



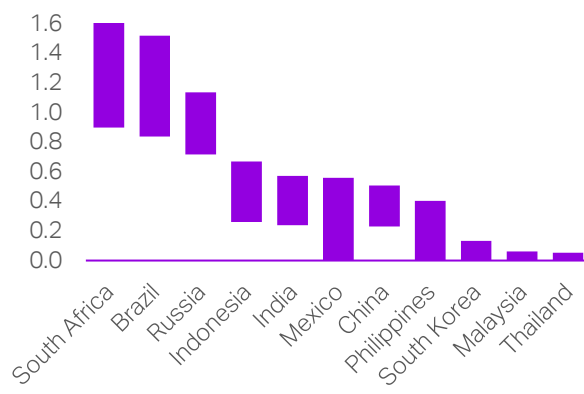
EM Watch

ONE CRISIS TOO MANY

Jon Harrison / EM Team

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EM inflation impact of FX



Source: Bloomberg, TS Lombard.

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Investor focus on Turkey has diverted attention from an important economic impact of the stronger dollar. EM inflation expectations have surged while headline CPI has consistently surprised to the upside. The implication for investors is that the domestic macro environment in EM is becoming less predictable, which will favour credit over more risky local debt and equities.

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[China](#): Weak data to accelerate stimulus

Weak domestic growth drivers will prompt more policy support. Infrastructure investment and total credit will rebound in 2018H2. We maintain our view that GDP will fall below 6.5% in 2018H2, despite easing. The trade war has triggered leakages and reorganized trade flows.

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[Brazil](#): Polls to dictate market sentiment

With official campaigning now underway, markets will turn their focus to polls that will be released this week in an attempt to get an early indication of voter sentiment. Although the free ad time does not begin until 31 August, two recent debates could start to influence voters.

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[India](#): Weaker rupee: worsening fundamentals

The depreciating rupee has been making the headlines as it breached the psychologically key level of 70 to the US dollar last week. We believe the Turkish lira crisis and India’s widening trade deficit are just triggers to what was an inevitable weakness, given its REER overvaluation.

[Russia](#): Tax: Sechin vs Siluanov

Continuing discussions this week of the proposed Rb500 billion tax hit on metals and chemicals companies should not unnerve investors: we stick firmly to our view that this initiative will be buried. But it still deserves attention for the light it sheds on Rosneft tax lobbying and the wider “open contest” policymaking process – in which the government/CBR has the strongest team.

[Mexico](#): Direct exposure to Turkey via BBVA

Mexico’s main risk from the Turkish crisis is limited to the operation of the Spanish bank BBVA in the country. Although the Mexican peso has experienced a degree of contagion, it is likely that, global sentiment permitting, the currency will reverse its losses as the market realizes that Mexico’s economic fundamentals are not significantly linked with Turkey.

[Indonesia](#): Two more hikes to come

The trade balance returned to deficit in July, suggesting that the current account deficit will widen further in Q3/18. Meanwhile, rupiah depreciation pressures were back with a vengeance.

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Turkey

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Brunson on US-Turkey vs Turkey on EM

Our main title this week “One crisis too many” refers to both the case of US Pastor Brunson that could be the step too far that causes an irreparable rift between the US and Turkey, and the Turkey crisis itself, the incremental impact of which could be the final straw for global EM.

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Our short answer to both questions is “yes”. We consider whether the case of US Pastor Andrew Brunson could trigger an irreparable rift between the US and Turkey, and whether the incremental impact of the Turkey crisis could be the final straw for global EM – where Russia, Brazil, South Africa and to a lesser extent India and Indonesia could be the markets most at risk.

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Turkey continues to resist US pressure to release Pastor Brunson. President Erdogan has characterised the dispute as an “economic war” and called for a boycott of US products as videos of Turks pouring away their Coke and smashing iPhones have gone viral. At the same time, efforts to reassure investors have fallen flat (see second [Turkey](#) section).

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Treasury Secretary Mnuchin sought on Thursday to bring the dispute back to reality.

Mnuchin warned that Turkey faces more sanctions, beyond those already imposed on two cabinet ministers, if it does not release Brunson quickly. The earlier US imposition of steeper tariffs on steel and aluminium has clouded the view of the dispute in the global media; reports conflated the tariff measures with the entirely unrelated US trade battles elsewhere. Mnuchin returned the focus to Brunson, while Trump reminded Turkey that the administration had in July persuaded Israel to release a jailed Turkish citizen, accused of having links with Hamas. This is just one indication, of which more below, of how much the US values its relationship with Turkey.

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The window for a quick resolution is rapidly closing. The US administration is increasingly using the Brunson case to shore up support among Trump’s electoral base. Evangelical Christians are urging citizens not to travel to Turkey and lobbying hard in support of imposing further sanctions. Turkey remains reluctant to capitulate to US demands. Brunson is accused of having links to Gulenists and to PKK terrorists, as well as being implicated in the July 2016 coup attempt. The issue is yet more personal for President Erdogan, with some local commentators alleging that US security services were involved in the failed coup, or at least, that they support Erdogan’s removal. The question of Brunson’s guilt or innocence becomes irrelevant, however, when punishing Turkey can be seen to have political value at a key point in the US election cycle.

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The clear and present danger for Turkey is that simply releasing Brunson may soon no longer be all that is required to reset relations with the US and restore calm to markets.

If the dispute with Turkey continues to deepen, the US will become ever more likely to revisit the other areas of tension between the two countries.

1. **Imposing a fine on Halkbank.** The US Department of Justice is currently conducting an investigation into Turkey’s Halkbank following the prosecution of senior Halkbank director Mehmet Hakan Attilla for conspiracy to violate US sanctions on Iran. At the trial in May, Attilla received a much lighter sentence than sought by prosecutors and could be free next year. The question of whether a fine will be imposed on Halkbank is undecided, but is a possible outcome of the investigation. The administration is currently said to favour a softer penalty.
2. **Widening the Iran sanctions investigation.** Other Turkish banks, including Vakfiban, Ziraat and Deniz Bank, are also alleged to have been involved in sanctions-breaking activity. A deepening of the US investigation into violations of Iran sanctions could lead to catastrophic consequences for the Turkish banking system and the wider economy.

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3. **Reducing defence cooperation.** Turkey remains insistent that it will push ahead with the purchase of the Russian S-400 missile defence system, in response to which the US has delayed the sale of F-35 fighter aircraft to Turkey pending a risk assessment report by the Pentagon, due in 3 months.
4. **Reducing cooperation in Syria.** There is also the allegation that oil bought from ISIS found its way to Turkey among legitimate shipments from Iraq – a trade in which Treasury and Finance Albayrak could be personally implicated as Energy Minister at the time. The conflict in Syria offers other potential sources of US-Turkey tension, including Turkish opposition to the US allied Kurdish YPG, which the US administration has so far tolerated.

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President Erdogan has been seeking to strengthen relations with allies, securing a \$15billion investment from Qatar, holding discussions with Chancellor Merkel and meeting with President Macron. All of which, however, will be of little use if he is unable to repair relations with the US.

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The combination of the Brunson affair and the administration’s realisation of the political value in punishing Turkey could now lead to an irreparable rift between the US and Turkey.

[Brazil](#)

For global EM economies and markets, it is not simply the exposure to Turkey that matters, but the incremental impact of the crisis, which follows on the heels of the many other external and domestic dislocations that have developed this year. Much has been written about the financial exposure of the European banking system to Turkey (see last week’s [Europe Watch](#)). Indeed, Turkey’s most important financial, economic and trade linkages are with the small economies in its immediate geographical neighbourhood and with the much larger economy of the EU. The linkages with other global EM economies are relatively small.

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We expand upon our conclusion that limited links to Turkey are no comfort to global EM (see last week’s [EM Watch](#)), by considering the incremental impact of the crisis on trade, inflation and ability to service debt. Turkey itself appears in none of the comparative charts below – politics rather than economics and markets is now the critical factor.

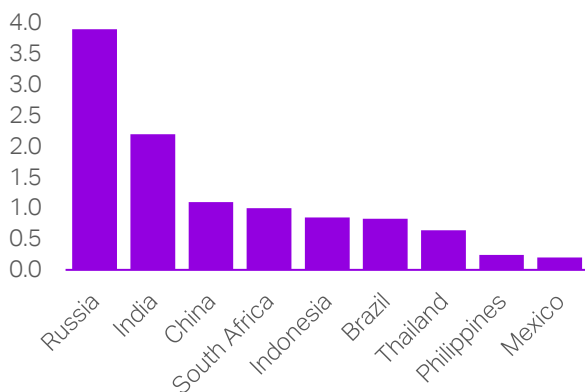
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Trade

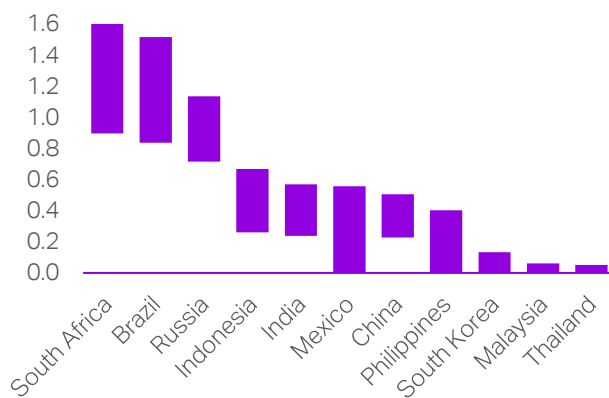
Russia and India are most at risk. If its economy continues to implode, Turkey’s imports will decline sharply. Among major EM, Russia sends the largest share of its total exports to Turkey at 4% of total, while India is second placed at 2% (see Chart below). We note, however, that India’s trade deficit has recently widened to a five year high (see our 16 August report [India: The return to inflationary normal](#)), suggesting that incremental damage to India from the Turkey crisis could be greater than that for Russia, where the trade balance is in surplus and rising.

Share of exports to Turkey



Source: Bloomberg, TS Lombard.

EM inflation impact of FX depreciation



Source: Bloomberg, TS Lombard.

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In the case of Russia, however, balance of payments damage could be self-inflicted. The rapprochement between Turkey and Russia since the resolution of tensions over the 2015 downing of a Russian fighter by Turkey, and the opportunity to increase tensions within NATO, could lead to Russia extending assistance to Turkey, perhaps by granting favourable trading terms, which may then become detrimental to Russia's own economy.

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Inflation

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Brazil and South Africa are most at risk. The Turkish crisis has contributed to the depreciation of EM currencies this year, which has triggered an uptick in EM inflation expectations (see [Global](#) section). Rapidly changing EM economies do not make ideal candidates for exchange rate pass-through analysis. The problem is compounded by the fact that some of the depreciation to date will already have been passed through to prices.

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A 2016 [IMF paper](#) calculates exchange rate pass-through coefficient for advanced economies and major EM, based on monthly data from 2000 to 2015. The study finds China to have the greatest pass-through of nominal effective exchange rate movements to inflation over a 12 month period (0.34 cumulative CPI response after 12 months for 1% NEER shock). But, of course, China's exchange rate regime (and indeed its economy) has changed beyond recognition since 2000. The IMF also finds relatively high pass-through coefficients in South Africa, Russia and Indonesia (from 0.18 to 0.24). There has, however, been a considerable improvement in monetary policy credibility in many EM economies, which will likely reduce exchange rate pass-through coefficients, compared with historical levels. We therefore take a conservative view and assume a pass-through coefficient of 0.1 in all cases.

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We calculate a potential range for inflation impact by considering the depreciation of the NEER vs its average over the past 12 months and vs the maximum of the past 12 months. The scale of EM FX depreciation to date suggests that Brazil and South Africa could be most at risk from an inflation shock (see Chart above).

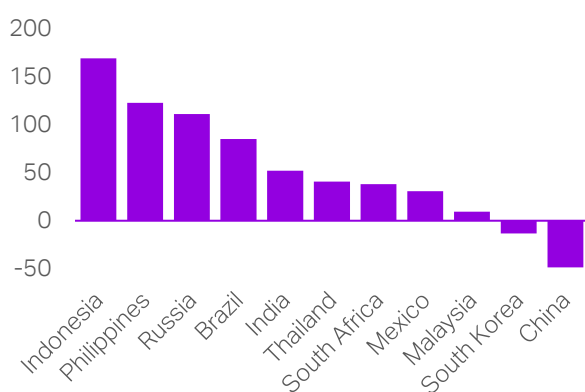
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Debt service

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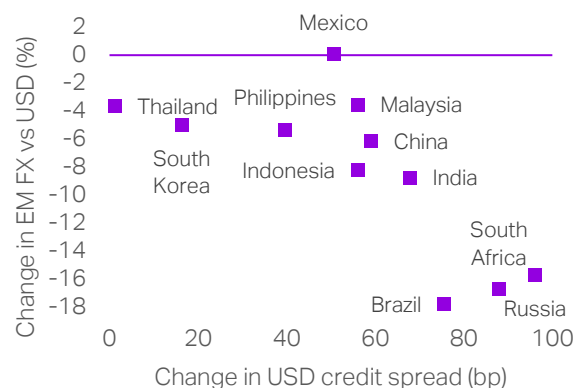
Brazil, South Africa and Russia are most at risk; and to a lesser extent India and Indonesia. The correction in local yields, exchange rates and credit spreads will make debt service more challenging for EM companies. While there may be few EM economies facing systemic risks (except Turkey), the cumulative impact of market weakness across EM represents a significant deterioration in the environment for companies operating in those countries (see Charts below).

Local bond yield: change vs January



Source: Bloomberg, TS Lombard.

EM FX & credit spread vs January



Source: Bloomberg, TS Lombard.

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Turkey

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Lira on the edge as new Fin Min attempts to reassure investors

The new Finance Minister Berat Albayrak promised investors tough fiscal policies to combat economic overheating, but monetary policy was not addressed. As Turkey heads for a hard landing, the economy's primary vulnerability is financial and is tied to the credit deterioration of the financial system's assets. This blind spot of the new administration is a major flaw of the government's adjustment programme.

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An investor call by the new Finance Minister Berat Albayrak last Thursday attracted over 3000 listeners. The Minister sought to reassure investors that the government will take tough economic measures to lower inflation and the current account deficit. It was notable that the remedies he pledged to implement were primarily fiscal not monetary. He promised to implement budget cutbacks, mandating expenditure reductions of 10-30% from ministries and he said the government would target a primary surplus of TL6bn for the rest of this year and implement a "fiscal rule" to ensure spending discipline.

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But at the same time he said the government would ensure that credit continued to flow to corporate borrowers; banks for example would be prevented from demanding collateral top-ups owing to the slide in the lira and loan pricing was to remain "flexible". Albayrak's reliance on fiscal tightening while continuing monetary ease is completely misguided. The economic crisis facing the government is primarily monetary; pledging to keep lines of credit open to borrowers tells us his understanding of financial markets is limited or that he was told to avoid mentioning monetary policy. This is a fatal flaw. Without a strategy to manage the monetary and currency aspects of the crisis will likely prolong and worsen the economic adjustment that will eventually have to come.

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A reckless development strategy based on credit stimulus funded by bank borrowing abroad has created a time bomb that could easily explode into a broader financial crisis, not just a sharp slowdown in growth. As we emphasized in our May [call](#), Turkey is heading for a hard landing: the economy's primary vulnerability is financial and is tied to the credit deterioration of the financial system's assets, both loans of the banks as well as the government's Credit Guarantee Fund, which channelled huge volumes of credits to borrowers, many of which will struggle to repay them.

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Amid a global environment of easy credit created by the ECB's QE policies, EU banks were quite happy to fund Turkish banks, given attractive yields vs alternative lending opportunities at home. The environment for the continuation of such favourable borrowing conditions has now changed radically. In Turkey, rising inflation and inept monetary policies have fuelled currency weakness and credit deterioration. Abroad, liquidity has tightened as the Fed has pushed rates higher and begun to exit QE. Turkey's development model is no longer viable under the new conditions in global markets.

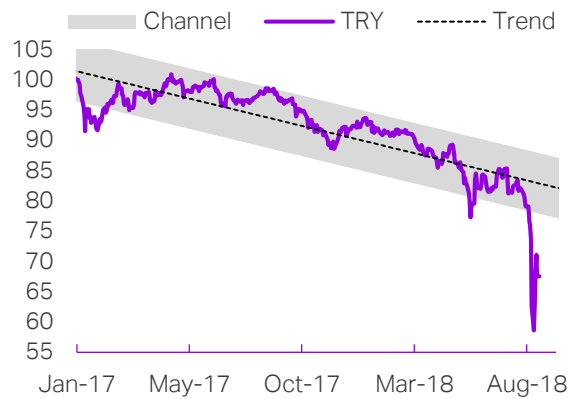
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Lira vs US\$



Source: Bloomberg

TRY REER



Source: Bloomberg

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What might have turned into a cycle of rising NPLs and slower growth could now turn into a much broader financial crisis as the banks' access to continued FX from abroad shrinks. It is likely to be squeezed because the Central Bank failed to act in time to stabilize financial conditions just at the time that President Trump unleashed his Twitter storm, thus undermining the currency. The demonstration effect on the share prices of several EU banks with large Turkish exposures will undoubtedly lead other banks to cut their Turkish credit exposures where they can. And credit downgrades last Friday from S&P, to B+, and Moody's, to Ba3 will not help matters. Further, the Turkish banks' strong capital positions, which are frequently mentioned as underpinning their creditworthiness, will be rapidly eroded by rising NPLs associated with the recent slide in the lira.

As Jon Harrison argues above in the first [Turkey](#) section, further US sanctions have been prepared and could be unleashed if a deal on releasing Pastor Andrew Brunson is not reached. Erdogan has responded to Trump's demands by shoring up his relations with EU leaders, who do not welcome potential disruptions to their strong economic ties with Turkey, and with Qatar (his lone Arab friend). At the same time Erdogan will adamantly refuse IMF assistance because he is proud that he succeeded in terminating the country's previous Fund programme back in the early 2000s.

As the economy heads toward a hard landing the absence of top economic management that understands the full dimensions of what policies are essential to avert a deeper financial crisis should be the major concern of EM investors. Signs that a deal between the US and Turkey could be reached in the near future could lead to a significant market rebound but the underlying economic policies of the Erdogan administration will not bring this crisis to an early resolution.

Larry Brainard

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Global Backdrop

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Rising inflation raises macro risks

Investor focus on Turkey and the deepening risk-off in EM assets have diverted attention from an important economic impact of the stronger dollar, namely, rising inflation expectations. Expectations have surged while headline inflation has consistently surprised to the upside. The implication for investors is that the domestic macro environment in EM economies is becoming less predictable, which will increasingly favour credit over more risky local debt and equities.

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The crisis in Turkey deepened last week, adding fuel to rising risk aversion among EM investors.

The lira rebounded strongly from weakest levels, but remains under threat while the risk of new US sanctions or trade measures hangs over Turkey. Most other EM currencies weakened as the appreciation of the dollar gathered momentum. For global EM economies and markets, it is not simply the exposure to Turkey that matters, but the incremental impact of the crisis (see [Turkey](#) section above).

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Investor focus on Turkey and the deepening risk-off in EM assets has diverted attention from an important economic impact of the stronger dollar, namely, rising inflation expectations.

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Inflation expectations in EM economies have surged. Analyst inflation forecasts are being revised steadily higher, but it is the sharp increase in breakeven inflation expectations over the past few weeks that is most striking; here calculated from yields on the inflation-linked debt of 8 EM countries. And there is an ever more a marked correlation between inflation expectations and the dollar (see Chart below). The strengthening dollar is likely to remain a threat to EM. Turkey may be the proximate cause of recent market jitters, but even if the US and Turkey agree to turn down the temperature, the US-China trade conflict represents a still greater threat to EM economies and markets (see last week's [EM Watch](#)).

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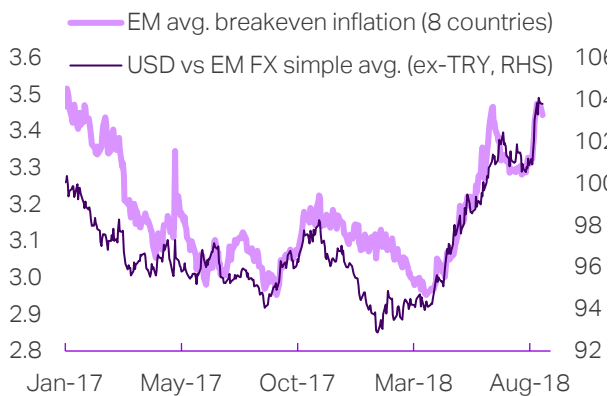
The announcement last week of low-level US-China talks to be held at the end of August is a positive development,

which in the best case could lead to an agreement to hold higher level talks, but is unlikely either to resolve the deep differences between the two sides or to secure a change in direction of planned US tariff imposition, and so does not warrant any significant reduction in risk perception. Indeed, the passage of the Defense Authorization Act earlier this month represents an escalation in measures targeting China and makes an early agreement even less likely (see last week's [China Watch](#)).

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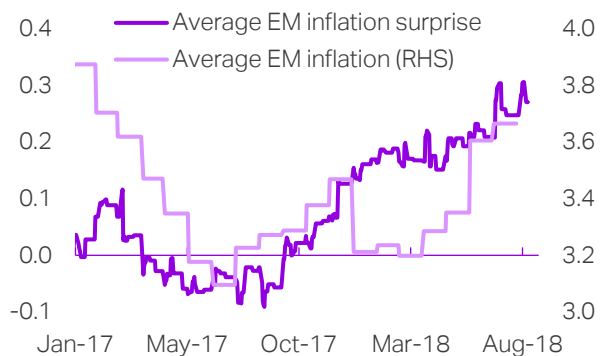
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EM breakeven (ex-Turkey) vs USD



Source: Bloomberg, TS Lombard.

Average EM inflation surprise (ex-Turkey)



Source: Bloomberg, TS Lombard.

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The common element in China- and Turkey-induced market turmoil is, of course, the Trump administration. Trump’s multiple ongoing trade and sanctions disputes are only likely to drive the greenback stronger, regardless of the any US efforts to weaken the dollar or to denounce others as currency manipulators (see our 14 August [Daily Note](#)).

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At the same time, inflation releases are increasingly surprising to the upside, even excluding the distorting effect of Turkey’s runaway inflation. Our cumulative inflation surprise indicator suggests that the surge in inflation in Q4/17 exceeded the consensus view, while the softer inflation earlier this year was largely forecast correctly. The most recent inflation uptick across EM economies has once again delivered an upside surprise to consensus (see Chart above). Aside from Turkey, inflation has risen to the greatest extent over the past 3 months in Brazil and Philippines, although there is upward pressure on prices elsewhere too.

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Economic surprises are likely to be bad for markets, as will be rising domestic macro volatility. Financial markets quickly adjust to any change in economic outlook that can be anticipated, which is of course, the over-riding reason why unpredictable US foreign policy is so disruptive for markets. US politics is also raising the level of uncertainty for EM domestic economies. Not only is inflation increasingly surprising to the upside, but the volatility of measures of both price and activity for EM economies has increased in recent months, returning close to post-US election highs (see Chart below).

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There may be some temporary respite if the economic impact of planned US tariff measures is delayed (see last week’s [EM Watch](#)), or indeed if there is an early resolution to the Turkey crisis. Ultimately, however, we expect the economic outlook for EM to become increasingly uncertain.

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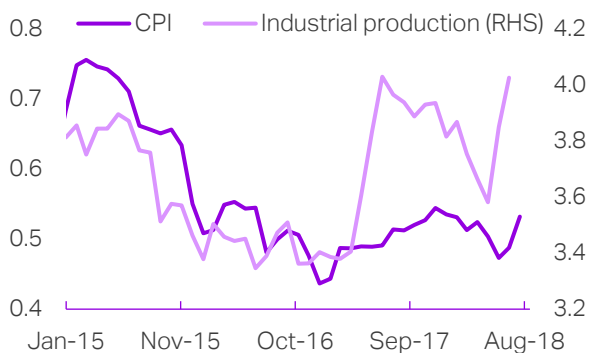
[Mexico](#)

Higher economic uncertainty will result in a relatively greater risk premium on more risky assets. The impact on markets will be overall negative for EM and will favour credit over more risky local debt and equities. This is already reflected in the relative risk adjusted returns of EM asset classes in recent months and will likely become more pronounced as the US continues to fight on multiple trade and geopolitical fronts.

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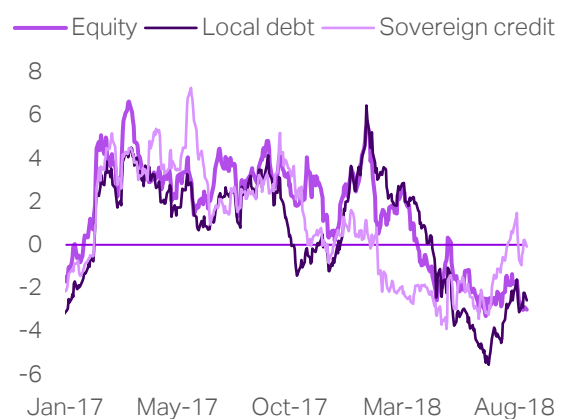
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Average volatility of EM CPI & IP
(Vol of monthly changes annualised, ex-Turkey)



Source: Bloomberg, TS Lombard.

EM risk adjusted 3 month returns



Source: Bloomberg, TS Lombard.

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China

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Weak data to accelerate stimulus

Weak domestic growth drivers will prompt more policy support. Infrastructure investment and total credit will rebound in 2018H2. We maintain our view that GDP will fall below 6.5% in 2018H2, despite policy easing. The trade war has triggered leakages and reorganized trade flows.

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The overall macroeconomic picture painted by July data is decidedly negative, heralding weaker growth in 2018H2. We expect softening data to prompt Beijing to accelerate implementation of a mini fiscal stimulus and measured monetary easing. Accommodative policy will stabilize credit and investment in the second half of this year, thereby mitigating the slowdown in growth. This is not a deviation from the overall deleveraging path laid out by officials; rather, it is an adjustment to the rhythm and pace of said restructuring. We retain our lower-than-consensus GDP forecast of 6.5% for 2018, which implies that GDP growth will fall below 6.5% YoY in 2018H2, despite the fine-tuning policies.

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Despite the recent plunge in domestic market interest rates, credit data has yet to rebound from tightening in 2018H1. Repo rates for banks (DR007) and non-banks (R007) have lowered significantly since the beginning of July, indicating that financial institutions have abundant liquidity. R007 has been below the seven-day MLF rate since the start of July, while DR007 now at 2.56 is well below the January 2017 to June 2018 average of 2.84. Nevertheless, total credit numbers for July still evidence the previous tightening bias. Total credit numbers for July still evidence the previous tightening bias. Our measure for total credit growth – TSF adjusted for local government bonds – slowed further to 11.4% in July, down from 11.7% in June, and thereby reached a new low. This was largely due to a steep decline in shadow credits. Our figure highlights that the transmission of looser monetary policy to the broader economy is weak. We expect transmission channels to improve in 2018H2. Monetary policy is expected to remain accommodative through the remainder of the year, with falling total credit growth to rebound to 13% by yearend.

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Relative policy loosening is missing from the investment data, too, but this will change as officials overtly encourage local government spending. We have [noted](#) that in the past week Beijing has given very clear signals pushing investment to return to previous growth trends. The calls for accelerated fiscal spending came as infrastructure investment continued to decline: overall, infrastructure investment growth (including tertiary infrastructure, and production of electricity, gas and water) was down -4.7% yoy from 1.7% in 2018Q2. While manufacturing and real estate investment remained strong, they failed to fully offset the decline in infrastructure investment. Overall, FAI decelerated to just 3% yoy in July. [We have repeatedly noted](#) that local governments had been exceptionally thrifty in 2018H1 (see Chart 1 below): we estimate that local governments have RMB2.7trn in unspent debt quota (including the aforementioned special construction bonds) to use in 2018H2. Amid positive signals from Beijing to encourage infrastructure investment, we expect local government investment to rebound in 2018H2.

Industrial production was unchanged in July – at 6% yoy – below the consensus estimate of 6.3%. Official and Caixin manufacturing PMIs point to more weakness in production ahead. Our leading indicators of cement, steel and transport are slowing, too. Domestic industrial activities should rebound on the stimulus efforts described above. However, supply-side reform and growing environmental restrictions will introduce seasonality into the said indicators, which must be interpreted with caution.

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The trade war appears to be encouraging front-loading of both imports and exports.

Imports, in particular, have been strong, recording a 27.8% yoy increase in July, while exports grew steadily at 11.4% yoy. Preliminary data show that the import surge came largely from ASEAN (up 30.2 % yoy), South Korea (31.4%) and Canada (70.5%) (see Chart 2). We can already observe sanctions leakage: grain imports were down 39.2% yoy, although imports of grain oils and protein meals rose 73.7% yoy. Front-loading was evident, above all, from integrated circuits imports, which were up 19.5% yoy. Should tensions escalate further, front-loading effects will dissipate; we expect sanctions leakage and supply chain to increase. [We estimate](#) a boost to exports via RMB depreciation with a lag of two to three quarters.

Meanwhile, the household sector is showing weakness. Retail sales in July were softer than expected - 8.8% yoy, down from 9% in June. Real estate-related spending was a major contributor. Lower housing turnover meant decreased discretionary consumption as fewer households spent realized property gains. Related expenditure on home appliances and furnishings fell, too. Furthermore, real income gains were offset by precautionary saving by prospective home-buyers. The survey-based unemployment rate, an indicator closely watched by policymakers, rose to a four-month high of 5.1%, up from 4.8% in June. While one should not read too much into volatile monthly data, it may indicate a weakening consumer economy.

Key investment and credit indicators were decisively bearish in July. We expect government stimulus activity to mitigate the slowdown. We maintain our lower-than-consensus GDP forecast of 6.5% for 2018 - which implies that GDP growth will fall below 6.5% YoY in 2018H2 – despite the fine-tuning policies.

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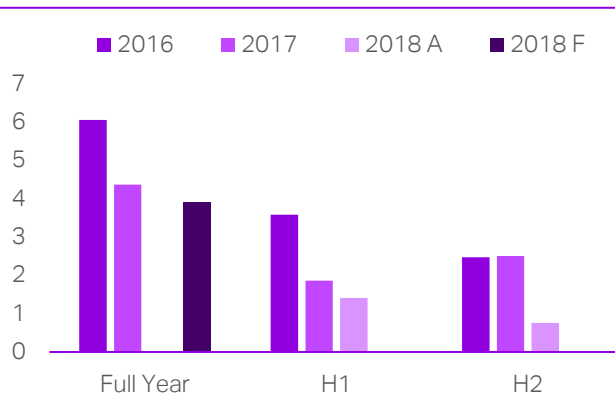
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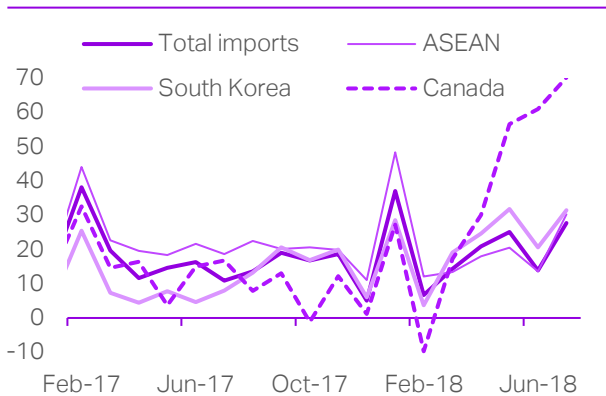
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Chart 1: Local government bond issuance to accelerate (RMB tr)



Source: TS Lombard and CEIC.

Chart 2: Imports accelerate on front loading and leakages (yoy %)



Source: CEIC

Bo Zhuang / Rory Green

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Polls to dictate market sentiment as campaigning heats up

With official campaigning now underway, markets will turn their focus to polls that will be released this week in an attempt to get an early indication of voter sentiment. Although the free ad time does not begin until 31 August, two recent debates could start to influence voters.

[Turkey](#)
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Brazil's leading public opinion firms will be releasing polls this week. Market sentiment this week will be dictated by poll results, which will be released in the coming days. Although several polls have been released in recent weeks, most rely on telephone interviews, which are believed to be less accurate. By contrast, the polls scheduled to be released later this week will use data collected during in-person interviews. Two polls scheduled to be released today – one from MDA and another from Ibope, will set the tone for the market this week.

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The Datafolha poll will also be important to monitor. Later this week, the Datafolha poll promises to influence markets. This poll will use an 8,300-person sample, which is significantly larger than recent in-person polls. Additionally, the polls will offer a breakdown of voter support by region, social class and gender, which offer an indication about the impact the early campaigning will have on voter sentiment. The poll, which was commissioned by Brazil's leading TV network *Globo*, will likely be released during the evening news, after markets are closed.

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The market will be monitoring Geraldo Alckmin's poll numbers closely. Alckmin's weak poll numbers remain a cause of concern, because the market views the business-friendly candidate as the most likely to push ahead with much-needed reforms. Although Alckmin has formed the largest coalition of any candidate and has also put together a top-notch team of economic and policy advisers, his poll numbers have been disappointing and he has been stuck in fourth place in most recent polls. Furthermore, his performance in the first debate (9 August) was uninspiring, although he did slightly better in last Friday's debate. Still, it will be hard for him to shake his dry, professorial nature. Alckmin and his team continue to hope that once the free TV and radio advertising begin on 31 August, his poll numbers will improve.

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Former Finance Minister Meirelles takes aim at Alckmin. But Alckmin's plan could be foiled by former Finance Minister Henrique Meirelles, who is pulling no punches in his bid for the presidency. Last week, his team filed a petition with the country's highest electoral court (TSE), questioning the size of Alckmin's alliance. The petition will be analysed this week and is based on the fact that six parties formalized their support for Alckmin, but did not include the names of all of the parties in the coalition. If the TSE agrees with Meirelles' legal team, Alckmin could lose as much as 36% of his free TV and radio time, which would be a devastating blow.

Marina takes aim at Bolsonaro, which could have an impact on poll numbers. After a weak performance by most candidates in the first debate, several candidates elevated their game for the second debate on Friday. The candidate who generated the most buzz from her performance was former Environment Minister Marina Silva, who called out Jair Bolsonaro for an earlier response to a question about equal pay for women. Marina touched on one of Bolsonaro's weak spots, which is his high rejection rate among female voters. It was also clear from the debate that Marina is more prepared than in her previous bids for the presidency, which means she remains a contender. Unfortunately for Marina, she has now become the target of attacks on social media by Bolsonaro's core group of loyal followers, but it remains to be seen what impact this will have on her voter intentions in upcoming polls.

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The market will also be monitoring voter intentions for the Workers' Party (PT). Although the PT did not have a representative at either debate, former President Lula continues to loom large in the electoral debate. Last week, the party officially registered Lula as its candidate, despite the assumption that he will not be allowed to run because of his criminal conviction. Lula's current running mate, former São Paulo Mayor Fernando Haddad has been increasing his media exposure in recent weeks and is expected to take over as the PT candidate once Lula's candidacy is rejected. The market will continue to closely monitor Haddad's evolution in the polls. Any increase in his voter intentions will likely result in more market and currency volatility.

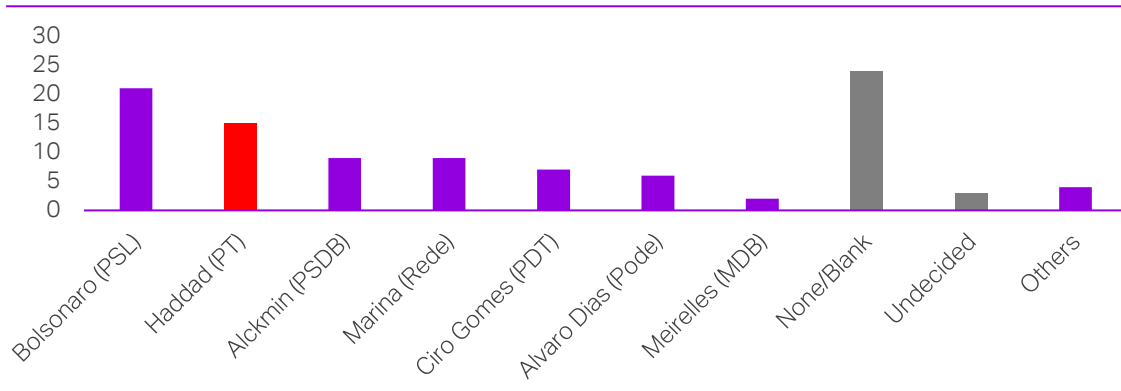
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First round voter intentions: Scenario: Haddad receives support from Lula
%



Source: XP/lpespe.

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Weaker rupee signals worsening macroeconomic fundamentals

The depreciating rupee has been making the headlines as it breached the psychologically key level of 70 to the US dollar last week, and continued to be among the worst performing currencies so far this year. However, we believe the Turkish lira crisis and India's widening trade deficit are just triggers to what was an inevitable weakening of the rupee given its overvaluation in REER terms.

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India's trade deficit expanded to a five-year high in July, which in turn implies that the already widening current account deficit (CAD) may widen even further. The CAD jumped to 1.9% of GDP in FY18 from 0.6% in FY17, and if the trade deficit continues to run at levels close to July's \$18 bn, the CAD in the current fiscal year may expand to anywhere between 2.5-3% of GDP. The rupee, which had already hit an all-time low against the dollar early last week due to investors panicking over EM currencies after the Turkish lira crisis, weakened even further to close the week at 70.2/US\$, although it pared some of its losses on Monday morning. India's exposure to Turkey is small, but the incremental impact of the crisis on the rupee and potentially also on the trade deficit could exacerbate an already difficult situation (see [Turkey](#) section).

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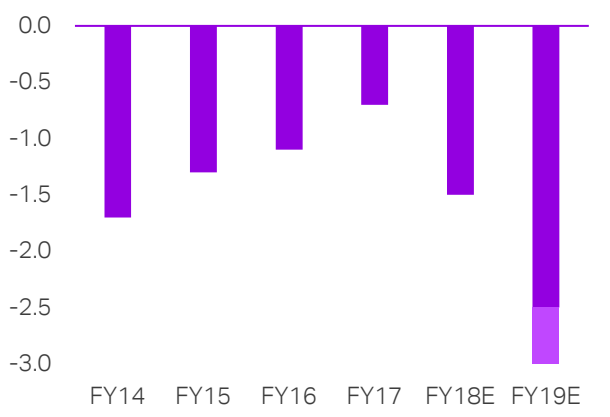
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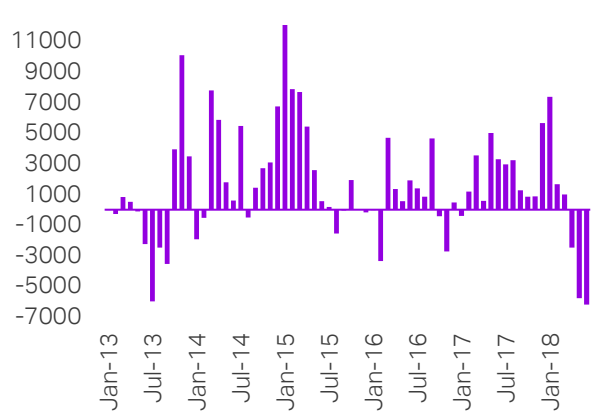
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Current account (% of GDP)



Sources: RBI, TS Lombard.

Net US\$ purchases by RBI (mn)



Source: RBI.

The headlines and the optics apart, the rupee is still marginally overvalued in REER terms and will likely settle around the current levels. As the chart above on the left shows, the Reserve Bank of India (RBI) has been intervening in the forex markets to contain the pace of the rupee's depreciation. However, it is unlikely to take more drastic steps such as a policy rate hike at this juncture, when India's growth recovery is still nascent.

A report last week said that GDP growth under the previous government was higher than earlier stated, which makes the current growth numbers appear weak in comparison. The back series calculations by the National Statistics Commission (NSC) show that the economy grew at just over 10% in FY08 and FY11, and that the average growth over the 10 year-rule of former Prime Minister Manmohan Singh was 8.1%. GDP growth has averaged 7.3% in Prime Minister Narendra Modi's four years in office, with the pace slowing to 6.7% in FY18. The Modi government was quick to say that these calculations are not official estimates and the NSC too said that the back series are a work in progress. But as we have highlighted in our previous research, a broad-based recovery is still lacking (see our 2 August 2018 report [Investment conundrum reveals downside risks](#)).

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The RBI, meanwhile, is likely to continue tightening monetary policy as inflationary pressures are taking root in the economy. Although the central bank will likely pause in October to allow for the transmission of two successive policy rate hikes over the past two monetary policy reviews, we expect it to start raising rates again in December 2018 (for more details, see our 16 August 2018 report [The return to inflationary normal](#)).

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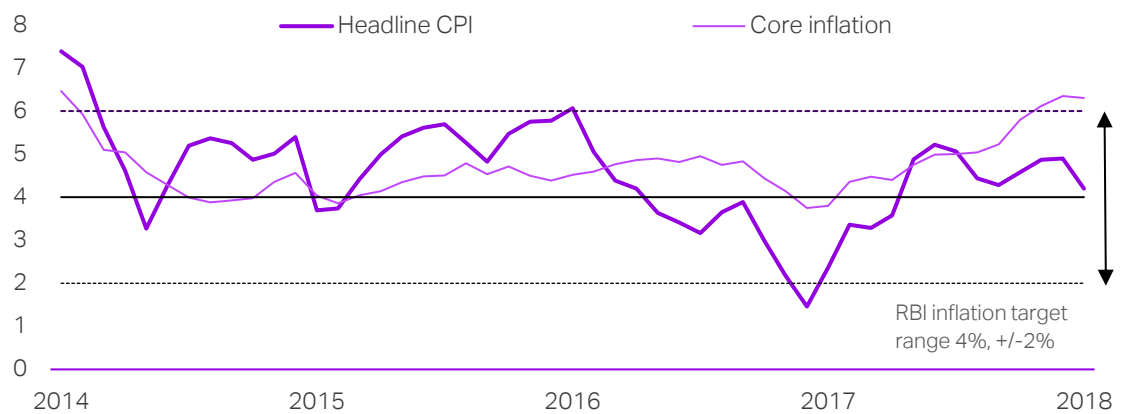
The RBI has a flexible inflation target of 4% with a +/-2% band, but it is focused on keeping inflation at close to 4%. Minutes of the last monetary policy review released last week showed that most members of the Monetary Policy Committee (MPC) were worried about strengthening core inflation – and some were even concerned about the credibility of monetary policy as inflation is forecast to remain well above the 4% target in the coming quarters.

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Inflation vs RBI target (%)

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Sources: RBI, Central Statistics Office, TS Lombard.

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The rupee's depreciation makes the job for India's central bank even more complicated as it walks the fine line between checking inflationary pressures and supporting growth.

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For one, it will have to manage the exchange rate pass-through of elevated oil prices and other imports. Although the headline CPI number dipped in July to 4.2% yoy, the moderation was due to a likely temporary fall in food prices. But these will start rising once the increased minimum support prices for crops take effect after the harvest starts at the end of September/in early October. Meanwhile, fuel inflation at 8% yoy in July was at its highest level since November 2017, and average fuel inflation in the period January-July was the highest for a comparable period since 2013.

Importantly, core inflation remains elevated at over 6% – the highest level in 4 years. Even though the central bank does not explicitly say so, it closely tracks core inflation. The two successive policy repo rate hikes in the June and August 2018 monetary policy reviews occurred as core inflation exceeded – and then stayed above – the 6% mark.

Shumita Deveshwar

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Continuing tax battles deserve attention

Continuing discussions this week of the proposed Rb500 billion tax hit on metals and chemicals companies should not unnerve investors: we stick firmly to our view that this initiative will be buried. But it still deserves attention for the light it sheds on Rosneft tax lobbying and the wider “open contest” policymaking process – in which the government/CBR has the strongest team.

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The threatened tax hit on two sectors – metals & mining and chemicals – deserves continued attention.

As set out in a memo to President Putin from his economic aide Andrey Belousov that surfaced in public on 9 August, the proposal is to levy retroactive tax of Rb517 billion on the “windfall” profits of fourteen companies in those sectors. This would be profoundly negative – not only for the companies concerned but also for the entire Russian equity investment case (putting even sanctions in the shade, in our view). For the implication would be that companies’ ROEs may be arbitrarily capped by the government.

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We think the risk of this happening is negligible. We set out the reasons for this view in the Russia section of last week’s edition of [EM Watch](#). At a meeting convened for next Friday by the big business lobby (the “Union of Industrialists and Entrepreneurs”), Belousov will meet with top representatives of the targeted companies. At first sight, this may suggest that the outcome is still in doubt – despite the previously stated unequivocal opposition of Anton Siluanov (First Deputy Prime Minister and Finance Minister) underlying for our sanguine view. In principle, the maxim that “it’s never over till it’s over” justifies vigilance and caution.

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Latest potentially worrisome newsflow does not change our view. As announced by his press secretary at the end of last week, Siluanov will be joining next Friday’s meeting. As if that signal were not clear enough in itself, that same announcement included a still more conclusive and positive element: tax increases will not even be on the agenda for the planned discussion on 24 August. The message here was that all fundamental tax reform decisions have already been finalized not only for this year but for the entire new political cycle through to 2024. The topic next Friday will instead be how to ensure the most favourable conditions for these companies to recycle more of their (presently) buoyant cash flow into domestic, job-creating investments.

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That point about the now passed deadline for tax decisions highlights some other developments and lessons relevant for Russian equity investors. Another important tax change signed and sealed by the parliament and president last month is the final stage of the multi-year oil tax “manoeuvre” launched in 2011, raising royalties levied at the wellhead by a third in exchange for abolishing export duties. This change will generate Rb1.6 trillion of additional annual federal tax revenue, offset at times of high oil prices (shrinking refining margins relative to crude exports) by a Rb600 billion rebate of oil product excise – with an additional rebate boost for refineries that are physically located far from export markets.

Rosneft is at the centre of a rearguard action on this oil tax manoeuvre. Only modernized refineries (producing high grade gasoline to the Euro-5 standard) will be eligible for that oil product excise rebate. One of the strategic goals of this tax change has been to incentivize refining capex, and all the oil majors have now more or less completed their upgrade programmes – with the exception of Rosneft (with over a third of Russia’s total refining capacity), which is still only half way there and has postponed the completion date until 2027. The completion of the tax manoeuvre makes unmodernised refineries uneconomic. Rosneft’s CFO Pavel Fyodorov said on an analyst call earlier this month that some details of the manoeuvre remained to be finalized. Last March, the Rosneft CEO Igor Sechin requested Putin to authorize a Rb145 billion subsidy for the company’s refineries.

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The question may be discussed at a meeting of the Energy Commission chaired by Putin on 27 August. Government officials maintain that there is nothing to discuss. Having extracted last year a major tax subsidy for Rosneft's upstream (Samotlor), Sechin is clearly trying to repeat the trick now with the downstream. He is campaigning in parallel against a separate government initiative to levy a utilization fee on various kinds of industrial equipment used by the oil & gas sector (this is a protectionist measure as domestic manufacturers, such as the sanctioned turbine producer Power Machines, would get an offsetting subsidy).

On this utilization fee proposal, the oil industry should secure some relief as the government has not finalized the details of this levy. But the stakes are relatively low (up to Rb15 billion for Rosneft, according to Sechin). On the much larger matter of the oil tax manoeuvre, we reckon that a Rosneft lobbying effort also lies behind the Belousov initiative. Extracting Rb500 billion in additional tax from other (i.e. non-oil) sectors would create room to relieve Rosneft from the tax manoeuvre hit stemming from its failure to modernize its refineries.

These struggles also hold a wider lesson about policymaking in the Putin system. Putin himself has in the past described Belousov in public as a lobbyist. This shows that such lobbying is not only acceptable but desired. Putin likes to preside over open gladiatorial debates in which arguments are tested and leaving him as the final arbiter as to who has the strongest case. In recent years – especially since the shocks of 2014 – the “economic policy bloc” in the government and Central Bank has won all such debates. This time will be no exception.

Christopher Granville

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Direct exposure to Turkey only via BBVA

Mexico's direct risk from the Turkish crisis is limited to the operation of the Spanish bank BBVA in the country. Although the peso has experienced a degree of contagion, it is likely that, global sentiment permitting, the currency will reverse its losses as the market realizes that Mexico's economic fundamentals are not significantly linked with Turkey.

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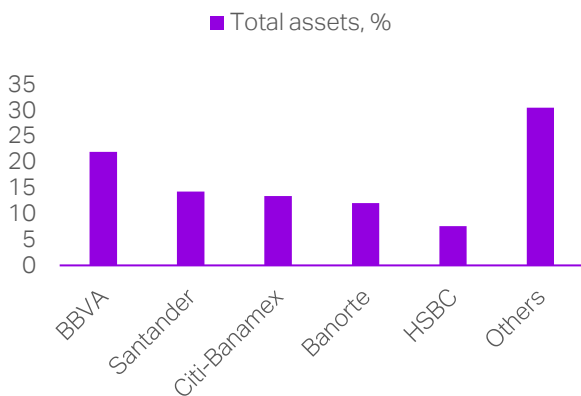
[Mexico](#)

Mexico's fundamentals are not significantly affected by the Turkish crisis. Indeed, exports to Turkey amounted to US\$ 275 mn (0.1% of Mexico's total trade) in the four-quarter to Q1/18, well behind trade with Canada, US, China or South Korea. But the lack of significant trade links does not remove Mexico's exposure to Turkey. And some ripple effects have already taken place. The most serious impact has been to the peso amid contagion concerns, as Jon Harrison observes in our [13 August Daily Note](#). However, once the market realizes that the linkages in the economic fundamentals between both countries are small, the peso is likely to reverse its early losses. The greatest risk to Mexico is via European banking sector exposure to Turkey, and its ramifications for banking subsidiaries operating in Mexico.

The Spanish bank BBVA is the largest holder of assets in the Mexican commercial banking sector. In 2017, five out of the 42 banks operating in Mexico held more than 70% of the total assets, with BBVA at the top of the list. BBVA had 22% of total Mexican assets (US\$ 97 bn) well above Santander, which holds 14.3% (see Chart 1). As Shweta Singh and Davide Oneglia note in our [14 August Daily Note](#), BBVA's US \$90 bn exposure to Turkey means that the Spanish economy and its banking system is vulnerable if Turkey's current situation deteriorates.

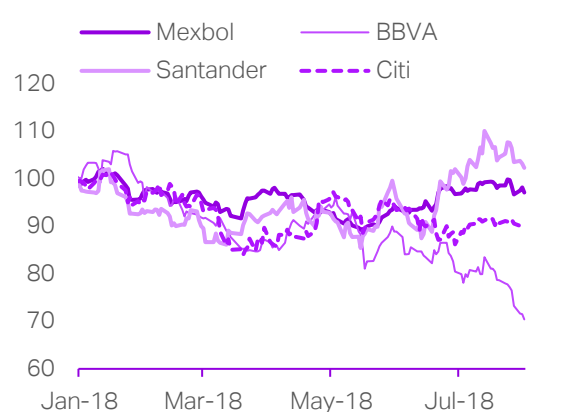
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Chart 1: Market share by bank



Sources: CNBV, TS Lombard

Chart 2: Share price



Sources: Bloomberg, TS Lombard

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BBVA shares have performed significantly worse than peers. The market has already adjusted in an effort to price in the large size of BBVA's Mexican subsidiary and its effect on the bank's operations. BBVA's share price in the Mexican stock market is down almost 30% since the beginning of the year, below the market's negative return of 3% over this period. Moreover, BBVA's poor performance in the stock market accelerated soon after the Turkish crisis erupted (see Chart 2). By contrast, Santander is up more than 2% since January and its share price has barely reacted to Turkish developments.

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Although we do not expect BBVA's credit growth to slow for now, further negative developments could lead to the scaling down of the bank's operations in Mexico.

Moreover, further distress in the highly concentrated Mexican banking sector strengthens the case for the incoming government to foster competition in this sector in order to mitigate any risks. Indeed, the next administration has already set out its aim to develop and strengthen the existing state banks (see our [3 August Mexico note](#)) in order to provide credit for small businesses that face difficulties in obtaining loans.

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Two more hikes to come

The trade balance returned to deficit in July, suggesting that the current account deficit (CAD) will widen further in Q3/18. Meanwhile, rupiah depreciation pressures were back with a vengeance in the wake of the Turkish crisis. Last week, Bank Indonesia (BI) surprised by raising the policy rate by 25bps to 5.5%, thereby underscoring its hawkish stance. We expect two more rate hikes this year following the Fed hikes in September and December.

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The trade balance returned to deficit in July, which suggests that CAD will continue to widen in Q3/18. Last month imports grew 31.6% yoy helped by significant increase in import of customer goods (up over 60% yoy). Export growth rebounded, too, to 19.3%, which was above consensus. The trade deficit widened to a five-year high of US\$2bn (see Chart). This does not bode well for CAD in Q3/18: it had already recorded a four-year high of 3% of GDP in Q2/18 owing to the larger trade gap and the increase in dividend repatriations.

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The government is seeking to narrow the trade gap. It recently introduced measures to boost consumption of domestic palm oil biodiesel to reduce imports of oil and plans to curb imports of capital goods for big infrastructure projects. At the same time, it has asked SOEs to review imports of these goods. Moreover, the government will impose a 7.5% tariff on imports of some 500 goods that can be produced locally.

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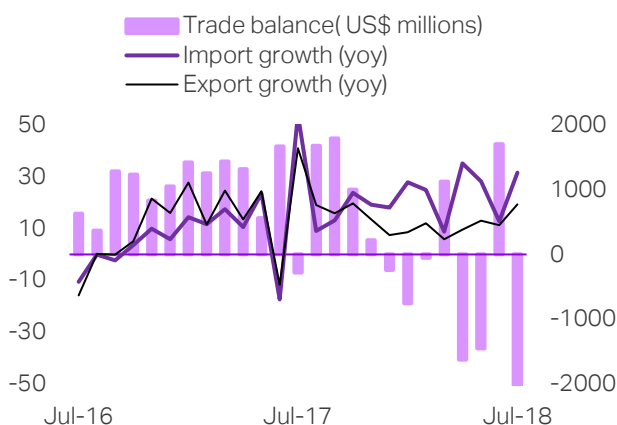
Meanwhile, BI has hiked interest rates to support the currency. It increased the policy rate by 25bps to 5.5% as rupiah depreciation pressures returned following the release of the worsening current account data and, more important, amid the general risk-off sentiment triggered by the situation in Turkey (see Chart). The move was largely unexpected but is in line with BI's philosophy of being "pre-emptive, front-loading and ahead of the curve". The Bank's stance remains hawkish, and it will continue with its dual FX and bond market interventions to support IDR. We expect two more rate increases this year following the Fed hikes in September and December. This will keep the interest rate differential at the current level as the risk premiums have increased owing to global uncertainties.

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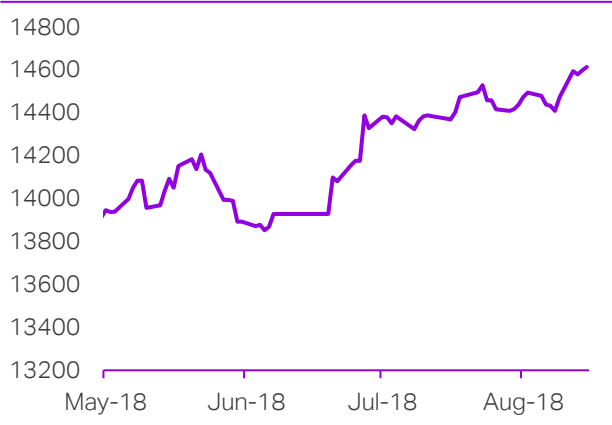
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Trade deficit



Sources: Bloomberg, TS Lombard.

USD/IDR



Sources: Bloomberg, TS Lombard.

Krzysztof Halladin

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The GRID: The fundamental guide to emerging markets

In our monthly edition of [The GRID](#), Larry Brainard and team raise the short term growth outlook for China and Mexico, extending the trend prevailing this year in both those economies, while we mark down the short term view of Russia and Brazil. Since last month, the overall rating derived from the scores we assign to short- and long-term drivers of growth is illustrated in two charts for each country to easily allow comparison.

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Russia: Financial deepening boosts investment case

Christopher Granville and Madina Khrustaleva examine the increasingly compelling Russian financial deepening story. Monetary policy underpins the recent advances and brightening prospects of financial deepening in Russia, but fiscal policy is also contributing to the strengthening local bid. An imminent and decisive breakthrough is the launch of a new pension investment system. See our 16 August report [Russia: The local bid](#).

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India: The end of low inflation

The recent dip in headline CPI masks the fact that core inflation remains above the RBI's 2-6% tolerance range. Shumita Deveshwar warns that inflationary pressures from rupee depreciation and oil prices will be exacerbated by fiscal slippage in a key election year, while food prices will start to rise once the government begins to pay out higher minimum support prices. See our 16 August report [India: The return to inflationary normal](#).

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Philippines: Less balanced growth is coming

The manageable level of public debt to GDP will allow the government to finance the planned infrastructure agenda. But Krzysztof Halladin warns that recent rate hikes will dampen domestic demand, meaning that growth will be more reliant on infrastructure, increasing risks to the medium-term outlook. See our 17 August report [Philippines: Growth will rely on infrastructure](#).

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Brazil: Investor roadmap to the presidential election

The official electoral campaign is now under way amid news of a rising violent death rate and concerns about the 2019 budget. Grace Fan and Elizabeth Johnson note that the first presidential debate held few surprises. See our 13 August report [Brazil: Campaign season begins, amid 2019 budget worries](#). With 13 candidates in the race, Grace and Elizabeth profile the presidential pack – including their strengths and weaknesses, views on key economic issues and their possible routes to victory. See our 17 August report [Brazil: Investor roadmap to the presidential election](#).

Europe: Banking sector exposure to Turkey

In last week's [Europe Watch](#), Shweta Singh argues that European banks are some of the most vulnerable to Turkey's currency crisis. Direct financial linkages are large, but the indirect exposure is much bigger – Spanish banks are the most exposed, followed by French and Italian lenders. Yet, the fallout from Turkey does not appear systemic at this point.

Global Political Drivers: Trade war: radical invisibility

In the case of the US-China trade war now driving global markets, the obvious point is that this is an overwhelmingly political project that is made in America. In last week's [Global Political Drivers](#), Christopher Granville warns that structural constraints on Trump – from voters, official and Congress – are minimal, while his reticence on the decisive geopolitical agenda accentuates uncertainty. A change of course would likely come as a vintage Trump surprise.

[Asset Allocation](#)

Asset Allocation

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We present below our EM asset allocation views, which are updated once per month, most recently in our 1 August [EM Strategy Monthly](#).

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We will publish our next Asset Allocation in our EM Strategy Monthly on 4 September.

[Turkey](#)

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

Scale

Last month in brackets

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

For further explanation, see our [methodology](#).

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Absolute Views

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

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Table 1: Current Absolute Views*

| Country | Asset | Market view | Units | Date opened | Open level | Current level | Performance to date |
|-----------|------------------|-------------|-------|-------------|------------|---------------|---------------------|
| Mexico | Sovereign credit | Positive | bp | 12-Jun-17 | 149 | 168 | +0.8% (-19 bp) |
| Indonesia | CNY/IDR | Negative | % | 30-Jul-18 | 2,115.0 | 2,127.8 | -0.3% |

Date/time 20-Aug-18 08:19

*The legacy EM sovereign bond indices that we were using to monitor fixed income views have been discontinued by Bloomberg; the opening and current levels have been updated to use the replacement Bloomberg EM bond indices.

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](#).

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Closed Views

Levels are for London close of business, obtained from Bloomberg.

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Table 2: Closed Absolute Views

[Turkey](#)

| Country | Asset | Market view | Units | Date opened | Date closed | Open level | Performance to close |
|--------------|------------------|-------------|-------|-------------|-------------|------------|----------------------|
| Russia | Equities, energy | Positive | USD | 18-Sep-15 | 12-Jan-16 | 596.6 | -17.7% |
| Brazil | Equities | Negative | USD | 30-Jan-15 | 5-Feb-16 | 1,711.0 | +42.6% |
| Brazil | 10-yr local debt | Positive | % | 7-Apr-16 | 7-Sep-16 | 14.24 | +34.9% (+224 bp) |
| Philippines | Equities | Positive | USD | 17-Jun-16 | 7-Sep-16 | 28.36 | -1.5% |
| South Africa | Local debt | Positive | % | 10-Nov-16 | 3-Feb-17 | 9.27 | +9.7% (+19 bp) |
| Turkey | Sovereign credit | Positive | bp | 27-Jul-16 | 7-Mar-17 | 322 | +2.1% (+11 bp) |
| Russia | Equities | Positive | USD | 8-Dec-16 | 12-Jun-17 | 576 | -8.3% |
| Turkey | Local debt | Positive | % | 15-May-17 | 11-Sep-17 | 10.69 | +7.6% (-1 bp) |
| Indonesia | Equities | Positive | USD | 5-Apr-17 | 20-Nov-17 | 495.1 | +5.6% |
| Russia | Sovereign credit | Positive | bp | 16-Oct-17 | 16-Apr-18 | 140 | -2.0% (-63 bp) |
| Thailand | Equity | Positive | USD | 22-Jan-18 | 18-Jun-18 | 20.22 | -9.3% |
| Russia | Equity | Positive | USD | 18-Jun-18 | 23-Jul-18 | 578.1 | +3.2% |

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Source: Bloomberg, TS Lombard.

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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.

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For further explanation, see our [methodology](#).

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