EM Watch

DISINFLATION AND TRADE WOES

Jon Harrison / EM Team

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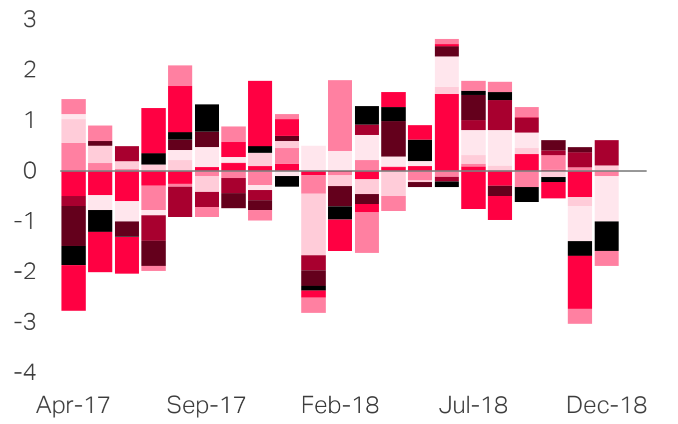
Monthly change in EM headline CPI
9 EM economies, ex-Turkey



Source: Bloomberg, TS Lombard.

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Global

Inflation win vs trade woes

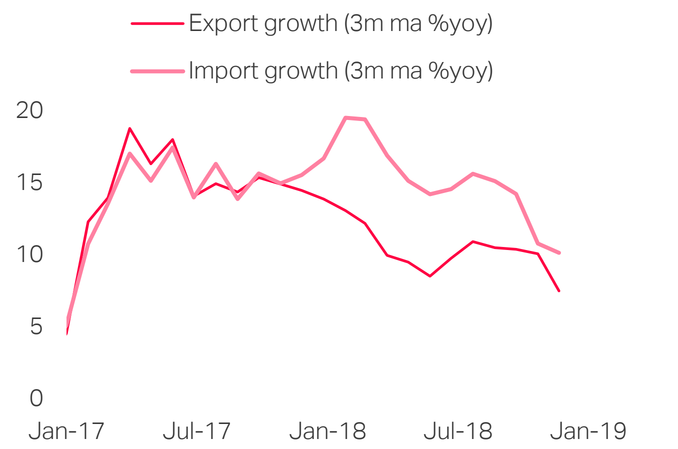
US-China trade talks are making progress, supporting our view that the threatened tariff hike in March will not go ahead. The lagged impact of trade disruption to date, however, will continue to weigh on EM economies in the coming months, while the return of disinflationary forces in China will drive inflation in wider EM lower still.

Trade talks are progressing. In marked contrast to the negotiations about the government shutdown, the current round of US-China trade talks ended amicably last week. The statements issued by both sides set the ground work for further talks, which in the best case would involve more senior officials from both sides. Reports suggest that China's Vice Premier Liu He is due to visit Washington at the end of the month. On a less positive note, President Trump announced that he will not be attending the upcoming meetings in Davos, which could have provided an opportunity to meet with Xi Jinping, suggesting that the distraction of the shutdown and the border security wall could divert attention from China and reduce the chance of a trade deal being agreed. A trade agreement with China will only be credible when Trump is directly involved.

A less damaging trade conflict nonetheless appears ever more likely. The US economic weakness and stock market decline raises the incentive for the administration to call off the tariff hike threatened for 1 March (see last week's EM Watch). We expect that either a deal of sorts based on reducing the trade deficit will be announced, or that the tariff hike will be postponed in order to allow for further talks (see China section below). The wider conflict between the US and China will continue, but the transition of the "trade war" into a "tech war" will be less damaging for EM economies. The tariff deadline is still more than six weeks away, however, suggesting that EM assets will face further volatility before any relief is forthcoming.

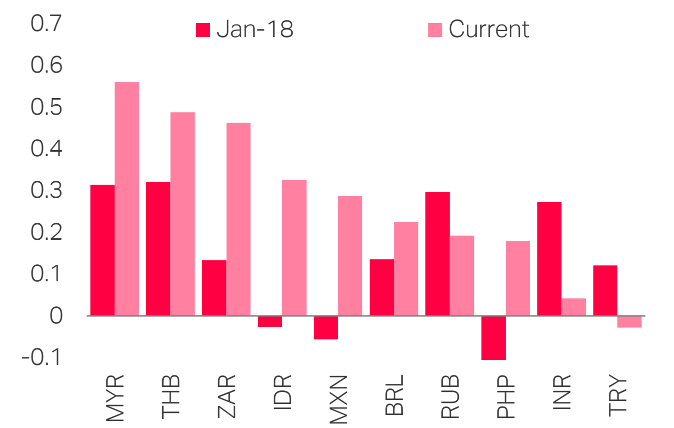
The lagged impact of the Trade War on EM will take time to subside. Trade data for EM economies provide evidence of disruption to trade and for the emergence of a China-centred Asian trading bloc (see last week's EM Watch). For most EM, however, export growth has fallen faster than that for imports (see Chart 1). The latest data have started to show an improvement but there will likely be several more months of relatively weak EM trade balances.

Chart 1: EM export & import growth (simple avg.)



Source: Bloomberg, TS Lombard.

Chart 2: USD/EM FX correlation vs USD/CNY
(3 month, daily changes)



Source: Bloomberg, TS Lombard.

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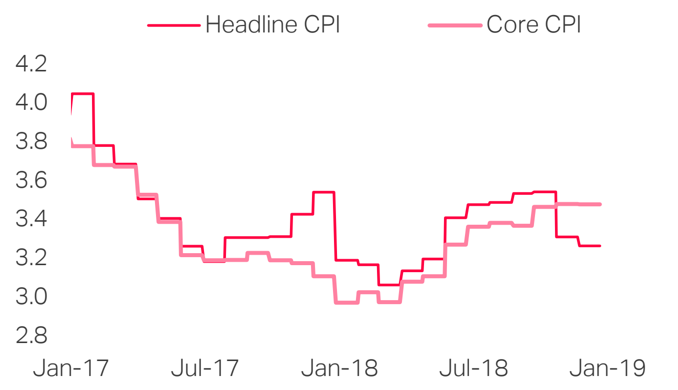
Deteriorating trade dynamics will weigh on EM current account balances and currencies in the coming months, although there are some exceptions. In Turkey, earlier lira weakness has boosted competitiveness, helping to reverse the current account trend, while in Brazil the gradual recovery from recession has contributed to an improving trade balance. China too, saw its exports surge in the wake of last year's depreciation, but the effect is now wearing off. Indeed, front loading ahead of tariffs has created the conditions for renewed disinflation in China that is already showing up in the data (see our 11 January China Watch).

The lead from the US to EM will remain weak. Last week's FOMC minutes support our view of a Fed "soft ease" that may be backed by slowing the pace of QT (see our 10 January Daily Note). A relatively weaker dollar will help support EM currencies at the margin, but this positive impact will in part be offset by negatives.

EM FX will have to contend with higher oil and a weaker renminbi. The oil price bounce will weigh on the currencies of oil importers, particularly the rupee, although the worst of this negative impact may pass quickly. We expect a fragile oil price rebound (see our 9 January Daily Note). The more serious threat to EM currencies is the prospect of renewed depreciation of the renminbi. Disinflationary pressures in China have already pushed PPI to less than 1%, taking it lower than CPI for the first time since 2011. Reports on Friday's that the PBoC is wary of renminbi appreciation support our view that risks are biased toward RMB downside. The easing of trade tensions in recent months has reduced the importance of the renminbi as a driver for EM currencies, but EM FX correlation with CNY is broad-based and remains higher than at the start of 2018 (see Chart 2).

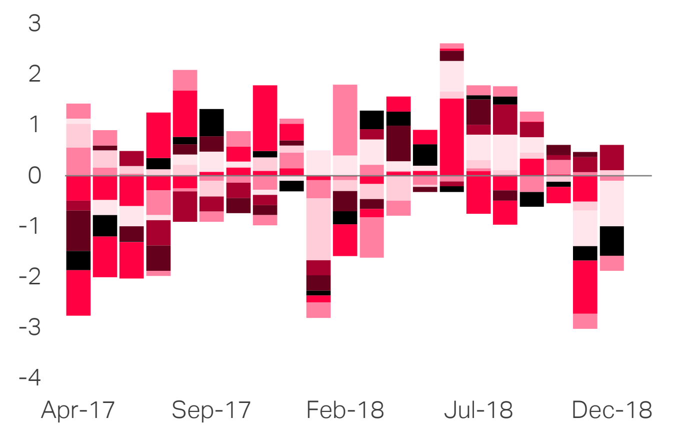
EM disinflation likely has further to run. We have been highlighting the increasingly benign EM inflation outlook since late last year (see our 3 December EM Watch). EM central banks' have not responded decisively to lower headline inflation that has been falling for several months (see Chart 3) as a broad-based disinflationary trend takes shape (see Chart 4). In India, easier monetary policy is increasingly likely under the new RBI governor (see our 17 December EM Watch), while in China itself a shift to prioritise growth is taking shape (see our 7 January Daily Note). Despite lower than expected inflation elsewhere, central banks are likely to be reluctant to ease policy too soon given the EM currency risks ahead.

Chart 3: EM headline and core CPI
Simple average, ex-Turkey



Source: Bloomberg, TS Lombard.

Chart 4 Monthly change in EM headline CPI
9 EM economies, ex-Turkey



Source: Bloomberg, TS Lombard.

Jon Harrison

China

Towards a two-stage trade deal process

The US and China are both keen to strike a deal and avoid tariff escalation as economic headwinds strengthen respectively. Last week's trade talks failed to produce any meaningful move towards a deal, with the thorny issues relating to China's subsidies of targeted industries left to later rounds of negotiations. Any resolution to the trade war will not occur because the two sides have found a way to iron out their differences on this issue- but rather because the economic incentive to calm the markets grows strong enough to force a deal.

We are nearly half-way through the timeframe established by Donald Trump and Xi Jinping for a trade deal to be reached between China and the US and the two sides have only just concluded their first meeting, at deputy ministerial level in Beijing. Official accounts are sparse on detail as negotiators will be keen to avoid the same media confusion that occurred in the aftermath of the Xi-Trump dinner in Buenos Aires, where both sides published mismatched statements on what had in fact been agreed. What is clear, however, is that in last week's meetings the two sides focused on China's existing pledge to reduce the trade deficit through purchases of US agricultural and energy commodities. This leaves the thornier issues of China's state-led economic model and practice of reverse engineering foreign technology to be dealt with in the follow-up talks between Robert Lighthizer and Liu He.

In those negotiations, US demands will likely be similar to the list presented to the Chinese in May, which, crucially, demanded that the PRC stop subsidies for all advanced manufacturing industries and cease policies related to technology transfer. Beijing lawmakers have shown some flexibility on these questions, introducing draft legislation to protect the IP rights of foreign companies, banning local governments from sponsoring reverse engineering and stipulating that any government initiatives that support industry should also be applied to foreign firms. These measures are unlikely to convince Lighthizer, whose deep suspicion of China's tendency to fail to deliver on trade deal promises will drive him to seek external enforcement mechanisms that ensure Beijing enforces any promises to protect foreign IP and apply the concept of "competitive neutrality" to SOEs.

For its part, the Chinese side will point-blank reject any external monitoring of the state's relationship with industry as an infringement of national sovereignty. Having failed to secure the necessary enforcement mechanisms, the US will be able to rely only on coercive pressure through tariffs – namely, their removal will be made contingent on verifiable evidence that Beijing is delivering on its undertakings.

By the 1 March deadline set by Trump and Xi, we forecast one of two scenarios unfolding. Either the US will extend the deadline of tariff escalation on the US$200bn of goods from 10% to 25% while talks continue; or there will be a hastily drawn up "deal" that focuses on a reduction in the trade deficit and includes vague, non-enforceable promises on the part of the Chinese to protect foreign IP and make the Chinese market more competitive for foreign firms- and cancels the scheduled tariff hike.

Regardless of whether it comes at the beginning of March or later, any deal will be, as Commerce Secretary Wilbur Ross commented, one that "we can live with" rather than one that delivers on Lighthizer's aim of structural changes to China's economic model. The US trade team is ultimately at the beck and call of Trump, who focuses on the state of the stock market as the key indicator of economic performance and will be looking for comfort from the S&P as vindication of his policies. But despite high corporate earnings in 2018, US capex has almost ground to a halt, with businesses reluctant to invest in the face of tariff uncertainty. As he enters an election cycle, it is highly feasible that the US President will seek to boost confidence by claiming that the "trade war is over" and that immediate tariff hikes can be taken off the table.

The content of any deal struck either at the beginning of March or following an extension of the deadline will be superficial. It will not mitigate the risk of the President at some stage implementing a further tariff round; nor will it de-escalate the "tech war", which involves moves by the US government to block Chinese access to Silicon Valley's technological know-how, as detailed in our 28 November China Watch.

Eleanor Olcott

Brazil

Stage is set for economic recovery

The combination of low inflation and improved consumer and business confidence has set the stage for economic recovery in 2019. But recent economic indicators highlight that the economy remains sluggish despite the optimistic mood.

Low inflation sets the stage for economic recovery in 2019. The Bolsonaro administration will benefit from the low inflation backdrop during the first quarter, which sets the stage for a stronger economic rebound this year. The CPI (IPCA) increased 0.15% mom in December, its lowest print for the month since the Real Plan in 1994. Falling regulated price contributed to the decline in December inflation. With the December number, annual inflation ended 2018 at 3.75%, below the 4.5% target for the second consecutive year. Lower fuel and electricity prices throughout Q4 and the currency – which strengthened amid rising hopes of reform –helped ease inflation at the end of 2018. Inflation should remain at benign levels through Q1/19 thanks to still-low electricity prices, weak fuel prices and a relatively stronger BRL. The favourable inflation backdrop will allow Banco Central to keep the SELIC policy rate at its current, historically low level of 6.50% for longer this year, contributing to the economic pickup in coming months.

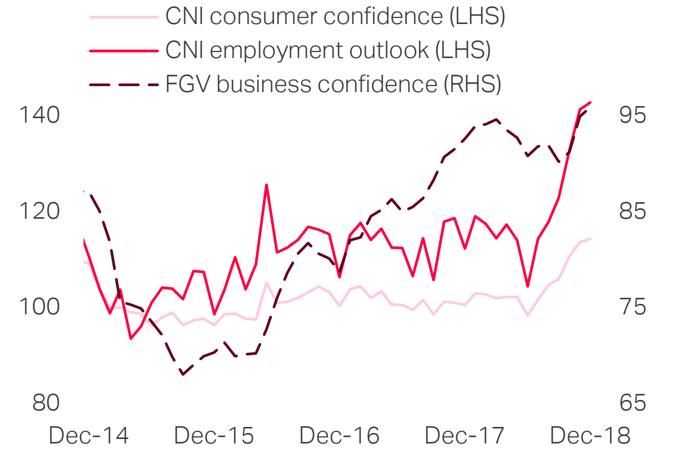
Economic confidence continues to improve. Confidence continued to improve in December following confirmation that the new government will push ahead with an aggressive reform agenda. The Getulio Vargas Foundation's (FGV) business confidence indicator, which aggregates sentiment in the industrial, retail, services and construction sectors, has been rising steadily since October, reaching 95.9 points in December, the highest level since Q1/14. Similarly, consumer confidence reached its highest level since March 2013, thanks to the improved outlook for wages and the job market, according to data released in December by the National Industrial Confederation (CNI).

Concrete improvements in economic activity have yet to materialize. The upsurge in confidence levels has yet to translate into stronger economic activity. Industrial production (IP) rose by just 0.1% mom/sa in November vs -0.1% mom/sa in October. Likewise, capacity utilization has not recovered to levels seen prior to the May truckers' strike. Retail sales were also weak in November, declining by 0.4% mom/sa. Although unemployment has been slowly declining, reaching 11.6% in the quarter that ended in November, the improvements in the job market have come as a result of rising employment in the informal sector, which reached record levels in November.

Leading indicators for December remained weak, adding downside pressures on activity data for the month. Auto production and exports fell 6% and 2.6% in mom/sa terms, vs -5.9% and -19% in November, respectively, according to the Auto Producers Association (ANFAVEA). The flow of vehicles on highways, which affects both IP and retail, also fell 2.1% mom/sa in December, vs 1.7% in November, according to the Highways Concessionaries Association (ABCR). This was the first negative number for December since 2013 and was also the lowest for the month since 2002. The weak leading indicators will add downside pressure on main activity indices for December. Still, growth is expected to pick up in H1/19, in part because of the base effect, especially because of the weak Q2/18 print because of the May truckers' strike.

Longer-term growth hinges on pension reform, which is slowly advancing. Despite improvements in the short-term outlook, growth has been stymied by the unsustainable, long-term fiscal outlook. Economy Minister Paulo Guedes is expected to present his pension reform proposal this week. Despite indications in early January that Bolsonaro might be willing to accept a less ambitious reform, Guedes is expected to push for a deeper rewriting of the social contract. If this ambitious reform is passed this year, it will set the stage for a stronger rebound, allowing the new government to push ahead with a micro-reform agenda, which would be less challenging to approve.

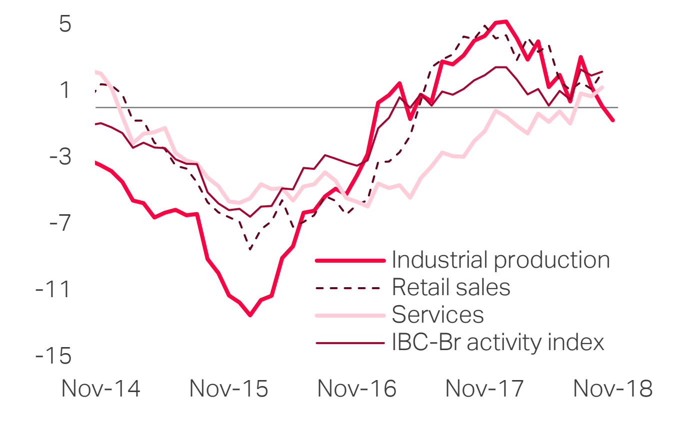
Chart 1: CNI consumer confidence vs FGV business confidence



Source: CNI, FGV.

Chart 2: Industry, retail, services and economic activity growth

% change yoy, 3mma



Source: IBGE, Banco Central.

Wilson Ferrarezi

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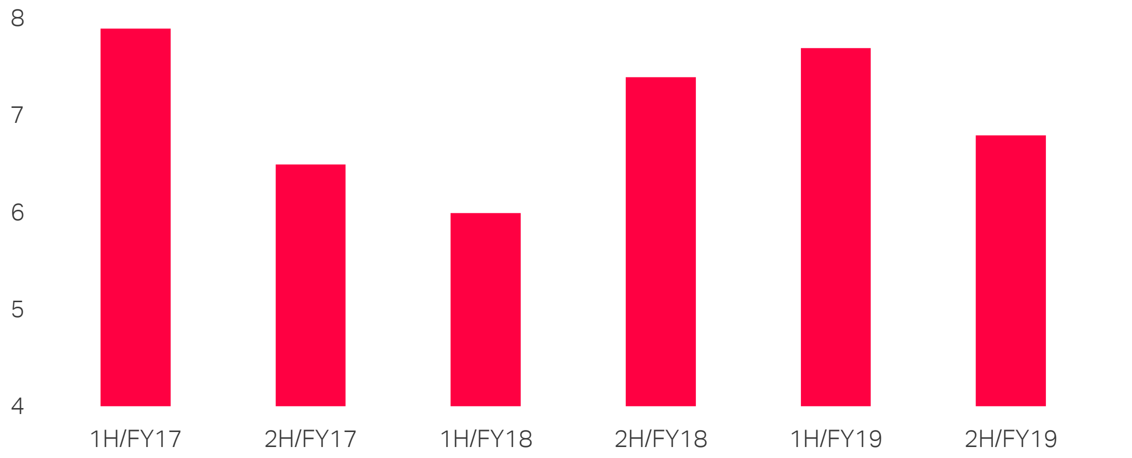
India

Growth concerns will make way for easier monetary policy

India's economic growth remains volatile, with the Central Statistics Office (CSO) having forecast a slowdown in the second half of the fiscal year and the latest industrial output numbers reaffirming that expectation. We believe that given the slowing growth, low inflation and the government's need to jumpstart the economy before the elections, there is a possibility of an interest rate cut as early as February.

Industrial output for November at 0.5% yoy was far slower than market expectations of 3.5-4%, but the number is broadly in line with the direction of projected economic growth in 2H/FY19. The economy, according to the CSO's forecast, is likely to slow down in the second half of the current fiscal year to 6.8% from a 7.6% expansion in 1H/FY19. The official estimate of overall GDP growth of 7.2% in FY19 is slower than the 7.4% forecast by the Reserve Bank of India (RBI).

Half-year GDP growth



Source: CSO, TS Lombard.

To be sure, other ground-level data, show that the economy is still on the path to recovery – albeit with caveats. The composite PMI for December at 53.6 remained well above the 50-level that demarcates expansion from contraction, but slowed from a 25-month high of 54.5 in November. Maruti Suzuki, India's largest car maker which accounts for more than half of domestic car sales, reported record sales in December. However, the jump in sales reportedly came on the back of steep discounts. The auto industry was hit badly in the last few months of 2018 due to sluggish consumer demand and tight liquidity conditions in the financial sector.

The government, clearly worried about the slower than expected economic momentum, last week the GST Council doubled the tax exemption limit for small and medium businesses. The step is aimed at boosting manufacturing activity as well as for improving the competitiveness of small firms, but is also targeted at assuaging the concerns of small traders – a key voter constituency for the ruling Bharatiya Janata Party. Small businesses were badly hurt due to the November 2016 demonetization drive followed by the rollout of the GST just a few months later, and the latest changes in the GST policy will help ease tax compliance for many businesses.

Earlier in January, the RBI also eased rules for small businesses, allowing lenders to restructure certain loans provided to micro, small and medium enterprises. The softer stance towards smaller firms comes soon after the change in leadership at the RBI as well as amid easing stress in India's banking sector. The gross non-performing loans ration declined from 11.5% in March 2018 to 10.8% in September 2018, the first drop in three years, according to the RBI's latest data.

Amid concerns over India's growth as well as low inflation, we believe that there is slight chance that the RBI may start cutting interest rates as early as February. The December CPI inflation number will be released later today and is expected to remain well below the RBI's target of 4% for the fifth straight month. It eased to a 17-month low of 2.3% yoy in November even as core inflation stayed high, at 5.5% yoy. At its last monetary policy review, the Monetary Policy Committee (MPC) noted that food inflation has continued to surprise on the downside and oil prices have softened consideraby, although it remained worried about inflation in non-food groups.

The minutes of the December MPC meeting show that most members were concerned about growth prospects, even though none of them voted for a rate cut. One member, Ravindra Dholakia, voted to change the stance to neutral from calibrated tightening. If Dholakia – the known dove in the MPC – votes for a rate cut in February, and the new RBI Governor Shaktikanta Das adopts a dovish approach to monetary policy as well, it will take only one more member's vote for a rate cut. The RBI Governor has the casting vote in case of a tie among the MPC's 6 members. The 5-7 February MPC will be the first since the appointment of Das as Governor following the shock resignation of Urjit Patel, and will therefore be keenly watched.

Shumita Deveshwar

Russia

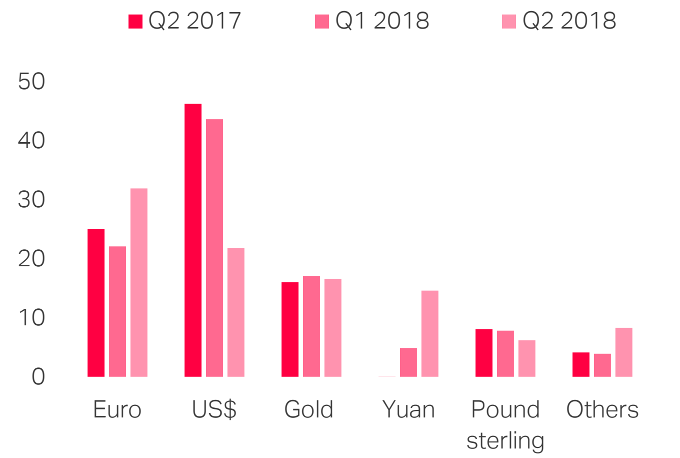
Serious CBR sanctions insurance linked to Rusal/En+

With the Rusal/En+ sanctions case - and the related value opportunity in those names - hanging in the balance in Washington, fascinating light on wider sanctions risks is cast by last week's CBR reserves disclosure. This reveals a material shift from USD to RMB despite the trade war. Such de-dollarization insurance is no real cure for sanctions risk: but we do still expect a 'happy ending' on Rusal.

The 'happy end' to the Rusal/En+ sanctions story remains in the balance. This is the only conclusion possible after last week's demands by newly installed Democratic Congressional Committee Chairmen that the Trump administration should abandon the deadline at the end of this week for Congress to determine whether to avail itself of its legal right to block the Treasury's decision to lift the sanctions imposed on those companies last April. After successive sanctions waivers since then, that decision was announced by OFAC last month after Oleg Deripaska – now defined as the "real" sanctions target, as opposed to his companies – reduced his shareholdings below the controlling level in line with US conditions for granting such sanctions relief.

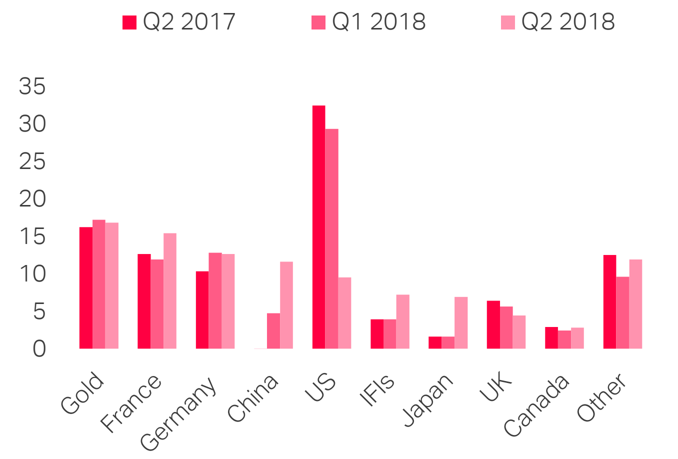
Last week also produced a data release that is highly relevant to this case – and the overall risks from the US sanctions campaign against Russia. This was the CBR's disclosure – with the usual six-month lag – of the structure of its international reserves. We already knew, including from US sources, that the CBR had cut its holdings of US Treasuries. What now becomes clear is that the proceeds of those divestments were not kept in US dollar cash. Instead, the CBR reallocated about US$100 billion into RMB and euros in Q2/18 alone (with that euro allocation concentrated on relatively Russia-friendly France). That means that the CBR increased the share of RMB in its portfolio from 5% in Q1/18 to almost 15% in Q2.

Chart 1: CBR reserves by currency



Source: CBR

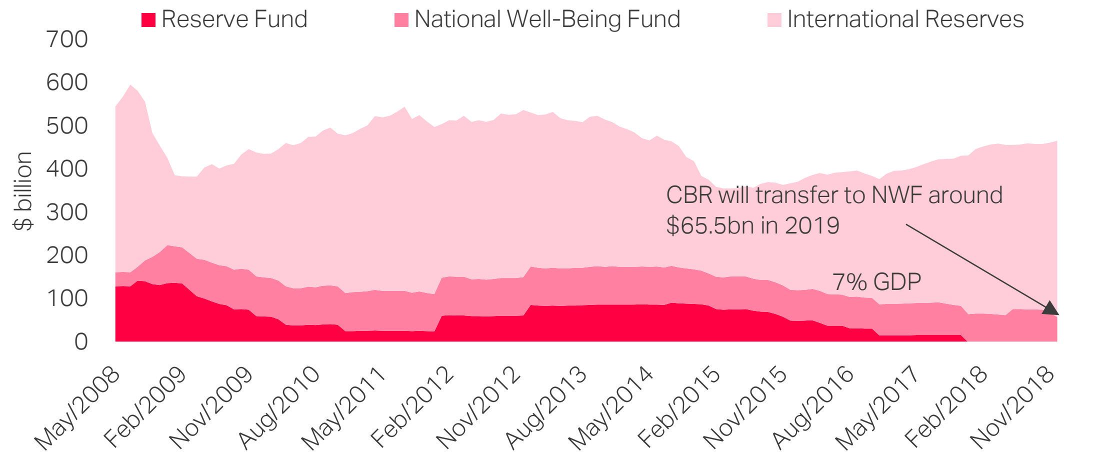
Chart 2: CBR reserves by geography



Source: CBR

The timing of this shift is revealing – coinciding as it did with the escalation of the US-China trade war. This means that the CBR was ready to pay the price of likely RMB depreciation in return for the insurance of reduced exposure to US dollars amid escalating sanctions. Just at the peak of China-US trade war, CBR had increased share of Yuan in its portfolio from - clearly understanding that it might be devalued as a possible weapon, so, ready to pay an insurance price. The last time the CBR acted in this way was at the height of the Crimea crisis in March 2014, when it moved $115 billion-worth of its reserves out of US dollars. The difference now – thanks to the RMB allocation – is the highest ever share of EM currency in Russian reserves

Chart 3: CBR and MinFin reserves



Source: MinFin, CBR

This policy of insurance against the US dollar will be continued and extended. This year, the balance of the National Well-Being fund will rise above the 'minimum rainy day budget spending back-up' threshold of 7% of GDP (Chart 3). According to guidance from Finance Minister Anton Siluanov, the excess will be used mainly for financing export credit. Siluanov spoke last week about the delays that Russian exporters are experiencing in receiving dollar payments because of the foreign (especially Chinese) counterparties' fears of OFAC. Another sign of the times is the reduction in accounting transparency at Promsvyazbank. This newly nationalized bank is now dedicated to serving the defence sector, itself subject to blanket US sanctions.

This defensive 'insurance' reflects risks and may mitigate them – but it does not remove them. The aerospace sector last week provided examples of the risk posed by sanctions to the economic strategy of investment-led growth with the particular focus on diversifying exports away from oil and gas. Local press reports indicated problems importing from the US and Japan components for Russia's new MC-21 wide-bodies airliner project, and an OFAC threat to the contracted export of $1.2 billion-worth of SSJ-100 regional jets to Iran.

Returning to the Rusal/En+ case, in our view these companies will probably escape from US sanctions – creating an interesting value opportunity. Congress looks like running out of time to block this, and/or the Democrat-majority House may well clash on this question with the Republican-majority Senate against the background of renewed 'Trump-Russia' polarization. Another significant development here last week was a formal message from the EU Council of Ministers to the US supporting sanctions relief for these companies, which are important for European automotive supply chains.

Christopher Granville / Madina Khrustaleva

Mexico

Toll to mount as fuel crisis continues

As the fuel distribution shortage stretches on in the central region and capital city, two new polls show that a majority of Mexicans back the government's fight against fuel theft, even as businesses warn that the broader economy will suffer if supplies are not normalized this week.

Long lines at gasoline stations persisted over the weekend in Mexico's central zone and capital city, as the government has stayed its course in a battle against fuel theft. As state oil firm Pemex amplified its partnership with the private transport sector in the hopes of normalizing fuel supplies, at least seven states continued to report significant fuel supply problems – Jalisco, Aguascalientes, Guanajuato, Querétaro, Michoacán, México and Hidalgo – in addition to Mexico City. According to local press reports, roughly half of the gas stations in Jalisco and Aguascalientes were out of fuel this weekend, as well as about 40% in Michoacán, roughly one-third of gasoline stations in Hidalgo and Querétaro and a sizeable number in Mexico City.

The government of President Andrés Manuel López Obrador (AMLO) late last month initiated its war on fuel theft, by shutting down key pipelines and sending thousands of soldiers out to guard refinery and pipeline infrastructure. Although few dispute the importance of this fight – the issue caused an estimated USD3 billion in losses in 2018 – poor logistical planning at a time of seasonally high demand for fuel has exacerbated the supply problems, especially as schools reopened last Monday and many residents returned from their yearend holidays. On average, Mexico only has a mere three days of gasoline stocks, but the capital city and nearby states are particularly vulnerable with just one to two days of gasoline stocks on average. To add to the problems, transporting fuel by trucks costs an average 14 times more than by pipeline, as we highlighted last week (see our 11 January note New year, new fuel crisis) ; this means that until the government agrees to reopen the pipelines, prices are likely to rise as a consequence. However, both AMLO and Energy Minister Norma Rocío Nahle in recent days have vowed that the fuel shortage will continue "as long as necessary" to win the fight against fuel theft.

As the fuel distribution supply shock has deepened, local industry groups and Banxico Governor Alejandro Díaz de León have issued more warnings, highlighting that if the supply problems are not normalized by the end of this week, the broader economy will likely suffer a material hit. Employers' confederation Coparmex on Thursday affirmed that food and raw material shortages were already evident in four states, while the country's national automakers' association AMIA said it feared that plant operations could be suspended, especially in the auto manufacturing powerhouse of Guanajuato. This weekend in Mexico City, major thoroughfares were eerily empty, even as there were reports of local drivers going to the neighbouring states of Puebla and Morelos to fill up their tanks. Meanwhile, bottlenecks at Mexican oil ports have continued, with dozens of fuel tankers waiting to offload imported fuel.

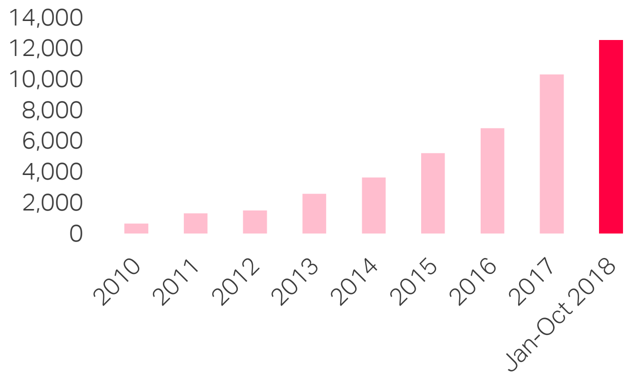
In a bid to normalize supplies, Pemex on Friday finally approved a plan by the National Chamber of Trucking to use an additional 3,500 fuel trucks (or more than double its current fleet) from roughly 150 private firms, which will now be allowed to work 24 hours, seven days a week to distribute fuel, under the protection of federal police. Although this could temporarily improve supplies to hard-hit states, the problem is that the country will still have a big truck deficit and most of its ports and refineries are not designed to offload to trucks, adding to the logistical inefficiencies.

Despite the problems, two new surveys published this weekend show that a majority of those polled support the government in its fight, giving AMLO ammunition to soldier on. According to an online survey taken 9-11 January and published on Saturday by Consulta Mitofsky, 56.7% of those polled said they believed that the government has adopted the correct strategy vs 36.1% who said it was the wrong strategy. In addition, nearly two-thirds of those polled said they believed it would take the government more than one more week to normalize supplies vs 21.9% who thought it would take one week or less.

In a second poll taken by De Las Heras Demotecnia, 57% of those surveyed in a telephone poll said that their view of AMLO had improved after the launch of the fuel theft fight while an additional 8% said that their opinion of AMLO had remained equally good. This contrasts with a minority of 18% who said that their view of AMLO had worsened and an additional 2% who said it had remained equally negative. The polls are likely to shore up the President's belief that he is on the right course, adding to the risk that the fuel theft fight will turn into an increasing drag on the economy, should Pemex fail to reestablish fuel supplies in a timely fashion and the government forge on with its current strategy.

Chart 1: Fuel theft in Mexico

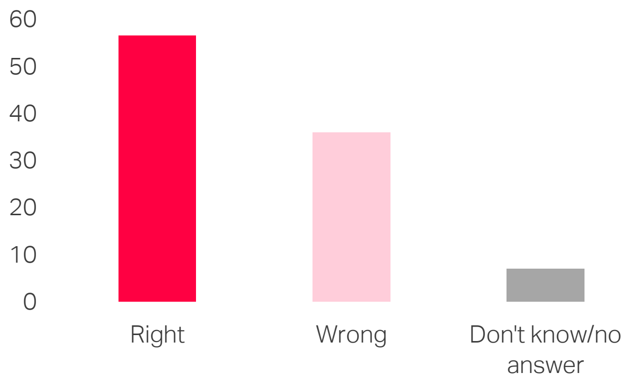
No. of illegal fuel taps



Sources: Pemex, Animal Politico.

Chart 2: Poll: Despite fuel problems, is the government's strategy right or wrong?

% / Poll dates: 9-11 Jan



Source: Consulta Mitofsky.

Grace Fan

Philippines

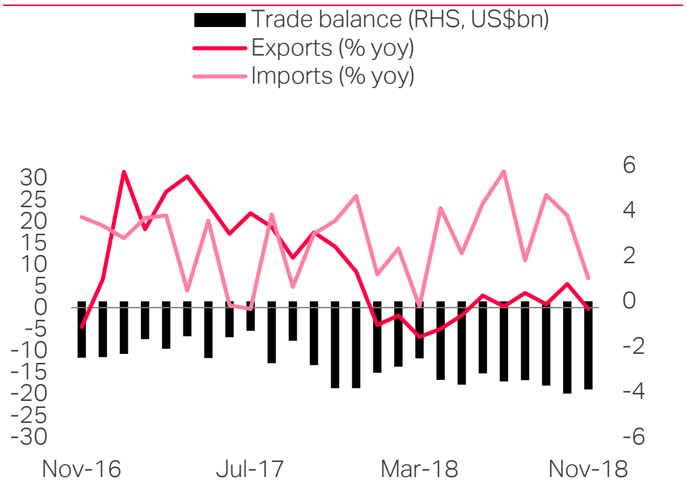
Improvement in trade balance unlikely to continue

Import growth decelerated in November owing in part to high base effects, while the decline in exports was driven by soft shipments of electronics. The trade deficit narrowed in November; however, going forward, imports will return to strong growth while exports are likely to remain soft. Large trade deficits will persist in the medium term despite lower global oil prices.

Import growth decelerated in November while exports declined. Imports increased 6.8% yoy, a significant deceleration from the 21.4% yoy growth in October. The biggest contributions to overall imports were raw materials, fuels and capital goods, but all nonetheless decelerated yoy. Moreover, there was an almost 30% yoy decline in imports of consumer goods driven by the drop in passenger cars, which was caused by high base effects owing to a surge of demand in November 2017 ahead of the 2018 tax reform. Exports remained lacklustre, contracting 0.3% yoy. Electronic shipments, which account for more than half of total exports and constituted a bright spot for most of 2018, dropped 1.6% yoy (see Chart 2 below). This, however, is in line with the regional trend as electronics shipments were soft in other ASEAN countries in November. As regards the impact of the trade war, exports to the US recorded double-digit growth for the third consecutive month while shipments to China decelerated to 1.6% yoy, vs. 11.1% in October. The trade deficit narrowed to US$3.9bn from US$4.1bn in October (see Chart 1 below).

The trade deficit will remain large, exerting downward pressure on the currency. Trade data going forward will likely continue to show lower imports of mineral fuel, lubricants and related materials owing to falling global oil prices. But oil imports account for just some 8% of the total import bill. Other components of imports (capital goods, raw materials) will continue to record strong growth driven by import-intensive public infrastructure projects, while export growth will likely remain sluggish amid slowing economic growth in the Philippines' main trading partners (the US, China and Japan). Indeed, while the manufacturing PMI in December (53.2) showed rising domestic orders, export orders declined for the fourth consecutive month. The trade balance will remain deeply in deficit, subjecting the peso to downward pressure.

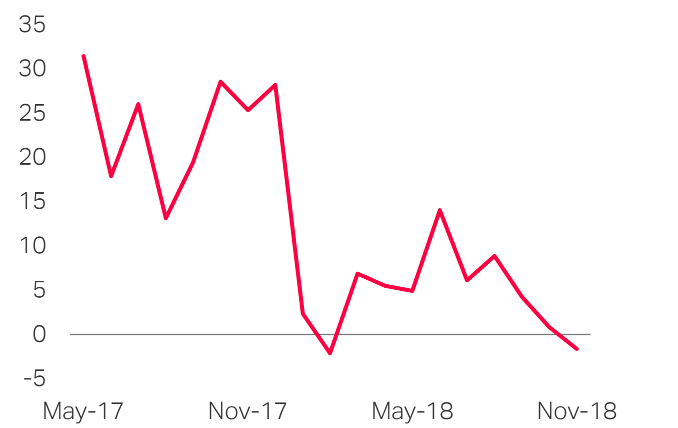
Chart 1: Foreign trade (US$ terms)



Sources: Bloomberg, TS Lombard.

Chart 2: Export of electronics

%yoy, US$ terms



Sources: CEIC, TS Lombard.

Krzysztof Halladin

Turkey

Pre-election series of support measures rolled out

Government measures are mainly targeted at relieving economic pressures on its major support base rather than to frontload aggregate spending ahead of a hoped-for economic recovery.

As expected, the government announced a series of measures last week to lessen the impact of the economic downturn on various sectors of the population. While the fiscal costs of the government's initiatives are uncertain, their aim was clearly to bolster the prospects of the AKP ahead of the 31 March municipal elections. The measures included a grab bag of income support, debt rescheduling and supported loan facilities:

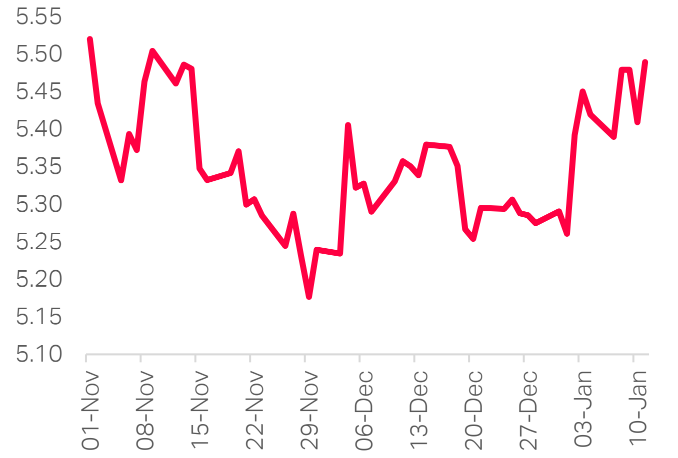
- The government will cover electricity costs of up to 150kwh usage of household receiving social assistance, which number an estimated 2.5 million.
- Consumers' credit card debt from any source will be rescheduled by the government-run Ziraat Bank. The bank will grant loans to pay such debts for up to two years at a monthly rate of 1.1%, less than half the typical rate.
- A Treasury-backed loan programme will be extended to tradespeople and artisans via Halkbank. An estimated 350 thousand eligible borrowers can tap the TRY22bn (US$4bn) available under the programme.
- Farmers can reschedule debts with Ziraat Bank, receiving a one-year extension at an interest rate of 11%. Government support prices for major farm products were also raised.
- Firms with over 500 employees will receive government outlays to meet mandatory social security payments.
- A loan package totalling TRY20bn (US$3.6bn) will be provided by 13 banks to SMEs with gross incomes below TRY25mn (US$4.5mn) at an interest rate of 1.54%/mo. An estimated 40 thousand firms may benefit from this facility.

These various measures are primarily fiscal and are targeted to lessen the impact of the economic downturn on individuals and small businesses rather than to fuel an economic recovery. At the same time the government is attempting to encourage a decline in interest rates by limiting government borrowing in domestic markets. To do this Parliament earlier this month adopted a measure mandating the early payment of dividends to the Treasury from firms with a minimum 50% state ownership; this includes the Central Bank, Turkish Airlines and several others. Market sources estimate the Treasury will receive TRY50bn (US$9.1bn) three months earlier than usual. With these cash inflows the Treasury should be able to reduce domestic debt issuance in the coming weeks, thus relieving upward pressure on interest rates.

Taken together the government's recent actions suggest policymakers might be hoping to keep monetary policy unchanged ahead of the elections. Markets fears that the Central Bank might ease monetary policy at its next MPC meeting on 16 January have led to a weaker lira in recent weeks. As is evident in the left-hand chart below, the lira has been stuck in a TRY5.25-5.50/US$ trading range since the end of October.

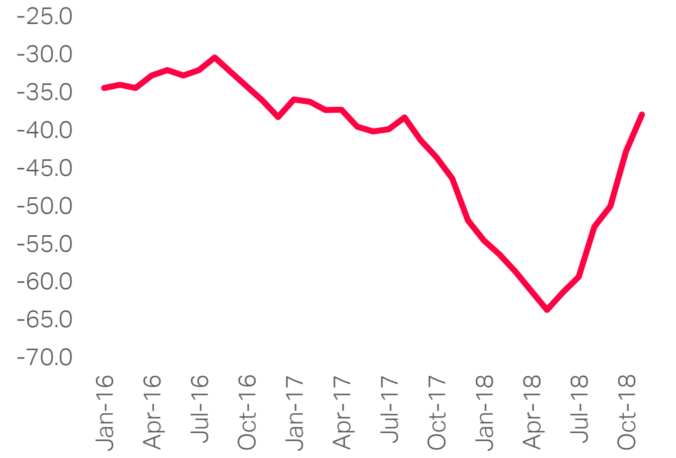
Economic data indicate the lira is still undervalued; its real effective rate according to the Central Bank was only 75 in December. Meanwhile, current account surpluses have been recorded for the last four months straight, something that has not occurred for several decades. The November surplus was just short of US$1bn, reducing the 12-mo running deficit to US$38bn; a similar surplus for December would bring the annual deficit down to about US$30bn.

TRY vs USD



Source: Bloomberg

Current account, 12mo rolling sum, US$



Source: Bloomberg.

Larry Brainard

Strategy

Asset Allocation summary

We downgrade our view of overall EM risk to neutral from moderate positive. The economic slowdown in the US and China will weigh on EM economies in the coming months, but the likely further delay of tariff escalation offers the prospect of a less damaging US-China trade conflict that will provide a boost to EM. We reverse our view on Chinese equities to moderate negative and are take more positive on India. We remain positive Brazil and negative Russia.

We downgrade our view of overall EM risk to neutral from moderate positive (see our 9 January EM Strategy Monthly). Widespread fears of a severe China slowdown are likely overdone. At the same time, the lagged impact of Trade War uncertainty will continue to hit the US economy. The Fed has put monetary tightening on hold and will likely ease by slowing the pace of QT before ultimately cutting interest rates (see our 6 January US Watch). The global economic slowdown will weigh on EM economies in the coming months, while the likely further delay of tariff escalation offers the prospect of a less damaging US-China trade conflict The US slowdown and equity decline increase the probability that the pause in tariff escalation will turn into an extended postponement, which will provide a boost to EM (see last week's EM Watch).

In the paragraphs below we explain the reasons for the country selection and asset class calls presented in our asset allocation heatmap.

China

The renminbi will continue to be an important policy tool and the gradual depreciation prevailing for the past 6 months will likely continue. A more substantial depreciation is possible if the next round of US tariffs goes ahead as threatened at the beginning of March or if China's slowdown is deeper than expected. The economy is likely to slow in Q1/2019 before the impact of stimulus measures, including targeted tax cuts, begins to have an impact. Indeed, the latest RRR cuts mark the start of a gradual shift to prioritising growth (see our 7 January Daily Note).

Brazil

Markets will continue to benefit from positive sentiment surrounding the new government. We see potential for risk premiums to decline further, if Bolsonaro is able to deliver on his privatisation plan and move forward with pension reform. The new administration appears to understand the necessity to make progress on reform quickly in order to take advantage of the honeymoon period (see our 4 January report Brazil: Bolsonaro's honeymoon begins). Growing popular support for essential pension reform will boost sentiment (see our 11 January report Brazil: Pension reform takes shape. Inflation expectations have fallen sharply owing to global factors and the stable real, which remains undervalued vs its REER over the past year.

India

India stands to benefit most among major EM economies from the moderation in oil prices – high oil prices weigh on the current account deficit and on the budget deficit as well as on inflation. Falling oil prices have driven inflation to its lowest level since June 2017 and will reduce pressure on the rupee and ease the fiscal challenge facing the government.

Oil prices may yet rise further, but we expect a fragile rebound (see our 9 January Daily Note). Investor focus on the Chinese economic slowdown may also favour India at the expense of China. At the same time, the replacement of RBI governor Patel with Shaktikanta Das will herald a more dovish monetary policy that will focus on falling headline inflation. The combination of a less hawkish central bank and further populist policies from the government, including loan waivers, is likely to boost the economy and markets ahead of the April/May national election. It remains probable that the election will return Modi to power, but the opposition challenge has intensified to a greater extent than previously expected (see our 7 January EM Watch).

Russia

The market outlook has deteriorated even before the impact of possible sanctions is taken into account. Inflation has been rising steadily for the past six months and there is a risk of further upward pressure on prices owing to the uncertainty over second round effects from the increase in VAT that came into effect on 1 January. The VAT hike will weigh on consumer demand at a time when low oil prices have already hit disposable incomes. The prospect of US sanctions remains the most important negative driver of Russian assets. In the worst case the US could sanction Russia's sovereign debt or target state-owned banks. The potential for reduced tension in Ukraine could ultimately present a buying opportunity. The Ukraine presidential election due to be held on 31 March will likely result in a more pragmatic government than that currently in place, which could time (see our 7 January EM Watch)

Mexico

Sound monetary and fiscal policy continue to underpin Mexican assets. The 2019 budget bill appears fiscally reasonable and contains few headline surprises, although the decline in oil prices poses a potential risk to government revenues. The AMLO government nonetheless still has an uphill struggle ahead to regain investor trust after a series of missteps beginning with the public consultation on the Mexico City airport (see our 19 December report Mexico: A closer look at the 2019 budget). Investor sentiment has improved following the airport bond buyback deal, which has affirmed the administration's commitment to take the market into account and to avoid a prolonged dispute with bond holders. AMLO has stayed clear of the US debate on the border security wall, and the comment from President Trump that Mexico had already paid for the wall through the USMCA trade deal suggests that US-Mexico relations will remain calm.

Indonesia

The authorities will struggle to maintain rupiah stability amid slowing global growth and deteriorating trade outlook. Indonesian exports contracted by more than 3% yoy in November, following three successive months of sub-5% growth as a result of the slowdown in global growth and disruption to world trade. Exports represent a smaller share of GDP than some other countries in the region, but the deteriorating trade balance will hit the current account and weigh on the rupiah. Government efforts to reduce imports have started to have an impact. Import growth slowed to 12% yoy in November from 24% October, but the improvement in trade dynamics may be too little too late for the currency (see our 7 January EM Watch). The 17 April general election is a possible risk factor for markets. President Jokowi remains well placed to be re-elected but the increase in populist spending ahead of the election could be a risk to fiscal targets later in the year.

Philippines

Infrastructure spending will help support growth, but the deteriorating current account will weigh on the peso. Inflation has at last started to decline after rising rapidly for the whole of 2018. Falling inflation will put downward pressure on interest rates, although further rate hikes cannot be ruled out. Lower rates will reduce the attractiveness of the peso, although the most important driver will likely be the weaker current account. The government will continue to prioritise infrastructure, which will boost imports at a time when exports are already under pressure as a result of falling world trade volumes (see our 17 December EM Watch). Unpredictable comments from President Duterte aimed at bolstering his standing among the local electorate remain an ongoing risk to international investor sentiment and will likely increase ahead of the June midterm elections, which will be seen as a test of the President's popularity.

Thailand

The baht will benefit from higher interest rates and government stimulus – including infrastructure spending and measures to help the agricultural sector – aimed boosting the economy ahead of the general election scheduled for February. Doubts about the election timing may yet hit investor sentiment. The Bank of Thailand finally raised interest rates in December, citing uncertainty global financial markets. Inflation risks nonetheless remain to the downside, and the central bank has signalled that it will likely pause the tightening cycle, despite higher global and regional interest rates. The Thai economy is likely to be hit further as global trade slows, but will ultimately benefit from growing regional trade links.

South Africa

There is a growing risk that South Africa's credit rating will be downgraded. The underlining outlook for GDP growth remains weak, we forecast just 1.0-1.5% in 2019, while the government has little fiscal room for manoeuvre ahead of the national elections due later this year. The financial difficulty facing state owned electricity producer Eskom and the risk of renewed power cuts this year is another risk to debt to GDP dynamics. South Africa markets are among the highest beta to EM risk appetite. The scaling back of Fed rate hike expectations in recent weeks has therefore benefitted the rand and local debt. At the same time, the inflation outlook remains relatively benign, which under different circumstances could provide a favourable backdrop for markets.

Turkey

High interest rates and the disinflationary economic slowdown will benefit local debt. The government is likely to introduce stimulus measures ahead of the end-March local elections, but for now, we expect the Central Bank to hold off from cutting interest rates prematurely (see our 7 January EM Watch). Inflation fell slightly in December, but remains around 20%. The recovery of the lira, however, has substantially improved the outlook for inflation expectations, while low oil prices and the economic slowdown will add further to the downward pressure on prices. Furthermore, the lira remains relatively undervalued in real effective exchange rate terms. The combination of improved export competitiveness and weak demand for imports has boosted the current account balance, reducing the risks to markets.

Jon Harrison

Must Read

EM Strategy Monthly: China fears overdone, but rough patch for EM ahead

In our latest EM Strategy Monthly, Larry Brainard and team reduce our call on overall EM risk to neutral from moderate positive owing primarily to concerns about Fed policy. In his monthly notes on portfolio strategy, Larry highlights Fed communication, China's economic slowdown, the lagged impact of the Trade War on the US economy, the return of disinflation in China and the likely shift of US-China conflict from tariffs to technology. See Strategy section above, for a summary of the reasons underlying our asset allocation views.

Brazil: Progress on pension reform

A recent opinion poll shows growing popular support for reforming the pension system. Our Brazil team explain that Economy Minister Guedes appears to be winning the battle for a more ambitious pension reform. Another good sign for reform is growing support for the re-election of Lower House Speaker Maia. Initial signs indicate that the new administration is keenly aware of the need to push the reform through as quickly as possible, but it remains unclear whether Bolsonaro himself understands the gravity of the situation. See our 11 January report Brazil: Pension reform takes shape.

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

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	200	-1.9%
Brazil	Local debt	Long	7-Jan-19	%	7.68	7.70	+0.2%

Date/time 14-Jan-19 08:23

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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