EM Watch

CONDITIONS SET FOR CORRECTION

Jon Harrison / EM Team

- **Global**: Valuation, positioning and risks ahead
- **China**: Beijing to benefit from Korea gamble
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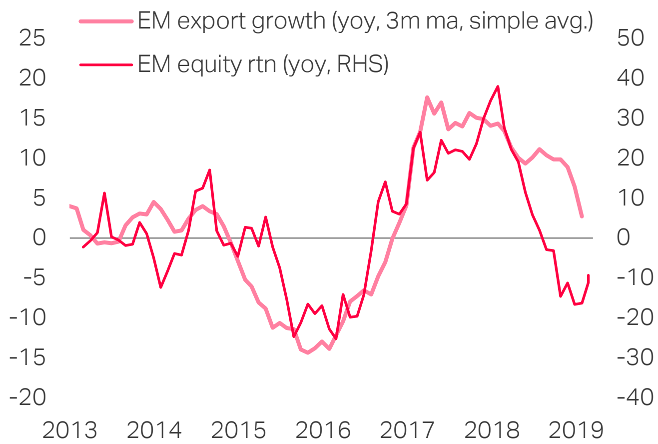
EM export growth and equity returns



Source: Bloomberg, MSCI, TS Lombard.

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Global

Valuation, positioning and risks ahead

A US-China trade deal offers little further upside for markets, while differences within the US administration raise downside risk. At the same time, valuations, positioning and fundamentals create the conditions for a correction, while relief from stimulus remains a story for H2/19.

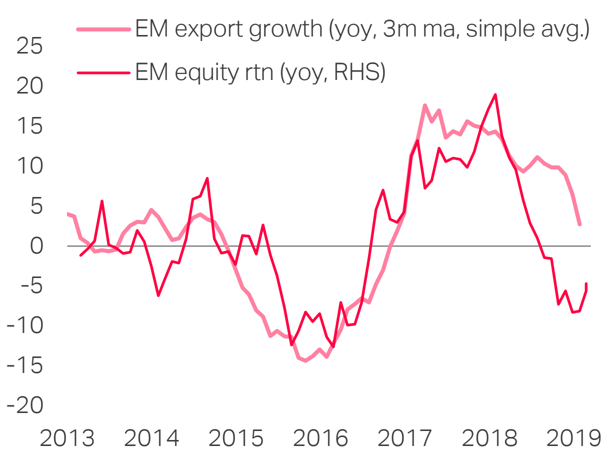
The pressure to reach a trade deal intensifies. The failure of the Trump-Kim summit had minimal impact on markets but could raise the chance of a US-China deal on trade. The pressure on President Trump to achieve a "win" on China is likely greater after the setback in Hanoi, while China's cooperation is essential to bring North Korea back to the table (see China section).

Differences of opinion are evident in the US administration. During the latest US-China trade talks it had appeared that USTR Lighthizer had the upper hand among senior members of the administration in advising the President. The positive tone projected by Trump at the end talks, however, obscured a difference of opinion. On Wednesday, Lighthizer cast doubt on the prospect of a quick deal, bringing the focus back to structural changes and enforcement, and warning that any initial deal would require extensive follow up. In a further demonstration of potential disunity, both Treasury Secretary Mnuchin and economic advisor Kudlow subsequently sought to downplay the Lighthizer scepticism.

A downside tariff surprise remains possible. The different perspectives of Trump and Lighthizer highlight the tension between the economic necessity for a deal and the complexity of reaching an agreement on both structural issues and means of monitoring compliance. A US-China deal that removes the tariff threat is probable; but a less positive outcome is still possible.

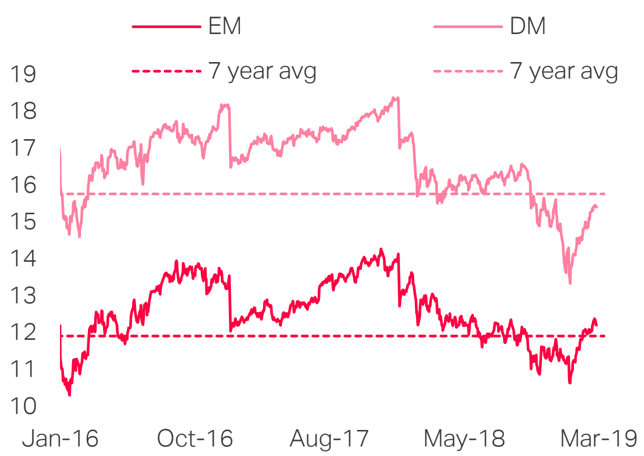
A trade deal offers little further upside for markets. The US announcement that tariff escalation will be postponed "until further notice" is ultimately positive for world trade. EM economies are likely to be among those that are most sensitive to global trading conditions. As we have frequently noted, in recent years there has been a high correlation between EM export growth and EM equity returns. Our expectation that EM exports will fall further in the coming months, even if there are no new tariffs, however, suggests that there is little remaining upside for EM equities based purely on the outlook for trade (see Chart 1).

Chart 1: EM export growth and equity returns



Source: Bloomberg, MSCI, TS Lombard.

Chart 2: EM and DM forward P/E vs average



Source: Bloomberg, MSCI, TS Lombard.

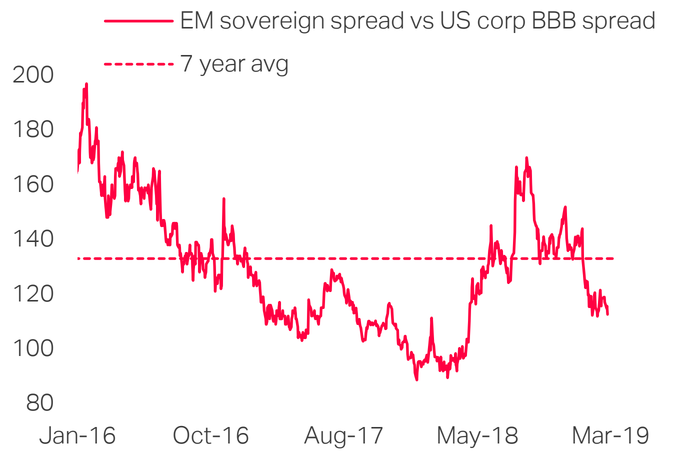
Valuations create the technical conditions for a correction. After strong gains this year, EM equities have retraced much of the loss from H2/2018 and valuations are now above longer term average levels (see Chart 3). Indeed, the best performing EM equity markets and currencies this year are those that were relatively the cheapest at the start of the year, supporting our view that valuation is a key consideration (see our 18 February EM Watch), and raising the risk of a market correction, if only for technical reasons. A similar picture exists in EM sovereign credit. Spreads are not excessively overvalued in historical terms, but have nonetheless tightened rapidly and are now slightly beyond longer term average levels (see Chart 4).

Positioning supports our correction view. Our analysis of global EM equity ETFs (based on 90 funds with $250bn in assets), suggests that investors have increased exposure over the past four months at a greater monthly rate than for much of last year (see Chart 4). Total inflows may not yet be sufficient to have fully reversed the impact of the preceding six months of EM caution, but there has nonetheless been a sustained increase in exposure that will likely be scaled back as economic fundamentals deteriorate.

Relief from stimulus remains a story for H2/19. Our analysis suggests that forward looking indicators are tentatively pointing to better economic momentum in H2/19. Those hoping for a synchronised global reflation along the lines of 2016/17, however, are likely to be disappointed. This time around both the Fed and the PBoC are playing defence, not setting up a Goldilocks scenario (see our 28 February Global Leading Indicators). In the meantime, global disinflationary pressures will drive easier monetary policy in EM economies (see our 11 February EM Watch).

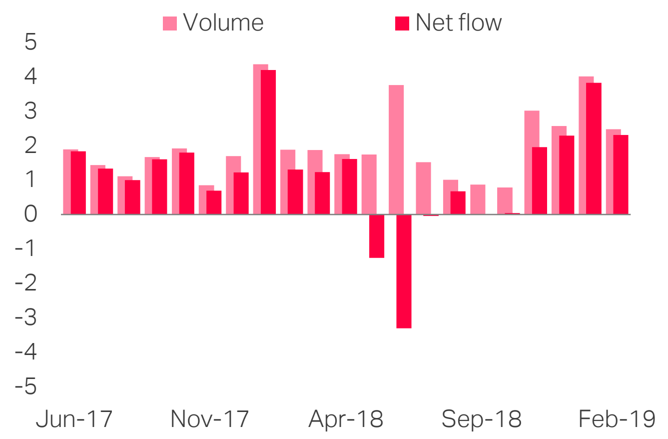
Investors will first sell those EM assets that have posted the strongest gains. The synchronised slowdown in the US and China, tech cycle downturn and lagged impact of tariffs will weigh on EM economies in the coming months, while easier US monetary policy and China stimulus will ultimately boost markets (see our 1 March EM Strategy Monthly). China has been driving aggregate EM equity returns since the start of the year. Brazil too has outperformed significantly. Consolidation lies ahead for EM equities and investors should not chase either China or Brazil. Indeed, it is probable that investors' response to deteriorating fundamental and technical conditions for EM assets will be to first sell those that have posted the strongest gains.

Chart 3: EM sovereign spread vs US corporates



Source: Bloomberg, St Louis Fed, TS Lombard.

Chart 4: Global EM equity ETF flow (%AUM)



Source: Bloomberg, TS Lombard.

Jon Harrison

China

Beijing set to benefit from Trump's North Korea gamble

Whilst the breakdown in the Trump-Kim summit means the prospects for denuclearization and the economic integration of North and South Korea have deteriorated, the market risk is limited. One trend to emerge from the breakdown is Beijing's increased leverage over Pyongyang.

Trump walked away from a deal last week. After giving away cheap concessions on US-ROK military exercises in Singapore, Trump played it safe this time to "walk away from a deal" on complete sanctions relief in exchange for the destruction of selected nuclear facilities. The status quo of the "freeze for freeze" joint moratorium on missile testing and military exercises will remain in place, serving to limit a rebound in DPRK-related market risk as measured by the CDS on Korean government bonds, which remains at historical lows (see Chart 1).

What next? The talks appeared to end amicably and we are still in a context much improved from the "fire and fury" days of the early Trump Presidency. This does not spell the death knell for the negotiating process, as Trump made clear in the press conference. The onus will now shift to South Korea's President Moon, who will need to expend a huge amount of diplomatic energy to maintain momentum and build towards a third Trump-Kim summit. We are likely to see such a summit, but it will be preceded by more intensive preliminary sessions to identify specific areas on which the two leaders can agree, however symbolic those may be.

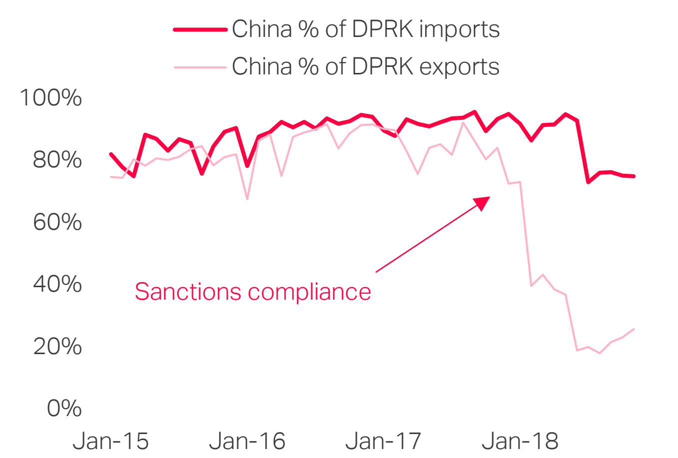
China to the fore-front. The focus will now be on sanctions-regime compliance, raising the importance of China as the North's economic lifeline. China remains the North's indispensable foreign economic partner, accounting for 75% of its imports and 25% of exports, down from 90% owing to sanctions compliance (see Chart 2). This relationship of dependency will give Xi another source of leverage for his meeting with Trump, expected later this month.

Xi for the status quo. The continuation of the "freeze for freeze" formula, a proposal long championed by China, will maintain the regional stability Beijing prizes. Moon's efforts to keep up the rapprochement dynamic fits in with Chinese policy. And the curtailment of joint US-South Korean exercises lowers the efficacy of US troops on the peninsula and so fits with the long-term Chinese aim of reducing US influence in East Asia.

Chart 1: DPRK risk is low (Korea 5Y USD CDS)

Source: Bloomberg.

Chart 2: DPRK dependent on China trade



Source: CEIC.

Xi won plaudits for applying economic pressure to get Kim to the Singapore summit and has continued to play the role of mentor to the Young Leader. Chinese companies are gearing up for economic opportunities in the North and there is recurrent speculation that Xi will visit Pyongyang this year. If Trump wishes to maintain sanctions pressure on North Korea and achieve tangible results, he will need Chinese help, which Xi can parlay into negotiating fodder in the broader China-US relationship.

Long road ahead. The path to complete verifiable irreversible denuclearization is bound to be long and difficult. In November, we expressed our doubts over the DPRK's sincerity and the US ability to foster a geopolitical environment that reduced Pyongyang's perception of external security risks. Given the asymmetric balance of forces weighing against the North, offering sufficient assurances of regime safety - or at least adequate economic carrots to induce dismantlement of Kim's nuclear insurance policy - are difficult tasks that will take years to achieve.

Rory Green

Brazil

2018 GDP confirms Brazil's weak cyclical recovery

2018 GDP rose below expectations, raising concerns regarding the recovery going into 2019. The lack of real economic improvement has started to weigh on confidence. Without economic reform, Brazil will remain stuck in a vicious, low-growth cycle.

Disappointing GDP growth in 2018, weakens 2019 momentum. Brazilian GDP rose by just 1.1% in 2018, on par with 2017 growth. It was just below the 1.2% expected by the market and significantly below the optimistic projections in early 2018 of 2.9%. Growth in Q4/18 was disappointing, too: the economy expanded by just 0.1% qoq/sa terms, vs 0.5% in Q3/18. Growth drivers remain limited on both the demand and supply sides, raising concerns on activity going into this year. On the demand side, household consumption – which remains the main growth driver in the Brazilian economy, comprising 64% of the country's GDP – was up by just 1.9% in 2018, compared to 1.4% in 2017, highlighting the still weak momentum. Investment growth was 4.1%, vs -2.5% in 2017. This increase, however, must be taken with a grain of salt as changes to the Repetro programme – which provides a special tax regime for oil & gas capital goods – allowed 82 oil platforms to be registered as capital goods imports in Q3/18, inflating the investment component within GDP in 2018. As a result, the actual improvement in investment was probably lower. In fact, had the Repetro rules remained unchanged, investment growth in 2018 would have ranged between 2-2.5%. Government consumption remained flat, in spite of the restrictive austerity measures currently in place.

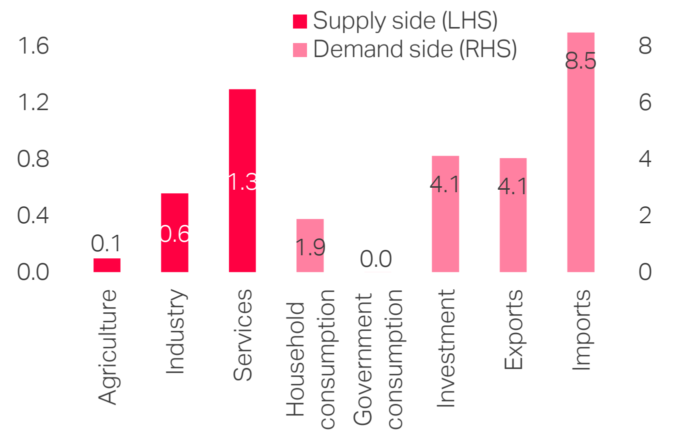
On the supply side, all sectors showed still weak growth last year. Growth in industrial output, which was affected by the 11-day truckers' strike in May and weaker external demand, expanded by just 0.6% last year from -0.5% in 2017, while services rose only 1.3%, from 0.5% in 2017, and agriculture weakened to 0.1% from 12.5% in 2017. The weak GDP figures from last year will weigh on this year's economic activity, as the statistical carryover for this year is just 0.4%, underscoring the weaker growth momentum this year.

Market sentiment is beginning to show signs of weakening. Although economic confidence improved steadily since last October reaching five-year highs in January, these indices are starting to weaken. Brazil's weak recovery has started to impact sentiment. Data for February show some flattening and even a reversal in the upward trend for some sectors and business confidence as well. Signs of a real economic recovery have yet to materialize, as there were no concrete improvements in economic activity in the wake of the upsurge in confidence, raising concerns about the strength of the cyclical recovery in 2019 as a whole.

The odds of the pension reform passing remain good, but the proposal will be watered down. While we expect the pension reform to be approved by the Congress, the fiscal savings will likely be watered down, and the extent of this dilution will depend on the administration's political skills. While Bolsonaro himself has admitted some possible changes to the legislation, the administration has promised a reform that will generate BRL1 trillion in savings over the next decade. While the market already expects changes to the proposal at some point, investor sentiment will likely turn more negative if expected fiscal savings over the next 10 years were to fall substantially below BRL700bn (vs BRL800bn in Temer's original reform proposal and BRL480bn in the final proposal).

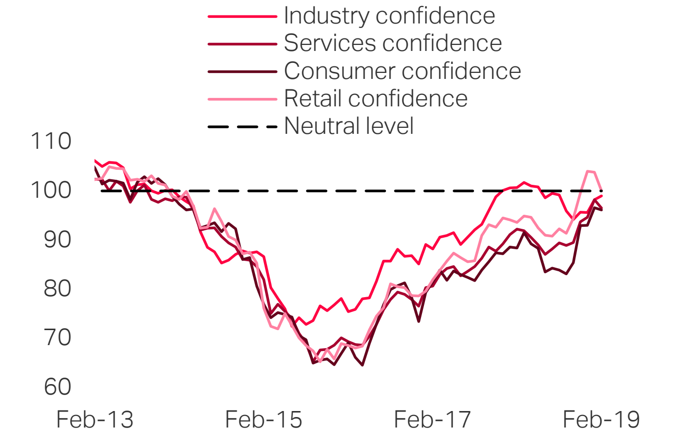
The pension reform has the potential to make or break the Brazilian economic recovery. Should the government fail to pass pension reform, Brazil is guaranteed to slide back into recession next year, according to estimates by the government. The Economic Policy Secretary estimates that without the reform, Brazilian GDP would grow just 0.8% this year. The outlook is even more negative from 2020 onwards, when the country could enter a recession potentially deeper than that of the 2014-16 period. The approval of the reform, on the other hand, would lead to GDP growth of 2.9% this year, to increase gradually to 3.3% by 2023. The key point to monitor going forward will be if the administration can convince Congress that the political cost of not approving the reform will be higher than the cost of passing it.

Chart 1: 2018 GDP growth breakdown
% change, 4Q rolling



Source: IBGE.

Chart 2: Economic activity indices trend growth
% change, yoy 3mma



Source: IBGE, Banco Central.

Wilson Ferrarezi

India

An election between economic performance and nationalist pride

As economic numbers continue to disappoint, the big question is whether voters will cast their ballot in favour of nationalistic pride amid the bubbling tensions between India and Pakistan, or whether the government's disappointing economic performance will dominate the upcoming April-May general elections. Even as political uncertainty has risen ahead of the polls, one issue is clear: it is in Prime Minister Narendra Modi's interest to keep the pressure on Pakistan high in order to reap electoral benefits.

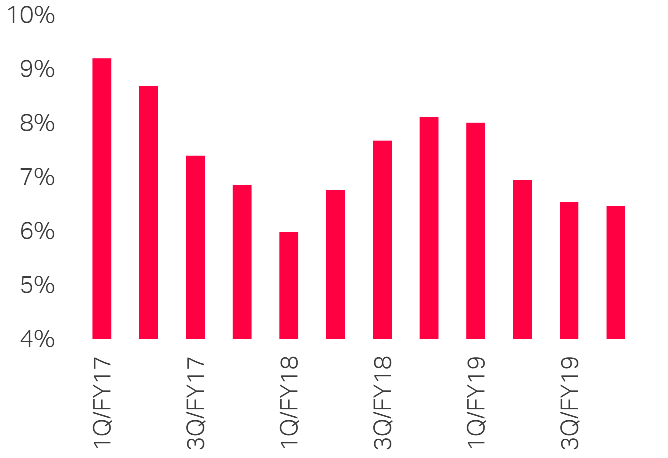
The conflict between India and Pakistan has the potential to overturn current thinking on India's upcoming election, a point that my colleague Amitabh Dubey will highlight in his forthcoming report this week. As we had noted in our previous research, Prime Minister Modi's re-election bid promised to be a tough fight due to sluggish economic growth and with opposition parties allying together. However, the February terrorist attack in Kashmir has raised political uncertainty – as we anticipated in our 18 February EM Watch – and Modi will want to be seen to dominate Pakistan in an election year.

The India-Pakistan situation is a fast-changing one. India responded to the killing of its 40 soldiers in a suicide terrorist attack by air bombing alleged terror camps situated in Pakistan last Tuesday. A subsequent dogfight between Indian and Pakistani fighter jets resulted in the capture of an Indian Air Force pilot by Pakistani forces. Pakistan's decision to hand over the pilot back to India two days later on late Friday night helped ratchet down the tensions although nationalist sentiment at home is still running high.

Modi is bound to campaign on nationalism in the April-May polls, and in a public speech on Sunday, the prime minister spoke of a "new India" that settles all scores. He exhorted the crowd to shout patriotic slogans and accused the opposition of demoralising the armed forces by asking for proof of the bombing of the terror camps in Pakistan. Modi criticised the opposition for causing a delay in the acquisition of the French Rafale jets. The main opposition Congress party has targeted the Modi government for alleged corruption in the purchase of the jets. Congress President Rahul Gandhi retorted to Modi's Sunday speech by saying that the corruption by Modi as led to the delay, and the air force is compelled to use old aircraft as a result.

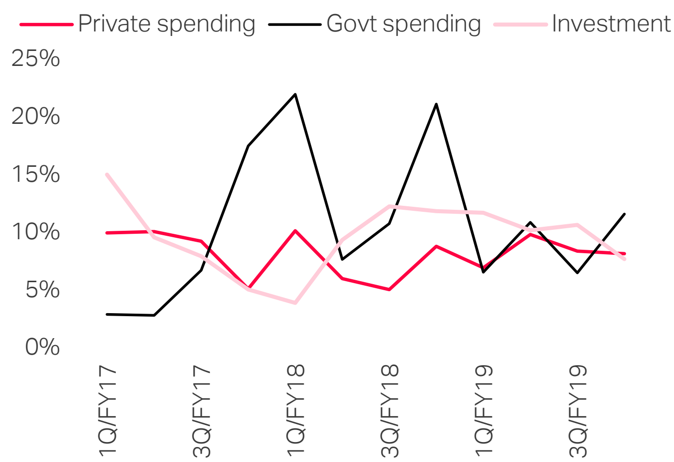
Meanwhile on the economic front, the government last week revised down its GDP growth forecast for FY19 to 7% from 7.2% projected earlier following a 6.6% yoy growth in 3Q/FY18, the slowest pace of expansion in five quarters. A breakdown of the growth data shows that while private consumption growth is relatively stable, investment growth is slowing down and government spending is picking up the slack (see charts on the following page). The Reserve Bank of India's monetary policy review in early February stated that investment activity was recovering but was "supported mainly by public spending on infrastructure". New central bank governor, Shaktikanta Das, signalled that his primary aim is to support economic growth, with a "need to spur private investment and strengthen private consumption". The RBI cut the policy repo rate by 25 bps and we expect further easing at the next monetary policy meeting in early April.

Quarterly GDP growth (% yoy)



Sources: Central Statistics Office (CSO), TS Lombard.

Breakdown of quarterly GDP growth (% yoy)



Sources: CSO, TS Lombard.

The government's big worry is the distress in the rural economy, with the farm sector growing at just 2.7% yoy in 3Q/FY18 – the slowest in 11 quarters. Modi's government has been trying to stimulate the economy through its fiscal policies, as we highlighted in our 4 February 2019 report Budget in Charts: Populism wins over fiscal discipline.

Shumita Deveshwar

Russia

Positive outlook for local currency debt – despite sanctions

The CBR is now signaling rate cuts this year given milder inflationary pressures. This positive outlook is not dimmed by the prospect of new US sanctions and increased government borrowing – posing a specific threat to (OFZ) market rates. This threat will be well contained in our view while prompting habitual CBR caution that could cause below target inflation in 2020.

The CBR put out a notable monetary easing signal last week. This came in the form of comments from Andrey Lipin (Deputy Head of the Monetary Policy Department) to the effect that lower than expected inflation pressure should allow rate cuts to begin this year. He added that by next year, the policy rate should reach the "neutral range" of 6-7%. In other words, with the CPI returning to the 4% target, the real interest rate should settle in what the CBR guides as being its estimated neutral range of around 2.5% (though CBR Governor Elvira Nabiullina also mentioned on one occasion last year that the neutral rate might be as low as 2%).

This prospect of, give or take, 100bps of rate cuts during the next 12 months is particularly noteworthy given the variety of present challenges. Three threats stand out.

- **Complacency over the eventual effect of home-grown inflation drivers**, especially last January's VAT increase. While the effect of higher VAT on the CPI has so far been mild, more time will be needed to be fully confident about there being no nasty feedback loops pushing up prices. Lipin cautioned that April was the earliest time that the CBR might revise down its inflation forecast. This implies that the consensus 'on hold' expectation for the CBR's next interest rate decision on 22 March is sound.
- **New US sanctions.** Last Wednesday saw the publication of the text of the latest sanctions bill in the Senate (a variant of the draft legislation originally proposed last August that, back then, had a material negative impact on Russian markets). The details broadly confirm the conclusion of our snap analysis after the bill's revival was announced on 13 February that this is a case of the "bark being worse than the bite". Compared to last year's version, the threat to state banks seems lower, while Russia's oil and LNG industry is more aggressively targeted. We would view this as a net easing, since the global reach of US sanctions is more powerful in the financial sphere than the real sector. That said, the bill retains the core provision of sanctioning newly issued Russian government bonds. The progress of this bill through Congress could trigger another bout of inflationary ruble depreciation as seen last year. In addition, the targeting of sovereign debt is obviously relevant to the outlook for market rates – a question that needs to be viewed separately from the CBR's monetary policy (more on this below).
- **Fiscal policy.** Fiscal policy will be disinflationary in H1/19 – mainly, once again, thanks to the VAT increase. This picture will not be changed by the extra social spending measures announced by Putin last month (fully reviewed in our new Austerity cushions note). Although the official estimate of the annual 'price tag' was increased last week from an extra Rb155bn to Rb180bn, this remains a very manageable 0.17% of GDP. By H2, however, fiscal policy is programmed to boost demand through investment in new infrastructure builds to the tune of 0.5% of GDP.

This infrastructure spending point is particularly relevant for market rates regardless of CBR policy. In contrast to previous years, this government investment will not be funded by drawing down free resources of the National Welfare Fund. The financing source instead is to be

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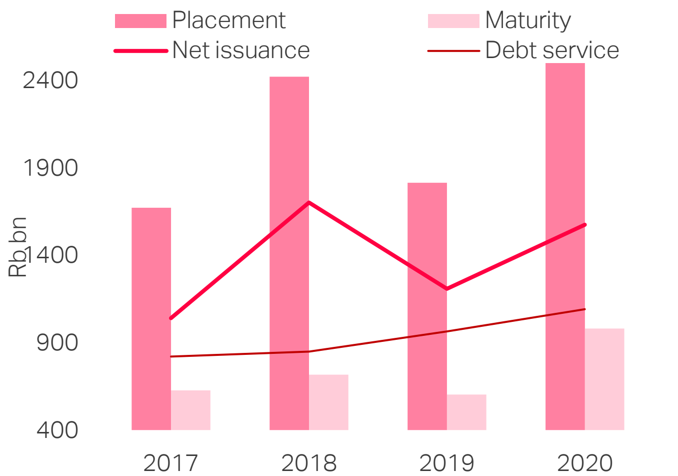
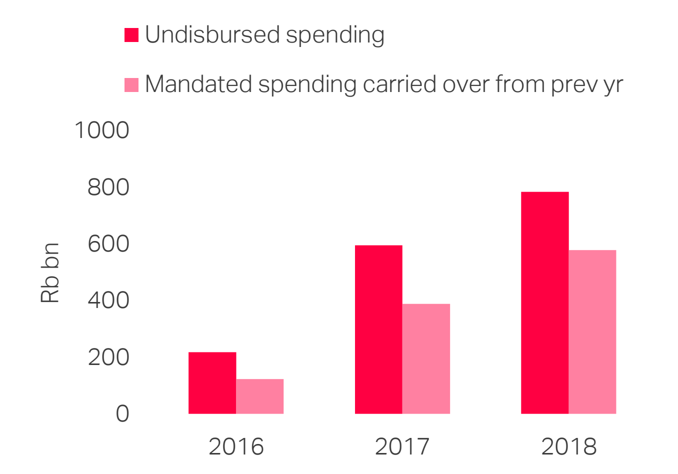
domestic borrowing. The left-hand chart below shows the steep net issuance programme, which seems all the more challenging given the prospect of government bonds being sanctioned. Three factors, however, suggest that upward pressure on market rates from fiscal policy will be mild.

OFZ net issuance: ambitious plans



Source: MinFin

Federal budget "moving residuals"



Source: Audit Chamber

Sticky implementation of the infrastructure drive. Besides the track record of administrative delays in approving and executing new projects, a specific cause of delay is now apparent in the form of internal government arguments about the method for appraising project proposals.

- **The Federal Treasury is awash with cash.** The Audit Chamber reported last week that the government started this year with a huge cash pile of Rb10.2tn of funds. Some of these funds are available to plug gaps between borrowing and spending since they relate to undisbursed expenditure from 2018 that has been carried over from last year (an established – but also intensifying – pattern, as shown in the right-hand chart above).
- **Ruble weakness** is the final reason why the Finance Ministry will not be forced to tap the market too aggressively for funds. This year's budget assumes an average exchange rate of Rb63.9/$. The ruble has been weaker than that level so far this year, and this trend should continue given the sanctions threat and last month's re-start of the Rb2tn-worth of FX market interventions that should have been made according to the fiscal rule in August-December 2018 but were postponed to calm sanctions-driven market nervousness. Last year we estimated that each one ruble depreciation against the dollar reduced the net borrowing requirement by Rb77bn owing to the boost to tax proceeds from the higher ruble oil price. On this basis, the YTD average nominal exchange rate of Rb66.5/$ would, over the year as a whole, reduce net borrowing needs by around Rb200bn.

The outlook for local currency debt is positive. Inflationary pressure will remain contained, and the same goes for the pressure on market rates from government borrowing needs and sanctions. With the proposed sanctions limited to newly issued debt as expected (i.e. no threat to the secondary market), the OFZ has arguably already priced in the non-resident outflows while standing to gain from the above-mentioned supply restraint stemming from any sanctions-related ruble weakness. Until any new sanctions are finally clear and absorbed, however, the CBR will remain cautious on the pace of rate cuts. That, in turn, could cause another positive surprise in the form of below-target inflation next year.

Christopher Granville / Madina Khrustaleva

Mexico

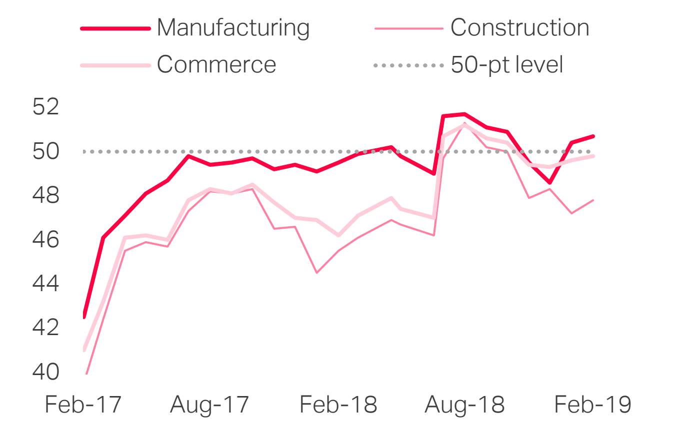
Business confidence rises despite clouds

In spite of recent disruptions to the Mexican economy, business confidence edged up in February, led by the industrial sector; still, mixed results for two PMI surveys underscore that the government must provide more investor certainty or face headwinds.

Notwithstanding a rocky start to 2019 for the Mexican economy, business confidence rose in February, according to a survey released on Friday by statistics bureau INEGI. The manufacturing sector was the most positive of the three sectors surveyed, with the index rising for the second consecutive month by 0.2pp mom/sa and 1.2pp yoy/sa to 51.3 pts – above the 50 pt level that indicates optimism (see Chart 1 below). The results were likely bolstered by the industrial sector's strong export performance in January, with manufacturing exports growing 8.5% yoy to USD28.5 bn (up from the 6.5% yoy growth seen in December, as Chart 2 below illustrates, although lower than the overall 9.1% growth registered in 2018). It was also an encouraging sign that the recent economic disruptions (regional fuel shortages, maquiladora strikes, rail blockades) did not unduly affect the sector's performance. Yet, in a sign that ongoing policy uncertainty continues to weigh on sentiment, the index component that measures whether it is the right time to invest still fell 0.2pp mom/sa and 1.5pp yoy/sa to 40 pts.

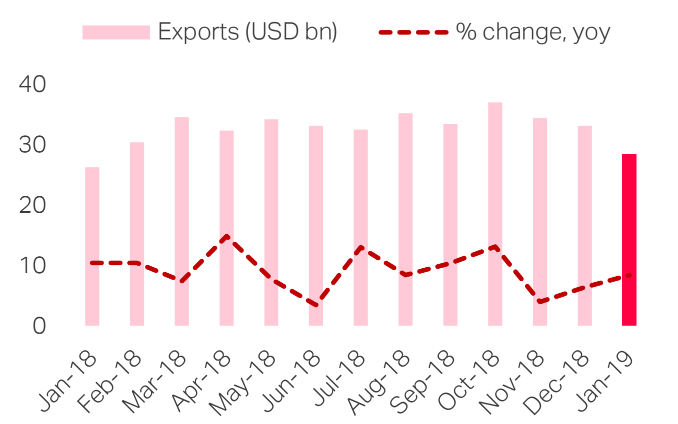
Chart 1: Business confidence levels

Index: Above 50 pts = optimism



Source: INEGI.

Chart 2: Manufacturing exports



Source: Banxico.

Mixed results from two recent PMI surveys also point to a partially cloudy outlook. In a positive surprise, the IHS Markit Mexico Manufacturing PMI surged to a 13-month high in February to 52.6, up 1.7pp mom/sa on stronger-than-average export demand, which helped to drive the biggest expansion in new orders seen in the index in 15 months. However, data from INEGI showed that its PMI fell by 0.14pp mom/sa in February to 52.4 pts, as expected orders and expected output fell by 0.32pp and 0.59pp respectively. While future surveys will clarify which trend prevails, average 2019 growth forecasts have continued to slip in the meantime. Last week, the Mexican central bank (Banxico) revised down its 2019 GDP forecast to a range of 1.1-2.1% (down from 1.7-2.7%), and its 2020 estimate to 1.7-2.7% (down from 2-3%). Similarly, in the latest Banxico investor poll, taken on 20-27 February, both average and median GDP forecasts for 2019 fell to 1.6%, down 0.2pp from the month before.

Although confidence levels in construction and commerce also increased in February, they remained below the 50-pt level. The construction index rose to 47.8 pts, up 0.6pp mom and 2.3pp yoy, in the fifth consecutive month for the sector below the 50-pt level. The commerce index edged up by 0.2pp mom and 3.6pp yoy to 49.8 pts, in its fourth consecutive month below the level that signals confidence. Taken all together, the results indicate that while the recent economic disruptions have not contaminated business sentiment as much as the market has feared, the government has nonetheless failed to inspire confidence among local businesses that would allow for a big jump in investments. Furthermore, labour unrest continues to grow, as we have previously highlighted, with an increasing number of unions clamouring for higher wages.

In a sign that President Andrés Manuel López Obrador (AMLO) belatedly understands that he needs to lift investments to jumpstart growth, the administration recently launched a new investment, jobs and economic growth council that will be headed by Chief-of-Staff Alfonso Romo. Moreover, the President himself has personally attended meetings in recent days with key business groups, hoping to emphasize this message. Yet whether AMLO can learn from his early mistakes and reduce uncertainty for private sector investors is another matter altogether. If he succeeds, it would be a welcome sign for the economy. If he fails, though, it will worsen the ongoing slowdown and add to the risks of medium-term fiscal erosion, not least because AMLO is already looking ahead to the 2021 mid-term elections to extend his political power (for more details, see our 27 February 2019 note Mapping the AMLO revolution).

Grace Fan

Indonesia

Jokowi's more realistic populism

The economy is the key focus of the presidential campaign in Indonesia. Subianto, the opposition candidate, is pushing for self-sufficiency in the production of food and energy as well as lower taxes that he believes will lead to improved compliance and hence increased tax collection. President Jokowi's pledges offer more realistic populism and more details. He remains the likely winner of April elections, according to a recent poll.

The economy is the central topic of the presidential debates. Inflation is benign, having come in at 2.6% yoy in February, and economic growth is stable, at around 5%. Nevertheless, it is the economy that is dominating the political discourse ahead of the presidential elections next month. Since 2014 economic growth has fallen short of the 7% promised by President Jokowi, public debt has been rising, and the country's twin deficits make it vulnerable to external shocks. These are just some of the indicators that are being highlighted by the opposition contender, Prabowo Subianto. Other key areas of focus in the presidential campaign are natural resources, taxation and infrastructure. Table 1 (on the next page) compares the achievements, pledges, plans and beliefs of the candidates in relation to five areas of economic policy.

Subianto has proposed populistic energy and food policies, promising to cut electricity and fuel prices by reversing Jokowi's reform of doing away with the RON88 gasoline subsidies, among other things. To support local farmers, he plans to halt imports of agricultural products, including rice and sugar. The opposition candidate believes food imports are too high, leading large trade deficits. Moreover, his aim is self-sufficiency not only in food but also in energy. With regard to the latter, he wants Indonesia to become self-sufficient through biofuels and renewable sources of energy.

Tax collection in Indonesia remains low and volatile. Subianto has pledged to cut personal and corporate taxes in order to compete for FDI with other countries in the region, including Singapore. Moreover, he believes that the tax reduction would boost compliance and hence tax collection. The opposition candidate has also pledged to increase the wages of civil servants, which he sees as the root cause of corruption, but he provides no details on how the wage hikes would be financed. Jokowi, for his part, has said that public servants are earning enough when performance awards are taken into account and that he favours merit-based political appointments to fight corruption.

Jokowi focuses on more realistic policies while offering some populist measures. He rightly believes that imports of foods serve as a stabilizer and will help keep inflation low. To support farmers, he wants to improve their access to the market and lending. With regard to energy, he plans more investment in oil exploration but over the longer term intends to reduce dependency on fossil fuels by expanding biodiesel programmes and introducing more renewable energy sources.

Infrastructure remains a priority for President Jokowi as a means of lowering logistics costs and increasing inter-island connectivity. He has already scored successes in this area but notes that infrastructure build-up takes time. Subianto, meanwhile, has accused Jokowi of rushing into infrastructure construction projects without proper feasibility studies having been conducted, which, he argues, is the reason why some projects are inefficient and loss-making. Nonetheless, many Indonesians consider improvements in infrastructure to be the current government's most significant achievement.

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Targeting the large number of Indonesians with modest means, President Jokowi has said he will increase outlays under the "Family Hope" programme – a government initiative that offers a basic payment for nearly 10 million families – to US$2.4bn from US$1.3bn in 2018. He also plans to increase the number of households benefiting from the scheme. Moreover, he has pledged to expand the scheme of free staple food cards and increase the amount of money allocated to the "Village Fund" programme, which co-finances local development projects. These populistic measures and his more realistic and detailed policies further increase the chances of Jokowi being re-elected. A recent poll by Roy Morgan suggests Jokowi will win with 58% of the vote (see here for more details).

Table 1: Policies of Indonesia's presidential candidates in five key areas

Jokowi	Subianto
Fiscal	
• Plans to reduce taxes but has not provided details. His administration is discussing with the parliament cuts in income tax and value added tax • Has hiked import taxes on some consumer goods, to lower the current account deficit. • Introduced a tax amnesty in 2016 that helped boost tax collection.	• Has pledged to reduce the corporate and personal income tax rates by 5-8pp. • Believes that cutting taxes will boost compliance and make Indonesia more tax-competitive. • Plans to increase the tax to GDP ratio from 11% to 16% and abolish tax on first home/property purchases.
Agriculture	
• Has focused on improving access to the market for farmers in a bid to cut out the role of the middle-man in the distribution process. • Plans to provide better access to lending for farmers. • Underscores the importance of imports to control inflation and avoid shortages.	• Aims at Indonesia being self-sufficient in agriculture. • Has pledged to halt the import of agricultural products and to continue subsidizing fertilizers. • Plans to increase the land holdings of small farmers and enable degraded forest land to be cultivated
Energy	
• Plans to reduce dependency on fossil fuels by gradually increasing the use of palm oil-based biodiesel and renewable energy sources. • Intends to increase investment in exploration to reduce imports of fuels and to take control of major mineral resources. • Has already assumed control of several natural resources sites previously owned by foreign firms.	• Has pledged to lower fuel and energy prices, reversing Jokowi reform of withdrawing RON88 fuel subsidies. • Wants Indonesia to be self-sufficient in energy resources through the increased use of biodiesel, ethanol and renewable sources. • Believes that the state must control all natural resources.
Infrastructure	
• Reduced fuel subsidies and reallocated funds into infrastructure soon after taking office. • Believes that investing in infrastructure is key to competitiveness and national unity.	• Has accused Jokowi of rushing into infrastructure construction without proper feasibility studies, which has led to some projects being inefficient and loss-making. But has not presented any detailed plan for infrastructure development.
Public debt	
• Plans to continue to rely on public debt as long it is used for productive purposes. • Intends to decrease foreign holdings of rupiah denominated bonds to 20% from c. 38% currently by increasing sales to retail investors.	• Plans to decrease borrowing by increasing state revenues through tax cuts and better compliance. • Pledges to use debt to finance only infrastructure projects, not to pay interest and other regular costs.

Krzysztof Halladin

Strategy

Asset Allocation summary

We maintain our neutral view of overall EM risk. EM assets are no longer at discounted valuations, raising the risk of a market correction, while economic data will bring downside surprises in the coming months. Positive news on tariffs is likely priced in. The prospect of a stable renminbi will remove one risk to EM currencies. We remain negative on China and India, positive on Russia and turn cautious on Brazil as Bolsonaro's honeymoon sours.

We maintain our neutral view of overall EM risk (see our 1 March EM Strategy Monthly). The synchronised slowdown in the US and China, tech cycle downturn and lagged impact of tariffs will weigh on EM economies. Following a strong recovery over the past few months, EM equities and currencies are no longer at discounted valuations, raising the risk of a market correction, while economic data will bring downside surprises in the coming months. Positive news on tariffs is likely priced in. At the same time, stimulus measures in China and the growing prospect of easier US monetary policy will ultimately boost markets in the second half of the year. Dollar weakness may moderate for the moment now that markets have recalibrated the Fed view, but prospect of a stable renminbi will remove one risk to EM currencies.

In the paragraphs below we explain the reasons for the country selection and asset class calls presented in our asset allocation heatmap.

China

We believe that the Chinese authorities will be willing and able to deliver a stable renminbi as part of a trade agreement with the US (see last week's EM Watch). Capital outflows have declined to manageable levels, while market reforms, along with the addition of China's bonds and equities to international benchmark indices, have enhanced the sources of inflows (see our 21 February China Watch). We expect the dollar to remain soft, which will likely mean that the RMB is relatively well supported, although the currency will remain a lower beta than other EM FX. As a caveat, however, if China's economic slowdown is deeper than we expect, and stimulus measures do not begin to have the anticipated positive impact on economic data, then the authorities will use depreciation to strengthen the impact of stimulus. PPI likely has further to fall, which will hit industrial profits and export disinflation to wider EM.

Brazil

Disappointing activity data and flat consumer and business confidence underline the slow pace of the economic recovery (see our 18 February EM Watch). Brazilian equities have underperformed over the past month as optimism surrounding the Bolsonaro administration has started to wear off. There is a growing realisation among investors that essential pension reform will be a long and difficult political process, which has contributed to profit taking (see last week's EM Watch). We nonetheless maintain our favourable view of local debt. Inflation expectations continue to decline, while weak economic activity and global disinflation are likely to maintain downward pressure on prices. We expect Banco Central to maintain its cautious monetary policy stance which, while not favourable for equities, should be supportive for local debt markets.

India

Lower interest rates and political uncertainty will weigh on the rupee. The RBI cut policy rates last month in response to falling headline inflation, despite the fact that core inflation remains relatively high. The change in central bank outlook under new governor Shaktikanta Das is likely to lead to easier monetary and regulatory policy. We see a growing probability of another cut as soon as April (see our 21 February report India: RBI credibility at stake). Global disinflationary pressures should nonetheless ensure that inflation in India remains subdued, but the loss of central bank credibility could mean that the RBI will be unable to manage any unexpected market volatility, for example, that stemming from rising political uncertainty ahead of the April/May general election. The declining support for the ruling BJP has led to an increasing in populist policies and a race to the bottom by both main parties. The fiscal position is likely to deteriorate, weighing on the rupee (see our 4 February India: Budget in Charts), while the uncertain election outcome raises the risk of a short term negative market impact (see our 18 February report India: The return of coalition politics). The rising tension between India and Pakistan threatens to overturn our assumptions about the upcoming election.

Russia

Lower inflation is likely to open the way for rate cuts, while the sound economic backdrop will support markets, despite ongoing sanctions risk. The CBR remains vigilant, while breakeven inflation is steadily declining and the core inflation trend points to the possibility of a rate cut by mid-year (see our 11 February EM Watch). The failure of Russia hawks in the US to overcome the easing of measures against Rusal in January suggests that threat of new US sanctions has declined (see our 14 February report Russia: Sanctions update - Cool hell). While new US measures cannot be ruled out, the economy is in good shape to withstand the impact of sanctions, as was noted by Moody's when it upgraded the sovereign credit last month. On a note of caution, however, events such as the recent arrest of a leading private equity investor underline the uncertainty that can hit investor sentiment (see our 18 February EM Watch).

Mexico

AMLO is starting to rebuild credibility after early missteps. The ongoing fuel crisis and strikes in the north of the country are likely to weigh on growth for the remainder of the year. The Pemex rescue package announced by AMLO last month has helped stabilise the company's corporate debt but is unlikely to be sufficient. There remains a risk that the Pemex bail out will undermine fiscal credibility (see our 18 February report EM Watch). The growing prospect of lower interest rates amid falling inflation, external disinflationary pressures and a softer dollar should benefit equities, sovereign credit and local debt markets (see last week's EM Watch).

Indonesia

Weak trade data is likely to weigh on markets in the coming months. Exports contracted year on year in January for the third month in succession. The synchronised economic slowdown in the US and China will hit exports in the coming month, while government measures and weaker growth have helped to slow imports, reducing pressure on the current account. Inflation dipped lower for the second month in a row. A softer dollar and easier trajectory for US monetary policy should allow Bank Indonesia to pause its tightening cycle and increase the prospect of lower interest rates later in the year. President Jokowi remains well placed to win the April presidential election after two live television debates between the main candidates. We expect the election to be positive markets, but any missteps by the incumbent could dent investor sentiment and increase uncertainty in the final stages of the race.

Philippines

The deteriorating current account balance will undermine the peso. The decline in headline inflation accelerated last month, while President Duterte approved measures to remove limits on imports of rice which should further reduce prices. Bangko Sentral has expressed caution about the risk of easing monetary policy too quickly and will likely wait until inflation has fallen sustainably to the 2-4% target range. The collapse of exports in December (released last month), hit the peso, raising the prospect of further deterioration in the current account. At the same time, however, the growth outlook remains favourable owing to the government's focus on infrastructure, while consumption will be boosted by strong remittance growth.

Thailand

Deteriorating world trade conditions are likely to weigh on markets. Exports to China that are inputs to supply chains contracted further in January. Trade data for China and its regional trading partners including Thailand will likely remain weak in February (see our 18 February report EM Watch). The change to the proposed date and the brief candidacy of Princess Ubolratana, suggest that despite the constraints of the new constitutional arrangement, there is a risk of political uncertainty during the democratic transition. Positive sentiment in the run up to the election should support domestic demand, which has been an important driver of growth (see our 26 February report Thailand: Election risk to sentiment).

South Africa

We maintain our negative view of local debt and of the rand. Inflation fell faster than consensus forecasts in January. We expect the SARB to maintain policy rates on hold given rising domestic and external risks. The difficulties of state-owned power utility Eskom are likely to remain a drag on the economy and markets. The impact of power blackouts that escalated last year will continue to weigh on growth, while the prospect of a bailout by the government could have negative consequences for the sovereign credit rating at a time when the budget deficit is already running at around 4% of GDP (see last week's EM Watch).

Turkey

The economic hard landing is starting to take shape. The collapse of industrial production in Q4/18 points to the onset of recession, with little sign yet of bottoming out (see our 18 February EM Watch). The disinflationary trend that is sweeping EM economies is facing headwinds in Turkey from rising food prices, although government subsidies will moderate the impact on consumers (see our 11 February EM Watch). The lira may still benefit from exceptionally high carry compared with other EM FX, but breakeven inflation expectations have ticked higher, while fiscal policy continues to deteriorate as the government ramps up populist measures ahead of the end-March local elections.

Jon Harrison

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EM Strategy Monthly: China has been driving EM returns

In our latest EM Strategy Monthly, we present our asset allocation views (see heatmap and Strategy section), and country pages for the 10 EM economies we cover regularly. In his notes on portfolio strategy, Larry Brainard highlights the extent to which China has been driving aggregate EM equity returns since the start of the year. Brazil too has outperformed significantly. Consolidation lies ahead for EM equities and investors should not chase either China or Brazil.

Brazil: Positive sentiment has not translated into growth

Economic activity data disappointed in Q4/18, weakening growth momentum for 2019. Wilson Ferrarezi explains that depressed investment levels during the recent recession have reduced the potential for economic recovery, while the slow improvement in the job market has prevented a rebound in household spending. GDP will grow 2.5–3% if the pension reform is approved; without that, a recession is likely in 2020. See our 1 March report Brazil: The underwhelming cyclical recovery.

Russia: Rising public disenchantment with austerity

An important element of Putin's state of the nation address last month was the announcement of new handouts to pensioners and poor families. Christopher Granville and Madina Khrustaleva explain that this reflects a major new risk theme: the government's economic growth strategy is friendlier to markets than it is to the Russian public. The fiscal price of latest measures is a manageable 0.17% of GDP, but the groundwork is already being laid for a more material fiscal loosening ahead of the important political test of the Duma election in 2021. We conclude that the strategy will work, but at a cost to the economy. See our 27 February report Russia: Austerity cushions.

Mexico: Making sense of the blizzard of policy announcements

AMLO's program of reshaping the country's priorities and policies is visibly advancing amid sky high popular approval ratings. Grace Fan examines the broad goals of the new administration and benchmarks progress towards meeting them. A divided opposition is playing into the President's hands, but there is a risk of market volatility as he further undermines the already weak political and institutional counterweights. On a note of caution, however, if the government fails to reverse its counter-reform agenda in the energy sector, sovereign ratings downgrades will be accelerated. See our 28 February report Mexico: Mapping the AMLO revolution.

Thailand: Upside potential but politics looms

The elections are scheduled for 24 March as external conditions look set to remain a drag on exports in Thailand's small open economy. Krzysztof Halladin explains that there is upside potential in risk assets because of the extent to which foreign investors have reduced positions in recent years but political uncertainty looms. Ultimately, however, we believe that the military leadership will be at least partially successful in achieving a transition to the new constitutional arrangement that will raise the profile of Thai assets among international investors. See our 26 February report Thailand: Election risk to sentiment.

Asset Allocation

We present below our EM asset allocation views, which are updated once per month, most recently in our 1 March EM Strategy Monthly.

We will publish our next Asset Allocation in our EM Strategy Monthly on 2 April.

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	0			
Asset class	-1	0 (+1)	+1	-1
Relative country views				
China	-1	0 (-1)	+1	n/a
Brazil	-1 (+1)	-1 (+1)	+1	0 (+1)
India	-1	-1	-1	n/a
Russia	+1	+1	+1 (-1)	+1 (0)
Mexico	+1 (0)	0	+1	+1
Indonesia	+1	+1 (0)	+1 (-1)	-1
Philippines	+1	-1	-1	-1
Thailand	+1 (-1)	+1	-1 (+1)	n/a
South Africa	-1 (0)	-1	-1	-1
Turkey	-1	+1	-1 (+1)	+1

Scale
+2
+1
0
-1
-2

Last month in brackets

The scores for our relative country views sum to zero in each column.

For further explanation, see our methodology.

Absolute Views

Table 1: Current Absolute Views

Asset		Long Short	Date Opened	Units	Open Level	Current Level	Total Return
Mexico	Sovereign credit	Long	12-Jun-17	bp	149	180	-0.1%
Brazil	Local debt	Long	7-Jan-19	%	7.68	7.49	-0.4%

Date/time 4-Mar-19 07:50

Source: Bloomberg, TS Lombard.

Closed views are in Table 2, below. Intra-day prices used for views that are opened or closed on the date of publication are modified to the close of business prices in subsequent reports. For further explanation, see our methodology.

Closed Views

Table 2: Closed Absolute Views

Asset		Long Short	Date Opened	Date Closed	Open Level	Close Level	Total Return
South Africa	Local debt	Long	10-Nov-16	3-Feb-17	9.27	9.08	+9.7%
Turkey	Sovereign credit	Long	27-Jul-16	7-Mar-17	322	311	+2.1%
Russia	Equities	Long	8-Dec-16	12-Jun-17	576.0	528.5	-8.3%
Turkey	Local debt	Long	15-May-17	11-Sep-17	10.69	10.71	+7.6%
Indonesia	Equities	Long	5-Apr-17	20-Nov-17	495.1	522.6	+5.6%
Russia	Sovereign credit	Long	16-Oct-17	16-Apr-18	140	204	-2.0%
Thailand	Equity	Long	22-Jan-18	18-Jun-18	20.22	18.35	-9.3%
Russia	Equity	Long	18-Jun-18	23-Jul-18	578.1	596.4	+3.2%
CNY/IDR		Short	30-Jul-18	7-Jan-19	2,114.3	2,055.2	+5.3%

Source: Bloomberg, TS Lombard.

Levels are for London close of business, obtained from Bloomberg. Intra-day prices used for views that are opened or closed on the date of publication are modified to the close of business prices in subsequent reports.

For further explanation, see our methodology.

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