

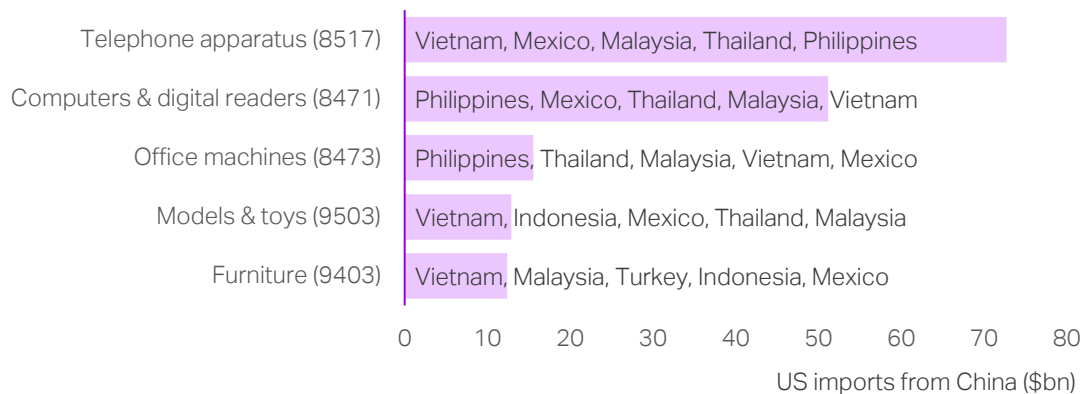


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Revealed comparative advantage (top 5 of 50 HS4 codes)



Source: UN Comtrade, TS Lombard.

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President-elect Jair Bolsonaro is likely to benefit from benign inflation when he takes office as falling energy prices and the bumper crop help to ease prices for consumers. As a result, incoming Banco Central president Campos Neto could keep rates on hold for longer.

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Economic Affairs Secretary Subhash Chandra Garg's comments over the weekend indicate that the differences between the Reserve Bank of India (RBI) and the Finance Ministry are far from being resolved despite the nine-hour long RBI board meeting last week. Garg, who also serves on the RBI board, said that the government wants to discuss changes to the RBI's governance structure to enable greater supervision at the 14 December board meeting.

[Russia](#): New conflict, more sanctions

Yesterday's Russia-Ukraine clash in the Azov Sea could make the US sanctions decision due this week worse for Russia. The incident also highlights the high level of domestic political risk in Ukraine and the contagion from this factor to Russian risks. The general lesson is that there is no shelter for Russia – whatever it does – from relentless sanctions pressure.

[Malaysia](#): Trade and infrastructure drag on growth

Despite strong private consumption, growth is slowing mainly owing to softer external demand. Going forward, an expansionary budget will support private consumption but the trade war and cancellation of public infrastructure projects will be a drag on growth. Owing to slower growth, low inflation and the current account surplus, the policy rate will remain at 3.25% in 2019.

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Trade War short vs long-term evidence

Last week's Trade War developments support our view of a slow motion tariff escalation. The tension between the short-term negative and long-term positive impact of the Trade War is playing out against a backdrop of declining world trade growth. Our case study of last week's trade data from Thailand finds evidence of both sides of the Trade War coin.

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The US opens another front in the Trade War. Last week, the Bureau of Industry and Security (BIS), part of the US Commerce Department, published an advance notice of proposed rulemaking ([ANPRM](#)). The BIS controls the export of dual-use and less sensitive military technology. The proposed rule change relates to the tightening of controls on US exports of high-tech products that are seen as essential to national security. The list of affected products covers 14 broad categories of emerging technology, including such areas as artificial intelligence, biotech and robotics. The proposal is subject to a period of public consultation that is due to end on 19 December.

The US Trade Representative underlined the focus on IP. In addition, the USTR published an [update](#) to its March Section 301 investigation into China's technology transfer and intellectual property that highlighted a catalogue of allegations of unreasonable and discriminatory practices. Last week's report concludes that there has been no improvement in China's behaviour, and accuses China of failing to respond constructively. The report also asserts that there has been an escalation of Chinese cyber theft directed against the US and its allies.

The shift to IP supports our view of a slower escalation of tariffs. Limiting China's access to US intellectual property has been a key element of the administration's objectives from the start of the trade conflict. It is no surprise therefore that the focus should turn to export restrictions. This new front in the Trade War, however, provides a means for the US to escalate pressure on China without having a direct impact on US consumers.

That is not to say that US companies and the wider economy will not suffer. From the perspective of cost to Trump's supporters vs political benefit, however, export restrictions are likely preferable to the immediate imposition of tariffs on the full amount of imports from China. We still expect the tariff hike to 25% to go ahead in January, but the opening of a new front could allow the administration to de-emphasise and therefore delay tariff escalation beyond that.

For emerging markets, tariffs remain the most important front in the Trade War. In last week's [EM Watch](#), we presented an update to our EM combined risk indicator assessing EM vulnerability to three dimensions of risk: liquidity, politics and Trade War. The Trade War and the broader US-China relationship are important drivers of global risk appetite and of EM. The trade specific aspect of the risks facing EM, however, could have very different short-term and long-term consequences as events play out against a backdrop of declining world trade growth.

We find evidence of positive and negative Trade War impact in last week's export data from Thailand. Thailand is one of the most open EM economies – exports are around 70% of GDP, compared with an EM average of around 30%. Thailand is also one of the most exposed to global supply chains. With the exception of Mexico, global manufacturing supply chains are among the longest in the world in South Korea, Malaysia and Thailand. In Thailand, more than 50% of exports are part of supply chains either as foreign value added in exports (upstream) or exported value added incorporated in third-country exports (downstream). The economy of Thailand is exposed to both positive and negative impact from the Trade War.

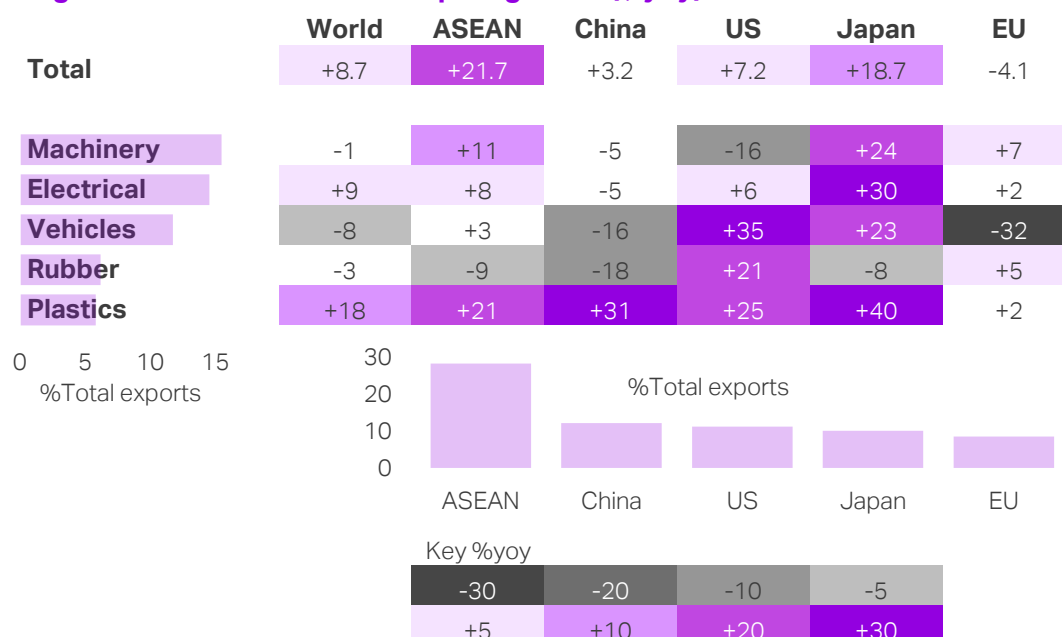
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We highlight evidence of Trade War impact in Thailand's recent trade data, although it is difficult, of course, to disaggregate the impact of different factors.

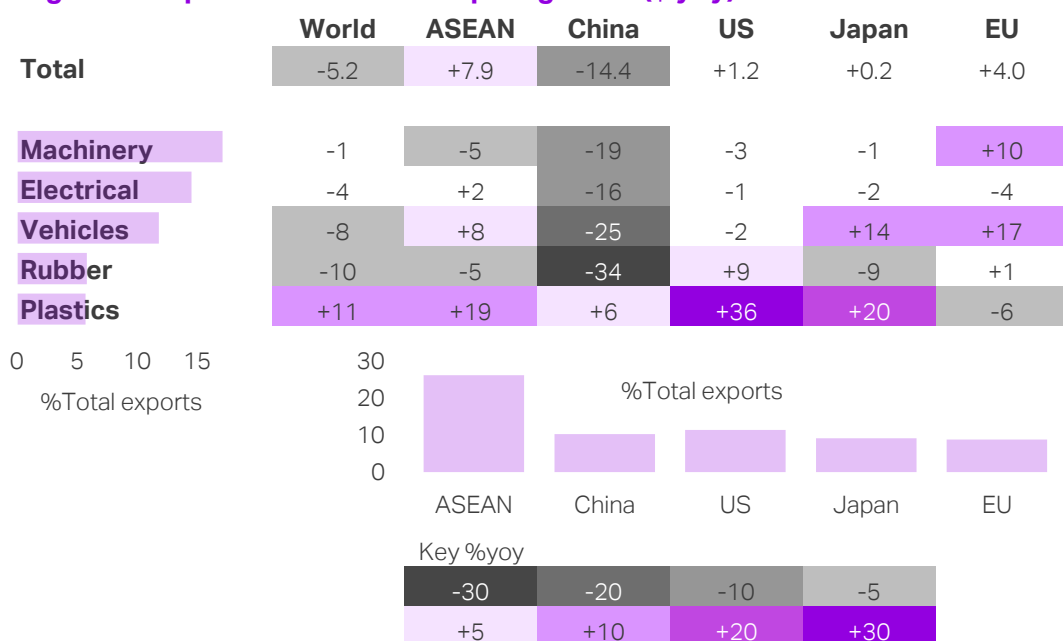
- **Supply chain disruption.** Despite the recovery in total exports in October, there was a contraction in exports of manufactured inputs to China in most categories (see Figure 1).
- **Falling overall demand for manufactured products.** The contraction of total exports in September (see Figure 2) was among the most severe in EM economies, while even in October, there was an overall fall in exports of machinery, vehicles, vehicle parts and rubber.
- **Loss of competitiveness vs China.** China's exports have surged in recent months, helped by the depreciation of the renminbi, resulting in a relative loss of competitiveness for Thailand that likely contributed to the decline of machinery exports to the US in October.
- **Supply chain reconfiguration and substitution.** With the exception of the October machinery exports to the US, there is a clear pattern in both September and October, of a decline in the export of manufactured products to China and an increase in exports to ASEAN neighbours and directly to the US. This is likely at least in part the result of supply chain reconfiguration away from China and of direct substitution of China-sourced US imports of final goods. Furthermore, since the onset of the Trade War, the government and businesses in Thailand have actively sought to diversify export destinations.
- **Emergence of an Asian trading bloc** (see our 21 September [LSR View](#)). For the past two months, the greatest increase in exports has been to ASEAN countries and to Japan (the latter boosted in October after the typhoon). This is consistent with our view that world trade will fragment into regional trading blocs, leading to a strengthening of linkages between Asian economies that will benefit the most open economies to the greatest extent.

Short-term disruption vs longer-term benefit. There will likely be further disruption to regional trade in the coming months, but Thailand, and other countries in Southeast Asia, will ultimately benefit vs wider EM from the positive drivers above. At the same, however, the overall level of world trade growth is declining. If we are correct and the pace of escalation of tariffs is relatively slow then companies and economies will have time to adapt to the new trading environment. If instead, however, the Trade War precipitates a collapse in world trade, then open economies, including Thailand, will be vulnerable.

Figure 1: October Thailand export growth (\$ yoy)



Source: CEIC, TS Lombard.

Figure 2: September Thailand export growth (\$ yoy)


Source: CEIC, TS Lombard.

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Supply chain winners (Top 50 products)

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A more granular analysis of US imports from China supports our view that Southeast Asia and Mexico will be among the greatest beneficiaries of global companies' relocation of production away from China in an effort to optimise supply chains for the new tariff environment.

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Slow escalation buys time for companies to relocate. There is growing evidence that US and Asian companies are seriously considering relocating at least some of their production out of China (see our 29 October [EM Watch](#)). If our view is correct and the imposition of tariffs on the remainder of US imports from China takes place over the course of next year at a slower pace than previously feared (see our 5 November [EM Watch](#)), then there will be considerable time for companies to optimise supply chains to the new tariff environment. The probable increase in tariff rate in January will be another wake up call for companies.

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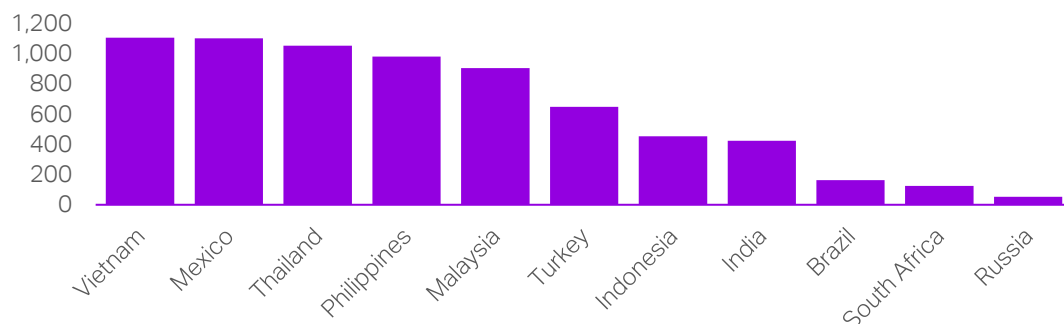
Supply chain reconfiguration winners. It is likely that low cost was an important consideration for global companies in their initial selection of a Chinese supplier, suggesting that similarly low cost EM economies are likely to be among the preferred destinations considered for relocation away from China. The most obvious alternative source of a particular US import is a supplier from a country that is already competitively exporting that product. We have previously calculated the revealed comparative advantage¹ of EM economies that are exporting those products that the US imports from China in broad categories defined by 2-digit [HS product codes](#) (see our 24 September [EM Watch](#)). We take a more granular view below.

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Southeast Asia and Mexico will be the supply chain winners. We analyse US imports from China as defined by 4-digit [HS product codes](#). The top 50 of such product categories account for nearly 70% of US imports from China. In 47 of these product categories, China is currently among the top five most competitive economies. We calculate the comparative advantage for major EM economies at the granularity of 4-digit product codes, excluding China (see Chart 2). The aggregate potential gain for the most competitive EM economies confirms our view that Southeast Asia and Mexico will be the winners from supply chain reconfiguration (see Chart 1).

Chart 1: Potential supply chain reconfiguration gain

US imports from China (\$bn) in which countries are in the top 5 revealed comparative advantage (derived from top 100 4-digit HS codes accounting for 80% of imports)



Source: UN Comtrade, TS Lombard.

¹ Revealed comparative advantage is the extent to which a country is able to export more than its "fair share" of a given product. For example, machinery accounts for 17% of Thailand's exports, but only 7% of global exports; therefore Thailand has a revealed comparative advantage in machinery.

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Chart 2: Who has revealed comparative advantage if not China?

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Source: UN Comtrade, TS Lombard.

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What monetary easing?

Bond yields are trending down but not because of monetary easing. Declining new bond issuance and the continuing squeeze on shadow banks are the primary reasons for abundant market liquidity. Banks are awash in liquidity and buying bonds, which is pushing rates down.

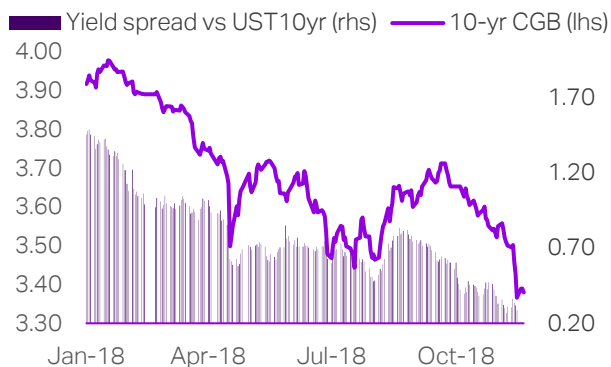
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On 16 November Bloomberg reported that China's bond rally was picking up steam. The reason? Monetary easing and stronger safe-haven demand, according to "China watchers" consulted by Bloomberg. There has clearly been an impressive bond rally, but neither of the quoted reasons is behind it.

Yields on 10-year government bonds have fallen from 3.70% at the end of September to below 3.40% currently, retracing an earlier rally in June and July. But at the same time, yields on short-term instruments have showed little change: the seven-day interbank repo rate has remained around 2.60-2.70% ever since dropping briefly in early August. The rate on the PBoC's Standing Lending Facility has meanwhile remained unchanged, at 3.55%, since it was raised 5bps this March (see charts below). None of this provides evidence for an easing by the PBoC. Nor do we believe the PBoC is particularly concerned about the likelihood that yield spreads between Chinese and US bonds will move into negative territory in the coming months. The current spread on 10-year bonds fell recently to below 30bps, but there has been little sign that capital outflows have picked up, largely thanks to tightened controls on such outflows.

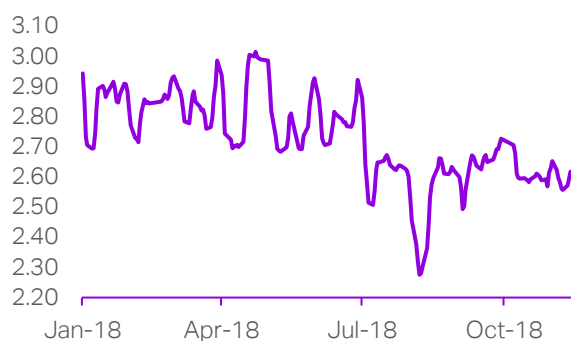
Furthermore, there is no evidence that safe-haven inflows have been behind the current rally. Although non-resident inflows into China's domestic bond market were strong earlier this year, recent weakness in the yuan contributed to outflows beginning last month. Foreign bond holdings rose from RMB785bn (US\$113bn) at the end of 2016 to RMB1.7tr (US\$240bn) in October 2018. NCDs currently account for nearly 12% of the total vs a negligible sum in 2016. The bulk of the foreign holdings are in China Government Bonds, approximately 65% at the present time; policy bank bonds, e.g. China Development Bank issues, account for just 20% of the total. Net flows of non-resident bond holding fell sharply from inflows of RMB111bn in June to a net outflow of RMB6bn in October. This outflow was likely triggered by RMB depreciation over the past three months.

China Govt Bond vs US 10-year



Sources: Bloomberg.

7-day interbank repo, 3-dma %



Source: Bloomberg.

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On Friday the PBoC declined to provide liquidity to the financial market for the 21st session in a row – the longest run since August.

In our view, the reasons for abundant financial liquidity at the present time are the continuing squeeze on shadow banks and the completion of large net new bond issuance by local government financing vehicles, which was concentrated in Q3/18 and absorbed market liquidity at that time. As a result, commercial banks have been awash in liquidity for the past two months and they appear to have placed a large portion of those funds into the bond market.

We do not expect current financial market conditions to persist into the New Year. We think liquidity will gradually tighten ahead of Chinese New Year, which begins on 5 February. The December Economic Work Conference will likely agree a new set of economic policy targets and we expect an easing of both fiscal and monetary policies to follow in the New Year.

Lawrence Brainard

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Inflation outlook improves, easing pressure on incoming administration

President-elect Jair Bolsonaro is likely to benefit from benign inflation when he takes office as falling energy prices and the bumper crop help to ease prices for consumers. As a result, incoming Banco Central president Campos Neto could keep rates on hold for longer.

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The short-term inflation outlook continues to improve. The incoming Bolsonaro government is likely to benefit from the benign inflation backdrop as upside risks for inflation remain limited in the short term. The October IPCA inflation increased 0.45% mom, compared to 0.48% mom in September, with the 12-month rolling rate reaching 4.56% yoy compared to 4.53% in September. While this is slightly above the centre of the Banco Central (BC) target (4.5%), inflation is expected to ease in the final months of the year. The improved outlook comes from both weaker regulated prices, which account for 26% of the index as well as market-driven prices, which account for the remaining 74%.

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Services inflation has continued to ease, aided by the weak recovery. Services inflation, which makes up 35% of the IPCA index, declined for the third consecutive month in October, reaching 3% yoy on a 12-month rolling basis, the lowest level since April 2001. Dynamics in this segment are particularly relevant because of its large weight in the index and because it is less prone to seasonal variations. For this reason, the BC closely monitors services inflation as a proxy for broader inflation trends. While we expect the economy to improve in 2019, the large pool of available labour will contribute to keeping services inflation under control in 2019.

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Lower international oil prices and the weaker currency have helped reduce gasoline prices. After jumping by more than 25% in the first 10 months of the year, crude oil prices have fallen by over 22% this month, reaching their lowest level since October 2017. The lower international prices, coupled with the strengthening of the BRL since the election, have significantly reduced gasoline prices. After peaking in mid-September, wholesale gasoline prices fell by nearly 14% in October and by an additional 13.6% so far this month, pushing down prices to the final consumers. The fall in gasoline prices also points to weaker inflation, as it is it accounts for 4.7% of the IPCA index.

Beginning of rainy season has lowered electricity prices. Electricity prices, which make up 4.1% of the index, are another regulated item contributing to downside pressures on inflation in the short term. Electricity prices increased 16.7% yoy in October vs 20.4% in September because of the late start of the rainy season. The National Electricity Agency (ANEEL) was forced to hike the surcharge to BRL0.05/KWh between June and October because of increased use of high-cost thermoelectric plants. But in November, the surcharge declined to BRL0.01/KWh, which will already contribute to lower inflation this month. Rainfall in central and southeastern Brazil, which holds the bulk of the country's hydroelectric capacity, has been above average so far in November, which indicates that the surcharge will be eliminated entirely in December, which would further ease inflation on the downside.

The food inflation outlook is also benign. Despite increased food prices in early November, favourable weather in recent months has also improved the outlook for food inflation, which accounts for 16% of the IPCA. After falling by nearly 5% in 2017, food inflation remained low in the first quarter of this year and only returned to positive territory in yoy terms in June after the supply shock triggered by the truckers' strike in May. In October, food inflation reached 3.3% yoy, vs 2.2% in September. Industrial products prices, which make up 23% of the index, have also seen only limited increase this year, rising 2% yoy in October, from 1.8% in September.

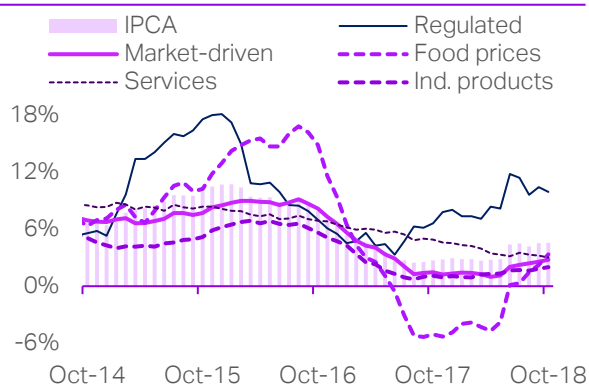
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The new Banco Central president should be able to keep rates lower for longer. The benign inflation outlook is good news for the incoming president of Banco Central Roberto Campos Neto. Campos Neto will be taking over the BC with record-low interest rates and inflation under control amid low inflation expectations. While the positive outlook for inflation should allow the BC to delay the next rate hike, keeping rates at their current, historically low levels for longer hinges on the approval of unpopular reforms, most important of which is the pension overhaul.

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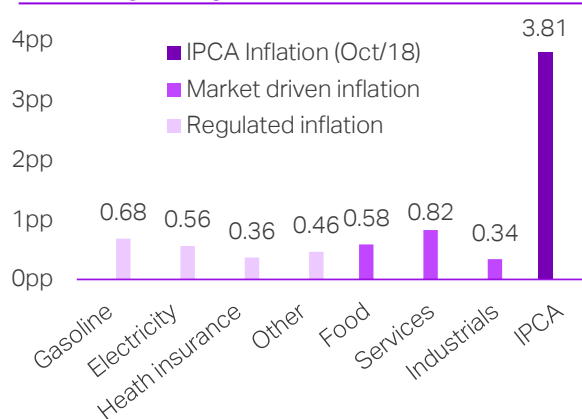
CPI (IPCA) by component

% change yoy



Source: IBGE, TS Lombard.

Breakdown of Jan-Oct CPI (IPCA) by component



Source: IBGE, TS Lombard.

Wilson Ferrarezi

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RBI-government tension far from resolved

Economic Affairs Secretary Subhash Chandra Garg's comments over the weekend indicate that the differences between the Reserve Bank of India (RBI) and the Finance Ministry are far from being resolved despite the nine-hour long RBI board meeting last week. Garg, who also serves on the RBI board, said that the government wants to discuss changes to the RBI's governance structure to enable greater supervision at the 14 December board meeting.

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Garg said that changes to the RBI governance structure should not be viewed as curbing its powers, the proposed oversight panels mean that the government would be doing just that. It will in turn intensify the tensions between the RBI and the government, with the former having staunchly defended its autonomy (see our 31 October note [Costs of the RBI-government spat](#)). Last week's RBI board meeting was believed to have defused the acrimony between the two sides, but Garg's latest comments signal that the tensions could flare up again.

The board has undoubtedly been playing a more active role than ever before in the RBI's workings for the past couple of months. Other government nominees on the RBI board have commented on the shortcomings over banking supervision, as well as on the need for greater flow of credit to industry and easing of liquidity to help India's shadow banks that are facing a crisis. A press statement by RBI following the 19 November board meeting detailed various steps decided by the board, and such a press release has rarely been issued previously.

Among the steps taken by the board was the constitution of an expert committee to examine the RBI's Economic Capital Framework, which follows the debate on the use of the central bank's reserves. Garg said over the weekend that the government will insist on more interim dividends from the RBI. The funds will help manage the fiscal deficit, which is at risk of spilling over the stated target of 3.3% of GDP in FY19 (see last week's [EM Watch](#)).

Ratings firm Fitch had said earlier in November that India's weak fiscal position continues to constrain its sovereign ratings at BBB-minus, one notch above the lowest investment grade, as revenues were lower than budget estimates in 1H/FY19 and spending may be more difficult to control ahead of the general elections due early 2019. Fitch had also warned against other risks to India's macroeconomic outlook, including a drop in credit growth amid challenges faced by the banking and the shadow banking sectors.

Pressure on the RBI to increase the flow of bank credit resulted in it agreeing to consider relaxing lending norms for the 11 state-run banks that have been put under the central bank's Prompt Corrective Action framework, as well as postponing the deadline to meet the RBI's capital adequacy norm of 9% by a year. The board also asked the RBI to consider a scheme to restructure the stressed assets of borrowers of small and medium firms.

The government appears to be under pressure to ramp up bank credit growth and spending before Prime Minister Narendra Modi's re-election bid in April-May 2019. As my colleague Amitabh Dubey pointed out in his 22 November note [State election turning point](#), Modi's Bharatiya Janata Party (BJP) faces a tough fight in the ongoing state polls just months ahead of the national elections. We toured the states of Rajasthan and Madhya Pradesh over the past five days and found much discontentment among voters, which signals further risks to the BJP's numbers in parliament when the national polls are held next year. We will be writing a report on the findings from our on-the-ground visit this week.

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Shumita Deveshwar

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New conflict theatre with Ukraine heightens and highlights sanctions risk

Yesterday's Russia-Ukraine clash in the Azov Sea could make the US sanctions decision due this week worse for Russia. The incident also highlights the high level of domestic political risk in Ukraine and the contagion from this factor to Russian risks. The general lesson is that there is no shelter for Russia – whatever it does – from relentless sanctions pressure.

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The Russia-Ukraine skirmish in the Azov Sea yesterday raises this week's sanctions stakes.

The US State Department is due this week to announce the second round of sanctions against Russia related to the Skripal affair. In contrast to more recent US sanctions laws, the enabling legislation for these particular sanctions – the Chemical and Biological Weapons Control and Warfare Elimination Act of 1991 – offers the executive branch a wide range of options. As far as damage to Russia's economy and financial markets is concerned, these range from the wholly innocuous (such as a further downgrading of diplomatic relations) to measures – such as banning all bank lending to Russia – that would be an escalation even relative to last April's unprecedented sanctions hit.

A reasonable assumption until now has been that the Trump administration's choice of three measures (as mandated by that law) would strike a balance. On the one hand, the new measures would likely be more than token – so as not to reignite domestic political battles by appearing to have gone soft on Russia. On the other hand, these Skripal sanctions would fall short of a true escalation. Russian markets, in particular OFZs, appear to have been discounting a middle-of-the-road outcome along those lines. Expectations may now need to be adjusted in a negative direction against the background of yesterday's incident in the Azov Sea.

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Sea of Azov (grey-shaded)



Source: Wikipedia commons

An Azov escalation has been brewing for months. Enclosed by Crimea, southeast Ukraine and mainland Russia in the north-east corner of the Black Sea (see map above), the Azov Sea has emerged this year as a new theatre of conflict between Russia and Ukraine. The initial incident in March this year saw Ukraine arresting a Russian trawler, detaining its crew and putting its captain on trial. The charges reveal the root of the problem: Crimea. By operating out of Crimea (i.e. Ukrainian territory) without the permission of Ukrainian regulators, the trawler was deemed to be illegal. Incensed by this "provocation", Russia has since retaliated by stopping and

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searching Ukrainian and international shipping serving Ukraine's Azov Sea ports, notably the important coal terminal at Mariupol. Russia has also deployed naval ships in the area as part of its security operation around the newly completed bridge linking the eastern tip of Crimea with the Russian mainland across the narrow Kerch strait between the Azov Sea and the Black Sea.

Tensions dating back to March have now escalated as of yesterday to the point of shooting and (non-fatal) injuries. The immediate point at issue appears to be a factual dispute. Ukraine claims to have notified Russia in advance that it was sending three naval vessels through the Kerch strait to Mariupol. A previous notification in September resulted in the Russians closely shadowing the warship concerned on that occasion, but the episode otherwise passed without incident. This time around, Russia's border coastguard denies having received any such notification, and accordingly confronted and arrested the Ukrainian vessels for "violating Russian territorial waters."

Ukraine's strategic goal is to supersede its 2003 agreement with Russia that preserved the Soviet-era arrangement defining the Azov Sea as an "internal water between republics" and, as such, without demarcated maritime territory. In 2016, Ukraine filed an action with the international tribunal that adjudicates the UN Convention on the Law of the Sea designed to have Azov recognised as a normal sea requiring the demarcation of territorial waters. Victory in this case, which is due to be heard in mid-2019, would provide Ukraine with a new way to assert its sovereignty over "occupied" Crimea posing considerable practical problems for Russia.

The Ukrainian government has various possible motives for bringing this Azov question to a head this year. One may be to support flagging political momentum – in Europe, especially – for maintaining unchanged sanctions against Russia. The most obvious and plausible explanation for this timing, however, is the Ukrainian presidential election due next March in which the unpopular incumbent Petro Poroshenko's only hope of a second term may be to ride a fresh wave of patriotic fervour. Tension with Russia in the Azov Sea fits this requirement alongside other recent gambits such as setting up a national Ukrainian orthodox church separate from the Moscow Patriarchate. Poroshenko's announcement in the early hours of this morning of a 60-day period of martial law in response to yesterday's incident has even caused speculation in Kiev that he may be planning by this means to postpone the presidential election,

On the Russian side, the decline in Putin's public approval rating since last summer's pension age increase provides a similar motive for renewed geopolitical escalation. But the incentive here – at the start of a new political cycle – is less compelling than in the Ukrainian case; and in line with Putin's track record, the Russian posture in the Azov theatre is less adventurist than reactive – in this case, reacting to the appearance of Ukrainian naval vessels in the Kerch strait.

The more important implication of the Azov tension for the Russian investment case is the lessons its holds for sanctions-related risk. These lessons extend beyond the immediate potential impact noted above of pushing the US – and perhaps even the EU – into imposing additional or more severe sanctions than they would otherwise have done. More significant for the long term is the Russian assumption – well aired in Sunday evening's regular weekly current affairs shows on national state television – that US officials instigated yesterday's Ukrainian "provocation" with a view to spoiling the planned Trump-Putin meeting at the G20 Summit in Buenos Aires at the end of this week and/or as grounds for escalating pressure on Russia. While the obvious Ukrainian domestic political motive makes such conspiracy theories seem superfluous in this case, such Russian reactions are a sobering reminder that there is scant prospect of stabilizing – let alone reversing – the sanctions situation. Russia's actions since 2014 give its opponents ample ways to create grounds for maintaining sanctions pressure.

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Trade and infrastructure drag on growth

Despite strong private consumption, growth is slowing mainly owing to softer external demand. Going forward, an expansionary budget will support private consumption but the trade war and cancellation of public infrastructure projects will be a drag on growth. Owing to slower growth, low inflation and the current account surplus, the policy rate will remain at 3.25% in 2019.

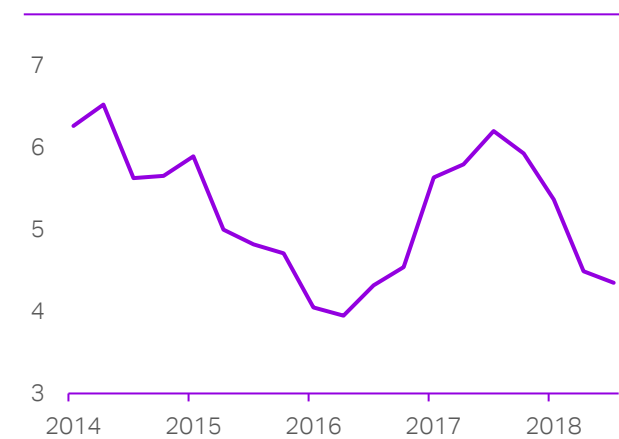
In Q3/18 real GDP growth slowed to 4.4%, down from 4.5% in Q2/18 (see Chart 1).

Domestic demand picked up, driven by strong private consumption due to the tax holiday in July and August and by improvement in private investments. In the public sector, the pick-up in government consumption helped to offset some of the decline in public investments, which has been driven by the review and cancellation of several big infrastructure projects. But the main reason for the slowdown was the 7.5% yoy decline in net exports, compared with 1.7% yoy growth in Q2/18. Supply shocks in agriculture and the mining sector were the main contributors to the weak export performance.

In 2019 growth will be supported by an expansionary budget. The 2019 budget focuses on raising the standard of living, especially for lower-income groups. Targeted cash aid and fuel subsidies, higher minimum wages and tax exemptions for individuals should support private consumption, which constitutes around 58% of GDP. Moreover, the government plans to settle all outstanding tax refunds, estimated at RM37bn, including RM18bn in income tax and RM19bn in the goods and services tax (GST). But, the income tax refund for individuals will affect mainly the more affluent taxpayers, who are unlikely to significantly boost their consumption. Nevertheless, most refunds will go to businesses. Corporates could spend it on investment, but given the external uncertainties, they are more likely to pay off some of their debts.

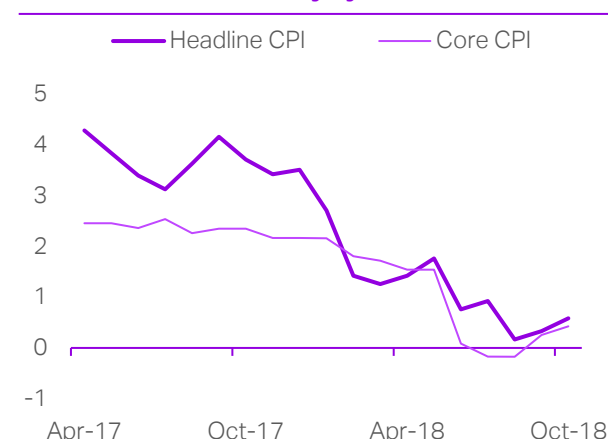
To raise more revenues, the government intends to hike stamp duties and the property gains tax as well as casino duties and fees. Moreover, a soda tax, a tax on imported services and an airfare levy for travellers will all be imposed next year. After several years of fiscal consolidation (see Chart 3), the new government is targeting a fiscal deficit of 3.7% of GDP this year (the original target was 2.8%) and 3.4% in 2019. The bigger deficit reflects higher one-off spending as the current government recognizes – unlike the previous government – some off-balance commitments and supplementary expenditure requirements.

Chart 1: GDP growth qtr (% yoy)



Sources: CEIC, TS Lombard.

Chart 2: Inflation (% yoy)

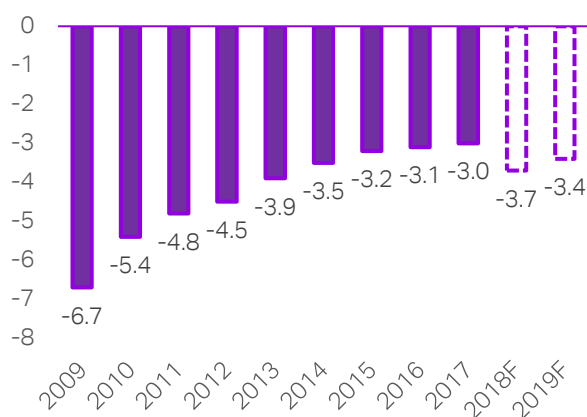


Sources: CEIC, TS Lombard.

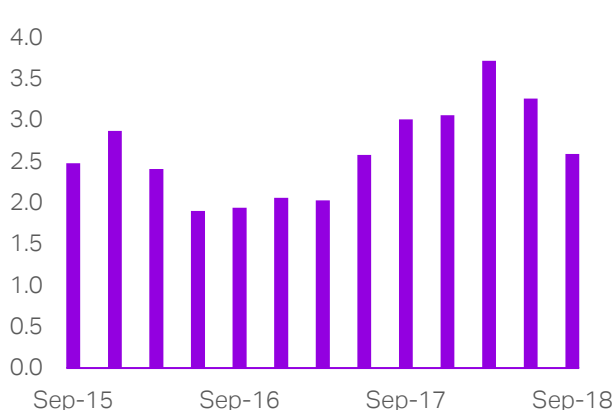
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But the external sector is a concern. In general, the impact of the US-China trade war will be negative as it will lead to lower volumes of world trade, which will likely hit small open economies such as that of Malaysia. However, in the short term the country could benefit from substitute demand from the US and China and, in the medium term, from production reallocation aimed at circumventing trade tariffs. Judging by our [solar panels case study](#), the shift of production and the subsequent export recovery could take 1.5-2 years to materialize. For this reason, we expect overall external demand to slow down next year. Combined with the impact of the cancellation and review of some big-ticket infrastructure projects, we expect GDP growth of 4.7% yoy in 2019. This is only slightly smaller than the 4.8% growth we expect in 2018 as private consumption will provide support.

Owing to low inflation, slower growth and the current account surplus, interest rates will remain on hold in 2019. Inflation is subdued owing to slowing growth and the net disinflationary impact of changes to the consumption tax regime (see Chart 2). We expect the effect of the tax reform to last for most of 2019, keeping inflation below 2%. Moreover, the fact that Malaysia is a net oil exporter contributes to its sustained current account surpluses (see Chart 4), which, in turn, provide a buffer against potential capital outflows driven by rising global interest rates. In this environment, it is unlikely that Bank Negara will increase interest rates in 2019.

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Chart 3: Fiscal balance (% of GDP)


Sources: Ministry of Finance, TS Lombard

Chart 4: Current account (% of GDP)


Sources: Bloomberg, TS Lombard.

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India: State election semi-final

The five upcoming state elections are seen as a semi-final before the general election in April-May next year. Amitabh Dubey believes that the BJP will lose seats but will be able to absorb the loss, and remain the frontrunner in the national contest. Promises of higher procurement prices and loan waivers in Chhattisgarh, where polls have closed, add an uncertain dynamic that could play out in the other agrarian states now going to the polls. See our 22 November report [State election turning point](#).

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China Watch: Gas demand may not rise as fast as expected

Gas demand has risen strongly in 2017-18 on the back of the environmental improvement programme. Stephen O'Sullivan explains that many 2018 demand forecasts appear too low in light of recent developments – we expect 17-18% growth this year. Conversely, 2020 forecasts look too high: watch for continuing coal-to gas switching, extension to southern China cities, infrastructure construction and access reform to determine if they are realistic or not. See our 21 November report [Chinese Energy: Stepping on the gas](#).

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

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

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Risk	-1			
	Equities (\$)	Currencies	Local rates	Credit (\$)
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

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

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

Absolute Views

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

Table 1: Current Absolute Views*

Country	Asset	Market view	Units	Date opened	Open level	Current level	Performance to date
Mexico	Sovereign credit	Positive	bp	12-Jun-17	149	205	-3.0% (-56 bp)
Indonesia	CNY/IDR	Negative	-	30-Jul-18	2,114.3	2,086.1	+3.3%

Date/time 26-Nov-18 08:09

Source: Bloomberg, TS Lombard.

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

Source: Bloomberg, TS Lombard.

Closed views are in [Table 2](#), below. Intra-day prices used for views that are opened or closed on the date of publication are modified to the close of business prices in subsequent reports. For further explanation, see our [methodology](#).

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Closed Views

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

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Table 2: Closed Absolute Views

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

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Source: Bloomberg, TS Lombard.

Intra-day prices used for views that are opened or closed on the date of publication are modified to the close of business prices in subsequent reports.

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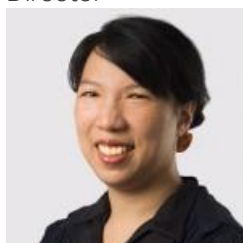
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