

EM Watch

Weekly

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Catch-up gets harder; China: Infrastructure growth slows; Brazil: Weak recovery ahead

- **Global:** EM equities outperform; but economic catch-up still hard
- **China:** Infrastructure growth will be below market expectations
- **Brazil:** Falling retail sales confirm weak economic recovery ahead
- **India:** Equity market rally is running ahead of ground reality
- **Russia:** Revived geopolitical hopes do not spell rapid re-rating
- **Mexico:** Subnational politics signal the rise of populism
- **Philippines:** Monetary policy continuity will help tame inflation
- **Strategy:** We add a positive view on Turkish local debt

In EM Watch this week we introduce a regular [market strategy](#) analysis.

EM Watch is grounded in recent and upcoming events; it begins with a one-page [summary](#) of our **economic, political and market** insights. Our strategists' analysis of a [global](#) theme and our [country teams'](#) views of the implications of key fundamental developments follow. Each week we include a [market strategy](#) analysis on a single-country or cross-country theme. Finally, we summarize the [must read](#) notes from our recent research; our relative [asset allocation](#) and [absolute](#) (total return) views and our monthly [macro and markets](#) summary.

Important information
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We have revised our EM service description. Click [here](#) for more details.

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Global: EM equities outperform; but economic catch-up still hard

Last week, EM equities posted modest gains and further narrowed the performance gap vs DM that had opened up since the US election. Global deflation will continue to drive growth; EM economies will grow faster than DM. But high average growth hides that fact that sustained economic catch-up vs DM remains the exception, rather than the rule.

China: Infrastructure growth will be below market expectations

Growth in infrastructure investment is unlikely to exceed 15% in 2017 due to funding constraints. The government is already over-budget and quasi-fiscal financing channels faces tighter rules.

Brazil: Falling retail sales confirm weak economic recovery ahead

Recent retail sales figures released last week confirm our view that an economic recovery will remain on hold in the first quarter of the year, dragged down by subdued growth in household consumption on the back of a sluggish labour market.

India: Equity market rally is running ahead of ground reality

India's equity markets jumped to new highs last week despite a spate of FYQ4 earnings pointing to sluggish corporate activity. Modi offers stability, economic reforms and new efforts to clean up bad debt. But market valuations appear rich in view of the slow economic recovery.

Russia: Revived geopolitical hopes do not spell rapid re-rating

Recent developments leading up to last week's meeting between Donald Trump and Sergey Lavrov look good for the geopolitical driver; but Russian assets are not about to enjoy a 'geopolitical' re-rating.

Mexico: Subnational politics signal the rise of populism

With less than one month to go to the gubernatorial election in Estado de Mexico, the tight race between the candidate from newly created party MORENA and the incumbent PRI signals the rise of populism ahead of the 2018 presidential election.

Philippines: Monetary policy continuity will help tame inflation

The nomination of Nestor Espenilla as the new BSP Governor is positive for taming inflation risks and strengthening the financial system.

Strategy: We add a positive view on Turkish local debt

As of today we add a positive view on Turkish local debt to our list of high-conviction total return views. As a result of tighter monetary policy, inflation expectations have at last started to decline and the lira has stabilized. But the currency remains undervalued and yields are relatively high, both vs the level of risk and vs comparable peers.

Global backdrop

EM equities outperform; but economic catch-up still hard

Last week, EM equities posted modest gains and further narrowed the performance gap vs DM equities that had opened up since the US election. Despite Q1 weakness in the US and risks ahead for the Chinese economy, global reflation will continue to boost world trade and drive growth; EM economies will on average grow faster than DM. But high average growth hides that fact that sustained economic catch-up vs DM remains the exception rather than the rule.

Q1 US weakness has not changed our reflation view

Weakness in Q1 US data has not deterred the market from believing in another rate hike in June, and over the past week, raising the probability priced into markets of a further hike in September. We still believe that the overall US outlook remains solid, and the Eurozone, which is currently enjoying an economic boom compared with previous standards, will help drive global reflation. Our 14 May [US Watch](#) cites retail sales and corporate profits among the reasons to forget Q1 GDP. The Chinese outlook remains a risk, although we do not believe that officials will be willing to force an aggressive downturn ahead of the Party Congress in November. Indeed, in our 11 May [China Watch](#), we speculate that the latest policy moves signal a reordering of official economic priorities to be unveiled at the Congress. Furthermore, the wider recalibration of US-China relations will reduce tail risks to the global reflation view (see our 12 May report [The Trump-Xi tilt](#)).

EM equity market outperformance vs DM hides a wide range of outcomes

Last week, despite a stronger dollar and generally higher local market yields, EM equities posted modest gains, outperforming DM and further narrowing the performance gap vs DM equities that had opened up since the US election. This steady relative recovery of EM equities vs DM hides a wide range of outcomes. The best and worst performing among major EM equity markets since the US election (adjusted to global EM sector weights) are Russia and Mexico, respectively, having around 15% difference between their dollar returns; although the difference between the various best and worst performers has at times been much greater than this over the 6 months since November (see Chart 1).

Global reflation continues to drive EM

Global reflation will continue to boost world trade and drive growth. We considered the export linkages and market correlations between EM and the drivers of reflation – US, Eurozone and China – in our 24 April [EM Watch](#). In an environment of rising world trade and increasing global growth, EM economies will on average grow faster than DM (see our 1 May [EM Watch](#)). Although EM market valuations and investment opportunities can, of course, be attractive even in the absence of economic catch-up. As an example, we currently have a positive view of Turkish equities in our relative [asset allocation](#) view, and as of today, we add a positive view of Turkish local debt to our list of high-conviction absolute views – see the [market strategy](#) section of this report. And Brazil offers an object lesson in how politics can dominate economics in driving markets – our analysis of the wide open

field for the 2018 presidential election underlines this point - summarised in the [must read](#) section below.

EM catch-up vs DM is getting harder

High average growth in EM economies hides that fact that sustained economic catch-up vs DM remains the exception rather than the rule. We use GDP per capita, relative to that of the average for advanced economies, as a measure of an economy's level of development. As our criterion for "catch-up" (or falling behind) we take as a threshold a 0.5 percentage point increase (or decrease) in GDP per capita vs advanced economies in any given year. We use IMF GDP data and forecasts and have excluded small countries (with fewer than 20 million people).

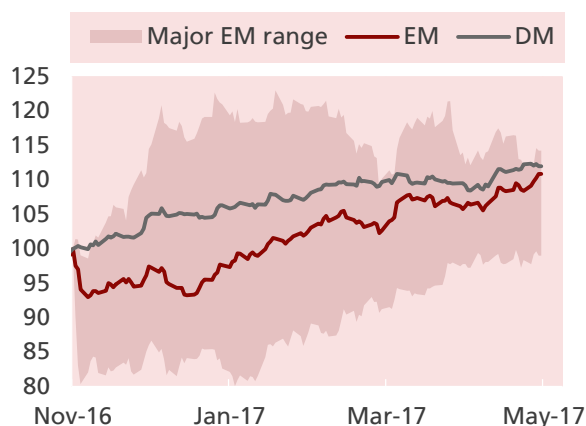
The number of EM "winners" remains low . . .

On these criteria, there were 10 "winners" – out of 51 EM and DM countries in the analysis – that will catch up during 2017, by more than half a percentage point in GDP per capita relative to advanced economies (see Chart 2). This compares with around 20 countries catching up during each year between 2006 and 2011. The 2017 winners are: China, India, Indonesia, South Korea, Malaysia, Philippines, Poland, Spain, Sri Lanka and Vietnam – Brazil and South Africa are among the losers. Unsurprisingly, Asia is well represented among the winners. The difference between 2017 and previous years is even more striking if the threshold is raised from 0.5pp to 1pp. In this case, only two countries (China and Poland) would be shown as catching up with developed markets in 2017, compared with more than 10 each year from 2006 to 2011.

. . . but could pick up in the coming years

The precise criteria used to identify catch-up are, of course, arbitrary – for example, reducing the threshold to just 0.4pp would include Thailand and others – but the conclusion remains valid. Despite an improving growth outlook this year, the number of EM economies catching up to DM remains low, and may even decline. But IMF forecasts offer hope of an improving outlook in the coming years.

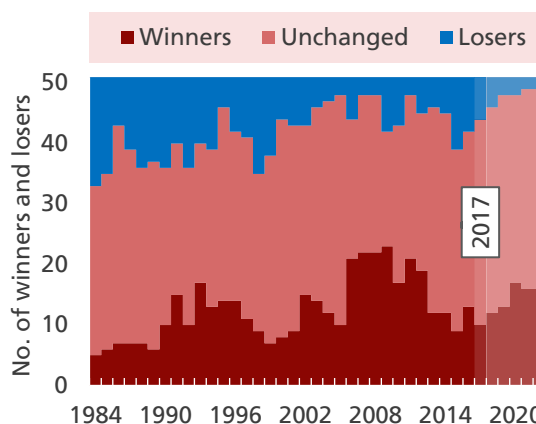
Chart 1: EM and DM equity index performance since the US election*



*DM index and EM country indices constructed using global EM index sector weights.

Sources: Bloomberg, MSCI, TS Lombard.

Chart 2: No. of countries per year that gained or lost more than 0.5 percentage point in GDP per capita vs advanced economies*



*IMF data and forecasts; lighter shading from 2017 onwards

Sources: IMF, TS Lombard.

China

Infrastructure growth will be below market expectations

Growth in infrastructure investment is unlikely to exceed 15% in 2017 due to funding constraints. The government is already over-budget and quasi-fiscal financing channels faces tighter rules.

Investors were bullish on infrastructure investment

China's growth rebounded more than expected in Q1/17. Infrastructure investment growth also leapt from 11% in Q4/16 to 18.7% in Q1/17 (see Chart 1), thanks to more active fiscal policy and an acceleration of the PPP project execution rate. On our recent marketing trips to Asia, we noted that some investors were overly bullish on infrastructure, expecting 20% growth for 2017, largely due to their optimistic view on PPP investments. However, we think that infrastructure investment in 2017 is unlikely to exceed last year's 15.8% growth rate - even though the government is likely to hit its GDP target of 6.5%.

Budget spending has been frontloaded

First, government has little room to increase spending. The 12-month rolling sum budget deficit as a share of GDP widened from 3.8% at the end of last year to 4.0% in March (see Chart 2).

Debt swap quota has been lowered

Second, local media [reported](#) recently that the Ministry of Finance (MoF) plans to reduce the quota for local government debt swaps from Rmb5 trillion last year to Rmb3 trillion in 2017, partly due to the steep rise in onshore bond yields. With this year's official TSF growth target lowered to 12%, which means the implied growth target for augmented total credit is only 14%, substantially lower than last year's actual growth of 16.4%.

Special financial bonds have been halted

Third, in recent years, quasi-fiscal spending funded by policy banks has helped bypass the on-budget fiscal deficit red line to stimulate growth. But five months into 2017, there has been no mention of these special bonds; though there has been no official explanation, it appears the program has been suspended.

LGFV bond issuance plunged

Fourth, local government financing vehicles (LGFVs) bond issuance plunged 61% yoy to Rmb213 billion in the first quarter of this year due to higher funding costs and tighter budgetary controls.

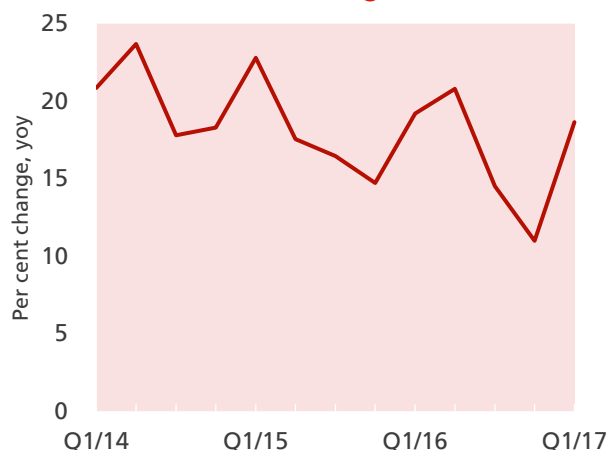
Fiscal support in form of tax cuts

Fifth, efforts to reduce corporate taxes and fees also suggest that support for infrastructure investment from public spending will be crowded out. The State Council recently announced cuts in administrative fees and VAT that could reduce fiscal revenue by Rmb580 billion this year. This shows that the government is attaching more importance to tax cuts than to infrastructure outlays as a means of stimulating the economy.

We expect infrastructure growth to be 15%

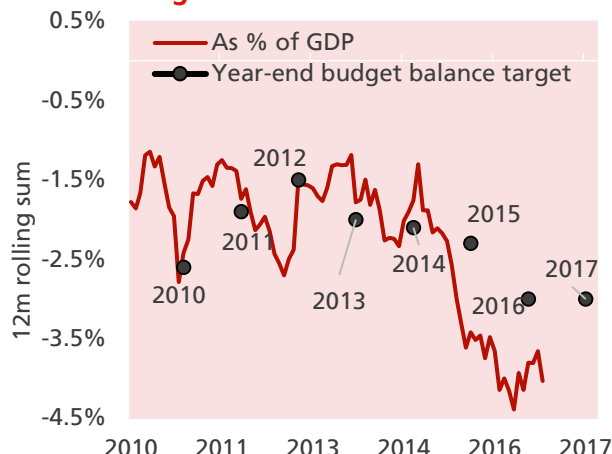
So, although the government has reiterated its commitment to a proactive fiscal policy, further fiscal expansion will be difficult under the current deficit target. PPP projects are set to pick up further this year, but the financing constraints listed above and higher funding costs due to rising bond yields suggest overall infrastructure investment growth is unlikely to accelerate. Instead, unless funding conditions improve, it is unlikely to exceed 15% for 2017.

Chart 1: Infrastructure FAI growth



Source: CEIC, TS Lombard

Chart 2: Budget deficit



Source: CEIC, TS Lombard

Brazil

Falling retail sales confirm weak economic recovery ahead

Recent retail sales figures released last week confirm our view that an economic recovery will remain on hold in the first quarter of the year, dragged down by subdued growth in household consumption on the back of a sluggish labour market.

Retail sales down on the back of weak labour market dynamics

Brazil's retail figures dropped 4% y-o-y and 1.9% m-o-m in March (see Chart 1), dampening hopes of an economic recovery in Q1/17. Although the drop in retail sales is lower than the rate observed last year in March at -5.7% y-o-y, a weak labour market continues to weigh down on the recovery – the unemployment rate rose to 13.7% in March and worked hours fell 4.6% during the same month.

Small and medium-sized retail corporates leading the drop in overall sales

However, there are some signs of modest economic improvements going underway as large corporates in the consumer sector have posted better revenues in March. The drop in overall retail sales figures is mainly driven by a contraction in sales by mid-size to small retailers' sales which together account for a larger market share.

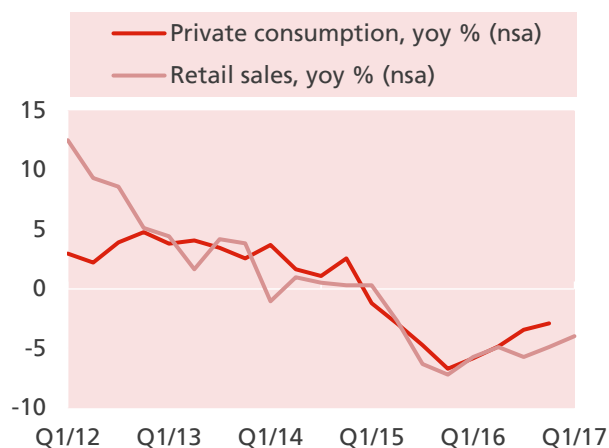
Sluggish consumer recovery will continue to weigh on corporates

The above also suggests that the recent squeeze in household incomes has resulted in lower consumer spending and, as we highlighted in a previous [EM Watch](#), has further translated into falling revenues for smaller corporates who are increasingly struggling to repay their debts leading to higher default rates.

Lower rates will provide a temporary boost

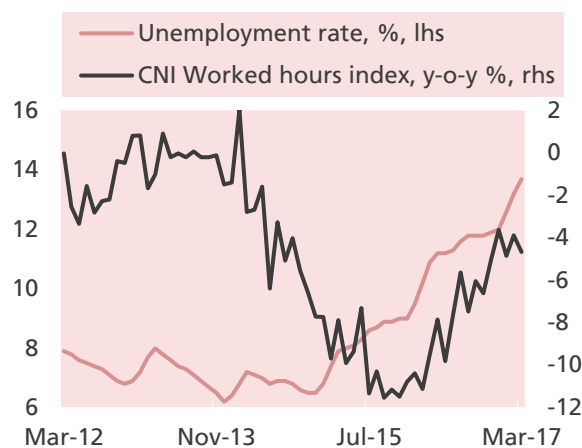
Further interest rate cuts expected at the end of May will provide a temporary boost to households by encouraging consumer credit and spending growth, boosting retail sales over the next quarters.

Chart 1: Retail sales vs private consumption



Source: Bloomberg, TS Lombard

Chart 2: Weak labour market dynamics



Source: Bloomberg, TS Lombard

India

Equity market rally is running ahead of ground reality

India's equity markets jumped to new highs last week despite a spate of fiscal fourth quarter earnings that showed corporate activity to be sluggish. To be sure, India's economic long-term outlook looks better relative to most other major emerging markets, and investors are enthused about the politically stable government led by Prime Minister Narendra Modi pursuing economic reforms such as rolling out the Goods and Services Tax and renewing efforts to clean up the bad debt at banks. But market valuations appear rich in view of the slow economic recovery, as India's industrial output and inflation data released on Friday show.

Asset prices appear overvalued...

Asset market indicators signal frothiness, with the benchmark Sensex and the Nifty indexes up almost 14 and 15% respectively so far in 2017, and the Sensex trading at around 22 times FY18 earnings compared to the five-year average of 18.6 times. Heavy dollar inflows into Indian equity and debt markets have strengthened the rupee as well, with the local unit appearing significantly overvalued now. The Reserve Bank of India (RBI) puts the rupee's overvaluation in terms of the real effective exchange rate derived from a basket of six currencies as 8% as of April, and another measured from 36 currencies of its trading partners at a far larger 21%.

... amid little signs of broad-based earnings recovery

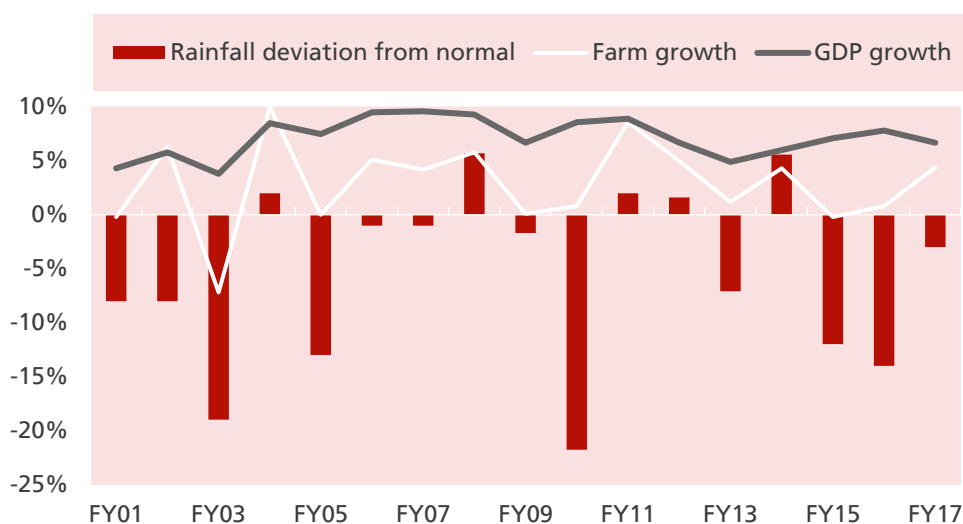
The run up in asset markets has gone far ahead of ground reality with the earnings reports for 4Q/FY17 showing little signs of a broad-based recovery. Economic data released by the government on Friday showed March industrial production growth at a still tepid 2.7% year on year compared with 1.9% in February, with manufacturing output at just 1.2% compared with 1.4% in the previous month. Meanwhile, RBI data released earlier last week showed bank credit slowing even further to 4.3% at the end of April from a six-decade low of 5.1% in FY17. Surprisingly, the April CPI inflation number was lower-than-expected at just under 3%, slowing sharply from 3.8% in March. Although inflation

is well below the RBI's medium-term target of 4%, the low food prices are an indicator of the weak economic activity in rural areas and the informal sector, which have still not fully recovered from the November currency notes ban.

Forecast of better-than-expected monsoon drives up markets...

Good news on the monsoon was a key driver of last week's market performance, with the India Meteorological Department saying last week that rainfall in the June-to-September monsoon may be better than earlier expected due to a possible weakening of the El Niño impact that usually disrupts the rainy season in India. As we pointed out in our 4 May report [Headline GDP obscures unbalanced growth](#), the outcome of the monsoon will be particularly important this year given the tentative recovery in consumer demand, especially in rural areas. Chart 1 below shows how weak rainfall can hurt farm growth significantly as the monsoon accounts for around 80% of India's annual rainfall, while 60% of the farmland lacks proper irrigation facilities.

Chart 1: Monsoon rainfall versus farm and GDP growth



Sources: IMD, Central Statistics Office, RBI.

But predicting the weather can be tricky...

It is of course impossible to predict the weather, and the IMD does not have a good track record in forecasting the rains, but many other factors are also constraining India's growth recovery.

GST to be potentially disruptive in the short-term

Another potentially disruptive factor to growth in the short run is the implementation of the Goods and Services Tax (GST), scheduled for 1 July. Although this landmark tax reform is expected to bump up India's economic growth in the medium-term to 8% (according to the IMF's forecast) by creating a unified market and enforcing better tax compliance, there is bound to be at least short-term disruption to businesses and consequently to broader economic growth.

Investment demand struggles to recover

Meanwhile, as the bank credit numbers illustrate, investment demand in India is still struggling to recover. Although policymakers are renewing efforts to clean up the bad debt in the banking system (as we noted in our 8 May [EM Watch](#)), bank reforms in India will likely be a

long drawn-out process, keeping credit growth and, in turn, investment demand muted for the foreseeable future.

■
Monsoon, GST and bank reform to determine India's growth recovery

By August-September, we will be able to gauge the outcome of the monsoon, while the potentially disruptive effect of the GST will be clear only by yearend, as will the progress on the bad debt clean up. Until then, any further rally in asset prices will continue to feel frothy.

Russia

Revived geopolitical hopes do not spell rapid re-rating

Recent developments leading up to last week's meeting between Donald Trump and Sergey Lavrov look good for the geopolitical driver for Russian markets. We stick to our view, however: downside geopolitical risk is low and the trend is marginally favourable; but Russian assets are not about to enjoy a 'geopolitical' re-rating.

■
Perhaps it is time to revise our downgraded view of geopolitical prospects for Russian markets.

Despite the prominent Russian angle to the latest political furore in Washington – over President Trump's dismissal of FBI Director James Comey – the prospect of a geopolitical dividend for Russian assets has come back in from the cold. The main signs of positive change have been Trump receiving Russian Foreign Minister Sergey Lavrov in the White House last Wednesday and, the previous week, taking a telephone call from President Putin about Syria.

Back in March, we [downgraded](#) our previously positive view of this geopolitical driver. The specific conclusion concerned the timing of any partial EU sanctions relief – pushed back beyond the next (and now imminent) decision point in Q2/17. Our general conclusion was that the geopolitical driver now looked blocked, but with decent downside protection and still some positive potential in the longer run. Could now be the time to upgrade this view?

■
Recent developments confirm our cautious view with a positive bias

The short answer is "too early". This cautious conclusion does not stem from any particular judgment about the domestic political dynamic in the US. Trump's past and present dealings with Russia may end up weakening but not terminating his presidency (see [Trump and a Russian Watergate: Forget it](#), 2 March). However that may be, Trump is clearly minded now to brush aside "Russiagate" and pursue his long-advertised policy of improving relations with Russia.

■
Despite the return to pragmatic US-Russia cooperation in Syria . . .

Instead, the main reason for caution is the limited scope for such improvement. The positive potential for now is confined to the Syrian theatre, where the Trump administration is supporting the latest Russian-led initiative on four security zones with de-militarized perimeters. For its part, Russia is working hard to keep the US on board with this initiative and is now positioned as the core partner for the US in attempts to resolve the Syria crisis – especially given increasing US-Turkey frictions over the question of the Syrian Kurds.

■
. . . and the equally low downside risks in the Donbas . . .

This positive turn coming a mere month after Trump ordered a missile strike on a Syrian government air base illustrates very well our point that for all the dramatic unpredictability of such conflict situations, the downside risk is low. The same applies to the decisive theatre as

regards the outlook for the Russian geopolitical risk premium and sanctions – namely, south-eastern Ukraine. In that Donbas conflict zone, regular flare-ups will not escalate to the extent of threatening increased sanctions on Russia.

... upside potential is equally limited

But the prospect of breakthroughs remains low. The positive vector in Syria will be faltering and subject to periodic setbacks. As for the Donbas, radical improvement is at least as unlikely as radical deterioration. The situation will remain blocked pending domestic political developments in Ukraine where elections are not due until 2019 (though shocks and surprises in that country are perfectly possible). Change would otherwise require the US and/or the EU to impose a much ambitious peacekeeping intervention in the Donbas. This looks highly unlikely.

Geopolitical developments will support but not transform Russian market sentiment

Instead, we would expect continued positive atmospheric to come out of the Trump-Putin meeting now scheduled to happen when both leaders attend the annual G20 Summit in Hamburg on 7-8 July. As for the EU, looking out 6-12 months, the “doves” led by Italy will start to raise their voices again in favour of a gradual start to dismantling the sanctions regime. To sum up, geopolitical trends will be marginally positive for market sentiment on Russia, but will not drive a re-rating – at least on our standard six-month forecast horizon.

Mexico

Subnational politics signal the rise of populism

With less than one month away from the gubernatorial election in Estado de Mexico, the tight race between the candidates from newly created party MORENA and the incumbent PRI signals the rise of anti-establishment candidate Andres Manuel Lopez Obrador (AMLO) for the presidential election in 2018, irrespective of the final result in the forthcoming state election.

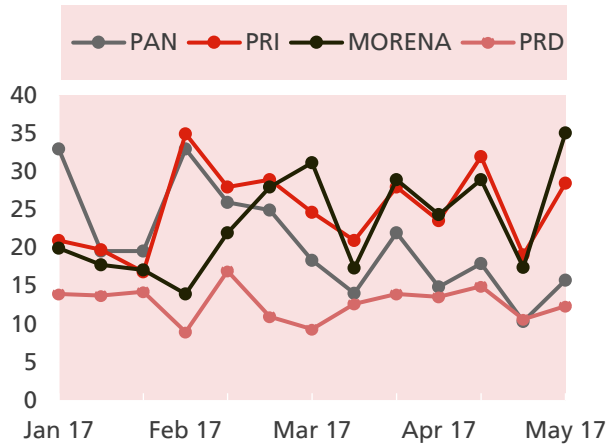
Close race between MORENA and PRI improves the odds for AMLO in 2018

The gubernatorial election in Estado de Mexico (EdoMex) will take place on 4 June, and never before has this election been so contested. The most recent polls give the newly created party MORENA a strong chance of winning the election against the incumbent PRI (see Chart 1). A victory by MORENA in EdoMex will confirm AMLO as the front-runner in the June 2018 presidential election; but even a good second place showing will boost AMLO’s chances in 2018.

EdoMex is a national barometer for its size and political history

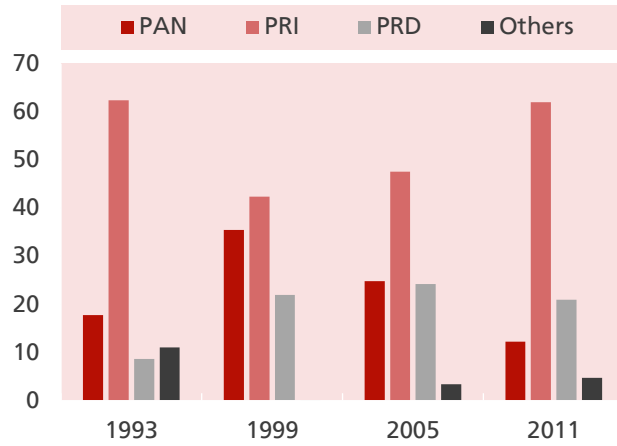
As the most populous state in the country, EdoMex is traditionally considered a barometer ahead of the presidential election. The PRI has comfortably won the past four state elections (see Chart 2). A lead in the polls by the relatively unknown candidate of MORENA is a strong indication of changing political sentiment in the state and perhaps also nationally.

Chart 1: Voting preferences



Source: Several Polls, TS Lombard

Chart 2: Historical election results

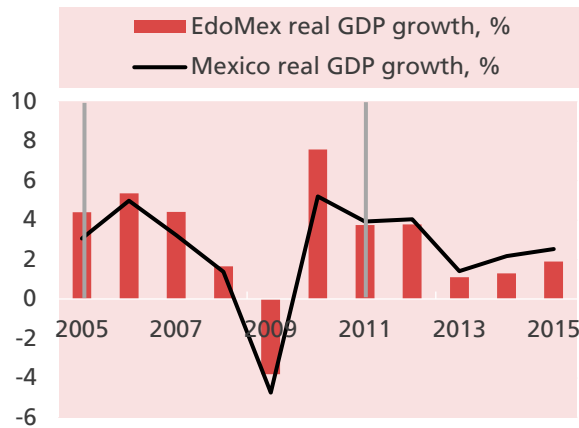


Source: IEEM, TS Lombard

■ Voter preferences are shifting

A mix of widespread dissatisfaction with the national government led by President Pena Nieto – owing to its perceived mishandling of Mexico-US relations and the once-off increase of over 20% in gasoline prices in January – and an underperforming local economy is shifting voting preferences away from PRI.

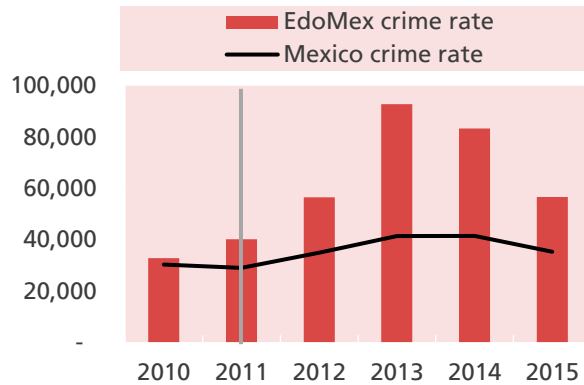
Chart 3: Economic growth



Source: INEGI, TS Lombard

Chart 4: Security

Number of reported crimes per 100,000 residents over 18 years old



Source: INEGI, TS Lombard

■ Mainstream candidates losing ground to anti-establishment contenders

In fact, EdoMex has underperformed the wider country both in terms of economic growth (see Chart 3) and security levels (see Chart 4) since the current local administration took office in 2011. Moreover, the recent hike in gasoline prices and the exchange rate pass-through to domestic prices has led to headline inflation in EdoMex (6.3% in April) rising faster than nationally (5.8% in April).

However, disenchantment with the PRI is not being translated into gains for the other mainstream parties the PAN and PRD, but is instead boosting support for anti-establishment parties like MORENA. The traditional left wing PRD is ideologically closer to MORENA than it is to

the other mainstream parties. The PRD and MORENA are both fielding candidates in EdoMex but we do not rule out their forming a coalition in 2018 – the PRD currently governs Mexico City and will seek to retain some of its current positions in the upcoming mayoral election next year in exchange of its support to AMLO.

Philippines

Monetary policy continuity will help tame inflation

Last week's nomination of Nestor Espenilla as the new Governor of the Bangko Sentral Pilipinas (BSP) is positive for taming inflation and strengthening the financial system at a time when inflation risks are biased to the upside and real rates are negative; we expect the BSP to hike rates in Q3/17.

The nomination of Espenilla is positive for monetary policy continuity

Last week, President Rodrigo Duterte announced that current head of the Supervision and Examination sector, Nestor Espenilla will succeed BSP Governor, Armando Tetangco who is due to step down on 2 July. The nomination of a BSP insider, preferred by Tetangco, is a positive development for monetary policy continuity. Over his 36-year long career at the Central Bank, Espenilla has earned a reputation for competence. His track record includes the crackdown on mismanaged banks and bank frauds, including the closure of Banco Filipino in 2011. His appointment is also a positive sign for the strengthening of the financial system and increased transparency.

Rising inflation and negative real interest rates will prompt the BSP to hike rates in Q3/17

Headline inflation has been gradually rising since mid-2016 driven primarily by rising oil prices. We expect inflation to increase towards the upper bound of the BSP's 3+/-1% target range on the back of demand-side pressures stemming from robust private consumption. Higher inflation has pushed real interest rates into negative territory since February, which should lead the BSP to begin raising interest rates in Q3/17.

Market Strategy

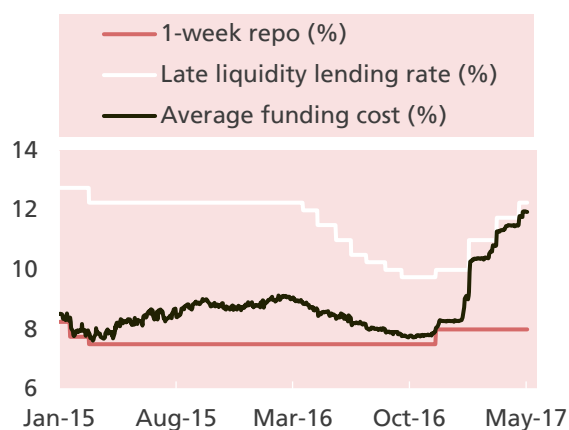
We add a positive view on Turkish local debt

As of today we add a positive view on Turkish local debt to our list of high-conviction total return views (see [Table 1](#)). The Central Bank (CBRT) has progressively tightened monetary policy since the start of this year. As a result, inflation expectations have at last started to decline and the lira has stabilized. But the currency remains relatively undervalued and yields are high, both vs the level of risk and vs comparable peers. Monetary policy under the newly assertive CBRT has improved conditions for local debt and we see potential for yields to fall further over the next 3-6 months.

Tighter monetary policy is beginning to work

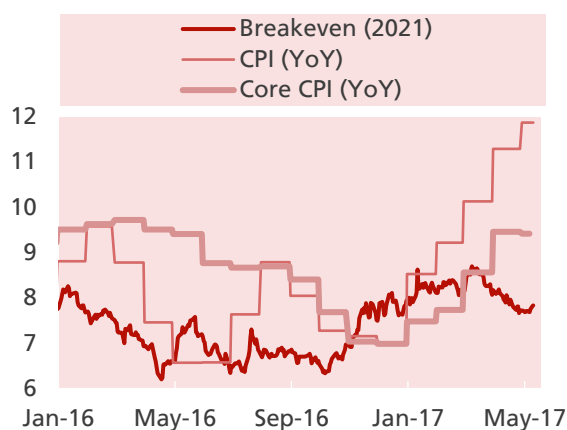
The CBRT has progressively tightened monetary policy since the start of this year, by raising its late liquidity lending rate and driving up the average cost of funding for the banking system (see Chart 1). In January, the average cost of funding was close to the 8.00% 1-week repo rate, but by restricting access to liquidity, the CBRT has forced average funding costs closer to the late liquidity window (LLW) lending rate, while at the same time raising the LLW rate by 225bp this year. As a result of this tighter monetary policy, inflation expectations have at last started to decline; current headline inflation is still rising but an unexpected drop in core inflation in April offers an indication that inflation may be starting to peak (see Chart 2).

Chart 1: CBRT repo rate, late liquidity lending rate and average cost of funding



Sources: CBRT, TS Lombard.

Chart 2: Turkey: Headline CPI, core CPI and breakeven inflation

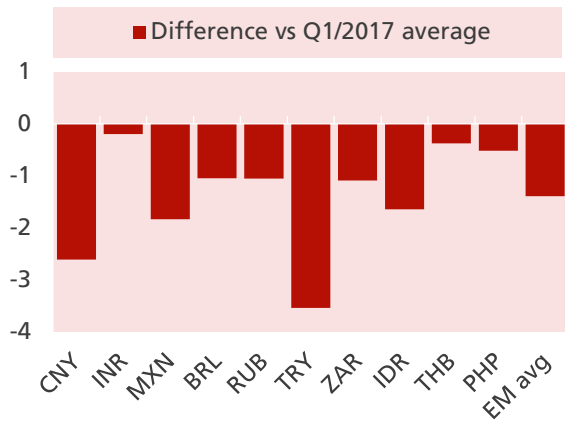


Sources: Bloomberg, TS Lombard.

USD/TRY implied vol has fallen sharply but politics remains a risk factor

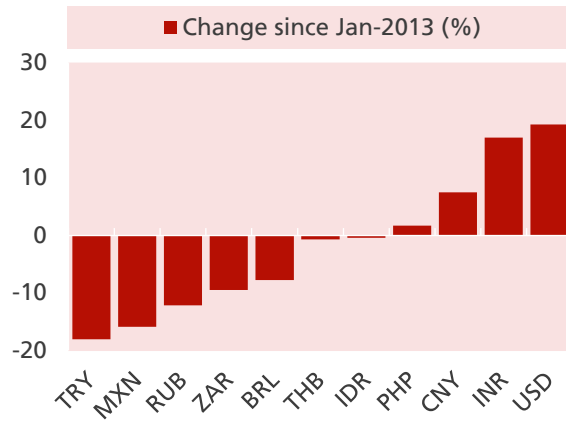
The impact of this more assertive monetary policy has helped stabilize the lira over the past month. USD/TRY implied volatility has collapsed reflecting investors' reduced risk perception (see Chart 3). But the currency remains undervalued relative to its longer term REER (see Chart 4). As well as domestic political tensions, the deteriorating relationship with the US is weighing on markets, but we believe that the incentives of both parties favour reaching an understanding at this week's planned meeting between Presidents Erdogan and Trump.

Chart 3: Difference in USD-cross 3-month implied vol vs Q1 average level



Sources: Bloomberg, TS Lombard.

Chart 4: Change in real effective exchange rate since January 2013

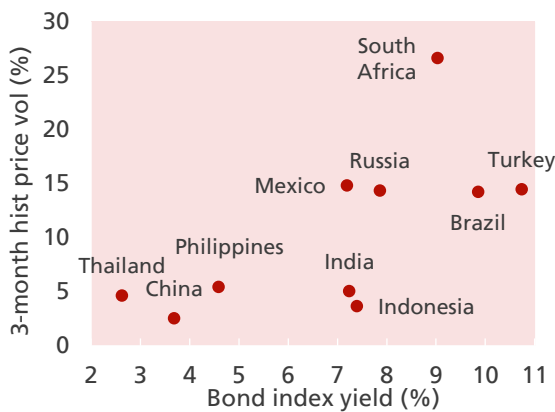


Sources: Bloomberg, TS Lombard.

Pressure to cut rates has not intensified

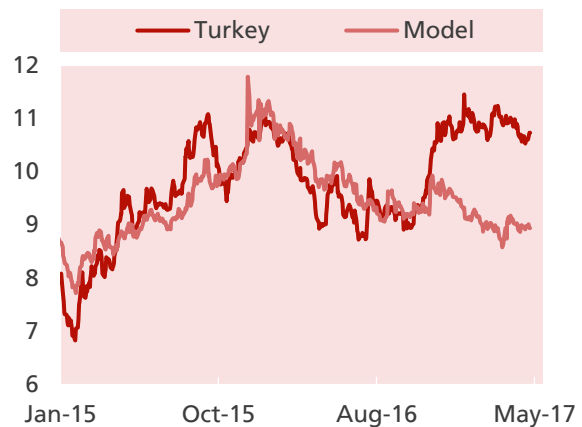
Since the beginning of the year, there have been regular calls for lower interest rates; from the government, presidential advisors and President Erdogan himself, but this political pressure on the CBRT has not increased since the 16 April constitutional referendum that granted the President sweeping new powers. In our most recent [EM Strategy Monthly](#), we note that some business interests are becoming uncomfortable with the extent of lira depreciation and would prefer to see a stable or even moderately stronger currency; in this case the President may prefer not to intensify pressure on the CBRT to cut rates.

Chart 5: Bond index 3-month historical price volatility (USD, annualized) vs yield



Sources: Bloomberg, TS Lombard.

Chart 6: Turkey: Bond index yield vs model based on South African and Brazilian yields



Sources: Bloomberg, TS Lombard.

We expect local debt yields to fall further

Despite the decline in bond yields over the past month, they remain high vs the level of risk (see Chart 5) and vs comparable high-yielding EM peers (see Chart 6). Yields are at relatively attractive levels and monetary policy under the newly assertive CBRT has improved conditions for local debt; we see potential for yields to fall further over the next 3-6 months.

Must read

Brazil: *Lava Jato* muddies the outlook for the 2018 elections

In an important analysis of political risks ahead, Elizabeth Johnson and Grace Fan warn that the *Lava Jato* corruption investigation will play a decisive role in the 2018 presidential election. Traditional centre-right candidates, who would have won the support of markets, have lost their popular appeal. Among those left-leaning candidates gaining ground, former Environment Minister Marina Silva at least offers a clean pair of hands and a fresh approach, but there is a growing risk of a step back in time as backing for former President Lula gathers momentum. Popular disenchantment with mainstream politics also opens the door to a mixed bag of political outsiders, perhaps the most disturbing of whom is Congressman Jair Bolsonaro, a right wing populist in the mould of Donald Trump, whose support is surging. See our 12 May report [Brazil: Looking ahead to the 2018 elections](#).

Russia: Domestic top-down drivers still net positive for oil stocks

Christopher Granville and James Henderson explain that short-term support for the oil price from the expected imminent extension of the OPEC-Russia production restraint agreement will not relieve structural downward pressure on the oil price. For Russia – as for other low-cost producer-countries – this reality highlights the importance of volume growth as the key to sustaining revenue while, at the company level, such growth is crucial for earnings. See our 8 May 2017 report [Russian oil – volume gearing](#).

China: A purposeful slowdown

In the economics section of our 11 May [China Watch](#) – economic, political and market analysis – Bo Zhuang cautions that investors have been overly bullish on infrastructure investment. Fiscal spending has been front-loaded and rules for quasi-fiscal financing have been tightened. Infrastructure investment growth will be capped if there is no improvement in funding sources. In politics, Trey McArver notes the heightened attention of Xi Jinping to the economy, which will give impetus to reform. While in markets, Larry Brainard advises that, by contrast with 2015, when economic policy blunders rattled markets, the authorities are better prepared to manage the monetary squeeze.

Strategy: Positive views of Russian and Indonesian equities

In our 8 May [Absolute Views](#) report, Jon Harrison maintains our positive views on equities in Russia: higher oil prices and larger dividends from SOEs will support the market, helped by sound monetary and fiscal policy; and Indonesia: equities have underperformed other EM since the US election and should recover now that the tensions around the Jakarta elections have subsided.

In future, these high-conviction total return market views be incorporated into our weekly EM Watch – we add a positive view on Turkish local debt in the [strategy](#) section above – and also summarized in our EM Strategy Monthly. See our updated [EM Service Summary](#).

Asset Allocation

We present below our EM asset allocation views which are updated once per month, most recently in our 3 May [EM Strategy Monthly](#).

We aim to publish our next EM Strategy Monthly on 1 June.

Asset Allocation View

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

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

Absolute Views

Table 1 below presents our high-conviction total return market views.

As of today we add a positive view on Turkish local debt to our list of high-conviction total return views. See [market strategy](#) section.

Table 1: Current Absolute Views

Country	Asset	Market view	Units	Date opened	Open level	Current level	Performance to date
Russia	Equities	Positive	USD	8-Dec-16	576.0	560.6	-2.7%
Indonesia	Equities	Positive	USD	5-Apr-17	495.1	503.3	+1.7%
Turkey	Local debt	Positive	%	15-May-17	10.75	10.75	+0.0% (+0 bp)

Source: Bloomberg, TS Lombard.

The intra-day yield used for the view opened today will be modified to today's close of business yield in subsequent reports. Current market prices are as of 8:00 a.m. on 15 May 2017.

Our closed views are shown in [Table 2](#); further [explanation](#) of Tables 1 and 2 can be found at the end of this note.

Macro and markets summary

The macro and market views below appear in our 3 May [EM Strategy Monthly](#) and are updated once per month.

China

Politics	Tensions in US-China relations have eased; domestic political environment will remain quiet ahead of Communist Party Congress later this year	
Economy	Growth is strong currently but will ease in H2/17: we project 6.5-6.6% average rate for 2017	
Equities	-1(+1)	Monetary tightening is negative for the equity outlook
Currency	-1	Near-term stability followed by gradual 3-5% depreciation in next 12-18 months
Local rates	-1	Interest rates under upward pressure owing to PBoC actions
Credit	n/a	

Brazil

Politics	President Temer is struggling to secure support for labour and pension reforms in the Congress amid growing public opposition; the passage of watered-down reforms is likely	
Economy	Economic activity, especially consumption, remains depressed and there is little sign of an upturn	
Equities	-1	The lack of growth momentum and lofty valuations will weigh on equities
Currency	-1	We view the BRL as currently overvalued and expect it to weaken in the next 6 months
Local rates	+2(+1)	Monetary easing will accelerate in the next 2-3 months
Credit	-1(0)	We expect credit spreads to widen due to rising political turmoil and reform delays

India

Politics	Modi has strengthened his political position ahead of the next general elections, due in 2019	
Economy	Growth slowed to 7.1% in Q4/16, outperforming market expectations	
Equities	+1	Modi's strengthening political position is positive for longer-term trends in equities
Currency	+1	Although we view the INR as overvalued, the near-term outlook is positive
Local rates	-1	We expect yields to rise in the next 3-6 months
Credit	n/a	

Russia

Politics	Orthodox monetary and fiscal policies enjoy continued political support	
Economy	A steady, albeit gradual, economic recovery is being led by a rebound in investment	
Equities	+1	An improving economy and steady declines in inflation are positive for stocks
Currency	-1	Following recent strength, the RUB is likely to ease marginally from current levels
Local rates	+1(+2)	Declines in yields will accelerate and a stable RUB will attract carry-trade capital inflows
Credit	0(-1)	Significant tightening of spreads has occurred but strong investor demand continues

Mexico

Politics	The renegotiation of NAFTA and domestic politics will dominate political developments	
Economy	Downward pressures on growth will ease on the back of strong services and exports performance	
Equities	-1	High cost-push inflation will weigh on earnings
Currency	+1(+2)	The peso remains undervalued; further near-term rate hikes will support the currency
Local rates	+1	A stable peso and higher rates will attract inflows into local market instruments
Credit	+2	Credit spreads continue to offer attractive relative value following unchanged ratings

Indonesia

Politics	Political tensions are easing following the Jakarta gubernatorial election	
Economy	Growth will remain stable at around 5% yoy	
Equities	+2	Positive, especially consumer staples and construction
Currency	+2(+1)	The IDR will be supported by BI as it aims to keep the rupiah stable vs the dollar
Local rates	+1(+2)	Stabilizing at current yield levels and likely to deliver positive carry
Credit	+1	Relative returns on dollar bonds remain attractive, despite recent tightening

Philippines

Politics	Political volatility remains high owing to the government's confused policy agenda	
Economy	Strong economic growth will be sustained, but there are higher risks due to policy confusion	
Equities	-1(-2)	Outlook for equities is negative because of the lack of a clear government policy agenda
Currency	-1	Despite intervention by the BSP, the peso will remain weak at around Ps50-50.50/US\$
Local rates	-2(-1)	Amid rising inflation relatively low yields on domestic bonds are unattractive
Credit	-1	Stable owing to strong local bid but trading at very tight spreads relative to credit risk

Thailand

Politics	The political climate is improving, but new elections will most likely slip to H2/18	
Economy	Growth is consumption-led and will continue to be fuelled by strong fiscal stimulus	
Equities	0(-1)	Improved political stability will attract portfolio inflows despite moderate growth
Currency	0(+1)	The baht is buoyed by the large current account surplus but now appears range-bound
Local rates	-1	BoT is likely to stay on hold through 2017; local bonds will lag other EMs
Credit	n/a	

South Africa

Politics	The battle for the election as head of the ANC in December has escalated political tensions	
Economy	Inflation is slowing thanks to falling food prices; low growth will continue in 2017	
Equities	-1	Fiscal erosion and political tensions will undermine equities
Currency	-1(0)	The rand as undervalued but near-term appreciation is unlikely
Local rates	-1	Foreign outflows are likely to gather steam as political turmoil rises
Credit	-2	Credit spreads will be adversely affected by the President's tilt towards populism

Turkey

Politics	The result of April's vote was too close to ensure stability; crackdown on opposition to continue	
Economy	Growth will continue to lag high inflation, but European growth will be positive for exporters	
Equities	+1	Stimulus, European demand and improving inflation outlook will support growth
Currency	+1(-1)	Political risk are still driving outflows, but monetary policy appears increasingly credible
Local rates	+1(-1)	Inflation to remain high, but likely peaking at the end of Q2/17
Credit	+1	Fiscal discipline has been eroded somewhat; monetary policy is driving positive outlook

Closed views

Table 2: Closed Absolute Views

Country	Asset	Market view	Units	Date opened	Date closed	Open level	Performance to close
Russia	Equities, energy	Positive	USD	18-Sep-15	12-Jan-16	596.6	-17.7%
Brazil	Equities	Negative	USD	30-Jan-15	5-Feb-16	1,711.0	+42.6%
Brazil	10-yr local debt	Positive	%	7-Apr-16	7-Sep-16	14.24	+34.9% (+225 bp)
Philippines	Equities	Positive	USD	17-Jun-16	7-Sep-16	28.36	-1.4%
South Africa	Local debt	Positive	%	10-Nov-16	3-Feb-17	9.27	+9.7% (+19 bp)
Turkey	Sovereign credit	Positive	bp	27-Jul-16	7-Mar-17	322	+2.0% (+11 bp)

Source: Bloomberg, TS Lombard.

Explanation of Absolute Views tables

The absolute views in [Table 1](#) and Table 2 above are our high-conviction total return market views for the next three to six months expressed as either positive or negative. No numerical price performance parameters are implied, nor should they be inferred. The performance to close is calculated using mid-market prices and does not include funding cost. All absolute views that have been closed in 2016 and 2017 are listed in Table 2.

Unless otherwise stated, equity market prices use the relevant MSCI index expressed in dollars; sovereign credit and local bond market prices use the relevant Bloomberg EM bond index. Equity performance is calculated in dollar terms. Local debt performance is calculated in dollar terms. Sovereign credit performance is calculated in dollars relative to a duration matched US Treasury hedge.

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