



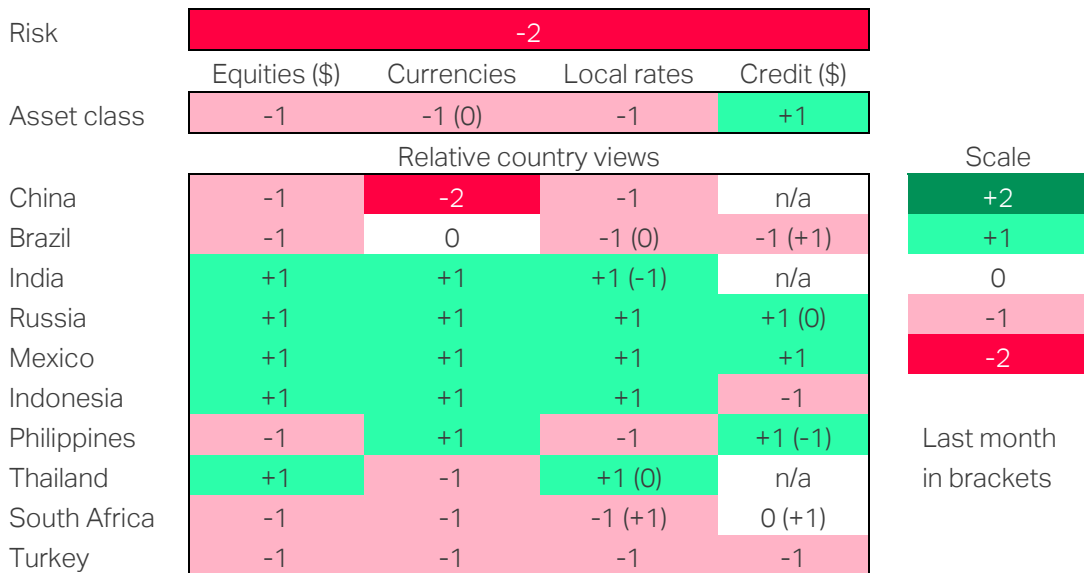
EM Strategy Monthly

WHY WE ARE FACING A PERFECT STORM IN EMERGING MARKETS

Larry Brainard / EM Team

- **Risk:** We maintain our strong negative call on overall risk.
- **Russia:** With sanctions risk mostly priced in, we maintain our positive call on equities.
- **China:** We maintain our strong negative call on the yuan.
- **Mexico:** With the tentative deal on NAFTA, we maintain our positive call on equities.

Asset Allocation View



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

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

This publication is part of our EM service. Click [here](#) for more details.

Notes on Portfolio Strategy

Below we explore in more detail the assumptions and judgments behind our current portfolio strategy recommendations.

Why we are facing a perfect storm in emerging markets

The answer, in one word, is contagion. The evident economic difficulties that have hit Turkey and Argentina this year have so far been viewed by markets as largely confined to those two countries, with limited spillover potential to other EMs. It is true that we have not yet seen larger shocks to EM markets that would qualify as “systemic”. In fact, many EM analysts believe that EM vulnerabilities have been priced in after the recent selloff and that assets are now set to rally.

We strongly disagree, as we believe the current environment is about to change for the worse. In our view, in the next two to three months there will be a perfect storm of multiple shocks on EM markets that will fuel contagion and, with it, a broader retrenchment in EM asset classes. Such potential shocks include:

- An escalation of Trump’s trade war with China starting later this month with the imposition of new tariffs on a significantly larger volume of trade than up to now;
- The slide of Turkey into a broad financial crisis as the country’s banks lose foreign funding and the government is forced into ad hoc bail-outs;
- The eruption of significant volatility if Brazil heads into the second round of its end-October presidential election without a centrist, pro-reform candidate – an electoral contest between hard-left and hard-right candidates would shock Brazilian markets out of their current complacency about the difficult fiscal challenges the country faces; and
- More fallout from the steady exit from QE on the part of the Fed and ECB affects EMs via tighter liquidity, rising interest rates and the unwinding of past portfolio inflows into EMs as investor fears of a global economic slowdown mount.

Below we examine each of these potential shocks.

The US administration increased pressure on China last month to fall into line following the announcement of a preliminary deal with Mexico on NAFTA revisions. President Trump and several other senior administration officials have publicly dismissed talks with China at this time and suggested they were looking for ways to declare China a currency manipulator. Launching this new threat about China’s currency management highlights that Trump is desperate to find new ways to hit China. It will likely widen the US-China dispute, rather than lead to new talks. We therefore expect a further escalation of the trade war, although the exact nature and timing are uncertain.

We do not believe new tariffs will have an outsized impact on China’s economic growth; the current expansion is already cooling owing to domestic policies and any tariff-related growth impact will likely be countered by the fine-tuning of policy stimulus. Of more concern is the threatened introduction of a 25% tariff on another US\$400bn in US imports if China retaliates. We believe retaliation is a certainty because such a tariff would push China’s current account into deficit and could lead to a further 15% depreciation of the yuan vs the dollar. This, in turn, could fuel a currency war, which would have not only an adverse regional impact but systemic global effects as well.

We conclude that negative systemic effects of a further escalation of the US-China trade war would likely come through currency channels, not via a sharp slowdown in Chinese growth. Such an outcome would fuel dollar strength and put significant pressure on Asian EM currencies, above all the Korean won and the Taiwan dollar.

Turkey's economic woes, meanwhile, are about to widen into a broader financial crisis.

Our judgment is that senior authorities in the current administration do not fully grasp the scale of the economic crisis that is facing them. And even if they did, widespread purges of personnel in key regulatory agencies since the aborted coup attempt in July 2016 will severely hamper government efforts to stabilize financial markets. This is of particular concern since President Erdogan has repeatedly said that asking for IMF assistance is out of the question.

Turkey therefore is sliding into recession with minimal buffers – net international reserves are less than US\$20bn and the recent erosion of Turkish institutions will hamper the effectiveness of any crisis response once the government is forced to act. To make matters worse, available data on the soundness of the banking system cannot be trusted to paint an accurate picture of banks' capital adequacy; as we [argued this week](#), the banks and the authorities have strong incentives to understate the scale of the country's bad debt problems, making it very difficult to gauge banks' capital adequacy.

We conclude that Turkey is wholly unprepared to deal with the looming economic and financial crisis it is facing. Hiking policy interest rates may help restrain inflation but it will do nothing for borrowers, who cannot service debts at current interest rate levels, let alone at higher rates. The roots of the developing financial crisis reflect a sharp erosion in the credit fundamentals of the system's loan assets. The failure of the Central Bank to act in a timely fashion to stabilize financial markets and the lira has exacerbated these credit problems, but hiking interest rates is not a solution.

In Brazil the failure of centrist Geraldo Alckmin so far to rise in the polls raises the prospect that he could fail to make it to the second round. Although much could change before the 7 October first round, a match-up in the second round between Jair Bolsonaro and Fernando Haddad, hard-right and hard-left respectively, would shock Brazilian markets out of their complacency. While we [concluded](#) that kicking the can of fiscal problems down the road is no longer a viable option, it is difficult to see how either of these two candidates would be able to deliver the needed fiscal adjustment, which former Banco Central President Armínio Fraga recently estimated at 6% of GDP.

No matter who wins the Presidency, markets will want to see concrete fiscal adjustment measures and a coherent economic recovery programme. This will prove challenging for whoever leads the new administration given that the post-election political environment in Brasilia will have changed little and the new Congress is unlikely to welcome tough fiscal reforms.

On balance, whoever leads the new administration will face an escalation of risks in every direction. Doubts must remain whether the President-elect will be able to escape the fate of Argentine President Mauricio Macri, who similarly entered office with high hopes and a sound reform programme but saw them go up in flames once markets focused on the country's large fiscal deficit and the impossibility of speeding up fiscal consolidation. A similar situation could easily develop in Brazil. While few expected President Temer to get pension reform approved, the next administration will be in the hot seat from day one to demonstrate that this time around is different. This will be a tall order, so much so that we believe Brazil is more likely to inject volatility into EM markets than calm them.

The final element of the perfect storm facing EMs is the effect of QE exit. Quantitative easing has changed the nature of global markets by pumping them full of liquidity – some US\$9-10tr and counting – which in large measure has found its way from DMs to EMs. What was not anticipated by the central bank wizards who conjured up such policies was that QE exit could put risky asset markets into very difficult situations. Markets have not paid much attention to the risks of QE exit either: they under-priced the possibility that easy market access to funds might

one day dry up or even turn into net repayments or outflows of portfolio investments. The result was that in all too many cases, investor complacency was matched by the blasé attitude of EM country leaders towards the need for essential economic reforms.

Implicit in QE policies was the assumption that risky borrowers would use their easy access to market funding to put their economic house in order, i.e. to fix leaks in the roof while the sun was shining. Judging by the current crises in Italy, Turkey and Argentina, this clearly did not happen. Furthermore, it is evident that global leverage is continuing to rise even though financing conditions are gradually tightening, potentially dragging additional countries into crisis. For a detailed examination of this phenomenon see our May survey "[The Destructive Dollar](#)".

The payback for QE is now coming due as global liquidity gradually tightens and rising interest rates force the unwinding of carry-trade positions in many EMs. The countries most at risk are those that have frittered away opportunities to put their houses in order. Turkey and Argentina head this list, followed by Brazil and South Africa not far behind it.

My colleague Jon Harrison has ranked the major EMs we follow in this week's "[EM Watch](#)" on a scale based on liquidity, politics and the trade war. He found that India and Mexico stand out as relative EM safe havens, followed by Russia and Thailand. On the other end of the scale the highest risks were in Turkey, South Africa and Brazil.

We judge that threat of EM contagion is material because we perceive that markets are failing to understand the nature of systemic risk. On its own, a financial crisis in Turkey is not important enough to trigger wider spillovers. Rather, it is the confluence of diverse developments, seemingly unrelated, that can trigger a systemic crisis, i.e. the perfect storm of the escalation of the trade war, an unexpected financial crisis in Turkey, a spike in Brazilian volatility and QE exit together could be such a trigger.

September Strategy Roadmap

Overview

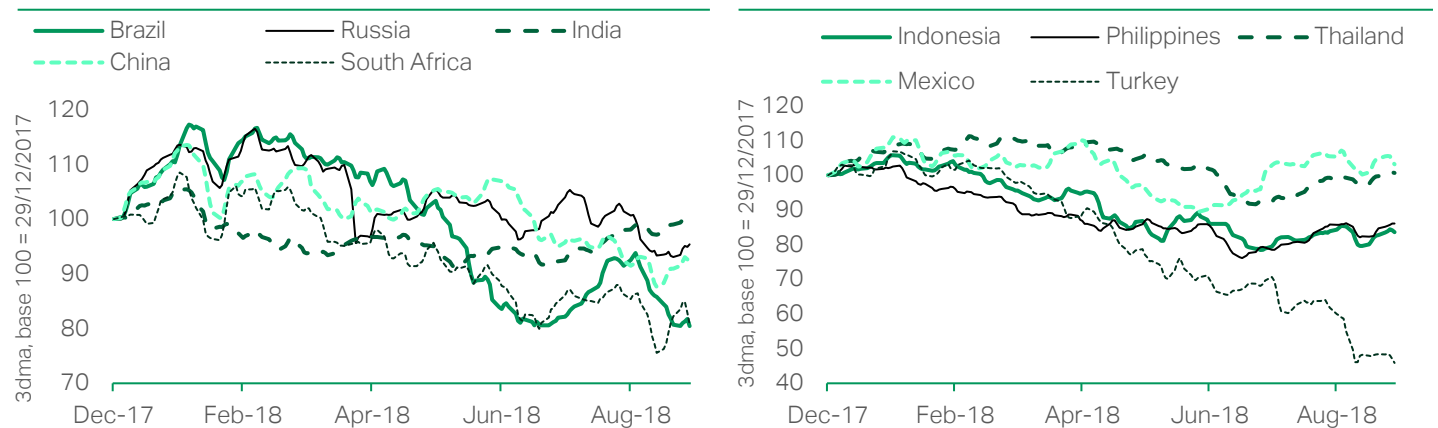
- **Risk:** We continue to view the current environment as strongly negative for emerging markets. In particular, the confluence of different and partly unrelated developments analysed in more detail above have the potential to fuel EM contagion. Foremost among these is the US-China trade war as we expect President Trump to escalate the dispute with new tariffs on US imports from China. The worsening economic and financial conditions in both Turkey and Brazil could also surprise investors. Our judgment is that markets currently fail to understand the nature of systemic risk.
- **Asset classes:** We maintain last month's sector-relative allocations, which performed well in a negative market environment. We see equities as the most vulnerable in a volatile overall environment and credit as the best placed to outperform on a relative basis. Meanwhile, we maintain our negative call on local rates owing to potential rate hikes in many countries as inflation rises. We cut currencies to negative from neutral as we expect the dollar to perform relatively well when President Trump escalates his trade war with China, which is likely to happen later this month.

Equities

- **China:** The outlook remains hostage to the next move in the US-China trade war, which is likely to be a series of new tariffs on exports to the US later this month. We maintain our negative call on equities.
- **Brazil:** Brazil continues vulnerable to adverse market developments amid ongoing political uncertainty ahead of October's presidential election. A second-round match-up between right- and left-wing candidates could shock investors out of their complacency. We maintain our negative call on equities.
- **India:** Despite evident inflationary pressures and RBI monetary tightening, India is likely to continue its role as a safe haven in a global risk-off environment. We maintain our positive call on equities.
- **Russia:** We think the sanctions risk is fully priced into current valuations. Given continued strong oil markets and fiscal surpluses, we maintain our positive call on equities.
- **Mexico:** The preliminary agreement on a revised NAFTA deal is positive for Mexican markets, even though eventual passage by the new US Congress is still a major unknown. We maintain our positive call on equities.

- **Indonesia:** Tighter monetary policies have stabilized financial conditions, although pressure on the rupiah continues. We maintain our positive call on the equity market.
- **Philippines:** Strong inflationary pressures persist and further rate hikes are likely. We view these conditions as likely to be unfavourable to equities; for this reason, we maintain our negative call on the market.
- **Thailand:** Strong growth, low inflation and safe-haven status are positives for equities. We maintain our positive call on the market.
- **South Africa:** The uproar that followed the government’s land reform initiatives and spillover from other EMs is likely to keep local markets under pressure in the near term. Ahead of national elections next year, we expect the government to gradually move towards more populist policies. We maintain our negative call on equities.
- **Turkey:** The Turkish authorities still do not seem to grasp the urgency of decisive action to stabilize financial conditions; the lira remains vulnerable to further downward pressure. We maintain our negative call on equities.

MSCI equity indices (\$ terms)



Sources: Bloomberg, TS Lombard.

Note: Yields and rates are as of 09:00h BST on 4 September 2018

Our next EM Strategy Monthly will appear on 3 October 2018

Asset allocation performance

Value added since our 1 August 2018 Asset Allocation View

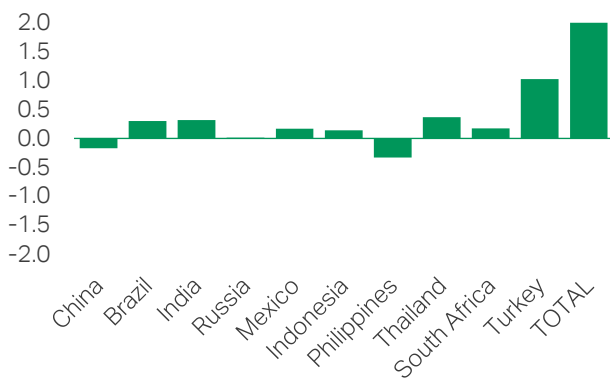
The charts below illustrate the tactical value added over the past month of the asset allocation views presented in our 1 August 2018 [EM Strategy Monthly](#).

EM equities delivered a negative return during August and continued to underperform DM, in line with our overall negative EM view. The expected escalation of the trade war in the coming weeks will be an important test for markets. Owing to relatively benign trade war developments over the past month, our negative view on China across asset classes proved incorrect. We nonetheless see a significant chance of a deeper risk-off for China and overall EM, although there remains a possibility that the next round of tariff implementation could have a delayed impact on markets (see our 13 August 2018 [EM Watch](#)).

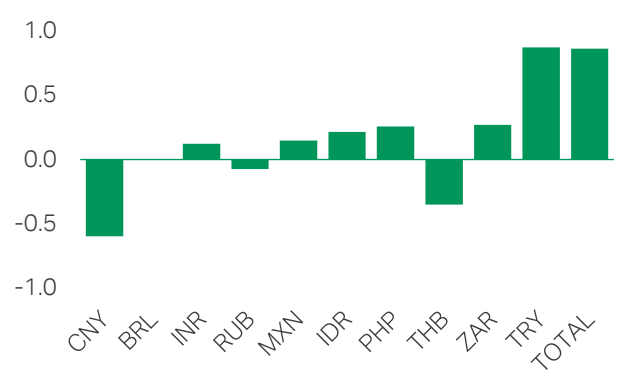
Our negative view of Turkey has been vindicated for all asset classes, as has our positive view of Mexico. In Turkey, valuations have fallen well beyond the point at which investors might otherwise be expected to step in, but an easing of US-Turkey tensions is a prerequisite for any market recovery. In Mexico, the prospect of an end to US trade tensions should return investor focus to the broadly positive domestic outlook.

In Brazil, markets are being driven by a combination of global risk appetite and domestic politics. Our negative view of Brazilian equities proved correct last month, but sovereign credit underperformed, contrary to our expectation.

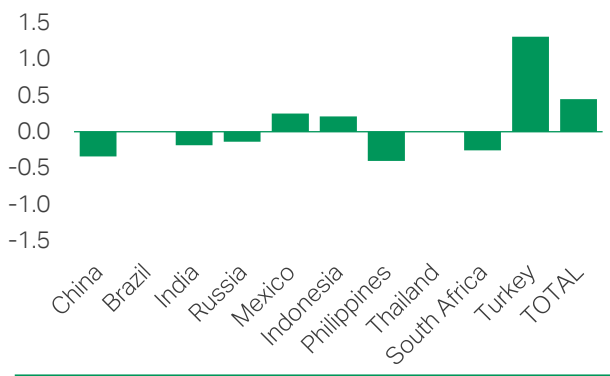
Equity value added (%)



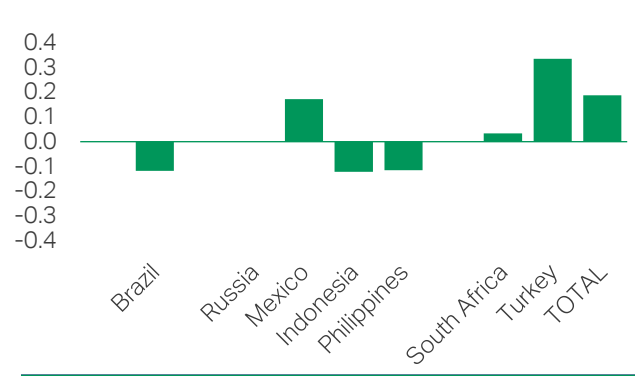
Currency value added (%)



Local market value added (%)



Sovereign credit value added (%)



Sources: Bloomberg, TS Lombard.

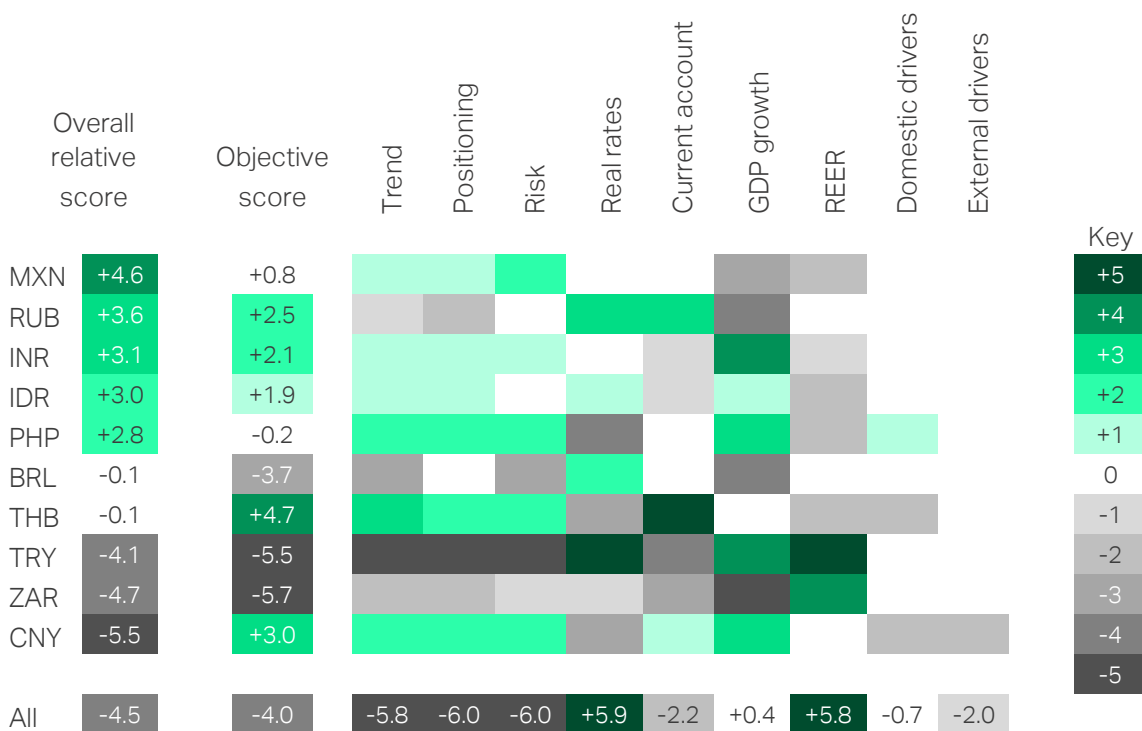
For further explanation, see our [methodology](#).

FX Scorecard

We have positive views on MXN, RUB, INR and negative views on TRY, ZAR, CNY

The figure below presents our latest FX Scorecard. We last updated the FX Scorecard in our 1 August 2018 [EM Strategy Monthly](#).

FX Scorecard: Relative scores for EM currencies



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

Below we summarize our most important view changes this month.

CNY

We maintain our negative view on the renminbi; the outlook for the currency will be driven by trade war escalation. Last month, China reintroduced the counter-cyclical factor in its exchange-rate management regime. This move will give the authorities greater control in managing the depreciation pressure on the renminbi. Further depreciation is nonetheless likely as outflows accelerate in response to trade war escalation and markets adjust to China's declining current account balance. Our analysis suggests that a further renminbi depreciation of as much as 15% vs the dollar could be required to mitigate the impact of US tariffs on China's exports (see our 9 August 2018 [China Watch](#)), although such an estimate depends on many assumptions and markets could easily overshoot our assessment of fair value.

It remains possible, however, that the economic impact of US trade measures could be delayed: for example, if the tariffs on the next US\$200bn of Chinese imports are phased in over a number of months (see our 13 August 2018 [EM Watch](#)) the renminbi could get a short-term boost. Nonetheless, deep divisions remain between the US and China; and with no resolution to them likely in the foreseeable future, we expect the renminbi to remain under pressure.

INR

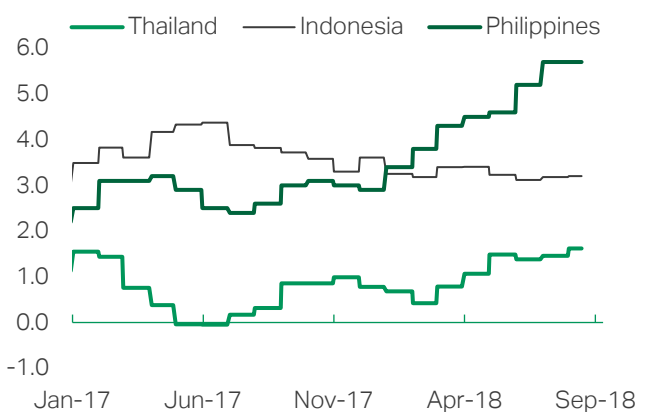
The rupee will likely benefit from higher interest rates and India's relative resilience to the trade war, but the political challenges facing the government are increasing. The depreciation of the rupee in recent months has further fuelled inflation at a time when it is already under pressure owing to higher food and oil prices and fiscal slippage. We expect rising inflation and strong GDP growth to prompt the RBI to take a more hawkish stance, which should help rein in inflation expectations. Government policy is likely to become more populist in what is a key election year, while core inflation, closely monitored by the RBI, has risen above the central bank's target range (see our 16 August 2018 report [India: The return to inflationary normal](#)).

Higher interest rates will help support the currency, while Indian assets may benefit, too, if investors rebalance from China to India, which may be less vulnerable to disruptions in global trade. Indeed, as the trade war escalates, India is likely to be a relative safe haven among EM economies (see our 3 September 2018 [EM Watch](#)). The longer-term outlook is less favourable as the political challenges facing Modi could mean that the next government will have a weaker mandate (see our 24 August 2018 report [India: Political competition adds to economic risk](#)).

PHP

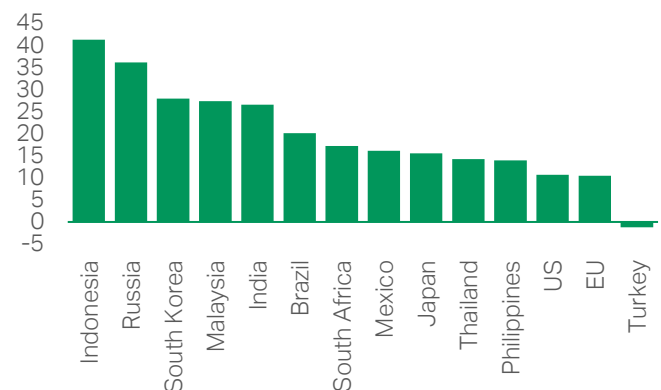
Higher interest rates will support the peso. Inflation continues to increase despite tighter monetary policy (see chart below), while the weaker currency has had little impact on exports, which have declined on a yoy basis in every month this year, in part owing to a strong base effect. The central bank has identified the peso as a significant risk to inflation. Interest rates were raised rates by a further 50bp in August, which has helped stabilize the currency, while Governor Espenilla noted the impact of exchange rate volatility on inflation and warned that risks are still to the upside. Inflationary pressure from tax changes earlier in the year is starting to decline, but the BSP expect inflation to peak in Q3/18, and will likely maintain a hawkish stance.

S.E Asia inflation



Sources: Bloomberg, TS Lombard.

Exports to China (YoY, 3mma)



Sources: Bloomberg, TS Lombard.

THB

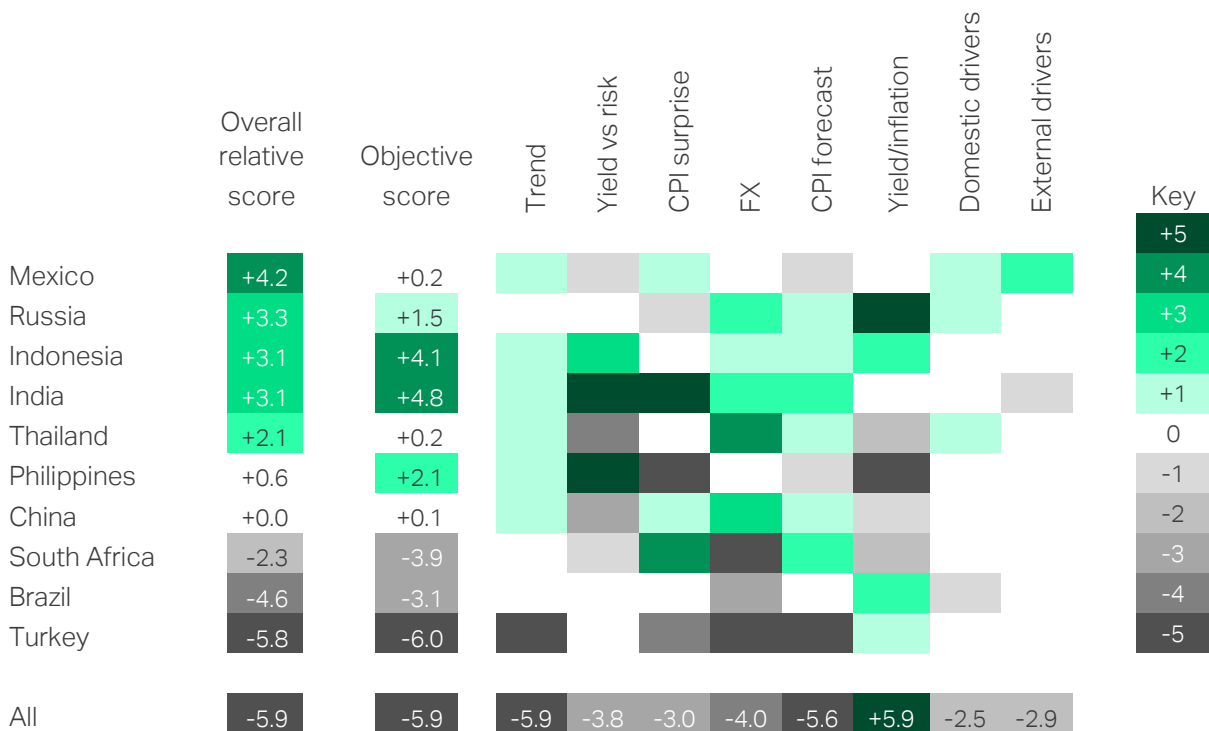
Deteriorating interest differential relative to peers could undermine the baht, despite sound fundamentals. Inflation remains at the low end of the BoT's 1-4% target range. The better-than-expected Q2/18 GDP growth number published last month prompted hawkish comments from the BoT, which said there is less need for accommodative monetary policy as the economy recovers and noted the upward trajectory of global and regional interest rates. Given that inflation remains low, rate hikes remain unlikely. At the same time, export growth is one of the slowest in the region, and there is risk that the trade war will result in supply chain disruption, to which the Thai economy is among the most vulnerable in the region.

Fixed Income Scorecard

We have positive views on local debt in Mexico, Russia, Indonesia and negative views on South Africa, Brazil, Turkey

The figure below presents our latest Fixed Income Scorecard, last updated in our 1 August 2018 [EM Strategy Monthly](#). For further explanation, see our [methodology](#).

Fixed Income Scorecard: Relative scores for EM local debt



Russia

Sound monetary policy and a stable macro backdrop will support local debt markets, but the US-Russia relationship is still a source of uncertainty. The depreciation of the ruble has contributed to upside price risks, but we remain confident that the CBR will succeed in managing inflation expectations (see chart below), which have increased in recent months as sanctions shocks have hit the market (see our 16 August 2018 report [Russia: The local bid](#)).

The US sanctions proposed in the bill put before Congress last month have raised investor fears that more severe measures could be implemented, including the sanctioning of sovereign debt, state banks and energy companies (see our 6 August 2018 [EM Watch](#)). There is, however, a degree of resistance among Republicans to this new bill, which suggests that the probability of further measures is relatively low. At the same time, the relatively minor sanctions imposed in connection with the Skripal affair have helped deflect pressure to implement more serious measures (see our 13 August 2018 [EM Watch](#)).

South Africa

We have turned negative on local debt as the government focus on land reform raises the risk of a shift to more populist policy. The land expropriation bill, which triggered a tweet from President Trump last month, has been withdrawn from the parliament pending an ongoing review of the constitution into the issue of expropriation without compensation.

The immediate threat of renewed pressure from the US administration has likely subsided, but Ramaphosa continues to face the challenge of making progress on land reform amid calls from populist elements in the parliament for more aggressive action (see our 28 August 2018 [EM Watch](#)). At the same time, the SARB's policy of allowing the market to determine the exchange rate will contribute to rising inflationary pressure. The SARB has said it will wait for evidence of second-round effects before reacting to the recent uptick in headline inflation.

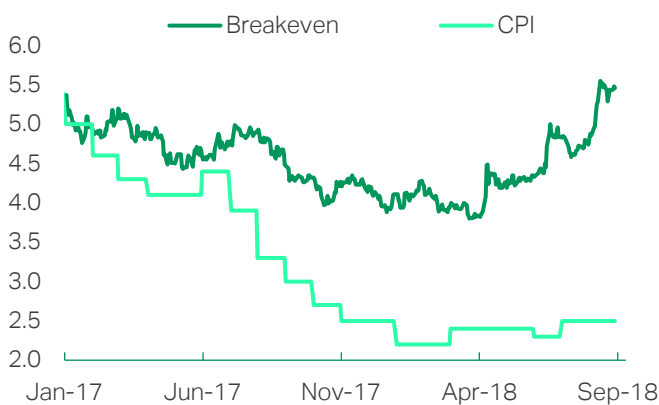
Brazil

Rising inflation and disappointing growth present a dilemma for policymakers that will weigh on local debt. Inflation continues to move higher, while currency depreciation will further fuel inflation expectations (see chart below), just as the presidential race enters its decisive and likely most volatile phase. At the same time, the May truckers' strike has hit GDP growth and damaged consumer and business sentiment, which, in turn, has negative consequences for markets. The start of the TV advertising campaign could bring significant swings in opinion polls, which will likely result in heightened exchange rate volatility (see our 17 August 2018 report [Brazil: Investor roadmap to the presidential election](#)). The underlying issue of fiscal sustainability means that the next administration faces a significant challenge (see our 31 August 2018 report [Is Brazil the next Turkey?](#)).

Turkey

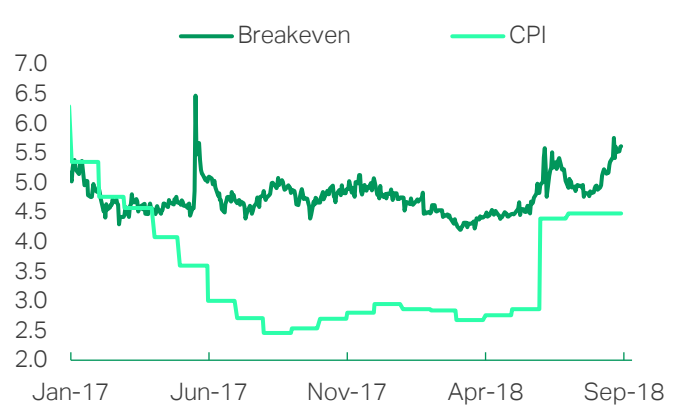
We maintain our negative view of Turkish local debt. The economy is facing a hard landing, and the challenges are considerable (see our 28 August 2018 [EM Watch](#)). A significant decline in creditworthiness is priced in to sovereign debt, but there could be further deterioration if the government does not come up with a credible fiscal plan. For local debt, the collapse of the lira has gone beyond the point where markets could easily be brought back on track by raising interest rates, and inflation is likely to rise further as the weaker exchange rate passes through to prices. In the short term, asset values could stabilise if US-Turkey tensions ease. Discussions aimed at securing the release of jailed US pastor Andrew Brunson are likely to cover other areas of the bilateral relationship, including defence cooperation and allegations of Iran sanctions violations by Turkish banks. At the same time, Brunson's legal team is likely to apply for the case to be heard by Turkey's Constitutional Court. The unpredictable nature of the US administration means that a risk remains of further pressure on Turkey, although both sides appear committed to finding a solution that would take the threat of sanctions off the table.

Russia: Breakeven and CPI



Sources: Bloomberg, TS Lombard.

Brazil: Breakeven and CPI



Sources: Bloomberg, TS Lombard.

Absolute Views

The table below presents our high-conviction total return market views

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	170	+0.6% (-21 bp)
Indonesia	CNY/IDR	Negative	%	30-Jul-18	2,115.0	2,164.6	-1.7%

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Sources: Bloomberg, TS Lombard.

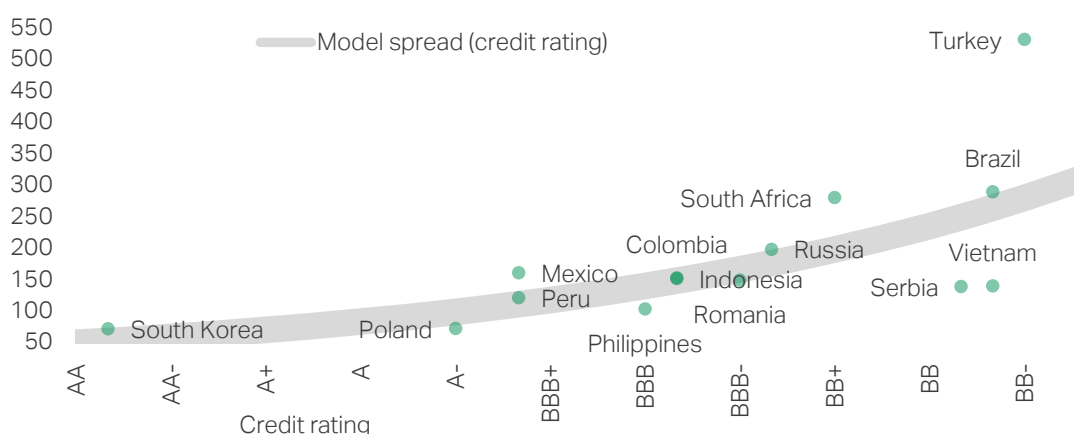
The list of closed views is published at the end of our weekly EM Watch. Intra-day prices used for views that are opened or closed on the date of publication are modified to the close of business prices in subsequent reports. For further explanation, see our [methodology](#).

Mexico

We maintain our positive view of Mexican sovereign credit that we opened in our 12 June 2017 [EM Watch](#). The Mexican sovereign credit spread compressed by around 5bps over the past month, during a period in which there was significant widening of many EM sovereign spreads, including Brazil, Russia and Mexico. The credit remains relatively cheap compared with comparably rated sovereigns (see chart below).

The trade deal reached between Mexico and the US last month had been widely anticipated by the market and the prospect of an easing of tensions was in part responsible for the recovery of the peso in recent months – along with the “buy on the fact” sentiment following the election victory of left wing populist AMLO in July (see our 28 August 2018 [EM Watch](#)). Indeed, we highlighted both the heightened prospect of a trade deal and the solid domestic economic backdrop in last month’s [EM Strategy Monthly](#).

Sovereign spread vs credit rating



For more detail, see our sovereign credit [methodology](#).

Sources: Bloomberg, TS Lombard.

It remains to be seen whether there will be any slippage towards populism when the new administration takes office (see our 13 August 2018 [EM Watch](#)), but the easing of US-Mexico tensions should lead to a renewed focus on solid domestic fundamentals, which will benefit sovereign credit.

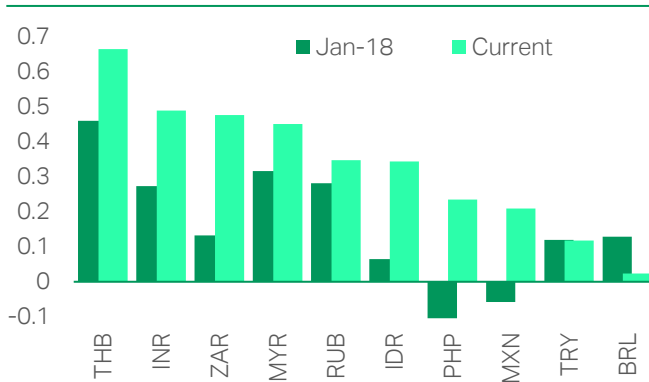
CNY/IDR

We maintain our short CNY/IDR view that we opened in our 30 July 2018 [EM Watch](#).

Indonesia has been among the greatest beneficiaries of the pick-up in China’s imports in recent months, which has contributed to the higher correlation between IDR and CNY (see chart below and our 28 August 2018 [EM Watch](#)). The renminbi is likely to depreciate further as the trade war escalates, which should help to mitigate the negative impact of global risk aversion on the rupiah. At the same time, both the Indonesian government and the central bank are increasingly focused on stabilizing the rupiah, while inflows as a result of the IMF/World Bank meetings in October are likely to provide support, too.

The government is implementing measures to cut imports in order to narrow the current account deficit. Measures include raising tariffs, postponing infrastructure projects and directing state-owned companies to use local suppliers. Bank Indonesia (BI) is committed to further raising rates if needed to control inflation. Contrary to analyst expectations, BI raised rates last month, taking the total rate hikes since May to 125bps, and has pledged to continue its FX swap and local bond market interventions aimed at stabilizing the rupiah. These efforts have helped stem outflows from Indonesian assets, including local debt markets (see chart below).

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



Sources: Bloomberg, TS Lombard.

Indonesia: Foreign holdings of debt (%)



Sources: Bloomberg, TS Lombard.

China

	Latest	Next 3–6 months
Inflation yoy%	2.1	Inflation rising to 2.5% in Q1/19
GDP growth%	6.7	6.3% in H2/18 and 6.5% on average for 2018

The economic outlook remains hostage to developments in the US-China trade war. We expect President Trump to escalate the conflict in early September with additional tariffs on US\$200bn of imports, although he may stagger the dates on which they become effective as well as the tariff levels – rates anywhere between 10% and 25% have been mentioned. Trump has threatened another US\$200bn tariff hit before yearend if China retaliates. On 3 August Beijing announced it would counter such a move with tariffs on US\$60bn of US imports; this leaves no uncertainty about retaliation, although the question remains about the exact nature and timing.

The US administration is increasing pressure on China to fall into line. Commerce Secretary Wilbur Ross lauded the agreement with Mexico on NAFTA revisions last Tuesday, adding that “it’s not the best time for negotiations with China”. Two days later Trump declared that China would not “outlast” the US in their trade dispute and that the Treasury Department was re-examining criteria used to declare a country a currency manipulator. Raising this new threat on China’s currency management highlights that Trump is looking for more ways to hit China. This is likely to widen the US-China dispute rather than lead to new talks; as TS Lombard Chief Economist Charles Dumas [wrote](#) on 7 August, an FX war would be damaging for stocks and possibly for bonds as well. We [argued](#) last month that the introduction of a 25% tariff on another US\$400bn of US imports would push China’s current account into deficit and could lead to another 15% depreciation of the yuan vs the dollar.

Economic data show few effects from Trump’s tariffs, but it is still early days. Government policies are largely targeted at problems that have domestic origins unrelated to tariffs. Monetary policy, for example, is attempting to boost lending to SMEs and other private sector firms, which are being adversely affected by the continuing squeeze on shadow bank lending. Claims that the PBoC is engaged in across-the-board monetary easing are not borne out in the data, which point to rising interest rates. Fiscal policy, on the other hand, is clearly being eased following an unexpected decline in infrastructure investment, down 4.7% yoy in July. Quotas for local government bond issuance were significantly underutilized in H1/18, but the authorities are now working to boost spending on infrastructure by local governments; by contrast, investment in property and manufacturing have both expanded strongly this year.

We expect growth to ease in Q3/18 but to recover in Q4/18. We project growth will slow to 6.3% for H2/18, bringing the average expansion to 6.5% for the full year. Meanwhile, inflation will head higher because of likely Q1/19 increases in pork prices owing to the effects of African swine flu. Given the multiple uncertainties around the evolution of the trade war, government policy will likely be subject to constant fine-tuning over the next six months.

Macro views

Politics	Xi Jinping is in a strong position to fight back against US trade policies
Economics	Growth is now slowing; we project 6.5% for the full year and 6.3% in H2/18

Markets

Equities	-1	Equities remain under pressure following the trade war escalation
Currencies	-2	Additional tariffs likely to be followed by further yuan depreciation
Local rates	-1	Following recent easing, interest rates are likely to be stable to higher

Brazil

	Latest	Next 3–6 months
Inflation yoy%	4.3	4.5-5% over the next six months
GDP growth%	1.0	Stagnating at 1% for the full year

Preliminary Q2/18 GDP data released last Friday confirm that the truckers' strike in late May led to a slowdown in economic activity. GDP rose 1% yoy and 0.2% qoq/sa in Q2/18 from 1.2% and 0.1%, respectively, in Q1/18. Household consumption growth dropped to 1.7% yoy from 2.8% and exports experienced a significant contraction – to -2.9% yoy from 6.1% in Q1/18. Moreover, seasonally adjusted qoq data show a sharp 1.8% contraction in capex; higher government spending (up 0.5%) was the main driver, which prevented an overall contraction in GDP from the previous quarter.

A slowing economy is not good news for the still-bleak fiscal outlook. Although fiscal deficits have narrowed over the last year, the improvement has not been enough to stabilize public debt ratios. The primary fiscal deficit narrowed to 1.3% of GDP in the 12 months to June, from 2.6% one year ago, while the nominal deficit declined to 7.3% of GDP from 9.5% the previous year. However, net and gross public debt reached historical highs at 51.4% and 77.2% of GDP in June, respectively. The sharp depreciation of the Real by more than 10% last month is likely to bring forward a rate hike by the Banco Central after the October elections, although the exact timing is uncertain; this would result in rising costs of servicing public debt. The gradual drop in government debt holdings by non-residents highlights how domestic economic and political uncertainties are influencing portfolio flows. Indeed, non-resident sovereign debt holdings dropped to 11.9% of total outstandings in June from 20.8% two years ago.

The outcome of the presidential election remains highly uncertain despite the approaching 7 October vote. Former Sao Paulo Governor Geraldo Alckmin will have 44% of free TV/radio ad time, but his main challenge is to gather enough support to reach the second round of the election; former Congressman Jair Bolsonaro is still leading the polls for the first round and former President Lula has now been banned from running. The most recent Datafolha poll for the second round shows Alckmin with about 40% of the voter intentions, just 5% more than Bolsonaro. Moreover, recent polls indicate that Lula's current widespread voter support will not automatically be transferred to his stand-in, Fernando Haddad. At this point, Alckmin, Bolsonaro and Haddad could all make it to the second round.

The failure of Alckmin to make it into the second round would fuel heightened market volatility. A match-up between Bolsonaro and Haddad, hard right and hard left respectively, would shock Brazilian markets out of their current complacency about the difficult fiscal challenges that lie ahead and risk spreading contagion to other EM markets.

Macro views

Politics	Highly uncertain ahead of next month's election	
Economics	Preliminary Q2/18 GDP data confirm a slowdown after the truckers' strike	

Markets

Equities	-1	Political uncertainty and economic stagnation negative for stocks
Currencies	0	Real is likely to stabilize following sharp decline in August
Local rates	-1(0)	Real weakness is fuelling fears of rate hikes in the next 3 months
Credit	-1(+1)	Rising deficits and political uncertainty are negative for credit

India

	Latest	Next 3–6 months
Inflation yoy%	4.2	Moving above 5% over the next 3-6 months
GDP growth%	8.2	7.5-7.75% growth in FY19

The big news in India last month was to be found in the RBI's annual report. The RBI reported that 99.3% of all the cash subject to Prime Minister Modi's November 2016 demonetization initiative was returned to banks. This effectively disproved Modi's claim at the time that the move would flush black money out of the economy. The news has led to severe criticism for his government from the opposition both in the parliament and from the financial media. Modi's demonetization action caused prolonged disruption in the informal economy for no measurable benefit. Last month the IMF noted in its annual Article IV assessment that "the impact on growth appears to have been more severe and longer-lasting than anticipated".

The Prime Minister, however, is likely to trumpet the latest GDP figures in response to his critics. Data released last Friday showed that GDP growth hit 8.2% yoy in the latest quarter (Q1/FY19), well above the 7.6% consensus forecast. The outcome was driven by strong expansion in manufacturing, up 13.5%, and construction, up 8.7%; both sectors, though, were aided by base effects, since the previous year's quarterly figures were construction up just 1.8% and manufacturing down 1.8%. The outcome cements India's position as the fastest-growing major economy, although 6.5% growth in China translates into a much larger aggregate increase in economic output owing to its much bigger GDP.

A less-welcome implication of the strong growth figures for Modi is that the RBI will continue tightening monetary policy. Although headline inflation dipped in July to 4.2% yoy from 4.9% in June core inflation remains elevated at more than 6%. India Research Director Shumita Deveshwar [wrote](#) last month that the RBI's statements and actions remain hawkish and that the bank remains concerned, above all, about rising inflationary pressures from planned hikes in the so-called minimum support prices for farmers beginning next month. Friday's strong growth figures can only reinforce the RBI's hawkish tilt. While rates may remain on hold following the October MPC meeting, a decision to hike the policy repo rate at the December RBI meeting is now likely.

The stage is now set for a move into a more combative political environment ahead of national elections next spring. Recent polls show a narrowing of the vote gap between the ruling BJP coalition and the Indian National Congress-led opposition. Indian political analyst Amitabh Dubey argues [[link 24Aug report](#)] that the opposition is likely to be strengthened by voters' economic concerns and the growing strength of regional parties. While it is too early to make any definitive judgments about next year's elections, these developments will undoubtedly lead to an increased populist direction in policy from Modi's government over the coming six months. Fiscal consolidation will be put on the back-burner for now.

Macro views

Politics	Policy uncertainty over upcoming elections and banking risks persist
Economics	Growth has strengthened but a rate hike before yearend is probable

Markets

Equities	+1	Indian stocks are less exposed to global shocks than other EMs
Currencies	+1	INR is now closer to fair value following recent depreciation
Local rates	+1(-1)	Rates are likely to stabilize following recent sharp increases

Russia

	Latest	Next 3–6 months
Inflation yoy%	2.5	Rising to 3.9% by end-2018, higher in 2019 after 2pp VAT hike
GDP growth%	1.8	1.8-1.9% for the full year

Despite high oil prices and record corporate profits Russian markets have struggled over the past month. Uncertainty around possible new US sanctions increased significantly in mid-August with the publication of draft sanctions legislation tabled in the US Senate that was unusually harsh, targeting sovereign debt, state banks and the oil & gas sector. Our judgment is that markets overreacted since adoption of the bill is unlikely ahead of the November mid-term elections, and it probably cannot be passed over President Trump’s veto. What clouded the outlook last month were puzzling new sanctions imposed by the Trump administration, ostensibly in reaction to the Skripal poisoning in the UK, even though London had not asked for them. We think the Trump administration was trying to forestall potential Congressional action, by demonstrating its “toughness” vs Russia; in any case the content of the sanctions was benign as they duplicated existing international agreements.

While markets rebounded following the US sanctions imposed on Russian oligarchs in April, there is no sign as yet of such a recovery this time. A key difference is that sanctions in the current Senate bill are open-ended, whereas sanctions in the April measures targeted only various oligarchs. As a result, sanction risk is likely to hang over Russian markets for the foreseeable future; we doubt the November US elections will provide any resolution, given the preoccupation with Russia in Congress by both parties’ members. For now, sanction risks appear priced in by the markets, although Russia remains a popular target on Capitol Hill.

The economy continues on a path of steady, albeit less robust, growth than earlier anticipated. Q2/18 growth was 1.8% yoy, up from 1.3% in Q1/19 but below earlier 2%-plus forecasts. Although the growth of industrial production and real retail sales continues to be relatively favourable, up 3.9% yoy and 2.5%, respectively, in July, agriculture will be a drag on overall GDP owing to a high base from last year’s record harvest and adverse weather this year.

The main uncertainty in the outlook revolves around inflation expectations and Central Bank monetary policy. Ruble depreciation totalled nearly 10% in August and some of this impulse will pass through to higher prices at a time when seasonal declines in agricultural prices have been much smaller than usual owing to adverse weather conditions. In addition, the 2pp hike in VAT will likely be anticipated ahead of its implementation next January. We think, however, that market expectations of an imminent hike in the Central Bank’s 7.25% policy rate are misplaced: the CBR will remain focused on its core inflation measure, which is likely to show limited volatility around its revised 4.85% June reading, hence a rate hike is unlikely at the upcoming 14 September monetary policy meeting.

Macro views

Politics	Minor changes in pension reform have been endorsed by President Putin	
Economics	Growth is steady, albeit relatively modest at 1.8-1.9% on average this year	

Markets

Equities	+1	Attractive – US sanctions risk largely priced in
Currencies	+1	Continued high oil prices point to relative ruble strength
Local rates	+1	Carry-trade outlook is positive – we expect no CBR rate hike
Credit	+1(0)	Attractive relative value after recent spread widening

Mexico

	Latest	Next 3–6 months
Inflation yoy%	4.8	Slowing to 4.5-5% in H2/18
GDP growth%	2.6	Moderate growth of 2-2.25% at yearend

After more than a year of negotiations, the US and Mexico have reached a deal “in principle” on revising NAFTA. President Trump and outgoing President Peña Nieto confirmed in a public phone call last week that they had reached a preliminary bilateral trade deal as part of the NAFTA renegotiation. The terms of the deal resolve several of the most contentious issues in the talks, namely rules of origin for cars and the sunset clause. The new agreement raises the minimum NAFTA content necessary for vehicles to be tariff-exempt from 62.5% to 75%. Additionally, new guidelines require that 40-45% of the car is assembled in locations where workers earn at least US\$16 per hour. The original US sunset clause proposal, which stipulated the termination of NAFTA every five years unless all parties agreed to extend it, was softened to 16 years with annual revisions from the sixth year onwards. Talks on including Canada in a final deal will continue during September.

In the short term, the proposed NAFTA deal is a better outcome than not having a deal at all. Trade between Mexico, Canada and the US is a natural consequence of their geographical proximity. NAFTA has been influential in shaping Mexican trade policy since its adoption in 1994. But regardless of the benefits NAFTA has brought Mexico, it made only a minimal contribution to correcting economic asymmetries between the three countries, especially regarding manufacturing wages. Trump’s challenge to the existing trade policy paradigm has meanwhile been reinforced by President-elect Andrés Manuel López Obrador (AMLO), who supports NAFTA but believes in strengthening Mexico’s domestic market as a means to foster economic development – in reality a “Mexico first” policy. From AMLO’s standpoint, agreeing to boost wages in the automotive sector partly fulfils one of his campaign promises. Even more important, the extension of NAFTA removes economic uncertainty and avoids a disorderly disruption to the Mexican economy and the North American region.

But the NAFTA renegotiation has not yet been finalized. The respective legislatures need to ratify the final version of the deal and the US Congress has already signalled it will not approve a deal without Canada. AMLO’s administration, moreover, is unlikely to seek further trade deals, given its already large portfolio of 13 agreements spanning more than 50 countries. Rising US-Mexico tensions are possible once AMLO takes office on 1 December, despite Trump’s warm welcome to, and frequent praise for, the Mexican President-elect.

Macro views

Politics	A deal on NAFTA renegotiation has been reached “in principle”	
Economics	Economic growth is stable but relatively low, at just over 2%	

Markets

Equities	+1	The rally is likely to continue after the preliminary NAFTA deal
Currencies	+1	The peso is likely to extend gains amid NAFTA optimism
Local rates	+1	Stable inflation is positive for local carry trades
Credit	+1	Sovereign credit remains attractive vs other EMs on a relative basis

Indonesia

	Latest	Next 3–6 months
Inflation yoy%	3.2	Remaining at 3-3.5%, the midpoint of BI's 2.5-4.5% target range
GDP growth%	5.3	Continuing at 5.3% yoy in H2/18

GDP growth of more than 5% will be sustained thanks to support from consumption. The economy grew 5.3% yoy in Q2/18, up from 5.1% in Q1/18. Private consumption grew 5.1% yoy in Q2/18 vs 4.9% the previous quarter. Stable inflation, one-off bonuses for civil servants and conditional cash transfers resulted in higher household consumption, while regional elections boosted government consumption. We expect growth to remain at around 5.3% this year sustained by government spending in the run-up to the 2019 general elections. The proposed 2019 budget targets increased energy subsidies and social spending, which will further support consumption.

The widening current account deficit has triggered government countermeasures. In July the trade deficit widened to a five-year high of US\$2bn. The CAD in Q3/18 will rise as a result: it already recorded a four-year high of 3% of GDP in Q2/18 owing to the larger trade gap and increased dividend outflows. Government actions are aimed at narrowing the trade gap but do not target services. The government has introduced measures to boost consumption of domestic palm oil biodiesel to reduce imports of oil and plans to curb imports of capital goods for public infrastructure projects. Moreover, it also plans to raise tariffs on imports of some 900 goods that can be produced locally.

Two more policy rate hikes from Bank Indonesia are coming this year. Last month, BI increased the policy rate by 25bps to 5.5% as depreciation pressures on the rupiah returned following the release of current account data and amid the fallout from Turkey's crisis. The move was largely unexpected but is in line with BI's philosophy of acting pre-emptively and being ahead of the curve. The Bank's stance remains hawkish and it will continue with its dual FX and bond market interventions to support the rupiah. Judging by net foreign inflows to government bonds in July and August and by the bid-to-cover ratio at the recent bond auction, which rose to the highest since January, investors find current yields on Indonesian bonds attractive. We expect BI to hike rates twice more this year following expected Fed rate hikes in September and December; this reflects BI's desire to maintain the interest rate differential with the US.

President Joko Widodo (Jokowi) has chosen an Islamic cleric as his running mate in the 2019 election. Amin Ma'ruf is one of the most influential Muslim figures in the country and was instrumental last year in convicting former Governor of Jakarta Basuki Purnama (Ahok) of blasphemy. His selection is a strategic move by Jokowi to become less vulnerable to attacks from conservative Muslims, who in the past have questioned his Islamic credentials. Although this move increases the chances of a Jokowi's victory, it adds to the risk that Islamic doctrine will adversely affect policymaking and economic management during a possible second term.

Macro views

Politics	Jokowi has chosen an Islamic cleric as his running mate in the 2019 election	
Economics	Economic growth is relatively strong and inflation stable	

Markets

Equities	+1	Stocks are more attractively valued following the recent sell-off
Currencies	+1	Higher rates, strong invisible earnings and lower imports are positive
Local rates	+1	Local rates are more attractive after rate hikes and low inflation
Credit	-1	Trading at relatively tight spreads compared with other EMs

Philippines

	Latest	Next 3–6 months
Inflation yoy%	5.7	5-6% owing to tax hikes, strong growth and the weak peso
GDP growth%	6.0	Strong growth around 6.5%

A negative outcome on net exports hit GDP growth in Q2/18. The economy grew just 6% yoy in Q2/18, well below the consensus expectation of 6.7%. Domestic demand, however, remains relatively strong: household consumption decelerated to 5.6% yoy, compared with 5.7% in Q1/18, despite the lower purchasing power resulting from higher inflation. Growth was supported by strong government spending, which grew 11.9% yoy, albeit down from 13.6% in Q1/18. Almost all sectors of the economy recorded slower yoy growth in Q2/18 than in Q1/18, the exception being construction, which expanded 13.5% yoy compared with 8.8% in Q1/18. The negative contribution of net exports – minus 4.7pp – was the main reason for the GDP disappointment as the decline in exports amplified the impact of strong imports of capital goods for infrastructure projects. However, with ever more projects under way, the huge infrastructure spend will eventually translate into higher growth. Therefore, we expect growth of around 6.5% in H2/18; the government's GDP growth target range for 2018 remains 7-8%.

Headline inflation rose 5.7% yoy in July, compared with 5.2% in June. The reading was well above the Bangko Sentral's (BSP) target range of 2-4%. The core CPI rose to 4.5% yoy, up from 4.2% in June. The inflation is driven by rising prices of food & non-alcoholic beverages, utilities and public transport. These price increases are being fuelled by last year's tax reform, higher oil prices and the weaker peso. At the same time, the high inflation reading is due to various second-round effects, including hikes in minimum Jeepney fares and in the minimum wage by several regional wage boards. The impact of adverse weather conditions resulted in rising rice prices, despite increased imports. For this reason, we expect a higher headline CPI for August. BSP expects inflation to peak in Q3/18.

Last month, as widely expected, the BSP hiked the policy rate by 50bps. The hike was intended to dampen inflation expectations and bring headline CPI to within the BSP's target range in 2019. At the same time, the bank increased its inflation forecast for this year and next to 4.9% (up from 4.5%) and to 3.7% (3.3%), respectively. The BSP's stance remains hawkish, although further hikes will be data-dependent. In our view, the total of 100bps in hikes this year will likely translate into somewhat slower domestic demand in 2019 and beyond as in past years private consumption and investment have been fuelled by robust loan growth. As we argued in our [17 August 2018 note](#), this is likely to lead to less balanced growth in future.

Macro views

Politics	President Duterte's popularity rating declined sharply in Q2/18.
Economics	Economic growth will remain strong (at 6.5%) for the remainder of 2018.

Markets

Equities	-1	Despite strong growth, relative valuations are unattractive
Currencies	+1	Hawkish rhetoric from the BSP will likely support the peso
Local rates	-1	Rising inflation and the prospect of policy rate hikes are negative
Credit	+1 (-1)	Strong growth and low beta credit in deteriorating global environment

Thailand

	Latest	Next 3–6 months
Inflation yoy%	1.6	Rising gradually to 2% at yearend
GDP growth%	4.6	4.4% for the whole of 2018

GDP growth will slow for the rest of 2018 after unexpected strength in H1/18. GDP in Q2/18 rose 4.6% yoy, above consensus, following an upward revision to 4.9% yoy growth in Q1/18. The economic expansion was driven by robust private consumption, which accounts for around half of GDP; it rose 4.5% yoy, compared with 3.7% yoy in Q1/18. The improvement was led by durable goods: vehicle sales rose around 25% yoy in Q2/18. Increased farming income and higher minimum wages have buoyed consumer spending. Although we expect the government to support low-income earners with cash transfers in the run-up to next year's general elections, the high level of household debt (around 80% of GDP) will restrain future growth in private consumption. Moreover, we expect further yoy declines in tourist arrivals from China (in July down 0.9% yoy) in the wake of the boating accident in Phuket. Although there is now less media coverage of the accident, Chinese internet searches for Thailand holidays remain well down on last year. Weaker tourism spending from China is likely to continue for another two or three months before the recovery begins.

Exports to China and the US slowed in July. Customs-cleared aggregate exports rose 8.3% yoy in July, as shipments of electronics as well as agricultural products slowed. Exports to the US dropped 1.9% yoy and growth of sales to China eased 3.5% yoy, compared with 11.8% in June. The decline in US shipments was led by televisions & parts and canned & processed seafood. Thailand's exports to China of the products subjected to the US tariffs on Chinese goods, including rubber, electrical machinery and vehicle parts, slowed down significantly, probably because Chinese importers expected fewer opportunities to re-export such products. Import growth continued strong at 10.5% yoy vs 10.8% in June, driven by an acceleration in petroleum products (up 64.4% yoy), reflecting both higher prices and volumes. Imports of capital goods rose just 0.6% yoy, down from 7.8% in June; this may reflect slowing demand for capital goods. The current account surplus fell to US\$1.1bn vs US\$2.9bn in July 2017.

A policy rate hike is unlikely, despite hawkish comments from the Bank of Thailand.

Following the strong GDP data release, BoT Governor Veerathai Santiprabhob said there is less need for an extremely accommodative policy stance since recovery is evident and Thailand should not move counter to global interest rate trends. Headline CPI, however, is still below the midpoint of the BoT's target range and the large current account surplus continues to support the baht. Additionally, the baht appreciated in August as Thailand is seen as a safe haven among EMs; this leaves the BoT less room for tightening. Moreover, there are risks to the growth outlook stemming from lower tourism from China and from the US-China trade war. Despite the BoT's hawkish tone, we do not expect a policy rate hike in 2018.

Macro views

Politics	The PM recently confirmed that elections are likely on 24 February 2019
Economics	Growth has surprised on the upside, led by robust private consumption.

Markets

Equities	+1	Improving growth and earnings are positive for stocks
Currencies	-1	Strong correlation with RMB and weak tourist arrivals are negative
Local rates	+1(0)	Safe haven demand is likely to support local rates

South Africa

	Latest	Next 3–6 months
Inflation yoy%	5.1	Remaining in 5-5.5% range over the next six months
GDP growth%	0.4	1.5% in 2018 as a whole

The rand was hit hard at the beginning of August by the spillover of crises in Turkey and Argentina. Amid a generalized EM selloff, markets saw the rand as vulnerable, given weak economic growth and uncertain prospects for the stabilization of key state-owned firms following the debacle of the Zuma Presidency. The currency fell 12% vs the dollar during August and failed to sustain a short-lived rally in the second half of the month.

Domestic political developments, however, added to the downward pressure on the currency. On 31 July President Cyril Ramaphosa announced his government will seek a constitutional amendment to permit the seizure of agricultural land without compensation. The lack of progress on land reform has been a failure of successive ANC governments since the end of apartheid in 1994, but introducing the issue now amid a still-weak economic recovery was pointless; banks, for example, have some R150bn (US\$10bn) in loans outstanding on agricultural land and securing title for poor blacks on land they already hold is far more important than seizing unused land. Ramaphosa opposed such an initiative at last December's elective conference, arguing that the existing constitution does not necessarily prohibit such moves, but he lost the conference vote on the issue. Announcing such a move now while specific details of future legislation are still being debated in the parliament merely gives the green light to extremist groups on the left and right alike to promote their own agendas. Fox News commentator Tucker Carlson was among those who jumped on the issue, falsely claiming that South Africa had already begun the seizure of land held by whites amid large-scale killing of farmers. This resulted in a tweet from President Trump instructing his Secretary of State to investigate the issue; South African markets and the rand sold off in reaction.

In economic news, consumer inflation jumped to 5.1% yoy in July, up from 4.6% in June. The rise was driven largely by price hikes in housing and utilities as well as transport. Fuel was responsible for the bulk of the increase in transport costs owing to a weak rand and high crude oil prices. Core inflation, meanwhile, only inched up, from 4.2% yoy to 4.3%, suggesting that further upward pressure on headline inflation will be limited: we expect the CPI to remain in the 5-5.5% range over the next six months. This is below the Reserve Bank's 6% upper inflation-targeting band and is unlikely to trigger a hike in the SARB's 6.5% policy rate during this period.

The ongoing clamour over land reform is likely to push the government towards more populist policies. The day of reckoning will be 24 October, when the government presents its medium-term budget policy statement. This is likely to reflect significant fiscal slippage from the 3.6% of GDP budget deficit target, which will have adverse market consequences.

Macro views

Politics	President Ramaphosa's reform agenda is faltering ahead of the 2019 elections	
Economics	The economic recovery is proceeding but at a very slow pace	

Markets

Equities	-1	Disappointing growth limits upside
Currencies	-1	Rand will remain vulnerable to EM risk-off cycles
Local rates	-1(+1)	Carry-trade investments are less attractive owing to rand volatility
Credit	0(+1)	Relative value has been eroded by fiscal slippage

Turkey

	Latest	Next 3–6 months
Inflation yoy%	17.9	FX depreciation pass-through will push the CPI toward 20%
GDP growth%	7.4	Growth slowing sharply in H2/18, slipping into recession in 2019

The Turkish authorities are still in denial about the need for corrective action to stabilize the currency and local financial markets. The new Finance Minister, Berat Albayrak, promised tough fiscal adjustments in his 16 August investor call, but the measures introduced so far have done little to reduce investor concerns about the coming economic hard landing. For example, last Friday the government slashed taxes on lira deposit accounts – to zero from 10% for one-year and longer maturities – and raised them marginally on FX deposit accounts. Given that the lira plummeted 35% vs USD in August, such changes cannot hope to offset the risk of potential losses of any savers switching into lira accounts.

Meanwhile, President Erdogan and other senior ministers continue to play the victim, claiming that Turkey is the object of “economic warfare by Western countries”. Such declarations highlight that senior economic officials do not fully grasp the risks of a financial implosion that could result from the pulling of funding lines to Turkish banks amid the marked deterioration of those banks’ loan assets. The risks of spreading contagion will not be contained by assertions that the economy remains strong because official data show otherwise: broad economic and manufacturing confidence measures both fell in August to their lowest levels since the global financial crisis in 2009.

Turkey has traditionally run relatively low budget deficits, but a significant erosion of fiscal performance is now likely. The accumulation of bad debts associated with unsecured FX liabilities of the construction and energy sectors, for example, is particular cause for concern. Furthermore, the status of credit extended under the government’s Credit Guarantee Fund is clouded in uncertainty. In 2017 the CGF accounted for 75% of lira-denominated corporate loan growth, mostly for working capital purposes rather than investment. Rules for claiming on the government’s guarantee are complex, but there is reason to believe that the government has not created adequate reserves for potential losses under the programme. Beyond actual losses on guarantees extended, the government could face demands on fiscal resources associated with the need to recapitalize state-owned banks, which are all suffering credit downgrades along with the sovereign. Last month S&P and Moody’s both cut Turkey’s sovereign rating, S&P from BB to B+ and Moody’s from Ba2 to Ba3.

What might have turned into a cyclical downturn is now at risk of becoming a broader financial crisis. The failure of the Central Bank to act in time to stabilize the lira and financial conditions came just at the time when President Trump unleashed his Twitter storm, which undermined the lira. Since relations with the US remain up in the air, risks are still rising.

Macro views

Politics	Government is still in denial about need for emergency stabilization measures
Economics	Hard landing is now under way; growth will slow sharply through H2/18

Markets

Equities	-1	Cheap on a relative basis but still facing a hard landing ahead
Currencies	-1	Inflation situation very difficult, external pressures severe
Local rates	-1	High and volatile inflation undermines returns
Credit	-1	Creditworthiness will deteriorate without a credible fiscal plan

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