2 May 2018

Economics / Politics / Markets

EM Strategy Monthly

TRUMP'S TRADE FOLLIES THREATEN WIDER FALLOUT IN MARKETS

Larry Brainard / EM Team

- **Risk:** We move to a moderate negative call on overall risk
- **Russia:** We cut our call on equities to moderate negative owing to high geopolitical risk
- **Turkey:** Equities and the lira are oversold; we move to a positive call on stocks

Asset Allocation View

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	-1 (+1)			
Asset class	+1	0	-1 (+1)	+1 (-1)
Relative country views				
China	+1	+1 (0)	-1	n/a
Brazil	-1	0 (-1)	+1 (0)	+1 (0)
India	-1	-1	-1	n/a
Russia	-1 (+1)	0 (+1)	0 (+1)	-1 (+1)
Mexico	+1 (+2)	+1	+1	+1
Indonesia	-1	-1	-1	-1
Philippines	-1	-1	-1	-1
Thailand	+1	+1	0	n/a
South Africa	+1	+1	+1	+2 (+1)
Turkey	+1 (-2)	-1 (0)	+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.

Notes on Portfolio Strategy

Below we explore in more detail the assumptions and judgments behind our current portfolio strategy recommendations.

Trump's trade follies threaten wider fallout in markets

As President Trump's trade delegation heads to Beijing for preliminary discussions later this week, we question how and when the US and China will be able to resolve their trade and economic disputes. This week's talks are likely to highlight not only the gulf that lies between the ultimate objectives of the two sides but also the difficulty in bridging it. Contrary to the expectations of the media and many analysts, we believe the starting point for serious negotiations between US and China is some way off and that considerable time may be needed to get there.

As a result, the risk of tit-for-tat trade actions is heightened because it is unlikely that formal negotiations will start ahead of the original deadline set for the US to make a decision on imposing tariffs, probably in late May or early June (public hearings on the tariffs end on 22 May). This deadline could be pushed back, perhaps repeatedly. Such a scenario of serial "deadlines" and rescheduling would likely be just as disruptive for markets as would be an outright trade war. In our view these risks have yet to be fully priced into markets.

The path to the current discussions is already strewn with US actions that the Chinese side will undoubtedly demand be revoked redressed before formal negotiations start. Among these was the US ban last month on American firms selling parts and software to China's ZTE Corporation for seven years in connection with violations of the prohibition on shipping US goods to Iran. ZTE, the second-largest Chinese telecom equipment maker, paid a fine for the violation but the US alleges it did not comply with the terms of the settlement; ZTE is appealing the ruling. This was followed one week later by news that the US Justice Department is investigating China's Huawei Technologies, the world's largest manufacturer of telecom equipment, for similarly violating US sanctions related to Iran.

That these actions were designed "to soften up" the Chinese side before talks get under way is unproved but credible. US media sources reported that US Trade Representative Robert Lighthizer opposed a Beijing visit at this time, arguing that it should be postponed until closer to the threatened imposition of US tariffs in order to increase pressure on China. Trump overruled him and included White House China trade adviser Peter Navarro, "a frothing mercantilist trade warrior" (as he is described by the FT's Alan Beattie), in the delegation along with Treasury Secretary Steven Mnuchin and self-professed free trader Larry Kudlow, Trump's chief economic adviser.

Faced with such an ideologically disparate group of individuals, Chinese officials may conclude there is little reason to engage with them in serious talks at this time. Moreover, China will remember its experience with Commerce Secretary Wilbur Ross, who apparently reached several agreements with Chinese negotiators last year only to have Trump throw them out when he returned to Washington. The Chinese side will want to know who speaks with authority on trade and economic issues for the US, so as not to repeat the Ross experience. Although Secretary Mnuchin is more senior than Lighthizer, who has ambassadorial rank, Trump's instincts appear closer to the latter's. Ultimately, the issue of who speaks for each side will likely have to be resolved between Trump and Xi Jinping.

Another challenge for the negotiations ahead is that there has been no clear statement of US goals or what type of economic relationship the US wants to have with China in the future. Trump has demanded a US$100bn reduction in China's US$375bn trade surplus and accused Chinese firms of stealing US technology and know-how in various ways, which he says must stop. For his part, Navarro has said the US goal is to prevent China from implementing its "Made in China 2025" guidelines, by preventing the transfer of high-tech equipment and expertise that China is seeking in order to meet the targets of that programme. It appears that Navarro's aim is to frustrate and delay China's acquisition of the latest technology and, by implication, its economic development.

Faced with such open-ended and ill-defined demands, the Chinese leadership will want to hear the administration's vision of the economic relationship it is seeking to establish with China. This is because there are areas in which the Chinese leadership is unwilling to consider any compromises, namely the high-tech targets outlined in the "Made in China 2025" document. In our view, the leadership will be willing to negotiate on trade and certain other market access issues, but not on any of Navarro's goals. Since Navarro appears to be Trump's alter ego, this could further delay the negotiations.

China's first priority in the current talks is likely to change the frame of reference. At the recent IMF Spring Meetings in Washington, a senior Chinese official pointed out that if US exports of services and the sales of China-based US firms are added to US exports of goods, they amount to roughly US$600bn, about the same as the combined total of China's sizeable earnings from exports of goods, its much smaller service exports and the sales of Chinese firms in the US market. Under such a broad definition, each country's "revenue" flows from economic activities are roughly balanced. This frame of reference contains an implicit threat that China will restrict the activity of US firms in its domestic market in retaliation for US restrictions on China's exports.

The US delegation is likely to start this week's talks by emphasizing China's checks on market access and its alleged theft of intellectual property. These issues provided the basis for the USTR's Section 301 investigation of China's "Acts, policies and practices related to technology transfer, intellectual property and innovation". It is unclear what Trump's trade negotiators will seek as solutions in these areas. Trump threatened 25% tariffs on some US$50bn of Chinese exports to the US, but such actions impose a penalty for alleged damage done to US firms rather than offer solution to the problems identified in the 301 report.

Trump's unilateral approach to addressing the larger problems associated with China's restrictive industrial policies suffers from a major flaw. The US has policies for controlling people and goods crossing borders but it lacks the ability to similarly control proprietary company know-how. Thus, while it might ban Chinese acquisitions of high-tech goods in the US or investments in high-tech firms, China can likely find most of the technology it is seeking in Europe, Japan, South Korea, Taiwan and India. Shutting Chinese firms out of the US technology market will merely accelerate China's involvement with technology firms from the rest of the world, possibly even with foreign subsidiaries of US-based companies. US firms operating in China could face a very disadvantageous future compared with their global competitors. By eschewing a multilateral approach to a widely perceived problem with China's industrial policies, Trump has put US economic interests in the China market at risk.

Detailed trade and economic negotiations are unlikely to get under way soon. Mnuchin and others on the US delegation will probably try to put a positive spin on this week's talks when they return home. The New York Times reported yesterday that China will call for flexibility in the talks but refuse to discuss Washington's demand that it cut its trade deficit by US$100bn and curb its "Made in China 2025" initiative. We believe the most likely scenario for reaching serious negotiations will involve multiple deadlines and subsequent postponements, similar to what appears to be happening with the US-EU steel and aluminium talks, which have been postponed for another month. EU Trade Commissioner Cecilia Malmstrom has refused to engage in discussions with the US until the EU is given a permanent exemption from the threatened tariffs. We expect China to take a similar hard-line approach.

Chinese officials will be very carefully watching the development of Trump's dispute with the EU and drawing lessons for their upcoming negotiations. The US is currently demanding that the EU agree to quotas on its steel exports, a move that violates WTO rules. This issue is straightforward compared with those in the US dispute with China, which are intrinsically convoluted. Thus, when negotiations finally come, they are likely to be long and ugly.

May Strategy Roadmap

Overview

- **Risk**: We cut our call on overall risk to moderate negative. Last month we were concerned primarily about rising volatility in an environment of continued global economic expansion. This month our concerns are related to the arbitrary and unpredictable environment created by multiple economic and geopolitical risks. These include the trade disputes the US has with China, the EU, Mexico and Canada, US sanctions on Russia and possible sanctions on Iran if the US pulls out of the existing nuclear agreement. Our judgment is that the likelihood of unintended consequences with negative market implications has risen significantly.

- **Asset Class**: Among asset classes we retain our preference for equities but downgrade local rates to moderate negative as we anticipate a rise in EM inflation over the next three months owing to rising oil prices and the strong dollar. We maintain a neutral rating on currencies as we believe dollar strength is likely to peak soon. We raise credit to moderate positive following the recent spread-widening trend, which we think has overshot appropriate levels for dollar bonds.

Equities

- **China**: Risks of economic warfare are rising as US trade talks get under way. The conflict is about much more than trade and relates to China's state-directed development model and its goal of moving its manufacturing rapidly up the technology ladder. We think the threatened tariffs will have very little impact on growth; as talks are likely to be lengthy, we maintain our positive call on equities.

- **Brazil**: The economic recovery is relatively weak amid growing uncertainty about the outcome of the October elections. This has undermined equities and the Real. We maintain our negative call on equities.

- **India**: Policy uncertainty ahead of the upcoming elections and banking risks persist. Meanwhile, fiscal pressures are likely to rise as a result of boosts to pre-election spending. We maintain our negative call on equities.

- **Russia**: Recent US sanctions do not provide for any exit, nor do they target any specified activity; thus, they are likely to remain in place for an extended period and further escalation cannot be ruled out. Given these open-ended geopolitical risks, we cut our call on equities to moderate negative.

- **Mexico**: The left wing anti-establishment candidate López Obrador has widened his lead in the polls ahead of the 1 July presidential election and is the clear front-runner. Meanwhile, progress on a NAFTA deal is evident and the negotiators appear committed to securing an agreement before the end of May. We cut our call on equities from strong to moderate positive.

- **Indonesia**: Economic growth is relatively strong and inflation stable as the government continues its infrastructure push. We believe these positive aspects in the outlook are already priced in, while currency volatility is on the rise. We maintain our negative call on equities.
- **Philippines**: Against a backdrop of strong growth and rising inflation, we expect the Bangko Sentral to hike its policy rate later this month. We view equities as fully valued at current levels; we maintain our negative call on the market.
- **Thailand**: The outlook is for strong economic growth led by tourism and exports, while inflation normalizes from earlier very low levels. The large current account surplus is easing but the baht will likely remain relatively strong. We maintain our positive call on the market.
- **South Africa**: Growth is accelerating, aided by a strong rise in consumer confidence. Meanwhile, President Ramaphosa has appointed a reform-minded cabinet. Although much of the good news is already priced into equities and the rand, we maintain our positive call on the market.
- **Turkey**: The outlook for equities is challenging: growth is slowing, credit is tighter and consumer sentiment is being repeatedly battered by lira depreciation cycles. However, on a relative-value basis vs other EMs, equities appear attractive owing to limited downside currency and market risks following recent selloffs. We raise our call on the market to moderate positive.

Note: Yields and rates are as of 09:00h BST on 2 May 2018

Our next EM Strategy Monthly will appear on 1 June 2018

Asset allocation performance

Value added since our 5 April 2018 Asset Allocation View

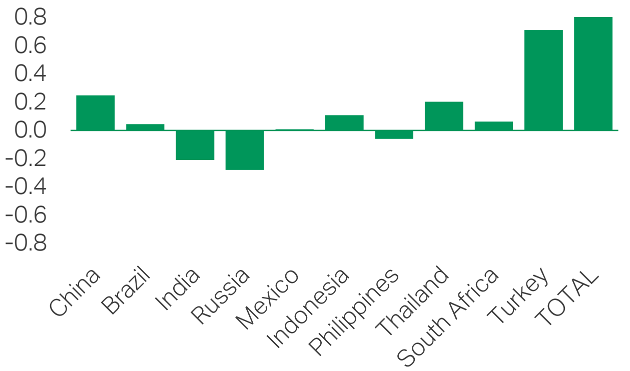
The charts below illustrate the tactical value added over the past month of the asset allocation views presented in our 5 April 2018 EM Strategy Monthly.

The MSCI index delivered a loss last month as risks for EM equities have increased owing to the escalation of the US-China trade confrontation, higher US Treasury yields and a stronger dollar. The lack of both a coherent US strategy and an achievable objective on trade, along with Trump's willingness to escalate tensions, suggests that EM assets will remain under pressure (see our 23 April 2018 EM Watch). Our positive relative views of China and Thailand fared well, as did our negative view of Turkey.

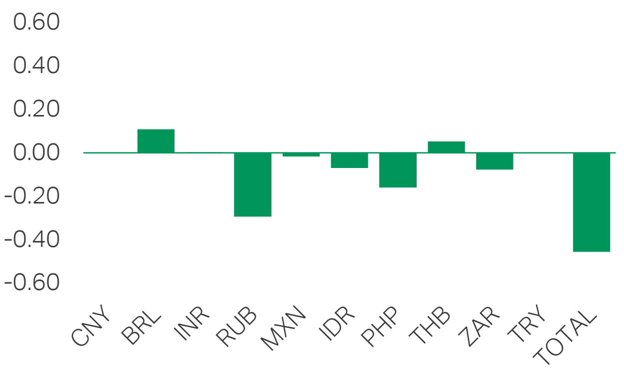
We did not anticipate the collapse of Russian asset prices and the ruble, which undermined our value added in all asset classes. The combination of a material escalation of US sanctions and rising tensions in Syria has increased the risk premium on Russian assets. We see a growing risk of a deeper correction in Russian markets, despite the improving domestic economic outlook (see our 9 April 2018 EM Watch and our 23 April 2018 report Russia: "Malign" speculation).

In foreign exchange markets, our positive view of the baht fared well as did our negative view on the Real, but our negative view of the Philippines peso proved wrong. Among local debt markets, Turkey was the best performing as high yields attracted investors, despite risks. Meanwhile, in sovereign credit, South Africa was among the best performers – in line with our positive view – even as President Ramaphosa honeymoon period comes to an end.

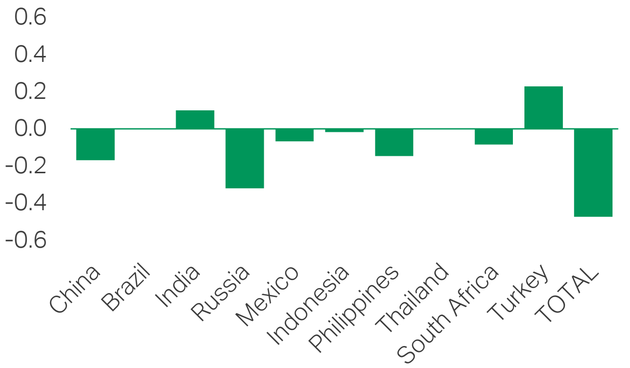
Equity value added (%)



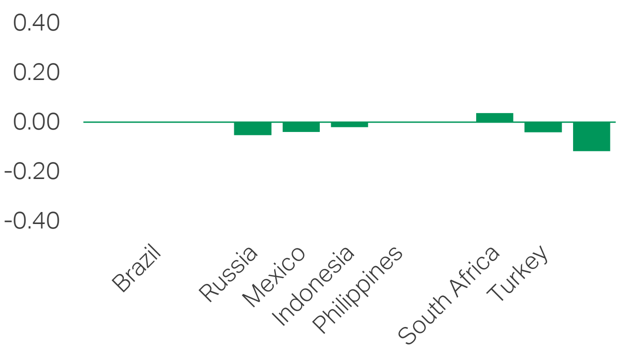
Currency value added (%)



Local market value added (%)



Sovereign credit value added (%)



Sources: Bloomberg, TS Lombard.

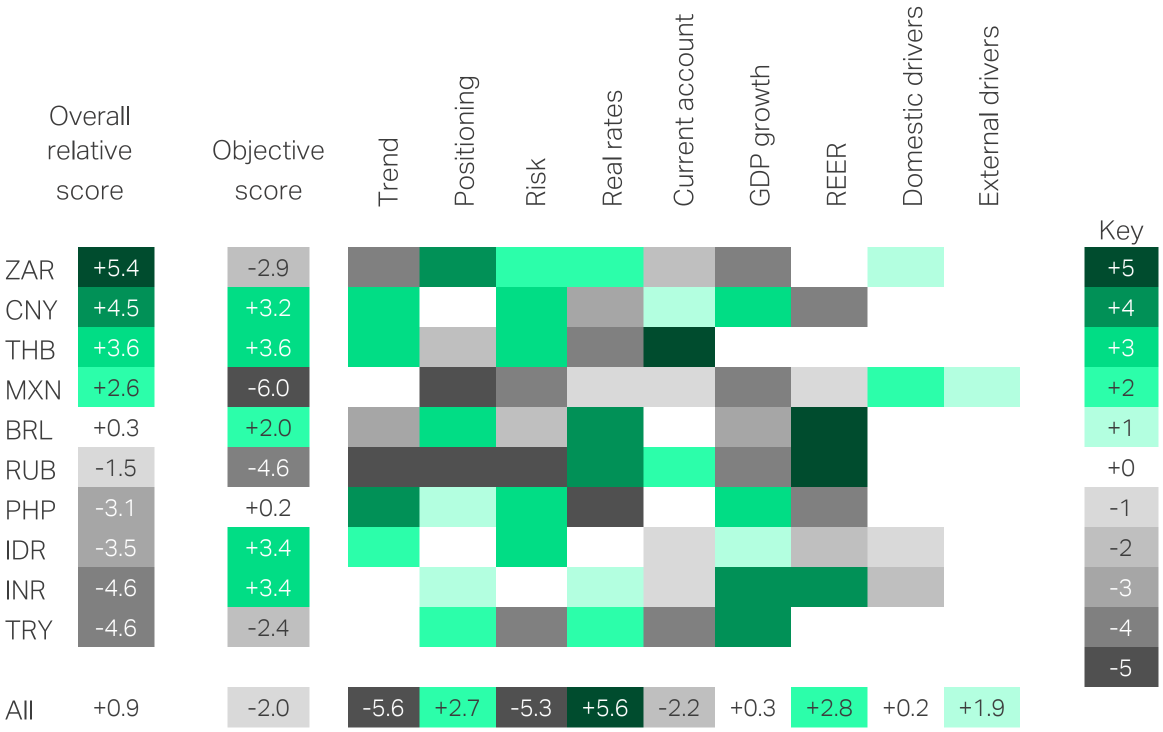
For further explanation, see our methodology.

FX Scorecard

We are positive on ZAR, CNY, THB and negative on IDR, INR, TRY

The figure below presents our latest FX Scorecard. We last updated the FX Scorecard in our 5 April 2018 EM Strategy Monthly.

FX Scorecard: Relative scores for EM currencies



For further explanation, see our methodology.

Below we summarize our most important view changes this month.

ZAR

South African assets and the rand will continue to benefit from the improved quality of policymaking under Cyril Ramaphosa. Inflation moved lower in March, vindicating the SARB's decision to cut rates by 25bps at its latest meeting, although the weaker rand over the past month will reduce the chance of further rate cuts. There are nonetheless risks ahead for the new President. There are powerful populist elements within the ANC as well as challengers on the left outside of the party. Furthermore, corruption pervades the political system as a whole.

CNY

The renminbi is poised to appreciate further in the coming months while the US-China trade confrontation complicates exchange rate policy. The improving economic outlook and greater market liquidity will likely continue to attract investor inflows, which will benefit the renminbi. We therefore expect the authorities to expressly avoid any unwarranted non-market RMB depreciation, thus holding the "nuclear option" in reserve. The moral high ground of a strong currency better suits Beijing at this stage in the trade negotiations (see our 23 April 2018 EM Watch). By yearend, however, the economy will nonetheless slow as policymakers withdraw stimulus, increasing the incentive to reduce the pace of RMB gains.

INR

We remain negative on the rupee. Rising inflationary pressure from higher oil prices adds to the risks to the rupee and Indian assets. The RBI's effort to keep banking sector reform on track is positive for the medium-term outlook. In the near term, however, the reported level of NPLs is likely to increase as banks are forced to recognize bad loans (see our 23 April 2018 EM Watch). Banking sector woes will continue to hinder the pace of economic recovery and weigh on investor sentiment. In recent meetings with the financial community in Mumbai, our India team found that sentiment has turned sharply negative. Perhaps the greatest fear among investors is that the BJP will fail to secure a majority in the 2019 national elections, resulting in a weak government that is unable to enact reform (see our 20 April 2018 report India: Politics and finance sour sentiment).

RUB

The deteriorating geopolitical environment will increasingly weigh on the ruble and Russian assets. Oil-related inflows and the improving domestic economic outlook will nonetheless provide some support for the ruble, while the fiscal rule will help reduce the impact of external events on the exchange rate. The combination of a material escalation of US sanctions against a background of unpredictable US policy and rising tensions in Syria has increased the risk premium on all Russian assets. The softening of US pressure on aluminium producer Rusal and Treasury Secretary Mnuchin's assurance that the US will not sanction Russian sovereign debt offer some respite. The random nature of US measures, however, suggests a risk of new sanctions being imposed on Russian entities, raising the prospect of a deeper correction to markets as international investors increasingly shun Russian assets (see our 10 April 2018 report Russia: Smooth growth, tripwire hazard and our 10 April 2018 Global Political Drivers: Syria Flash: US attack preview).

BRL

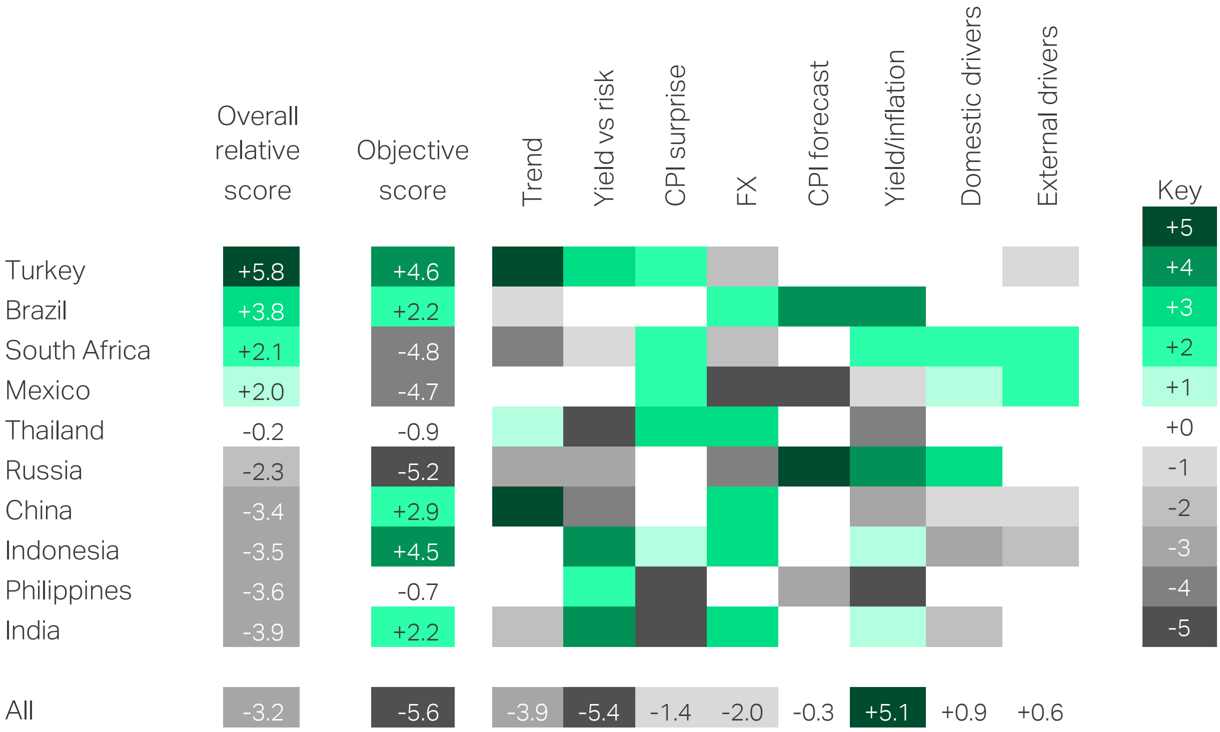
After depreciating steadily since the beginning of the year, the Real may begin to attract investor interest. The continuing gradual economic recovery should provide further support for the currency (see our 23 April 2018 EM Watch), as will inflows into still-attractive local debt markets. The political environment, however, remains mired in uncertainty. With former President Lula almost certainly out of the race, right-wing populist Bolsonaro has achieved a small lead among a wide field of candidates. Given that there is no clear favourite and no strong market-friendly candidate, the risk remains that the next President will lack the mandate or the willingness to implement essential fiscal reform (see our 24 April 2018 report Brazil: Alckmin gets more bad news).

Fixed Income Scorecard

We are positive on local debt in Turkey, Brazil and South Africa and negative on Indonesia, India and Philippines

The figure below presents our latest Fixed Income Scorecard, last updated in our 5 April 2018 EM Strategy Monthly. For further explanation, see our methodology.

Fixed Income Scorecard: Relative scores for EM local debt



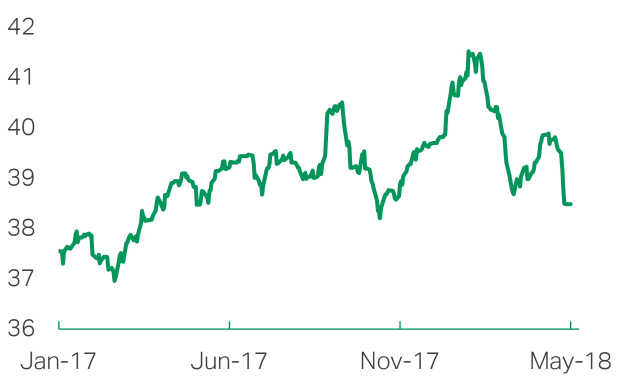
Indonesia

We maintain our negative view of Indonesian local debt. Inflation is gradually increasing but remains within Bank Indonesia's 2.5-4.5% target range, and government measures to curb fuel prices are likely to reduce upward inflationary pressures. However, rupiah volatility, exacerbated by the current account deficit, has led BI to step up its foreign exchange intervention. The market is likely to test BI's commitment to currency stability as external conditions become more challenging, while the prospect of higher interest rates could accelerate outflows from local debt markets, of which foreign investors remain significant holders (see chart below). Given that Indonesian export growth is slower than import growth and lagging that of many other EMs, it may suit the economy to have a weaker currency and thus potentially higher inflation. Furthermore, incoming BI Governor Perry Warjiyo could face political pressure to maintain a relatively easy monetary stance ahead of local elections in June and national elections next year.

Turkey

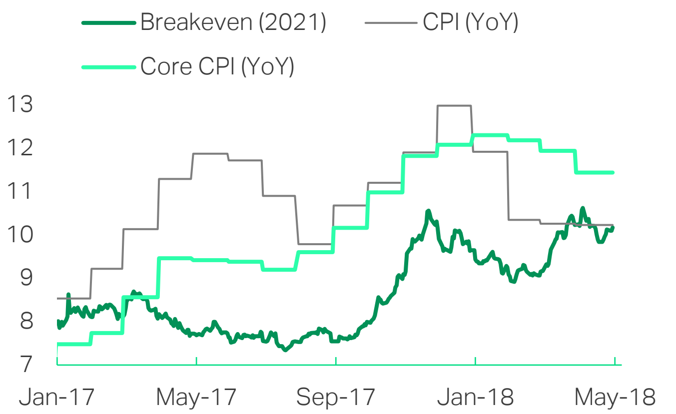
We maintain our positive view of Turkish local debt. Turkish yields are by far the highest among major EM local debt markets and are likely to attract investors regardless of the political and economic risks. Despite the volatility of the lira and the reluctance of the CBRT to raise interest rates significantly, inflation expectations remain relatively subdued (see chart below). The decision of President Erdogan to call early elections increases the risks for Turkish assets. Asset prices will suffer if, during the election campaign, the outcome starts to become less certain (see our 23 April 2018 EM Watch). At the same time, the sensitivity of the electorate to the value of the lira increases the probability that the CBRT will eventually tighten policy further in order to stabilize the exchange rate. A more hawkish central bank is likely to benefit local debt markets.

Indonesia: Foreign holdings of debt (%)



Sources: Bloomberg, TS Lombard.

Turkey: Breakeven CPI



Sources: Bloomberg, TS Lombard.

Philippines

Local debt yields are likely to rise further as inflation increases. Inflation is already above the Bangko Sentral's 2-4% target. The BSP acknowledges that risks are biased to the upside and that there is especially a risk of second-round effects from the minimum wage hike and from higher transportation costs, as well as from consumption tax increases earlier in the year. The BSP nonetheless believes that the latest spike in inflation is temporary and that policy rates should therefore be kept on hold. Additional upside risk to inflation comes from the weaker currency. The deteriorating trade deficit could put the peso under renewed depreciation pressure in the near term (see our 16 April 2018 EM Watch). Overseas workers' remittances continue to provide some support for the peso and the economy, despite a slowdown in payments from the Middle East, while in the medium term, the strengthening of President Duterte's pivot to China should help boost investment for his ambitious infrastructure plan.

Absolute Views

The table below presents our high-conviction total return market views

Current Absolute Views

Country	Asset	Market view	Units	Date opened	Open level	Current level	Performance to date
Mexico	Sovereign credit	Positive	bp	12-Jun-17	149	161	+0.8% (-12 bp)
Thailand	Equity	Positive	USD	22-Jan-18	20.22	20.36	+0.7%

Date/time 2-May-18 08:32

Sources: Bloomberg, TS Lombard.

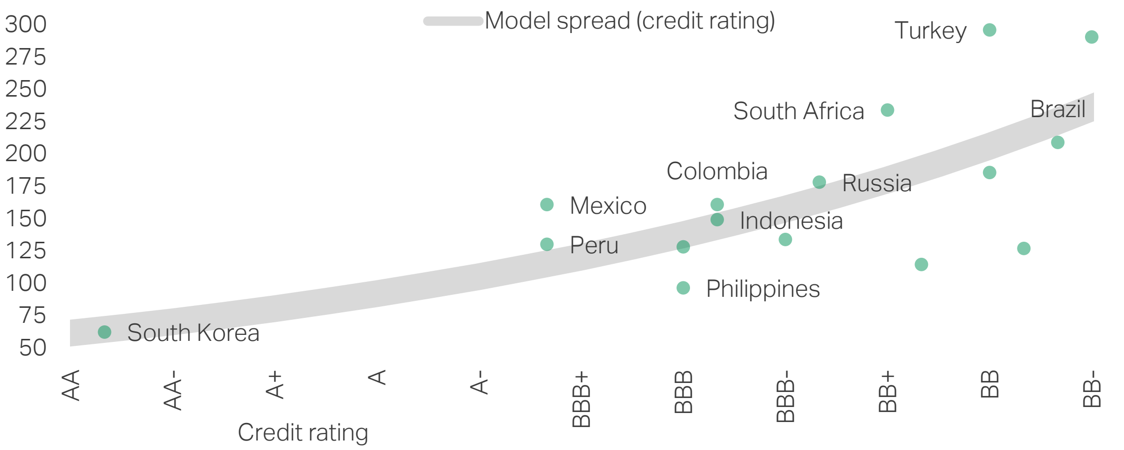
The list of closed views is published at the end of our weekly EM Watch. Intra-day prices used for views that are opened or closed on the date of publication are modified to the close of business prices in subsequent reports. For further explanation, see our methodology.

Mexico

We maintain our positive view of Mexican sovereign credit that we opened in our 12 June 2017 EM Watch. The spread on Mexican sovereign credit was little changed over the past month and remains cheap vs similarly rated sovereigns (see chart below). Earlier this month Moody's raised the outlook on Mexican debt to stable from negative, albeit acknowledging the risks from the NAFTA negotiations. Fitch and S&P reaffirmed Mexico's sovereign debt ratings in March. It now appears unlikely that there will be any change in the credit rating before the July election.

Left-wing populist AMLO remains the leading candidate in the presidential race – a position he has enjoyed since late last year. Markets have likely priced in the prospect of his victory, suggesting possible upside if his policies are not as populist as previously feared; but mixed messages about his likely agenda generate considerable uncertainty. AMLO has said he will not roll back oil sector reform but that he will audit existing oil contracts and stop the planned electricity sector privatization.

Sovereign spread vs credit rating



For more detail, see our sovereign credit methodology.

Sources: Bloomberg, TS Lombard.

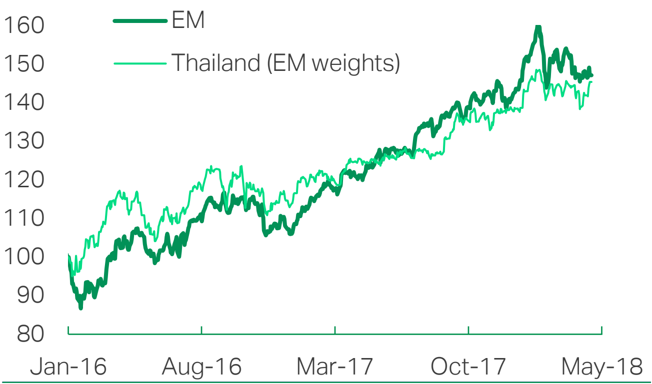
The fundamental outlook for Mexico remains strong: the next President will inherit healthy public finance and falling inflation (see our 16 April 2018 EM Watch and our 16 March 2018 report Mexico: Are fiscal surpluses sustainable? A hint from FX gains). Inflation expectations are well anchored despite rising peso volatility. The currency nonetheless remains a risk factor, as evidenced by its depreciation following a tweet by President Trump linking the NAFTA negotiations to border security. The US has dropped some of its earlier demands on NAFTA and a quick agreement in principle would suit Trump, providing positive headlines and allowing the administration to focus on China. A deal is still possible before the July election, although ratification by each country would take longer (see our 23 April 2018 EM Watch). An agreement on NAFTA would stabilize the peso, boost Mexican assets and reduce the global trade war risk premium.

Thailand

We maintain our positive view of Thai equities that we opened in our 22 January 2018 EM Watch. Thai equities have gained around 2% over the past month, compared with the lacklustre performance of global EM (see chart below). The domestic fundamental backdrop remains favourable. Inflation is rising only gradually while the Bank of Thailand believes that the economy is still at an early stage of recovery in domestic demand, suggesting that monetary policy will remain accommodative.

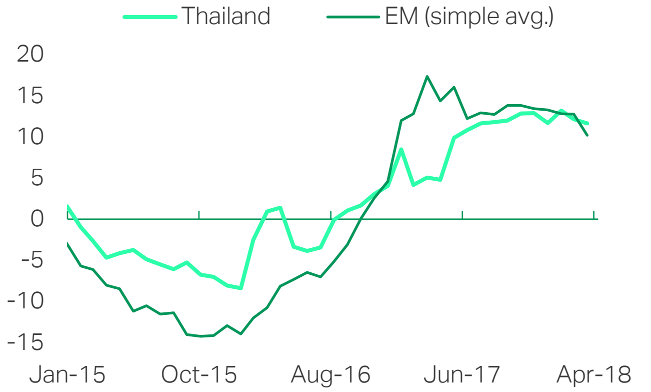
We expect strong export growth to remain an important driver for the economy (see chart below). Tourist arrivals, particularly from China, are surging, while the Eastern Economic Corridor will help boost investment. The appreciation of the baht is so far having little impact on export competitiveness (see our 26 March 2018 EM Watch), although the prospect of an escalation of the trade confrontation between the US and China is a threat to the Thai economy.

EM equities vs Thailand (EM weights)



Sources: Bloomberg, TS Lombard.

Export growth (3m ma)



Sources: Bloomberg, TS Lombard.

China

	Latest	Next 3–6 months
Inflation yoy%	2.1	To average 2.3-2.5% in 2018
GDP growth%	6.8	6.5% for 2018 as a whole

Economic growth continued strong in Q1/18 but signs of the slowdown we expect later this year are already evident. Property investment growth accelerated to 10% in Q1/18 from 7% for 2017 as a whole, but growth in floor space sold eased to 2% in the same period. Although investment will be supported by the government's shantytown development programme, we expect growth in overall property investment to fall to single digits beginning in Q2/18. Meanwhile, infrastructure investment is likely to slow to 10-12% growth in 2018, down from 14% last year. Financing for infrastructure is being tightened because of more restrictive fiscal policies overall as well as owing to the closing of loopholes that some local authorities used to fund local projects. In particular, PPP projects are being subjected to much greater scrutiny: China Research Director Bo Zhuang reported last month that 17% of the nearly 14,000 officially registered PPP projects have been cancelled since last November. We also expect net exports to fail to repeat their 0.6pp contribution to last year's final 6.9% result. Export growth will likely ease from last year's strong expansion as the growth in global demand slows. Besides these cyclical developments, rising trade frictions with the US could dampen the expansion in overseas sales.

Amid rising external uncertainty, domestic demand remains resilient. Claims that a US-China trade war would torpedo economic growth are overblown; the IMF estimates that the imposition of tariffs threatened by President Trump would subtract only 0.2-0.3pp from annual growth. This does not take into account possible secondary effects, but China's growth today is driven much more by consumption than by exports or investment. The contribution of gross fixed capital formation to last year's growth was just 2.2pp, compared with 4.1pp for consumption.

Hopes that US-Chinese negotiations could get under way soon are unlikely to be fulfilled. The Trump administration is pursuing a risky strategy in its trade confrontation with China. While the threat of tariffs on some US$50bn in Chinese exports appears targeted at the US$375bn imbalance in merchandise trade, the US has a significant surplus in services and in domestic sales in-country, i.e. sales of US firms in China sourced locally or in other countries vs the corresponding figure for Chinese firms in the US. This conflict is about much more than trade and relates to China's state-directed development model and its targets for moving its manufacturing rapidly up the technology ladder via state support and protection from foreign imports. While China may be willing to open up sectors in which its firms already have dominant positions – such as finance – its leadership will be unwilling to compromise on its development model. Risks of economic warfare are therefore rising.

Macro views

Politics	Xi Jinping has consolidated his political power and centralized control
Economics	Growth will ease marginally to 6.5%; inflation will average 2.3-2.5%

Markets

Equities	+1	Markets likely to be buoyed by portfolio inflows as growth stabilizes
Currencies	+1(0)	Stable vs official currency basket
Local rates	-1	Bond interest rates likely to trend higher following recent declines

Brazil

	Latest	Next 3–6 months
Inflation yoy%	2.8	Rising to 3.5-4% over the next six-nine months
GDP growth%	2.1	Remaining in 2-2.5% range to yearend

Former Chief Justice Joaquim Barbosa has burst onto the political scene as a strong presidential candidate. The political outsider is already in second or third place in polls that exclude former President Lula. He supports pension reform while emphasizing social protection for the poorest Brazilians. On the right, Congressman Jair Bolsonaro retains his leading position. While he is regarded as social media-savvy, he has kept a low profile recently to avoid turning off moderate voters. Instead, his main economic adviser, Paulo Guedes, has taken a more active public role in order to highlight his proposed economic reform goals.

Left-wing candidate Ciro Gomes, former Governor of Ceará, has potential to grow his base, too. In the absence of Lula, polls put Ciro in third or fourth place; he could gain further momentum but would need to build an effective working coalition to represent the left-wing movement that includes Lula's PT party. Ciro has toned down his radical rhetoric compared with earlier campaigns but he still is promising to roll back Temer's economic reforms and to nationalize private oil assets while calling the privatization of Eletrobras a "crime".

Significant uncertainty across the political and economic landscape is beginning to affect Brazilian markets. While some observers still believe traditional politicians such as Geraldo Alckmin or Henrique Meirelles will prevail in the first round of the October elections, we think anti-establishment sentiment will prevail and push candidates such as Barbosa or Bolsonaro into the second round. The economic recovery is weak thereby undermining economic technocrats such as Meirelles, while elected officials such as Alckmin are failing to gain much public support. The state of the labour market highlights the economy's underlying weaknesses: the unemployment rate remains elevated, having edged up to 13.1% in the three months to March. As long as unemployment remains high, the economic recovery will remain fragile.

The fall in the unemployment rate observed throughout last year was mainly driven by the rise of informal (off-the-books) and self-employment jobs. The downside is that such jobs are usually temporary and large gains can be followed by similar losses, thus making employment in this sector unsustainable. Indeed, the recent rise in the unemployment rate is explained by the falling number of informal jobs and almost nil growth in formal jobs.

The good news is that a weak economy will keep inflation from overheating despite low interest rates and a large fiscal deficit. The IPCA-15 rose 0.2% mom and 2.8% yoy in April, posting the lowest month-over-month growth rate for this period over the last 12 years. The degree of spare capacity still observed in the labour and industrial markets is weighing heavily on inflation, which offers room for another 25bps rate cut in May.

Macro views

Politics	Political uncertainty is rising ahead of the October elections
Economics	The economic recovery continues weak, except in agriculture

Markets

Equities	-1	Brazilian equities appear overbought and vulnerable to correction
Currencies	0(-1)	Real appears oversold following recent sharp decline
Local rates	+1(0)	Inflation has bottomed; another 25bps rate cut is possible
Credit	+1(0)	Fiscal stability in short term; huge deficits a long-term negative

India

	Latest	Next 3–6 months
Inflation yoy%	4.3	Moving up to around 5%, as food price inflation normalizes
GDP growth%	7.2	6.75-7% growth in FY19 (beginning 1 April)

The economy is gradually recovering from the government's demonetization and Goods and Services Tax initiatives. The most recent figures for the January-March period show an increase in growth to 7.2%, up from the 6.3% in the previous quarter. But as the disruptive effects of those earlier policy moves has ebbed, market confidence has been undermined by a developing banking crisis: tighter banking oversight has revealed a worsening bad loan performance at India's state banks.

Despite the Modi government's commitment of fiscal resources to recapitalize state banks, TS Lombard's India analysts learned in a series of interviews with private bankers that increased government scrutiny of the banks has made them reluctant to extend corporate credit; instead, banks are seeking to expand retail lending activities. This cautious lending mood among bankers has also been influenced by the RBI's robust defence of its February regulatory crackdown on banks' avoidance of recognizing non-performing loans. In an 18 April speech provocatively titled "It is not business as usual for lenders and borrowers", RBI Deputy Governor NS Vishwanathan told a banking audience that banks needed an "external nudge" to tackle their unresolved bad loans, especially to large borrowers.

The interest rate outlook meanwhile remains uncertain. The RBI's downward revision of its headline inflation forecasts following its 5 April MPC meeting fuelled market optimism about future rate cuts, but the publication of the minutes two weeks later revealed that the MPC is focused on targeting core inflation, which rose to 5.2% in March from 5% in February. The minutes therefore were in fact much more hawkish than earlier assumed, in particular the committee's emphasis on upside inflation risks from fiscal slippage, rising crude oil prices and likely hikes in minimum support prices for summer crops. Our judgment is that the RBI will remain on hold until after the monsoon season in September, when it will have a better reading on the outlook for inflation.

Higher crude prices and a falloff in capital inflows have weakened the rupee and pushed up domestic rates. India's current account deficit was only 1.5% of GDP in FY18 (which ended on 31 March), but it is rising rapidly, having reached 2-2.5% in current FY19. This negative move, together with a drying up of capital inflows, has led to a 5% depreciation in the rupee vs the dollar since end-January. However, measured in real effective terms, the rupee is still overvalued by 5-10%, depending on the index used. Further depreciation is both likely and needed.

Results from a crucial state election in Karnataka will be announced on 15 May. The Congress Party currently rules the state but Prime Minister Modi is hoping to reverse the recent swing away from the BJP in recent by-elections thanks to extensive grass-roots campaigning.

Macro views

Politics	Policy uncertainty ahead of the coming elections and banking risks persist
Economics	Growth is strengthening but remains below the government's 7.5% target

Markets

Equities	-1	Political uncertainty and rising fiscal pressures are negative for stocks
Currencies	-1	INR still overvalued, despite recent weakness vs USD
Local rates	-1	Rising fiscal deficits and higher bond issuance keep pressure on rates

Russia

	Latest	Next 3–6 months
Inflation yoy%	2.4	CPI rising to 3.3% by end-2018
GDP growth%	0.9	Our 2018 growth forecast cut to 1.5-2% (down from "at least 2%")

The US sanctions announced on 6 April were unprecedented. In contrast with sanctions dating from the Obama era and even the 25 January sanctions imposed by President Trump, they do not provide for any exit, nor do they target any specified activity other than Russia's "worldwide malign activity". It is therefore likely that they will remain in place for an extended period, i.e. years; further escalation of sanctions cannot be ruled out. Although Treasury Secretary Steven Mnuchin backtracked last week and made revisions to sanctions on Oleg Deripaska's Rusal in response to the disruptive conditions in global aluminium markets that they caused, Russian assets will be subject to heightened geopolitical risks for years to come.

The US Treasury has reiterated its determination not to subject Russian sovereign debt to sanctions. The reason offered for this decision is that it would hurt US investors holding Russian bonds while exacting little "punishment" on the Russian state. However, as the US Congress appears eager for further such sanctions against Russia, there is a risk that President Trump will follow Congressional wishes and reverse that position. A swing to the Democrats in the November mid-term elections would, however, likely dampen much of this hawkish agitation: most Democrats favour enforcing existing legislation without pursuing new initiatives against Russia. A remaining unknown is what President Putin is likely to do by way of retaliation against US sanctions. Options for economic retaliation appear limited, but Russia could easily use its military power to create problems for the US and its NATO allies.

The market volatility that followed the imposition of sanctions will delay further easing from the Central Bank. Last Friday the release from the CBR's rate-setting meeting noted that geopolitical tensions had weakened the ruble and might affect expectations and the path of inflation. However, the CBR emphasized that it ruled out risks of an overshooting of the 4% inflation target as a result. It projected inflation at 3-4% at end 2018 and close to 4% in 2019. The CBR also said the level of its key rate will continue in future to be determined by an expected transition of the policy stance to neutral later this year; this implies that the policy rate could fall a further 50-75bps from its current 7.25% level.

The recent rise in geopolitical risks has pushed up oil prices, which will lead to a higher fiscal surplus in 2018. The budget was already on track for a modest fiscal surplus before the US recent actions but an upward revision in the forecast surplus is now warranted. The Ministry of Finance has pushed up its expected outcome to 1% of GDP, but we believe a figure of 1.5-2% is more likely. Overall GDP growth is likely to be in the 1.5-2% range, slightly above the economy's potential and below our earlier, above potential forecast of "at least 2%".

Macro views

Politics	Reforms of taxes and pensions are likely to be announced later this month
Economics	Given current uncertainties growth is likely to be 1.5-2% in 2018

Markets

Equities	-1(+1)	Despite solid fundamentals geopolitical risks now dominate
Currencies	0(+1)	Official intervention will stabilize the ruble following recent weakness
Local rates	0(+1)	Carry-trade outlook subject to ruble volatility
Credit	-1(+1)	Relative value does not compensate for new geopolitical risks

Mexico

	Latest	Next 3–6 months
Inflation yoy%	4.7	Slowing to 4% by mid-year
GDP growth%	1.2	Moderate growth of 2-2.5% in next six months

The economy has surprised to the upside during the beginning of 2018. Following three consecutive months of deceleration last year, retail sales are showing signs of recovery: they were up 1.2% yoy in February from 0.5% in January. Falling inflation and rising formal job creation are driving the recovery of retail sales. Inflation fell from 6.7% in December to 4.7% in the first half of April, while formal job creation took the unemployment rate to a historical low of 2.9% in March. The release of GDP by expenditure data next month will likely confirm GDP expansion of 1.2% in Q1/18, driven primarily by private consumption.

On the trade front, the NAFTA negotiating teams have been holding a "permanent round" of talks in Washington. Following a major about-turn by the US administration, which last month offered the prospect of a deal "in principle" by May, optimism about reaching agreement resurfaced last month. Some earlier demands by the US regarding rules of origin for vehicles have been relaxed, but disagreements on US demands for a five-year sunset clause and US arbitration of commercial disputes remain unresolved. Optimism about reaching a quick NAFTA deal was reflected in a peso rally, but concerns that the US negotiating team is becoming preoccupied with trade negotiations with China cut the rally short.

President Trump has threatened to tie a NAFTA deal to migration policy. Unsurprisingly, his latest attempt to tackle migration issues with Mexico were not well received by Mexican government officials. In a statement, Foreign Affairs Minister Luis Videgaray rejected as unacceptable a condition to tie NAFTA to the stopping of illegal immigrants from Mexico. Political tensions rose further when Trump decided to deploy the US National Guard along the border. Although such a measure had been implemented during the Obama and Bush administrations, political relations were much more benign then than they are today: the Mexican Senate unanimously granted President Peña Nieto the powers to cease cooperation on migration with the US. Moreover, all presidential candidates for July's election closed ranks with Peña Nieto's decision to stand up to what was perceived as an unfriendly action by the US administration towards Mexico.

There are just two months to go to the presidential and legislative elections on 1 July, and the left wing anti-establishment candidate Andrés Manuel López Obrador (AMLO) has widened his lead to 20% in voter preferences over his closest rival, Ricardo Anaya of the PAN. While a sharp reversal of voter preferences cannot be ruled out, it appears likely that AMLO will be elected along and his Morena party will perform well in the legislative contests

Macro views

Politics	April polls give AMLO a 20% lead in the July presidential race
Economics	Economic activity bounced back in Q1/18

Markets

Equities	+1(+2)	Signs of progress in the NAFTA talks are positive for stocks
Currencies	+1	Improving sentiment on the outlook should support the peso
Local rates	+1	Falling inflation continues to attract portfolio inflows into carry trades
Credit	+1	On a relative basis, sovereign credit is attractive vs other EMs

Indonesia

	Latest	Next 3–6 months
Inflation yoy%	3.4	Likely to remain in the middle of BI's 2.5-4.5% target range
GDP growth%	5.2	Moving up to 5.5% for the year as a whole

Infrastructure investment will be the primary growth driver this year. We expect higher government infrastructure investment spending to be the main stimulus for growth. Private consumption is unlikely to improve much, given the decline in consumer confidence in March for the third consecutive month: the index slipped to 121.6, down from 122.5 in February. Government consumption, meanwhile, should accelerate on the back of spending ahead of the 27 June elections. Private investment will remain lacklustre, as reflected in sluggish credit growth: Bank Indonesia (BI) last month cut its 2018 credit growth forecast to 9-11% from its March 10-12% call. A freeze of energy and fuel prices should keep the CPI well anchored at around 3.5%.

The current account deficit is continuing to widen. Export growth beat consensus in March to grow 6.1% yoy, while import growth slowed sharply – to 9.1% yoy vs 24.9% in February – mainly due to a 9.5% contraction in consumer goods imports. Capital goods imports continued robust, up 21.6%, driven by ongoing infrastructure investment. A sizeable trade surplus of US$1.1bn was registered in March; however, the surplus for Q1/18 overall was just US$0.3bn compared with US$4.1bn in Q1/17. We expect the CA deficit to widen to around 2.5%/GDP in Q1/18, up from 1.8% recorded for the whole of 2017.

A weak rupiah last month triggered intervention by BI. Depreciation pressures returned with a vengeance owing to dollar strength; in April the rupiah fell to its lowest level since January 2016. Given a widening current account deficit and high level of foreign ownership of government bonds, Indonesia is vulnerable to a change in investor sentiment and capital outflows. BI intervened to stabilize the FX and bond markets and employed hawkish comments to communicate its resolve to support the currency. Governor Martowardojo also said the BI "won't hesitate" to hike the policy rate if such a move is needed to stabilize the rupiah. Moreover, President Jokowi pledged that the government will "leave BI to decide interest rate policy". The case for a rate hike has clearly strengthened, although much depends on the future trend in the dollar. We think BI is likely to hike its policy rate in H2/18, barring a reversal of dollar strength; it will tolerate some IDR weakness but will continue to use FX reserves to manage rupiah volatility.

President Jokowi is leading in opinion polls for the 2019 presidential election. Last month former General Prabowo Subianto, who lost to Jokowi in 2014, accepted his party's nomination as candidate in the presidential poll. Recent opinion polls show Jokowi with a wide lead over all prospective contenders: according to a Poltracking Indonesia survey, 58% of respondents are for Jokowi vs 34% for Subianto.

Macro views

Politics	Ahead of the 2019 election, Jokowi is leading polls by a wide margin
Economics	Economic growth is relatively strong and inflation stable

Markets

Equities	-1	Stocks appear fully valued at current levels
Currencies	-1	The rupiah is displaying a bias towards depreciation
Local rates	-1	Record low interest rates are likely to spur profit-taking and outflows
Credit	-1	Credit outlook is stable but recent spread tightening is overdone

Philippines

	Latest	Next 3–6 months
Inflation yoy%	4.3	Staying above 4% due to tax hikes, strong growth and weak peso
GDP growth%	6.6	Sustained strong growth in the 6.5-7% range

Amid the slowing of remittances and the drop in consumer confidence, infrastructure investment will be the sole driver of GDP growth. The growth of workers' remittances slowed to 4.5% yoy in February vs 9.7% in January. The ban on Filipino workers in Kuwait following allegations of mistreatment contributed little to the slowdown: remittances from that country dropped 44.9% in February, but they accounted for just 3% or so of all remittances before the ban. Meanwhile, the consumer confidence index fell to 1.7% from 9.5% in Q4/17 owing to rising inflation expectations, the poor harvest and increasing household debt levels. However, as the index was positive it indicates that consumers are somewhat more optimistic than pessimistic. All this points to infrastructure spending being the major growth driver in the medium term. Of 75 "high-impact and big ticket" infrastructure projects, 23 have now been approved and are ready to be launched. The green light for the remaining projects is expected to be given later this year.

The trade deficit continues to widen. Exports dropped 1.8% yoy in February vs an increase of 3.5% in January. This was the first decline since November 2016. Imports grew robustly at 18.6% yoy, above both consensus and the 11% rise in January. Like in previous months, growth was led by imports of capital goods and commodities. The trade deficit nearly doubled to US$3.1bn vs US$1.8bn one year earlier. The widening trade gap is caused by surging imports of infrastructure-related capital goods.

S&P upgraded its outlook for sovereign credit from stable to positive last month. Following the S&P move the peso strengthened, but comments by Bangko Sentral's Governor Nestor Espanilla took the edge off the market's optimism. In response to queries about rising inflation he said that the "economy is solid and can absorb tightening if needed". As March inflation was above the BSP's upper 4% inflation-targeting band, the policy rate will likely be hiked at the next meeting of the bank's MPC, which is scheduled for 10 May. If the CPI for April continues to show broad-based inflationary pressures and the BSP fails to hike, depreciation pressures on the peso are likely to gather momentum and be amplified by the widening trade deficit.

Public support for Duterte has fallen but remains strong. In a survey conducted by Social Weather Stations in Q1/18, President Duterte's "net trust rating" decreased to +65 from +75 in the previous quarter. This nonetheless signifies a "very good" rating compared with the "excellent" result in December. The decline may reflect the effects of the tax reform, which has led to surging food and beverages prices that hit poorer Filipinos hard, despite the cash subsidies granted to offset their impact.

Macro views

Politics	President Duterte' s public support dropped slightly in Q1/18 but is still strong
Economics	Economic growth will remain very strong in 2018, at 6.5-7%

Markets

Equities	-1	Despite strong growth, relative valuations are stretched
Currencies	-1	A renewed bout of peso weakness is likely
Local rates	-1	Rising inflation and the prospect of policy rate hikes are negatives
Credit	-1	Trading at very tight spreads relative to risk owing to strong local bid

Thailand

	Latest	Next 3–6 months
Inflation yoy%	1.1	Rising gradually to 1.5% at yearend
GDP growth%	4.0	Growth to be sustained in the 4-4.5% range in 2018

Tourism remains strong but government spending is weakening. In March tourism continued to increase rapidly, up 16.3% yoy; more than 1 million visitors from China were recorded during this period (up 27.2%). Owing to delays in budget disbursements, the Ministry of Finance's Fiscal Policy Office revised down its 2018 growth forecasts for public consumption (from 3.4% to 3%) and investments (from 11.8 to 8.9%). The forecast for GDP growth was unchanged – at 4.2% – owing to higher export projections. Although some private investment is likely to be postponed until after next February's elections, export-related investments will continue strong. For now, gains in private consumption are limited by the overhang of large household debts.

Headline CPI rose to 1.1% yoy in April, up from 0.8% yoy in March. The CPI has finally moved into central bank's target range of 1-4%. This is the highest reading since February 2017 and resulted mainly from higher food and energy prices. We expect inflation to gradually rise to 1.5% at yearend on the back of slight recovery in domestic demand and higher crude oil prices.

The current account surplus is narrowing gradually. In March exports rose 7.1% yoy, above consensus, led by shipments of electronics (up 18.5%). Imports grew faster –9.5% – driven by robust imports of raw materials especially crude oil. Imports of both capital and customer goods slowed to 2% and 1.4% yoy, respectively. Tourism and exports are still the main supports of the current account surplus. However, as Thailand is a net oil importer, higher crude prices will contribute to a narrowing of the surplus, which was 10.7% of GDP last year. Further, a pickup in investment associated with the government's infrastructure spending agenda will fuel a rise in capital goods imports. Nonetheless, we expect the baht to remain relatively strong, despite the still large CA surplus. Thanks to the relatively low foreign holdings of government bonds and large FX reserves, potential portfolio capital outflows are not a major cause for concern.

The current military junta is seeking to prolong its hold on power. There are unverified reports that the junta is anxious to forge alliances with small and medium-size parties in order to establish a military-backed party to support General Prayut Chan-ocha's hoped-for return as Prime Minister after the elections currently scheduled for February 2019. The constitution was changed in 2017 to increase the seats in the parliament held by medium-sized parties, meaning that the post-election parliament will most likely be fragmented and thus increasing the chances the military can hold onto power in the future. General Chan-ocha has said he will accept a nomination to become Prime Minister after the election if he feels there is enough support behind him. We expect a coalition government backed by the military to dampen the scope for free political expression while boosting populist government spending programmes.

Macro views

Politics	Elections are now expected to be held in February 2019
Economics	Growth has strengthened, led by exports and tourism

Markets

Equities	+1	Improving growth and earnings are positive for stocks
Currencies	+1	The baht will remain strong, buoyed by a large current account surplus
Local rates	0	Low volatility and the strong baht are attracting foreign portfolio inflows

South Africa

	Latest	Next 3–6 months
Inflation yoy%	3.8	Rising to 4.5-5% in near term due to 1pp increase in VAT
GDP growth%	1.5	1.5-2% in 2018

Although President Ramaphosa's honeymoon period is ending, a sharp rise in consumer confidence should sustain the economic recovery through 2018. The FNB/BER Consumer Confidence Index rose to an all-time high in Q1/18 and recorded the biggest quarterly increase since the series began in 1982. It showed confidence rising uniformly across all income and population groups. Current economic data, though, point to an overall slowdown in economic activity from the strong 3.1% qoq figure recorded in Q4/17; weakness in manufacturing and mining is the cause. For the full year we expect growth to be in the range of 1.5-2%, slightly above the government's current 1.5% GDP forecast.

Inflation has continued to ease primarily owing to lower food price inflation. The March CPI fell to 3.8% – its slowest pace in seven years. The combination of less favourable base effects and the impact of a 1pp increase in VAT will push up headline inflation in April to 4.5-5%. Given that core inflation is steady at 4.1%, we expect headline inflation to ease to around 4.5% by yearend. A major uncertainty in the medium-term outlook for inflation is how the stalemate in talks between public-sector unions and the government on a new three-year wage agreement will be resolved. The government has budgeted a 7% rise in public-sector wages in the current fiscal year as well as in the following two years, but the unions are demanding much more than that and growing unrest reflects the volatile nature of labour relations in the country. Containing public-sector expenditures on personnel is essential in order to reduce the budget deficit to the 3.6% of GDP target this fiscal year from last year's 4.3% outcome.

As regards equity and debt markets and the rand, positive news associated with recent political changes have been largely priced in. Nonetheless, we maintain a positive outlook on South African securities. We think valuations are largely immune from current geopolitical risks and for this reason will benefit from portfolio reallocations in the current risk-off investment environment. Further, President Ramaphosa has pushed reforms with a vigour and skill that has surprised us and many other analysts. This was displayed in his ousting of Jacob Zuma and his cronies and his launching of the clean-up of SOEs and key government ministries.

The reform path however is strewn with many significant challenges. Ramaphosa enjoys wide popular support but the rank and file of the ANC will want soon to see an improvement in their living standards as a condition of continued support. Besides more funds for social services and higher wages for civil servants, public enterprises are desperate for debt bailouts in order to avert defaults. In an initiative to boost FDI, Ramaphosa has assembled an impressive task force led by former Finance Minister Trevor Manuel to spearhead new capital inflows.

Macro views

Politics	President Ramaphosa is moving rapidly to establish a reformist political base
Economics	Growth is strengthening, aided by improved consumer confidence

Markets

Equities	+1	Positive owing to the appointment of a reform-minded cabinet
Currencies	+1	Rebound in the rand likely to be sustained
Local rates	+1	Rand carry-trade investments to stimulate capital inflows
Credit	+2(+)1	Attractive relative value following political changes

Turkey

	Latest	Next 3–6 months
Inflation yoy%	10.2	Rising sharply in Q2/18 as FX depreciation pressures prices
GDP growth%	7.4	Slowdown to 4% for year as a whole

With the rate hike done, the lira has for the time being stabilized. The Central Bank last week hiked its late liquidity window rate (the main policy rate) by 75bps. The action, however, was too late to prevent another weakening cycle in the lira; as a result, lira depreciation will now pass through into inflation, which will likely rise once more to near 12% at the end of Q2/18. Higher inflation weakens the case for local rate investments, but the hike will likely keep real interest rates sufficiently high to make those assets attractive relative to EM peers, especially since the lira is clearly oversold on a real effective basis, thereby limiting downside risks. The hike has stabilized the lira; but given the tense political climate and rising dollar strength, the outlook for the lira remains mildly negative over the next three months.

Market attention is now focused on the 24 June elections. Erdogan's decision to call a snap election has surprised markets and will affect the outlook for all Turkish asset classes. The elections will not only decide the makeup of the new parliament but also select Turkey's first "executive President", who will hold almost all executive power for at least the next five years.

The election campaign will likely be tense and we expect the presidential vote to go to a second round. Given the political uncertainty, this is not the time to increase Turkish risk. We found the short-lived rally in the wake of the election announcement perplexing. Turkish politics is highly polarized at the moment, and the election campaign is likely to be divisive. Although President Erdogan will almost certainly win the Presidency, current polling indicates that the race will go to a second round. Moreover, there is a risk of the AKP losing its majority in the parliament (as happened in June 2015), which would lead to political paralysis and the obstruction of any economic reform. In view of these risks, a negative outlook on sovereign credit is warranted over the coming month as the growing economic imbalances seen in the rising current account deficit argue for policy retrenchment. This is despite relatively cheap valuations and relatively low fiscal deficits.

In the context of a broadly more volatile outlook for EM equities, Turkish stocks will likely fair marginally better. As regards fundamentals, the outlook for Turkish equity is very challenging: growth is slowing, credit is tighter and consumer sentiment is being repeatedly damaged by lira-depreciation cycles. However, the last two weeks have seen intensive repositioning on the part of investors amid the perception that equities offer attractive relative value. Equities are therefore likely to be relatively unmoved by the election news, which will likely hit other asset classes. On a relative basis, we think Turkish stocks will outperform other EM equity markets.

Macro views

Politics	Election likely to go to second round, keeping uncertainty high
Economics	Growth slowing in 2018 owing to worsening sectoral imbalances

Markets

Equities	+1(-2)	Despite political uncertainty, equities offer attractive relative value
Currencies	-1(0)	Mildly negative outlook in view of dollar strength
Local rates	+1	Higher inflation is already priced in
Credit	-1	Bonds unattractive in current environment

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