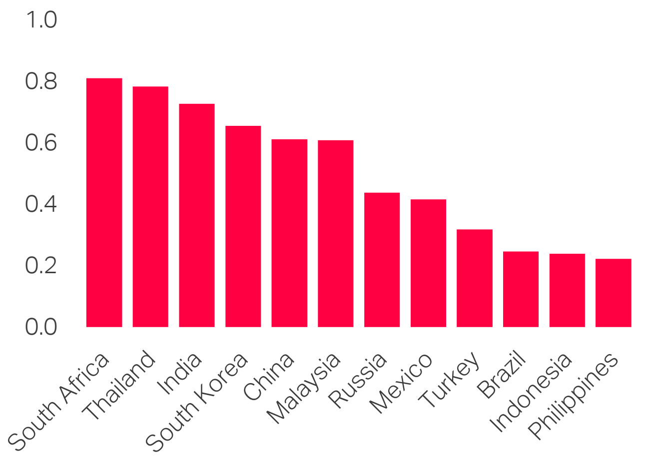
EM Watch

IS IT ALL PRICED IN

Jon Harrison / EM Team

- **Global**: EM bounce almost done
- **China**: Don't be fooled by the trade data
- **Brazil**: Data indicate weaker 2019 growth
- **India**: Terror attack raises political uncertainty
- **Russia**: Investment climate shock
- **Mexico**: Pemex, energy outlook darkens
- **Indonesia**: Weak exports delay CA improvement
- **Turkey**: Economic hard landing arrives

Correlation of export growth & equity return



Source: Bloomberg, TS Lombard.

This publication is part of our EM service. Click here for more details.

Contents

Global

EM bounce almost done

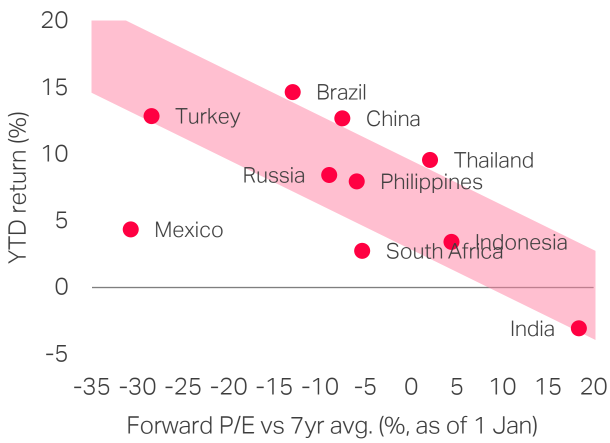
US-China trade progress points to a delay in tariff escalation. The surge in EM equities and currencies, however, has now unwound much of the valuation discount that existed at the start of the year. Declining world trade will renew attention on EM current accounts.

Signs of tariff flexibility boost markets. Emerging markets received a boost early last week when President Trump hinted at flexibility on the 1 March deadline for tariff escalation if the two sides are close to a deal. Risk sentiment was also helped by progress on border security that would avoid another US government shutdown. It is, of course, the imposition of new tariffs that is potentially more damaging to EM economies. Last week's trade talks ended on a positive note, with a growing likelihood of a Trump-Xi meeting as soon as March. We maintain our view that an extension of the tariff deadline is the most likely outcome. The economic and financial market incentives of both sides are aligned to limit further damage, which we ultimately expect to result in an agreement to lift the threat of new tariffs after the two Presidents have met.

The EM recovery this year has unwound previous undervaluation. EM equities and currencies were weaker over last week as a whole, despite progress on trade. The lacklustre week comes after many EM equity markets have delivered a strong start to the year. A comparison of equity valuations – using forward P/E vs its 7-year average level – as of the beginning of the year suggests that the most undervalued markets were the greatest beneficiaries of the year to date surge (see Chart 1). Furthermore, while Mexico and Turkey remain undervalued on this measure, the valuation of most other markets is now close to or above average levels. A similar picture is evident in EM real effective exchange rates. The undervalued EM currencies at the start of the year have delivered the greatest gains and, as a result, have all but eliminated earlier valuation discounts (see Chart 2). Many EM currencies now look overvalued on a short-term comparison, albeit in some cases still attractive vs longer term.

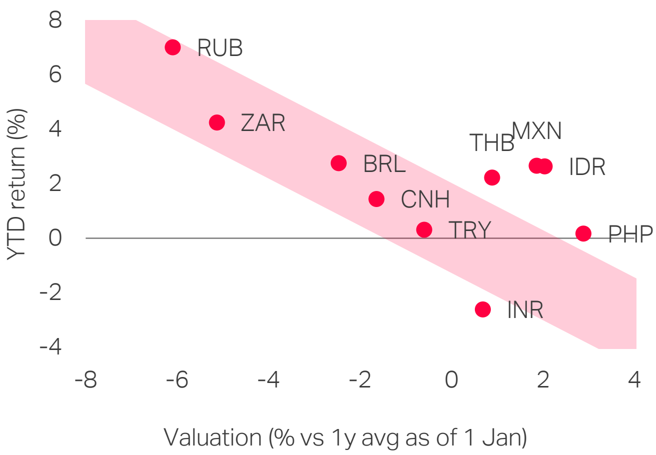
More good news will be required to drive further EM gains. The bounce in EM assets this year may have further to run if there is a strong lead from US equities, but with EM valuations no longer as attractive as at the start of the year, further positive developments in world trade will likely be needed if EM gains are to be sustained.

Chart 1: YTD equity rtn vs valuation as of 1 Jan



Source: Bloomberg, MSCI, TS Lombard.

Chart 2: YTD REER rtn vs valuation as of 1 Jan



Source: Bloomberg, TS Lombard.

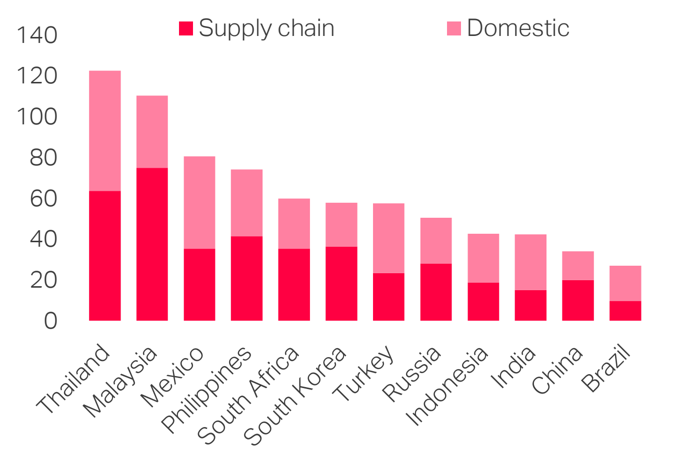
Contents Global China Brazil India Russia Mexico Indonesia Turkey Must Read Asset Allocation

US market recovery could threaten the trade deal. The US administration's willingness to escalate tariff measures against China last year was predicated on its belief that the US is able to win a trade war. The relative strength of the US economy and stock market vs China likely contributed to that belief. Strong US jobs data and the recovery of US equities this year raise the risk that the administration may conclude that the economy is able to withstand another hike in tariffs. We do not subscribe to this view. Our US economist, Steve Blitz, notes that much of the US stock market gain this year comes from outperformance of companies with exposure to foreign earnings and not from the domestic economy itself (see our 13 February Daily Note).

Declining trade will weigh on EM. Our analysis of EM trade data for December concluded that more bad news on trade is likely (see our 28 January EM Watch). January trade data confirm this picture. Exports contracted year on year in South Korea, Taiwan and Indonesia, illustrating the impact of the tech cycle downturn, supply chain disruption and the overall decline in world trade. In the first two of these countries the extent of the export contraction was less than that in December, which might suggest that a case could be made that the hit to global trade is at least starting to bottom out. Our analysis of Chinese trade data, however, highlights the distortionary impact of the Lunar New Year. It is probable that January and February taken together will present a deteriorating picture for trade (see China section). Disinflation will weigh on EM too. The collapse of China's January PPI, exceeding consensus to the downside, supports our view of an intensifying disinflationary impact on wider EM economies (see last week's EM Watch).

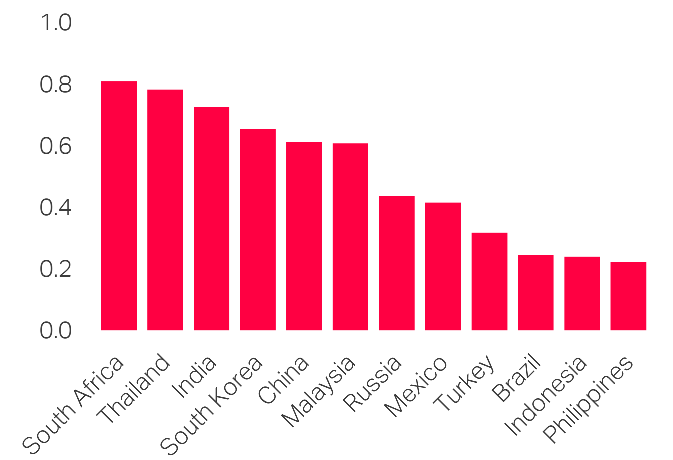
Cheap valuations cannot drive EM assets much further. The observation that the cheapest EM assets have outperformed this year may not be ground breaking, but this is often not the case. Tightening liquidity conditions in 2017 and 2018 meant that markets in the most resilient EM economies often outperformed. Indeed, we constructed a resilience indicator based on current account and FX reserves (see, for example, our 11 June 2018 EM Watch). The decline in export growth will renew investor focus on EM current accounts, but a softer dollar means that financing requirement is not the primary constraint for now. In the coming months the decline in world trade and disruption of supply chains will hit Asian economies hardest (see Chart 3). Furthermore, even in countries where trade is a smaller part of the economy, notably China and India, there remains a high correlation between export growth and markets (see Chart 4).

Chart 3: Exports + imports (%GDP)



Source: Bloomberg, UNCTAD, TS Lombard.

Chart 4: Correlation export growth & equity rtn



Source: Bloomberg, TS Lombard.

Jon Harrison

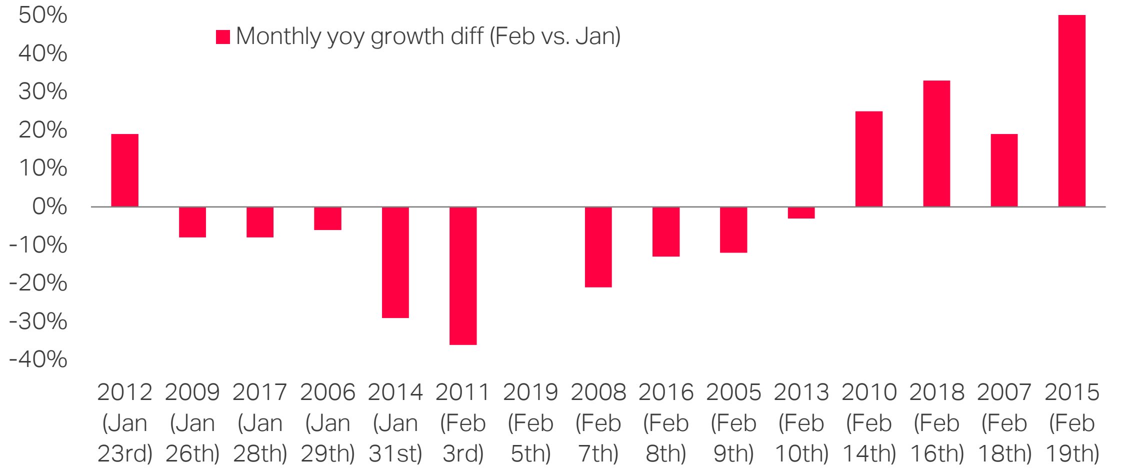
China

Don’t be fooled by upbeat trade data

Strong January export data surprised the market, but these growth figures do not imply a brighter trade outlook, but are a function of seasonality patterns relating to migrant worker travelling patterns during the holiday period.

China’s export data came in strong with a growth rate of 9.1% in January, higher than -4.4% in December and the market consensus forecast of -3.3%. While many analysts interpret the data from a regional growth and product distribution perspective, we do not see this as the appropriate way to read the latest numbers. Rather, we believe the date of the Lunar New Year (LNY) may have played a dominant role.

Chart 1: Lunar New Year distortion on export growth



Source: CEIC. * The dates of LNY are in the bracket below each year

If we extrapolate export growth data for the first two months of each year since 2005, we find that the closer the LNY date falls to 3 February, the more year on year export growth for that month plunges compared to January. For example, headline export growth was 38% in January 2011 when the date was 3 February, but then collapsed to 2% in February. The same pattern was repeated in 2005, 2008, 2014 and 2016. Hence the stronger export growth rate last month means growth in February is likely to plunge back to negative territory.

We always caution against reading too much into the January monthly numbers because the LNY calendar effect always has a major distorting effect on data released in the first two months of the year. More importantly, standard econometric seasonal adjustments may not apply appropriately.

LNY also known as “Chunjie” or the Spring Festival, sees Chinese people from around the world hold big family reunions, take long holiday, make large household purchases and travel abroad. However, the date of the holiday differs every year – usually falling between 20 January and 20 February as it is based on the lunar calendar. With migrant workers employed far from their places of origin, LNY sparks an enormous mass migration as people return home to reunite with families; some 3 billion trips were completed during the 40 day festival season in 2018. While transport, tourism and retail go into overdrive, the rest of the economy grinds to a stop and factories are shut down as migrant workers return home. Trade comes to a halt.

Why February 3rd?

The official LNY public holiday in China lasts for seven days. But blue-collar workers, especially those in the factories, typically take more time off. The last batch of them usually leave their jobs three days before LNY. Most do not return until after the Lantern Festival, 15 days after LNY. This means the country, and practically all its industries, can be shut down for three, or possibly even four, weeks overall. If the LNY falls on 3 February, the number of working days for factories falls to a minimum since plants shut down on the last day of January ahead of the New Year and a majority of workers return only after 18 February.

The way LNY fell on 5 February this year meant that trade activity was more compressed into January as factories rushed to fulfill orders before the LNY shutdown. Extrapolating the pattern based on our analysis, this means that export growth in February is likely to fall back to negative growth.

Bo Zhuang

Brazil

Weak activity in Q4/18 indicates weaker 2019 growth

Fourth quarter activity data disappointed, adding downside risks for both 2018 and 2019 GDP growth. The slow pace of recovery, despite record-low interest rates, indicates that the output gap remains wide. Without recovery in the job market, the output gap will remain wide.

Disappointing activity in Q4/18 indicates weaker-than-expected 2018 GDP growth. The surge in economic confidence following the October election has not translated into stronger growth. Economic indicators for December were disappointing, reinforcing our view that there are still limited signs of a robust recovery. Although retail sales increased by 2.3% yoy in 2018, vs 2.1% yoy in 2017, the retail sector was up only 0.5% qoq/sa in Q4, following a 0.1% increase in Q3/18. Even the robust Black Friday sales in November were not enough to push the retail sector for stronger pickup in the final three months of the year as most of the uptick was reversed in December. Likewise, the services sector is still struggling to recover and contracted for the fourth consecutive year in 2018, falling 0.1% yoy in 2018 after contracting by 2.8% in 2017. The overall picture was not different in the industrial sector, which fell 1.3% qoq/sa in Q4/18 comparing to 2.5% in Q3/18. Despite positive expectations for the credit market, which is seen increasing by 8-10% this year, economic growth drivers going into 2019 remain limited.

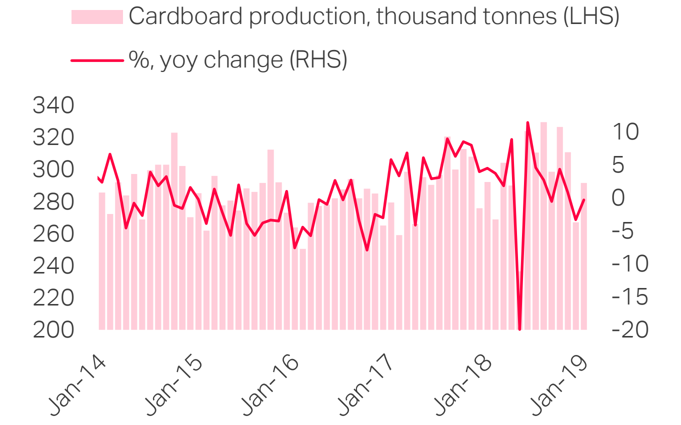
Leading indicators point to still weak activity going into 2019. Other factors also weigh on 2019 growth, including the smaller-than-expected soybean harvest as well as the recent rupture of mining giant Vale's tailings dam in Minas Gerais state. According to initial estimates, this could reduce Brazil's iron ore output by as much as 10%. Leading indicators also highlight the limited signs of recovery in January. Preliminary data show that cardboard production fell 0.2% yoy in January and remains below levels seen before the May truckers' strike. Although toll road traffic increased by 2.1% yoy in January, the recovery comes after a 1.9% decline throughout 2018, highlighting that freight demand is still struggling to recover from the May truckers' strike. The weak activity at the end of 2018 combined with the sluggish start to the year mean that the GDP growth could fall below the current market expectation of 2.5% for 2019.

The output gap will take longer to close as the weak job market weighs on consumption. Banco Central's GDP proxy (IBC-Br) economic activity index, showed expansion of just 0.2% in the fourth quarter and of 1.1% for the year. Although the official GDP number will be released on 28 February, it is likely that 2018 growth will be below the 1.3% currently projected by the market. The sluggish recovery comes despite record-low interest rates and inflation. Although the Selic rate has been below neutral for over one year, the lack of convincing growth drivers is clear evidence that the output gap remains wide. The fact that investment levels remained depressed during the recession is also weighing on the recovery, hindering the closure of the output gap.

Job creation remains concentrated in the informal sector. Because household consumption composes roughly 64% of Brazilian GDP, the weak job market means that the economy is struggling to break out of the vicious cycle resulting from the recent recession. Although unemployment ended last year at 11.6%, 20bps lower vs December 2017, the number of people in the informal sector increased throughout 2018 reaching a historical high of 35.4mn people up from 34.3mn in December 2017, according to the IBGE. Informal jobs typically pay lower wages, which has put a damper on consumption of goods and services. In spite of the approval of a labour reform in Q4/17 by the Temer administration – which promised to create more jobs with the relaxation of labour rules – the real impact on the job market has been negligible.

Pension reform expected to be presented this week, but conflicts within the government raise concerns. The proposal will set the minimum retirement age at 65 for men and 62 for women with a 12-year transition period and should allow for BRL1.1trillion in savings over the next 10 years, according to Social Security Secretary Rogério Marinho. Although those parameters were well received by the market, the recent scandal involving Minister Gustavo Bebianno has sparked concerns. Likewise, the lack of political coordination within Bolsonaro's inner circles, as well as his sons' interference in the government, is the main risks for the reform agenda. This scandal will be key to monitor over the next weeks as an eventual escalation could negatively affect negotiations with Congress.

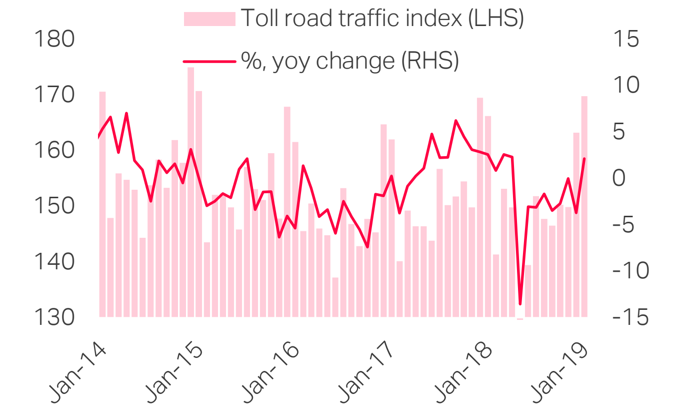
Chart 1: Cardboard production



Source: ABPO.

Chart 2: Toll road traffic levels

1999=100



Source: ABCR.

Elizabeth Johnson / Wilson Ferrarezi

India

Terror attack raises political uncertainty

Rising political uncertainty ahead of the April-May national elections has increased further following the terror attack on Indian paramilitary personnel in Kashmir last week. The suicide car bombing that caused the death of 44 Central Reserve Police Force (CRPF) soldiers is the worst attack in at least two decades in Kahsmir. With the Pakistan-based Jaish-e-Mohammed terrorist group claiming responsibility, it brings India-Pakistan tensions once again into the limelight and increases pressure on Prime Minister Narendra Modi to take strong action just months ahead of his re-election bid.

National sentiment is oscillating between anger and shock following the attack in Pulwama, with demands for retribution running strong. Prime Minister Modi has promised that those responsible will pay "a very heavy price" but any action against Pakistan will result in military escalation. The bomber was a local Indian Kashmiri youth who conducted the attack in an area close to his home. Pakistan for its part has denied any links to the attack. However, the chief of Jaish-e-Mohammed, Masood Azhar, is believed to reside in Pakistan.

In the immediate aftermath of the attack, Modi said that he is giving the military a free hand to decide on the response to the bombing and his government revoked Pakistan's Most Favoured Nation (MFN) status as a trading partner. Although the volume of trade between the two countries is low, accounting for less than 1% of India's total trade, the measure is intended to isolate Pakistan diplomatically. Early on Monday morning, Indian forces had also detained 23 men suspected of links to Jaish with an aim to reach the top commanders of the terror outfit.

Modi will feel the political pressure to take strong action but public declaration of any strike will lead to possible reprisal from Pakistan. The latter had denied that India carried out any strikes in 2016, when Modi had claimed that Indian forces entered Pakistani-controlled territory and carried out "surgical strikes" against militants. The Hindi-language movie "Uri" based on those strikes and released earlier this year has been doing brisk business in India, having captured popular imagination here. This time around, however, any such strike that India makes public will likely compel Pakistan to claim violation of sovereignty. Modi's critics have argued that India has carried out covert operations in the past but Modi made it a political issue in 2016.

Modi will likely make any action against Pakistan a political issue this time around as well, given that his re-election bid is just a couple of months away and his political standing is shaky due to disappointing economic performance. As we have highlighted in our research, Modi has become increasingly populist in the face of recent electoral losses (see our 4 February 2019 report Budget in Charts: Populism wins over fiscal discipline and our 14 December 2018 report The return of competitive politics). The Kashmir terror attack will provide Modi's Bharatiya Janata Party the trigger to increase nationalist rhetoric as well ahead of the national polls.

Shumita Deveshwar

Russia

Scandalous arrest of Russia's leading foreign PE investor: a big test

The Russian business and investment climate faces a major test following the arrest in Moscow last Friday of Baring Vostok (BV) founder Michael Calvey on a criminal fraud charge. This egregious case was instigated by the other major shareholder in one of BV's portfolio companies. It is no wonder that judicial reform is at the top of Russian business wish lists.

Investment risks affecting third parties can sometimes seem abstract until they come close to home. For foreign investors who know Russia well, such a moment came last Friday with the news of the arrest of Michael Calvey on a criminal charge of fraud. Calvey is a Senior Partner of Baring Vostok,(BV) a private equity group specializing in Russia that he founded in 1994. BV has been an early stage investor in several successful Russian companies. Some of them – most notably Yandex – have since become listed and therefore well-known also to portfolio investors.

The risk in question is the way that the criminal justice system is used in business disputes and shake-downs. This case revolves around a medium-sized bank called Vostochny, which operates mainly in Russia's Far East. BV has a controlling 52% stake after the bank's merger in 2017 with Uniastrum, owned by Artyom Avetisyan, a well-connected Moscow businessman, and some of his associates. Avetisyan's post-merger shareholding in Vostochny is 32%. The criminal complaint against Calvey and three other BV managers (who have also been arrested) was lodged by a Vostochny shareholder associated with Avetisyan. The overwhelming circumstantial evidence that Avetisyan instigated this scandal is the fact that the materials for the criminal indictment were collected by the FSB (former KGB) before being passed on to the Investigative Committee (that is, public prosecution service) for action. This fact alone attests to 'good connections'.

The egregious nature of this case was clear from the behaviour of the judge who considered the prosecutor's application for Calvey to be held for two months in pre-trial detention. The judge in question, Artyom Karpov, is not known for leniency. Most unusually, he took two days to grant the prosecutor's request and questioned the evidence presented against Calvey.

The complaint is that Calvey deceived other shareholders of Vostochny into approving a transaction whereby Vostochny received a 59% shareholding of an affiliate of another BV-controlled company (a debt collecting firm called PKB) in lieu of a Rb2.5 billion debt owed to the bank (Vostochny) by PKB. Instead of being worth around Rb2.5 billion as BV had stated, the complainant claimed that the true value of those shares was only Rb600,000. In court last Friday, the prosecutor initially claimed that the Rb600,000 valuation was carried out by PwC. At the next day's follow-on court hearing, the valuer was revealed to be a company connected with Avetisyan (who started out in the valuation business). Calvey was able to demonstrate a KPMG audit for 2016 supporting the Rb2.5 billion valuation. Despite all that, he must still await trial in custody.

Avetisyan seems to have two possible motives. BV had taken legal actions against him in the English courts over alleged dubious transactions related to Uniastrum. So this attack on Calvey may be designed to induce BV to end that litigation in the UK. The second factor is a Rb5 billion hole in Vostochny's balance sheet that the CBR requires to be filled by recapitalization. This claim against Calvey and BV might be seen by Avetisyan as a way to avoid further financial outlay and/or dilution arising from this recapitalization of the bank.

We are left with a major test case for the Russian investment climate. Several prominent figures in Russian business, starting with Sberbank CEO German Gref, have already spoken up in public in favour of Calvey. Based on similar situations in the past, the typical way forward would be behind the scenes discussions at a political level on how to find a way out that avoids overtly undermining legal due process. In the very best case, Calvey and his partners would be vindicated and the whole episode would catalyse renewed judicial reform efforts. The worst case would run along the lines of the honour of the FSB and prosecutors being upheld. In short, this is a revealingly binary situation that we will be closely monitoring.

Christopher Granville / Madina Khrustaleva

Mexico

Pemex, energy outlook darkens

Despite the government's announcement on Friday of more fiscal aid for Pemex, the measures will offer only a temporary reprieve to the firm's structural problems; moreover, when coupled with other negative moves in the sector, the longer-term energy outlook continues to dim.

The government on Friday (15 February) finally unveiled more fiscal measures to help Pemex, but they fell far short of what is needed. President Andrés Manuel López Obrador (AMLO) and his team announced a total package of MXN107 bn (USD5.5 bn) in overall fiscal help for the country's heavily indebted state oil behemoth, but in a big disappointment to the market, much of the fiscal aid package had previously been announced and Pemex was only awarded an additional MXN4 bn/yr in new E&P tax deductions (see Table 1 below for full details). Alongside the tax deductions (which will now total an estimated MXN15 bn/yr or a combined MXN90 bn through 2024), the firm has been granted a capital increase from the government of MXN25 bn (a measure already included in the 2019 federal budget), the prepayment of a MXN35 bn promissory note that backs up its pension liabilities (a fiscal sweetener for Pemex first announced by the government back in 2016) and an estimated MXN32 bn in newly announced savings from the government's fuel theft war (a shot in the dark in terms of final savings, given the administration's poorly implemented battle strategies thus far).

Table 1: Fiscal aid package for Pemex

Fiscal aid measures	MXN bn	USD bn
Government aid		
Capital injection	25	1.3
Prepayment of promissory note backing pension liabilities	35	1.8
Higher tax deductions/year*	15	0.8
Additional estimated revenues		
Savings from fuel theft war	32	1.6
Total	107	5.5

*The Finance Ministry on 28 January already announced tax deductions totaling an initial MXN11 bn/yr (or a combined MXN66 bn through 2024).

Sources: Finance Ministry, local press reports.

Government officials affirmed the aid package will allow Pemex to increase E&P investments, refrain from taking on more net debt and begin prepaying existing debts. According to Pemex CFO Alberto Velázquez García, the oil firm will be able to push up investments this year by 36% yoy in real terms to MXN288.1 bn, up 5.5% from a previous estimate. Finance Minister Carlos Urzúa added that Pemex – which has debt payments coming up of USD5.3 bn at the end of May, more than USD27 bn in debt payments over the next three years and around USD107 bn in overall debt – will no longer add to its net debt and would only refinance its existing debt. In a welcome nod to investors, both Urzúa and AMLO also said on Friday that Pemex would be given more government support in the future should more aid be needed. Yet while all the measures announced will buy the firm more time, they do not tackle Pemex's two overriding structural problems – its falling oil & gas output and its heavy debt load, exacerbated by its still-punishing key upstream tax rate of 65%. To add to E&P worries, Pemex CEO Octavio Romero once again reiterated that the firm would be focusing its investments on the low-hanging fruit of shallow-water and onshore production in a bid to quickly ramp up output, instead of more challenging and costly deepwater and unconventional blocks.

Not surprisingly, much of the market reaction following the announcement ranged from partly to deeply negative. Fitch – which had downgraded Pemex's credit rating on 29 January by two notches to one level above junk – immediately called the new plan inadequate and warned that it would likely fail to prevent "continued deterioration" in the firm's credit quality. Analysts from Citi similarly noted that while the measures would provide some near-term relief for the firm, the government ultimately failed to diagnose its problems correctly and therefore would likely fail to avert another ratings downgrade, even as JP Morgan called the plan a "stunning disappointment". If the silver lining of the government's announcement is that the fiscal package does not compromise the Finance Ministry's 2019 primary surplus target of 1%, the bad news is that the government appears likely to foot the bill for future Pemex bailouts, which will push up the rising odds of a sovereign ratings downgrade.

While energy reform – if it were to be continued – would allow for an improved outlook, the AMLO government's rising attacks on the reform are a bad sign. In our view, the only truly viable way to improve Pemex's fortunes longer term will be to push on with energy reform via more farmouts and E&P auctions – thereby allowing for a sustained increase in the trajectory of private sector investments, rather than public investments. Unfortunately, as we highlighted last week (see our 11 February note Power sector under pressure), the latest moves by the administration to extend its attacks on energy reform to the power sector underscore that the government is taking the reverse course. To add fuel to the fire, AMLO's ongoing criticism of independent federal organs (notably energy regulator CRE) – when coupled with the government's plan to staff vacant CRE board seats with nominees who are highly critical of energy reform – have only reinforced the sensation of an embattled sector under siege. To truly reverse the sector's darkening longer-term prospects, we believe that all the ultra-nationalists on AMLO's energy team must be replaced by more moderate voices; but right now there is no sign that the government is able – much less willing – to adopt this course.

Looking ahead, the bill to alter Pemex's legislation and centralize all power in the CEO's hands will be the next indicator to watch. Currently in the Lower House, the bill could be voted on as early as this Wednesday. If the firm's corporate governance laws are greatly weakened and the board of directors becomes largely irrelevant in the bill that is passed, it would be another shot in the foot for Pemex from the point of view of investors; but if more market-friendly changes are included, as Pemex suggested may happen, it would be one less crisis facing the troubled firm.

Grace Fan

Contents Global China Brazil India Russia Mexico Indonesia Turkey Must Read Asset Allocation

Indonesia

Weak exports delay CA improvement

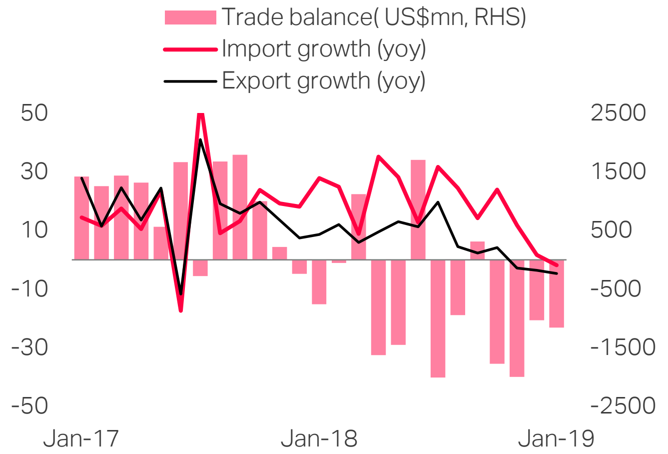
In January imports declined owing to government measures and softer private investment ahead of the April elections. But exports dropped, too, as a result of lower commodity prices. The trade deficit widened. Going forward, both imports and exports will continue to fall. The current account deficit (CAD) will narrow this year, albeit slowly. IDR will remain under pressure.

In January imports declined 1.8% yoy owing to government measures and the election-related postponement of investments. This was the first yoy contraction since June 2017 with shipments of capital goods down 5.1% yoy because of the postponement of several public infrastructure projects and some private investments being put on hold ahead of the April elections. Consumer goods imports fell 10.4% yoy, helped by import tax hikes in Q3/18.

The simultaneous contraction in exports has led to a widening of the trade deficit. Indeed, exports dropped 4.7% yoy compared with the 3.6% decrease in December, with non-oil & gas manufacturing shipments declining 3.9% yoy, likely owing to disruptions caused by the US-China trade war. Moreover, according to the head of Statistics Indonesia (BPS), export revenues declined amid lower prices of Indonesia's key commodities, including coal, copper, aluminium and zinc. The trade deficit stood at US$1.2bn, up from US$0.8bn in January 2017 (see Chart 1).

The current account deficit will narrow this year, albeit slowly, owing to soft exports. The CAD, which widened to 3.6% of GDP in Q4/18 (see Chart 2), is a concern for policymakers as it adds to rupiah depreciation pressures. We expect the trade deficit – and hence the CAD – to start narrowing in Q1/19 as the government measures aimed at reducing CAD and softer investments ahead of the elections will continue to curb imports. But exports are likely to decline further owing to lower commodity prices on the back of the global economic slowdown. Although the government initiatives to boost shipment, including a new trade deals and less strict export regulation will have a positive impact, they are unlikely to absorb the effects of lower commodity prices, especially in the short term. Hence, we expect CAD to narrow only slowly, which means that downward pressure on rupiah will continue for longer.

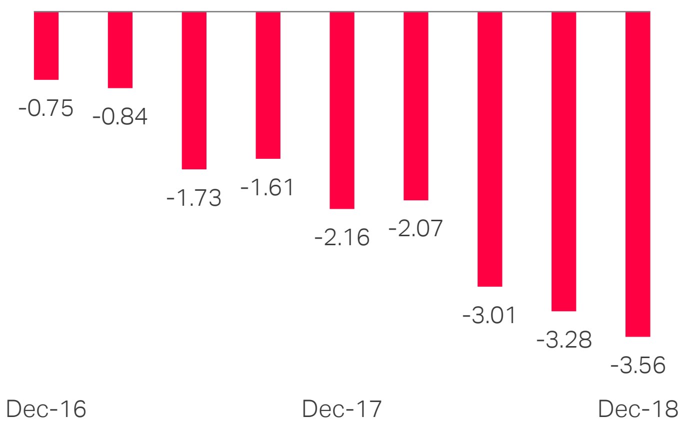
Chart 1: Trade deficit



Sources: Bloomberg, TS Lombard.

Chart 2: Current account deficit, quarterly

% of GDP



Sources: CEIC, TS Lombard.

Krzysztof Halladin

Turkey

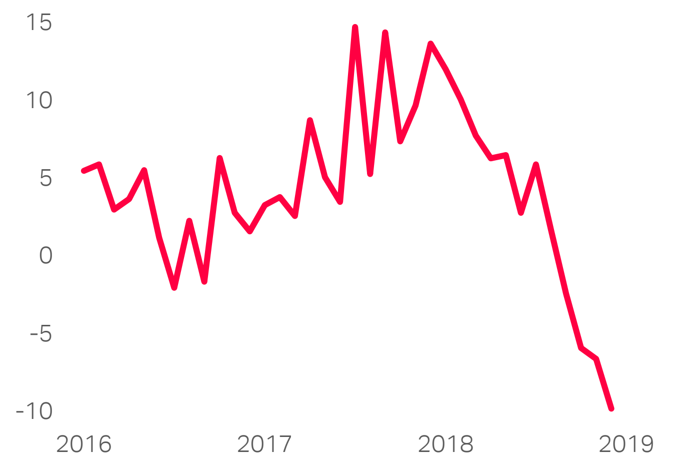
Economic hard landing arrives as industrial production plummets

The collapse of industrial production in Q4/18 points to the onset of a sharp recession. Meanwhile government policy is preoccupied with controlling food price inflation ahead of the 31 March local elections. Prospects for a bottoming out and recovery are not yet in sight.

The upbeat sentiment in Turkish markets so far this year had a reality check last week. Turkstat reported last Thursday that industrial production in December fell 9.8% yoy – consensus expectations quoted by Reuters were for a decline of "only" 7.5%. As the chart below highlights, the index of industrial production has been in free fall ever since December 2017 when it rose nearly 14%; the 2017 boom resulted from a massive fiscal stimulus that was rolled out following the abortive July 2016 coup attempt. The magnitude and speed of the current bust was the greatest since the global financial crisis, when the IP index fell from +2% in July 2008 to -21% six months later.

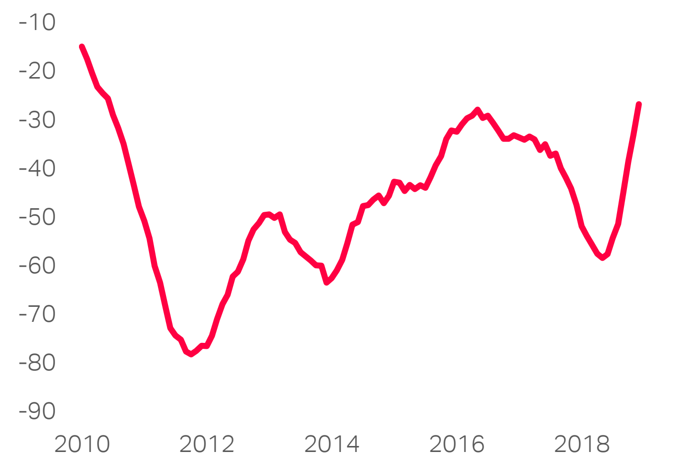
Despite positive comments on the 2019 outlook from Finance Minister Berat Albayrak, there are no signs as yet that the economic downturn is close to bottoming out. With an average decline in the IP index of 7.4% in Q4/18, the 11 March release of the Q4 GDP is likely to show a drop of GDP in the range of 2-4% yoy. The only positive economic news has come from the external sector where the current account finished 2018 with a deficit of $27bn, down from a 12-month rolling deficit of $58bn last May. Financing of the shortfall was aided by net errors and omissions, which recorded a surplus of $21bn, thus relieving pressure on financial markets. Much of such inflow reflected transfers on the part of SMEs which brought back funds held abroad to meet domestic financing needs and new investments from individuals seeking bargains following lira weakness last year.

Industrial production, % chg yoy



Source: Turkstat

Current account, 12-mo rolling balance, US$bn



Source: CBRT

Owing to 31 March local elections government policy at the moment appears mainly focused on controlling food prices. The media report that a large number of ad-hoc markets were opened last week by local authorities in Istanbul and Ankara to sell vegetables to residents at cut prices. Waiting times were said to be 1-1.5 hours with queues stretching longer than a kilometre. President Erdogan said in a speech that the government was considering extending the goods on offer to cooking oils and other household items. As we argued last week farmers are unlikely to boost output in the face of such price controls. Further, our Istanbul-based economist Sevin Ekinci reports that in her neighbourhood a number of small shops selling fruits and vegetables have closed up. Government rants about "food terrorists" are likely to aggravate food shortages in the run-up to the elections.

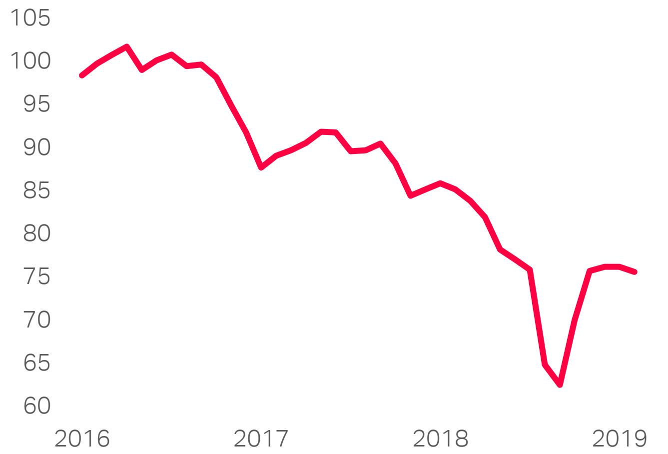
On Saturday the Central Bank announced reductions in required reserves on lira deposits and doubled the share of bank reserves that may be held in gold to 10%. Last Thursday Central Bank Governor Murat Cetinkaya gave an advance signal of the move in an interview with the state-run Anadolu News Agency. The statement made clear that any new liquidity measures would not lead to any change in the bank's monetary policy stance. These moves highlight that Cetinkaya is preoccupied with the issue that banks are not seeking new lending and that the lack of credit will be a major barrier to economic recovery. Given the deepening economic downturn boosting bank liquidity is unlikely to have a significant effect on bank lending.

The bad news is simply that a hard landing of the economy is underway but government policy is preoccupied with suppressing the legacy of its past policy failures, i.e. inflation. For the time being, sensible monetary policies will keep a lid on inflation but sooner or later Cetinkaya will come under political pressure to ease, most likely after the March elections. The lira is still undervalued based on measures of its real effective rate (see below right-hand chart). But the lack of clear direction in economic policy and the absence of any tangible results other than a falling current account deficit have stalled the lira's recovery since last November (left-hand chart below).

Lira vs US$

Source: Bloomberg

Lira CPI-based REER, index 2003=100



Source: Turkstat

Larry Brainard

Must Read

The GRID: The fundamental guide to emerging markets

In the latest edition of our monthly fundamental guide to emerging markets, The GRID, Larry Brainard and team present our views on the short- and long-term drivers of growth. In China, we expect stimulus measures stabilize economy in second half, while in Brazil we see a still modest economic recovery led by consumption already underway

Brazil: Stars align for pension reform

Investors are focused on the approval of pension reform because it will put federal government spending on a sustainable path. Elizabeth Johnson explains that support from a growing number of governors of cash-strapped states will help the government approve pension reform. At the same time, Economy Minister Guedes has shown his willingness to offer financial assistance to states in exchange for their support for reform. On a note of caution, however, because of the extension of his hospital stay, President Bolsonaro has not signalled whether he will push for a more ambitious pension reform. See our 11 February report Brazil: Maia takes the lead on pension reform.

Mexico: AMLO takes aim at the energy sector

The government is now taking aim at energy reform in the power sector, cancelling auctions and asking natural gas pipeline firms to voluntarily revise contracts. Grace Fan warns that these latest measures risk adding to investors' mistrust. Consumer and manufacturing confidence nonetheless continues to rise. See our 12 February report Mexico: Power sector under pressure.

Russia: Sanctions threat revived

Proposals to impose tough new sanctions on Russia were re-launched in the US Senate last week. Christopher Granville assesses this renewed risk in the context of the overall sanctions picture, concluding that the threat to state banks might be a game changer but for the fact that the bill does not propose direct sanctions on any particular banks. Furthermore, unlike "CAATSA" in 2017, there is now more veto scope – so DASKA may well be watered down even in the worst case. The permanent threat of further serious US sanctions nonetheless ensures a stubborn risk premium in Russian asset prices. See our 14 February report Russia: Sanctions update - Cool hell.

Asset Allocation

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

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

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	0			
Asset class	-1	+1	+1	-1
Relative country views				
China	-1	-1	+1	n/a
Brazil	+1	+1	+1	+1
India	-1 (+1)	-1 (+1)	-1	n/a
Russia	+1 (-1)	+1 (-1)	-1	0 (-1)
Mexico	0 (-1)	0 (+1)	+1	+1
Indonesia	+1	0 (-1)	-1	-1 (0)
Philippines	+1	-1	-1	-1
Thailand	-1 (+1)	+1	+1	n/a
South Africa	0 (-1)	-1	-1	-1
Turkey	-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	196	-1.5%
Brazil	Local debt	Long	7-Jan-19	%	7.68	7.28	+1.8%

Date/time 18-Feb-19 07:48

Source: Bloomberg, TS Lombard.

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

Closed Views

Table 2: Closed Absolute Views

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

Authors

Jon Harrison
Managing Director, EM Macro Strategy

Lawrence Brainard
Chief EM Economist, Managing Director

Bo Zhuang
Chief Economist, China Research

Jonathan Fenby
Chairman, China Team, Managing Director

Elizabeth Johnson
Managing Director, Brazil Research

Grace Fan
Director, Brazil/Latin America Research

Shumita Deveshwar
Director, India Research

Christopher Granville
Managing Director, EMEA

Madina Khrustaleva
Analyst, Russia & FSU Research

Rory Green
Economist

Eleanor Olcott
China Policy Analyst

Krzysztof Halladin
Economist

Nikol Hearn
Macro Strategist