EM Watch

DOWNSIDE CASE GATHERS MOMENTUM

Jon Harrison / EM Team

- **Global**: EM correction has further to go
- **China**: Stabilizing growth amid trade friction
- **Brazil**: No recovery in industrial output
- **India**: New Cabinet gets to work
- **Russia**: Divergent Russia-Saudi oil interests
- **Mexico**: Trump threat darkens path ahead
- **Indonesia**: Reshuffle will send positive signal
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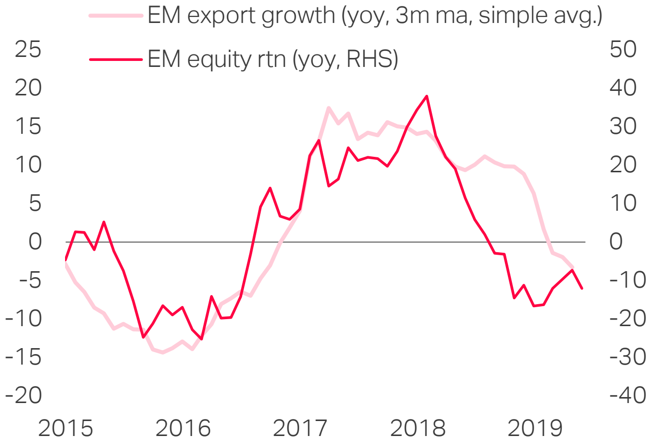
EM export growth and equity return



Source: Bloomberg, TS Lombard.

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Global: EM correction has further to go

Outflows from EM assets have further to go. EM equities have given up their gains for the year but are not yet pricing in the decline in exports that we anticipate. A best case resumption of trade talks would bring some relief, but EM are not pricing in either a protracted US-China disengagement or the risk aversion that would follow a deeper decline in US equities.

China: Stabilizing growth amid trade friction

Beijing will calibrate stimulus to trade war escalation with "structural deleveraging" is set to take a backseat. Without any de-escalation, the yuan will break USD/CNY 7 level. We adjust our growth forecast to 6.2% to reflect trade and sentiment risks.

Brazil: No recovery in industrial output

The sharp decline in Q1/19 industrial output is unlikely to be reverted this year, as weak domestic and external demand continue to weigh on the sector. While the decline in iron-ore output exacerbated the fall in industrial output, the sector still faces generalized weakness.

India: New Cabinet gets to work

Amid expectations of big-bang reforms, the Modi government started off its second-term with a dose of welfarist policies. Plans are reportedly afoot to introduce many reforms as well, and the full FY20 budget - to be presented on 5 July – will be watched closely for future policy direction.

Russia: Divergent Russia-Saudi oil interests

The stage appears set for this month's scheduled semi-annual OPEC+ meeting to lay bare the contrary oil market strategies of Russia and Saudi Arabia. While this tension may be muffled again this time by current pressures – i.e. countering the trade war-driven oil price decline, Russia has strong reasons to raise output and lower the price – and will opportunistically do so.

Mexico: Trump threat darkens path ahead

US President Trump's threat to impose 5% tariffs on all Mexican goods starting 10 June, which could rise to 25% by October, poses a big dilemma for the Mexican government on whether to kowtow further on migration policy, even as it aggravates the economic outlook ahead.

Indonesia: Reshuffle will send positive signal

The cabinet reshuffle expected to take place later this month will provide insight into Jokowi's resolve to carry out necessary reforms. Apart from some political appointments in return for the coalition partners having supported him, we expect that he will offer jobs to seasoned managers who will expedite the implementation of his policy agenda.

Turkey: The economy has not yet hit bottom

Although 1.3% qoq GDP growth was reported last Friday, we doubt the economy will climb out of recession anytime soon. Investment and household consumption continue very weak and there are limited options to stimulate the economy given a weak lira and rising fiscal deficits.

Strategy: Add Russian debt, Indonesian equities

As of today, we add a long position in Russian local debt and a long position in Indonesian equities to our list of Absolute Views.

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Global

EM correction has further to go

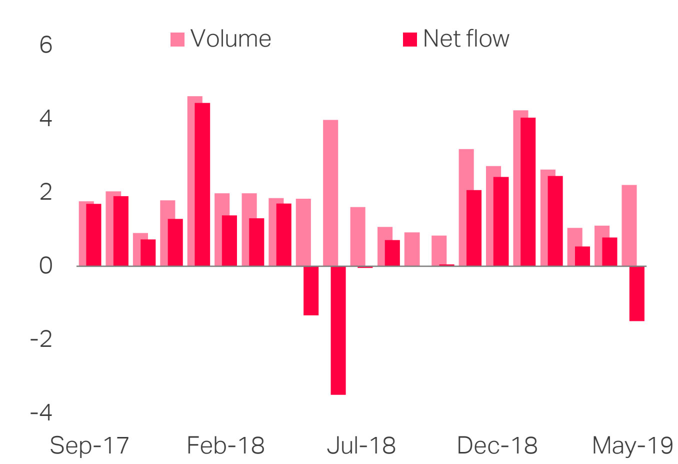
Outflows from EM assets have further to go. EM equities have given up their gains for the year but are not yet pricing in the decline in exports that we anticipate. A best case resumption of trade talks would bring some relief, but EM are not pricing in either a protracted US-China disengagement or the risk aversion that would follow a deeper decline in US equities.

Outflows from EM assets have further to go. EM equities have fallen by around 8% over the past month (MSCI index in $). Equity markets in China have led the collapse, falling by around 14%. EM equities have now all but given up the gains accrued since the start of the year, which was itself a low point following the selloff in Q4. Despite the scale and speed of this adjustment to the new trade war reality, the outflow from EM equities has been relatively limited. Our analysis of global EM equity ETFs suggests that selling has been small in comparison to the sustained of the preceding six months (see Chart 1). We see potential for outflows to accelerate.

Trade war uncertainty weighs on EM. The fate of the US-China trade negotiations remains in the balance. We maintain our view that this stage of the trade war will be dominated by threat and counter-threat in which each side seeks demonstrate its economic leverage over the other (see last week's EM Watch). Speculation about future escalation, whether in technology, non-tariff barriers or opening new fronts in the conflict is almost certain to disrupt financial markets.

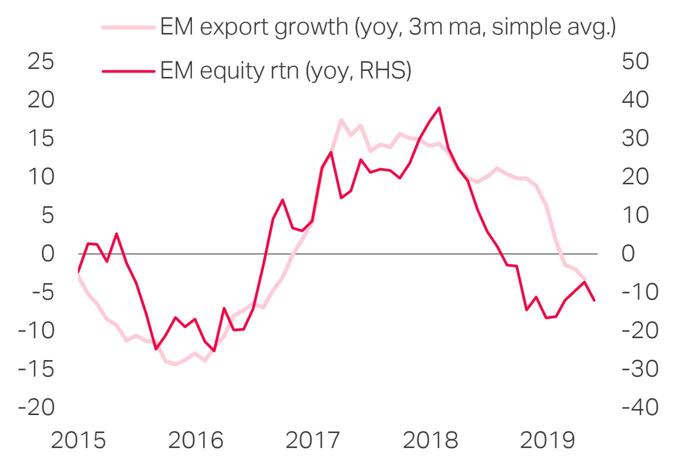
China's response will further damage sentiment. China continues to assert its preparedness for a protracted struggle. Chinese media have set out the government's red lines for future talks describing US efforts to change China's state-directed economic model as an invasion of sovereignty, published in a white paper on Sunday. Structural changes in the areas of state-owned enterprises, subsidies, technology transfer and IP enforcement are key to China hawks in the US administration. The hardening of language highlights fundamental differences (see our 31 May China Watch). China's tougher line raises the risk that the US administration leaves itself with little choice but to escalate further. The escalation of the trade war has overwhelmed the impact of previous front-loaded fiscal stimulus and will weigh on China's short-term economic activity. At the same time, the authorities will calibrate further stimulus measures to the trade war escalation while toning down the pledge of structural deleveraging (see China section).

Chart 1: Global EM equity ETF flow (%AUM)



Source: Bloomberg, TS Lombard.

Chart 2: EM export growth and equity return



Source: Bloomberg, TS Lombard.

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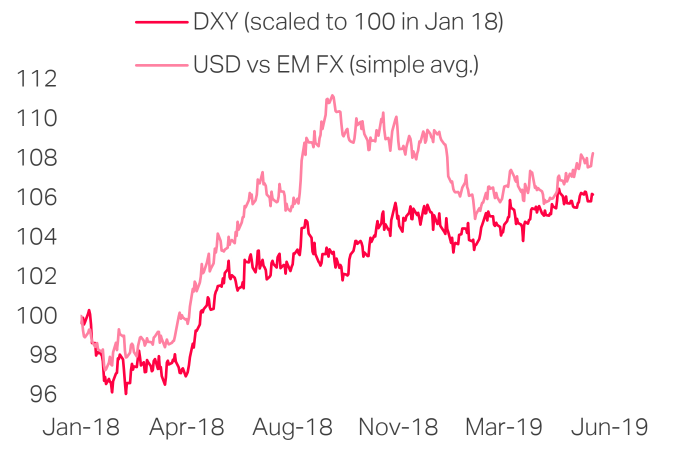
Heightened tension raises the risk of disengagement. The US escalation is the latest instance of now familiar Trump deal-making tactics: ratcheting up tension in advance of talks in an effort to extract greater concessions from the other side. It would be a mistake, however, to dismiss the risk to markets. Heightened tension raises the probability of crossing the point of no return beyond which there can be no resumption of friendly negotiations for an extended period. We do not believe that this point has yet been reached, but markets nonetheless will need to price in a non-zero probability of this scenario.

Markets are not pricing the coming contraction of EM exports. EM equities remain highly correlated with export growth. The decline in EM equities from mid-2018 correctly anticipated the subsequent collapse in exports. The recovery in EM equities in the first 3 months of this year was driven by the easing of trade fears and recalibration of the Fed outlook. While difficult to disaggregate the impact of these factors, the historical relationship between equities and exports suggests that markets are now pricing in a stabilisation of export contraction around current levels (see Chart 2). In our view, leading indicators already point to further export contraction (see last week's EM Watch). World trade will fall further still as the higher 25% tariffs begin to be applied on $200bn of US imports from China. The announcement that 5% tariffs will be applied to US imports from Mexico is a further negative for world trade, supply chains and global growth, reinforcing the message that the US administration believes that tariffs are a weapon can be deployed with little domestic economic consequence.

EM equities are not pricing in a further fall in US markets. While EM equities have collapsed, those in the US remain some 10% above levels at the start of the year. Trade war escalation will exacerbate an already deteriorating outlook for the US economy (see our 26 May US Watch), while the downturn in US corporate profits sends a further negative signal for US markets (see our 30 May Daily Note). Our analysis shows a high correlation between EM equity returns and the combination of US equity returns and the dollar (see Charts 3 and 4). A further decline in US markets would inevitably hit EM.

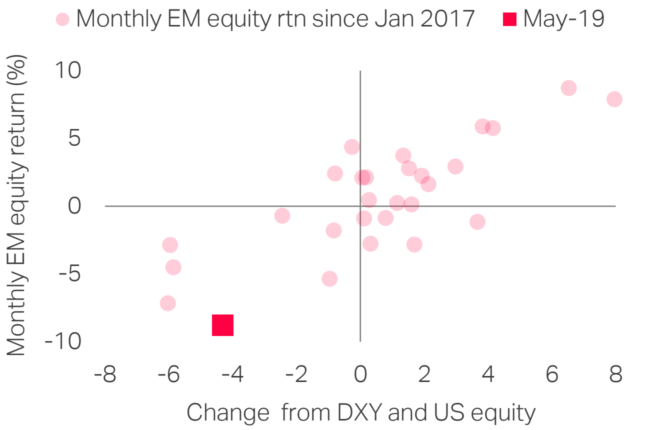
We aim to present our latest EM asset allocation view in our next EM Strategy Monthly, to be published tomorrow. In the meantime, we add a long Russian local debt position and a long Indonesian equity position to our list of Absolute Views (see Strategy section).

Chart 3: USD vs EM FX and vs majors



Source: Bloomberg, TS Lombard.

Chart 4: EM equities vs US equities and DXY



Source: Bloomberg, TS Lombard.

Jon Harrison

China

Stabilizing growth amid trade friction

Beijing will calibrate stimulus to trade war escalation with "structural deleveraging" is set to take a backseat. Without any de-escalation, the yuan will break USD/CNY 7 level. We adjust our growth forecast to 6.2% to reflect trade and sentiment risks.

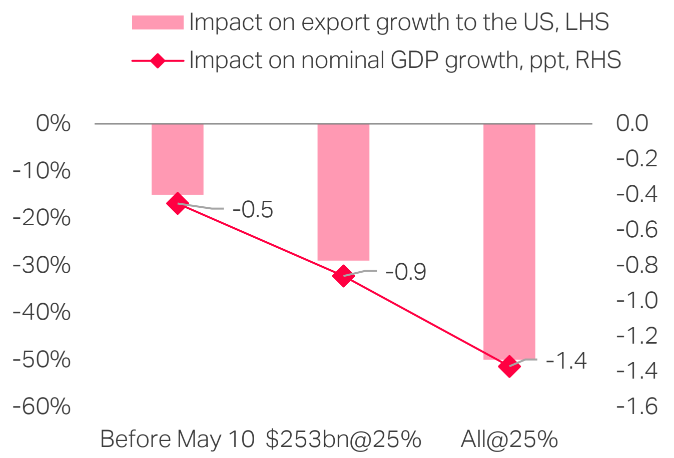
China's aggressive front-loaded fiscal stimulus has put a floor on growth in H1/19. The H2/19 growth trajectory now hinges on the interplay between trade tensions and future policy support. Authorities will respond to trade war uncertainty by toning down language about "structural deleveraging" and scaling back their previous commitment to stabilize the renminbi in order to gain greater policy latitude.

Our economic base scenario is that the existing tariffs are here to stay throughout 2019. The G20 Osaka meeting between Xi and Trump will likely delay implementation of the threatened tariffs on another US$300bn worth of Chinese goods. Quantifying the direct economic impact of the trade war, we estimate that the 25% tariffs already in place on US$250bn of US imports would reduce aggregate Chinese value added by US$56bn. Those losses would translate into a potential first-order impact of a 0.4% reduction in nominal GDP in the following four quarters. If there were a blanket tariff of 25% on all Chinese exports, the reduction in nominal GDP growth would be 0.9% (see left-hand-side chart below).

Owing to the sheer size of the Chinese economy and China's declining current account surplus, the immediate impact on growth of the additional tariffs imposed in May should still be manageable through trade channels. However, the trade war will also have a long-term effect on confidence, business capex, the labour market, domestic consumption and the most sophisticated global supply chain. Beijing will certainly take measures to offset tariffs, which will be the single-most important factor in driving the short-term growth outlook.

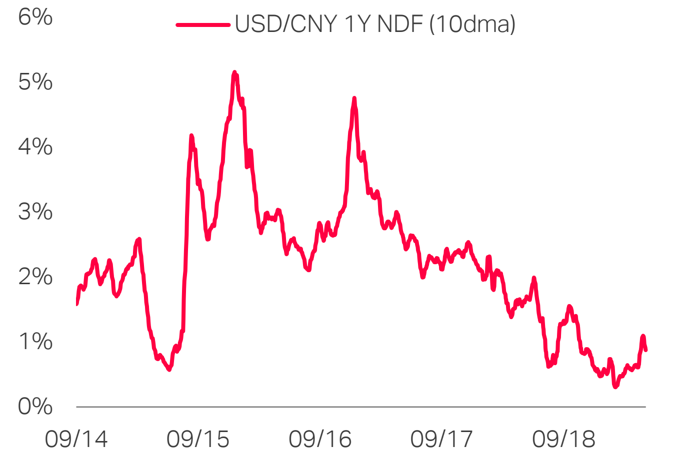
Ongoing credit easing and fiscal stimulus will likely strengthen once again in H2/19. The PBoC priority will now shift from deleveraging to enhancing policy transmission and channel existing liquidity within the banking system to the real economy, especially SMEs and private enterprises. But if the existing tariffs remain in force beyond June, we expect Beijing to recalibrate its policies to return to an easing bias. Additional RRR cuts, broad-based or targeted,

US trade tariff impact on China



Source: TS Lombard.

NDF not pricing in RMB depreciation



Sources: Datastream, TS Lombard.

are becoming more likely. Liquidity injection via OMOs and MLFs should be more proactive going forward, although interest rate cuts in 2019 remain unlikely.

Without a trade deal or material trade war de-escalation in the next three months, the RMB will break the USD/CNY 7 level in H2/19. Since RMB stability has been conditional on good-faith negotiations, we think Beijing may now choose to let the currency passively devalue against USD and the currency basket in order to partly offset the latest tariff escalation. However, prior to the G20 summit China will defend the 7 level to avoid further inflaming tensions.

A series of financial and regulatory changes since the 2015 devaluation have given authorities well-placed confidence in their ability to allow depreciation of the currency without excessive domestic turmoil. Despite the remarkable nominal fall of more than 9% against the US dollar from its April peak last year, the feared exodus of money did not materialize. Both households and corporates were unable to circumvent extremely tight capital currency controls. The domestic political and economic environment of 2015, an initial RMB depreciation of 3% spooked investors, threatened a financial crisis and raised questions about authorities' economic competency, mandating support for the currency. Today, depreciation is a viable option, China is not in crisis, nationalism is running high and the PBoC is able to frame currency moves as a market-driven response to US trade protectionism.

Fiscal stimulus more expansionary this year than in 2017-18: the broad fiscal deficit to GDP ratio is set to widen from 7.2% in 2018 to around 9.3% in 2019. Owing to the constraints of the annual fiscal budget, significant front-loaded spending and local government bond issuance in Q1/19 will lead to a decrease in the growth of on-budget fiscal expenditures in H2/19, particularly in Q4/19. If growth were to come under threat of further tariff escalation, there could be more proactive quasi-fiscal spending in the form of LGFV bond issuance as well as increased shadow-banking activities and local government land sales. One major move to expect in H2/19 is targeted measures to stimulate auto and durable goods consumption, which we expect to stabilize retail sales in H2/19.

We also expect Q1/19 growth stabilization to carry through Q2-Q3/19 as the impact of front-loaded fiscal stimulus and further credit easing continues to support growth. But the major front-loading of fiscal policy support is set to fade in Q4/19 and the escalation of the trade war will drive down growth to 6% towards yearend. **Under our base scenario of no tariff de-escalation, we expect the Chinese economy to grow 6.2% in 2019 as a whole, after factoring in China's additional policy response to support growth.**

Bo Zhuang / Rory Green

Brazil

Industrial output shows no signs of recovery

The sharp decline in Q1/19 industrial output is unlikely to be reverted this year, as weak domestic and external demand continue to weigh on the sector. While the decline in iron-ore output exacerbated the fall in industrial output, the sector still faces generalized weakness.

As expected, the industrial sector posted a strong contraction in the first quarter of the year. In Q1/19, industrial output fell 0.7% – the strongest decline since Q4/16. The sector was pummelled by mining company Vale's tailings dam disaster in January, which forced the company to slash output. As a result, output from the mining sector– which accounts for roughly 14% of total industrial output – plummeted by 6.3% in the first quarter, compared to a 2% increase in Q4/18. This was the strongest decline in the mining industry output since Q1/04.

The contraction in other segments highlights generalized industrial weakness. While the mining sector was the main culprit for the decline in industrial output, it was not the only segment of industry that contracted in Q1/19. The civil construction industry, for instance, contracted by 2% following a marginal decline of 0.1% in Q4/19, while the manufacturing industry also remained on a downward trend , falling 0.5%, after contracting 0.9% in Q4/18. In fact, these two sectors posted their lowest share of total GDP in the historical series: civil construction accounted for only 4.2% of GDP in Q1/19, while manufacturing accounted for 10.4% in Q1/19, compared to 6.4% and 12.1% in Q1/13, respectively. While the mining industry was hit by the Vale incident, the widespread industrial weakness highlights the poor momentum for the sector.

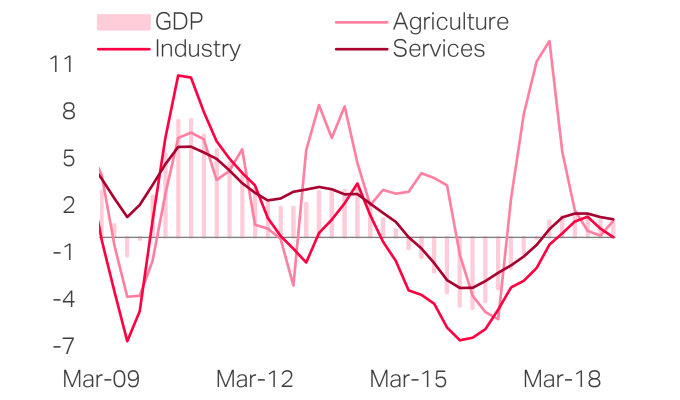
Industrial contribution to Brazilian GDP remains low, and is likely to fall further. The industrial sector remained in a downward trend in terms of participation in the economy, accounting for 21.5% of GDP at the end of Q1/19 on four quarter rolling terms, compared to its high at 29% in 2005 and 25% in the late 2013, prior to the crisis. This trend is a direct result of the persistently low capacity utilization levels, which remain well below pre-crisis levels, highlighting the struggle of the Brazilian industry to recover. In May, industrial capacity utilization was 75.3%, substantially below the 83% level in the late 2013. Capacity utilization levels will remain high in the short term, as the weak job market will continue to limited domestic consumption in the coming months, and external demand should remain subdued. As a result, there are few incentives for any expansion in industrial production and will contribute to further erosion in industry's contribution to GDP.

Weaker external demand also weighed on the Brazilian industry in the first quarter amid the deepening of the Argentine economic crisis. Another factor that contributed to the deterioration in industrial GDP in Q1/19 was the sector's reliance on exports. Unlike services and retail, a significant portion of demand for Brazilian industrial goods comes from abroad, and Argentina is one of the main destinations of Brazilian industrialized goods, especially for the auto industry. The deepening of the Argentine crisis through Q1/19 caused Brazilian auto exports to plummet 41.4% yoy in the first quarter, compared to the 3.7% yoy increase in Q1/18, according to the Auto Producers' Association (Anfavea). Data for April are even more disappointing: auto exports shrunk by 51.3% yoy. Looking ahead, a further slowdown in global economic activity would have a negative impact on Brazilian industry too.

The weak industrial dynamics are set to continue through the next months. The shortage of raw materials in the early stages of the supply chain in the wake of Vale's disaster will continue to have a cascade effect on the industrial sector, weighing on steel production and other industrial segments. The Brazil Steel Institute, for instance, revised down its estimates for steel production for 2019 to 2.2%, vs 2.7% before. Sentiment indicators for the industrial sector have also been suffering in the second quarter of the year. The National Industry Confederation's (CNI) industrial sentiment index has fallen 8bps since February, reaching 56.5 in May, close to pre-election levels, while industrial confidence as measured by FGV fell 0.7% mom/sa in May following the 0.7% increase in April. The weak performance of the industrial sector so far in the year led CNI to revise down its industrial output estimate for 2019 to 1.1% from 3% before. As a result, there is little hope for a rebound in the sector this year, which has contributed to the growing sense that 2019 will be another lost year in terms of economic growth.

GDP and supply-side components

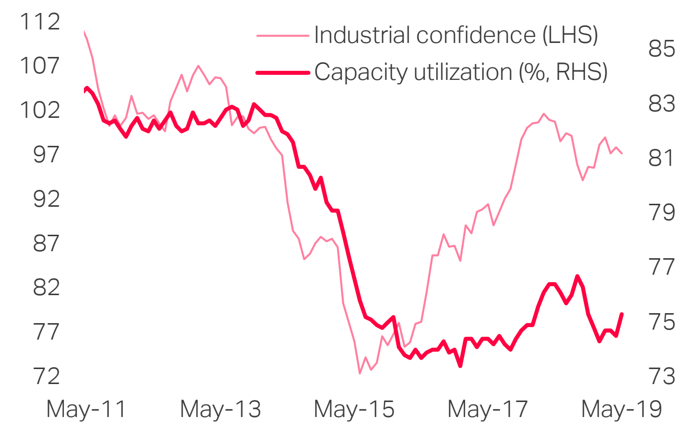
% 4Q rolling change



Source: IBGE.

FGV Industrial confidence vs capacity utilization

Avg. between Jun/10 to Jul/15 = 100



Source: FGV.

Wilson Ferrarezi

India

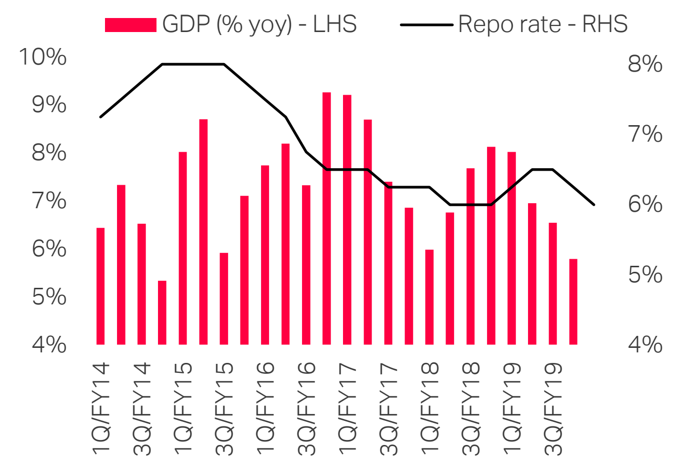
New Cabinet gets to work as economy slows to a 5-year low

The new Cabinet announced several measures to help revive consumer demand as GDP growth slowed to sub-7% for the first time since FY14. Amid expectations of big-bang reforms, the Modi government started off its second-term with a dose of welfarist policies. Plans are reportedly afoot to introduce many reforms as well, and the full FY20 budget - due to be presented on 5 July – will be watched closely for future government policy direction.

New Finance Minister Nirmala Sitharaman has a tough task ahead as she seeks to balance competing priorities in her first budget due just a month from now. She has to find ways to revive a sluggish domestic economy, where both consumer demand and industrial activity are slowing. However, room for sharply increasing government expenditure is limited if she wants to maintain fiscal prudence. India also faces global economic headwinds although the recent drop in international crude oil prices could prove lucky for its twin deficits as well as for keeping a lid on inflation. The Reserve Bank of India's Monetary Policy Committee, which is due to meet this week, will likely cut rates again to help boost the economy.

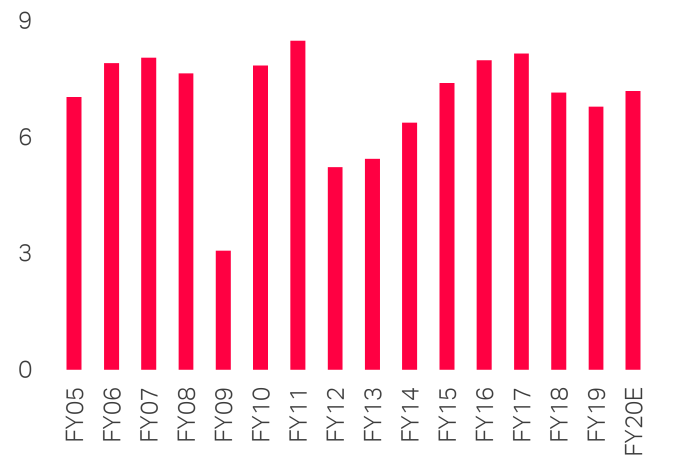
The latest GDP data for 4Q/FY19 at 5.8% yoy led to full FY19 GDP growth of 6.8%, lower than the government's earlier projection of a 7% expansion. The slowdown was broad-based, across sectors: the growth numbers for agriculture, manufacturing, electricity, construction, transport and communications all came in lower than the third-quarter data. Farm output in fact slipped into negative territory. The only sectors to beat the trend were public administration and the relatively small mining sector.

Chart 1: Quarterly GDP growth vs repo rate (%)



Sources: Central Statistics Office (CSO), RBI, TS Lombard.

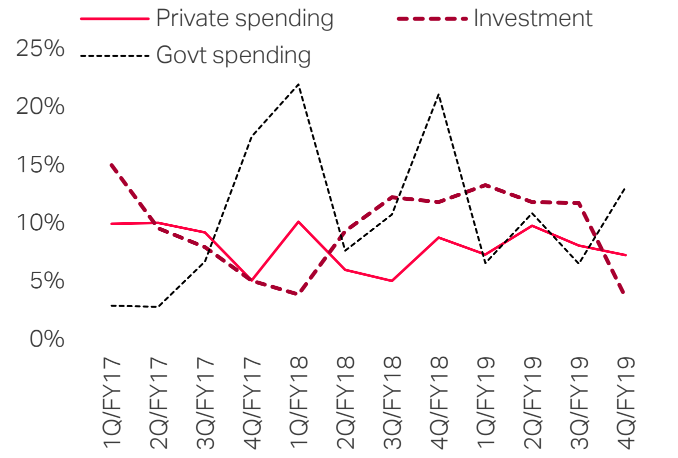
Chart 2: Annual GDP growth (%)



Sources: CSO, RBI. FY20 GDP growth forecast is by the RBI.

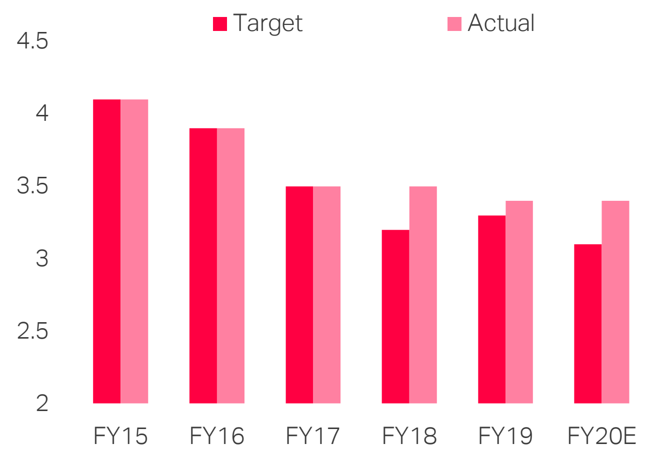
Government spending has indeed become increasingly important in supporting GDP growth, and grew faster in the fiscal fourth quarter than consumption and private investment (see Chart 3 below). However, the government sharply cut spending in March in order to meet its upwardly revised fiscal deficit target of 3.4% of GDP for FY19. That expenditure compression is believed to have hurt economic growth in the fiscal fourth quarter.

Chart 3: Growth in components of GDP (% yoy)



Sources: CSO, TS Lombard.

Chart 4: Fiscal deficit (% of GDP)



Sources: Budget documents, Controller General of Accounts.

The question now is whether the government will allow for further fiscal slippage in its budget in order to stimulate the broader economy. As Chart 4 above shows, the government has veered off its previously stated glide path for fiscal consolidation. The welfare measures announced by the government on its first day on the job on Friday include adding 20 million more farmers to the cash distribution plan that guarantees Rs6,000 a year in handouts. Annual spending on the plan to a total of 145 million farmers will rise by Rs120 bn to Rs 870 bn. The government also announced separate pension schemes for 125 million small farmers and 30 million small traders who were hit by the twin shocks of demonetization and the switchover to the Goods and Services Tax regime during Narendra Modi's first term as prime minister.

The welfare policies are in line with our view that Modi will stick to his winning mix of populism and some reforms. Markets have rallied sharply on the prospect that political stability and a second-term majority will help bring about long-anticipated structural reforms. Rajiv Kumar, the head of the state-run policy think tank NITI Aayog, told Reuters in an interview that the government is planning reforms that will include changes to labour laws, efforts to privatize state-owned companies and creation of land banks for industrial use. Modi had a mixed record on reforms in his first term, and we believe that the gradualist reform model will continue in his second term as well (see our 24 May 2019 note Poll outcome: continuity and risk).

Shumita Deveshwar

Russia

Divergent Russia-Saudi oil interests

The stage appears set for this month's scheduled semi-annual OPEC+ meeting to lay bare the contrary oil market strategies of Russia and Saudi Arabia. While this tension may be muffled again this time by current pressures – i.e. countering the trade war-driven oil price decline, Russia has strong reasons to raise output and lower the price – and will opportunistically do so.

This month's OPEC+ meeting in Vienna could prove significant. The decision on whether to prolong the 1.2mbpd output cuts agreed last December amidst an oil market rout will highlight more starkly than ever the divergent interests of Russia and Saudi Arabia. The paramount goal for the Saudis is to keep the oil price high (ideally close to $80/bbl and certainly no lower than $60/bbl); and the effect of the associated output restraint – i.e. the loss of global market share to the US, with its rapidly expanding shale oil production – is a price that the Kingdom is ready to pay. Russia has the opposite bias – in favour of higher volumes over higher prices.

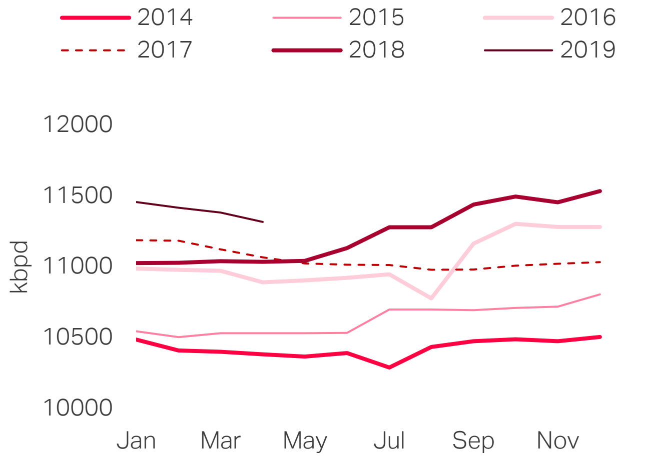
This Russia-Saudi tension over global oil market management has been clear since 2017. The day after Putin was re-elected last year, we drew attention to this as an underestimated theme for his second term. Back then, however, we also predicted that this tension would not come to a head in the short term owing to Putin's strategic priority of maintaining good relations with all regional players in the Middle East, as crucial underpinning for his geopolitical gambit in that region. As things turned out, however, such calculations proved moot as the reimposition of US sanctions on Iran in May 2018 casted OPEC+ into reactive mode: raising output last June, then cutting again in December as the US decision to grant 6-month sanctions waivers depressed the market.

New sharp oil price falls – continuing this morning – may end up keeping OPEC+ in this reactive mode – muffling the strategic divergence between its principals (Saudi, Russia). This price decline is clearly being driven by fears of a global economic downturn on the back of the US-China trade war escalation; and, as a result, the timing for OPEC+ is all the more tricky. The next key trade war trade war signal is expected to come at the G20 Summit in Osaka on 28-29 June (i.e. what, if anything, comes out of a meeting, if any, between Donald Trump and Xi Jinping). This suggests that the OPEC+ meeting, for which no firm date has yet been announced, could slip into the first week of July.

In any event, the underlying Saudi and Russian positions are contradictory. The supply problems from Iran have now crystallized, along with those from Venezueal and Libya. So continued OPEC+ volume restraint would allow US producers to extend their market share gains seen in H1/19 as the oil price recovered. The prospect of the build-up of US crude inventories going into reverse in H2 would also support an output increase. In extensive remarks last week about the next OPEC+ decision, First Deputy Prime Minister Anton Siluanov drew pointed attention to the US market share gains, while admitting that a balance needed to be struck with promoting the desirable stability and predictability of the oil price.

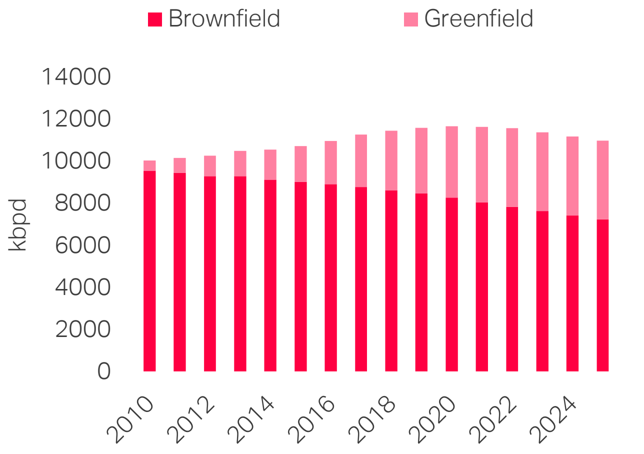
We see two reasons why the Russian government is now leaning in favour of higher output volumes over higher prices. First is the base effect of the production increase in H2/18 shown in the left-hand chart below. If not reversed in H2, the annualized YTD production decline – stemming from a combination of seasonality and OPEC+ compliance – would deepen markedly in H2. The resulting hit to industrial production would feed through to the overall GDP outturn, and also depress budget revenues (not only through oil-specific taxes, but also through the profit tax paid by oil companies).

Oil output: No increase in H2/19 would be painful



Source: TEK-CDU

Crude output capacity: Minimal headroom



Source: Energy Intelligence Institute

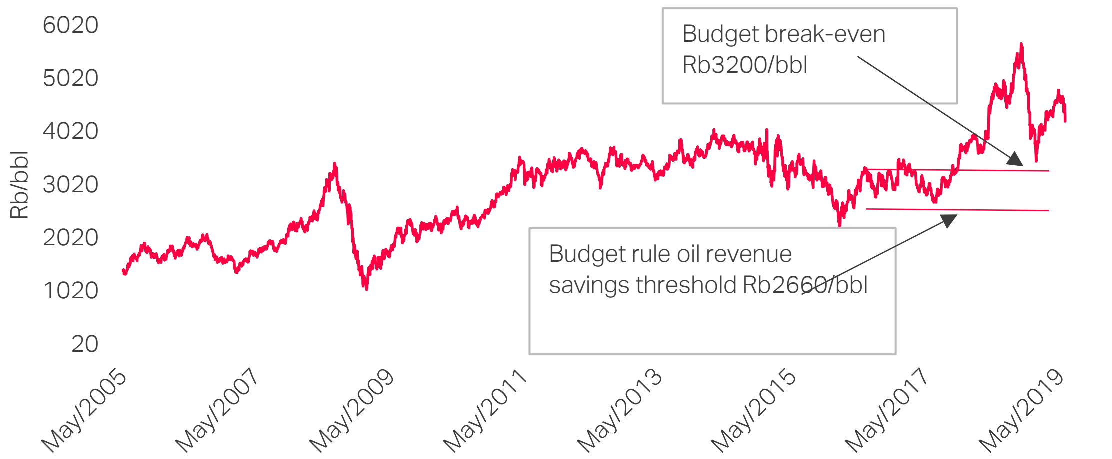
The second reason is more powerful: high oil prices are now causing a fiscal headache to do with the gasoline/diesel price freeze.. The problem stems from the ruble exchange rate decoupling from the oil price. This is partly an intended effect of the fiscal rule, and partly the result of sanctions (actual and threatened) weakening the ruble. This has pushed the the oil price in ruble terms way above the break even level for this year's federal budget (see chart below). Another effect has been to make the exporting business of Russsian oil companies much more profitable. So far, so good: but here lies the catch – for Russian consumers and inflation. Left to their own devices, domestic oil product prices would rise to the same stellar levels that the Russian companies can get for the same products in foreign markets. To stop this happening, the government has agreed with the companies on freezing domestic gasoline and diesel prices, and compensating the companies for more than half of the resulting difference between the (frozen) domestic price and buoyant export price.

The cost of this compensation is now soaring. Latest Finance Ministry estimates put it at around 0.4% of GDP in 2019, rising next year to over 1.5% of GPD. The initially planned funding source for this compensation scheme had been to dip into the 'excess' oil tax revenues saved in the National Welfare Fund. In other words, the fiscal rule would be marginally relaxed for the sake of domestic demand and living standards (since the alternative of standing aside would have meant not only higher gasoline prices but a resulting CPI uptick and, in turn, CBR rate hikes). Now, however, the Finance Ministry is determined to make the oil companies themselves bear more of the rising cost of this compensation, by means of another hike in the royalty ("mineral extraction") tax. That, however, would inhibit the capex needed to boost the oil sector's now almost exhausted capacity to raise output. This dilemma is captured in the right-hand chart above and in the chart below.

The whole dilemma would be eased were the oil price to settle in a lower range around $60/bbl. At present, the global market appears to be delivering that outcome. And since oil price volatility is highly unwelcome from the Russian government's point of view, consensus at the upcoming OPEC+ meeting may prove easy to reach in the form of another holding operation in the face of a tricky conjuncture – i.e. to continue for another six months with the lower output level agreed last December. This outcome would suit Saudi Arabia, which has been consistently producing well below its quota, affording plenty of room to raise production without breaching the OPEC+ agreement. Having laboriously reduced output to the agreed level by the May 2018 deadline, Russia has now such leeway.

Ruble oil price

Cost of gasoline price freeze: either raise budget break-even or raise oil taxes



Source: Bloomberg

We would therefore predict that any market recovery in H2 following an OPEC+ 'on hold' decision this month, will result in Russia becoming less compliant. The economic underpinning of the Russia-Saudi rapprochement looks weaker after last month's announcement that the Saudis will no longer be investing in the second phase of NOVATEK's Actic LNG project and have agreed to buy LNG from the US Sempra Energy. One way or another, the OPEC+ construction will come under increasing strain.

Christopher Granville / Madina Khrustaleva

Mexico

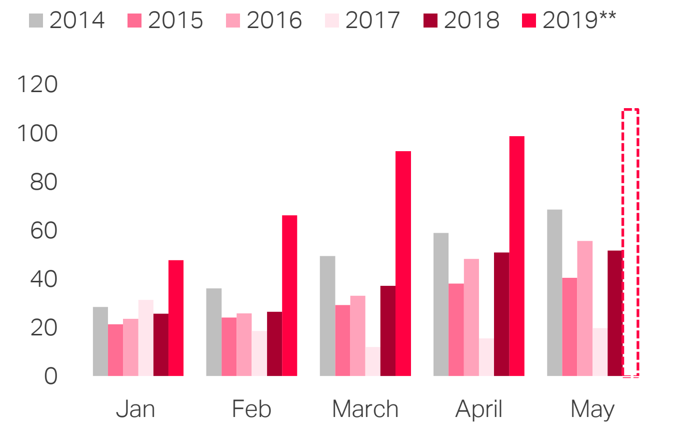
Trump threat darkens path ahead

US President Trump's threat to impose 5% tariffs on all Mexican goods starting 10 June, which could rise to 25% by October, poses a big dilemma for the Mexican government on whether to kowtow further on migration policy, even as it aggravates the economic outlook ahead.

The Mexican government is in a tough spot, after US President Trump opened up a new front in the trade war by tying higher tariffs to a drop in illegal migration and drug inflows. Trump's surprise ultimatum last Thursday (30 May) that he would impose a 5% tariff on all Mexican goods starting on 10 June – which could rise an additional 5% on the first day of each successive month until it reaches 25% on 1 October – should Mexico fail to curtail a surge in illegal migrant and drug inflows at the southern US border exploded like a bomb on the young government of President Andrés Manuel López Obrador (AMLO). The decision was all the more unexpected as it had been made on the same day that Mexico and the US had both kickstarted the formal process to ratification of the NAFTA 2.0 (USMCA) deal by sending the final text to their respective legislatures.

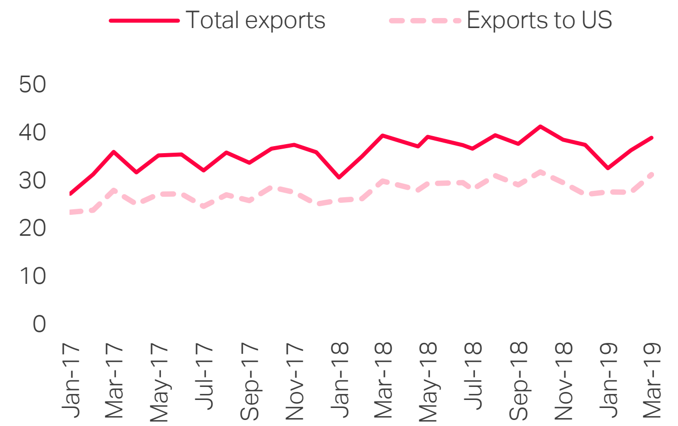
In recent months, AMLO has bent over backwards to placate Trump by beefing up measures to stem Central American migration, even as he maintained a message of "peace and love" in the face of provocative rhetoric from the US President (for more background, see the Mexico sectionin our 1 April 2019 EM Watch: Diverging inflation trends and our 9 April 2019 note Mexico: Appeasing Trump). Still, the measures were not enough to stem a surge in illegal migration numbers in April and May at the southwestern US border, as Chart 1 below illustrates. While border apprehensions usually peak in the spring before the brutal summer heat kicks in, the number of illegal migrants apprehended at the southwestern US border in recent months have roughly doubled compared to the year-ago period, adding to Trump's ire in the same week that the US President announced the date for the official launch of his re-election bid.

Chart 1: US southwest border apprehensions
Thousand people



*Does not include those found inadmissible at ports of entry.
**May estimate from US Homeland Security.
Sources: US Customs Protection, local press reports.

Chart 2: 80% of Mexico's exports go to the US
USD bn



Sources: INEGI, US census.

Not surprisingly, the peso sank on the news, weakening as much as 3.6% against the US dollar on Friday before paring back some of its losses; growth forecasts also fell. Looking ahead, if the full scale of the Trump tariffs were to be implemented, the fragile Mexican economy – which already contracted 0.2% qoq/sa in Q1/19 – could enter a tailspin this year. Exports account for 38% of Mexico's GDP, while nearly 80% of the country's exports go to the US. Moreover, the start of tariff implementation would likely close the door on an expected rate cut in H2/19 from Mexico's central bank (Banxico), heightening pressure on the bank to jack up its reference rate (already at a one-decade high of 8.25%) further, in order to stop a depreciating peso. Estimates vary as to where the peso would land, with UBS estimating MXN21/USD and local Banco Base forecasting MXN23.5-24/USD if the full 25% tariff on all Mexican goods is implemented. What is clear, however, is that a weaker peso would stoke inflation; so too would the likely imposition of new tit-for-tat Mexican tariffs on US goods in retaliation for the Trump tariffs. As a result, BBVA Bancomer on Friday cut its growth forecast from 1.4% to less than 1% and warned that a recession later this year cannot be ruled out.

A broader problem ahead is that Trump has upended a seminal investor assumption that Mexico would be a safe haven, especially from the ongoing US-China trade war. Following the announcement on 17 May that the US would lift its steel/aluminium tariffs on Mexico and Canada, there was newfound optimism in some quarters that NAFTA 2.0 might be ratified before yearend. While this was not our base case, given that the toughest hurdle still lay ahead – that of winning approval from House Democrats in the US Congress ahead of a rapidly shrinking legislative window, as we recently highlighted – Mexico was seen as a natural safe harbour by many multinationals seeking to avoid the escalating US-China trade conflict. However, the latest Trump threat has toppled that supposition, by showing that the US President is perfectly willing to impose new tariffs on a close ally, even after a free trade deal has been struck.

The upshot is that the Mexican outlook for investments has gotten a new shot in the foot, as USMCA ratification simultaneously becomes less important and companies reassess the risk of investing south of the border in the Trump era. Long term, this could further complicate the panorama for economic growth in Mexico. Yet at the same time, there is no sign that one of Trump's key aims – that of forcing companies to relocate back to the US – will have much success either, with US production costs still far higher than in many other countries.

The AMLO administration will hold meetings with top Trump officials this week in the hopes of defusing the threat; key to watch is the US goal of a 'safe third country' deal. This Monday, Mexican Economy Minister Graciela Márquez is scheduled to meet with US Commerce Secretary Wilbur Ross in Washington D.C. That will be followed on Wednesday by a meeting between a high-level Mexican delegation headed by Foreign Minister Marcelo Ebrard and US Secretary of State Mike Pompeo. But while AMLO signalled this weekend that he would indeed be willing to further tighten local migration controls to mollify Trump, the big question is whether he would go so far as to agree to allow Mexico to become a so-called "safe third country" – a designation that would allow the US to quickly deport illegal migrants either to Mexico or back to their home countries because international law generally directs migrants to ask for asylum in the first safe country they enter.

However, immigration advocates have long protested against this idea, arguing that Mexico – where intentional homicides broke new records in Q1/19, after already reaching record levels in 2018 – is not a safe third country. Furthermore, if Mexico were to agree to such a designation it would greatly exacerbate its own problems, after the latest influx of Central American migrants have already strained local resources in both its southern and northern border regions. Moreover, because the number of US southwest border apprehensions surpassed half a million in the 2018 fiscal year (October-September) and will be much higher than that this fiscal year, such a concession would add yet another order of magnitude of problems for Mexico from a purely economic point of view. From a structural point of view, it is patently clear that the reasons for the growing Central American exodus are based on worsening local economic and public security conditions that are not solved by Trump's hardball tactics. To address the root causes of the problem, AMLO has argued that what the region truly requires is a new "Marshall Plan" to provide an influx of new investment dollars to develop the region; however, this is not the quick-fix solution that Trump is looking for.

In a sign that AMLO too may have reached a point he cannot cross, despite his willingness to appease Trump, he wrote "I do not lack courage nor am I a coward" in his letter to the US President after the tariff threat was announced, even though he proposed more dialogue as the solution to the problem. A similar point was underlined in an editorial published this Sunday by Jorge Islas, the Consul-General of Mexico in New York, when Islas wrote: "Clearly, Mexico as a sovereign country cannot perform immigration functions for another country". Still, if the US were to be willing to accept a range of intermediate measures, it is possible that the tariff schedule could be delayed. Furthermore, because illegal migration inflows usually fall in the summer months, a window could open for the Trump administration to declare temporary victory without structural changes being implemented.

If, however, the two countries fail to meet an agreement, AMLO has said his administration will file a case against the US at international trade tribunals on the grounds that the tariffs violate both NAFTA as well as WTO rules. He also hinted at the fact that the government could take other measures to prop up the local economy, although this may add to fiscal erosion for the already embattled Finance Ministry (for more background, see our 28 May 2019 note Urzúa's uphill battle).

Unfortunately, for Mexico, the 2020 US presidential race is only beginning to fire up – pushing up the likelihood that the country will stay on the hot seat when it comes to being Trump's punching bag, even though there are still 17 long months left before the election. In addition, because Trump won the 2016 election in large part by bashing Mexico and playing the illegal immigration card, there is little reason for him not to employ the same tactic again as he steps up his re-election campaign, adding to the looming clouds south of the border.

Grace Fan

Indonesia

Expected cabinet reshuffle will send positive signal to markets

The cabinet reshuffle expected to take place later this month will provide insight into Jokowi's resolve to carry out necessary reforms. Apart from some political appointments in return for the coalition partners having supported him, we expect that he will offer jobs to seasoned managers who will expedite the implementation of his policy agenda. The reaction of the markets to this development will be positive.

President Jokowi has now officially won re-election with a higher turnout and a wider margin of victory compared with 2014. This gives him a strong mandate to pursue his investor-friendly policy agenda, which underscores his understanding that Indonesia needs foreign direct investment to accelerate growth and finance the current account deficit. Although he will not start his second and final term until 20 October, he is expected to undertake a reshuffle of his cabinet later this month, providing insight into the strength of his commitment and resolve with regard to reform.

The key thing to watch out for will be the balance between technocrats and political appointees in the new government. There are several reasons for the cabinet reshuffle. First, three of the ministers in the current government are connected to corruption cases currently being probed by the Corruption Eradication Commission; hence the reshuffle offers an opportunity for Jokowi to replace them. Second, some of the ministerial positions will be offered to coalition partners in return for their pre-election support while others could be given to the opposition parties in order to garner an even larger majority in the legislative house. Third, and most important, a renewed, competent government team will allow Jokowi to facilitate the implementation of his reform agenda. From his comments, we know that he favours individuals with good managerial skills and wants to offer younger politicians a chance to help govern. Nevertheless, he will need to make sure he achieves a balance between technocrats and political appointees to ensure strong backing in the parliament.

Sri Mulyani Indrawati will coordinate the implementation of Jokowi's economic agenda. There are unconfirmed reports that the current Finance Minister has been offered the role of Coordinating Minister for Economic Affairs in the new cabinet. The former managing director of the World Bank improved the fiscal position of the country during her current tenure as Finance Minister, and this was instrumental in securing upgrades of Indonesia's sovereign credit rating, including, most recently, S&P's decision to raise that rating from BBB- to BBB. While Coordinating Minister for Economic Affairs is a more senior role and entails overseeing several ministries, including trade, finance and industry, that of Finance Minister is arguably more powerful; hence, there is uncertainty over whether Indrawati will accept the new job if indeed it is offered to her. Overall, we believe she would be the right person to undertake the difficult task of synchronizing the actions of the economic ministries in order to expedite the implementation of the reform agenda.

The announcement of the government reshuffle will support investor sentiment. Not least, President Jokowi will want to signal his determination to accelerate the pace of reforms, and this in itself will support investor sentiment, which suffered last month. The significant foreign portfolio outflows in May were exacerbated by escalating US-China trade tension, negative surprises in the trade and current account data as well as softer-than-expected tax collections. Equities sold off and although they recovered some of their losses towards the end of the month, some upside potential remains if Jokowi were to send such a positive signal by announcing a new, strong economic team. In terms of timing, we think that the reshuffle, which was originally expected in early June following the end of the Idul Fitri holiday, could be postponed until the Constitutional Court has ruled on the legal challenge against the presidential elections results filed by Prabowo Subianto. This means sometime after 28 June.

Krzysztof Halladin

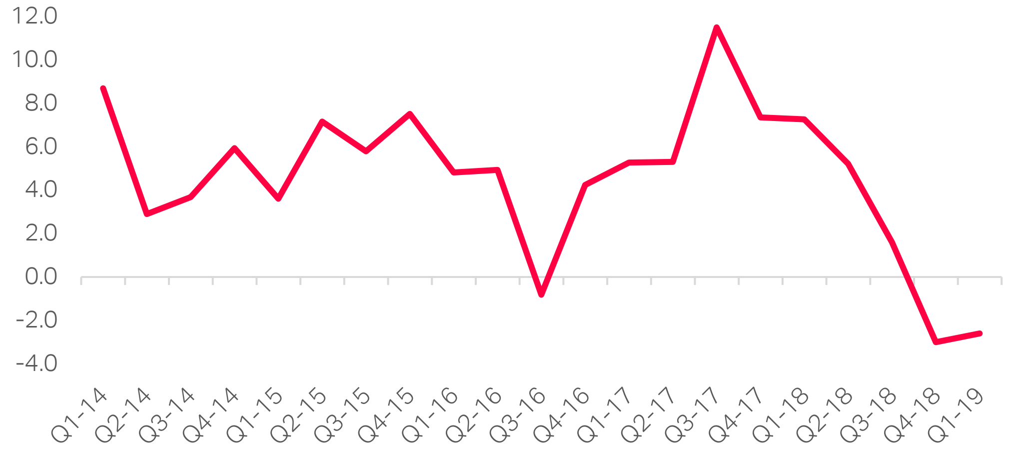
Turkey

GDP data fail to show the economy has hit bottom

Although 1.3% qoq GDP growth was reported last Friday, we doubt the economy will climb out of recession anytime soon. Investment and household consumption continue very weak and there are limited options to stimulate the economy given a weak lira and rising fiscal deficits.

The first quarter GDP figures released last Friday confirmed that government spending is the only source of growth currently. Finance Minister Berat Albayrak was quick to claim that the worse of the recession was over, pointing to a 1.3% qoq GDP increase in the March quarter. In his words Turkey's "technical recession" (two successive qoq declines in GDP) was over. On this basis, he is right. However, a look at the breakdown of the figures shows no evidence of a turnaround in the economy's underlying growth drivers. On a yoy basis Q1 GDP fell 2.6%, slightly up from -3% in Q4/18, but a 7.2% yoy rise in final government consumption was the major factor preventing an even deeper drop in growth. Household final consumption was down 4.7% yoy, while gross fixed capital formation dropped 13%. Net exports were also positive, contributing 9.4ppt to GDP growth, but this was largely due to a sharp fall in imports: ytd exports through April are up only 3.1% yoy in nominal terms vs a 19.4% decline in imports.

GDP, % change yoy



Source: Turkstat

Our judgment is that the economy will remain mired in recession through yearend; we forecast a 1.5-2% GDP decline for the full year. Judging by the marked erosion in the primary budget deficit – from 0.4% of GDP in April 2018 to 2.7% currently, expansionary fiscal policies that buoyed the economy ahead of the 31 March local elections will likely be reined in. Beginning in April the government acted to limit the deficit by hiking excise and custom taxes. Excise taxes on alcohol, tobacco and cell phones were all raised in April and previous duty-free e-commerce purchases from abroad are now subject to levies of up to 20%; a 0.1% tax on FX transactions was also reinstated. These moves are unlikely to prevent a further rise in the government's fiscal deficit, but the increase will likely be much smaller than seen in the March quarter. Concerns that a marked deterioration in the government's fiscal performance will restrict the access of the government and domestic banks to external financing is likely a major concern for policymakers in Ankara.

Faced with a weak lira and rising fiscal deficits we see limited room for the government to boost spending to get out of recession. Finance Minister Berat Albayrak has been trying to boost the economy via a series of loan packages led by state-run banks. The latest effort rolled out on 23 May was the 7th such scheme since he took over the finance post 10 months ago. The latest package is promising up to TRY30bn (US$4.9bn) in loans for import substitution and export expansion. The effectiveness of such initiatives is likely to be low, since potential borrowers will be reluctant to take on new debt or they may simply use the proceeds to repay other debt.

Two additional factors are likely to restrain a recovery in GDP growth currently. One is the fact that there was a major drawdown of inventories in Q1/18. As firms begin to restock inventory levels the contribution of net exports to overall growth will fall. A more important sign of future economic weakness was the sharp erosion in household and business sentiment that we highlighted last week: household confidence fell to its lowest reading ever, while business confidence plummeted from 90.7 in April to 78.3 in May. In addition to currency volatility the upcoming 23 June election rerun of the Istanbul mayoral election is likely also eroding economic confidence.

Larry Brainard

Strategy

Adding Russian local debt, Indonesian equities

As of today, we add a long position in Russian local debt and a long position in Indonesian equities to our list of Absolute Views.

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Long Russian local debt

Benign inflation and a stable ruble favour local debt, upcoming rate cuts should drive bond yields lower. The relatively high oil price should continue to boost investor sentiment while the system of FX interventions under the fiscal rule reduce the volatility of the ruble. Headline inflation has stabilised in recent months and core inflation trends remain downward. Breakeven inflation has fallen further over the past month (see Chart 1). We expect the CBR to deliver two 25bp rate cuts before the end of the year underpinning our favourable view of local debt (see our 20 May 2019 EM Watch).

The stabilising effect of the fiscal rule allows the Finance Ministry to calibrate its issuance of local debt. The fiscal rule dictates that oil price revenues attributable to prices above $40/bbl can be spent, while the actual revenue available will depend on the exchange rate. A weaker ruble, therefore, means that revenues in ruble terms will be higher, thereby reducing the debt issuance requirement. The measure will likely result in higher issuance and reduced gains for bond investors under favourable conditions of high oil prices and a strong currency, but will also have a stabilising impact that should favour Russia in the current challenging external environment.

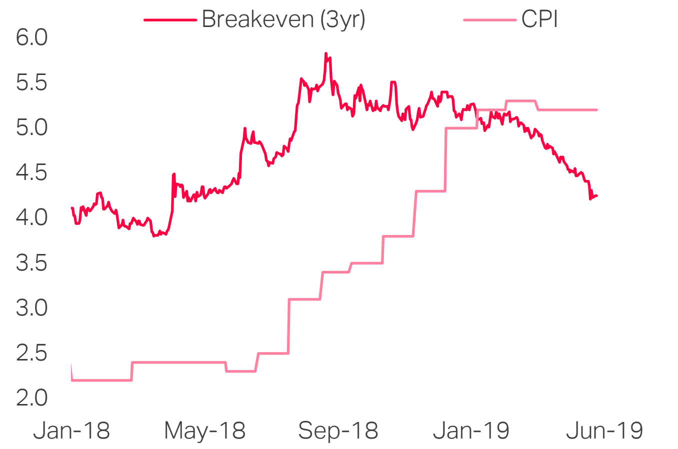
We maintain our view that the threat of new US sanctions is unlikely to entirely disappear, although the probability that the US will deploy the most severe measures has declined.

Long Indonesian equities

Indonesian equities have sold off ahead of the announcement of the official result of the elections and should now recover. The anticipated appointment of members of the cabinet later this month will provide an indication of the direction of the new administration. In achieving his recent election win, the President has had to compromise some of the secular and reformist principles that were evident during his first term. We nonetheless expect the government to make progress on structural reform in areas such as reducing corruption and improving the business environment.

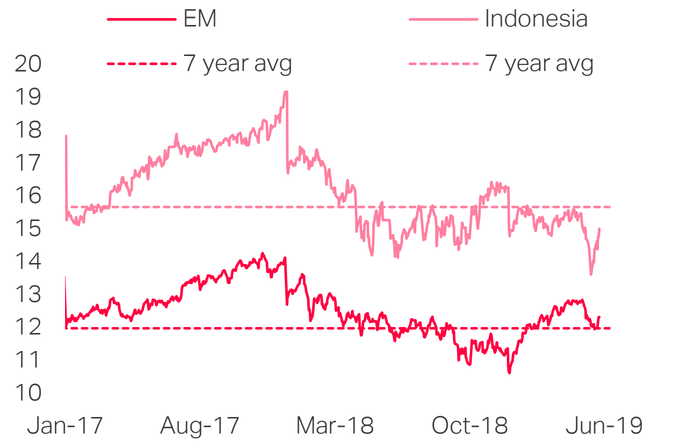
It is probable, however, that there will be resistance to any substantial opening up of the market to foreign investors, although there remains a chance that further progress will be forthcoming later in the President's second term. The escalation of opposition protests seeking to challenge the election outcome remains a short-term threat to markets, but we expect disruption to be short-lived. Valuations had lagged global EM since the beginning of the year and fell further behind in the run up to the election (see Chart 2). We see potential for further recovery as tensions with the opposition subside and the new cabinet takes shape.

Chart 1: Russia: Headline CPI and breakeven



Source: Bloomberg, TS Lombard.

Chart 2: Indonesia and EM forward P/E ratio



Source: Bloomberg, TS Lombard.

Jon Harrison

Must Read

Mexico: Fiscal remains on track for now

The recent exit of two top officials from AMLO's cabinet exposes rising political friction over budget cuts. Grace Fan warns that while Finance Minister Urzúa is committed to austerity, a central question ahead for investors is whether ratings agencies will be pre-emptive on a downgrade. The odds remain good that Finance Minister Urzúa will retain the support of AMLO in order to maintain fiscal discipline this year. See our 29 May report Mexico: Urzúa's uphill battle.

Brazil: Weak activity weighs on fiscal stimulus

GDP contracted by 0.2% in Q1/19 as expected, underscoring the economy's weak momentum. Weaker growth poses a threat to Brazil's fiscal accounts, underscoring the challenges ahead. Wilson Ferrarezi and Elizabeth Johnson expect further erosion of the outlook for cutting the budget shortfall. See our 31 May report Brazil: Fiscal outlook: From bad to worse.

China Watch: Trade war tension escalates

Anti-US rhetoric in China rises as fundamental differences emerge. Jonathan Fenby explains that the leadership sees the China model under attack. The core message is that China believes that the US is trying to invade China's economic sovereignty and force China to damage its own fundamental interests. This entrenches both camps and makes meaningful compromise that much more difficult. See our 31 May China Watch.

Asset Allocation

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

We will publish our next Asset Allocation in our EM Strategy Monthly tomorrow.

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	0			
Asset class	+1 (-1)	-1 (0)	0 (+1)	0 (-1)
Relative country views				
China	0 (-1)	0	-1	n/a
Brazil	-1	+1	+1	+1
India	+1	+1	-1	n/a
Russia	+1 (+2)	+1	+1	+1
Mexico	+1	+1 (-1)	+1	+1
Indonesia	+1	0 (+1)	+1	0
Philippines	-1	-1	+1	-1
Thailand	0 (+1)	-1	-1	n/a
South Africa	-1	-1	-1	-1
Turkey	-1 (-2)	-1 (0)	-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	198	-2.3%
Brazil	Local debt	Long	7-Jan-19	%	7.68	6.98	-0.2%
Indonesia	Equity	Long	3-Jun-19	-	0.49	0.49	+0.0%
Russia	Local debt	Long	3-Jun-19	%	7.60	7.60	+0.0%

Date/time 3-Jun-19 07:32

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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