EM Watch

TROUBLE AHEAD

Jon Harrison / EM Team

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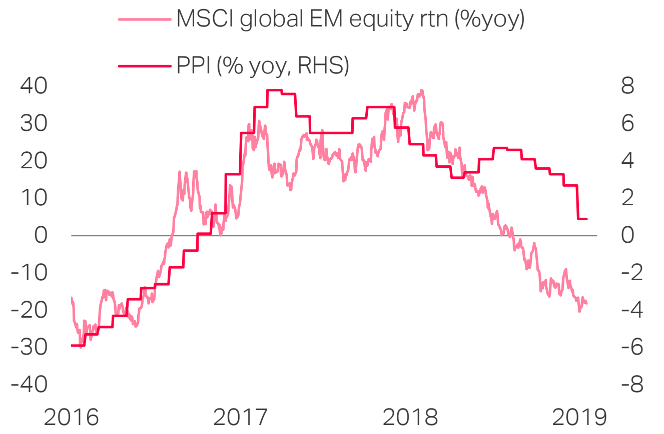

Source: Bloomberg, TS Lombard.

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Global

China threat to outweigh positive EM drivers

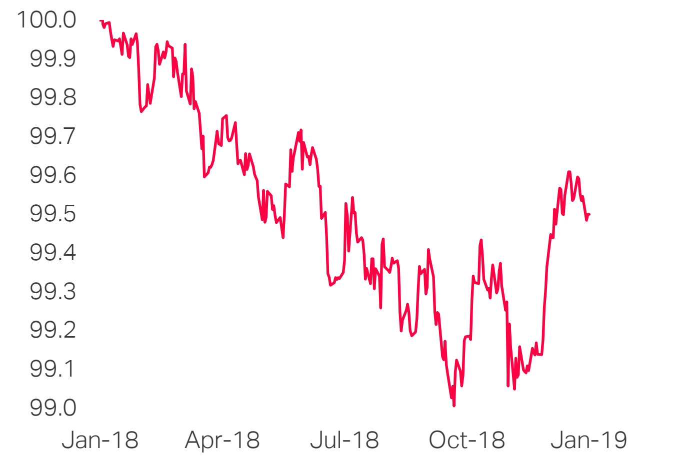
The moderation of dollar strength, helped by the easing of US-China tensions, will support EM FX and likely has further to run, although the oil price bounce remains a risk to oil importers. But the threat to EM from China is likely to grow as stimulus measures become more urgent.

The currencies of EM oil importers were among the worst performing last week even as the oil recovery showed signs of moderating. The currencies of oil importers, including the rupee and rupiah, are likely to remain among the most sensitive to oil prices. If we are correct that the oil bounce will remain fragile, then the damage to EM economies and markets from this source at least should be relatively limited. Indeed, the uncertain outlook for global growth makes it unlikely that there will be a return to the threat of $100 oil. Furthermore, the oil price bounce has had limited impact on the overall picture for terms of trade in EM economies, which remains more supportive for currencies than for much of the second half of last year (see Chart 1).

Favourable liquidity conditions continue to underpin EM. The dollar strengthened significantly last year owing to both the prospect of higher US interest rates and the escalating US-China trade conflict. The impact of both of these factors is now receding. EM currencies are always likely to be higher beta vs the dollar than their DM counterparts, but it was the intensification of the Trade War from mid-2018 that triggered a more severe divergence between EM FX and majors. Trade War related risk aversion weighs far more heavily on EM than on DM (see Chart 2).

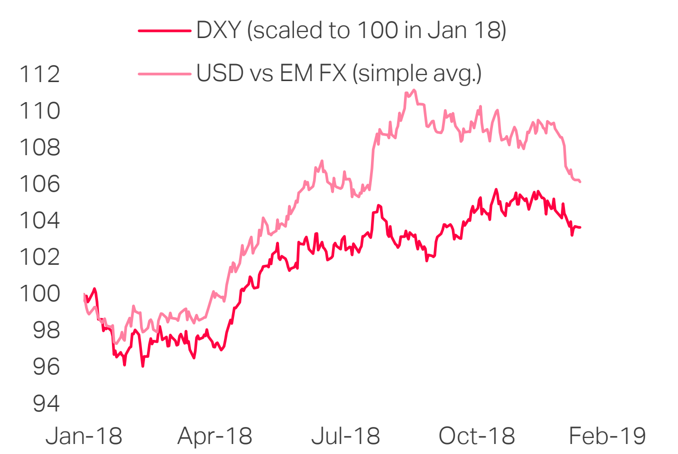
The relative appreciation of EM currencies in recent weeks has gone a long way toward reversing last year's underperformance, but further short term EM FX outperformance may yet be on the cards. Indeed, the easing of trade tensions and thus of safe haven dollar flows should for the time being favour higher beta EM currencies, including the lira and even the rand, despite the deteriorating fundamental dynamics of their underlying economies. At the same time, the trajectory of US monetary policy has shifted unequivocally toward easing. Our US economist highlights three "policy errors" that are weighing on Fed decision making: the lagged impact of the Trade War, misjudgement of the yield curve impact of quantitative tightening, and finally, the government shutdown (see our 16 January Daily Note).

Chart 1: Average terms of trade for major EM



Source: Bloomberg, TS Lombard.

Chart 2: USD vs EM and DM



Source: Bloomberg, TS Lombard.

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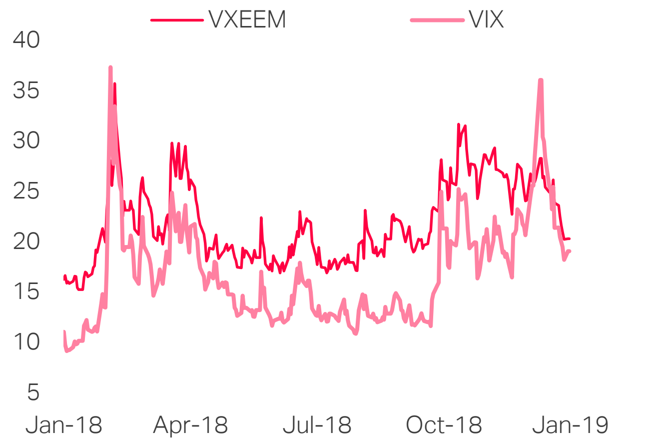
US-China trade negotiations are on track towards a favourable outcome for EM economies. Beijing confirmed last week that Vice Premier Liu He will travel to Washington on 30-31 January for the next round of trade talks, which will be held with both Treasury Secretary Mnuchin and USTR Lighthizer. In a further development, Mnuchin was said to be considering the case for rolling back some of the existing tariffs as a way to move the negotiations forward and ease the pressure on markets, although this was subsequently denied. By contrast, Lighthizer, who is leading the negotiations, was reported saying that little progress has been made so far on the important structural issues including intellectual property. We maintain our view the weak US economy and markets make it more likely that Trump will reach a deal of sorts that will at least call off the threatened escalation of tariffs (see last week's EM Watch), and in the best case could begin the process of rolling back the existing tariffs.

An end to the tariff escalation threat would provide a welcome boost to EM economies, in particular those in Southeast Asia, although this may not be sufficient to overcome the headwinds from China. Indeed, the easing of investors' EM risk perception in recent weeks, both in absolute terms and relative to developed markets, suggests that a benign outcome to US-China trade negotiations is at least partly priced in (see Chart 3).

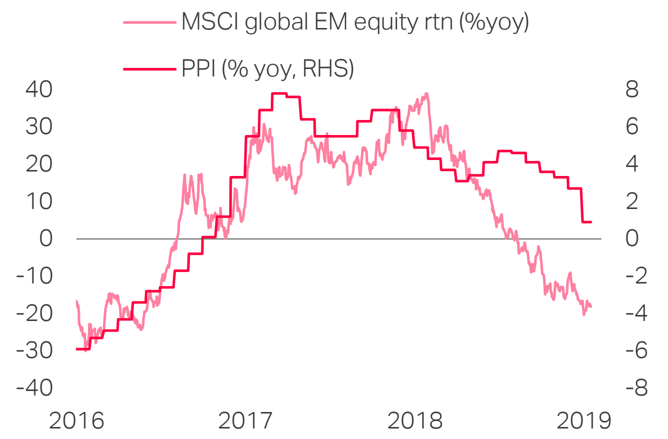
The PBoC and the government have unleashed a range of new stimulus measures in the wake of a succession of disappointing economic data so far this year, including foreign trade, car sales and industrial production. The recent RRR cut marked a shift by the authorities to prioritise growth rather than deleveraging (see our 10 January China Watch). Last week, the PBoC injected record liquidity via its open market repo operations, while the government pledged larger scale tax cuts. The PBoC also said it will introduce a targeted medium term lending facility aimed at encouraging banks to provide lower cost financing to smaller companies. These stimulus measures will take time to revive the economy, while the downturn in Q1 is already baked in for both China (see our 14 January China Watch) and for the global tech cycle (see China section), which will weigh on Southeast Asia. At the same time, the precipitous fall of PPI in China will hit China's industrial profits with negative consequences for equity markets in China and wider EM (see Chart 4)

Chart 3: EM and DM equity volatility



Source: Bloomberg, TS Lombard.

Chart 4: EM equity return and China PPI



Source: Bloomberg, TS Lombard.

Jon Harrison

China

Trade war and tech cycle losers

North East Asia is at the epicentre of China and tech cycle downturns. Moreover, the lagged impact of the trade war is exacerbating the effect of slowing global growth. Fiscal stimulus is on the cards in Korea and Japan as pressure on the region's FX mounts.

Weak Chinese trade data and revenue warnings from Apple and Samsung Electronics have spooked markets this month. And rightly so. The events underscore two trends that will weigh on East Asian growth in H1/19: China's domestic slowdown and a turn in the global electronics cycle. Chinese demand is weakening irrespective of the trade war- and growth in Korean and Taiwanese exports to China had already turned negative in November and December. Export data for the first 20 days of January show total exports down 14.6% yoy, while those to China are down 22.5% and semiconductors down 28.8%. Policymakers in Beijing are gradually shifting towards prioritizing growth. Successive tax and RRR cuts, accelerated bond issuance and infrastructure investment will engineer an underwhelming policy-led rebound to Chinese activity in H2/19. We expect import demand to remain weak through H1/19.

China-US trade truce no panacea for East Asia. We expect Beijing to offer concessions to gain further delays to tariff hikes. However, after significant frontloading in Q4/18, US firms have limited inventory space and credit capacity to further increase imports from China. As US firms struggle to clear inventories, Chinese exporters will reorient sales to other markets. It looks like trade competitor countries' export prices will need to adjust to both a weaker RMB and lower prices. Export prices are already trending down in Japan, Korea and Taiwan.

Adding to the region's woes is the end of the semiconductor supercycle. Demand from the driving forces of the industry - smartphones, computers and data centres - is set to fall in 2019 for the first time in 10 years. Samsung called the end of the cycle in October 2018 when it scaled back capex plans and cut prices. The market leader has been followed by Apple, SK Hynix, Taiwan Semiconductors et al this year. Korea and Taiwan are particularly exposed to the chip cycle. Semiconductor stocks make up 25% of the KOSPI and 22% of the TAIEX; semiconductors constituted over 20% of Korea's and Taiwan's exports last year.

Semiconductors key to Korean growth (%, yoy)

Source: CEIC

East Asian export prices decline (US$ index)

Source: CEIC

Seoul will be compelled to act as the country's economic engine splutters. Faced with a diminishing current account surplus, we expect the Bank of Korea to allow the market to weaken the won to 1,140 per dollar, the upper end of its tacit trading band. We also expect President Moon, who already plans to frontload 70% of the 2019 budget in H1, to push for an emergency supplementary budget in H2/19. Even with currency and fiscal measures, the outlook for H1/19 GDP is dim.

Japan's export-dependent expansion under threat. The combination of trade war uncertainty and the cooling tech supercycle also has adverse implications for Japan. Core machinery orders are well off the summer highs, with rolling three-month growth in manufacturing orders turning negative YoY in November for the first time since Q4/17. Annual growth in shipments to Asia, which comprise over a third of total exports, has virtually ground to a halt since the autumn, dragged down by a sharp deceleration in Chinese orders after a robust 2017.

Fiscal 'arrow' to take the lead. With consumer confidence on the back foot and household spending lacking impetus, the outlook for Japanese GDP growth in the near term is poor, not least as the scope for the exchange rate to act as a release valve seems low. The yen is already significantly weaker than it was at the onset of Abenomics, both against the dollar and in real effective terms. What is more, as we pointed out in a recent note, with the yuan comprising around 30% of the trade-weighted basket (almost double that of the dollar), the downside looks limited even if CNY depreciation were to also put JPY under pressure – itself now a less likely scenario as signs of a dovish Fed turn are taking some shine off the dollar. All this suggests it is largely up to the government to pull the economy along, pointing to a progressively looser, pro-growth fiscal stance.

Rory Green / Konstantinos Venetis

Brazil

It's reform time

The Bolsonaro administration moved ahead with the first phase of its pension reform proposal last week when it issued a decree aimed at combatting fraud while reducing some benefits. The decree is a curtain raiser for the broader pension reform proposal, which the government has promised to present to the Congress in early February.

Bolsonaro takes first steps to pension reform. Although Economy Minister Paulo Guedes has not yet finalized the proposal for the broad pension overhaul, the administration announced its first measures to reduce the country's deficit from the entitlement. Last Friday, Bolsonaro issued a decree aimed at curbing pension and disability fraud as well as rolling back some benefits. The government aims to save BRL9.8bn in disability payments alone by conducting medical exams on people who have been receiving them for more than six months and those declared permanently disabled. The government estimates that 5.5mn disability pension recipients need to be audited.

The government will also require stricter proof for domestic partnerships and rural pensions. The decree will also require greater proof for domestic partners to receive benefits following the death of a pension holder. Previously, it was possible to claim a domestic partnership by simply presenting witnesses, but survivors will need to provide documentary evidence going forward. The government will create a national registry, and starting in 2020, new rural pensions will only be paid to those who have registered with the new entity. Presently, rural workers who have never contributed to the social security system simply need to present a declaration which is certified by local authorities.

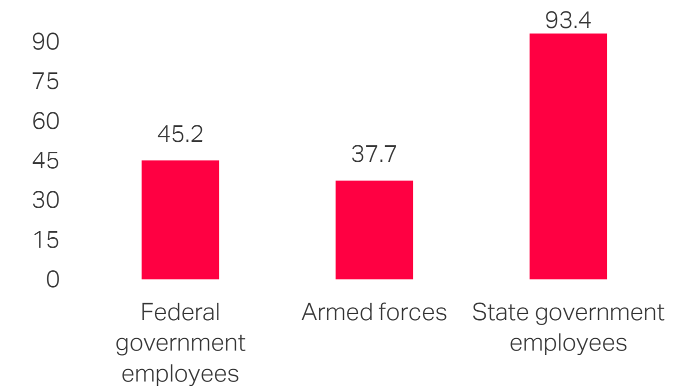
The decree also changed the rules for benefits granted to the dependants of prison inmates. As part of his tough-on-crime stance, Bolsonaro pared back pension benefits granted to the families of prison inmates. With the decree, these pensions will only be paid after 24 months in jail, rather than after one month. Likewise, the benefit will no longer be paid to people under house arrest, nor will it be paid to people receiving any other government benefits. Although the savings will be marginal, since total annual payments for these benefits were only BRL630mn in 2018, the changes to these benefits will please Bolsonaro's base.

The decree will be a proxy for Bolsonaro's ability to pass a broader pension reform. Because the changes were made by presidential decree, they still need to be approved by the Congress in the next 120 days. Although only a simple majority will be needed for the decree to be approved, investors should closely monitor this vote, which will be an indication of congressional support for the pension reform.

The final details of the plan will be presented after President Jair Bolsonaro's return from the World Economic Forum in Davos, where he will reaffirm his government's commitment to a liberal reform agenda. Despite indications in early January that the administration would be willing to accept a less ambitious reform, Economy Minister Paulo Guedes will likely push for a more aggressive one. Key elements to watch include the transition period for the new pension scheme to go into effect and the minimum retirement ages, which have a significant impact on the long-term savings from the reform, as illustrated below. Social Security Secretary Rogério Marinho indicated that the government plans to use the Temer reform, which already cleared several hurdles in the Lower House, as a base for the reform. Marinho said the changes to the Temer bill will be presented as an amendment in the second week of February, after the election of the Lower House Speaker and Senate President on 1 February. The decision to work with the Temer proposal highlights the economic team's understanding that this reform needs to pass as quickly as possible in order to take advantage of the administration's honeymoon period.

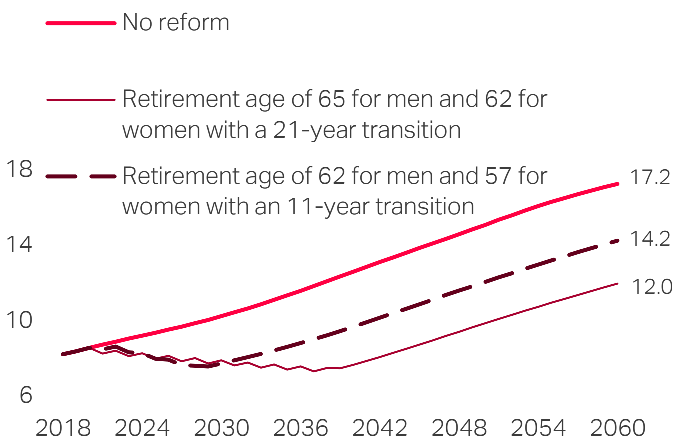
State and municipal workers are expected to be included in the reform. Treasury Secretary Mansueto Almeida signalled the proposal will include state and municipal workers, alongside federal employees. Most state pension systems are currently under heavy stress, having posted more than twice the deficit of the federal system in 2017. In that year, state pension systems registered a BRL93.4bn deficit, while the federal system posted a BRL45.2bn deficit for its civil servants. Killing two birds with one stone by addressing the states' pensions in the coming proposal would be very positive for the fiscal positions of the states, which are running out of time. Six out of 26 states declared states of financial calamity, unable to pay salaries and other financial obligations.

Chart 1: Public workers' pension deficit
BRLbn



Source: Social Security Secretariat, Finance Ministry.

Chart 2: Private workers' pension spending
% of GDP



Source: IBGE, Finance Ministry, TS Lombard estimates.

Elizabeth Johnson / Wilson Ferrarezi

India

Slow bankruptcy law compels creditors to seek other means of resolution

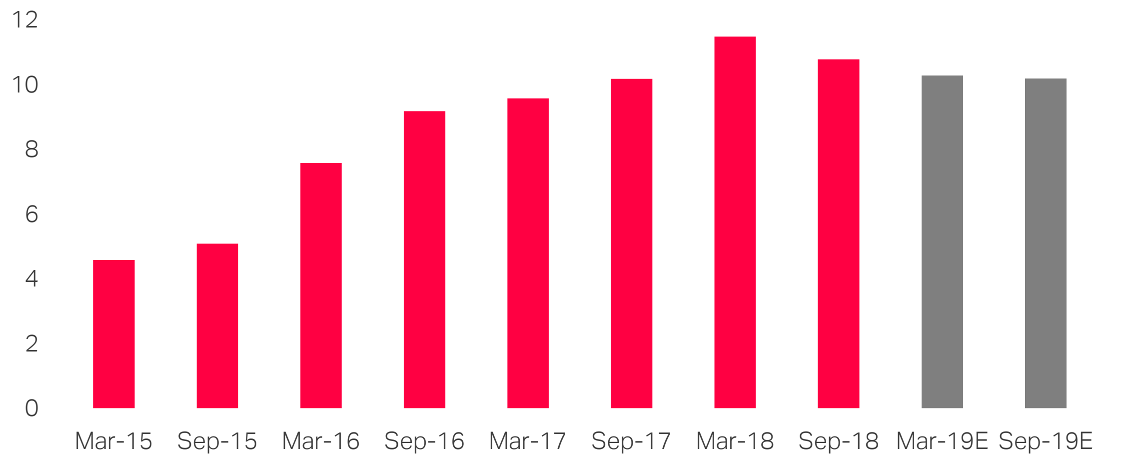
State Bank of India (SBI) Chairman Rajnish Kumar said over the weekend that the Insolvency and Bankruptcy Code (IBC) is the most significant reform by the Modi government, but his comments came days after his bank – the country's largest – put the loans of Essar Steel on sale failing a quick resolution to the latter's bad debt under the bankruptcy code.

Resolution of distressed assets cases under the IBC has been extremely slow, with the process having been completed for only three large cases since the Reserve Bank of India (RBI) identified the first list of 12 big defaulters in June 2017. The Ministry of Corporate Affairs is reportedly due to meet lenders today to review the IBC's progress of 52 cases involving large defaults that comprise 60% of the banking sector's bad loans.

A quick resolution to defaulting loans is a cornerstone of the bankruptcy law, but as Kumar admitted, the new law is facing delays. As a result, SBI was forced to put on sale its Rs154 billion exposure to Essar Steel as litigations continue to drag the resolution progress. This sale has been criticised by some observers as opening up the possibility of the Essar Steel owners getting away with retaining control of their company (in case the new debt holder backs the owners). For its part, however, the SBI seems to have had limited options. Kumar said that his bank was facing losses of Rs170 million a day due just to the single account of Essar Steel.

The IBC promised to resolve cases within nine months, but of the first list of 12 defaulters, nine cases are still pending. The majority of the claims resolved so far under the IBC have been small, according to data from the Insolvency and Bankruptcy Board of India (IBBI). This will not help quickly reduce the pile of bad debt in India's banking system. To be sure, there has been some decline in the banking sector's non-performing assets (NPA) ratio following the first half-yearly decline in three years (see chart below).

Gross NPA ratio of all Indian banks (%)

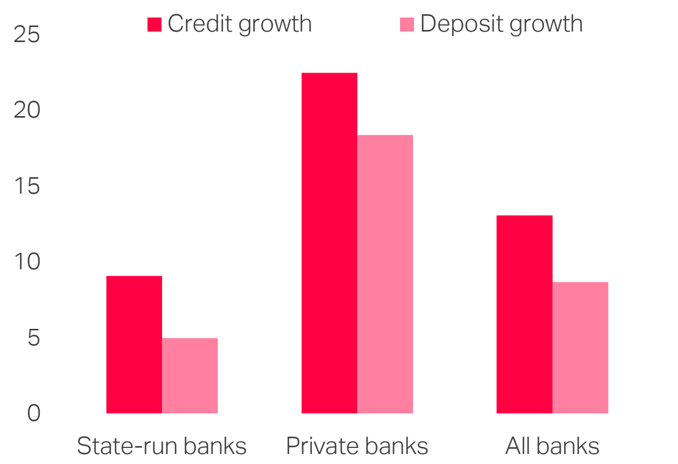


Source: RBI.

The RBI expects a further improvement in the NPA ratio by March 2019 but says that the current level "remains still high for comfort". In its December 2018 Financial Stability Report, the central bank also noted that the resolutions under IBC are lagging behind the envisaged timelines and that a time-bound resolution of the stressed assets "will go a long way in unclogging the credit pipeline".

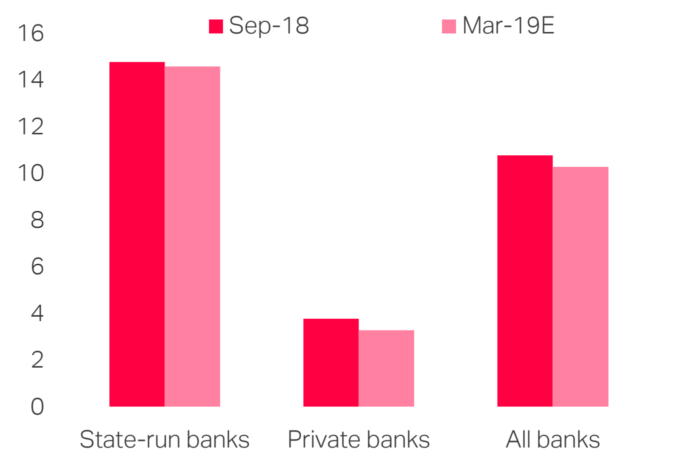
Bank credit growth is improving, but it is mainly due to private sector banks with the state-run banks that own around 70% of India's banking assets, lagging behind. Credit and deposit growth at private banks continue to far outstrip state-run banks, and the RBI projects that the reduction in gross NPAs at state-run banks will be at a slower pace than private sector banks. The RBI cautioned that as many as eight public sector banks under its Prompt Corrective Action framework that limits the expansion of a bank's operations may have a Credit to Risk-weight Assets Ratio (CRAR) of below the he minimum regulatory level of 9% by March 2019 without the further planned recapitalisation of these banks by the government.

Credit and deposit growth as of Sep-18 (% yoy)



Source: RBI.

Gross NPA ratio by bank type (%)



Source: RBI.

Shumita Deveshwar

Russia

Positive inflation surprise underlines improving rates outlook

The positive surprise in this month's initial inflation data reflects the negative reality of depressed consumer demand. For rates, this picture looks constructive – as reflected in the success of last week's primary OFZ auction. We would agree with S&P's sanguine take on the sanctions risk to this improving rates outlook in its new sovereign credit rating announcement.

The new-year inflation spike driven by the VAT increase is so far turning out to be weaker than expected. That much can be seen from Rosstat's first two weekly CPI releases of the year. The average daily inflation rate recorded in the first of those, for the period 1-9 January, was 0.051%; and this indicator fell in the second period (10-14 January) to 0.038%. This declining trend will continue with the dilution of the one-off effect of price increases at the start of the month in various regulated utilities (transport, housing) and gasoline. Speaking at last week's Gaidar Forum in Moscow (an annual government-sponsored policy talking shop that we attended), the head of the CBR's Research Department Alexander Morozov said that the CBR would now be revising down its previous estimated range of 0.6-1.5% for the CPI increase caused by the VAT hike from 18 to 20% that came into force on 1 January. He added that worst case now looked more likely to be the middle of that range.

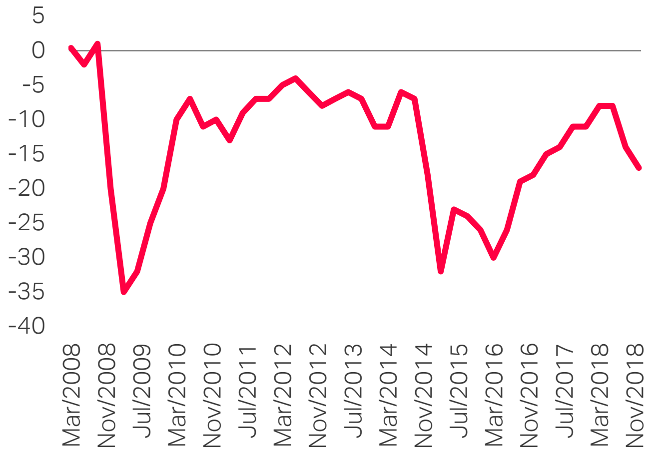
On this basis, this year's inflation peak should not exceed 5.5%. The main evidence Morozov pointed to was this month's seasonally adjusted stability in durable goods prices (the category most exposed to higher VAT as an unchanged lower VAT rate still applies to food and some other staples). This reflects anticipatory purchases of such items (cars, TV sets) in Q4. Demand will also be compressed by the new-year indexation of many public sector wages being legally pegged to end-2018 annualized inflation of 4.3% while actual inflation this quarter is set to rise by more than a full percentage point above that level.

This highlights the negative cause of this positive inflation surprise: weak consumer demand. Rosstat's consumer sentiment index for Q4/18 was three points lower than the previous quarter and nine points below Q1 (see Chart 1 below). These data should be supported by the CBR's forthcoming release of its own consumer sentiment estimate and the results of the regular monthly inflation expectations (IE) survey for December. The IE headline will be worse, since expectations react to current CPI trends: and increases in IE always go hand in hand with deteriorating consumer sentiment.

All this points to a brightening outlook for rates. The market is already reacting in this sense – as can be seen from the success last Wednesday of the Finance Ministry's weekly primary auction in which it placed the full offered volume of Rb35 billion. As shown in Chart 2 below, OFZ yields are already correcting down, but still offer a premium of 1.4-1.5% on 2-7 year maturities compared to the April 2018 levels on the eve of the new US sanctions campaign.

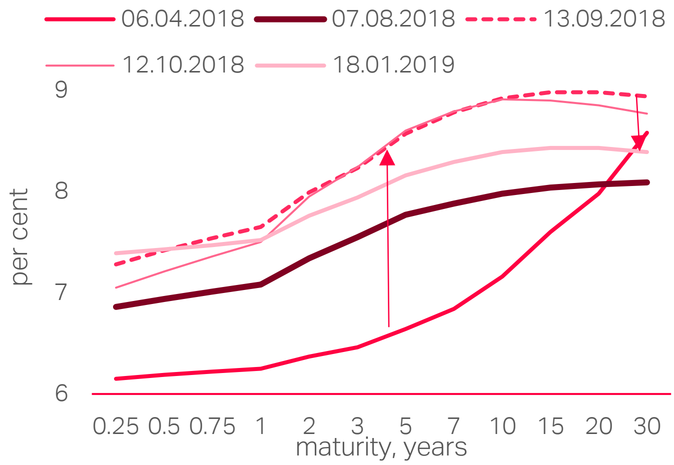
In addition to the good inflation news, other factors are at work here. These include the recovering oil price – which, in turn, boosted the volumes of the re-started FX market interventions under the fiscal rule – and increased demand from banks which this year face regulatory (Basel III-related) pressure to increase their relative holdings of highly liquid assets. The Finance Ministry will have to further increase the pace of weekly OFZ issuance – to at least Rb40 billion – if it is to reach its Q1 target of Rb450 billion. The improved overall EM risk environment should help here.

Chart 1:Consumer Sentiment Index



Source: RosStat

Chart 2: OFZ zero coupon yield curve



Source: Moscow Exchange

The main negative risk to this outlook remains possible new US sanctions. On this topic, we would draw attention to the commentary accompanying last Friday's confirmation by Standard & Poors of its BBB- (investment grade) sovereign rating for Russia, with the "stable" outlook also unchanged. In the context of its obligatory mention of new sanctions as a possible future reason for cutting this rating, S&P drew a distinction between the sanctioning of new sovereign debt issues on the one hand and, on the other hand, a ban on US persons owning *any* Russian government bonds or dealing in any way with a systemically important [i.e. state-controlled] Russian bank. Mapping this distinction onto the actual situation, none of the draft sanctions bills in Congress targets the secondary market, while the proposals on state banks would allow the president to select only one such bank – giving the Trump administration scope to steer clear of systemically important ones (i.e. Sberbank or VTB) in line with the US Treasury's stated view that Russia sanctions should be designed in such a way as to avoid wider financial stability risks. We infer that S&P's base case – reasonable, in our view – is that some new sanctions may well be imposed, but their effect will not be materially negative.

Christopher Granville / Madina Khrustaleva

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Mexico

New farm policy with price guarantees unveiled

The AMLO government on Friday launched a programme to offer minimum price supports for five agricultural products in order to help more than two million small rural producers and aid Mexico's food self-sufficiency – a move that critics fear will increase market inefficiencies.

Fulfilling a campaign vow, President Andrés Manuel López Obrador (AMLO) on Friday unveiled a programme to subsidize small rural producers via minimum price guarantees. The new programme is a key element of AMLO's broader vision of making Mexico more food self-sufficient and will offer price guarantees for five basic agricultural products: 1) corn (MXN5,610/tonne) up to a limit of 20 tonnes/producer; 2) beans (MXN14,500/tonne) up to a limit of 15 tonnes/producer; 3) wheat (MXN5,790/tonne) up to a limit of 100 tonnes/producer; 4) rice (MXN6,120/tonne) up to a limit of 120 tonnes/producer; and 5) milk (MXN8.20/litre). The President has estimated that it could help more than two million small rural producers nationwide this year, despite a modest estimated 2019 programme budget of MXN6 billion. Critics charge, however, that the AMLO government has opened the door to the return of failed agricultural policies dominated by greater state intervention that were a hallmark of Mexican government policy back in the 1970s.

The price guarantee programme will be run by the newly created Mexican Food Security Agency (Segalmex), a fusion of two former social assistance programmes – Diconsa (in charge of supplying the basic basket of food to rural communities) and Liconsa (a state-run firm focused on selling and distributing milk at subsidized prices). However, Segalmex's mandate goes well beyond social assistance and includes the coordination of the production, distribution, stocks and sales of basic foodstuffs, the management of imports and exports to balance basic food supplies, and oversight of fertilizer and seed sales, stocks and distribution, in addition to managing the crop price support programme. How this will translate into practice is still unclear, as the government decree creating Segalmex was only published on Friday (18 January). But its blueprint appears to be a former Mexican state-run agricultural trading firm called the National Company of Popular Subsistence (CONASUPO) which played a significant role in the agricultural market in the 1970s and early 1980s, was riddled with corruption and was finally eliminated in 1999. To add to the similarities, Ignacio Ovalle Fernandéz, a former CONASUPO director, has been named by AMLO to be the head of Segalmex.

Opponents warn that the new price support programme will distort market prices and increase inefficiencies. For example, bean producers in Zacatecas and Durango will reportedly earn 45% more than current market prices with the new price guarantees, corn producers could earn 34% more and milk producers may earn 14% more. In addition, because bigger, more efficient farmers will not qualify for the subsidies, they may either find themselves discouraged from producing key crops in certain years, which could further push up prices, or could find ways to "cheat" the system by dividing up their farmland into smaller lots in a bid to receive the subsidies. Local distributors also highlight that if the price guarantees are not paid in a timely fashion, struggling rural producers will likely be forced to sell their crops at market prices in order to pay their bills, likely allowing profit-seeking intermediaries to benefit from the price guarantees.

Not surprisingly, the Mexican Institute for Competitiveness (IMCO) last year called the revival of minimum farm prices a bad idea and argued that to truly help small rural producers, the government should invest in technology instead. Other critics have complained that another big failing of the price guarantees is that they are not linked to productivity and appear designed, more than anything else, to help AMLO and his Morena party at the polls.

Still, it remains to be seen how extensively the AMLO government plans to implement the programme – and how limited or far-ranging it will become over his *sexenio*. Judging by AMLO's most recent comments, he retains strong ambitions of increasing Mexico's food security, although actual food self-sufficiency itself appears a distant goal. In his speech on Friday, he highlighted that the country imports roughly 85% of its rice, more than 70% of its wheat and10% of its beans. It also imports roughly 40% of its corn, nearly all of it from the US, a fact that AMLO attributed to "irresponsible, corrupt bureaucrats".

Grace Fan

Thailand

Election optimism to boost markets

The 24 February elections will be postponed owing to the coronation. The delay is likely to be short – we expect elections on 10 or 24 March. The confirmation of the date will boost equities.

Thailand will soon return to democracy. In May 2014 the democratically elected Prime Minister Yingluck Shinawatra was ousted in a military coup. Since then, the ruling military junta has promised and then postponed elections several times. However, in September of last year the King endorsed the organic laws on the election of members of the parliament and the selection of Senators. The current constitution requires the Election Commission (EC) to "complete" the elections within 150 days of the law on the election of parliamentary deputies entering into force. The law took effect on 11 December 2018, which means the constitutional deadline for the elections is 9 May 2019. Also in December, the government provisionally set the election for 24 February and lifted the ban on political activities, which meant political parties were able to start campaigning. All these developments signalled that the odds of the elections happening were the highest since the 2014 coup.

The provisional February election date was not subsequently confirmed. At the beginning of January, the government failed to issue an official decree committing to the February timeline for the elections. About two weeks later, EC officials announced that it was too late to hold elections on 24 February, as the Commission would require more time for the preparations. For its part, the government said the reason for not confirming the February date for the elections was the confirmation of the timing of the coronation ceremony of the Thai monarch.

Owing to the timing of the coronation, elections will now be postponed. King Maha Vajiralongkorn has been serving as monarch since his father died in 2016, but he has not yet been officially crowned. His coronation has now been scheduled for 4-6 May. Deputy Prime Minister Wissanu Krea-ngam responded by saying that post-election events could disrupt the rituals ahead of the coronation ceremony. Indeed, according to the government, the royal rituals will need to take place 15 days before and after the three-day ceremony, which means that they will have to start on 19 April. The EC must endorse new members of parliament within 60 days of an election. The new parliament must hold its first session within 15 days of the election results being announced. Thus, if elections had taken place on 24 February, they would have come shortly before or during the rituals leading up to the ceremony.

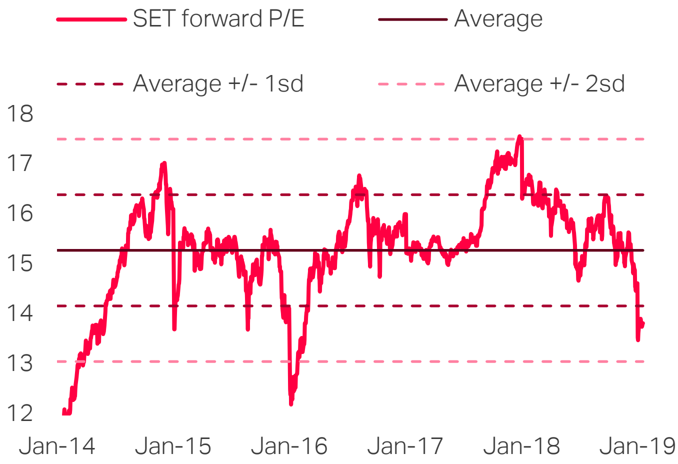
The ballot will not be postponed beyond the end of March. We think that the current military government will seek to choose a date for the elections that meets the constitutional deadline while limiting any coronation ceremony disruption. Delaying the elections beyond the end of March would damage the political climate and dent investor sentiment. Indeed, the failure to confirm the February election date sparked protests around the country, prompting Prime Minister Prayuth Chan–ocha to address the date issue for the first time by saying the election will "definitely" be held before 9 May. Moreover, from recent comments by the Deputy Prime Minister Krea-ngam, we know that the government is now tending towards dates in March.

The pre-election fiscal stimulus is another incentive not to postpone elections further. The government has already launched stimulus measures targeted at low-income households. Among them are cash handouts worth some US$1.5bn, including the 500THB "New Year's gift" for nearly 20% of the population. Because the impact of this measure on voters will be diluted over time, the military government will be spurred to hold elections sooner rather than later.

The most likely election dates are 10 and 24 March. In Thailand, general elections are traditionally held on Sundays. Since no date has yet been announced and because the endorsement of the results would clash with the pre-coronation rituals, 3 March would seem to be too soon. Nor is 17 March a real option, since this would disrupt university entrance exams, likely triggering student protests given that some entrance exams had already been moved to avoid clashing with the previously planned date in February. For its part, based on comments by EC officials, the EC favours 10 March. Although this date would leave less time for preparations, it would allow more time for announcing the result before 9 May. The Commission's desire to endorse results by then stems from unclear wording in the constitution – namely, that the EC is required to "complete" elections by a certain date, which fails to clarify whether the popular vote needs to take place or the results need to be announced by that date. The Commission is concerned that the elections results, which would be endorsed after the deadline could later be declared null and void by the Constitutional Court (CC). Meanwhile, according to comments by the Deputy PM, the government seems to prefer 24 March because the announcement of the results would likely not overlap with the post-coronation rituals. Moreover, this date leaves also more time for election campaigning. Given that the government ultimately has more power than the EC, the elections on 24 March are more likely.

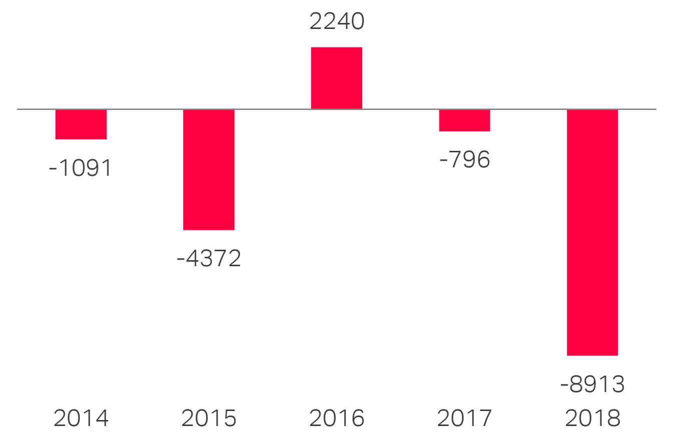
The confirmation of the election date will likely trigger an equity rally. Regardless of whether the election takes place on 10 or 24 March, we expect the election date to be confirmed by official decree by the beginning of the next month at the latest – since the EC has indicated that it needs at least 45 days to arrange the ballot. The confirmation of the election date offers the best opportunity for the government to ensure a smooth transition to the new constitutional arrangement, which will reduce the likelihood of protests. Currently, Thai equites in P/E terms are trading at the level of 1.5 standard deviation below the five-year average (see Chart 1). Apart from the expected slowdown in global trade, which will negatively affect exports and hence economic growth in Thailand, equities are also discounting the risk of the elections being postponed much further. Moreover, foreign investors net sold nearly US$13bn in the last five years –the bulk of which was sold in 2018 alone (see Chart 2). Dispelling doubts over the election date could be a catalyst for some foreign investors to return to Thai equities.

Chart 1: Price/ Earning Thailand's equities



Source: Bloomberg, TS Lombard.

Chart 2: Net foreign stock investments (US$mn)



Source: Bloomberg, TS Lombard.

Krzysztof Halladin

Turkey

Budget trends raise concerns about ongoing erosion of fiscal disciplines

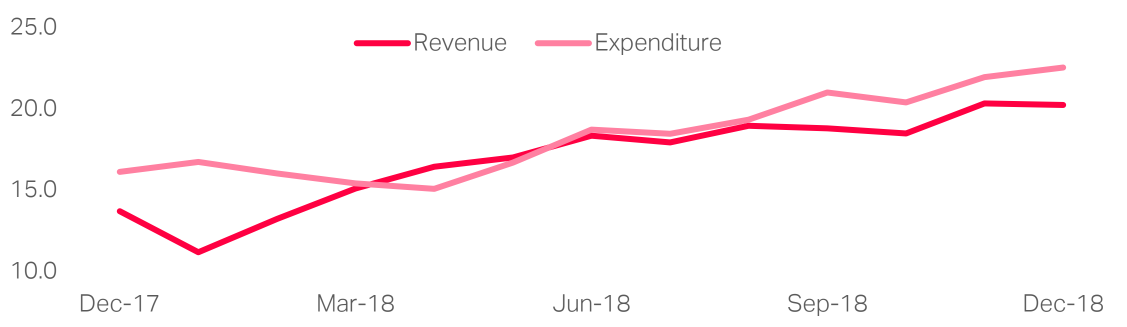
The 2018 preliminary fiscal deficit of 1.9% of GDP was less than we expected. However, the economic recession that is now biting will likely boost the deficit substantially this year. Further, the government's expansion of off-budget support measures via various guarantees will create longer-term problems for the budget when the inevitable bailouts materialize

The Treasury last week released budget data for December and they highlighted limited fiscal deterioration during 2018. According to preliminary figures, the Central Government nominal deficit rose to 1.9% of GDP vs deficits of 1.5% in 2017 and 1.1% in 2016. The primary balance (before interest) went from small surpluses of 0.7% of GDP and 0.3% in those years to a zero balance for 2018 as a whole. While fiscal performance was less bad than might have been expected given the slide of the economy into recession, there are reasons to believe that the government's fiscal position is likely to worsen substantially this year.

Fourth quarter GDP is likely to show a larger decline in the economy's growth than the government is assuming. Current readings on economic activity are only available through October and they show that the economy began a sharp decline in that month: industrial production plummeted 5.7% yoy, the biggest drop since recordkeeping began in 2010 and retail sales dropped 7.5% yoy. There is no evidence that these developments were reversed in the last two months of the year. Assuming that the data on revenues and expenditures will not be revised materially, a lower than projected nominal GDP for Q4 and the full year – final Q4 GDP will be released on 13 March – will push up the final measured deficit. Nonetheless, such revisions will probably only push up the final deficit by 0.2-0.4pp.

Of more concern are recent trends in revenues and expenditures, which point to deterioration in the overall deficit this year. Given high inflation rates we examine trends in nominal variables rather than attempt to convert them to real terms. The chart below shows trends in nominal revenues and expenditures by month, accumulated for the prior 12 months. The data show that the growth of expenditures has outpaced revenues since June, at first by a small margin and then beginning in September by roughly 2% a month through the end of the year. In the midst of recession, the government will find it impossible to rein in the deficit. Indeed, all the special programmes that we highlighted last week in EM Watch will cut the growth of revenues via tax breaks, for example, while expenditures on social welfare measures and bailouts will boost expenditures.

12-mo running totals of revenues and expenditures, % chg yoy



Source: Bloomberg

Meanwhile, continued reliance on off-balance sheet fiscal initiatives are creating future fiscal vulnerabilities. Such quasi-fiscal measures include the use of the government's Credit Guarantee Fund (CGF) and the increase in government liabilities associated with the rapid rise in Public-Private Partnership Projects (PPPs). Because they are off-balance sheet these programmes will be difficult to resolve and they will likely fuel future inflation.

The CGF rose tenfold in 2017 to approximately 7% of GDP; it was expanded rapidly following the failed coup attempt in July 2016 in order to stabilize economic activity. In that year CGF-enhanced loans accounted for roughly 75% of all TL-denominated commercial loan growth. Typical CGF terms are: 80-90% of the loan principal is covered by government guarantee; final maturity of 3 years, 6-mo grace period and monthly instalments thereafter. The bulk of CGF loans were extended during 2017, so most started amortizing at some time during 2018. In February 2018 the government announced that the unused CGF capital amount of some TL50bn (then US$13bn) would be channelled to exporting firms and certain other preferred borrowers. The IMF noted in its May 2018 Article IV report that "most of the CGF-backed loans were used for working capital, with some ending up rolling over existing loans on the back of favourable risk weighting and provisioning requirements [for the banks]". At the beginning of this year outstanding CGF loans totalled TL497bn (US$90bn).

The CGF has now been reintroduced, though without the fanfare that accompanied it in 2017. As we reported last week, EM Watch the government announced a new loan package totalling TL20bn (US$3.6bn) that will be provided by 13 commercial banks to SMEs at an interest rate of 1.54%/mo (20% at an annual rate, i.e. slightly below the current inflation rate); an estimated 40 thousand firms may benefit from this facility. This new facility is substantially smaller than amounts outstanding under the earlier CGF programme. Nonetheless, firms taking out the loans are likely to use the funds for making instalments on earlier loans or for working capital, rather than for new investment. While the current recession will likely have increased the government's contingent liability to cover its guarantees, the potential losses of CGF loans is unknown, but could be substantial unless new facilities are provided to refinance existing loans.

The government's fiscal risks associated with PPP projects stem primarily from guarantees it offered for individual projects. Such liabilities run the gamut from FX, debt and investment guarantees, to explicit minimum revenue guarantees and possible contract termination clauses. The IMF estimated in its Article IV report (see above link) that there were 221 projects as of May 2018, totalling some US$60bn, though over 50% of projects were either under construction or not yet started. Reflecting the confusing legal and economic situation of these PPP projects, the Finance Ministry recently submitted draft legislation to parliament to regulate conditions under which builders can revoke or transfer existing contracts, not just PPP projects. Under the draft bill the Finance Ministry would have an important influence on how any such applications are decided.

While the financial burden the government might incur under its PPP programmes is likely to be large, such costs would be spread over a number of years. Legal and other agreements to resolve what are likely to be long, drawn-out negotiations are in prospect. What is more certain is that the government is unlikely to embark on any new PPP investment projects as long as the uncertainty over its involvement in such ventures is unresolved. This will undoubtedly curb Turkey's ability to rebound economically once the current recession is over because there will be little room in the budget to finance such investments.

Larry Brainard

Must Read

India: GDP growth is becoming unsustainable

The relatively strong growth seen in the first half of the fiscal year is unlikely to be sustained in H2/FY19. Shumita Deveshwar warns that slowing growth will compel the government to become more populist. India's growth trajectory is not decoupled from global headwinds, while easier fiscal, monetary and banking policies put growth sustainability at risk. See our 18 January report India: Growth path is not sustainable.

Brazil: The economic recovery remains weak

Economy Minister Paulo Guedes has promised to unveil his pension reform proposal next week in Davos. Elizabeth Johnson and Grace Fan caution that early economic indicators, including car production, toll road traffic and cardboard sales also point to still-tepid activity in December. The good news is that Bolsonaro's popularity remains high, one cloud, however, is that the scandal involving a former driver to Bolsonaro's son Flávio continues to simmer. See our 18 January report Brazil: Economic recovery still sluggish.

China Watch: The Party is tightening its influence over businesses

The Communist Party has ramped up its influence over private and state enterprises through the "Party cell". Eleanor Olcott explains that, under Xi's campaign to assert the Party's dominance, the Party cells have started actively influencing the day-to-day management of business at state-controlled firms. The role of party cells in private enterprise is more limited, although the increased dominance of the Party is becoming particularly pronounced at China's leading tech companies. See our 18 January China Watch: The Party's business play.

Asset Allocation

We present below our EM asset allocation views, which are updated once per month, most recently in our 9 January EM Strategy Monthly.

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

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	0 (+1)			
Asset class	-1 (+1)	+1 (-1)	+1	-1
Relative country views				
China	-1 (+1)	-1	+1 (-1)	n/a
Brazil	+1	+1	+1	+1
India	+1 (-1)	+1 (-1)	-1	n/a
Russia	-1	-1	-1	-1
Mexico	-1	+1	+1	+1
Indonesia	+1	-1 (+1)	-1 (+1)	0 (-1)
Philippines	+1	-1 (+1)	-1 (+1)	-1
Thailand	+1 (-1)	+1 (-1)	+1 (-1)	n/a
South Africa	-1	-1	-1	-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
Mexico	Sovereign credit	Long	12-Jun-17	bp	149	193	-1.3%
Brazil	Local debt	Long	7-Jan-19	%	7.68	7.64	-0.3%

Date/time 21-Jan-19 08:10

Source: Bloomberg, TS Lombard.

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

Closed Views

Table 2: Closed Absolute Views

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

Source: Bloomberg, TS Lombard.

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

For further explanation, see our methodology.

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