EM Strategy Monthly

# TRADE WAR IS ALREADY PAST 'PEAK TRUMP' FOR EMS

Larry Brainard / EM Team

- **Risk**: We maintain our moderate negative call on overall risk.
- **Brazil:** We hike our call on equities to strong positive following the recent elections.
- **Mexico:** We cut our call on equities to negative following the cancellation of Mexico City's new airport project.
- **Russia:** Large current account and fiscal surpluses put Russia in a strong position in the event of renewed sanctions. We maintain our positive call on equities.

## Asset Allocation View

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

| Scale |
|---|
| +2 |
| +1 |
| 0 |
| -1 |
| -2 |

Last month in brackets

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

For further explanation, see our methodology.

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.*

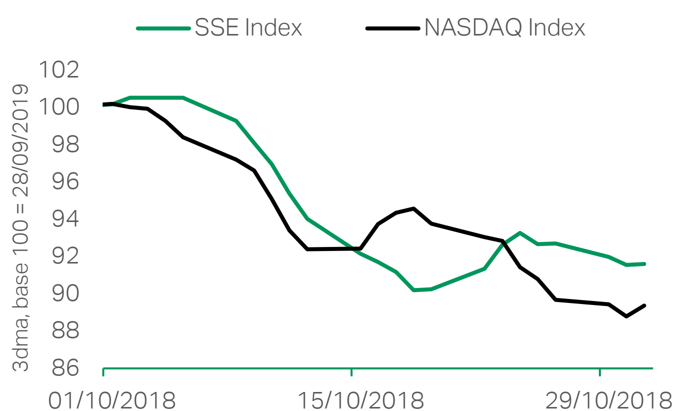
## The trade war is already past 'peak Trump' for EMs

**The strength of the US economy and markets has always been key to President Trump's confidence that trade wars can be won.** The turmoil that characterized US markets during October does not appear to have fazed him one bit. In an interview with Fox News on Monday, he declared that "a great deal" with China on trade was possible but "China was not ready" for it. Trump announced that for this reason, he was preparing to impose tariffs on all remaining Chinese imports by early December. He did not explain how this move would get China ready for a deal, which makes his announcement rather unconvincing.

**We do not doubt the President's intentions but his pronouncements on trade and the US economy are sounding increasingly hollow and becoming more incoherent.** In the past few weeks he has repeatedly blamed the Fed for signs the US economy is slowing, and more recently he said fears the Democrats would take over the House of Representatives after next week's mid-term elections caused the US stock market to plummet. Unsurprisingly, there was no mention amid all his bluster of the role played by his trade wars in deflating the market's earnings expectations; in recent weeks these have been based on much more cautious forward guidance from most US firms that have reported during the current earnings season. While Q4/18 and Q1/19 earnings reporting is still some months off, stock valuations appear to be factoring in that the peak in earnings may have already passed.

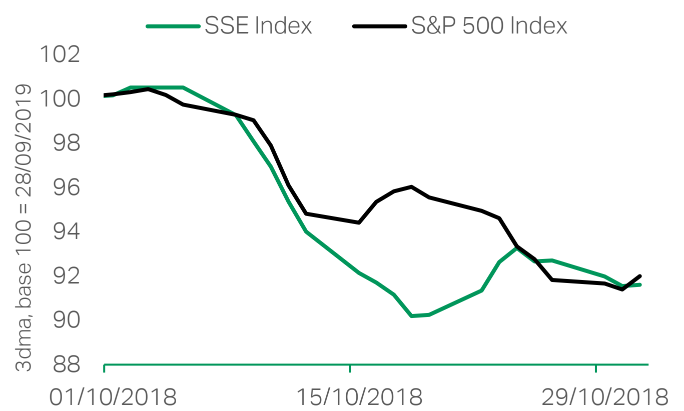
Shanghai Stock Exchange vs US stock indices:

**SSE vs NASDAQ**




Sources: Bloomberg, TS Lombard.

**SSE vs S&P 500**




Sources: Bloomberg, TS Lombard.

**We expect Trump to follow through in hiking tariffs from 10% to 25% on the US$200bn in Chinese imports that he targeted in September.** We think that thereafter further escalation will probably be trickled out, rather than imposed in one go. The reason is because exporters of the remaining US$267bn in goods, which are both Chinese and US firms, enjoy significant pricing power in US markets: estimates put the share of these goods in US imports at 40% (vs 8% for the first US$50bn tranche and 17% for the second US$200bn tranche); in the case of cell phones and electronic equipment the import share is much higher, up to 80%. Moving to 25% tariffs in one go on the final US$267bn in US imports would create upward pressure on US inflation, which could push the Fed to continue tightening, and that is something that Trump probably wants to avoid.

**We believe that EMs have overreacted to the potential downside effects of Trump's trade wars.** A recent two-week visit to Asia highlighted for me that regional markets are in full-adjustment mode, including China, where the major concern of economists we talked to was the government's deleveraging campaign, not the trade war. My colleague Jon Harrison argued in our 29 October 2018 EM Watch that EM equities are pricing in a collapse in trade, for which there is so far little evidence and which may never be realized: EM equities have declined in a straight line, despite the relative stability of EM export growth.

**In other words, Trump's trade war is having a very real economic impact on global trade but markets are adjusting rapidly.** In September we argued that these same market forces will "re-globalize" China's trade, which will react to US barriers on trade and technology transfer by reassembling trade flows into a new trading bloc centred on China. I found evidence for this view of a future Asian trading bloc in comments by a cabinet-level Indonesian official who said at the IMF Bali meetings last month that his government's primary policy goal would be to build regional economic initiatives within ASEAN in order to blunt Trump's "weaponizing" of the US dollar via his trade wars.

**The Chinese leadership is in wait-and-see mode ahead of a further escalation in Trump's trade war.** We are not sure whether this reflects a temporary pause in what has so far been outright resistance to Trump's trade moves or whether it is part of a longer-term strategy. In any case it is probably the right strategy for China to adopt because economic trends over the coming 12-18 months will likely lead to a US economic slowdown at the same time the fallout of Trump's trade war on US firms and farmers continues to mount.

Bo Zhuang and I came away from Beijing last month believing that Chinese policy was beginning to refocus on strengthening economic ties with their major ASEAN trading partners as part of Xi Jinping's Belt and Road Initiative. One economist we visited remarked that improving land-based transport links that run from central and western China southward through the Mekong basin to Thailand, Malaysia and Singapore made much more sense in terms of potential returns than any of the Silk Road-focused projects. Currently, however, China's top leadership has not formulated a revised economic development strategy to replace or update the "Made in China 2015" programme.

**We think the US-China trade war is past 'peak Trump' because further escalation tilts the costs more towards US firms and the US economy than China.** This means that investors will be less likely to assume the worst for the Chinese outlook when new tariffs are imposed. The value added from the assembly of Apple's products in China is very small whereas the potential inflationary impact of tariffs on Apple's imports from China would be significant. Furthermore, the market is aware that Chinese policymakers are monitoring economic trends very closely and are prepared to act with appropriate stimulus measures when required. We conclude that Trump's next steps in escalating his trade war will have less impact on investor sentiment that was the case earlier this year.

**If our view is confirmed in the next two to three months, then other economic factors will assume more importance in driving markets over the coming year.** Thus, a US economic slowdown and possible pause next spring in the Fed's rate hiking cycle would emerge as main market drivers. In such a scenario EMs would not escape the broader effects of the end of the global economic recovery. So while EMs may be spared some of the fallout from future tariff escalation, they are obviously vulnerable if the global economy turns down.

# November Strategy Roadmap

## Overview

- **Risk**: We maintain our moderate negative call on overall risk. We expect President Trump to impose a hike in tariffs from 10% to 25% on US$200bn of Chinese imports in December. But as we argue above, we think this move will have a more limited impact on emerging markets than his earlier tariff decisions did. Of more concern is the likelihood of a US economic slowdown and the rising market volatility that is likely to accompany it. These risks obviously apply across asset classes, not just to EMs.
- **Asset classes:** We make two changes in our calls on asset classes: we raise local rates to neutral and cut equities back to negative. On local rates we judge that recent monetary tightening in a number of EMs has been successful in stabilizing monetary conditions; despite the strong dollar, further tightening is now less urgent. On equities, we have resumed our negative call out of concern for growing evidence that a US economic slowdown could happen sooner than we had expected.

## Equities

- **China**: Growth is slowing, but mostly owing to overaggressive fiscal tightening earlier this year. Nonetheless, evidence of trade war-related effects will gradually be seen in the next three to six months. Markets are likely to be skittish ahead of the probable hike of existing tariffs from 10% to 25% from next January. We cut our call on equities to moderate negative.
- **Brazil**: We are optimistic that President-elect Bolsonaro's economic team will move quickly to boost economic sentiment in the presentation of its reform priorities. We raise our call on equities to strong positive.
- **India**: Although domestic inflation has surprised – coming in below the RBI's 4% target – financial volatility shows no signs of settling down. Ahead of elections in five states over the next six weeks, we think markets will remain on edge. We maintain our negative call on equities.
- **Russia**: Strong fiscal and current account surpluses buoy the sovereign's creditworthiness. In our view, sanction risks are priced in. We maintain our positive call on equities.
- **Mexico**: The cancellation of Mexico City's new airport project via a popular referendum is negative for confidence. We cut our call on equities to negative.
- **Indonesia**: Growth is likely to trend slightly weaker to around 5% yoy amid stable 3% inflation and improving fiscal performance. We maintain our positive call on equities.
- **Philippines**: Signs that inflation is peaking and that further rate hikes will likely be deferred are positive for sentiment. We raise our call on equities to positive.
- **Thailand**: Amid the slight slowdown in growth and still-low inflation, the outlook remains positive. We raise our call on equities to neutral.
- **South Africa**: Rising pressures on fiscal performance and lacklustre economic growth weigh on the outlook for equities; we maintain our negative call.
- **Turkey**: An economic hard landing is under way. Stocks other than those of exporters are likely to suffer. We maintain our negative call on equities.

**Note: Yields and rates are as of 09:00h GMT on 1 November 2018**

**Our next EM Strategy Monthly will appear on 4 December 2018**

# Asset allocation performance

## Value added since our 3 October 2018 Asset Allocation View

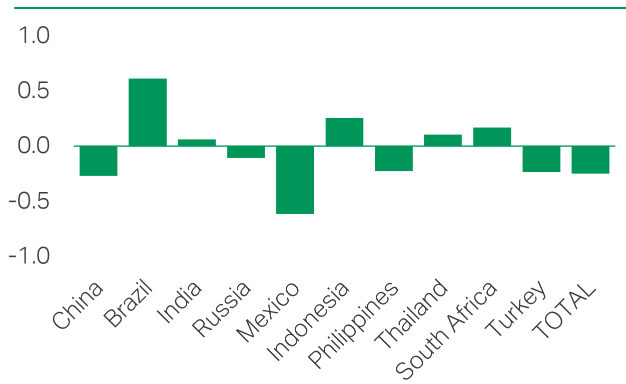
The charts below illustrate the tactical value added over the past month of the asset allocation views presented in our 3 October 2018 EM Strategy Monthly.

**EM assets delivered gains in some of the markets that had been worst hit**, including Brazil and Turkey. On average, however, yields and spreads were generally higher last month and EM equities lost around 8% (MSCI index in dollars), similar to the DM equity loss, which was broadly consistent with our overall moderate negative view.

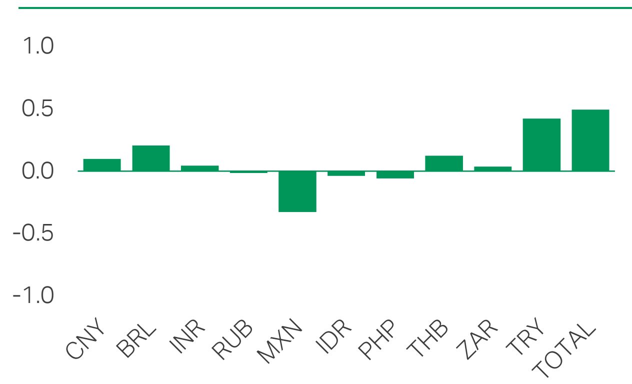
**In equities, our positive view of Brazil and negative view of India proved correct** but was overshadowed by our positive view on China and negative views on Turkey, both of which fared badly. We had anticipated an improvement in investor sentiment in Turkey following the rate hike and the release of Pastor Brunson and upgraded our view of the lira and local debt accordingly, but equity sentiment proved stronger than we had expected. In Brazil, we upgraded our calls last month ahead of the widely expected election victory of right-wing populist Bolsonaro.

**In FX and currencies, our overall value added was positive.** Our positive views on FX and rates in Brazil and Turkey proved correct, as did our negative view of the renminbi. The timing of further RMB depreciation remains difficult to call, but we maintain our view that further weakness is likely as part of China's adjustment to the trade war. In sovereign credit, our positive call on Brazil proved correct, but Mexico fared worse than we had expected following the airport vote, while Turkey delivered strong gains contrary to our view on rising fiscal risks.

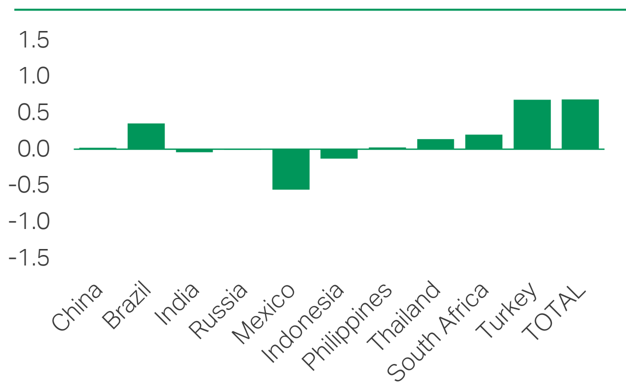
### Equity value added (%)



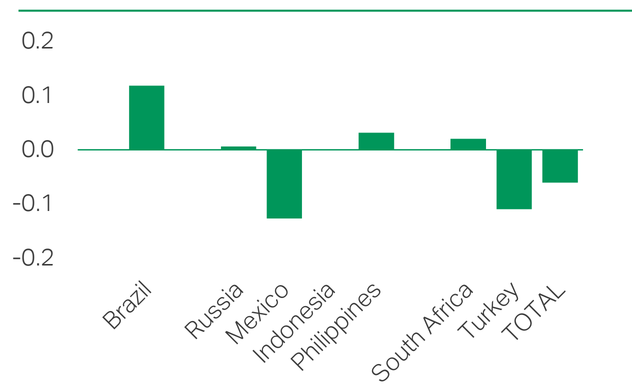

### Currency value added (%)




### Local market value added (%)




### Sovereign credit value added (%)




Sources: Bloomberg, TS Lombard.

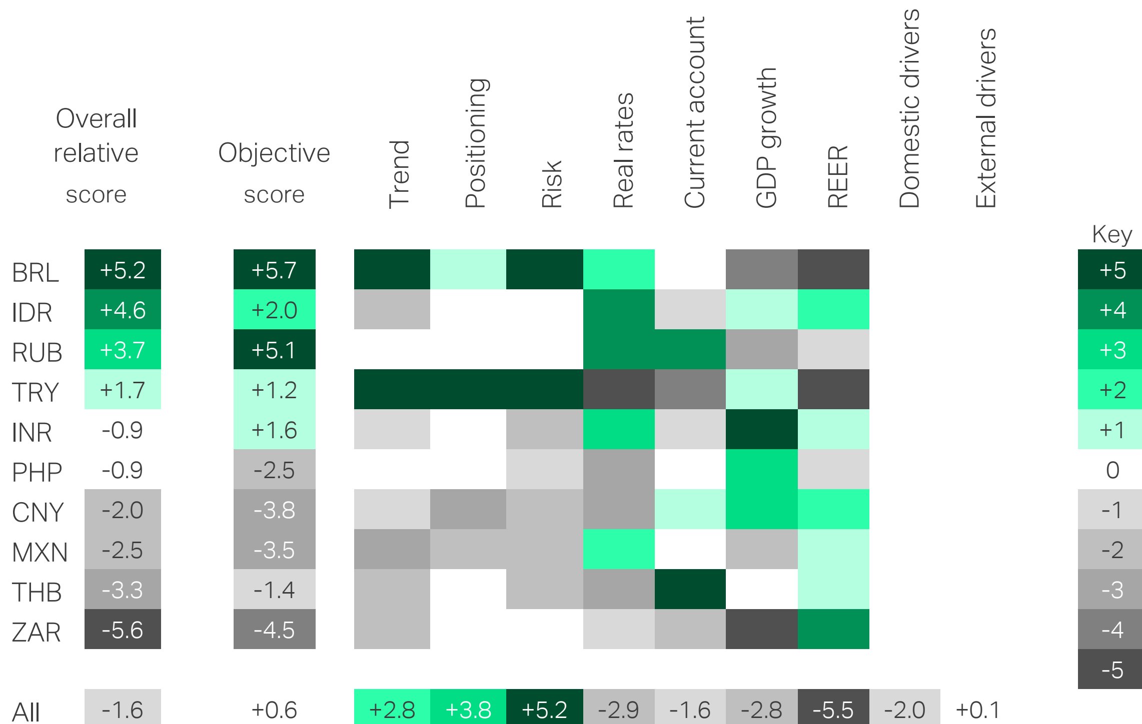
For further explanation, see our methodology.

# FX Scorecard

## We are positive on BRL, IDR, RUB and negative on MXN, THB, ZAR

The figure below presents our latest FX Scorecard. We last updated the FX Scorecard in our 3 October 2018 EM Strategy Monthly. For further explanation, see our methodology.

### FX Scorecard: Relative scores for EM currencies




Below we summarize our most important view changes this month.

## CNY

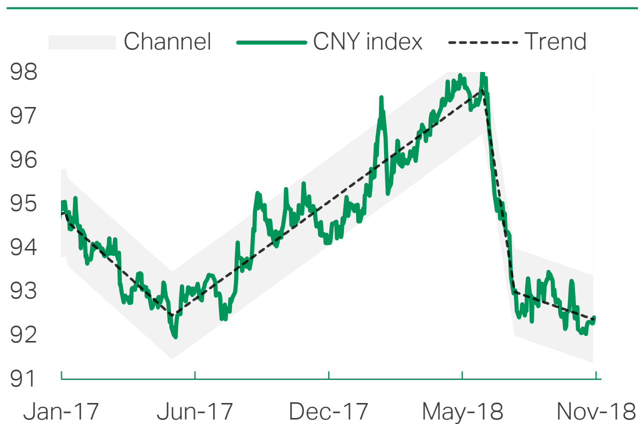
**A slow-motion ratcheting up of US pressure on China does not change our negative renminbi view**. The absence of further negative trade war news over the past month contributed to a moderation of dollar strength vs EM and a reduced pace of renminbi depreciation (see chart below). Our view remains that the US will continue to escalate the trade war in the coming months and that currency depreciation is among the most likely policy responses of the Chinese authorities, although the timing of escalation remains uncertain (see our 25 October 2018 China Watch). Targeted tax cuts and other directed spending measures and subsidies will be used, too, to boost the economy. We believe that the authorities will continue to give priority to deleveraging and financial system risk control, both of which could be put in jeopardy by alternative stimulus measures such as credit or property easing.

## INR

**A dip in oil prices could provide a temporary reprieve for the rupee, but downward pressures remain.** Despite moving lower in recent weeks, oil prices remain relatively high and our analysis shows that India is among the most vulnerable EM economies with respect to the impact of oil prices on both inflation and the current account balance (see our 1 October 2018 EM Watch). Furthermore, high oil prices weigh on an already weak macroeconomic environment at a time of rising political uncertainty (see our 23 October 2018 India in Charts).

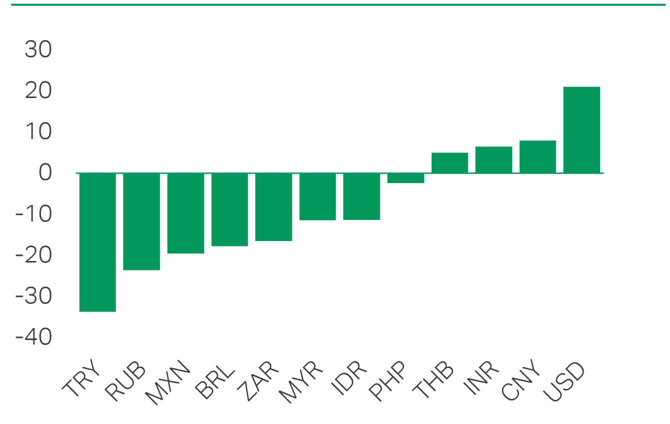
The RBI kept policy rates on hold last month, and we believe it will focus on inflation targeting, rather than on reversing the depreciation of the rupee (see our 8 October 2018 EM Watch). Indeed, following the deprecation of the renminbi in recent months, the rupee now stands out as relatively strong among EM currencies in real effective terms, suggesting potential for further correction (see chart below). It is nonetheless likely that the RBI will raise rates again before year end, which will provide some support for the currency. At the same time, however, upcoming state elections in November and December will raise the political temperature (see our 29 October 2018 EM Watch).

**CNY index**




Sources: Bloomberg, TS Lombard.

**REER change Jan-13 to Nov-18 (%)**




Sources: Bloomberg, TS Lombard.

## PHP

**The peso will find some support from higher interest rates and workers' remittances** but will remain under pressure owing to the deteriorating current account balance. Inflation rose further in September, although the recovery of the peso over the past month and the implementation of government measures to reduce food prices helped allow Finance Minister Dominguez to assert that prices would begin to fall soon. Bangko Sentral has signalled a more dovish stance over the past month, hinting that there will be a pause in the tightening cycle. We agree that inflation is likely peaking. At the same time, a seasonal increase in overseas workers' remittances ahead of the Christmas holidays will provide support for the currency. In addition to the risk of renewed peso depreciation, high oil prices and adverse weather conditions will maintain upward pressure on prices.

## THB

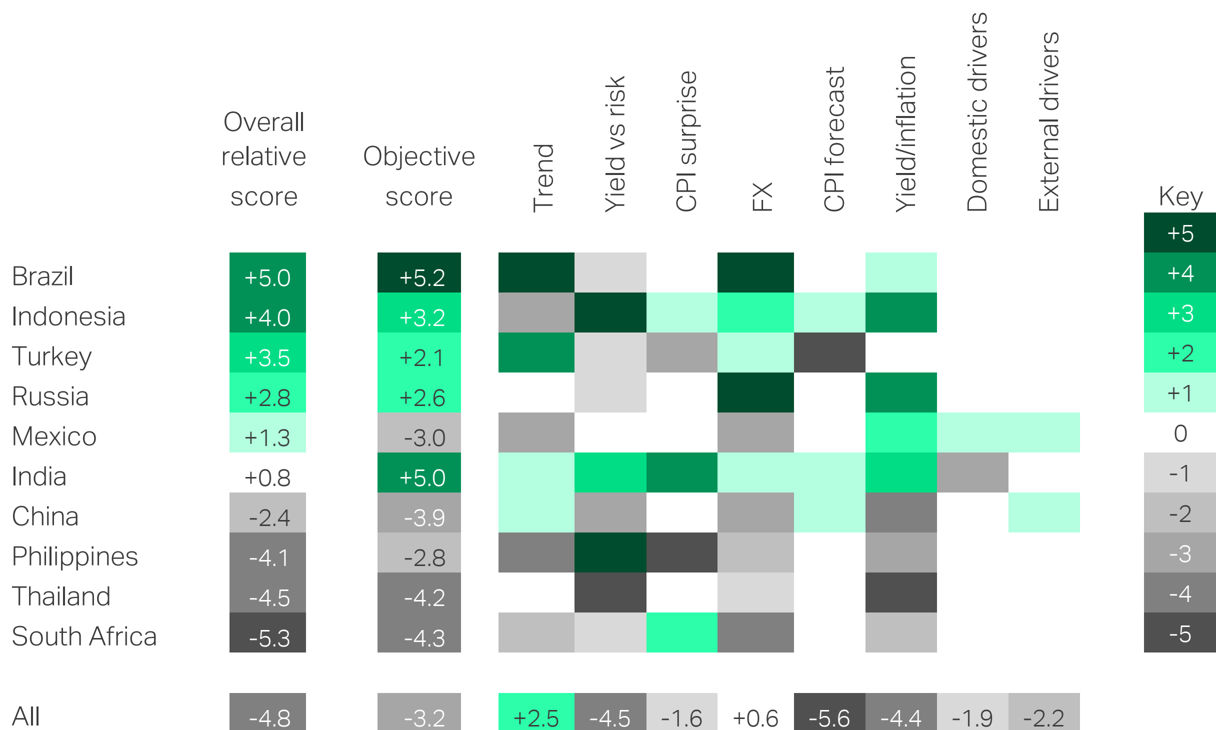
**Low interest rates and relative overvaluation will weigh on the baht.** Data released last month showed that exports in September contracted by more than 5% yoy owing to the combination of a high base and the impact of trade tariffs imposed as part of the US-China trade war (see our 29 October 2018 EM Watch). We maintain our medium-term view that Thailand is well placed to benefit from the reconfiguration of supply chains as companies relocate production out of China – our analysis of revealed comparative advantage supports the medium-term case for Thailand and other countries in Southeast Asia to benefit from the trade war (see our 24 September 2018 EM Watch). In the short term, however, the deteriorating interest rate differential vs peers will be a more important driver. Inflation edged slightly higher in September while the Bank of Thailand noted that an increase in policy rates would have little impact on consumers or businesses. The BoT's commentary is gradually becoming more hawkish, but given that inflation is still low and the baht remains among the strongest regional currencies, the likelihood of higher rates this year continues to be low.

# Fixed Income Scorecard

## We are positive on local debt in Brazil, Indonesia, Turkey and negative on Philippines, Thailand, South Africa

The figure below presents our latest Fixed Income Scorecard, last updated in our 3 October 2018 EM Strategy Monthly. For further explanation, see our methodology.

### Fixed Income Scorecard: Relative scores for EM local debt




## Turkey

**High policy rates and an improving current account balance should boost investor and sentiment help stabilize the lira and local debt**. The economy is nonetheless facing a hard landing and the government has yet to articulate a policy to stabilize the financial system in the face of rising defaults (see our 15 October 2018 EM Watch). The pass-through from the weaker currency will continue to put upward pressure on prices, but the more stable macro backdrop since the rate hike has already helped rein in inflation expectations (see chart below), which is positive for local debt. At the same time, the improvement in US-Turkey relations over the past month removes the immediate threat of deeper sanctions, which in the worst case could precipitate the collapse of the banking sector.

## Brazil

**We maintain our positive view on Brazilian assets this month**. Brazil is one of the few markets to have delivered gains across all asset classes over the past month, so it is no surprise that there was some profit taking in the aftermath of the election. We nonetheless believe that expectation of market-friendly policies under Bolsonaro will continue to drive positive investor sentiment. In particular, the likelihood that economic decisions will be outsourced to the President-elect's economic adviser, Paulo Guedes, should ensure that foreign investors remain on board (see our 29 October 2018 report Brazil: Far-right assumes power in historic shift).

It remains to be seen whether the new administration will rise to the challenge of fiscal consolidation; but in the short term, positive investor sentiment, a stable currency and falling inflation expectations will likely ensure a favourable environment for local debt. Our positive view assumes that the new government will support the monetary policy autonomy under Banco Central. Bolsonaro has explicitly said that he supports central bank independence but at the same time has spoken about fixing currency and inflation targets (see our 29 October 2018 EM Watch).

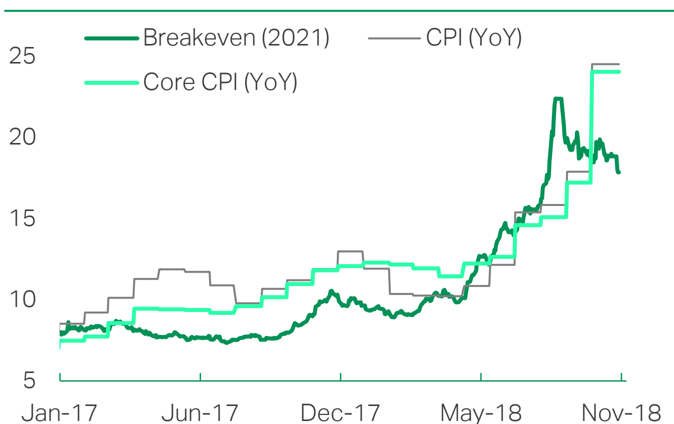
## Russia

**The publication of the government's strategic policy document last month underlines our favourable outlook**. The policy is aimed at increasing the potential rate of growth and has a strong policy bias towards the supply side at the expense of domestic consumption (see our 25 October 2018 report Russia: Supply-side drive). The downturn in oil prices will have little impact on Russia's twin surpluses, while the relaxation of the fiscal rule will help relieve pressure on consumers while at the same time increasing the flexibility of the Central Bank to resume market intervention if required. The planned increase in VAT in January will raise inflation but the rate hike in September has helped to rein in inflation expectations, which should help support local debt markets. Indeed, local rates have already adjusted to the higher level of inflation (see chart below). The threat of new US sanctions remains a tail risk, although we believe that the most extreme scenarios will be avoided (see our 13 September 2018 report Russia: Economic effects of sanctions). The planned meeting between Presidents Trump and Putin in Paris on 11 November is a risk factor, which in the worst case could trigger renewed pressure on the US administration to impose more severe sanctions on Russia.

## South Africa

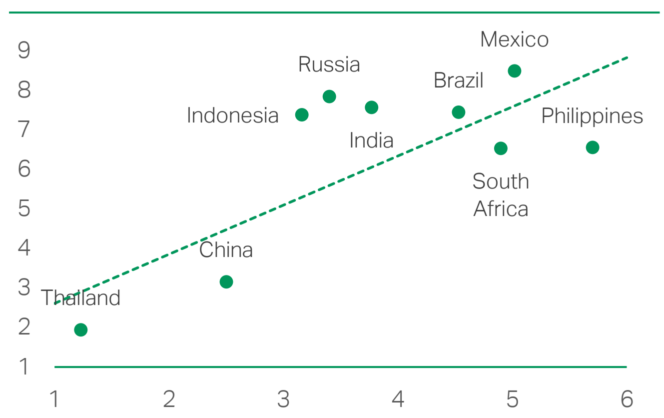
**The risk of a credit rating downgrade is increasing**. Such a move would hit the rand and further increase the inflation shock from exchange rate pass through. The medium-term budget presentation last month surprised those in the market who had been expecting new Finance Minister Mboweni to announce austerity measures. The budget deficit forecast for the current fiscal year was raised to 4.3% and will likely stay above that level for the next three years, although government debt is forecast to remain below 60% of GDP (see our 29 October 2018 EM Watch). Moody's warned that the budget was credit negative. The decline in oil prices will likely reduce some of the pressure on South African assets, but the prospect of a stronger dollar remains a risk factor. At the same time, Ramaphosa is facing growing political calls for more aggressive populism.

### Turkey: Breakeven CPI




Sources: Bloomberg, TS Lombard.

### Nominal yield (2yr) vs headline 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 | 183 | -1.0% (-34 bp) |
| Indonesia | CNY/IDR | Negative | % | 30-Jul-18 | 2,115.0 | 2,178.2 | -1.3% |

Date/time 1-Nov-18 08:06

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.

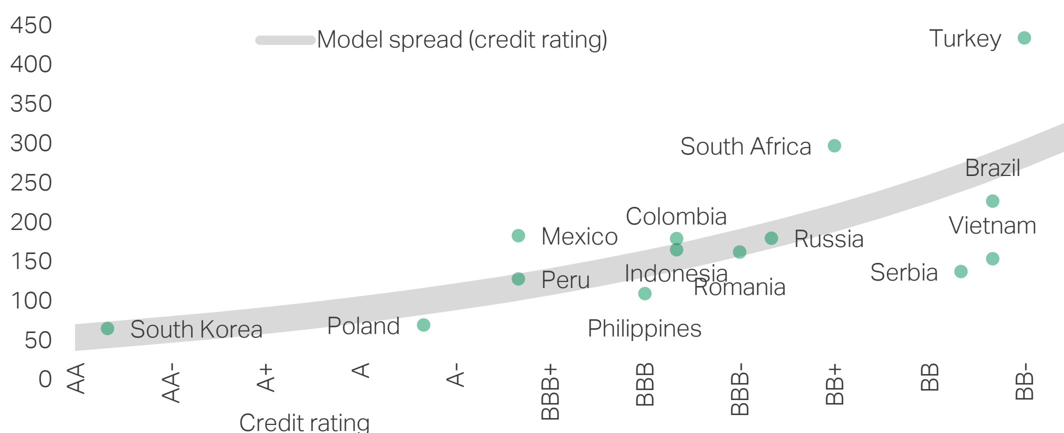
## Mexico

**We maintain our positive view of Mexican sovereign credit**, which we opened in our 12 June 2017 EM Watch, but the President-elect's decision, following a public consultation, not to go ahead with the planned new airport in Mexico City raises the risks for investors (see our 29 October 2018 EM Watch). Following the decision, which delivered on a campaign promise to review the airport development, AMLO sought to reassure investors that contracts will be respected. The move has nonetheless triggered negative comments from rating agencies. Concerns about bias and transparency in the organization of the vote have raised questions about AMLO's commitment to business-friendly policies.

It is probable that the airport decision is a one-off and does not mark a shift by the administration towards populism and uncertainty, but it could nonetheless weigh on investor sentiment.

Mexican sovereign spreads widened by around 40bps over the past month, erasing the gains made in September, as overall EM risk conditions remain relatively weak. Mexico is cheap vs similarly rated credits (see chart below).

### Sovereign spread vs credit rating




For more detail, see our sovereign credit methodology.

Sources: Bloomberg, TS Lombard.

**We expect sound fundamentals to support spreads in the coming months.** Headline CPI edged higher in September, but core inflation remains low, while the minutes of the October monetary policy meeting suggest that Banxico remains prepared to raise rates if inflation expectations start to drift higher.

**The agreement of a trilateral trade deal is positive for markets in the short term** because it removes the uncertainty of trade negotiations and reduces the vulnerability of Mexico to the trade war. However, it brings some negatives for Mexico and could ultimately lead to a decline in the volume of regional trade (see our 10 October report Did Mexico lose or win with the new trilateral deal?). Indeed, Mexico is likely to be among the beneficiaries of supply-chain reconfiguration (see our 24 September EM Watch).

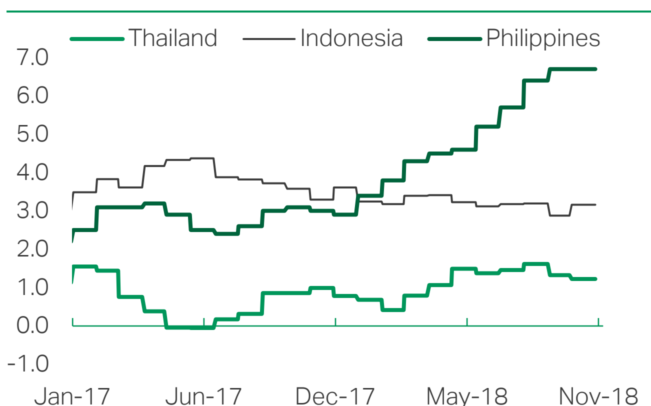
## CNY/IDR

**We maintain our short CNY/IDR view**, which we opened in our 30 July 2018 EM Watch. The cross is little changed over the past month as the relatively slow pace of trade war escalation has reduced the immediate incentive of the Chinese authorities to allow the RMB to depreciate more rapidly. We nonetheless believe that further depreciation is likely as the US ratchets up pressure on China in the coming months.

At the same time, the Indonesian authorities remain committed to currency stability. Bank Indonesia kept policy rates on hold in October, saying that the interest rate outlook will depend on the current account, inflation and the rupiah. The pause in the tightening cycle is justified by a trade surplus and a downturn in inflation in September and will likely help boost inflows into local debt markets (see charts below).

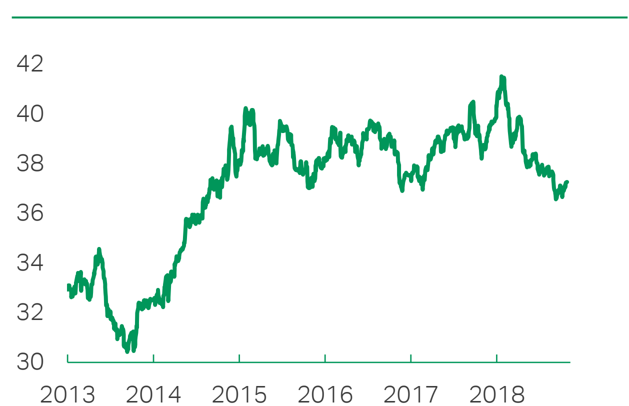
**The rupiah nonetheless remains vulnerable if external conditions lead to a renewed surge in the dollar**, putting pressure on those economies with current account deficits, including Indonesia. Government measures to curb imports have not yet had any significant impact and lower international prices for Indonesia's exports, including coal and palm oil, could contribute to a deterioration of the current account balance in the coming months.

### S.E Asia inflation




Sources: Bloomberg, TS Lombard.

### Indonesia: Foreign holdings of debt (%)




Sources: Bloomberg, TS Lombard.

# China

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 2.5 | Inflation in 2.5-3% range in H1/19, driven by food price hikes |
| GDP growth% | 6.5 | 6.3% in H2/18 and 6.1-6.2% on average in 2019 |

**We believe market hopes for across-the-board stimulus will be disappointed.** A recent trip to Beijing confirmed our view that the stimulus being rolled out in the near term will be targeted to aid exporters and private firms and to sustain consumption. Analysts we visited believe that the government's deleveraging campaign had been too aggressive and needs to be eased. In particular, they said that efforts to rein in shadow banks was inflicting considerable pain on private firms and especially on SMEs; efforts to boost commercial bank lending to those firms have so far been ineffective. At the same time, none of those to whom we talked thought the deleveraging push would be abandoned. Rather, the consensus was that policymakers would introduce new measures to encourage commercial bank lending to private firms to offset the squeeze associated with deleveraging. In addition, recent developments highlight that some provincial and local authorities, for example in Shenzhen, are seeking ways to aid private firms.

**Additional stimulus measures will also aim to support consumption via cuts to personal income and import taxes.** Data on tax revenue so far this year highlight that there is ample room for fiscal easing. Overall, tax revenue rose 8% yoy in Q3/18, ahead of nominal GDP growth and fiscal expenditure. Personal income tax receipts meanwhile have surged more than 20% ytd, well ahead of the 2017 trend. The draft personal income tax cuts unveiled 10 days ago were moderately larger than anticipated but could be expanded as part of the fiscal easing that we think could be adopted in next year's budget: we expect the fiscal deficit target to be hiked to more than 3% of GDP vs this year's 2.6%.

**We found broad agreement among Beijing-based analysts that further depreciation of the yuan was likely as the current account heads into deficit.** While the size and timing of US tariff escalation in 2019 is uncertain, we found support for our thesis of passive depreciation as a primary policy response to the marked current account deterioration that is likely to follow the imposition of higher tariffs. Analysts told us that so far the 10% tariff on some US$200bn of Chinese exports introduced in September has had little effect on exports since exporters were simply passing on the higher costs to US buyers. We expect the 10% tariffs to be raised to 25% in January and the White House to trickle out new tariffs on the remaining US$250bn in US imports from China over the course of 2019.

**Beijing's leadership will remain in wait-and-see mode ahead of and through the US mid-term elections.** We think that Trump's ultimate goal in confronting China is to create effective leverage on China's industrial policies. We do not think he will succeed in doing so; we expect the US-China confrontation therefore to widen into other non-economic spheres, especially the military. Meanwhile, China's top leadership faces the challenge to develop new strategic policies to counter this threat; for now, it is waiting to see what happens later this month.

## Macro views

| | |
|---|---|
| Politics | China is determined to fight back against US trade policies |
| Economics | Growth is now slowing; modest targeted stimulus is being rolled out |

## Markets

| | | |
|---|---|---|
| Equities | -1(+1) | Equities likely to remain under pressure ahead of new tariffs |
| Currencies | -1 | Further yuan depreciation is likely in the next six months |
| Local rates | -1 | Following recent easing, interest rates are likely to be stable to higher |

# Brazil

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 4.5 | In the 4.5-5.0% range in H2/19 |
| GDP growth% | 1.0 | Trending between 1.25-1.5% by H2/19 |

**Right-wing candidate Jair Bolsonaro won Brazil's presidential election with more than 55% of the valid votes.** Former Congressman and anti-establishment candidate Bolsonaro beat former Sao Paulo Mayor Fernando Haddad of the Workers' Party by more than 10% in the second electoral round last Sunday. The market had been pricing in Bolsonaro's victory since early October, when polls showed him gaining on his competition ahead of the first-round vote. Although the President-elect has not disclosed the precise details of his administration's programme, his economic team has promised to prioritize key economic reforms in order to tackle long-standing fiscal imbalances and to get growth going again.

**Fiscal deficits remain wide, despite modest improvements so far this year.** The primary fiscal deficit widened marginally to 1.3% of GDP in September from 1.2% in August, while the nominal deficit narrowed to 6.8% of GDP from 7.4% over the same period. Although the primary and nominal deficits are down from 2.4% and 8.8% of GDP, respectively one year ago, the improvement has not been enough to reverse the steady rise of public debt levels observed over this period. Net debt rose to 52.2% of GDP in September, up from 50.9% one year ago, while gross debt is up to 77.3% of GDP, up from 73.9% one year ago.

**Pension reform is likely to drag on throughout next year.** While pension reform is the key to stabilizing debt levels, the challenge of getting a complicated reform through a fragmented legislature is a major challenge; Bolsonaro will need to display administrative and political skills that he has so far not demonstrated. What is more likely is that his economic team, led by Paulo Guedes, will attempt to achieve some quick gains on reforms that will, in essence, be low-hanging fruit to restore market confidence and to boost growth while leaving discussions on pension reform to play out over the course of next year. Moreover, Guedes intends to open up Brazil's economy beyond Mercosur in order to attract new foreign investment.

**There is significant potential for economic recovery after three years of recession and stagnation.** The incoming administration will formally take office on 1 January and we expect the end of the uncertainty associated with the elections to jump-start new investment projects; Bloomberg has estimated that Bolsonaro's victory has the potential to unlock US$33bn in new capital market transactions. Consumer sentiment has meanwhile bounced back, posting a 7.5% yoy gain in September, up from 3.1% in August; this is positive for a recovery in retail sales. Inflation stood at 4.5% in the first half of October and is likely to continue rising very gradually. Banco Central is likely to keep the Selic rate at 6.5% for the rest of the year amid an appreciating currency.

## Macro views

| | |
|---|---|
| Politics | The end of electoral uncertainty is positive for business confidence |
| Economics | The economy recovery will slowly gain momentum |

## Markets

| | | |
|---|---|---|
| Equities | +2(+1) | A post-election hope rally is likely to continue |
| Currencies | +1 | The Real is likely to post gains as political uncertainty recedes |
| Local rates | +1 | Local rates look more attractive as the Real is set to appreciate |
| Credit | +1 | A hope rally is positive for credit |

# India

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 3.8 | Moving back to 4.5-5% range over the next 3-6 months |
| GDP growth% | 8.2 | 7.5-7.75% in FY19 |

**Weaker oil prices provided relief from pressures on inflation and the rupee, but a growing rift between the RBI and the government has inflamed tensions.** The issue is the RBI's retained profits. In an election year the government is anxious to hit its 3.3% of GDP budget deficit target and it can do this only by tapping into the RBI's retained profits to a much greater extent than it has done to date; last year the RBI transferred a Rp500bn (US$6.8bn) dividend to the Treasury. In an unusual move, the RBI has gone public with claims that the government is attempting to undermine its autonomy by depleting its reserves, while the government is adamant that the RBI should pay out most of its profits in the national interest. As India Research Director Shumita Deveshwar notes in a recent report, the spat is likely to adversely affect credit growth while raising questions about government fiscal performance.

**Headline inflation has continued to run below the RBI's 4% target.** In September headline inflation rose slightly to 3.8% yoy, vs 3.7% in August, thanks to a weak trend in food prices. Core inflation eased, too, but is tracing a significantly higher path at 5.8% yoy, down from 6% in August. Given that earlier the government announced higher minimum support prices, which become effective with the current harvest, we project that headline inflation will rise gradually over the next three to six months toward 5%. At its 5 October MPC meeting, the RBI kept its repo rate unchanged at 6.5%, while lowering its inflation forecast for H2/FY19 (October through next March) to 3.9-4.5%; at the same time the RBI changed its stance from "neutral" to "calibrated tightening". The change in stance appears at odds with the new inflation forecasts; we conclude that the MPC wanted to highlight uncertainties surrounding the inflation outlook.

**The crisis surrounding non-bank financial companies (NBFCs) continues to undermine lending to SMEs.** Intervention in the troubled firm Infrastructure Leasing & Financial Services in September staved off a wholesale implosion of shadow-banking institutions but the government has yet to devise a recovery plan for the company. This has led to rising funding costs for NBFCs as banks, which account for 45% of their funding, become more cautious. On 19 October the RBI relaxed short-term liquidity guidelines for bank funding of NBFCs and housing-finance institutions in an effort to avert renewed liquidity shortages. Even if this relieves short-term pressures on NBFCs, sectors that rely heavily on finance from shadow banks, such as real estate and SMEs more broadly, will face limited and more expensive credit availability.

**In political developments, five states will go to the polls between now and 7 December.** The results of these elections will provide a test of Prime Minister Modi's popularity ahead of national elections next spring. Opinion surveys show that it will be a close contest between the BJP and the opposition Indian National Congress in the top three of these states.

## Macro views

| | |
|---|---|
| Politics | Policy uncertainty persists over upcoming elections, as do banking risks |
| Economics | Growth is strong and a rate hike has been deferred as inflation has eased |

## Markets

| | | |
|---|---|---|
| Equities | -1 | Financial system volatility is negative for Indian stocks |
| Currencies | 0(-1) | Pressure on INR eases after oil price declines |
| Local rates | -1 | Rates are likely to continue under pressure given the financial turmoil |

# Russia

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 3.4 | Rising to 4% by yearend; at 5% in mid-2019, 4.5% at yearend |
| GDP growth% | 1.9 | 1.8% average for 2018; lower next year, around 1.5% |

**The Central Bank (CBR) kept its "key rate" unchanged at 7.5% after its meeting on 25 October.** The reason for the unexpected 25bps rate hike at the previous 14 September meeting became clear following publication of core inflation figures, which rose from 4.9% yoy in July to 5% in August and 5.1% in September. We have long believed that the CBR's core inflation measure has a major influence on the bank's rate decisions. Last month's CBR narrative was viewed as hawkish by the market, but we think this is a misreading. The economic environment has changed in important ways since September: the 7% strengthening of the ruble during the second half of September and subsequent stability along with lower global oil prices have eased inflationary pressures and hence the urgency of rate hikes.

**The decision made at the September meeting to suspend the fiscal rule through yearend has given the CBR a new short-term policy instrument.** Although this decision was taken to ease pressure on the ruble associated with dollar purchases (from excess oil tax proceeds), it tightened domestic liquidity (as ruble injections ceased). Such tighter liquidity has given the CBR increased control over market rates, forcing increased bank borrowing from its lending facilities and thus triggering higher deposit and lending rates. Last week's CBR press release noted approvingly that higher real rates "will support the attractiveness of savings and balanced growth in consumption". Barring the imposition of major sanctions, we do not think that the CBR will hike its key rate in the next three to six months.

**Economic growth meanwhile continues to notch up stable, albeit modest, rates of expansion.** The growth rate for this year will come in at around 1.8%, lower than our forecast and that of most analysts made earlier in the year. Further, we see few chances of a breakout to a higher pace of expansion in 2019. The primary reason is because we expect consumption to slow owing to the effects of next January's VAT hike, which will push up headline inflation and interest rates on consumer credit and mortgages. Additionally, we expect public sector wages to remain unchanged in real terms. Despite lacklustre growth trends, the country's sovereign credit strengths are impressive. This year a fiscal surplus of 2.5-3% of GDP is likely, along with a current account surplus of more than US$100bn, equivalent to nearly 7% of GDP.

**There has been marked calm on sanctions over the past month.** President Trump's National Security Adviser John Bolton, who visited Russia last month, said afterward that additional sanctions on Russia were possible but that he was not aware of "any kind of sanction on Russian sovereign debt". At the same time, he confirmed a meeting between Trump and President Putin at the Paris Peace Forum on 11 November to mark the centenary of the end of World War I.

## Macro views

| | |
|---|---|
| Politics | Domestic political scene remains stable |
| Economics | Growth is stable at 1.8% on average; easing to 1.5% next year |

## Markets

| | | |
|---|---|---|
| Equities | +1 | Outlook is attractive as US sanctions risk is largely priced in |
| Currencies | +1 | Continued high oil prices point to a stable ruble |
| Local rates | +1 | Carry-trade outlook is positive as domestic bond issuance is cut |
| Credit | +1 | Attractive relative value given strong underlying fiscal performance |

# Mexico

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 4.9 | Easing to 4.5% in H2/19 |
| GDP growth% | 2.6 | Moderate growth of around 2.5% in 2019 |

**The market has recently been under pressure amid local and international developments.** On the domestic front, a public consultation organized by President-elect determined that the construction of a new airport for Mexico City initiated under the outgoing administration should be halted in favour of keeping the existing airport and building two new runways at another location. The airport construction was a campaign pledge: the incoming administration believes the long-term maintenance costs of the new airport and the lack of transparency in the awarding of construction contracts will undermine the public finances. Although the investments completed so far are guaranteed by the government, the market reacted negatively. The Hacienda issued a statement on Tuesday that all costs associated with the cancellation have been included in next year's budget, which will be debated in the Congress in early December.

**On the international front, Mexico-US relations hit another bump regarding migration.** Although trade tensions have receded following the announcement of the new trilateral deal at the beginning of October, migration-related concerns have resurfaced. Trump's recent tweet about assigning priority to a secure US border over the new trilateral deal failed to deter Central American migrants from setting out for the US through Mexico, but it did cause new market jitters. Meanwhile, the US administration stated its intentions to deploy more than 5,000 armed troops along the Mexico-US border to contain the migrant caravan heading from Honduras, Guatemala and El Salvador to the US. The incoming Mexican government has expressed its willingness to work with Trump to foster the economic development of southeast Mexico and Central America to prevent further migration into Mexico and the US.

**Meanwhile, economic growth bounced back in Q3/18.** GDP data released on Tuesday show the economy grew 0.9% qoq/sa in Q3/18 after contracting 0.2% in Q2/18. Moreover, in Q3/18 real GDP growth maintained the 2.6% yoy of the previous quarter. Monthly indicators suggest private consumption and a modest pick-up in the external sector led the economic expansion. Indeed, retail sales growth of 3.9% yoy in August continued a recovery from a prolonged contraction last year; more recently, the trade balance narrowed in September driven by strong double-digit export growth.

**The economy will hit the new government's 4% target.** The incoming administration aims to boost economic growth by at least 4% annually during its six-year term by expanding social and infrastructure expenditures and implementing institutional reforms to eliminate corrupt practices, which contribute nothing to growth. The sharp monetary and fiscal tightening in the past two years, however, has left little room to implement high-impact expansionary policies.

## Macro views

| | |
|---|---|
| Politics | Tensions in Mexico-US relations have escalated over migration issues |
| Economics | In Q3/18 the economy bounced back from contraction the previous quarter |

## Markets

| | | |
|---|---|---|
| Equities | -1(+1) | Scrapping the partly built airport is negative for investor sentiment |
| Currencies | -1(+1) | Regional political tensions will add pressure to the peso |
| Local rates | +1 | Stable to falling inflation is positive for local rates |
| Credit | 0(+1) | Fiscal outlook remains stable; 2019 budget will be published soon |

# Indonesia

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 3.2 | 3-3.5%, around the midpoint of BI's 2.5-4.5% target range |
| GDP growth% | 5.3 | Easing slightly to 5.1% in H2/18; 5-5.5% in H1/19 |

**Both Bank Indonesia (BI) and the government have recently downgraded their growth outlooks.** BI expects economic expansion to slow in Q3/18, down from 5.3% yoy in Q2/18, because net exports dragged down growth. Moreover, Finance Minister Sri Mulyani Indrawati said the government now expects GDP growth of 5.1% yoy both in 2018 (down from 5.2% earlier) and in 2019 (vs 5.3%) largely owing to slower global growth. In our view, slowing momentum in private consumption and recent aggressive monetary tightening will add to downward pressure on growth. We expect GDP to expand 5.1% in 2018 and 5% next year. Meanwhile, we think headline inflation will remain stable in the 3-3.5% range until H2/19 as the government is committed to keeping energy prices stable before next year's national elections, as indicated by President Jokowi's recent reversal of a hike in fuel prices.

**The trade balance returned to surplus in September but export growth is slowing.** Import growth slowed in September to 14.2% yoy from 23.7% the previous month as imports of both oil and non-oil products decelerated. This suggests that government measures aimed at reducing imports – which we highlighted last month and which came into effect in September – were effective. However, the deputy head of Statistics Indonesia said that both import tariffs and biodiesel regulations "have shown no results". Export growth meanwhile weakened to just 1.7% yoy, compared with 4.3% in August. The breakdown of exports shows a decrease in prices of non-oil & gas shipments. The trade balance recorded a small surplus of US$200mn, following deficit readings in the last two months. Despite an improved trade balance for September, BI expects the current account deficit to have widened in Q3/18 from 3% of GDP in Q2/18 and thinks it will start narrowing beginning in Q4/18.

**In its Board of Governors' meeting on 23 October, BI kept the policy rate unchanged at 5.75%.** At the end of September, the budget deficit was reported at 1.4% of GDP, compared with 2% in Q2/18; improved tax collections accounted for the stronger outcome, having grown16.5% yoy. Along with an improved trade balance, this provided support for the currency and underpinned stability during October. International reserves dropped to US$115bn in September, down from US$118bn in August, following BI market interventions to dampen currency volatility. Although reserves remain ample, continuing interventions are clearly not sustainable in the longer run. This suggests that BI will likely need to hike the policy rate again before yearend. At the meeting in October, BI decided to save its FX ammunition for more volatile periods ahead, as relative stability in the rupiah has provided the necessary room. We expect another 25bps hike in response to a widely expected 25bps Fed rate increase on 19 December. Indonesia, however, remains vulnerable to potential capital outflows triggered by general risk-off sentiment and that could lead to even more hikes early in the new year.

## Macro views

| | |
|---|---|
| Politics | Campaign for 2019 presidential election has started; Jokowi leads the polls |
| Economics | Economic growth is relatively strong and inflation is stable |

## Markets

| | | |
|---|---|---|
| Equities | +1 | Stocks provide attractive relative value following the recent sell-off |
| Currencies | +1 | Higher rates and measures to narrow the CAD will support the rupiah |
| Local rates | +1 | Local rates are more attractive due to rate hikes and lower inflation |
| Credit | -1(0) | Relative value less compelling following recent spread tightening |

# Philippines

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 6.7 | Easing steadily to around 4.5% in H2/19 |
| GDP growth% | 6.0 | Growth of 6.5% in 2019 driven mainly by infrastructure spending |

**After strong monthly increases, inflation likely peaked in September.** Headline inflation hit 6.7% yoy, vs 6.4% in August, which was above the Bangko Sentral's (BSP) target range but below market consensus. Core inflation slowed slightly to 4.7% in September, vs 4.8% in August, which suggests a slight easing of demand-related inflationary pressures. The main drivers on the supply side were higher prices of food and non–alcoholic beverages, which were up 9.7%, vs 8.5% in August, owing mostly to adverse weather conditions. Almost all other items in the CPI basket were higher compared with August, the exception being utilities. However, there have been signs recently that government counter-inflationary measures have boosted the supply of rice and other foods, which led to lower domestic prices for those products in October. We expect headline inflation to start declining beginning in October.

**The trade deficit will likely continue widening.** While August exports rose just 3.1%, this was still better than the 0.3% increase in July. Electronic shipments (55.6% of total exports) were a bright spot, growing 7% yoy. This, however, might be an effect of front-loading some exports in anticipation of the escalation of US-China trade tensions: shipments to China grew 34.4% compared with 10.3% in July. Meanwhile, import growth came in at 11% yoy compared with 31.6% in July. Although demand for customer goods decelerated somewhat, imports of oil products, iron & steel and transport equipment were strong, reflecting the impact of higher crude oil prices and rising imports for the public infrastructure push. The trade deficit remained essentially unchanged at US$3.5bn in July and August but was significantly higher than the US$2.7bn deficit in August 2017. We expect electronic exports to weaken owing to the US-China trade war but imports of capital goods to remain strong thanks to the infrastructure investment programmes, which will boost future monthly trade deficits. Overseas workers' remittances meanwhile fell 0.9% yoy as the trend of weaker inflows from the Middle East continued. Seasonally strong cash remittances in December will provide temporary support for the current account in Q4/18.

**BSP will likely pause its tightening cycle in November.** The peso appreciated slightly in October, contrary to general trends elsewhere in the region. This, along with the expected lower inflation reading for October, will likely provide room for BSP to leave the policy rate unchanged at 4.5% at its November policy meeting. MPC member Felipe Medalla commented in October that if there is a sign of inflation abating, the bank will "take a pause" in tightening. On the other hand, the BSP Governor said recently that at the next meeting, the bank will judge if "there is a need of at least one more modest hike to seal the deal and firmly anchor inflation expectations". We expect BSP to tighten another 25bps at the 13 December meeting, several days before a widely anticipated Fed rate hike.

## Macro views

| | |
|---|---|
| Politics | President Duterte's popularity rating rebounded at the end of Q3/18 |
| Economics | Economic growth will be strong at 6.5% for the remainder of 2018 and in 2019 |

## Markets

| | | |
|---|---|---|
| Equities | +1(-1) | Easing inflation will boost investor sentiment |
| Currencies | 0(-1) | Seasonal remittances will help the peso despite a widening trade gap |
| Local rates | -1 | Inflation risks are likely to remain high despite expected easing |
| Credit | -1 | Trading at very tight spreads relative to risk owing to strong local bid |

# Thailand

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 1.2 | Moving up to 2.5% at the end of H1/19 |
| GDP growth% | 4.6 | Growth of 4.3% in 2018 and 4.1% in 2019 |

**Chinese tourist arrivals continued to fall in September but we expect a recovery in Q4/18.** Overall, tourist arrivals in September increased by 2.1% yoy, but numbers from China fell by 14.9%, the third consecutive month of yoy contraction. Although the drop can be attributed to the ongoing impact of the July boating accident in Phuket (see August Strategy Monthly), baht strength played a role, too. Nevertheless, the preliminary data from the Ministry of Tourism and Sport show that during the Golden Week Holiday (1-7 October), Chinese tourist arrivals grew 2.8% compared with the same week last year. We expect the impact of the accident to fade in Q4/18 as the government introduces measures to facilitate the recovery, among them the waiving of fees for visas on arrival.

**Exports were hit by the US-China trade war and the strong baht.** Customs-cleared exports declined 5.2% yoy, driven by weaker shipments of cars & parts and electronics. Exports to China fell sharply by 14.1% yoy on the back of a decline in products reprocessed by Chinese firms for export to the US, especially electronic circuit boards and rubber products. The drop reflects the impact of the US-China trade war and earlier frontloading efforts by Chinese exporters. Relative baht strength against other EM currencies was another contributor to weaker exports, as evidenced by softer shipments to the ASEAN 5 and India. In particular, automotive parts have been hit by the strong currency. Moreover, natural disasters in Japan resulted in exports slowing to 0.2% yoy from 14.6% in August. On a positive note, Thailand has started to benefit from Chinese demand for some agricultural products as US agricultural shipments fall. Export sales to the US grew just 1.2% yoy, led by exports of computers, rubber products and cell phones.

**The weaker growth outlook leaves little room for a policy rate hike in November.** Last month a Bank of Thailand MPC member told Bloomberg in an interview that the economy is strong enough to handle even a 50bps hike. However, later, at the IMF Annual Meetings in Bali, the Governor reiterated that there is no imminent need for tightening. Although the baht weakened around 3% against the dollar in October, other regional currencies have depreciated more in the last several months when the baht was strong. Inflation meanwhile remains benign owing to weak demand as indicated by a relatively stable core CPI. More important, softening external demand due to the US-China trade war points to slower GDP growth in Q4/2018 and next year. Indeed, September manufacturing production declined 2.6% yoy, below consensus. The BoT is unlikely to increase the policy rate at its 13 November meeting as the bank will likely opt to wait for more data on the impact of the trade war on domestic demand. Given the weaker export outlook as well as a drop in tourist arrivals from China in Q3/18 we downgrade our growth forecast for 2018 to 4.3%. In 2019 we project a further slowing of growth to 4.1% on decreasing world trade volumes. We think inflation will rise gradually to 2.5% by the end of H1/19.

## Macro views

| | |
|---|---|
| Politics | Elections are likely in Q1/19 with a high chance of Chan-ocha remaining PM |
| Economics | Growth will slow on weaker external demand |

## Markets

| | | |
|---|---|---|
| Equities | 0(-1) | September selloff has made equity valuations more attractive |
| Currencies | -1 | The policy rate remains low while other regional peers are hiking |
| Local rates | -1 | The growing debate about possible rate hikes is negative |

# South Africa

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 4.9 | Rising to 5-5.25% range over the next six months |
| GDP growth% | 0.4 | Growth limited to 1-1.5% yoy in H1/19 |

**Tito Mboweni received few accolades for his first budget statement, presented to parliament last Wednesday.** The new Finance Minister played it straight, delivering a Medium-Term Budget Policy Statement (MTBPS) that acknowledged the difficult position the country finds itself; and he did not sugar-coat his message by trying to identify a light at the end of the tunnel. In terms of growth and inflation there were no surprises: growth this year is forecast at 0.7%, rising to 1.7% next year and 2.1-2.3% in 2020-21. The forecast trend in CPI inflation was centred around 5.5% to 2022, slightly higher than today's 4.9% rate. The main budget deficit forecast likewise showed little change, averaging 4.3-4.4% of GDP before falling slightly to 4.2% in FY2022. Currently, the main areas of relative economic strength are manufacturing and retail sales: manufacturing production in August rose 1.3% yoy following a 2.8% gain in July; retail sales meanwhile were up 2.5% yoy in August, compared with 1.3% in July.

**Market reaction to the MTBPS was uniformly negative.** The reasons reflected disappointment with the much-higher-than-anticipated VAT and other tax refunds that eroded the overall revenue figure. Although the revenue shortfall owing to lower-than-forecast growth this year – 0.7% vs the original 1.7% assumption – was widely anticipated, the market was surprised to learn that the tax refund backlog accounted for about 75% of the revenue gap, estimated at ZAR26bn (US$1.8bn) vs the original February forecast. This result reflects largely serious institutional weaknesses at the South African Revenue Service since 2014 that have delayed payment of refunds.

**President Ramaphosa has launched two medium-term initiatives to boost economic growth.** The MTBPS identified a total of ZAR32.4bn (US$2.2bn) that would be reallocated over the next three years from underperforming or underspending programmes; these funds will go to priority infrastructure projects. Another ZAR15bn (US$1bn) is being directed into the upgrading of informal settlements. In addition to such on-budget initiatives, last Thursday President Ramaphosa launched South Africa's first investment summit in Johannesburg, which is seeking to raise up to US$100bn in private and multilateral funding for investment in new projects over the next three years.

**The SARB is likely to remain on hold over the next six months.** Headline CPI in September was 4.9%, unchanged from August; meanwhile the core CPI index appears relatively stable at 4.2%. Given weak demand, upward pressure on prices is likely to come from external factors, among them rand weakness and a possible rebound in oil prices. We expect the CPI to move above 5% early next year but remain below the SARB's 6% upper targeting band.

## Macro views

| | |
|---|---|
| Politics | President Ramaphosa is pushing new growth initiatives before 2019 elections |
| Economics | The recovery has stalled; inflation remains stable at around 5% |

## Markets

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

# Turkey

| | Latest | Next 3–6 months |
|---|---|---|
| Inflation yoy% | 24.5 | FX depreciation pass-through will keep the CPI above 20% |
| GDP growth% | 5.2 | Growth slowing sharply in H2/18, slipping into recession in 2019 |

**Despite the rise of inflation to 24.5% in September, monetary policy is likely to remain on hold in the near term.** The Central Bank kept its policy rate unchanged at last Thursday's MPC meeting. Although the pass-through of earlier lira depreciation is still working its way through the economy, the sharp fall in aggregate demand will restrain further CPI acceleration. Inflation for October, to be released on 5 November, is likely to approach 30%; thereafter we expect the index to fall gradually over the next three to four months to around 20% in Q1/19. Governor Cetinkaya reiterated on 25 October that the CBRT would continue to use "all available instruments" to keep a lid on inflation; but given that leading economic indicators are already at lows reached during the global financial crisis in 2008-09, further monetary tightening is not needed at this time. At a speech at AK Party headquarters the following day President Erdogan acknowledged that the economy was suffering a "cash crunch" and asked his supporters to have patience, promising that measures were being taken to solve the "problem".

**Policies are urgently needed to stabilize the financial system, which is facing a surge in credit defaults.** Finance Minister Berat Albayrak told a seminar at the mid-October IMF/World Bank Annual Meetings in Bali that he was getting advice from all sides on what to do to head off a financial crisis but had decided to undertake a thorough review of the top eight banks (covering 85% of banking sector assets) before drawing up a stabilization plan. He said that the findings of a detailed bank-by-bank assessment was due to be finalized in the next two to three weeks, i.e. by early November and that this report would provide the basis for whatever measures will be taken. So far there has been no comment from the Finance Minister on how he intends to address the developing financial crisis, but he did introduce temporary consumption tax cuts to boost spending before yearend.

**The Finance Minister's caution is understandable in light of his limited financial experience.** Nonetheless, events are moving rapidly, especially rising concerns of external creditors about how Turkish banks will be able to refinance large external debt maturities. The latest figures confirm that the rollover of external funding for banks has now slipped slightly below 100%; further declines could risk sparking contagion. Furthermore, the lack of financial buffers seen in official net international reserves of below US$20bn highlights that the government lacks the resources to execute bailouts should they be needed. After blaming external actors for undermining the Turkish economy, Erdogan has for now toned down his combative public persona. Bloomberg reported on 25 October that at a private meeting, a group of visiting German executives were open in their criticism of Erdogan's handling of the economy; according to that report, the President addressed their concerns and asked for patience.

## Macro views

| | |
|---|---|
| Politics | Government emergency stabilization measures are welcome but lack detail |
| Economics | Hard landing is now under way; growth will slow sharply in Q4/18 and in H1/19 |

## Markets

| | | |
|---|---|---|
| Equities | -1 | Cheap on a relative basis but a hard landing is negative for stocks |
| Currencies | +1 | The lira is significantly oversold; a short-term rebound is likely |
| Local rates | +1 | High inflation but rates are too high with recession looming |
| Credit | +1(-1) | Relative value is attractive at current spreads |

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