. Advanced economies will be the leads, as emerging market economies face trying times given the mounting threat of financial risks arising from the scale-back of the accommodative policy stance of the US Federal Reserve. The world's largest economy, the US, is projected to be the central force behind the growth outturn accruing to advanced economies, while continued recovery in countries such as UK and Canada should help to drive the growth momentum. Having been beset by obstacles since 2008, the euro area looks poised to hurdle these challenges. The "Zone" is expected to transition from being at the cusp of a recovery to registering an estimated 1% growth rate in 2014, as policy actions have reduced major risks and have largely stabilized financial conditions.

The spotlight on emerging market (EMs) economies will likely be dimmed this year as growth in some of these countries begin to cool and others deal with curtailing debt levels in an effort to improve fiscal flexibility.This will mean tight fiscal policies which will largely restrain

domestic demand. Further, with the trimming of the monthly bond buying strategy in the US, there is the expectation that US interest rates will begin to inch upwards. In anticipation of this, investors have already begun to redirect funds from EMs to safer assets. Of note, outflows from EM equity funds in the first five weeks of 2014 have exceeded total outflows for all of 2013. The exodus of foreign investors will alarm governments, many of which rely heavily on this portfolio capital to plug balance of payments deficits and finance spending. This could increase volatility in domestic currencies and destabilize financial institutions within the EM space, due to liquidity constraints.

Advanced Economies Generally "Stronger"



Source: IMF staff estimates.

The US

After a weak first half, higher taxes and a two week government shut-down later in the year, recent economic data suggests that the world's largest economy is getting stronger. The US expanded by an estimated 1.9% in 2013 with much of the growth occurring in the last two quarters. Ironically, this was propelled by stronger personal consumption, higher exports and capital investment, as well as growth in inventory investments. Key indicators from the job and housing markets have been promising. Unemployment dipped from 7.9% in January to 6.7% in December 2013, the lowest level since October 2008. Admittedly, this was due in part to persons leaving the labour force, which suggests that the US is not completely out of the woods. Unemployment still has some way to go before getting to its long-run normal rate which is estimated to range between 5.2% and 6.0%. Despite still tight credit conditions, the troubled housing market saw a 12.0% increase in prices.

In light of the cumulative progress towards employment and the improvement in the outlook for labor market conditions, US Federal Reserve (Fed) took a decision to scale back its accommodative monetary policy stance (Quantitative Easing) as the need for significant monetary support becomes less critical. The trimming of its monthly bond purchases which started in December 2013, will likely place upward pressure on long term interest rates, such as mortgage rates. Higher mortgage rates may lead to a retracement of some of the gains made in the housing market. As such, it will be critical for the Fed to avoid a premature withdrawal of its accommodative policy.

The IMF projects that the US economy will grow by 2.8% in 2014 and a further 3.0% in 2015. Consumer and business confidence will improve further this year, despite uneven results seen in FY2013. Rising home values and the turnaround in financial market has increased private wealth and will prompt consumer spending, which accounts for 70% of the US economy. Unexpected increases in inventory growth suggest companies are more confident about the prospects for demand. Despite stronger prospects for growth this year, it is likely that inflationary pressures will remain at bay considering that the US and other advanced economies are estimated to have large output gaps, which means there is meaningfully scope for greater output, without upward pressure on prices.

Europe

The consolidation strategy adopted in 2010 following the debt crisis which crippled the Eurozone, is now starting to bear fruit. Although a number of member countries still have a long way to go before reaching sound fiscal positions, the euro area government deficit has been more than halved from its peak level and the aggregate euro area debt ratio is expected to stabilize in 2014. The European Commission projects that in 2014 the euro area budget deficit will fall below the reference value (2.5% of GDP). Given improving fundamentals, we will likely see a gradual downward movement in bond yields on Euro debt, closer to that of pre-crisis levels as credit spreads decline.

Within the context of progress being made to implement strategies aimed at reducing the risks relating to the Zone, it is expected that the euro area will make a turnaround this year. The region is expected to stage an estimated 1% growth and 1.5% in 2015, but the this recovery will not be broad based. The pickup will generally be more modest in economies that are still working through problems relating to high debt and financial fragmentation. Going forward, continued emphasis will need to be placed on recapitalizing weak banks, improving liquidity and reviving credit. Activity in the United Kingdom has been buoyed by easier

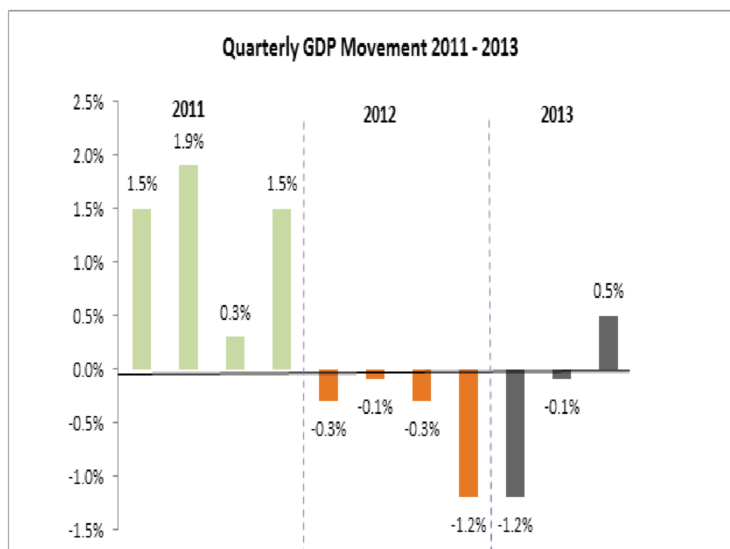
credit conditions and increased confidence. This has led to an improvement in the property market. A large part of the pickup in the housing market can be attributed to further improvements in the labor market and the brighter economic outlook. Within this context, the UK is expected to grow by 2.25% in 2014-2015.

Emerging Markets

Overall, growth in emerging market and developing economies is expected to increase to 5.1% in 2014 and to 5.4% in 2015. China will continue to see growth in the 7.5% region despite some weakness in manufacturing. Emerging markets have started to benefit from stronger external demand in advanced economies and China. However, restrictive fiscal policies to deal with rising debts, tighter financial conditions as well as political uncertainty will weigh on domestic demand.

The Jamaican Economy- Still has Many Rivers to Cross

After six (6) consecutive quarters of decline, the local economy saw marginal improvement in activity in the third quarter of 2013. According to Statin's figures, the economy registered growth of 0.5%. As the negative effects of Hurricane Sandy have finally begun to dissipate, output levels from the Goods Producing industries have increased. Heavyweight subsectors such as Agriculture Forestry & Fishing, Mining & Quarrying and Construction grew by 5.4%, 6.4% and 2.1% respectively. However, overall growth was tempered by a relatively flat outturn from the Services Industry.



Local economic growth in 2014 is expected to remain weak but positive. On the brighter side, the government has shown strong commitment to fiscal discipline which has resulted in it passing the first two IMF tests. This has led to improved confidence largely from the investment and international community. Export dependent industries such as Tourism and Mining & Quarrying should benefit from stronger global growth. The US which is the island's main source market for tourism is expected to record higher growth in 2014 and improvement in employment conditions. China, which accounts for nearly half of the global market demand for aluminum, has increased demand for the product (by 13% in the last two months of 2013, up from 7% earlier in the year). However, the many rivers relate to the difficulty in balancing fiscal consolidation with growth enhancement strategies. Under the current IMF program, the government may have to further increase taxes and reduce spending throughout the year, in order to meet its targets- both of which will have adverse effects on economic activity. Further, unemployment levels are expected to rise further than the 15.4% reported in June 2013 as companies trim cost in a difficult environment. In addition, the effects of the National Debt Exchange (NDX) and structural changes are expected to affect key sectors- Finance & Insurance which will further reduce overall activity. There is also the risk of Hurricanes and adverse economic conditions which could derail the Agricultural sector. Overall our expectation is that growth will hover in the 0.5% to 1.5% range for calendar year 2014.

Fiscal –Bridge Over Troubled Waters

With renewed efforts to get its house in order, GOJ signed another agreement with the IMF which was approved in May 2013. The four-year program (Extended Fund Facility or EFF) may be viewed as a bridge to help Jamaica get over its troubled financial situation. The aim is to reduce public debt, stem balance ofpayments risks, and create the conditions for sustained economic growth through a significant improvement in fiscal management and growth-enhancing structural reforms. GOJ has been making some strides in correcting the structural impediments to growth. This has resulted in the passing of the first two quarterly tests under the program which includes meeting fiscal and monetary targets as well as implementing structural reforms. However as the targets increase significantly in 2014, the tides become more precarious further down the line, and

it will take much more effort to keep this bridge in place.

Year to December Performance

The FY2013/14 performance to December has been creditable. The primary balance outturn of $61.7Bn just about met the December target under the program. This came entirely through expenditure cuts which overall was 5.2% below budget at $294.24Bn. The biggest cost saving was seen in Capital Expenditure which was reduced by 27.4%. There were also savings in Recurrent Expenditure mainly from Interest costs following the NDX in February 2013.

FY 2013/14 (to December) Relative to Budget/IMF Targets

ITEM (In J$Bn)	FY to DECEMBER 2013	BUDGET
REVENUES & GRANTS	274.6	285.6
Tax Revenue	242.7	255.2
Income & Profit	71.3	76.5
PAYE	46.1	48.7
Production & Consumption	84.3	85.8
International Trade	85.5	91.2
Custom Duty	19.6	22.0
GCT (Imports)	38.8	40.7
SCT (Imports)	18.7	22.5
EXPENDITURE	294.2	310.3
Recurrent	270.6	277.3
Capital	24.0	33.0
FISCAL BALANCE	-19.6	-24.8
PRIMARY BALANCE	61.7	61.6

Revenues have trailed budget for much of the year and totaled $274.62Bn for the fiscal year to December 2013. This was 3.8% below budget as tax receipts fell short. Shortfalls in receipts from *Income and Profits* and *International Trade* were the primary reason for the underperformance. Given high unemployment levels, PAYE receipts have also been below expectations and was the main driver of lower receipts from *Income and Profits*. At the same time, revenues from International Trade have been affected by the decline in imports. This has resulted in marked decline in custom duty receipts and GCT and SCT collected on imports.

Expectations for FY2013/14

While the government has made good strides so far under the IMF programme, the risk of underperformance in meeting the $6.7Bn deficit target (0.5% of GDP) for the current fiscal year is still high. The current path of cutting expenditure to enhance performance is unsustainable and as such a stronger revenue performance is necessary. The challenge is that revenue growth will be hard to come by in the current state of economic weakness. The IMF has projected economic growth of 0.8% for FY2013/14, however, stronger growth is necessary in order to recoup the existing shortfall and meet its target.

IMF staff has admitted that the shortfall relative to earlier revenue projections is now expected to continue later in the fiscal year, due to a smaller tax base than foreseen in earlier projections. The trend in PAYE receipts should intensify as a number of companies have implemented staff cuts in the face of declining revenues. In addition, the introduction of the new tax incentive regime at the start of 2014 poses risks to initial tax receipts as entities may opt to delay their transactions until the incentive is in place in order to limit their tax obligations. The IMF is willing to make minor adjustments to the tax revenue floor, however they remain inflexible relating to the primary balance target. GOJ will need to grow revenues to improve its chances of meeting its target. That said, the IMF has stated that GOJ has identified recurrent and capital expenditure contingencies equivalent to 0.5% of GDP, to address these risks on the revenue side.

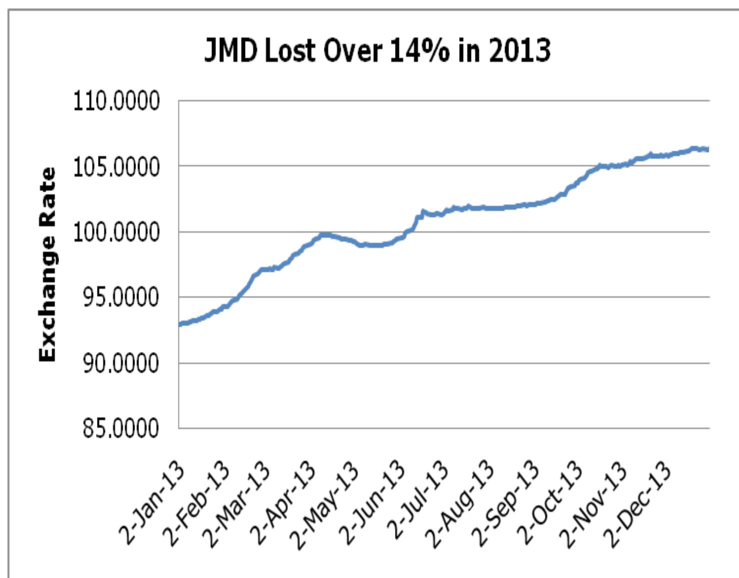
Our projection is that tax revenues will grow by 7.5% to $343.6Bn with the pace picking up in the final quarter of the year, when receipts will be strongest. The government will continue to keep a lid on expenditure. However these costs (particularly capital expenditure) usually ramp up in the final month of the year. Total expenditure is expected to be flat in nominal terms helped by savings from the NDX, and further cost savings identified. As such, the fiscal deficit for FY2013/14 is expected at roughly $12.25Bn (0.8% of GDP), which is just above the 0.5% target. We also envisage a primary balance outturn equivalent to 7.2% of GDP (just below the 7.5% IMF target). That said, unless there is steeper than expected cuts in expenditure or if non-tax receipts outperform, the government will need faster than projected growth in Q4 in order to meet its target.

The IMF program has placed a lot of emphasis on tax reform which (among other things) seeks to eliminate ministerial discretion in the granting of incentives, broaden the tax base, and reduce rates. The government

remains on track as it relates to the implementation of key elements of the overall agenda which bodes well for long term revenue collection, lower fiscal deficits and lower debt levels.

Foreign Exchange Market- Tumbling Down

The local currency tumbled to a 14.4% depreciation in 2013 marking its worst annual decline since 2003 when the currency lost 18.9% of its value relative to the USD. The movement in the currency reflected for the most part the level of uncertainty caused by the protracted delay in the signing of an IMF agreement which contributed to increased demand for hard currency. Supplies were also limited as foreign exchange flows declined in light of reduced flows from multi-laterals, weak remittances and lower foreign exchange earnings. While a signed IMF agreement in May eased some of the uncertainty, the IMF's view that the JMD was overvalued resulted in the Bank of Jamaica maintaining a neutral stance in the face of tight supply conditions. At the same time, low Net International Reserves (NIR) also limited BOJ's ability to intervene in the market to shore up hard currency supplies. After falling to critical levels during the year, the NIR stood at US$1,047.83Bn as at end of December which is equivalent of 12.6 weeks of imports.

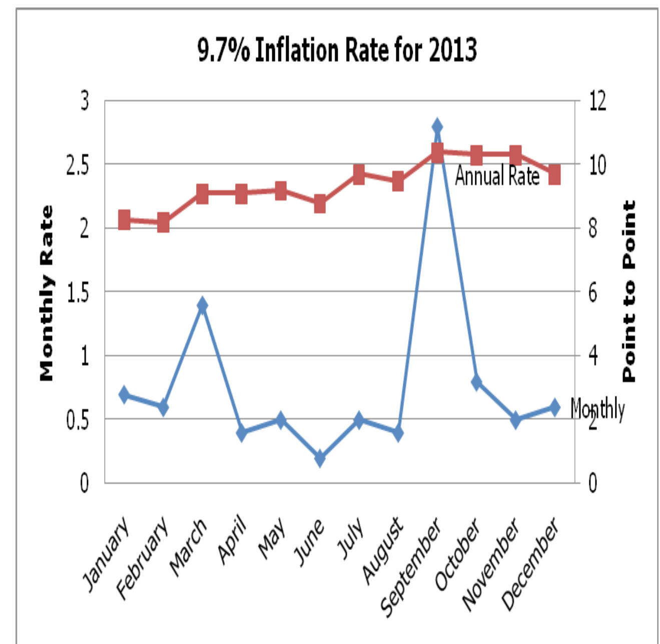


Given the significant adjustment in the local currency last year, we believe the pace of depreciation will moderate in 2014. This is premised on an expected ease in demand pressures from speculators as the economic prospect improves and the government continues to pass its quarterly tests. A narrowing of the current account deficit also bodes well for reduced pressure in the foreign exchange market. S&P estimated that the current account deficit narrowed to 10% in 2013 and will be slightly lower in 2014 which should help to ease pressures on the currency. Further, flows from the World Bank and IDB (roughly $270Mn in the first quarter which is part of the US$1Bn pledged by the multilaterals for the duration of the program) should help to lubricate the market. We expect a similarly neutral stance from the BOJ as greater emphasis will be placed on meeting the NIR target.

For the full year, we are forecasting a depreciation of 7.5% which is more in line with that of 2012. This forecast balances expectations of an ease in demand pressure, improved dynamics in the current account, but also accounts for the fact that BOJ will not be as active in the market except in the case of accelerated depreciation.

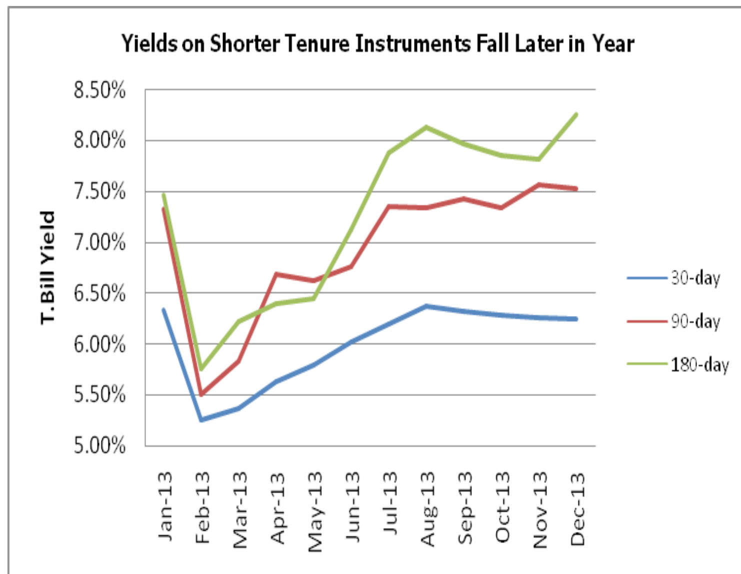
Inflation

The pass-through effects of the rapid depreciation in the local currency were evident in the inflation rate. While the weak economic environment prevented some manufacturers and retailers from fully passing on higher input cost to consumers, the pace of inflation picked up last year. Inflation was 9.7% in 2013, which was 1.7 percentage points above the 2012 outturn. The division recording the highest movement for the calendar year was 'Transport'which increased by 20.4% due to increased bus fares in September. Another heavy weight "Housing, Water, Electricity, Gas and Other Fuels" climbed 11.5% on the back of higher water rates. The division recording the lowest movement was 'Communication' which was the only division to register a decline, moving down by 4.2% as telecommunication rates fell during the year in light of intense competition in the mobile segment.



The expectation that the depreciation in the currency should cool, bodes well for a reduction in inflationary pressures in 2014. Economic growth should remain weak which will curtail the passthrough effects of higher input costs. In addition, commodity price pressures are likely to remain in check due to subdued oil prices as US production increases. That being said, local electricity provider, JPS, is currently negotiating a rate increase which is expected to materialize in the current year. As such, we expect an increase in the 'Housing, Water, Electricity, Gas & Other Fuels' Index due to higher electricity costs. There is also the ever present risk of adverse weather conditions, which could trigger an increase in prices in the most heavily weighted index 'Food and Non-Alcoholic Beverages'. There could also be some second round effects from exchange rate movements. Overall inflation is expected to be more in line with 2012 levels (8%), but stronger impulses from the aforementioned risks could push it to as high as 9.5%.

Interest Rates

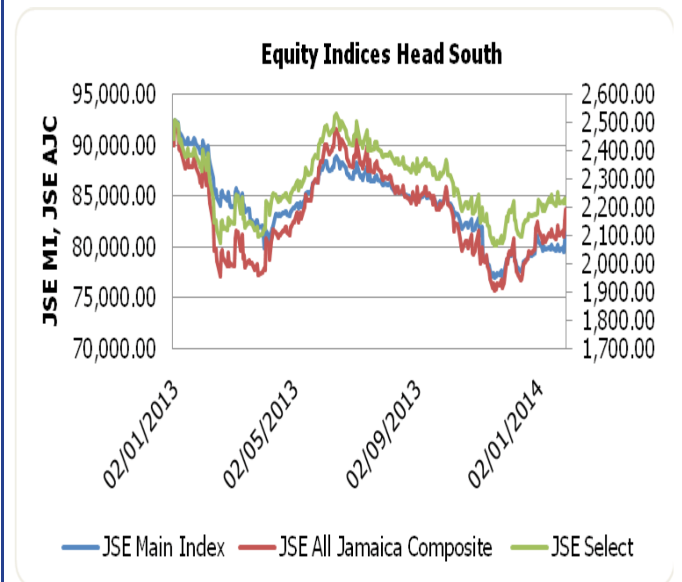


Despite tight J$ liquidity conditions as a result of BOJ's open market operations, yields on the 30-day and 90-day instrument ended 2013 close to levels seen at the beginning of the year. After a significant decline in February following the NDX, yields on shorter tenures rose steadily for much of the year and then tapered off toward yearend. As such, for the year, the average yield on the 30-day instrument declined by 6bps to 6.25%, while that on the 90-day instrument fell 14bps to 7.53%. With a limited number of short term instruments available in the market and with retail repo rates at historically low levels, many investors have opted to enter sub-market yields so as to ensure take-up during T-Bill auctions. Investors have shown a strong preference for shorter term instruments which has been reflected in the subscription amounts. 180-day T-Bill yields have however increased 107bps to 8.25%. On the other hand, broker rates reflected market conditions with 30-day rates moving from just over 6.0% to nearly 10% in light of low J$ liquidity.

We believe interest rates have bottomed and will not exhibit any significant change in the current year. If the government maintains the current fiscal discipline, upward pressure on rates will remain contained.

That said, broker rates could remain at the higher end of its current range given BOJ's continued presence in the market- reducing liquidity levels and low OMO maturities.

Stock Market-Good Opportunities Underneath it All



Last year the equities market experienced significant levels of volatility, which was partially attributable to uncertainty surrounding the strength of corporate earnings. With manufacturing and finance stocks comprising the majority of stocks listed on the equities market, negative developments in these sectors such as shrinking spreads within in the financial sector and weakened consumer demand, kept investors at bay. Carreras, which was one of the largest decliners was affected by legislations banning smoking in public places. Further, lower dividend payments reduced the attractiveness of local stocks. All main market indices declined, with the JSE Main

Index falling by 11.4%, followed by the JSE Select Index, down 9.7% and the All Jamaica Composite which lost-7.6%.

The junior market took the spotlight for another year. There were 5 new listings as companies rushed to take advantage of the 10 year tax incentive. Companies listed after January 1st 2014 will be entitled to the full relief from income for just the five years from the date of listing, but will not receive the additional 5 years of reduced corporate taxes that was in place before. Returns were also better with the index gaining 17.4%.

Despite a weak equities market in 2013, there are good market opportunities underneath it all. Valuation multiples continued on its downtrend, with average PE declining from 8.2X at the start of the year to 7.3X and while this may be indicative of a new norm, there are still some stocks that are trading below justified and relative value multiples. With Jamaica passing its second IMF test, there is an improvement in the level of market confidence and optimism regarding the growth prospects for the country and company earnings alike. We believe that these sentiments will be reflected in the demand for equities going forward, however this may not be broad based as investors remain very cautious as it relates to riskier assets.

Conclusion

In 2014, more of the same voices which were heard last year will remain audible. That said, the volume (weighting) on some, may be adjusted. Global financial markets are expected to be more in tune with what the governments are saying and doing to improve fundamentals and less inclined to ride on the waves of Central Banks' policies. In fact, as growth in advanced economies gather momentum, Central Banks are likely to unwind accommodative monetary programs, but only gradually, so as to not jeopardize the recovery. Developing economies will benefit from stronger export demand but will have to sort out fiscal issues in order to see robust growth.

In Jamaica, the IMF 'pays the piper' and will naturally call the tune. As such, meeting the fiscal and structural reform targets may be the only song we hear for another 3 years if the current strong commitment to fiscal discipline is maintained.

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