29 July 2019

Economics / Politics / Markets

EM Watch

NOT BOTTOMING OUT

Jon Harrison / EM Team

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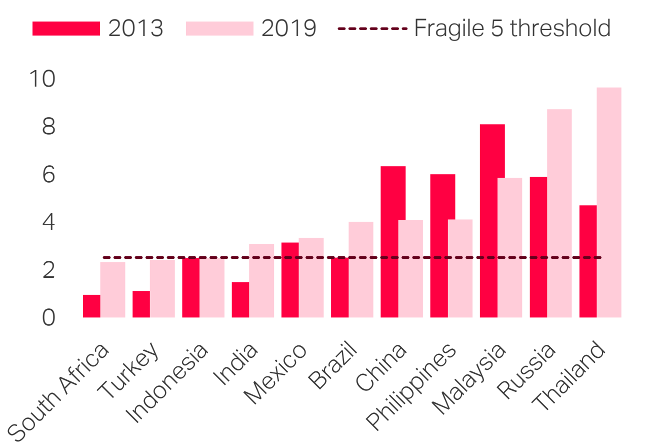
EM resilience indicator



Source: Bloomberg, TS Lombard.

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Global

Trade remains an underlying drag

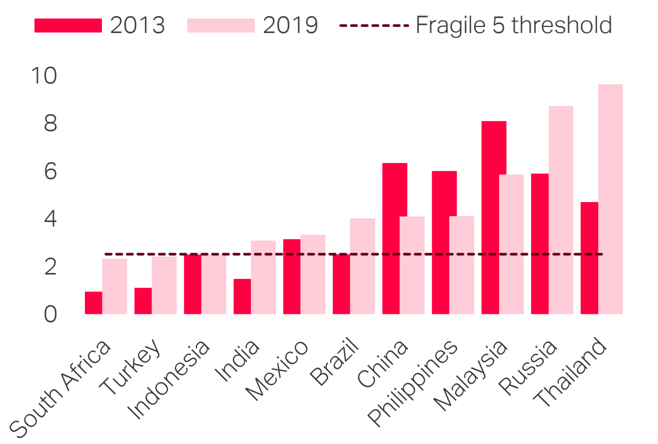
The moderately stronger dollar continues to weigh on EM. This week's FOMC meeting remains the most important short-term driver of EM, but comes against a backdrop of declining world trade that shows few signs of bottoming out.

EM gained on the announcement of new trade talks. Last week's announcement of the first face-to-face talks since May scheduled early this week involving China's Vice Premier Liu He and USTR Robert Lighthizer gave a boost to EM. While the chance of a meaningful breakthrough remains remote, the meeting will likely help facilitate a further easing of tensions and, other things being equal, is positive for emerging market assets. But US monetary and fiscal policy – and its impact on global financial conditions – are likely to be the most important drivers of EM.

A stronger dollar sounds a warning for EM. The dollar continued to edge higher last week creating a drag on EM assets. The trajectory of the dollar in the coming week will, of course, depend on the FOMC meeting, but the prospect of higher Treasury yields following the agreement reached on the debt ceiling adds to the uncertainty of the direction of global financial conditions. We expect the Fed to cut rates by 50bp during Q3 (see our 22 July Daily Note). Our global strategists, however, caution that liquidity has tended to tighten and the dollar strengthen following previous instances of relief from debt ceiling restrictions, although the impact may not be as pronounced as in the past because of Fed easing (see our 24 July Macro Strategy).

Most EM economies and markets are better placed to withstand a stronger dollar and tighter financial conditions than in the past, but some, including South Africa, Turkey, and to a lesser extent Indonesia and India may still be vulnerable if liquidity deteriorates significantly (see Chart 1). Our measure of the resilience of EM economies to tighter financial conditions is derived from an analysis of EM equity performance during the onset of tightening fears during the 2013 taper tantrum. We find that equity market returns in each EM during this period were highly correlated to current account balance and FX reserves/GDP, while other measures, including external debt/GDP, short term debt and fiscal deficit, were less correlated with markets. Our resilience measure uses 75/25 weights for current account and FX reserves.

Chart 1: EM resilience indicator



Source: Bloomberg, TS Lombard.

Chart 2: Thailand: June export growth (%yoy)

(ex-precious metals)	World	ASEAN	China	US	Japan	EU
Total	-9.4	-12.4	-15.2	-1.1	-1.9	-5.1
Machinery (16%)	-13	-21	-16	-13	+7	-6
Electrical (14%)	-8	-9	-17	-2	+1	-23
Vehicles (12%)	+0	-1	-22	+15	+5	+51
Rubber (6%)	-3	-12	-18	+24	+3	-1
Plastics (5%)	-14	-15	-9	-14	-16	-3
%Total exports		25%	10%	11%	10%	8%

Source: CEIC, TS Lombard.

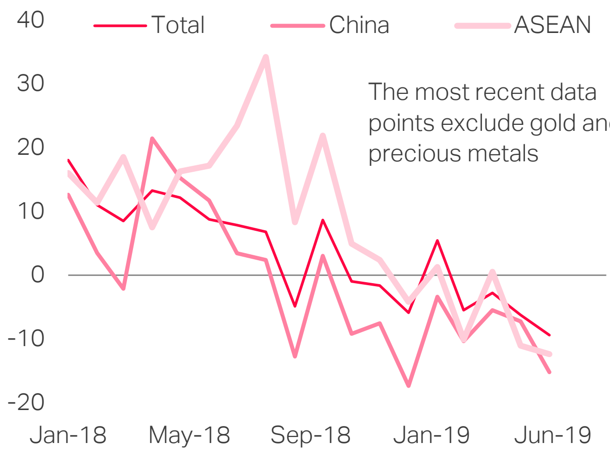
Declining trade shows few signs of bottoming out. We return to our analysis of Thailand's exports as an indicator of the impact of the US-China conflict on the structure of regional trade. The most recent data for June showed a yoy contraction of 2.2% for total exports vs analyst expectations of a 5% contraction. This relatively strong headline number, however, includes an increase in exports of gold and precious metals by more than 120% to around 12% of total exports, much of which went to Switzerland. Removing gold and precious metals from the June export data, as well as from the base month, and focussing on products linked to manufacturing supply chains, paints a significantly worse picture for trade (see Chart 2).

Exports to China are down sharply in all categories of supply chain inputs, while those to ASEAN partners have fared little better. There is continuing evidence of substitution effects, as US imports that may have previously come from China are sourced from elsewhere in order to avoid tariffs. The potential benefits from the trade war to Thailand, and other regional economies, are nonetheless overwhelmed by the overall trend of deteriorating trade. Our analysis of the trade outlook in Malaysia reaches a similar conclusion: the mitigating impact of potential trade war benefits is wearing off, suggesting that further contraction in exports lies ahead (see our 24 July report Malaysia: Recovery delayed).

Base effects offer hope of year on year export improvement. The escalation of the trade war from May last year disrupted supply chains and precipitated a decline in the export of manufactured products to China. The diversion of exports to avoid US tariffs likely contributed to an increase in Thailand's exports to ASEAN economies, but this was quickly overtaken by the overall decline in world trade (see Chart 3). The steep decline in total exports in September 2018 suggests that accelerating year on year contraction becomes increasingly less likely from September this year.

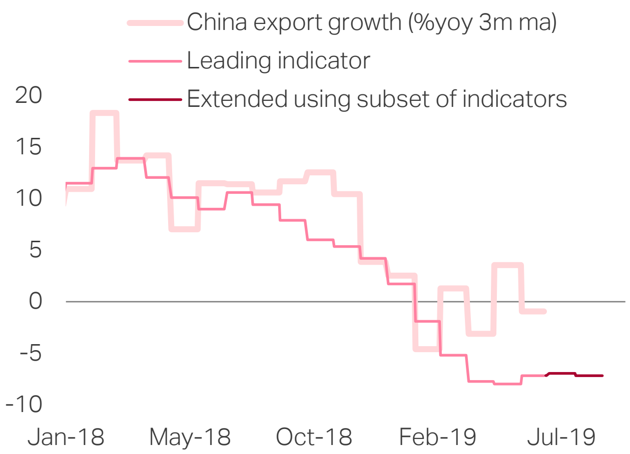
Leading indicators point to stability but no redound yet. Our leading indicator for China's export growth is based on South Korean semiconductor exports and export new orders for China, Singapore, Taiwan and Japan, with lags of 2-3 months. The latest releases of all inputs to the indicator take into account the growing anticipation of an easing of US-China tensions in the run up to the end-June G20 Summit. Despite this greater optimism, there has been little improvement in the predicted contraction of China's exports (see Chart 4).

Chart 3: Thailand export growth ($ %yoy)



Source: CEIC, TS Lombard.

Chart 4: China exports vs leading indicator



Source: Bloomberg, TS Lombard.

Jon Harrison

China

Inventory liquidation to hit growth

Chinese manufacturing faces headwinds in H2/19. PPI weakness will cause inventory liquidation while the trade war has induced unsustainable countercyclical tech inventory build.

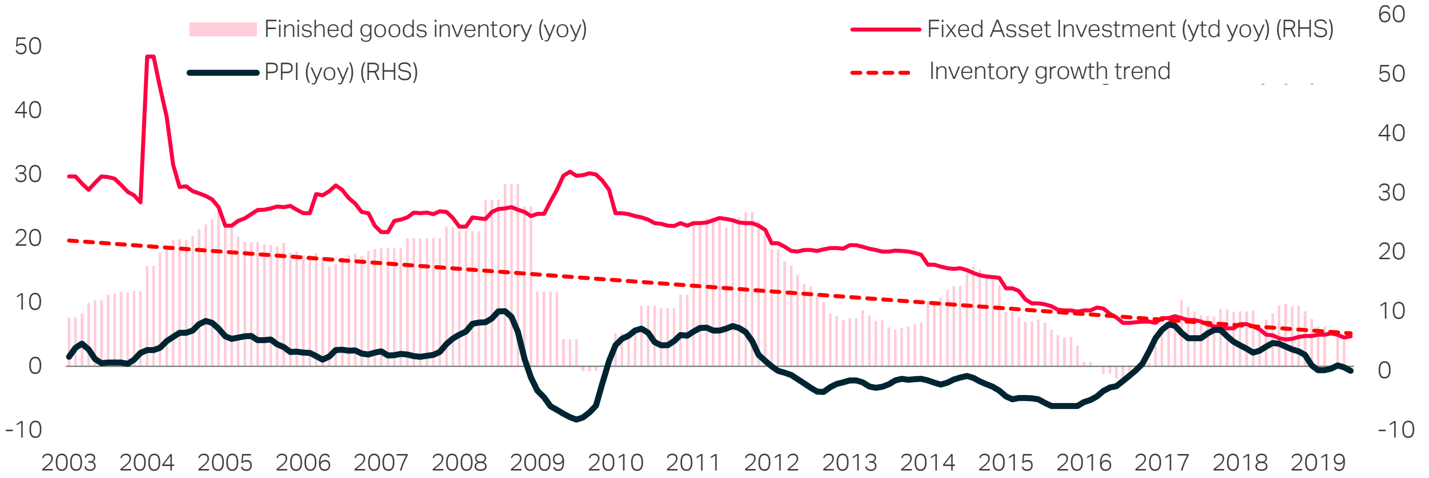
China's inventory growth rate slowed last month to a cycle low of 4.2% YoY. As PPI is set to remain weak through H2/19, inventory growth will continue to decelerate, further sapping already soft industrial production. Thus far, the trade war has had a mixed impact on inventory, but its effect will turn decisively negative in the coming months. Threats to China's tech firms had led to a countercyclical inventory accumulation, while export tariffs caused manufacturers to draw down stockpiles. Given our negative outlook on industrial prices, the unsustainability of a prolonged build-up in tech inventories and the undiminished threat of future tariffs, we expect inventory liquidation over H2/19, which will in turn weigh on industrial activity.

Industrial inventory growth rates in structural decline. As investment contributes progressively less to GDP, commodity production and stockpiling is slowing. Industrial commodities account for approximately 21% of total inventory. This is the key sector determining macro level inventory and output trends in China. While inventory growth is in a long-term downtrend, over the short term it fluctuates around producer price expectations, credit supply and the pace of fixed asset investment (see chart below).

Active inventory building occurs when the outlook for raw material prices is positive and credit conditions are loose. Firms use cheap financing to fund inventory accumulation, essentially betting on future spikes in commodity prices. Neither condition for active stockpiling is present in 2019. We expect PPI to average -0.5% yoy over H2/19. The PBoC is easing monetary policy but not aggressively enough to prompt firms to carry the cost of declining inventory value. An uptick in infrastructure investment is positive for industrial production, but this will be offset by weak property and manufacturing capex. As PPI turns negative and demand remains tepid, producers will draw down inventory and slow output.

China's shift towards consumption makes consumer goods the new driver of inventory growth. Autos and computer, communication and electronic equipment (CCE) now make up a

Structural decline in inventory growth



Sources: TS Lombard, CEIC.

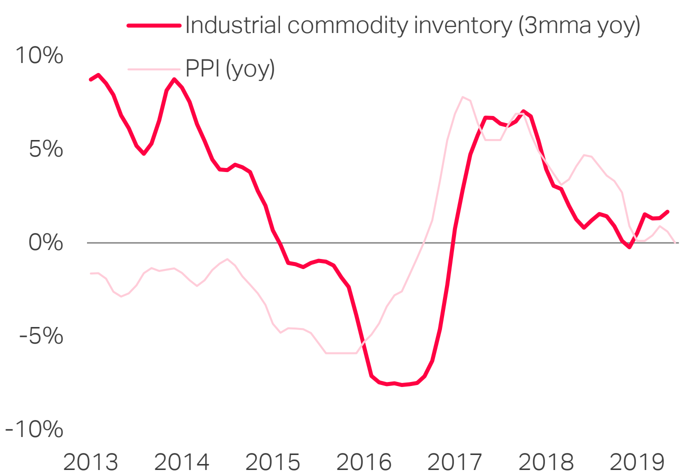
combined 17% of total inventory, a 5pp increase over the past five years. Their respective performance is especially important in 2019 as both sectors are in cyclical decline.

The global consumer technology industry is in retreat. A synchronised contraction in demand predated the trade war, as sales of computers, smartphones and tablets entered a cyclical downturn in Q3/18. Logic dictates that with demand falling and high levels of inventory, firms should liquidate stockpiles and cut production. In China, output is falling but inventory growth continues apace due to Trump's tech war. Sanctions against ZTE in May 2018 were a warning shot to the Chinese technology sector. As US hostility against PRC tech firms grows, companies continue to build inventory buffers against prospective sanctions. Since May 2018 the growth in CCE inventory has diverged from broader trends. Even as CCE sales declined both domestically and abroad, the sector's stockpiling rate was double that of the broader industrial complex (chart below right). Much of the growth comes via overseas purchases. Although the nominal value of Chinese semiconductor imports has fallen, the volume purchased remains near all-time highs, pointing to an active not passive inventory build-up.

The supply chain risk posed by the trade war means Chinese firms must now carry large inventories. Stockpiles will remain high, even if Huawei is removed from the "Entity List". There is a limit to how much they can grow as the cost of stockpiling will dampen corporate profits. Consumer-oriented technology also has a clear product cycle shelf life as preferences can shift unexpectedly. We expect tech demand both at home and abroad to remain subdued until late Q4/19 at the earliest. With little demand to work off inventory, the pace of purchases, stockpiling and production will slow, meaning that manufacturing will weaken. Globally, the countercyclical inventory build-up helped put a floor under electronic component prices. Slower China inventory growth will weigh on semiconductor and related component prices.

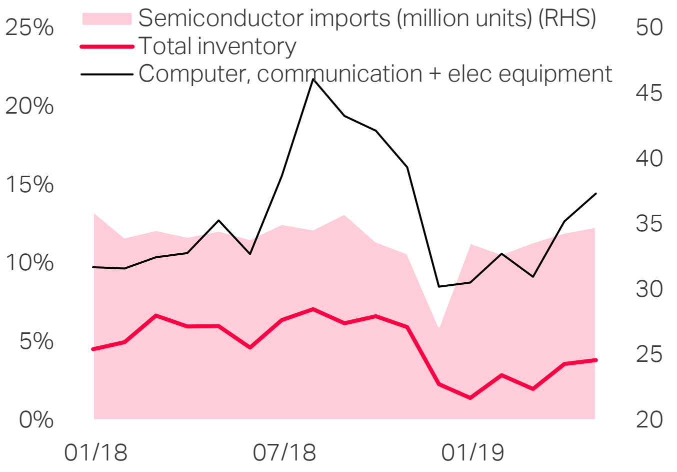
Beyond technology, the trade war's impact on inventory has been negative. Initially, stockpiles of export-orientated products rose as external demand fell. As the trade dispute dragged on, producers began to liquidate inventory rather than restock. Stockpiles of intermediate and finished goods have dropped sharply in response to fears that goods will be stuck in the China market. With domestic and external demand tepid, and the risk of further tariff hikes still looming, producers will continue to draw down inventory, keeping production and orders for raw materials in maintenance mode.

PPI leads inventory cycle



Sources: TS Lombard, CEIC.

Tech inventory divergence (3mma yoy)



Sources: TS Lombard, CEIC.

Rory Green

Brazil

Weak economy weighing on fiscal

The government expects lower revenues owing to weaker economic growth. Government debt levels will remain under pressure over the next year as reforms will only have an economic impact in the medium term, forcing the government to rely on non-recurring revenues this year.

Weaker economic activity will weigh on fiscal revenues this year. The government reduced its GDP growth estimate for 2019 to 0.8% from 1.6%, in line with market expectations, since the much-hoped-for economic recovery did not materialize in H1/19. This will result in a BRL5.3bn reduction in fiscal revenues this year, according to Economy Ministry estimates. Still, the government maintained its primary fiscal deficit target for 2019 at BRL139bn, or 1.9% of GDP. As a result, the Bolsonaro administration will have to further tighten the belt on government spending. The government announced it will block BRL2.3bn more in this year's budget. With the most recent announcement, a total of BRL32bn has been blocked from the 2019 budget. While we expect the government to comply with the fiscal target this year, it will remain heavily dependent on non-recurring revenues in the short term as tax revenues will remain under pressure.

Slow growth is already weighing on fiscal results. Tax revenues totalled BRL757.6bn between January and June, up from BRL714.3bn in the same period of 2018. Although this represents a 1.8% increase in real terms, the growth rate declined sharply when compared to the 6.9% real increase for the same period of last year relative to H1/17, underscoring the impact of the economic slowdown on fiscal revenues throughout the first half of the year. With the government reducing growth forecasts, the fiscal result outlook for 2020 is also more negative owning to the expectation that tax revenues will also disappoint. Recall that the government raised its primary fiscal deficit target in April for next year to BRL124bn, up from BRL110bn before.

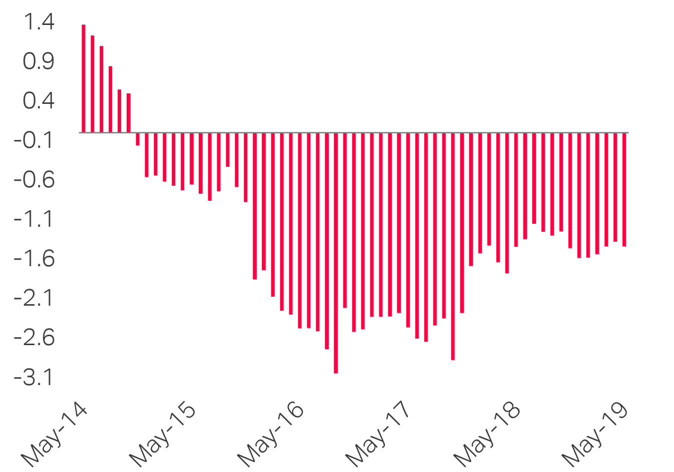
Gross government debt will remain pressured on the upside over the next year. Gross government debt reached 78.7% of GDP in May. Back in January, the Treasury had estimated that the gross debt-to-GDP ratio would climb to 78.2% by the end of this year, up from 77.2% in 2018. But owing to the higher financing needs of the government this year, especially on the back of the lower revenues, the Treasury was forced to raise its estimate once again in June to 80% of GDP, up from its previous revision in April at 79% of GDP. For 2020, the gross debt-to-GDP ratio is expected to rise to 81.3%, up from Treasury's previous estimate at 80.2%. Despite the more pessimistic estimate, the Treasury's longer-term debt estimates are substantially below those of the Senate's Independent Fiscal Institute (IFI).

Although the pension reform cleared its first hurdle in the Congress this month with the approval in a first round vote in the Lower House of a proposal that will result in over BRL900bn in savings over the next decade, the fiscal relief will take longer to be seen in the government debt numbers. Meanwhile, the Bolsonaro administration will focus on the repayments of the BNDES development bank to the Treasury, privatizations and the pre-salt transfer-of-rights mega auction, scheduled to take place on the early November, to help lower the government debt level in the short term.

BNDES repayments and pre-salt auction revenues will provide short-term relief for debt-to-GDP ratio. As has been the case with recent governments, the Bolsonaro administration will rely on non-recurrent revenues to help lower gross debt levels this year. The government requested BRL126bn to be paid back by the BNDES this year, and the bank already repaid roughly BRL44bn. Paying back the remaining BRL82bn is a top priority to the bank, according to the new president of BNDES Gustavo Montezano, and we believe it is very likely to happen. This is because the low rates environment, with the Selic rate falling 775bps since the late 2016, favoured the pre-payment of loans by companies to the BNDES. This is because it became more advantageous for corporates to refinance debt with private banks at the current market rates. This resulted in around BRL40bn being pre-paid to the BNDES since early 2018. This trend will likely be intensified in H2/19 as rate cuts are imminent. This move by companies has boosted the BNDES funds, providing the fuel to move on with paying back funds to the Treasury. The bank's debt with the Treasury currently accounts for about BRL240bn.

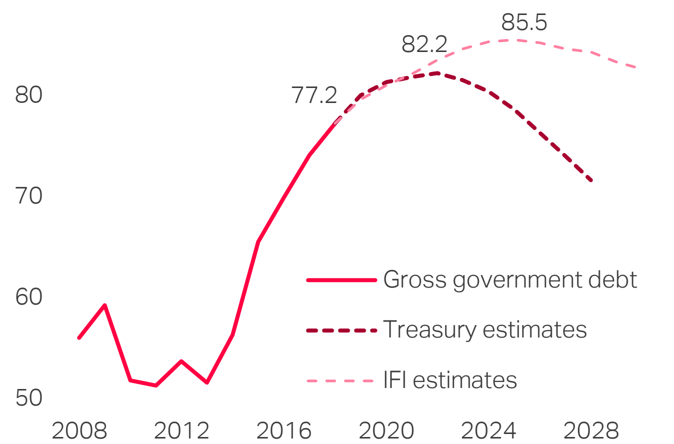
In addition, the pre-salt mega auction is expected to raise up to BRL107bn in November, which will be divided among state-owned oil giant Petrobras, states and the Federal government. Together, these revenues could lower the gross debt level by 1pp this year. The privatization agenda underway will also help lower gross debt level, while non-recurrent revenues from concession programs will help the government comply with the primary deficit target. For this year, the government has a target of BRL77bn in privatizations – of which is has already raised roughly BRL50bn – and expects BRL17.1bn in concession sales, down from BRL21.9bn in 2018. But Privatization Secretary Salim Mattar remains confident that the target could be surpassed, with revenues from privatizations potentially reaching BRL100bn this year alone.

Consolidated primary fiscal result
% of GDP, 12m rolling



Source: Banco Central.

Gross debt level vs forecasts
% of GDP



Sources: Treasury, IFI.

Elizabeth Johnson / Wilson Ferrarezi

India

Fiscal credibility increasingly under question

Latest reports that the Comptroller and Auditor General (CAG) estimates the central fiscal deficit to be far higher than government estimates add to concerns over the credibility of the budget numbers that have been raised from other quarters – including a member of the Prime Minister's Economic Advisory Council and a former top central banker.

India's CAG, who audits governments at all tiers, said that the central government's fiscal deficit works out to be 5.9% of GDP in FY19 vs the 3.5% reported by the Finance Ministry. A 25 July report by *The Economic Times* said that the CAG had questioned the government three days after the 5 July presentation on whether the extra-budgetary resources in the budget were correctly accounted for.

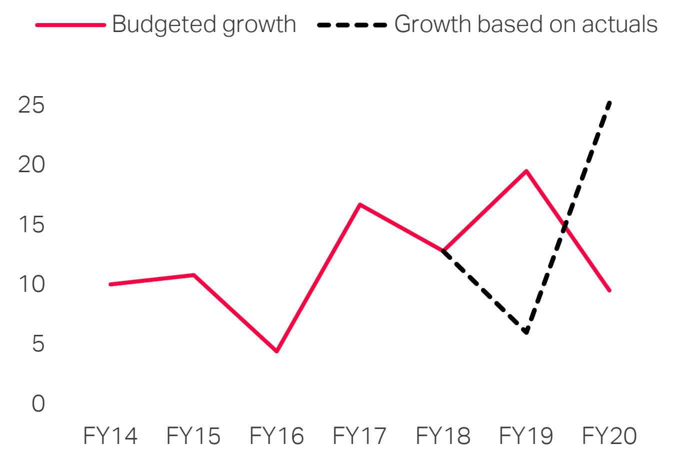
Table 1: Fiscal deficit components (% of GDP)

Revenue deficit	2.59
Fiscal deficit	3.46
Off-budget borrowings for revenue spending	0.96
Off-budget borrowings for capital spending	1.43
Revenue deficit (with off-budget borrowings)	3.48
Fiscal deficit (with off-budget borrowings)	5.85

Source: CAG presentation as quoted in *The Economic Times*

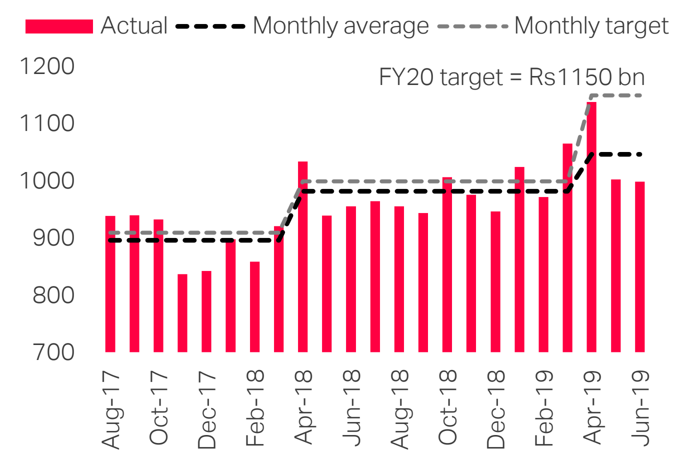
The CAG is one among many quarters questioning the budget nubers. As my colleague Amitabh Dubey pointed out in his 22 July report A turbulent second innings, Rathin Roy, a member of the Prime Minister's Economic Advisory Council, said that the government's tax forecast in its FY20 budget is unrealistic, and as a result it will have to borrow more or spend less. We had also shown in our 8 July report Budget in Charts: Fiscal targets are questionable that the Finance Minister's tax revenue assumptions were based on old estimates, not the actuals reported. As a result, the estimated growth for FY20 is extremely ambitious. GST monthly revenues, too, continue to fall below target.

Chart 1: Growth in net tax revenue (%)



Sources: Controller General of Accounts, budget documents.

Chart 2: GST monthly revenues (Rs bn)



Sources: Ministry of Finance, Press Information Bureau.

Former RBI Deputy Governor Viral Acharya has suggested that India's fiscal deficit could be as high as 8-9% of GDP if borrowings at all levels of government as well as those by state-run firms are taken into account. The outspoken Acharya left the central bank last week, six months prior to the end of his term. He had stated in a November 2018 speech that was made public only this month that higher government borrowings not only crowds out the private sector but "it can also induce the private sector to borrow more short-term", thereby increasing financial fragility. He said that a rise in government borrowings in 2H/2017 could have contributed to the asset-liability mismatch that the shadow banks have been facing since last year, which in turn has contributed to the credit crunch. (For more details on the latest developments in the banking sector, see our 25 July report Bank reforms within political limits.)

The questions over the government's fiscal credibility come at a time when India is planning to issue its first overseas bond (for more on this, see our Strategy section below). The proposal has been opposed by many economists and former central bankers who are wary of its potentially destabilizing effect on macroeconomic balances. However, Finance Minister Nirmala Sitharaman who needs to raise resources on the cheap appears intent on raising up to US$10 bn from the overseas market.

Shumita Deveshwar

Russia

The CBR's cautious easing explained

Last Friday's 25bps cut in the CBR's policy rate to 7.25% is predicated on fiscal stimulus kicking in by year-end. Such growth expectations may be disappointed. The underlying reason for CBR caution is pending government policy decisions on pension investments and NWF spending.

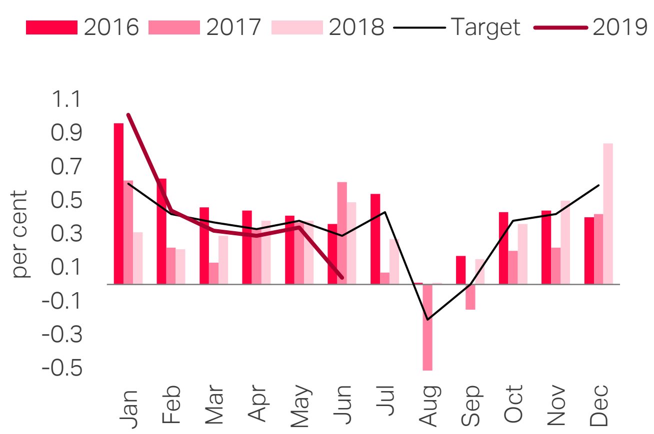
The CBR's 'communication' had formed solid market consensus expectations for a 25bps rate cut that it duly delivered last Friday, but a different kind of surprise may lie in store. While acknowledging that growth had undershot its forecast, the accompanying press release indicated that the economy will perform better in H2 on the back of the pent-up fiscal spending on the national projects. We think the outturn may disappoint – and that the CBR will therefore have proved over cautious in this easing cycle.

There was no change to the advertised rates outlook: another cut is signalled "at an upcoming meeting" (formally, that means at one of the next three meetings, but in our view the next 25bps cut will come straight away at the very next meeting in September). And the shift to a "neutral" monetary stance – bringing the policy rate below 7%, hence the real rate into the 2-3% range with core inflation set to be at the 4% target – is programmed "during H1/20". That wording was slightly easier than the "in mid-2020" formulation in the press release after the previous rate cut on 14 June. Yet there is no mistaking the habitual underlying caution.

The CBR's cautious bias is asymmetric: we will not see now anything like last year's prompt CBR reaction to renewed (sanctions-driven) inflationary pressure showing up in pre-emptive rate hikes. The CBR will wait to gauge the stimulatory the effect of the expected late-year budgetary splurge – but it may well be kept waiting beyond year-end. The time needed to get infrastructure projects "shovel-ready" may well delay this effect. As for private investment, many projects will likely be kept on hold pending the enactment of legislation designed to shelter capex projects from future tax and regulatory changes. Far from being submitted to the Duma and passed in the (now finished) spring parliamentary session, this draft law remains stuck in the government.

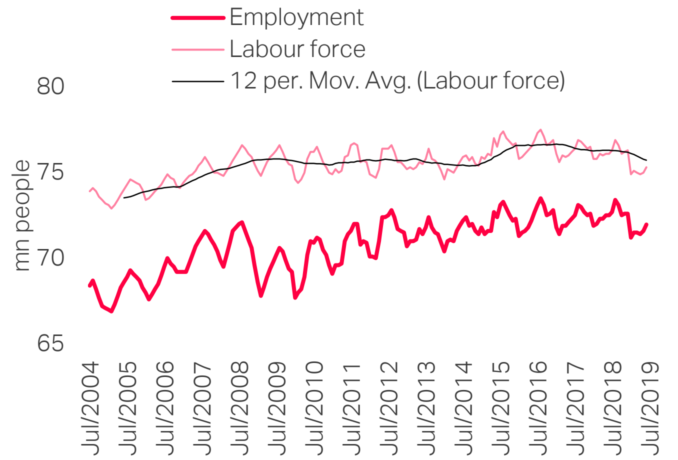
The growth outlook is gloomy. As we highlighted in an edition of EM Watch earlier this month, the Q2 real GDP outturn – due out from Rosstat in mid-August – has every chance of showing a

MoM CPI vs target run rate



Source: CBR, TS Lombard

Tight labour market



Source: Rosstat

second straight QoQ decline. Prospects of bouncing back from this possible technical recession could be paradoxically dimmed by DM central banks easing faster than the CBR. For this would tend to sustain the ruble's REER appreciation, which already reached 5.8% in H1 according to CBR estimates. Any boost to growth from easier global financial conditions and stronger external demand will only be felt in slower time.

Why then is the CBR so persistently cautious – despite the CPI's run rate showng inflation trending comfortably below its 4% target (left-hand chart above)? A structural reason is simply that easing is hazardous in the teeth of such a tight labour market – with unemployment beating record lows with each passing month (right-hand chart above). In addition, the CBR is concerned about the inflationary effect of the expected national project spending.

The most powerful considerations now holding back the CBR, however, have to do with pending policy decisions on pension investments and NWF spending. Latest indications are that the crucial 'individual pension capital' reform may take the form of a purely voluntary scheme (as opposed to automatic enrolment of employees with an opt-out provision). In that case, the reform won't be sufficient to support an adequate savings rate and the resultant stronger household consumption will increase structural inflationary pressure. It's no wonder then that the CBR is advocating delaying this reform by another year (until 2021) rather than launching it now in such a form.

As for the mooted spending of the liquid balance of the National Welfare Fund in excess of 7% of GDP, this will still boost aggregate demand even it the spending is confined – as the government now seems to have in mind – to providing lines of export credit. The effect would be the same as a stronger world economy/higher commodity prices, only now the source would be the Russian federal budget reserves. This would force the CBR into a marginally tighter monetary stance than would otherwise have been the case. And given the monetary policy lag of 9-18 months, any such policy adjustment would have to be made a year before the government's advertised timeline of 2021 for implementing decisions on NWF spending.

The CBR aims to balance its caution on rate cuts with the easing effect of other shorter-term measures. Top of the list here is its communication policy, which itself makes monetary conditions easier as cuts are priced by the market ahead of the actual decisions. A second channelthrough which monetary policy will work in the near term is the banking sector liquidity situation. With the federal budget still for now continuing to absorb more funds than it returns to banks (and, as discussed above, the expected reversal of this picture is likely to take longer than expected), the CBR will reduce the volumes of liquidity absorption through its own bond issuance. However, this would not be a source of easing as such, but merely neutralize the negative effect of the fiscal side.

The outlook for the ruble exchange rate looks balanced. As already mentioned, faster monetary easing by the Fed and other DM central banks would support the ruble, but this effect may be offset by the sharp deterioration in the current account on the back of lower price and volumes of oil & gas exports – a trend set to continue into Q3. An upside surprise for the ruble may come from the possibility of political compromises with Ukraine that would reduce the Russian geopolitical risk premium. On the other hand, the sanctions threat from the US Congress persists.

Christopher Granville / Madina Khrustaleva

Thailand

No export recovery in Q3/19

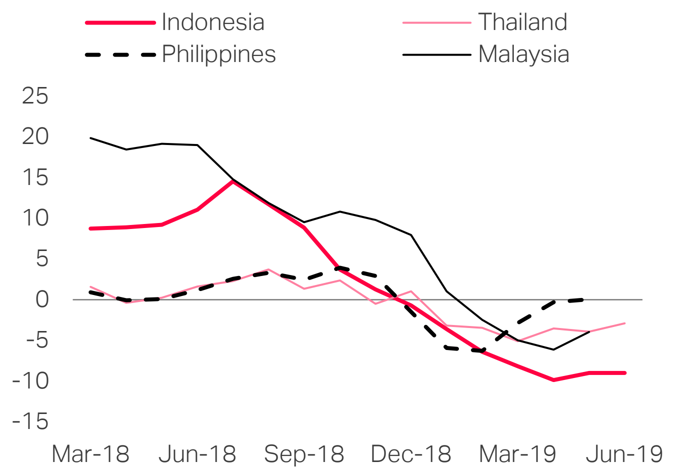
Exports continue to decline on the back of the trade war, the strong baht and slowing global growth. But the surge in gold shipments somewhat masked the extent of the contraction. Although Thailand's PMI data point to a potential export recovery, we expect exports to continue to contract in Q3/19.

Customs-cleared exports fell 2.1% yoy in June compared with a 6.2% decline in May. When adjusted for large shipments of arms to the US in February, the June data mark the eighth consecutive month of yoy contraction. Negative export growth has become familiar in the countries of the region on the back of the US-China trade war and slowing global growth (see Chart 1 below). The fall last month was led by a broad range of products, including oil-related goods (-22% yoy), electronics (-11.7% yoy) and agricultural and agro-industrial goods (-9.0%). The decline in shipments of the last one can be attributed to the strong baht (see Chart 2 below) as these products are price-sensitive. Shipments of gold, which rose 317.4% yoy last month, have propped up the June export number; if excluded, overall exports dropped by 8.7% yoy.

Shipments to all major markets declined (see Chart 3 below). Exports to China declined 14.9% yoy vs the 7.3% contraction the previous month primarily owing to lower sales of intermediate goods that would normally be reprocessed by Chinese firms for further export to the US, mainly electrical and electronic goods (E&E), rubber products and machinery. Meanwhile, shipment to the US declined 2.1% yoy vs.7.6% yoy increase in May. This was on the back of weaker shipments of plastics, electrical machinery and iron and steel. However, US substitute demand for rubber and rubber products and vehicles & parts provided support. Exports to India (3.2% of total exports) recorded positive growth driven by surging shipments in "pearl, precious stones and metals" category (up 411% yoy; gold, which is included in this category, rose only 25.4% yoy).

Imports fell more than exports, resulting in a significantly larger trade surplus (see Chart 4 below). The 9.4% yoy decline was steeper than consensus and driven by falling demand for capital goods (-12% yoy) and fuel lubricants (-19.5% yoy). The trade surplus came in at US$3.2bn vs US$181mn in the previous month.

Chart 1: Regional export growth (3mm, % yoy)



Sources: CEIC, TS Lombard.

Chart 2: US$ vs THB

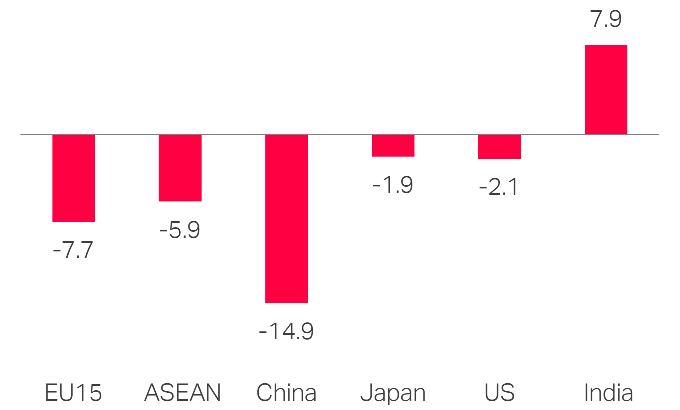
Sources: Bloomberg, TS Lombard.

We expect exports in Q3/18 to remain soft. The baht has appreciated 5% vs the US dollar so far this year. Because the strong currency is threating the country's competitiveness, BoT has decided to limit THB holdings by foreigners. Accounts held by non-residents are capped at THB200mn as of 22 July. This, however, has had a limited impact to date on the currency, which has softened only marginally (see Chart 2 above). We think that as long as BoT remains reluctant to cut rates, the baht will continue to be relatively strong.

Thailand's manufacturing PMI in June showed that new export orders grew at the second-strongest pace on record, which gives hope of improvement in the export sector. But because Thailand is integrated into regional supply chains, the regional trade in general will need to improve for Thai shipments to start to meaningfully recover. The PMI's new export orders in other countries in the region provide a mixed picture and the leading indicators that we follow (see the Global section) suggest that regional exports will bottom out in Q3/19.

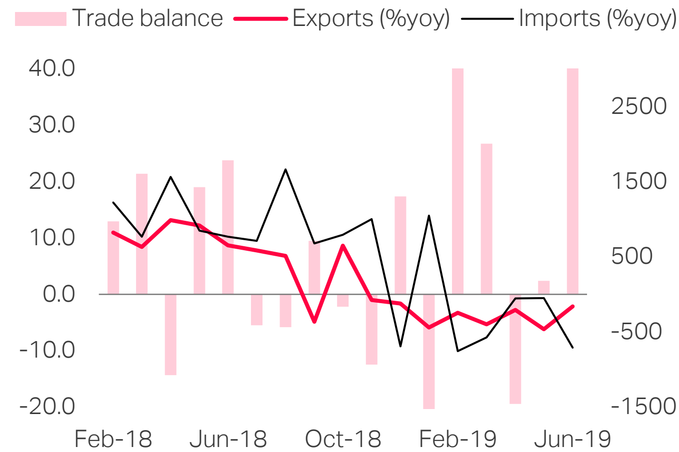
Chart 3: Export growth by destination markets

% yoy



Sources: CEIC, TS Lombard.

Chart 4: Foreign trade



Sources: CEIC, TS Lombard.

Krzysztof Halladin

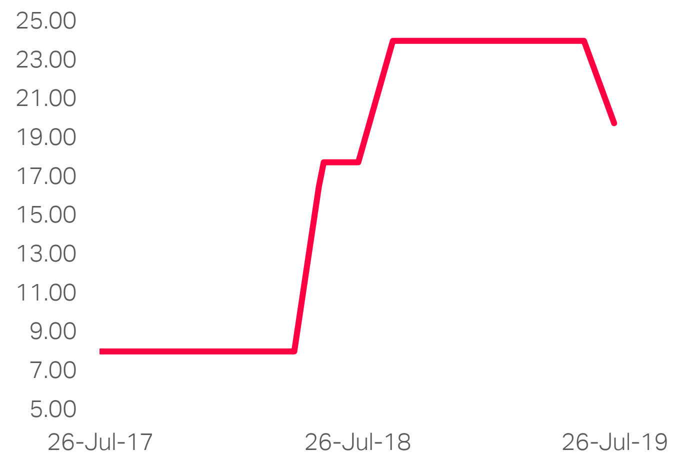
Turkey

Stagnant growth, not Erdogan, is mainly responsible for the large rate cut

The Central Bank eased its policy rate substantially last Thursday; further, though smaller, cuts are likely by yearend. Owing to continuing economic stagnation we expect another 300-400bps of cuts by December, bringing the one-week policy repo rate to around 16%.

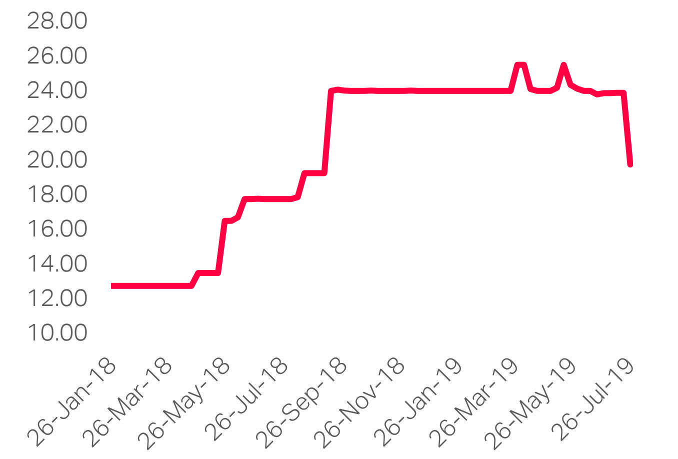
Turkey's new central bank governor kicked off his term last Thursday with a sizeable 425bps cut in the one-week policy repo rate. Although the Bloomberg consensus was forecasting only a 250bps cut, we were not surprised by the move nor do we view the cut as excessive. Former Governor Cetinkaya would have opted for a large cut in the policy rate, maybe not quite as large but a significant one, nonetheless. What worries analysts is that President Erdogan's direct intervention in monetary policy will undermine the lira and precipitate another monetary crisis. That is likely to come eventually, but the recent cut is really just a recognition that the economy is stuck in recession and inflation is therefore easing rapidly. The rate cut had little impact on the lira most likely because of support from state-owned banks; the lira rose slightly to TRY5.66/US$ from TRY5.71/US$ at the open on Thursday and continued range trading was evident on Friday. With consumer price inflation having fallen 300bps in June and another smaller drop likely in July (figures to be released on 5 August), implied short-term real rates are still relatively high, around 4-4.50%.

One-week policy repo rate, in %



Source: CBRT

Weighted ave cost of CBRT bank funding, in %

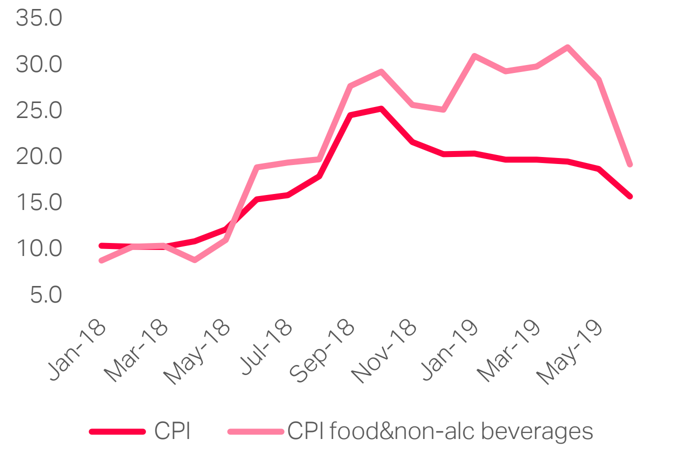


Source: CBRT

The real test of Murat Uysal, the new governor, will come beginning in September when positive base effects on the CPI will have eased substantially. Recent strong deflationary trends reflect two primary forces: the sharp drop in food prices and continued recessionary trends in economic activity. As is shown in the left-hand chart below, food price inflation shot up early this year well above overall inflation, because of both adverse weather conditions and the sharp depreciation in the lira during Q3/18. Food price inflation has now reverted much closer to the overall trend in consumer inflation and may even trend down further, below the aggregate CPI.

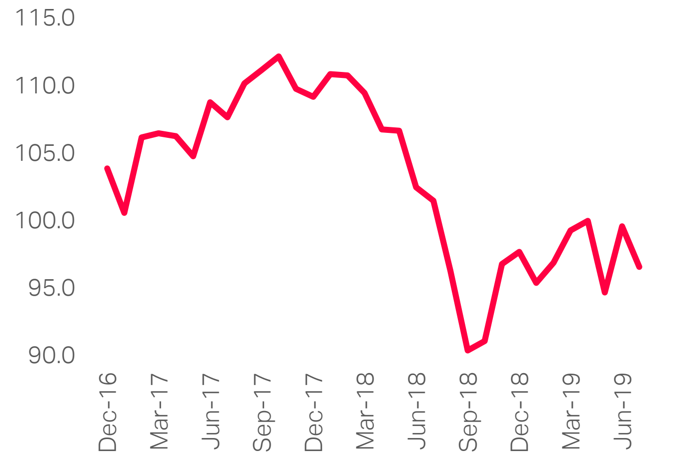
Meanwhile, there are few signs of a sustained recovery in economic activity. Manufacturer confidence, which has mirrored the overall trend in economic activity, has been stuck in the 95-100 range since last November. The latest June reading reflected a 3-point drop from the previous month; a sustained improving trend is not as yet evident (see right-hand chart below). We do not expect easier monetary policy to have much effect on reviving economic growth because the government is busy tightening fiscal policy to shore up fiscal performance, given massive pre-election spending. Further, the massive liquidity squeeze that we highlighted in last week's EM Watch will keep economic growth in negative territory through the end of the year. This is likely to create conditions for further declines in inflation and additional cuts in the CBRT's policy rate. We forecast CPI inflation of 12-13% at yearend along with a one-week policy repo rate of 16%. As always, new policy interventions from President Erdogan cannot be ruled out, so those investors contemplating short-term local rate plays should be wary.

CPI, yoy change in %



Source: Turkstat

Manufacturer confidence, diffusion index, sa



Source: Turkstat

Larry Brainard

Strategy

India: 10yr USD bond spread 90-110bp

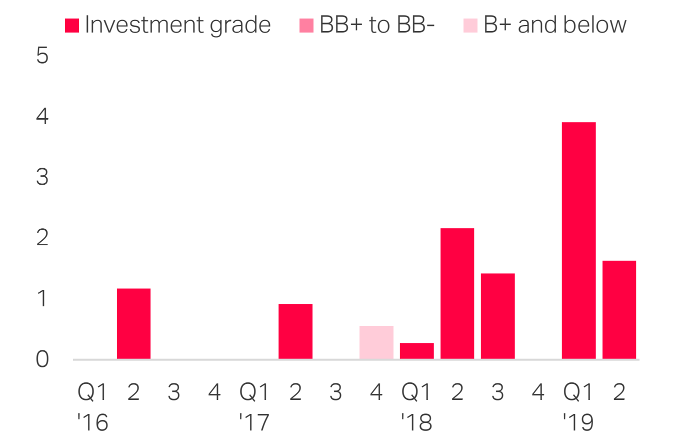
India's announcement of an intention to issue foreign currency debt was welcomed by the market. The currency, maturity and size of the bond, or indeed, if it will go ahead at all, remain uncertain. Our assessment of India's EM sovereign credit peers based on both credit rating and fundamentals suggests that a 10 year dollar bond could trade at a spread around 90-110bp.

India's announcement of an intention to issue foreign currency was welcomed by the market. The budget presentation earlier this month contained much of what we had expect in terms of spending plans, and much of what we had feared in terms of revenue assumptions (see our 8 July Budget in Charts). The announcement of a plan to issue as much as $10bn in foreign currency debt, however, was a surprise to the market. Local currency bond investors greeting the move enthusiastically, concluding that there may be less local debt issuance than expected, while global EM foreign currency investors welcomed the prospect of an opportunity to diversify their exposure to a new large EM sovereign issuer.

The bond sale may not go ahead. The government is currently in the planning stage with a view to issuing the new debt in October. The move has attracted criticism from former central bankers highlighting the increased debt management risk that comes with issuing in a foreign currency, and has also exposed fault lines among the stakeholders in the administration (see our 22 July report India: A turbulent second innings). Significant voices in the ideological parent organisation of the ruling BJP are opposed to increasing the economy's exposure to foreign investor portfolio flows. Over the weekend, Finance Minister Sitharaman rejected calls to reassess the plan, although it remains possible that the bond sale may not go ahead at all.

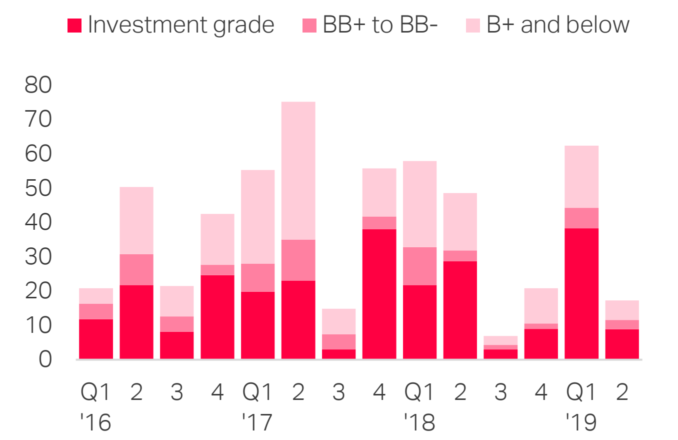
The currency, size and maturity are uncertain. In an effort to reduce the borrowing cost, the government is considering issuing in yen. The total issuance of Samurai bonds this year is $11bn; of which $5bn is EM sovereign credit (see Chart 1). Mexico, Malaysia and Indonesia have issued JPY debt this year, each around $1.5bn, while Philippines is planning a $1bn Samurai issue. It is unlikely that in such a small market India will be able to issue as much as $10bn in JPY debt at one time. The dollar market is more readily able to absorb a benchmark size issue from India (see Chart 2). Indeed, there could well be a pick in EM USD issuance following a weak Q2.

Chart 1: EM JPY sovereign debt issuance ($bn)



Source: Bloomberg, TS Lombard.

Chart 2: EM USD sovereign debt issuance ($bn)



Source: Bloomberg, TS Lombard.

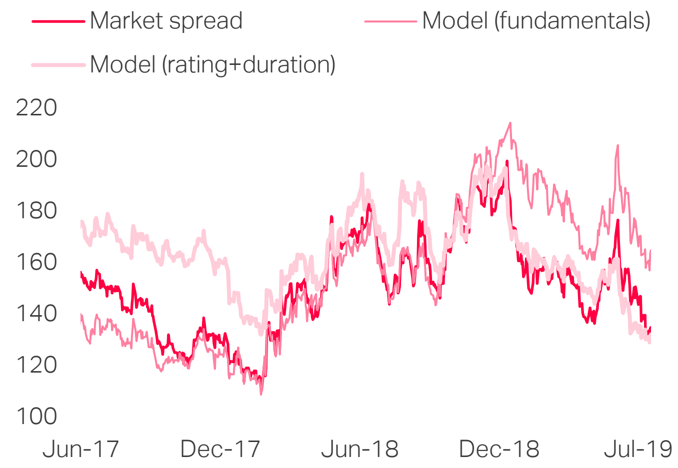
The decisions surrounding the bond issue will require compromise. A yen denominated Indian sovereign bond will certainly generate some interest among EM investors. Other EM issuers have found, however, that bond issuance in meaningful size in the Samurai market has had to be distributed over time and across multiple maturities. Investors will demand a liquidity premium for small size issues, raising the cost of borrowing. By contrast, a dollar bond would be at a structurally higher yield, but would take fewer auctions or placements to achieve the targeted $10bn, and would be easily tradable by investors. A liquid sovereign bond issue would act as a benchmark for other issuers helping to facilitate lower borrowing costs for companies. We consider a hypothetical 10 year Indian sovereign bond denominated in dollars.

Indonesia appears the most comparable EM sovereign credit. One indication of the price of Indian sovereign credit risk can be obtained from the small amount dollar debt of the SOEs that issue internationally, including: State Bank of India, Export-Import Bank of India, Bharat Petroleum Corporation and Indian Railway Finance Corporation. The bonds of these entities trade at spreads between 130bp and 160bp over the US Treasury curve. The sovereign credit will likely trade a premium to these. Indonesia appears the most comparable among India's EM sovereign credit peers. Indonesia has a similar credit rating at BBB vs India's split BBB-/BBB. Indonesia is a similarly closed economy and is an oil importer like India. Both are towards the low end among global EM economies in terms GDP/capita. Furthermore, the current account dynamics in both can mean that their financial markets are relatively sensitive to global financial conditions.

Indonesian credit is trading in line with credit rating (see Chart 3) at around 125bp (OAS spread for the Bloomberg Barclays index), while on the same measure the 10 year Indonesian USD bond is at 110bp. Indonesia is trading at a premium of around 30bp to our fundamental sovereign credit model, which takes as inputs: GDP/capita, budget balance, external debt/GDP and inflation (see our credit methodology).

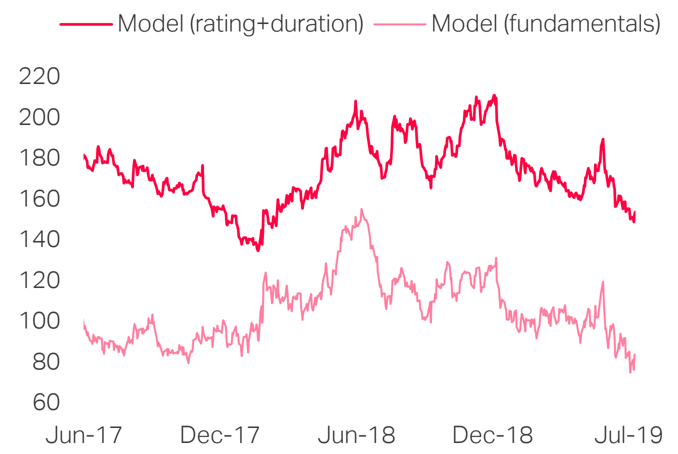
India is likely to trade at a premium to the spread implied by its credit rating. India scores well in the important fundamental drivers of credit spread, including external debt to GDP and CPI. Our models suggest a fundamental-based spread of 80bp and a spread based on credit rating of 150bp (see Chart 4). There will be strong demand for the debt of an important new EM sovereign credit issuer suggesting that it will likely trade closer to fundamentals than to credit rating. Based on current market conditions, we estimate a spread of 90-110bp for Indian 10 year dollar debt, slightly richer than comparable Indonesian debt (see Charts 5 and 6).

Chart 3: Indonesia: Sovereign credit vs model



Source: Bloomberg, TS Lombard

Chart 4: India: Sovereign credit model spread



Source: Bloomberg, TS Lombard.

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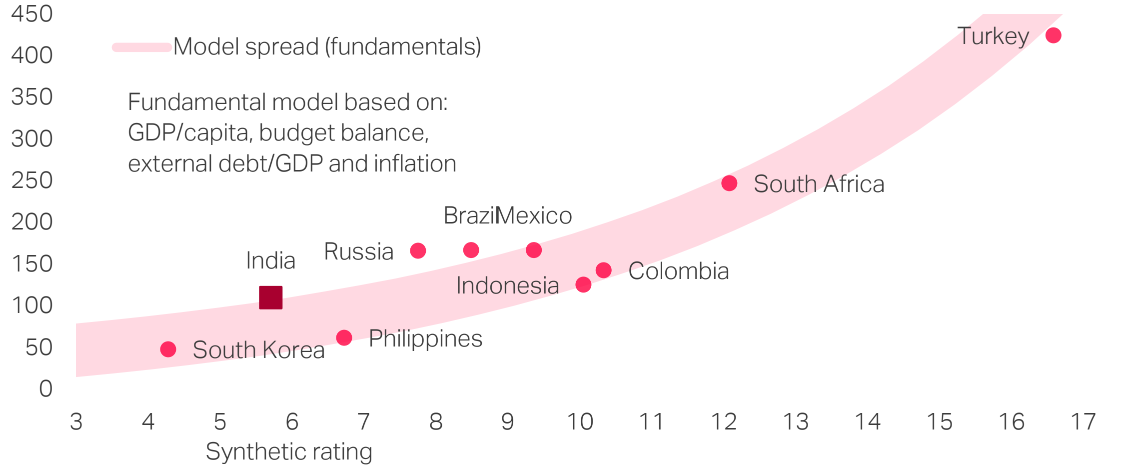
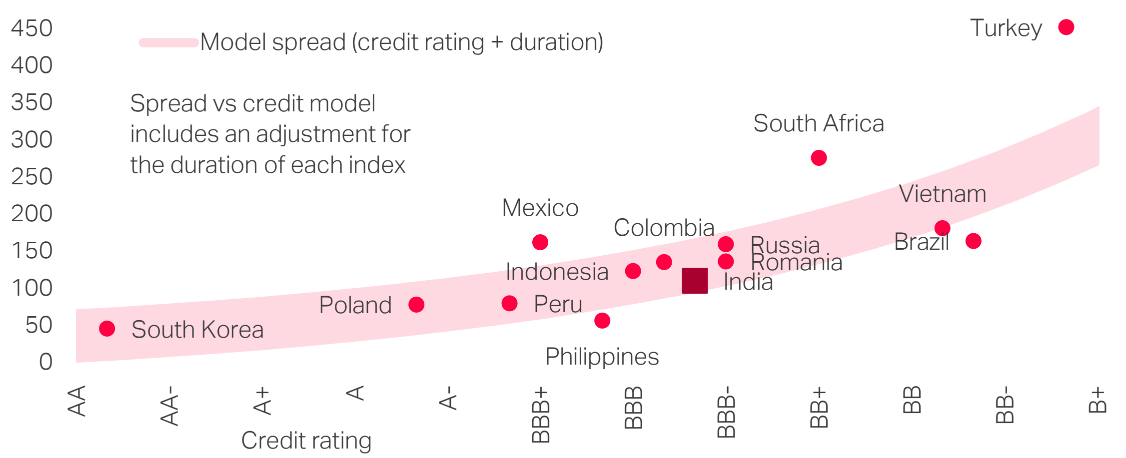
Fiscal credibility is increasingly under fire (see India section). On a note of caution, however, in addition to the uncertain external environment, the deteriorating fiscal credibility of the government could raise concerns among some investors about foreign currency borrowing. Fiscal worries may have a small detrimental impact on the issue spread, but are unlikely to moderate the overall investor enthusiasm for what would be an important new issuer in the EM sovereign credit space.

Chart 5: EM sovereign credit spread vs fundamental model



Source: Bloomberg, TS Lombard.

Chart 6: EM sovereign credit spread vs credit rating



Source: Bloomberg, TS Lombard.

Jon Harrison

Must Read

India: A recipe for unpredictable policymaking

The second Modi government had a shaky start after the newly appointed Finance Minister Nirmala Sitharaman presented her first budget earlier this month. Amitabh Dubey explains that the gap between professional economists and the Modi government has widened, while Hindu nationalist activists now have a seat at the table, along with business and bureaucrats. The interplay of these various interest groups makes for unpredictable policymaking. See our 22 July India: A turbulent second innings.

Brazil: Next on the agenda: Tax reform

Now that the pension reform hurdle has been nearly cleared, politicians in Brasilia are seeking to move ahead with tax reform. Elizabeth Johnson and Wilson Ferrarezi explain that the primary goal is to simplify the byzantine tax system and thereby boost productivity, not to lower the tax burden. Despite the complexity of tax reform, positive momentum means that its approval is a real possibility. See our 24 July report Brazil: Tax reform on centre stage.

Malaysia: No strong recovery

Trade and industrial production data point to stronger growth in Q2/19. Krzysztof Halladin warns, however, that because of weak exports and the government's fiscal consolidation agenda, we do not expect the recovery to continue in H2/19. We expect Malaysian equites to underperform other EMs on average in H2/19. See our 24 July report Malaysia: Recovery delayed.

India: Banking reforms are not yet enough

Finance Minister Nirmala Sitharaman announced plans to inject more capital into state banks allowing them to direct some funds towards loan growth rather than just protecting their balance sheets. Shumita Deveshwar warns that masked fiscal laxity is likely impeding a broad-based credit revival, while confidence of improved governance at state banks is still lacking. See our 25 July report India: Bank reforms within political limits.

Brazil: Rate cuts to follow pension reform

The approval of pension reform will improve sentiment, but the economic impact will not be felt until 2020. Wilson Ferrarezi explains that the same applies to monetary stimulus: although Banco Central is set to cut rates this month, only next year will it begin to have any effect. See our 26 July report Brazil: Economy gets a shot in the arm.

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Asset Allocation

We present below our EM asset allocation views, which are updated once per month, most recently in our 2 July EM Strategy Monthly.

We will publish our next Asset Allocation in our EM Strategy Monthly on 1 August.

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	+1 (-1)			
Asset class	+1 (-1)	-1	+1	0
Relative country views				
China	+1 (-1)	0 (-1)	-1	n/a
Brazil	+1	+1	+1	0 (+1)
India	-1	-1	-1	n/a
Russia	+1 (+2)	+1	+1	+1
Mexico	-1	-1	+1	+1
Indonesia	+1	0 (+1)	+1 (0)	-1
Philippines	0 (+1)	-1	-1 (+1)	-1
Thailand	-1	+1	-1	n/a
South Africa	0	+1	+1 (0)	-1 (0)
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
Brazil	Local debt	Long	7-Jan-19	%	7.68	6.11	+7.4%
Russia	Local debt	Long	3-Jun-19	%	7.61	7.03	+7.2%

Date/time 29-Jul-19 07:48

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	2,115.0	2,055.5	+5.3%
Mexico	Sovereign credit	Long	12-Jun-17	8-Jul-19	149	167	+1.4%
Indonesia	Equity	Long	3-Jun-19	8-Jul-19	0.4948	0.5197	+5.0%

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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