Deutsche Bank
Markets Research

Emerging Markets	Economics Foreign Exchange Rates Credit		Date 8 June 2017

Emerging Markets Monthly

Inflation "Bonus"

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Special Reports

The Anatomy of Breakeven Inflation in LatAm

EM Vulnerability Monitor

India's Macro Improvement in the First 3 Years of Modi Government

Mexico's Inflation: The Odd One Out

Turkey: CGF, the Current Account and TRY

Tales of Three Cycles: Mexico, Colombia, and Peru Trip Notes

Egypt: Staying the course

Deutsche Bank Securities Inc.

Note to U.S. investors: US regulators have not approved most foreign listed stock index futures and options for US investors. Eligible investors may be able to get exposure through over-the-counter products. DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1. MCI (P) 083/04/2017.

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Key Economic Forecasts

	Real GDP (%)			Consumer prices (% pavg)			Current account (% GDP)			Fiscal balance (% GDP)		
	2016	2017F	2018F	2016	2017F	2018F	2016	2017F	2018F	2016	2017F	2018F
Global	**3.1**	**3.6** ↑	**3.7** ↓	**4.3**	**5.3** ↑	**4.5** ↑	**0.4**	**0.3**	**0.1**	**-3.3**	**-3.2**	**-3.0** ↑
US	**1.6**	**2.4** ↑	**2.6**	**1.3**	**2.3**	**2.1**	**-2.6**	**-2.9**	**-3.2**	**-3.1**	**-2.9**	**-2.9**
Japan	**1.0**	**1.4** ↑	**0.8** ↓	**-0.1**	**0.4** ↓	**0.5** ↓	**3.7**	**4.0** ↑	**4.1** ↑	**-3.5**	**-3.5** ↑	**-3.2** ↑
Euroland	**1.7**	**1.8** ↑	**1.6** ↑	**0.2**	**1.6** ↑	**1.5**	**3.3**	**3.1** ↑	**2.9** ↑ -	**-1.5**	**-1.4** ↑	**-1.3** ↑
Germany	1.9	1.3 ↑	1.5 ↓	0.4	1.6 ↓	1.6	8.3	8.0	7.8	0.8	0.5	0.2
France	1.1	1.4 ↑	1.6 ↑	0.3	1.3 ↑	1.3	-0.9	-0.6 ↓	-0.5 ↓ -	-3.4	-3.1 ↑	-2.8 ↑
Italy	0.9	1.0 ↑	1.0 ↑	-0.1	1.4 ↑	1.3 ↑	2.6	2.7	2.3	-2.4	-2.3	-2.3
Spain	3.2	2.7 ↑	2.1 ↓	-0.3	2.0 ↑	1.8 ↑	2.0	1.9 ↑	1.8 ↑ -	-4.5	-3.3 ↓	-2.8
Netherlands	2.2	2.1	1.5	0.1	1.1 ↑	1.4 ↑	8.4	10.2	10.2	0.4	0.6 ↑	0.0 ↑
Belgium	1.2	1.6 ↑	1.6 ↑	1.8	2.3 ↑	1.9 ↑	-0.4	1.0	1.0	-2.6	-2.1 ↑	-2.1 ↑
Austria	1.6	1.8 ↑	1.6	1.0	1.9 ↑	1.6	1.7	2.8	3.1	-1.6	-0.9 ↑	-0.8 ↑
Finland	1.5	1.2	1.5	0.4	1.0 ↓	1.4	-1.1	-1.0 ↓	-0.7 ↓ -	-1.9	-2.1 ↑	-1.6 ↑
Greece	0.0	0.9 ↓	2.0 ↑	0.0	1.1 ↓	1.0	-0.6	1.0 ↓	1.0 ↓ -	0.7	-1.3 ↑	0.6 ↑
Portugal	1.4	1.7 ↑	1.3 ↑	0.6	1.2 ↓	1.5	1.0	0.7	0.7	-2.0	-2.0	-2.0
Ireland	5.2	4.0 ↑	3.2 ↑	-0.2	0.2 ↓	1.3 ↓	4.7	10.0	8.0	-0.6	-0.7 ↑	-0.5 ↑
Other Industrial Countries	**1.8**	**2.1** ↑	1.9	**1.0**	**2.2** ↑	2.2	**-1.6**	**-0.9** ↑	-0.7 ↑ -	**-1.2**	**-1.5**	**-1.2**
United Kingdom	1.8	1.6 ↓	1.2 ↑	0.6	2.7 ↑	2.8 ↑	-4.4	-4.0 ↑	-4.0	-2.9	-2.9	-2.5
Sweden	2.9	3.0 ↑	2.4 ↑	1.0	1.5 ↓	1.5 ↓	4.7	4.9 ↑	5.1 ↑ -	2.0	0.0 ↑	0.3 ↑
Denmark	1.3	1.7	1.8	0.3	1.1	1.4	6.5	6.5	6.5	-2.1	-2.5	-1.9
Norway	0.7	1.6	1.8	3.6	2.7	2.5	4.4	6.2	7.0	3.7	3.9	4.2
Switzerland	1.3	1.5	1.7	-0.3	0.5	0.7	9.5	9.3	9.0	-0.1	-0.1	-0.1
Canada	1.5	2.5 ↑	2.2	1.4	2.0 ↑	2.0	-3.6	-2.7	-2.1	0.0	-1.1 ↑	-1.4 ↓
Australia	2.5	2.4	2.9	1.3	2.3	2.1	-2.6	-0.9	-1.2	-2.2	-1.8	-1.2
New Zealand	3.1	3.2 ↓	3.0 ↑	0.6	2.0 ↑	2.3 ↑	-3.4	-3.5	-3.3	0.3	0.6	1.3
Emerging Europe, Middle East & Africa	**1.5**	**2.5**	**2.8**	**6.6**	**7.2** ↑	**6.0** ↑	**-2.2**	**-1.2** ↓	**-1.1** ↓	**-4.8**	**-4.1** ↓	**-3.7**
Czech Republic	2.3	2.8 ↑	2.1 ↓	0.7	2.3	2.0	1.1	1.1	1.0	0.6	-0.6	-0.6
Egypt	4.3	3.5	4.0	14.5	29.9	16.9	-5.6	-5.1	-3.8	-12.0	-10.9	-9.9
Hungary	2.0	3.5 ↑	3.3 ↑	0.4	2.5 ↓	2.9 ↓	4.9	3.2 ↓	2.8 ↓	-1.9	-2.5	-2.3
Israel	4.0	3.3 ↓	3.6 ↑	-0.5	0.5 ↓	0.9 ↓	3.9	3.3 ↓	2.9 ↓	-2.2	-2.6 ↑	-2.5 ↑
Poland	2.7	3.4 ↑	3.2 ↓	-0.6	1.9	2.1	-0.3	-1.1	-1.2 ↑	-2.5	-3.0	-2.9
Russia	-0.2	1.6	2.0	7.1	4.1 ↑	4.3 ↑	1.9	2.9	3.3	-3.4	-3.0	-2.2
South Africa	0.3	0.4 ↓	1.7	6.3	5.2 ↓	4.9	-3.3	-2.6	-2.8 ↑	-3.4	-3.0	-2.8
Turkey	2.9	3.4	3.7	7.8	10.6	8.5	-3.8	-4.5 ↓	-4.8 ↓	-1.1	-2.9	-2.1
Asia (ex-Japan)	**6.2**	**6.1** ↓	**6.1**	**2.6**	**2.4** ↓	**3.2**	**2.0**	**1.4** ↓	**1.2** ↓	**-3.1**	**-3.2**	**-3.1**
China	6.7	6.7	6.3	2.0	1.7	2.7	1.6	1.3	1.1	-3.8	-4.0	-4.0
Hong Kong	2.0	3.8 ↑	3.0 ↓	2.4	1.0 ↑	3.8 ↑	4.6	5.3 ↓	6.7 ↑	4.4	2.0 ↑	2.5 ↑
India	7.9	7.0 ↓	7.8	5.0	3.6 ↓	4.8 ↑	-0.5	-1.1	-1.5	-3.5	-3.2	-3.0
Indonesia	5.0	5.2 ↓	5.0 ↓	3.5	4.2 ↑	3.4 ↓	-1.8	-1.4	-0.8 ↓	-2.5	-1.6	-1.4
Korea	2.8	2.8 ↑	2.6	1.0	2.2 ↑	2.3	7.0	4.6 ↓	4.2 ↓	1.0	0.4 ↑	0.1 ↑
Malaysia	4.2	4.8 ↑	4.7	2.1	4.2	2.7	2.4	1.6 ↓	2.2 ↓	-3.1	-3.0	-2.9
Philippines	6.9	6.2	6.5	1.8	3.2 ↓	3.3	0.2	-0.1	-1.2	-2.4	-3.0	-3.0
Singapore	2.0	2.5	3.0	-0.5	0.9 ↓	2.1 ↓	19.1	21.0	21.4	1.3	0.4	1.2
Sri Lanka	4.4	5.0	5.5	4.0	6.0 ↑	4.5	-2.4	-2.7	-2.7	-5.5	-5.0	-4.5
Taiwan	1.5	2.3	2.3 ↓	1.4	1.1 ↓	1.7 ↑	13.6	10.9 ↓	10.3 ↑	-0.2	-0.2	-0.4 ↓
Thailand	3.2	4.0	4.0	0.2	0.8 ↓	2.0 ↓	11.5	10.1 ↑	10.1 ↑	-2.8	-2.8	-2.8
Vietnam	6.2	6.4	6.5	2.7	4.1 ↓	6.1 ↑	3.8	-0.5	-0.9	-6.0	-5.4	-5.0
Latin America	**-1.1**	**1.2** ↑	**2.4** ↓	**27.4**	**35.9** ↓	**23.0** ↑	**-2.1**	**-1.9** ↑	**-2.1** ↑	**-6.8**	**-6.5** ↓	**-6.0** ↓
Argentina	-2.3	2.4	2.8	40.9	26.6	17.4 ↑	-1.8	-3.0	-3.3	-5.8	-6.2	-5.5
Brazil	-3.6	0.7	2.4 ↓	8.7	3.8 ↓	4.2 ↑	-1.3	-0.8 ↑	-1.7 ↑	-9.0	-8.2 ↓	-7.8 ↓
Chile	1.6	1.5	2.8 ↑	3.8	2.7 ↓	2.8 ↓	-1.4	-1.3	-1.0	-2.1	-3.2 ↓	-3.2 ↓
Colombia	2.0	2.0	3.0	7.5	4.5	3.6 ↓	-4.4	-3.7	-3.5 ↓	-4.0	-3.9 ↓	-3.6 ↓
Mexico	2.3	1.8 ↑	2.4	2.8	5.8 ↑	4.6 ↑	-2.1	-2.7	-2.6	-3.0	-2.6	-2.4
Peru	3.9	2.6 ↓	4.0	3.6	3.2 ↓	2.4 ↓	-2.8	-2.2 ↑	-2.3 ↑	-2.6	-3.1	-3.5
Venezuela	-10.0	-4.5	-2.5	320.4	555.0	350.0	-3.4	-0.9	0.7	-25.7	-26.1	-23.8
Memorandum Lines: 1/												
G7	**1.5**	**1.9** ↑	**2.0**	**0.8**	**1.9** ↑	**1.8**	**-0.3**	**-0.4** ↑	**-0.5**	**-2.6**	**-2.5**	**-2.5**
Advance Economies	**1.6**	**2.1** ↑	**2.0**	**0.7**	**1.8**	**1.7** ↓	**0.1**	**0.1** ↑	**-0.1** ↑	**-2.4**	**-2.3**	**-2.2** ↑
Emerging Markets	**4.2**	**4.7**	**4.9** ↓	**6.8**	**7.7** ↑	**6.3** ↑	**0.5**	**0.4** ↓	**0.3**	**-4.0**	**-3.8**	**-3.6**
BRICs	**5.3**	**5.7** ↓	**5.9**	**3.8**	**2.6** ↓	**3.5**	**0.8**	**0.6**	**0.4**	**-4.1**	**-4.0**	**-3.9**

↑/↓ Indicates increase/decrease in level compared to previous EM Monthly publication; a blank indicates no change

1/ Aggregates are PPP-weighted within the aggregate indicated. For instance, EM growth is calculated by taking the sum of each EM country's individual growth rate multiplied it by its share in global PPP divided by the sum of EM PPP weights.

Egypt forecasts are fiscal year forecasts

Source: Deutsche Bank

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This Month's Special Reports

The Anatomy of Breakeven Inflaton in LatAM
We study the relative valuation of LatAm's BEI versus their drivers. We conclude that other than Mexico, breakevens are cheap not only optically but also from a conditional point of view. That said, the high sensitivity of inflation expectations brings a caveat to the analysis: if the latter keep on declining the breakeven curves will likely continue to bull-flatten independent of their "cheapness". At the opposite side of the spectrum, we see Mexico's nominals performing vs linkers if inflation does stabilize and resume convergence to the target in the next couple of months as we currently foresee.. 14

EM Vulnerability Monitor
Strong inflows to EM largely explained by 'push' factors rather than 'pull' factors. In this report, we take stock of the internal conditions in EM by assessing macro. Overall EM macro vulnerability increased slightly over the past few months; but this comes after a period of sustained improvement, hence the level of macro vulnerability remains subdued........19

India's macro improvement in the first 3 years of Modi Government
Prime Minister Narendra Modi-led NDA government completed its third year in office last month. During this period, a number of landmark reforms have been implemented, while the macro picture has also improved significantly. In this Special, we take stock of the changing macro landscape by comparing the progress in the last three years with that of the preceding five-year period across 24 key economic indicators. We also provide FY18 and FY19 forecasts for key economic indicators to indicate what lies ahead.. 30

Mexico's Inflation: The Odd One Out
The combination of a sustained FX depreciation and a surprising increase of gasoline prices have left Mexico as the only LatAm economy with rising inflation and a hiking cycle. An inflation forecast that combines seasonal and structural factors as well as leads us to expect Banxico to cut the policy rate in H2 '18 once the uncertainty regarding the '18 election is on the rearview mirror. 36

Turkey: CGF, the current account, and TRY
The Turkish government introduced quantitative measures to revive business loans in the aftermath of failed coup attempt last year. The take-up has been remarkable with trend growth in commercial credit having jumped to 50% in May. Such explosive rate has recently led to elevated concerns over external gap, given the close relation between credit growth and external balances in Turkey. Our findings reveal commercial credit per se does not have a significant impact on the current account. External gap is however fairly responsive to consumer loans, TRY and import prices. Rather than the size of current account, we are more worried about its funding this year, and still expect the lira to remain weak due to fundamental reasons, including lack of adequate FX buffer against external shocks as well as a vicious circle between TRY and inflation under CBT's liquidity-focused framework.. 42

Tales of Three Cycles: Mexico, Colombia, and Peru Trip Notes
We present the key findings of an investor trip to the largest investment grade economies in LatAm. The worst of the cyclical slowdown seems to be behind in the three countries, but there is uncertainty on the strength of the recovery in 2018. Contested elections are likely to weigh on sentiment and postpone needed fiscal consolidation in Colombia and Mexico. Peru is better-positioned to jump-start investment due to ample fiscal buffers, mining competitiveness and reforms to expedite reconstruction, but it requires the de-escalation of political conflicts. Local rates in all countries still price some premium that will likely support receivers in this accommodative global backdrop. Peru's rising metals production and stronger external position favor the PEN vs. MXN and COP, particularly given the worsening outlook for the oil industries in Colombia and Mexico. 51

Egypt: Staying the course
Egyptian authorities reached a staff-level agreement with the IMF on the first review under the US$12bln EEF. The Current account improved and private sector inflows picked up markedly allowing for FX accumulation by the CBE. Risks stem from persistent inflation and reform fatigue.. 58

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Emerging Markets and the Global Economy in the Month Ahead

- EM's "intrinsic" value has diminished, but so have the incentives to divert flows into DM. We see inflows still favoring fixed income despite tight valuations. Vols seems set to stay low for longer, which is crucial to compensate for lower carry.
- US growth acceleration has been priced out and US-EU growth differentials have narrowed. We see less of a boost for EM assets from both UST yields and the USD, which may have bottomed. Instead, we expect narrower range for global rates and FX – favoring carry/vol.
- For EM CBs, more favorable external developments do bide time. Our composite EM inflation expectations index shows a continued decline in inflationary pressures overall in EM space. While largely idiosyncratic, we see an inflation lull in Asia and CEE, and continued disinflation in commodity exporters.
- This low inflation external "bonus" has been accompanied by heightened market complacency. Premium has been compressed while political risks have re-emerged in the US-Russia relationship, realignment in the Middle East, while often detrimental in South Africa and LatAm.
- EM FX has led the USD but significantly lagged the EUR. We expect some reversal of this trend and favor carry with reduced DXY exposure. Stay long TRY, USD/INR puts and range-bound BRL. Position for retracement in CNH (vs. KRW) and in USD/TWD, but hold long USD/RUB and open long USD/MXN. Favor CE3 long vs. EUR and open short EUR/PEN.
- In local rates, limit short-end receivers to Brazil, Russia, and Israel while switching to 5Y in Turkey. Open short-end steepeners in CZK IRS. Favor flatteners in Colombia, Peru, Hungary, South Africa (vs. 5Y IRS) and in Israel (vs. US). Stay long duration in Indonesia, Romania, and hold MYR bonds FX-unhedged. Only in Mexico and Thailand we favor linkers vs. nominals on valuation.
- We remain constructive credit on supportive external and technical drivers but stay close to the benchmark given tight valuation. Overweight Argentina, Ecuador, Mongolia, underweight South Africa, Hungary, Poland, Peru, and Sri Lanka.
- In relative value, favor 36s vs. 28s and EUR Discounts vs. USD Discounts in Argentina, 26s vs. 28s in Russia, 27s vs. 24s in Ecuador, 47s vs. 40s, 27s vs. 25s in Egypt, MONGOL 2021s vs. SRILAN 25s. We also retain long Argentina Pars vs. 5Y CDS, South Africa 24s vs. 5Y CDS, and Turkey 26Ns vs. South Africa 26s.

The Inflation "Bonus"

EM's "intrinsic" value has diminished, in our view, but so have the incentives to divert flows into DM. Premium across EM asset has been compressed and politics are weighing on growth prospects throughout most of LatAm and other large emerging economies such as South Africa and Turkey. Asian exports posted strong gains in Q1, but the latest signals suggest that they have peaked. However, the risk of portfolio rotation into more growth-sensitive and DM assets has also been tamed by the lack of meaningful initiative to deregulate and stimulate the larger DM economies. This impasse has again tamed vols faster than carry.

We expect inflows to continue to favor fixed income despite tight valuations. Inflation risks have eased globally and core central banks have reinforced their measured stance. This reduces the risk of policy surprises. Asia was accelerating more noticeably in Q1 and inflation risks were rising, but recent global developments likely bide the region's central banks time. The same applies to CE3, while – with the help of easing food prices and FX pressure – inflation across South Africa, Turkey, and most of LatAm (ex-Mexico and Argentina) is easing.

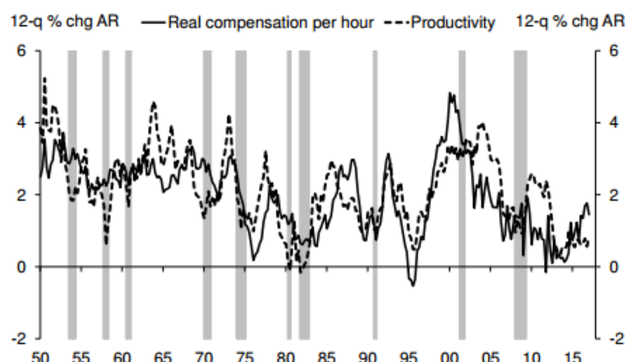
EM in a World of Diminished Expectations

Volatility seems set to stay low for longer, which is now crucial to compensate for lower carry.

DM Growth: Reduced upside, low downside. While "momentum" remains solid in the EU, markets have priced out acceleration in the US. Still, the flipside risk of pricing higher risks of recession seems low to us – especially at this gradual pace of policy normalization and contained inflation. Both hard and soft data have been consistent with US growth running near 2.5% and the recent deceleration in hiring should be taken as a normal by-product of an economy that is approaching full-employment. Employment growth peaked in 2015 and it has naturally decelerated since. At 4.3%, unemployment is running at its lowest since May 2001.

We expect the FOMC to stay the gradual course. At 2.5% yoy, average hourly earnings are consistent with the recent pace of productivity (chart) and consistent with gradual reflation. What is missing – and unlikely to materialize soon – is a boost to both investment and productivity that would push the economy to higher-growth/rates equilibrium. Altogether, tail risks to both inflation and growth are now low. Also, with US equities earnings growth in mid teens, the downside for equity markets seems limited in the near term.

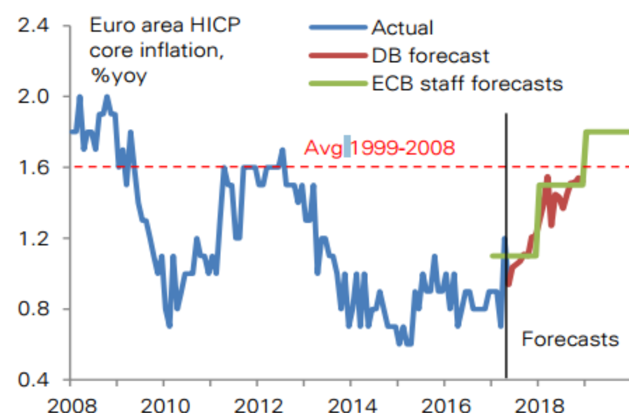
US: Upside limited by productivity



Source: : BLS, Haver Analytics & Deutsche Bank.

Core rates: Slowly but surely DB expects the FOMC to hike by 25bp in June then announce the details of tapering its reinvestments in September, and hike again in December. Tapering would start in October to give the FOMC time to assess its impact before hiking again later in the year. In light of recent data markets will likely test the FOMC's conviction to hike three times keeping UST 10Y subdued. However, with term-premium at the lows since August 2016 (near -25bp in our estimation) and growth running above trend, we believe UST yields are near the bottom. In contrast, DB's rates strategy see more premium in the EU curve, while our economists now believe the ECB will refrain from changing forward guidance or sending more hawkish messages given EUR strength.

EU: Core inflation is about to turn.



Source: Deutsche Bank; Eurostat, ECB.

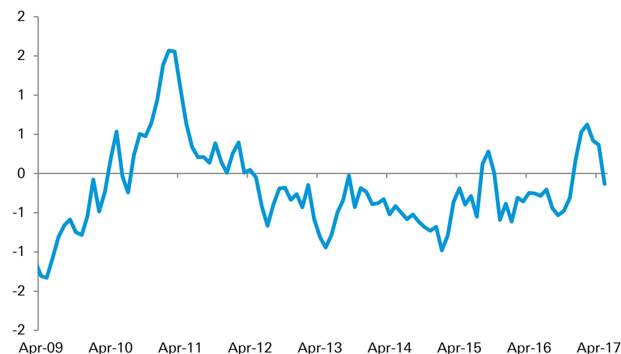
EUR/USD: More balanced risks. We have been of the view in recent months that falling US growth expectations favored the EUR. But cleaner positioning, recent EUR appreciation, a potential ECB reaction and re-priced US-EU growth gap suggest a narrow range in the coming month instead. Also, the ECB Council may delay tapering[1], since it remains "unconvinced" about inflation, the euro has strengthened, and September elections in Italy are likely. We doubt we will see an outright dovish ECB, however. Surveys continue to imply upside risks to ECB's (and DB's) 1.8% growth, and core inflation is about to turn (chart above). Rather than jawboning the EUR weaker, we expect the ECB to preempt a stronger currency.

EM: Bonus and Onus

To start with a word of caution, this low inflation external "bonus" has been accompanied by heightened market complacency. Premium has been compressed despite unresolved leverage issues in China and growth outlook for large economies such as Brazil, South Africa, and Turkey has deteriorated. Debt dynamics are most explosive in Brazil, where subdued market pressure is hardly conducive to action. In South Africa, poor growth outrun will weigh on ratings. The EM electoral calendar is light this year, but it picks up significantly in 2018. Entering this cycle with weakened fundamentals may backfire if external conditions turn less supportive.

For local central banks, however, external developments do bide time. Our composite EM inflation expectations index (chart) shows a continued decline in inflationary pressures overall in EM space.

Continued decline in expected inflationary pressures

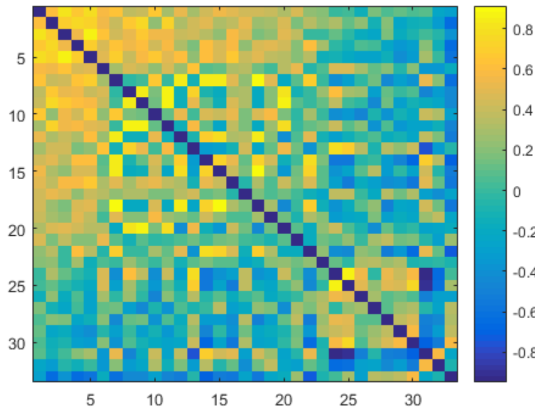


Note: composite EM inflation expectations is the median the inflation expectations score from our Emerging Markets Inflation Heatmap publication. Countries in the index include: Czech, Hungary, Poland, Russia, South Africa, Turkey, Brazil, Mexico, China, Indonesia, Malaysia, Korea, and Colombia. Source: Haver Analytics, CSO and Deutsche Bank

As we have highlighted earlier, EM inflation remains largely idiosyncratic. This also applies to core inflation. But evidence from a monthly panel from more than 30 EM countries, over a history of one hundred months, shows that CPI core inflation exhibits some degree of synchronicity in seasonal patterns (see figure below).

[1] DB expected it to be pre-announced in September.

EM core inflation: Some common seasonal factors..



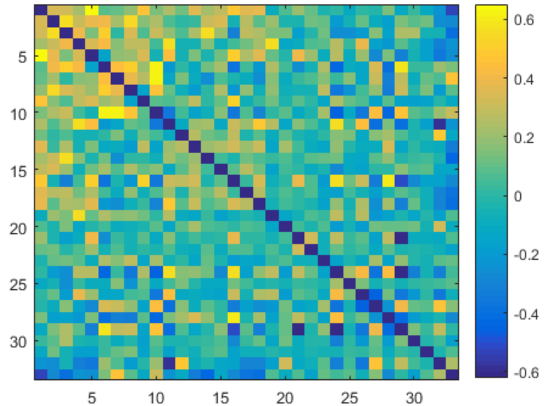
Note: Seasonals are obtained from an unobserved components decomposition methodology, and cross correlations are shown in the colored matrix above. Bright yellow values correspond to high positive correlations, while dark blue values correspond to high negative correlations. Source: Haver Analytics, CSO and Deutsche Bank

However, evidence of synchronicity in trend changes[2] is much weaker. Importantly, changes in CPI core trends in EM are still loosely disconnected from changes in core inflation in the EU and US (first and seventh columns, respectively in cross-correlations figure below). Again, the takeaway from recent years is that it will take stronger reflationary forces in DM to act as a coordination device across EM cycles. Differences stem from varying stages in the business cycles, base effects from FX pass-though, changes in the monetary policy frameworks, and local supply shocks in food prices. Nonetheless, we see inflation decelerating in a number of countries.

In Asia, due to falling food prices, headline inflation is likely to be muted for some time. As region's negative output gaps close, however, we expect inflation to return. In South Korea and Taiwan, we could see food price inflation returning as soon as June, due to bad weather conditions. We expect the region's CPI inflation to rise above 3% in 2018 – levels not seen since 2012. Higher inflation would guide real rates lower, deeper into negative territory for some. Real rates are already negative in Malaysia, the Philippines, Singapore and South Korea. In response to sustained economic recovery and rising inflation, we expect EM Asia's central banks to follow the Fed in monetary tightening.

Our Taylor Rule model suggests that the regional monetary policy rates look at least 50bps too low, on average. We expect the BSP to move first, hiking its policy rates by 25bps in August, followed by a 25bps rate hike by BI in October, while others follow in 2018. Apart from the two, Korea's policy rate looks also too low. Meanwhile, we also expect a reversal of EM Asia currencies' strength in 2H, taking away one more reason for CBs to maintain their dovish bias.

..but less in common when it comes to inflation trends



Note: cross-correlations in the month-on month changes in stochastic trends on individual EM core CPI series are shown. Bright yellow values correspond to high positive correlations, while dark blue values correspond to high negative correlations .Source: Haver Analytics, CSO and Deutsche Bank

In EMEA, inflation is subdued. Turkey stands apart, but even here we have hopes of deceleration in inflation. In Turkey, we expect only a shallow and cyclical improvement in inflation during summer, which CBT could take advantage from – but not now (perhaps in late July or early August). Further rise in deposit and loan rates, reflecting the impact of the Credit Guarantee Fund on both loan demand and supply (read more in our special report *Turkey: Credit Guarantee Fund, the current account, and TRY*), could however accelerate the CBT move. In Russia inflation came down to the CBR target of 4% in recent months, allowing the CBR to continue with cuts even if effects of the good harvest are fading. In South Africa, we continue to see downside momentum on inflation. Inflation decelerated sharply in recent months, as we had expected with core at 4.8% - lowest in four years.

In CEE inflation appears to be topping off. In Czech, inflation expectations have declined for two months in a row and hikes may be even pushed into 2018. In Poland inflation has already softened of late and we now expect NBP on hold until end-2018. In Hungary, we expect inflation to reach target-compliant levels on a sustainable basis from late 1H2018 onwards, allowing NBH to continue with accommodative stance.

In LatAm, disinflation remains the norm with the notable exceptions of Argentina and Mexico. In both cases the electoral cycle is playing an important role, although in Mexico it is also the consequence of a significant adjustment in gasoline prices, seasonality, and steep depreciation, as we discuss in a special

[2] We compute the cross-correlations in the month on month changes in stochastic trends, where we decomposed a liberalized series into stochastic seasonal, irregular and smooth trend-cycle components, under well known unobserved component ARIMA extraction methods, controlling for the presence of a variety of outliers, including level shifts in the original series.

report *(see "Mexico's Inflation: The Odd One Out").* In both cases central banks have tightened, but, while Argentina may be able to resume easing soon, Banxico has yet to tighten further on still rising inflation. We expect another 25bp next, but another 25bp (or more) is possible if inflation fails to turn during the summer. The PRI's victory in Edomex has eased concerns, but it also invites stronger campaigning in 2018. This may trigger fiscal loosening – another potential onus for disinflation and ratings. We expect the central banks of Brazil, Colombia, and Peru to continue easing.

Politics may remain a drag on growth and reform agenda. While US-Russia relationship as well as geopolitical re-alignment in the Middle East have been at the forefront of the news, politics is important in many countries. But it seems that external conditions would have to deteriorate for markets to fully price in these risks. In Mexico, near-term political noise has eased, but recent data show moderating consumption, plummeting investment, rising unemployment, and weaker imports of intermediates and manufacturing exports. In Brazil, the outlook for reforms has dimmed, and debt dynamics remain explosive. A strong President has been crucial in pushing reforms, and this seems to be missing now. Moreover, investigations continue and this will likely divert the attention of both Congress and the Executive branch.

In South Africa politics is weighing on activity. We expect the next large event to be the Policy Conference in June/July. Post the NEC meeting, whereby the President remained intact, it is very likely that the "no confidence" vote in Parliament (when it happens) will fail. The ANC has decided to reunite for now. In Colombia, the outlook is unlikely to improve significantly either ahead of highly contested congressional and presidential elections in 2018. In Peru, political compromise may be nearer, which in combination with reconstruction efforts, favorable terms of trade, mining competitiveness and monetary accommodation support a sharp recovery into 2018 amid falling inflation and contained CAD. In Turkey, more encouragingly, we expect a lull in political news.

Strategy: Squeezing premium - again

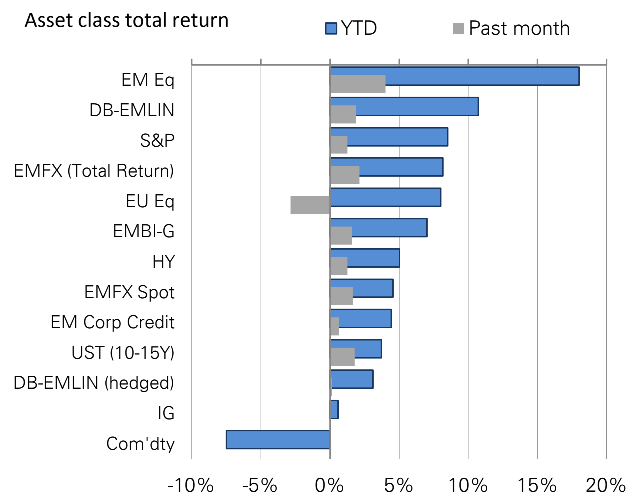
We expect EM inflows to continue but to decelerate as valuation has turned less compelling. The push forces remain strong, with above-potential growth in the US and EU amid low inflation as the central scenario, while the most detrimental stagflation scenario seems now even less likely. Also, USD weakness has been supportive to cross-border and portfolio flows – a crucial external tailwind as we discussed in our previous Monthly (see EM's Slow Turn: The Green Shoots). Therefore we refrain from turning outright negative EM markets despite overall tight valuations, since as carry alone – under low vol – seem enough of an anchor for foreign investors.

In credit, we remain constructive due to supportive external and technical drivers but stay close to the benchmark given tight valuation. We favor higher-yielding credits with a positive narrative - overweight Argentina, Ecuador, Mongolia, underweight South Africa, Hungary, Poland, Peru, and Sri Lanka.

EM FX has outperformed the USD but significantly lagged the EUR. We expect some reversal of this trend and favor carry with reduced DXY exposure. Stay long TRY, USD/INR puts and range-bound BRL. Position for retracement in CNH (vs. KRW) and in USD/TWD, but hold long USD/RUB and open long USD/MXN. Favor CE3 long vs. EUR and open short EUR/PEN.

In local rates, limit short-end receivers to Brazil (July 18), Russia's 19s and local swaps (with front-end flatteners in XCCY), Israel (3Y1Y) and switch to 5Y receivers in Turkey. Open short-end steepeners in CZK IRS. Favor flatteners in Colombia, Peru, Hungary, South Africa (vs. 5Y IRS) and in Israel (vs. US). Stay long duration in Indonesia, Romania, and hold MYR bonds FX-unhedged. Despite disinflation only in Mexico and Thailand we favor linkers vs. nominals on valuation.

Collateral benefits of lower volatility



Source: Deutsche Bank; Bloomberg Finance L.P..

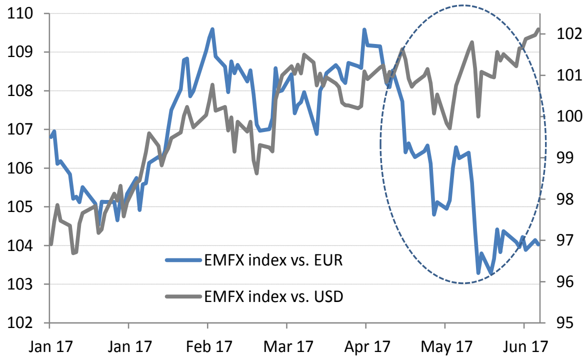
EM FX: Dollar sedation

The weak USD has overshadowed some deterioration in fundamentals. EM currencies are back to highs vs. the USD, but this is mainly a by-product of USD weakness rather than EM FX strength. In fact, the opposite holds against the EUR – the hard currency of recent months. As the chart below shows, EM FX is trading near the lows of the recent range vs. the EUR.

In our view, this underperformance vs. hard currency reflects not only the unwinding of reflation trades of the

past months, but also diminished expectations for several important emerging economies. The latest on Asia exports suggest a peak, political noise in Brazil and South Africa will take a toll on growth, and China's deceleration may also weigh on commodities and trade.

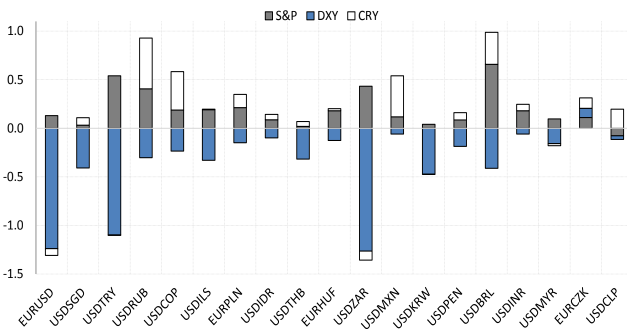
EM FX: Strong vs. the USD; weak vs. the EUR



Source: Deutsche Bank

Encouragingly, Asia inflows remained surprisingly strong in May (at $53bn ytd) – with the help of reduced global markets volatility. But the quarterly pace of portfolio inflows into EM is running near multi-year highs and it seems unlikely to hold. Altogether, we expect external (push) forces to dictate returns.

EM FX exposure: High DXY exposure



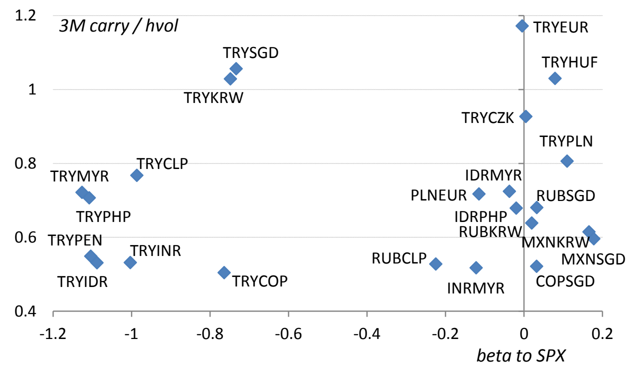
Source: Deutsche Bank. Last 3 months, in 2-day returns.

Choice of funding will be crucial for performance in coming months. Having favored USD funding vs. the EUR we see increasing risk of ECB jawboning at current levels. This may set a floor for EUR/EMFX. Also, as the chart above shows, DXY betas are relatively high when compared with US equities and commodities betas – and they have increased over the past 2-3 months. In our view, this combination favors reducing DXY exposure and a bias toward more EUR funding – outright or via a basket.

"Safer" carry trades are now scarcer. When we extend our trade search to EM crosses and look to maximize carry-vol while minimizing exposure to DXY we find a concentration around TRY longs — and funded by EUR, SGD, MYR, and KRW (chart). Most high-carry crosses have been either too volatile or too sensitive to external shocks. We recommend staying long TRY on valuation, relatively light bond positioning, and tight monetary policy. Also hold USD/INR puts on lower positioning unwinding risk.

Having been stopped of long BRL/MXN we see BRL holding the more elevated range (especially vs. the EUR) on strong FDI vs. CAD, reduced local positioning, and our perception that foreign investors will turn a blind eye on minimal reforms and likely fiscal and overall macro deterioration through 2018. We find risk-reward less appealing in ZAR at current levels, and open long USD/MXN on recent outperformance, worse positioning, and unresolved fiscal and political issues. We hold long USD/RUB on valuation and increased geopolitical risk.

EM FX crosses: Maximizing carry/vol vs. DXY exposure



Source: Deutsche Bank; Bloomberg Finance L.P...3M carry and vols. Censored by highest carry-to-vol and lowest betas

In Asia, the impact on the other currencies in the region of the less predictable and transparent "counter-cyclical factor" in CNH fixing has been muted. Fundamentals and the widening gap vs. DXY suggest further CNH retracement, which we express via CNH/KRW longs on valuation and positioning. Also, sell USD/TWD on excessive longs by insurers, banks, and exporters. Positioning, reduced political noise, and CA also support shorting USD/THB.

In low-yielders outside Asia, spillovers from EU's upbeat growth, valuation, strong CA, robust macro, and steady reflation favors CE3 vs. EUR in these countries. Similarly, a cyclical upturn and recovery in exports underpin our recommendation to extend the target on USD/ILS shorts to 3.45. We also recommend shorting EUR/PEN on valuation, improving CA, and our view that the economy is about to turn. In contrast, low growth and fiscal slippage support selling USD/COP downside, in our view.

- **Asia**: Long 3M CNH/KRW NDF (target 175 spot); Short 3M SGD/PHP NDF (target 34 spot); Short 6M USD/TWD NDF (target 29 spot); Long USD/SGD 1.42 call w/1.455 RKO; Short 3M USD/THB (target 33 spot); Long 6M ATMS USD/INR put.
- **EMEA**: Short USD/TRY (target 3.40); Long 3m 59:62.5 USD/RUB call spreads; Long CE3 (equally weighted) vs. EUR (target 3% appreciation); Short USD/ILS (target 3.45).
- **LatAm**: Buy 1M USD/BRL DNT (3.19/3.40) @20% (~5:1 payout ratio, ref FX 3.27); Buy USD/MXN (target: 18.8); Buy ARS/MXN (target: 1.175); Buy 2M USDp/CLPc @ATMS with AKO @645 ~0.4%; Sell 1M USD/COP strangle (2850/3000) ~1.2%, ref FX 2915; Sell 3M USDc/COPp @2800 ~0.8%, ref FX 2915; Sell EUR/PEN (target: 3.560)

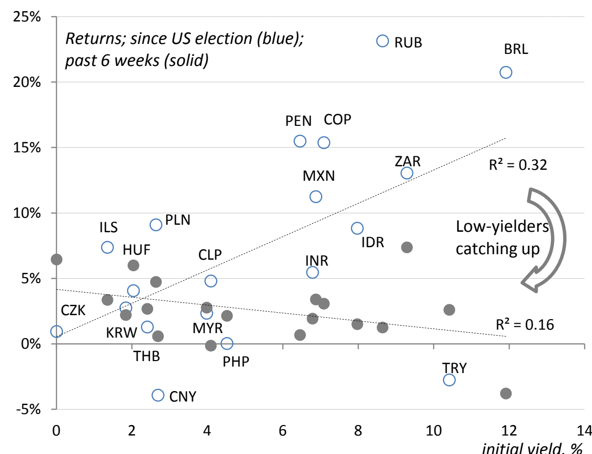
Local rates: Weaker pull, stronger push

Search for yield has been the main driver of performance for several months. However, we have seen signs of exhaustion in this trend. This has been evident in the waning outperformance of high-yielders and overall reduced returns. Pull forces such as valuation and local fundamentals have weakened – thus requiring stronger push from foreign investors. While carry-seeking investments have been persistent, we see reduced scope for rallies from a starting point of strong inflows, very low yields, and a weak USD.

We trim our receivers and expect investors to become more selective as appealing carry and valuation opportunities have vanished. In our previous Monthly, we recommended rotating into the laggards (mostly lower yielders) on strong performance of high-yielders and on the view that global yields would rally more broadly. As the chart below shows, this rotation has materialized in recent weeks, reducing the opportunities across all EM. Both "monetary" and term premia have made new lows throughout EM.

Markets are pricing monetary policy paths close to our forecasts – with few exceptions. We favor 1Y receivers in Brazil on the view that low inflation and lingering output gap support continued easing to 8.50% this year. We believe that worse fiscal prospect, increased FX risk, and possible loosening in public credit point to no further easing in 2018. In Russia, with cross-currency swaps overshooting our policy forecast but inflation comfortably reaching the 4.0% target, we recommend 1Y-2Y2Y flatteners in cross-currency swaps, while receiving in local swaps and short-end bonds instead as they have lagged. We also see room for retracement in the short-end of Turkey as core inflation eases and headline has peaked. Flows have been strong and positioning remains relatively light, but at almost 70bp inversion vs. funding we favor the 5Y sector.

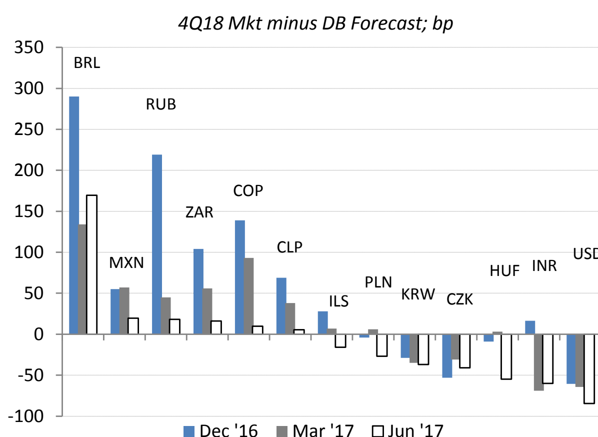
Rally exhaustion: Squeezing the lower yielders



Source: Deutsche Bank

We recommend taking profit in short-end receivers in Mexico, Colombia, Chile, Peru, and Poland, while paying Czech rates and positioning for bear-flattening in Hungary. Negative carry, currency strength, and lingering political uncertainty compel us to wait for better levels to re-enter receivers in Mexico. Valuation favors longer tenors in Colombia, Chile, and Peru, while robust wage growth and activity support bear-steepeners in Czech Republic. We also find premium-to-vol to be low in South Africa and see longer tenors more attractive. In contrast, carry-vol in Israel remains attractive, in our view.

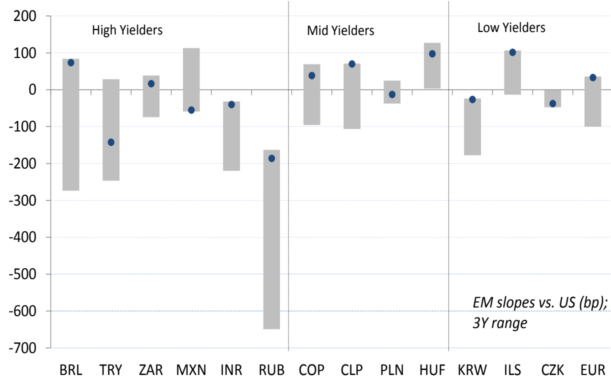
Shrinking "monetary premium"



Source: Deutsche Bank

We see a few left-over opportunities in longer tenors. EM slopes are mostly low vs. core curves (chart), but a few EM curves still offer some value. Colombia and Peru curves are relatively steep vs. shorter tenors given disinflation trends and light positioning in local pension funds. Israel remains steep vs. the US, while – across high-yielders – only Brazil and South Africa look dislocated vs. the US.

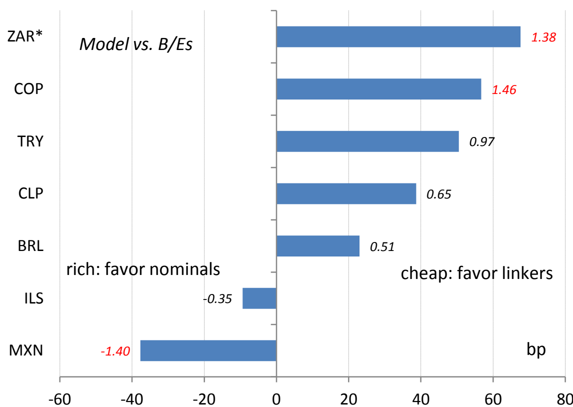
Long-end: Compressed slopes vs. US and EU



Source: Deutsche Bank

We have been bearish duration in Brazil for months and see no reason to change this view amid deteriorating fiscal accounts. In the case of South Africa, long-end bonds price excessive risk of downgrading, in our view, and we favor receivers vs. IRS payers. Romanian bonds are our top pick in CEE on improving inflation dynamics and light positioning. In Asia, we focus our duration exposure in Indonesia where premium is still high. Hold MYR bonds FX-unhedged. Elsewhere, the region compares unfavorably with EMEA and LatAm while yield seeking dominates.

Local fixed income: Assessing B/E inflation



Source: Deutsche Bank, *: Lowest R-square of regressions.z-score of residuals next to bars.

When comparing nominals vs. linkers we find that the unwinding of reflation trades has overshot in several cases. . Inflation breakevens in Brazil, Colombia, Chile, Turkey, and South Africa are running below what our model predicts – favoring linkers. In contrast, markets price a more subdued disinflation path in Mexico than our estimation (chart)[3].

- **Asia**: Pay 10Y KRW IRS, buy KTBs (target -20bp); Pay 5Y HK versus US swaps (target 0bp); Buy 3Y-6Y India bonds, currency unhedged; Buy MGS Sep-18 bonds, currency unhedged.
- **EMEA**: Long short-end RUB bonds: May-19 (target: 7.50%); Receive 1Y RUB IRS (vs. Mosprime) (target: 8.50%); Enter RUB 1Y–2Y2Y XCCY flatteners (target: -210bp); Switch from 1Y TRY XCCY receivers into 5Y TRY XCCY receivers (target: 10.25); Buy TURKGB Feb-20 (target: 10.0%); Pay 5Y HUF IRS vs HGB 25/B or 27/A); Receive ILS 3Y fwd 1y IRS (target: 1.00%); Buy 5Y5Y ILS IRS vs US-swaps (target: -0.20); Pay 2Y ILS vs Long ILGOV Oct-26 or Mar-27 (target: 125bp); Receive 5Y ILS vs 5Y CZK (target:-30bp). Buy ROMGB Feb-25 (target: 3.25%); switch from 6x9 CZK FRA payers into 6x9 FRA – 1Y1Y IRS steepeners (target: 40bp); Keep 5s10s CZK IRS steepeners (target: 75bp); Long POLGB Jul-21 (target: 2.00%); Pay 5Y ZAR IRS vs SAGB Dec-26 (target:90 bp).
- **LatAm**: Receive July 18 (target 8.85%) in Brazil, Jan22 vs. 3M NDF (target 45bp) and long 5Y BEI (target 300) in Chile. Switch from the front end (TES 19s) into TES26s (target 30bp of rally), and favor UVR 21s BEI (target 330bp BEI) in Colombia. Receive TIIE10s vs. US10s (target 480bp), and favor MBONO vs. MUDI in Mexico. In Peru. Receive in the 2Y sector of the cross currency swaps (target 485bp), and buy Soberanos 26s (target 5.10%).

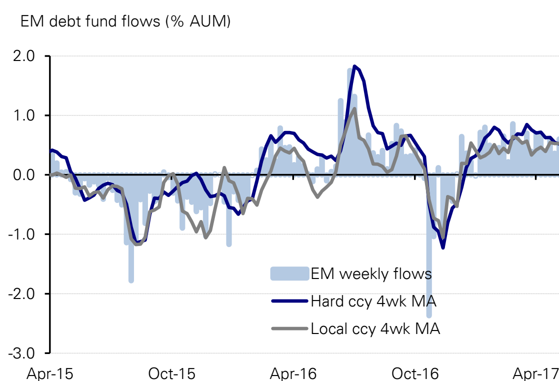
Credit: Carry On

The external backdrop continue to be supportive of EM credit. Most importantly for credit, core rate curves have bull-flattened, with the latest US employment report helping entrench the view of low-for-longer. An "unconvinced" ECB should also support gradual normalization. Commodities have dropped to the lower end of the range recently, but USD weakness benefits credit quality. Meanwhile, the very low volatility in the global risk markets – certain EM idiosyncratic risks not withstanding – continues to lend addition support for yield seeking and spread compression.

The setbacks in Brazil, South Africa, among others and lower external pull will weigh on cyclical growth recovery across EM, but external deficits have adjusted since 2013 to "safe" levels. There are clear problems in select countries, such as Venezuela, South Africa, and Brazil, but they are seen as idiosyncratic rather than systematic. Also, we think they will manifest themselves in higher sensitivity to external shocks rather than immediate repricing on increased complacency.

[3] See "The Anatomy of Breakeven Inflation in EM" in this publication.

Figure 1: Robust inflows

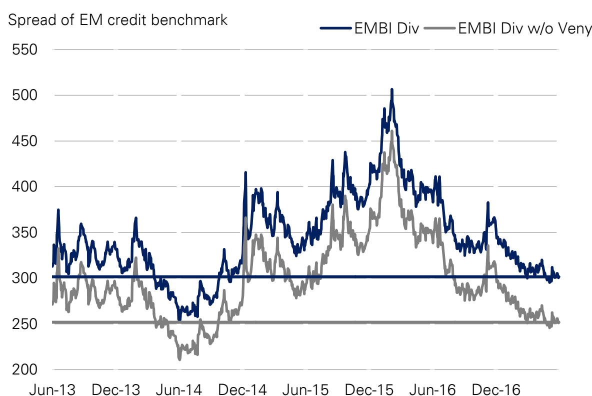


Source: EPFR, Deutsche Bank

Consequently, inflows into EMD funds should remain robust, underpinning supportive technical conditions. The EM hard currency funds are seeing its 24th week of consecutive inflows, having taken in USD 4.6bn (or 2.7% of AUM) in May, USD 20bn (or 13.3% of AUM) year–to-date. Despite an overweight positioning as indicated in our mutual fund beta measure[4], the robust inflows and a reduced pace of primary market supplies from the previous few months limit spread upside.

Valuation, however, looks very tight, even in the context of exceptionally low vols. Spread volatility has been exceptionally low since December 2016. The attractive carry-to-vol dynamic plays a key role in keeping demand for EM yields strong, in our view. However, EM credit benchmark has just bounced off the tightest level since September 2014, when commodity prices – already in correction – were much higher than the current levels. The current benchmark spread (EMBI Global Diversified) is at 300bp, but without Venezuela component, the spread is only around 250bp. The lack of intrinsic value in EM may constrain the extent of any further spread compression.

Figure 2: Spreads are back to late 2014 levels



Source: Deutsche Bank

We see enough reasons to stay constructive EM credit, but tight valuation and the lack of EM intrinsic value do not justify over-exposure. With the understanding of spread compression mostly driven by external factors rather than EM intrinsic value, and that risk premia have compressed very significantly, we see value likely limited to carry rather than in potential spread compression.

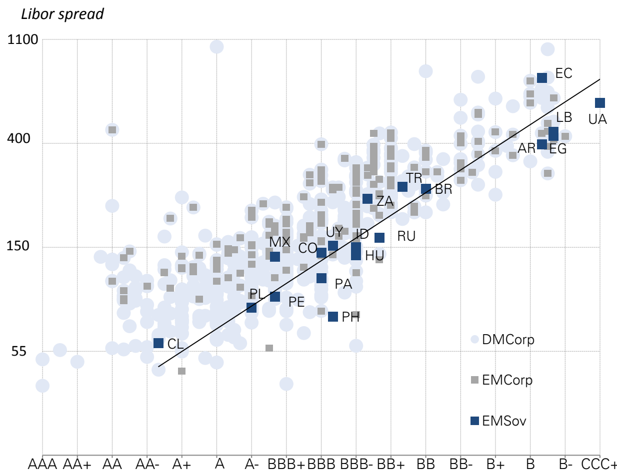
Our asset allocation preferences still favor higher-yielding credits, especially the ones offering a good narrative. Political noise and lower commodities have weighed on LatAm, but relentless search for yield have favored more indiscriminate investments and the laggards. We cover our underweight in Brazil as markets are turning a blind eye on lack of reforms and explosive fiscal accounts. We move both Argentina and Ecuador back to overweight and cover underweight on Colombia given the improvement in valuation over the past two months but move Peru to underweight purely due to the negative carry it offers vs. the benchmark. We are increasingly cautious on Venezuela given the political and financing situation, and focus on recovery value than potential profit on survival, and recommend investors position for price equalizations.

In EMEA, we retain our core underweight on South Africa, on the view that the recent recovery is unjustified given the country's negative trajectory – politically and economically. While we do not have a core overweight in the region, we continue to favor Russia, Turkey, Ukraine on relative basis vs. South Africa and CEE majors (Hungary and Poland) – the latter solely due to their tight valuation.

In Asia, we see no material fundamental catalysts that could help sovereign bonds outperform the rest of EM, even on volatility-adjusted basis in 2H17. We recommend use market strength to selectively reduce holdings in such curves as Philippines and Sri Lanka, put on cheap hedges via China & Korea 5Y CDS, reduce duration in Malaysia and go long Mongolia 2021s.

[4] See EM Debt: Technicals Monitor - May 2017.

Figure 3: Market valuation of EM sovereign credits in the global context



Source: EPFR, Deutsche Bank

In relative value, we retain a neutral position in terms of duration exposure overall, although we favor curve steepeners in Mexico and Malaysia. We favor long basis in Argentina (via long end bonds) and South Africa. Finally, we see a number of cash switch opportunities in Argentina, Russia, CIS, Egypt and Ecuador.

Summary of key recommendations

- Key overweights: Argentina, Ecuador, Mongolia
- Key underweights: South Africa, Poland, Hungary, Peru, Sri Lanka
- Inter-credit RV: AZERBJ 24s vs. SOIAZ 23s. Turkey 26Ns vs. South Africa 26s. MONGOL 2021s vs. SRILAN 25s.
- Curve trades: Malaysia 26s vs. 46s. Mexico 27s vs. 47s.
- CDS/Bond basis: Argentina Pars vs. 5Y CDS. South Africa 24s vs. 5Y CDS
- Cash RV: Russia 26s vs. 28s. Ecuador 27s vs. 24s. Egypt 47s vs. 40s, and 27s vs. 25s. YPF 25s vs. 24s. Argentina EUR Discounts vs. USD Discounts (FX-hedged); PDVSA 35s vs. 21s

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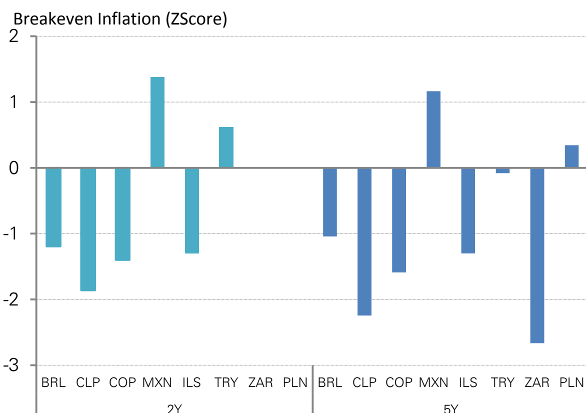
The Anatomy of Breakeven Inflation in LatAm

Introduction

With one exception (Mexico) LatAm BEI's have been hovering around their recent lows, many times implying forward inflation paths that are close (and at times through) the lower bound of Central Banks' adopted inflation targets. Beyond the consistent decline in spot and expected inflation, the low growth/disinflationary environment in the US, generalized USD weakness (low FX volatility), stable oil/commodities outlook and the continued foreign inflows into local markets (yield-seeking) have altogether contributed to the compression of BEI curves. Although the price action seems consistent with this "benign inflation backdrop", it is natural to ask whether BEI's are properly pricing this backdrop or have undershot fundamentals – especially in light of low inflation premia across the region (charts below).

2Y-5Y BEI: Hovering around the lows



Source: Deutsche Bank

Looking beyond the optical cheapness we question:

- Are LatAm BEI actually low (cheap) relative to their drivers or are they simply in sync with the overall deflationary backdrop?
- Besides "valuation", how sensitive are BEI to changes/shocks to these drivers across different curves?
- For a given curve, how should we expect different tenors to react to the aforementioned shocks?
- Is there any relevant commonality across different curves?

In an attempt to answer these questions, we develop a simple valuation framework for LatAm BEI based on the time-series behavior of the last 10-years. The framework allows us to:

- Indentify the main drivers within and across curves in a parsimonious fashion
- Quantify the richness/cheapness of BEI versus these drivers across curves/tenors
- Access the sensitivities to different shocks across curve/tenors

Qualitatively, we find that:

- Breakeven curves tend to be mostly driven by a "tilt" single factor, bull-steepening in sell-offs and bear-steepening in rallies.
- There is little commonality among markets despite their exposure to "external factors". However there is significant correlation within the Andeans (positive) and across the LatAm high yielders (negative, possibly spurious)
- Other than Mexico breakevens have in general undershot their fundamentals, being particularly cheap in Chile and Colombia
- Mexico breakevens are expensive across the board, in line with our view on spot inflation convergence in "Mexico's Inflation: The Odd One Out", published in June's Monthly

We divide the note in 3 parts. First we briefly explain our approach and how it efficiently summarizes the BEI dynamics across tenors/curves. We then explore country specifics and identify the drivers for each one of the curves, assessing both the relative valuation and sensitivity analysis. We conclude by placing specific recommendations across curve/tenors in the different markets.

Inflation Breakevens: A Simple Model

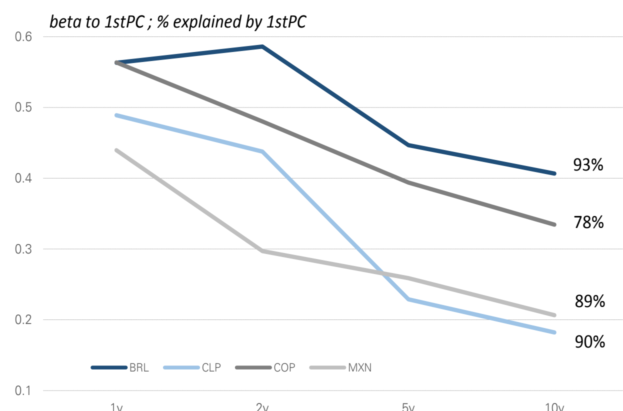
We choose a simple (yet effective) approach to jointly model the term structure of inflation breakevens (BEI's) for each of the markets considered. Starting with a 10-year history of fitted constant maturity BEIs (defined simply as the difference between fitted nominal and real yields) we follow the simple procedure for each of the curves studied:

- Extract the first principal component (1st PC) associated with the history/tenors (1Y,2Y,5Y,10Y) considered.

- Summarize the time series dynamics of the latter using a set of potential economic and financial drivers
- Draw valuation/sensitivity analysis for the 1st PC from the set above and map them back into observable yields

Extracting Latent Drivers: First Results Incidentally, the 1st PC explains the vast majority of the variance for the samples considered, being therefore a good summary proxy for the BEI curves dynamics in most cases. Our results suggest that volatility is in general higher in the shorter tenors, with curves bull-steepening when breakevens compress and bear-flattening otherwise which is in accordance with the exposure that the front end has to inflation carry. The “volatility decay” is however different across curves. It is milder in Brazil than in Chile for example. This is natural, since high-yielders tend to trade directionally with less “fine-tuning” than low-yielders, where inflation shocks and seasonality account for more of performance. The chart below depicts the results.

Sensitivity of Tenors to the 1st PC: The “Tilt”



Source: Deutsche Bank

A second result suggests little co-movement across the different markets in LatAm (a result that is for example different than EMEA): while individually exposed to similar external variables, BEI seem not to be exposed to a common external driver. That said, a closer look at the cross country correlations in LatAm suggests a strong co-movements among the Andeans (Chile and Colombia, positive) and among the “high-yielders” (negative, Brazil and Mexico). Although the former is in line with their small-economy, commodity-exporter status, the latter may be spurious or likely to change as Mexico has become more sensitive to oil shocks and also to shocks to fixed income inflows given the large share of foreign investment in local debt.

BEI markets: Correlated by blocks

	BRL	MXN	CLP	COP
BRL				
MXN	***-58%***			
CLP	32%	27%		
COP	16%	18%	***56%***	

Source: Deutsche Bank

What drives BEIs PCs? With the summary dynamics in hands, the next step involves mapping them into macro-observables. As suggested above we choose a “parsimonious approach”: from a set of “candidates”, that are statistically and economically significant and that could jointly explain a significant portion of the 1st PCs for the countries considered. The table summarizes the variables country-by-country as well as the signal of the contribution. Since rich-cheap/sensitivity analysis only makes economic sense for actual observable BEI’s we leave it to next session.

Drivers across LatAm: Diverse

	BRL	MXN	CLP	COP
Inf (YoY)	+			+
Inf Expect (12M)	+	+	+	+
Activity (YoY)			+	
Policy Rate		+		
FX				+
Local Equities		+		
Oil/Comm		+		+
US B/E (5Y)			+	
Total Explained	*83%*	*80%*	*81%*	*79%*

Source: Deutsche Bank

Accordingly:

- Across the different countries a relatively small number of observables explain the bulk of the BEI dynamics (only significant t-stats were selected)
- Not surprisingly, Inflation Expectations (12M ahead) shows as one of the main drivers of BEI (although not the only)
- Although unintuitive at first, the positive sign associated with policy rates in Mexico is associated with “FX-subordination period” when Banxico was perceived as targeting the FX (instead of inflation)
- Spot inflation is particularly important in Brazil and Colombia, consistent with the possible undershooting of the current cycle

- FX is significant in COP, consistent with our former studies of pass-through in the region
- US B/E's only appear to contribute in Chile suggesting that in the last 10-years, market implied expectations have been mostly dissociated from the US counterpart.
- Other than through the expectations channel, commodity prices seem to only play a relevant role in Mexico and Colombia

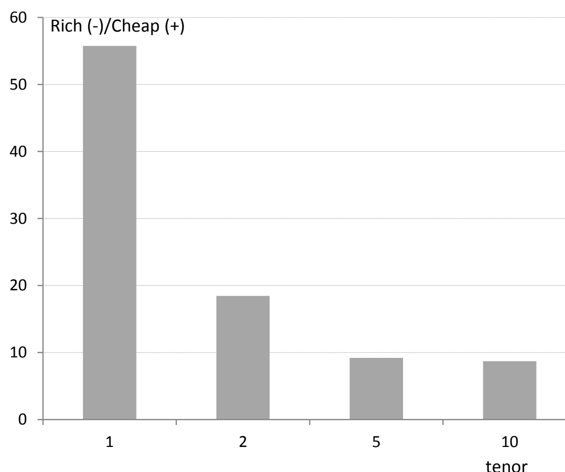
Rich/Cheapness and Economic Significance We map both the relative rich/cheapness and sensitivities of the 1st PC back into the original BEI term-structure using the factor loadings. Since the 1st PCs are good proxies of the BEI curve dynamics, the “macro-modeling” of the former can be translated to the latter.

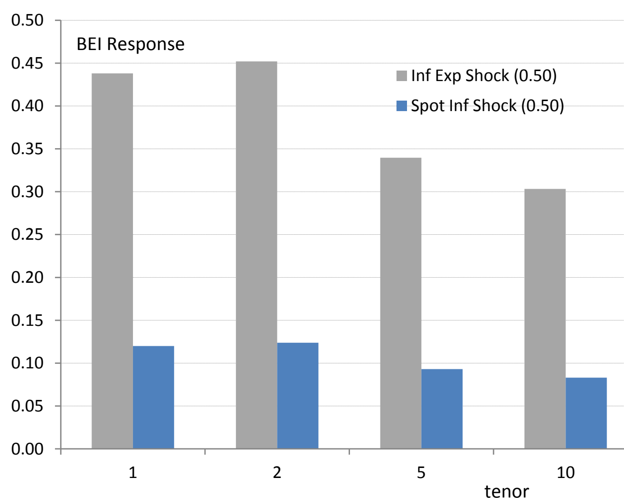
We summarize the results for the countries considered in the bullets below:

Brazil: Spot inflation and inflation expectations are jointly responsible for the bulk of the dynamics for Brazil's B/E. Compared to these variables breakevens seem slightly cheap especially in the front tenors. However, the economic significance of these 2 variables raise a couple of interesting caveats from a simple rich and cheap analysis. The chart below suggests that while being both statistically significant, the economic significance of the “inflation expectations” is significantly higher than “spot”. Accordingly, the response of the BEI curve to a shock to inflation expectations is almost 4 times higher than to spot inflation (when one considers shocks of the same magnitude). Moreover the shocks tend to have a slow dissipation across tenors since Brazil's 1st PC loading is less “tilted” then its LatAm's peers. We find the result particularly interesting in the current market conjuncture in Brazil: While spot inflation continues to collapse, fiscal risks could in principle result in a divergence of spot and expected inflation and the widening of breakevens even if spot continues to decline.

Takeaways: BEIs are cheap (but not much), fiscal risks could potentially affect inflation expectations leading to the widening of breakeven inflation even if spot inflation continues to fall.

Brazil BEI's: Cheap and Sensitive to Expected Inflation





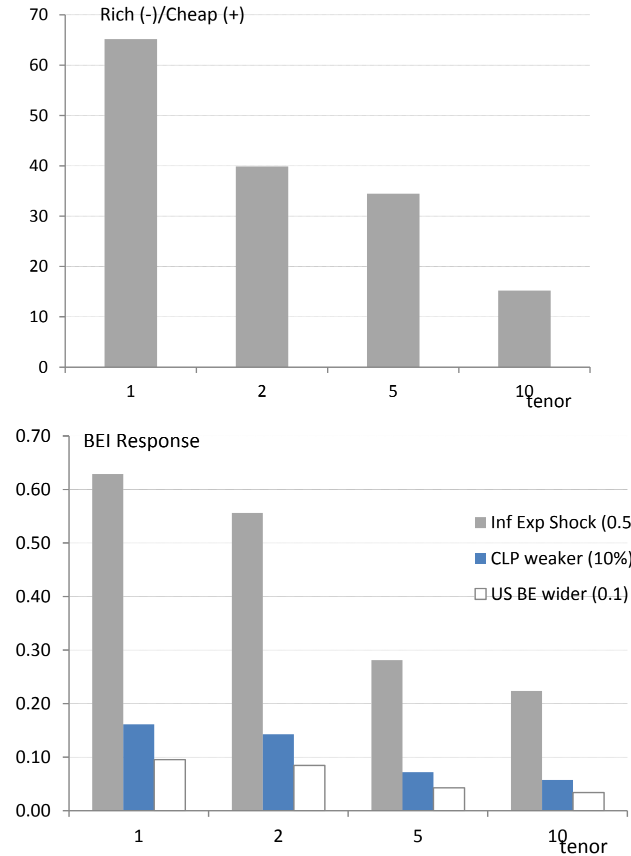
Source: Deutsche Bank

Chile: Inflation expectations, FX and US BEI dynamics are the main drives of the Chile's BEI curve. Compared to these drivers (and in accordance with the optical levels) breakevens are low (cheap) and more so than in Brazil. Like Brazil, inflation expectations play a significant role in the BEI dynamics, but differently from the latter, expectations shocks tend to overshoot in the front end (1bp of inflation expectations translates to >1bp shock in breakevens), quickly dissipating from there on. FX plays an important role for BEI's but less so than Colombia. Finally, US BEI's dynamics plays a minor role on Chile's BEI giving significance for the cross country relative value trades that are sometimes placed by market participants.

Takeaways: BEI are cheap but weaker USD and the US deflationary backdrop tends to push the compression. Inflation expectations play a strong role in BEI dynamics (that tends to overshoot) and the likely pick-up of the latter into the presidential election might trigger

widers especially in the front-end (this would have to be weighed against carry if realized inflation remains low)

Chile BEI’s: Also cheap, sometimes overshooting

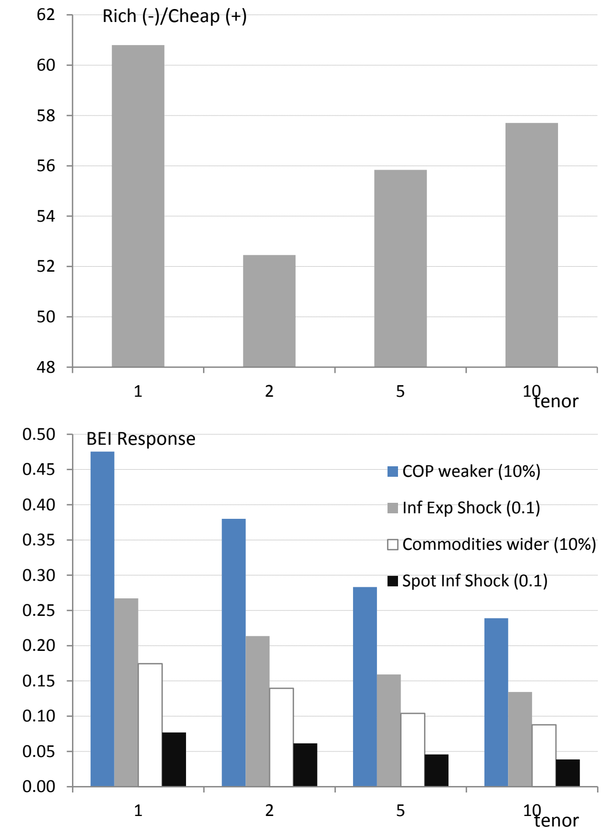


Source: Deutsche Bank

Colombia: Colombia’s BEI are slightly more complex than the previous 2 cases: they are explained by spot inflation, inflation expectations, FX and commodities. As in the case of Brazil, the curve seems more responsive to inflation expectations than to spot inflation assuming shocks of the same magnitude. FX plays a role as it does in Chile (and it is likely one of the causes of the cross country correlation mentioned above), but in Colombia’s case the response of BEI to a surge in the USD is more pronounced. The latter is in accordance with our study on inflation pass-through across the region expressed here (link), where we illustrate the importance of FX-pass through in Colombia’s inflation. As in the case of Chile, BEI’s look cheap versus its drivers. Front end BEI’s have recently retraced to the lows (on the latest benign inflation readings) but could widen again especially as the re-basing effect in spot (expected for the second half of 2017) has a joint-effect on expectations.

Takeaways: BEI are cheap across the board, USD weakness and favorable seasonal and one-off factors could, however, slow this widening. BEI’s seem to co-move with Chile likely due to the FX channel.

Colombia’s BEI: Sensitive to FX

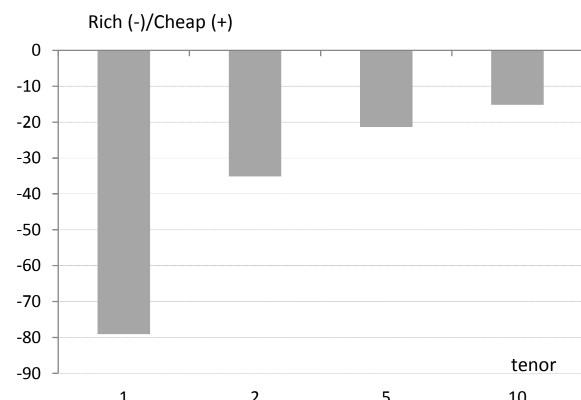


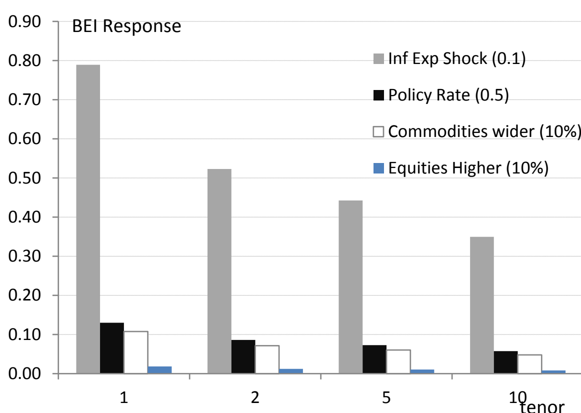
Source: Deutsche Bank

Mexico: At odds with the rest of the region Mexico’s BEI are rich which is in line with the unraveling of inflation and inflation expectations observed in the last couple of months. Not even the significant rate hikes have been enough to curb the widening of BEI as Banxico has been perceived to be behind the curve. Indeed, our model suggests that inflation expectations and Banxico’s response both feed positively into BEI creating a perverse dynamics of higher inflation expectations, higher policy rates and higher breakevens! We however expect this dynamic to change. First we expect inflation to subside Mexico: inflation has been on the rise mostly due to the lagged effects of an exogenous shock earlier in the year (gasoline prices) and some residual pass-through from last year’s MXN depreciation. As noted on “Mexico’s Inflation: The Odd One Out” (published in the June’s edition of the EMM) we expect spot inflation to resume convergence to the target. Second we expect the

perception of Banxico being behind the curve to change given its active inflation targeting behavior.

Mexico's BEI: The exception





Source: Deutsche Bank

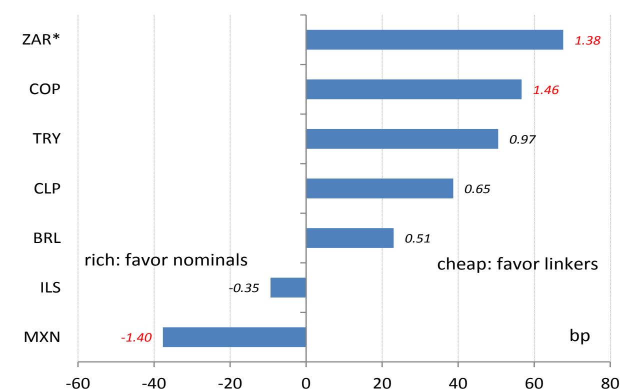
With these 2 elements we believe that breakevens are bound to tighten which leads us to favor nominals in the front-end even if cuts take a while to materialize There are however caveats. As in Chile, shocks to inflation expectation tend to overshoot, which brings risks to the longs if the latter get contaminated by political/fiscal risks into the elections.

Takeaways: BEI are expensive and more so in the front-end. We expect spot inflation to converge which together to a change in perception in the CB's approach to inflation (from being behind to being ahead of the curve) might lead BEIs to tighten (and nominals to outperform) even if eventual cuts take a while to materialize. Inflation expectations shocks tend to overshoot and political risk spillovers into the elections next year are in our view the main risk to this view

Conclusion

In this note we study the relative valuation of LatAm's BEI versus their drivers. We conclude that other than Mexico, breakevens are cheap not only optically but also from a conditional point of view. That said, the high sensitivity of inflation expectations brings a caveat to the analysis: if the latter keep on declining the breakeven curves will likely continue to bull-flatten independent of their "cheapness". At the opposite side of the spectrum, we see Mexico's nominals performing vs linkers if inflation does stabilize and resume convergence to the target in the next couple of months as we currently foresee.

Rich/Cheapness Snapshot Across EM



Source: Deutsche Bank

In terms of trades:

- Long 5Y BEI in Chile
- Long 2Y-3Y BEI in COP (UVRs21s vs TES 19s or TES 21s)
- Short 3Y BE in Mexico (MBONOs 20 vs MUDI 20s)
- We remain neutral Brazil for now

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EM Vulnerability Monitor: growth and moderate inflation

- We update the indicators of macro and structural vulnerabilities in 26 EM economies. This exercise assesses the susceptibility of emerging market countries to economic crises or a period of painful adjustment should external conditions worsen.
- EM has staged a strong rally in 2017 with strong inflows to EM largely explained by 'push' factors rather than 'pull' factors. In this report, we take stock of the internal conditions in EM by assessing macro vulnerabilities – this provides insight into the longer-term sustainability of EM inflows and performance, and also highlights the pressure points should external conditions deteriorate.
- Overall EM macro vulnerability increased slightly over the past few months; but this comes after a period of sustained improvement, hence the *level* of macro vulnerability remains subdued. 'Internal' macro conditions in EM have improved significantly over the past 3 years – inflation has fallen, FX valuations have improved, and growth is starting to accelerate.
- The top cohort of high risk economies in the vulnerability exercise is still dominated by Venezuela, South Africa, China, Brazil and Ukraine. These economies are still struggling to fully shake-off weak growth, high inflation, poor fiscal position and high debt. Our colleagues in Asia also flag Hong Kong's vulnerability.
- We find Singapore, Turkey, Mexico, Colombia, Malaysia and India in the medium risk group. At the favourable end of the risk spectrum are Russia, Central Europe, Thailand, Indonesia and Philippines. Peru, Romania, Russia, Thailand and Hungary comprise the top-5 of the low risk cohort.
- Notable changes in vulnerability rankings since December: vulnerability for Poland and Mexico has increased, while it has decreased for Colombia and Chile. Brazil and Argentina also continued to improve.
- There are fledgling signs that EM growth, along with global growth, is accelerating after a prolonged depressed period. As a result, real rates have replaced growth as the main source of EM vulnerability, but still are far from worrying levels and our outlook for inflation in the coming months is benign.
- High public debt and deficits are another important source of EM vulnerability. However, while debt levels remain a concern for many EMs, progress has been made on this front.

Introduction

Our vulnerability monitor assesses the susceptibility of emerging market countries to economic crises or a period of painful adjustment should external conditions worsen. We look at 10 indicators, capturing vulnerabilities across four key dimensions: macroeconomic stability; private leverage; external imbalances; and sovereign risk. Details of the framework are outlined in an earlier publication ("Assessing Vulnerabilities", October 2014) as well as in the appendix.

Vulnerabilities are measured on the basis of the position of each indicator for each country within the distribution of observations for that indicator across our sample of EM countries for the last 5 years. The resulting percentile rankings are then aggregated across indicators to give us our composite overall vulnerability measure.

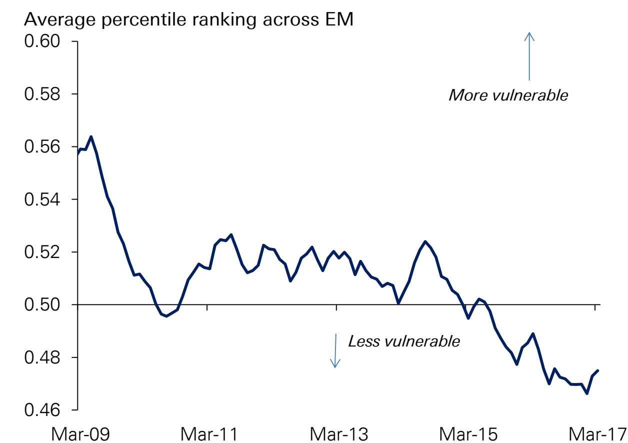
We also provide a summary of our work on an index of structural strength of EM economies in a separate section. The index captures the quality of institutions, infrastructure, and education; the efficiency of local financial, labour, and product markets; economic openness; and the degree of state intervention in an economy.

Results

EM has staged a strong rally in 2017 with strong inflows largely explained by 'push' factors rather than 'pull' factors. In this report, we take stock of the internal conditions in EM by assessing macro vulnerabilities – this provides insight into the longer-term sustainability of EM inflows and performance, and also highlights the pressure points should external conditions deteriorate.

As the chart below shows, overall EM macro vulnerability increased slightly over the past few months, but the *level* of macro vulnerability remains subdued as this comes after a period of sustained improvement. 'Internal' macro conditions in EM have improved significantly over the past 3 years – inflation has fallen, FX valuations have improved, fiscal positions are stronger and growth is on the mend.

Overall EM vulnerability increased slightly in the past few months, but remains at subdued levels



Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

While the trajectory of EM macro vulnerability is broadly positive, there are concerns of near-term sell-offs driven by external shocks. Given very benign expectations of the Fed (both on rate hikes and balance sheet reduction), Trump fiscal policy delivery and on geopolitics, there are risks of an EM-negative surprise in the coming months. Given this potential for a spike in risk and capital flow volatility, those countries ranked as highly vulnerable in our analysis are more likely to be under scrutiny.

The top cohort of high risk economies in the vulnerability exercise is still dominated by Venezuela, South Africa, China, Brazil and Ukraine. Generally, these economies are still struggling to get out of a pernicious nexus of weak growth, high inflation, poor fiscal position and high debt.

China remains in the high-risk category due to the well-known factors—a decline in growth momentum, an overvalued currency, and a heavily-leveraged corporate sector. While the authorities have recently enacted targeted tightening to curb financial sector leverage, there is a long way to go, and implementing de-leveraging without undermining the growth dynamic will be a tall order. Frothy equity and property markets add to its vulnerability.

We find Turkey, Mexico, Colombia, Malaysia and India in the medium risk group. At the favourable end of the risk spectrum are Russia, Central Europe, Thailand, Indonesia and Philippines. Peru, Romania, Russia, Thailand and Hungary comprise the top-5 of the low risk cohort. Looking at the more detailed assessment by our colleagues in Asia, India is less vulnerable than it is shown here, particularly when the RBI's effort to lower (on a durable basis) inflation and inflation expectations is taken into account. For further details, please refer to our India Chief Economist work on the matter.

Significant changes in vulnerability rankings since December

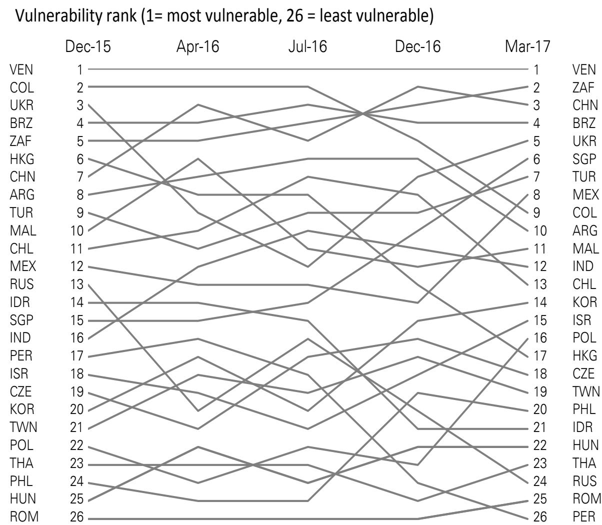
Within EMEA, Poland's vulnerability has increased since December, and Russia's continued to improve. Poland's has been driven mainly by the sharp rise in inflation (relative to December) and the implied deterioration in real rates. However, the overall level of Poland's vulnerability remains limited, and it is still in the low-risk cohort. Furthermore, we expect inflation to top off in the coming months as already evidenced in the latest prints. On the other hand, Russia continues to improve on our macro vulnerability rankings, due to falling inflation, rising real rates and accelerating growth.

Within LatAm, Mexico's vulnerability has increased, while Columbia and Argentina's vulnerability eased. Mexico's as a result of slowing growth and worsening current account and fiscal dynamics. Colombia and Argentina's vulnerability has eased markedly – both have moved from the high-risk cohort to the medium-risk one. Chile's vulnerability has also decreased. In Brazil balance of payments and inflation are positive factors, whereas growth and fiscal policies are still negative factors. In the case of Argentina, fiscal is a negative factor, the external accounts are deteriorating slowly, growth is recovering slowly, and inflation is declining more slowly than expected. Both have made important progress, however.

There have been limited moves for Asian economies, except for continued reduction in Hong Kong's vulnerability and increase in Singapore's vulnerability. Hong Kong's rapid improvements in our rankings may not be granted; over distinct metrics, it remains more vulnerable than it may appear from the current analysis. Please refer to our Emerging Markets Asia Economics team work on the matter, where more suitable measures of vulnerability have been designed with Asian economies in mind.

While not captured in our metrics, the political dimension is critical to consider. Political risks have re-emerged with the renewed focus on the US-Russia relationship as well as geopolitical realignment in the Middle East. Politics will continue to weight on growth and reform most notably in South Africa, Brazil, and the Andeans.

Recent changes in vulnerability rankings

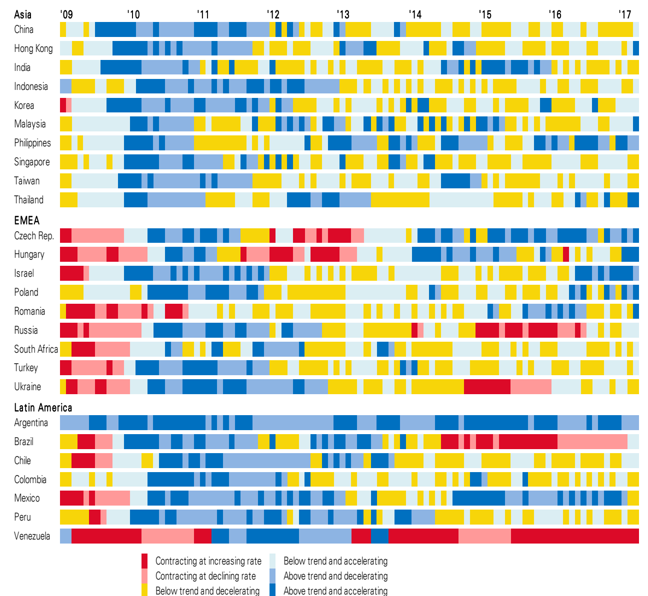


Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

Growth momentum: green shoots

Over the past 1-2 quarters green shoots have begun to appear – there are fledgling signs that EM growth, along with global growth, is accelerating after a prolonged depressed period. There is evidence of stabilization and marginal improvement in Brazil and Russia. Growth in Central Europe remains strong (it is one of the few regions in EM with above-trend growth) as a result of both domestic demand and net exports (which are benefitting from the euro area recovery). Turkey continues its cyclical upswing following credit and fiscal stimulus. Meanwhile, most Asian economies are also showing signs of improving growth dynamics, aided by a strong rebound in the exports cycle over the past few quarters. In particular, Malaysia, Thailand, South Korea and Philippines flag as accelerating in the growth tracker below; recent activity data in China has also been robust.

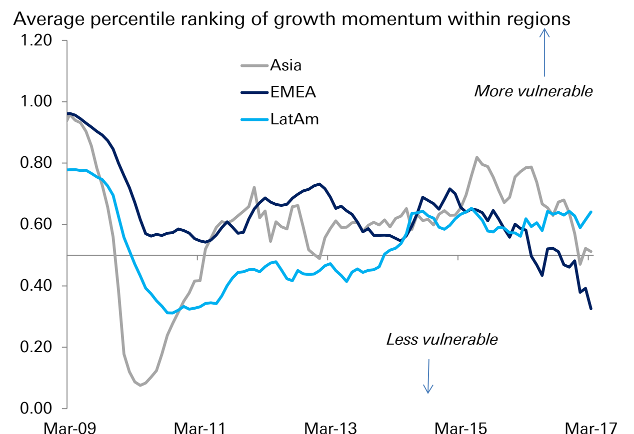
EM Growth Tracker: signs of improvement



Macroeconomic momentum is based on z-scores for high-frequency indicators that track well with GDP growth, such as credit growth, trade, industrial production, and retail sales. The intensity of shading or color intensifies in the heat-map as the z-score becomes more negative, while it becomes lighter at the z-score rises. The z-score for a country is based on its own history.
Source: Haver, CEIC, Deutsche Bank

This acceleration in growth can also be observed in the regional growth momentum chart. EM vulnerability on the growth dimension has been declining since late 2016, particularly for EMEA and Asia. However, LatAm is lagging, with progress on the growth front much more mixed. While Brazil is on the cusp of recovering from a deep recession, growth is slowing in Peru and Colombia. Growth momentum is slowing in Mexico as well, where consumption and investment sentiment is impacted by political risk and recent policy tightening; the growth outlook for Venezuela remains bleak.

Growth momentum score across regions



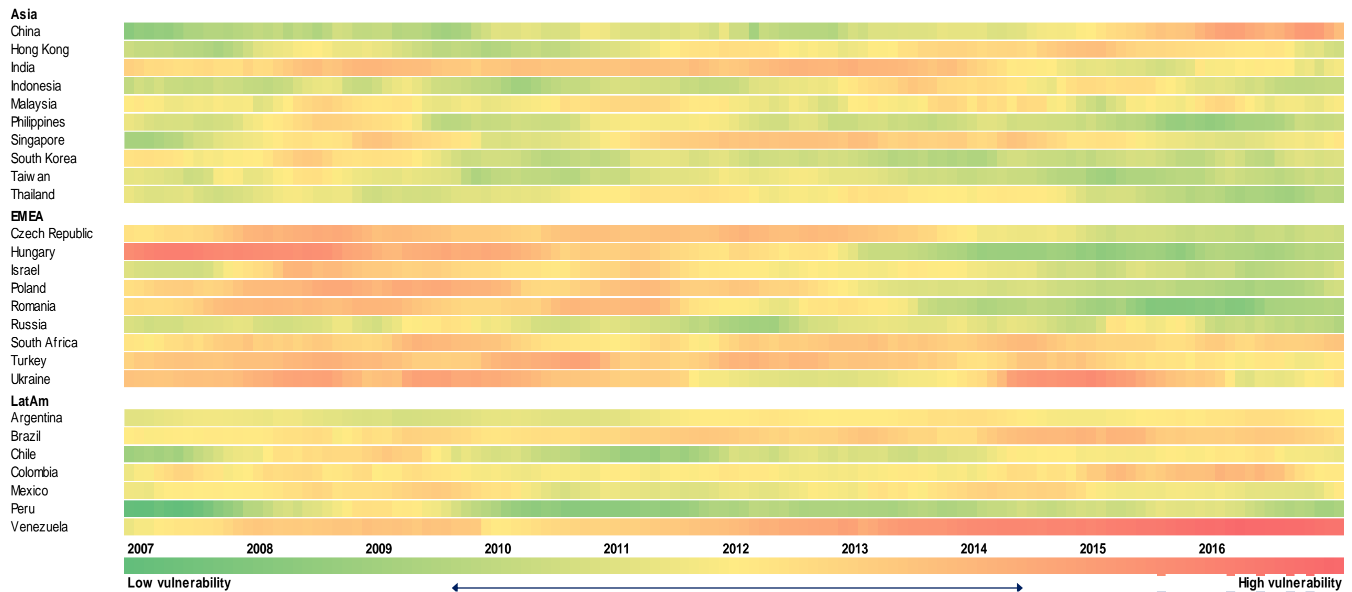
Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

EM Vulnerabilities March 2017: Summary Table

	Growth	Inflation	Credit growth	Private debt	Real rates	Current account	Reserve cover	FX valuation	Public debt	Fiscal balance	Overall
	Z-score	YoY%	Excess %	% GDP	%	% GDP	% GEFR	%	% GDP	% GDP	Percentile
VEN	-0.66	180.9	2063.9	2744.6	-59.2	-1.6	27.0	402.0	31.7	-14.5	0.85
ZAF	-0.66	6.3	-0.8	75.5	1.0	-3.2	115.7	0.7	50.9	-3.5	0.63
CHN	-0.76	1.4	5.3	145.2	2.6	1.5	345.5	7.3	47.0	-3.7	0.56
BRZ	-0.48	4.9	-5.1	61.3	7.7	-1.1	524.0	18.2	79.0	-9.0	0.55
UKR	-0.14	13.9	-22.3	41.4	-0.7	-3.7	77.6	-17.7	83.4	-2.4	0.55
SGP	-0.63	0.6	3.2	135.5	0.3	19.1	27.0	-4.0	112.0	2.9	0.53
TUR	-0.32	10.2	1.1	57.7	0.9	-3.9	78.2	-14.9	29.3	-2.4	0.52
MEX	-0.28	4.3	6.7	51.5	1.3	-2.7	218.8	-15.9	57.9	-2.9	0.52
COL	-0.64	5.5	0.9	48.0	2.2	-4.4	175.3	-7.8	47.1	-3.3	0.52
ARG	23.81	34.0	-2.8	13.5	-7.9	-2.8	87.7	-18.7	50.8	-5.9	0.52
MAL	0.19	4.3	-0.6	121.5	-0.8	2.2	104.4	-19.4	56.2	-3.0	0.50
IND	-0.54	3.6	-1.1	56.1	4.1	-0.5	386.5	-0.1	69.1	-6.5	0.49
CHL	-0.72	2.8	1.4	81.4	0.7	-1.9	185.9	-12.2	22.1	-2.9	0.48
KOR	-0.25	2.1	1.8	167.8	-0.6	6.6	356.9	5.7	38.6	0.4	0.45
ISR	0.19	0.5	0.3	109.5	-0.4	3.8	331.8	4.0	62.3	-2.7	0.44
POL	0.26	2.1	1.4	52.9	-0.4	0.0	216.6	-9.3	54.3	-2.6	0.43
HKG	0.11	0.6	0.6	332.1	0.4	4.6	43.2	15.6	0.1	4.0	0.42
CZE	0.52	2.4	1.5	55.9	-2.1	0.6	198.4	1.3	37.3	0.1	0.42
TWN	-0.42	0.8	2.4	145.2	-0.1	12.8	258.8	-7.5	35.0	-1.6	0.41
PHL	0.23	3.2	7.0	52.1	-0.8	-0.2	530.6	-1.3	33.4	-0.6	0.41
IDN	-0.93	3.6	-0.7	32.2	3.1	-1.5	207.3	-1.9	27.9	-2.5	0.40
HUN	0.67	2.7	-7.4	33.5	-2.4	4.9	193.1	-4.2	74.0	-2.0	0.38
THA	0.02	1.3	-0.7	122.3	0.3	10.2	342.6	4.3	42.1	-0.1	0.37
RUS	-0.37	4.6	-2.4	49.9	5.8	2.7	779.2	6.4	17.1	-3.4	0.36
ROM	0.12	0.2	-4.9	28.9	0.5	-2.6	134.4	-7.3	39.5	-2.7	0.36
PER	-0.69	3.2	-1.5	34.7	1.8	-2.0	552.2	-6.4	25.1	-2.3	0.35

Notes: (1) the indicator for growth is our measure of macroeconomic momentum based on z-scores for high-frequency indicators that track well with GDP growth; (2) inflation is the average headline inflation rate for the last three months; (3) credit growth is measured as the excess of private credit growth over nominal GDP growth over the last four quarters; (4) reserve cover is measured relative to the sum of short term external debt (at original maturity) and the current account deficit (for those countries that have deficits; (5) FX Valuations are taken from our Behavioral Equilibrium Exchange Rate Model (BEER), or Productivity-Adjusted Purchasing Power Parity Model for the couple of countries not covered by the BEER model (see our monthly EM FX Valuation Snapshot); (6) the overall vulnerability score is an average of the percentile rankings of each indicator within the distribution for that indicator over the preceding five years across our sample of EM countries .For the overall score, the colour coding reflects the percentile ranking for the current period – red reflects the most vulnerable 33% of countries in the present period, yellow the middle 33% and green the least vulnerable 33%. However, for each individual indicator, the colour coding is based on 33 percentile ranges of the true panel (i.e. within the set of the readings for all countries over the past 5 years).
Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

Evolution of EM Vulnerabilities

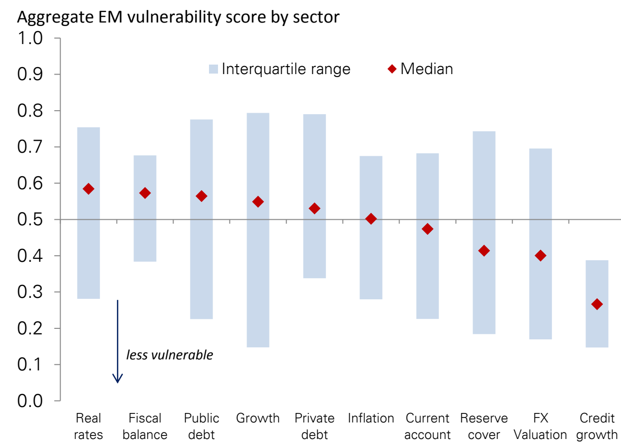


This heat map shows the evolution through time of our overall vulnerability measure for each country.
Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

Sources of vulnerability: growth was replaced by real rates and public debt as the main source of EM vulnerability

Real rates have replaced growth concerns as a source of EM vulnerability during the analyzed period. Until recently, weak growth was the primary source of vulnerability in EM. However, that started to change with the recent acceleration in activity (both EM and global) since the last update in end-December 2016. Both growth and inflation accelerated from a low base, pushing real rates lower and increasing EM's vulnerability on this metric. However, as we expect inflation to taper-off in the coming months and the levels are not yet a concern, we don't want to over-emphasize this 'vulnerability' as of yet.

Sources of EM vulnerability



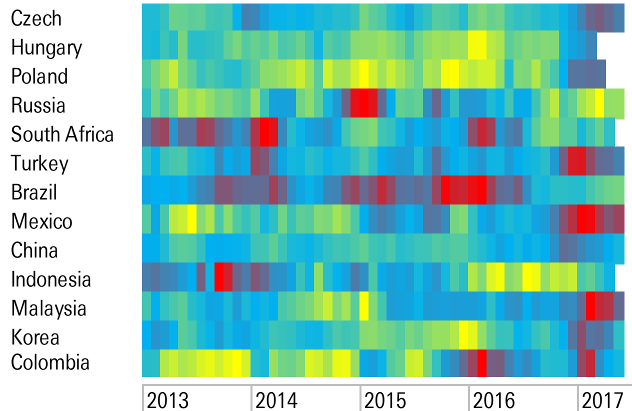
Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

While EM as a whole has re-flated somewhat, there is significant divergence in inflation trends. For example, our Asia economists expect the region's CPI inflation to rise above 3% in 2018, levels not seen since 2012. Real rates are already negative in Malaysia, the Philippines, Singapore and South Korea.

On the other hand, high yielders like Brazil, Russia and South Africa are on disinflationary paths, opening the door for policy easing. Elsewhere in LatAm– in Colombia, Peru and Chile – we expect the central banks to maintain a dovish stance due to benign inflation. Mexico is the exception, where inflation continues to print above expectations and hence Banxico is likely to continue with its tightening cycle, following the Fed in June with a 25bps hike.

In fact, going beyond the backward nature of the analysis here, we note that forward looking indicators of inflation point to a possible future decline in vulnerabilities stemming from inflation.

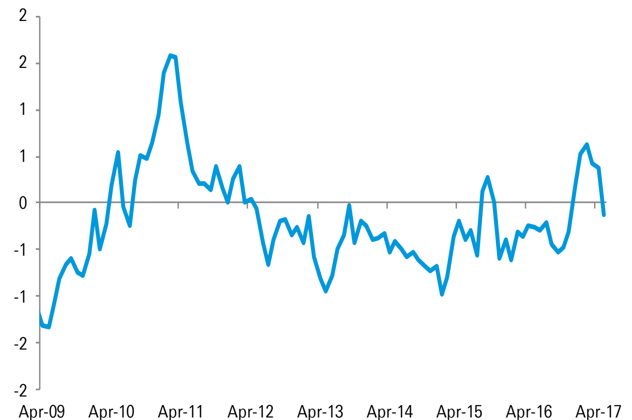
Divergence in inflation trends across EM (inflation expectations)



Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank; In the above heatmap for select EMs, yellow stands for low and red stands for high inflation with respect to historical averages.

Assuming general dynamics prevail as in April, our composite EM inflation expectations index shows a continued decline in inflationary pressures overall[5]. At the same time, with the risk of policy surprises emanating from core central banks subdued, together with May PMIs pointing to a quick deceleration in Chinese producer price inflation, inflationary pressures are likely fated for a break in 2H 2017.

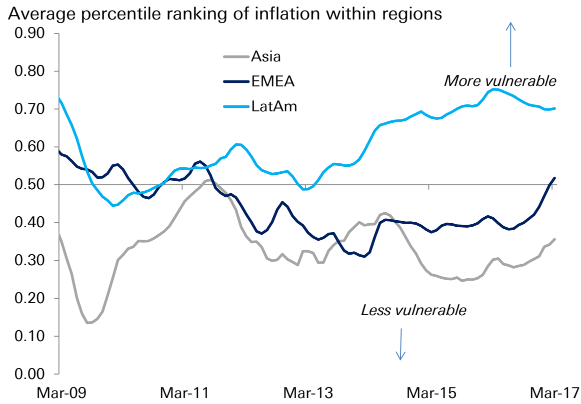
However...our forward looking EM inflation expectations index shows inflationary pressures may subside in the near term again



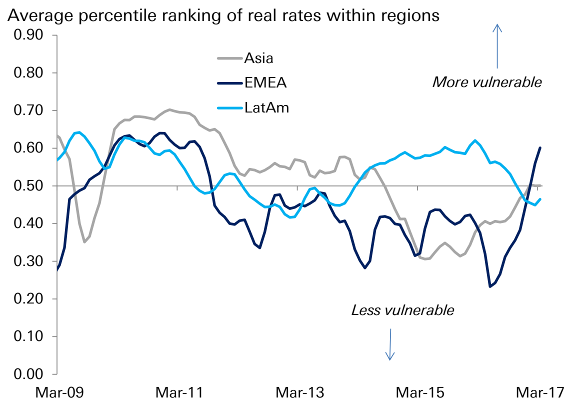
Note: composite EM inflation expectations is the median the inflation expectations score from our Emerging Markets Inflation Heatmap publication. Countries in the index include: Czech, Hungary, Poland, Russia, South Africa, Turkey, Brazil, Mexico, China, Indonesia, Malaysia, Korea, and Colombia. Source: Haver Analytics, CSO and Deutsche Bank

[5] Countries in the index include: Czech, Hungary, Poland, Russia, South Africa, Turkey, Brazil, Mexico, China, Indonesia, Malaysia, Korea, and Colombia.

Inflation has risen in EMEA and Asia (but not in LatAm)



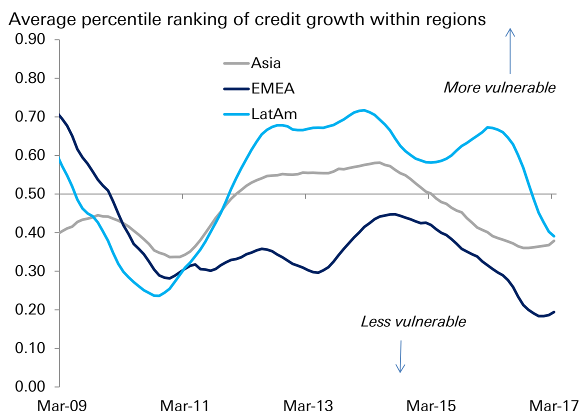
As a result, real rates are falling in EMEA and Asia (but not in LatAm)



Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

High public debt and deficits are another important source of EM vulnerability. However, while debt levels are a concern for many EMs, some progress has been made on this front. There are encouraging signs that borrowing constraints may be easing. This is reflected in the chart below, which highlights slowing credit growth across all three regions.

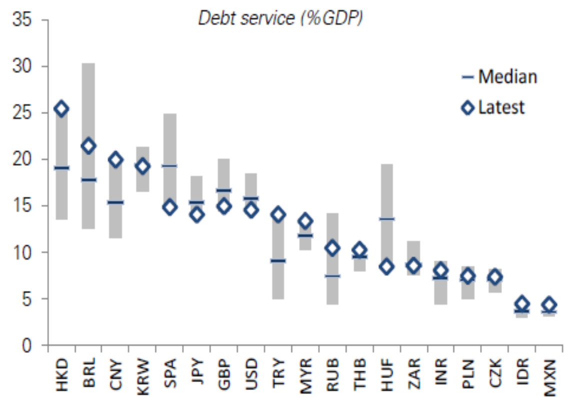
Credit growth score



Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

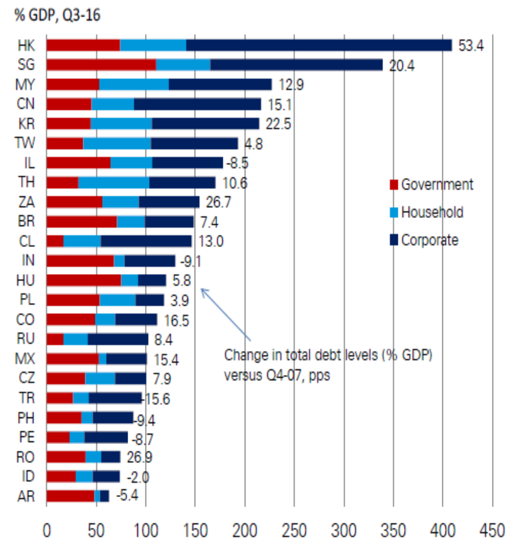
More specifically, we have seen meaningful progress on deleveraging in Russia, Brazil, South Africa, Hungary and more recently in the rest of LatAm. This adjustment has been concentrated in household credit, while deleveraging for many corporates has been hindered by external shocks – particularly for commodity exporters. While we have seen progress on deleveraging across several economies, it has been slow and from a high base. Therefore high debt levels are still a drag on growth for many EMs (see charts below). In particular, debt burdens remain elevated in Brazil and in most Asian economies. (For more details please see our recent special report, “EM’s Slow Turn: the green shoots”.)

Debt burdens across EM: some progress but still elevated



Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

Large stocks of debt remain a drag on EM recovery



Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

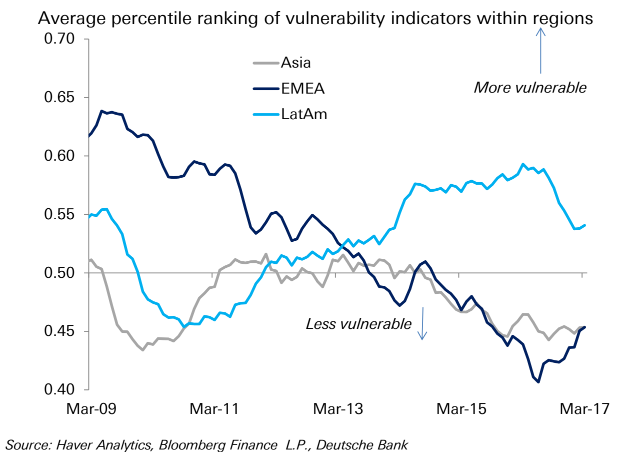
Lastly, it is important to note that despite the recent rally in EM FX, the asset class as a whole is still relatively ‘cheap’ vs. fundamentals. FX valuation is thus not a major source of vulnerability for EM.

Regional vulnerability

Within regional cohorts, Latin America remains the most under stress. With its concentration of commodity-exporting economies and continued political tension, the elevated levels of risk are not surprising. However, over the past 6 months, there has been a marked reduction in LatAm’s vulnerability, driven by falling inflation, rising real rates, and (selectively) improving growth and current accounts.

On the other hand, EMEA vulnerability has increased due to worsening macro conditions in Turkey, South Africa and Ukraine. As noted earlier, Poland has also seen an increase in vulnerability due to rising inflation and falling real rates. The level of EMEA vulnerability still remains manageable – on a regional basis, EMEA and Asia (where there has been no major shift in overall vulnerability) are far less vulnerable than LatAm. Note that country-by-country vulnerability charts are provided in the appendix.

Vulnerability score across regions



Source: Haver Analytics, Bloomberg Finance L.P., Deutsche Bank

Structural vs. macroeconomic vulnerabilities

While tracking short-term macro vulnerabilities is important, medium term, performance tends to be determined considerably by structural factors. In a previous study, we developed an index to gauge an economy’s structural health. This index captures the quality of institutions, infrastructure, and education; the efficiency of local financial, labour, and product markets; economic openness; and the degree of state intervention in an economy (see “Why structural reforms are EM’s last stand,” Deutsche Bank Special Report, May 2016).

In the following chart, we combine this structural index with the latest data from our macro vulnerability monitor. High scores (i.e. poor) on both dimensions tend to go hand in hand (for example, Venezuela, Brazil and South Africa). Strong structural scores, however, do not guarantee macro resilience, as seen in cases such as China and Singapore.

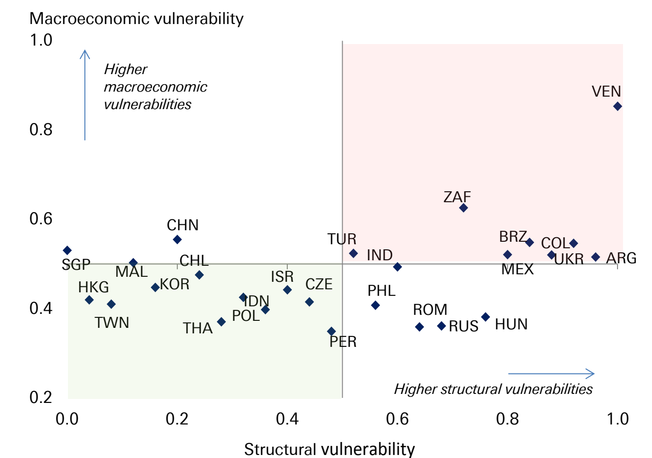
Singapore for example has the best structural score in EM. While its macro score is not confidence inspiring, the sustained strength of its institutions should hold it in good stead during periods of global macro stress. Hong Kong, South Korea and Taiwan should also be able to differentiate themselves along the same lines.

China scores reasonably well on structural metrics, reflecting recent structural development (for example in financial and goods markets), but its macro vulnerability is high.

Russia’s relatively weak institutional score is compensated by the resilient macro-economic framework. Turkey, however, is facing a moment of truth, where the outcome could be binary on both structural and macroeconomic developments.

There are a growing number of countries in the ‘safe quadrant’ of low structural and macro vulnerability. These include Thailand, Poland, Peru and Indonesia.

Structural vs. macroeconomic vulnerabilities



Source: Deutsche Bank

Elina Ribakova, London, +44(20)7547-1340
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Appendix: EM vulnerability methodology

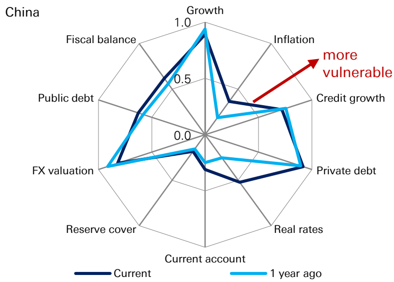
Vulnerabilities are measured on the basis of the position of each indicator for each country within the distribution of observations for that indicator across our sample of EM countries for the last 5 years. The resulting percentile rankings are then aggregated across indicators to give us our composite overall vulnerability measure. In particular, the following ten dimensions are used: Rank Growth, Rank Inflation, Rank FX Valuation, Rank Credit Growth, Rank Private Debt, Rank Real Rates, Rank Current Account, Rank Reserves Adequacy, Rank Government Debt and Rank Fiscal Balance.

(1) Growth: a measure of macroeconomic momentum that is based on average z-scores from high-frequency indicators like IP, retail sales, private credit growth, non-oil imports among others that track well with GDP growth.
(2) Inflation: is the average headline inflation rate for the last three months.
(3) Credit growth: measured as the excess of private credit growth over nominal GDP growth over the last four quarters, defined as $(1+c)/(1+g)$; where c is private credit level; and g is nominal GDP growth.
(4) Reserve cover: is measured relative to the sum of short term external debt (at original maturity) and the current account deficit (for those countries that have deficits).
(5) FX Valuations: taken from our Behavioural Equilibrium Exchange Rate Model (BEER), or Productivity-Adjusted Purchasing Power Parity Model for the couple of countries not covered by the BEER model (see our monthly FX Valuation Snapshot);
(6) Private debt: is defined as the private sector credit stock as a percentage of GDP.
(7) The real rates: indicator measures real ex-post short-term interest rates. We use the average 3m interbank interest rate for each month, deflated using headline CPI inflation; for countries where the 3m interbank rate data is not available we use available short-term rates as substitutes.
(8) Current account: is the current account balance as a percentage of GDP over the last four quarters.
(9) Fiscal balance: general government balance as % of GDP, from IMF for the past year (monthly series interpolated from annual data).
(10) Government debt: general government debt as % of GDP, from IMF for the past one year (monthly series interpolated from annual data).

For the overall score, the colour coding in the heatmaps reflects the percentile ranking for the current period – red reflects the most vulnerable 33% of countries in the present period, yellow the middle 33% and green the least vulnerable 33%. Note that for each individual indicator, the colour coding is based on 33 percentile ranges of the true panel (i.e. within the set of the readings for all countries over the past 5 years).

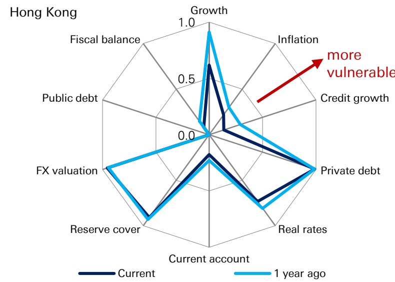
Appendix: country-by-country vulnerability charts

China



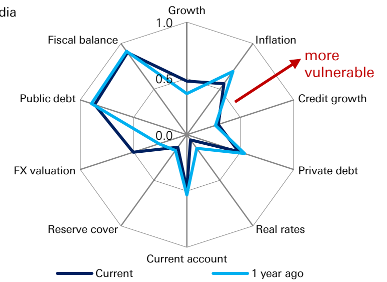
Source: Deutsche Bank

Hong Kong



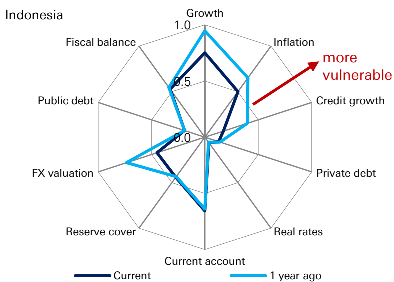
Source: Deutsche Bank

India



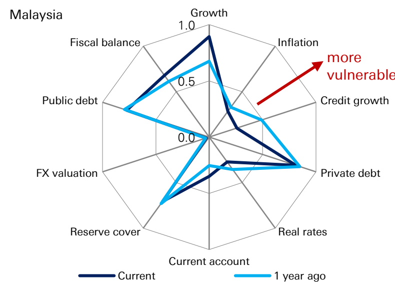
Source: Deutsche Bank

Indonesia



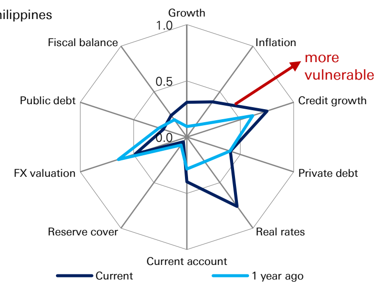
Source: Deutsche Bank

Malaysia



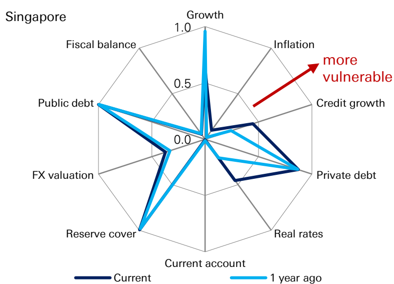
Source: Deutsche Bank

Philippines



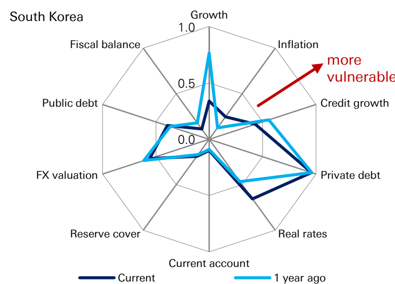
Source: Deutsche Bank

Singapore



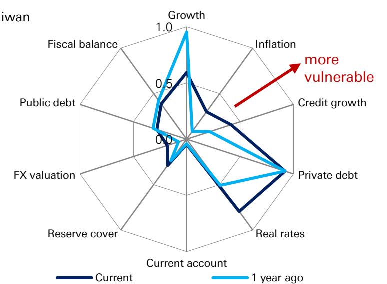
Source: Deutsche Bank

South Korea



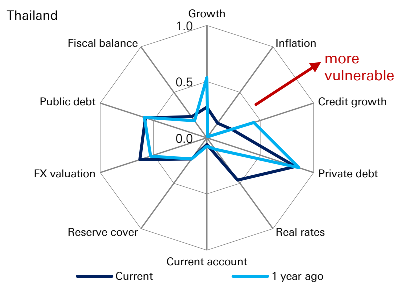
Source: Deutsche Bank

Taiwan



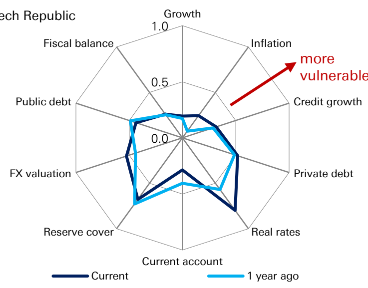
Source: Deutsche Bank

Thailand



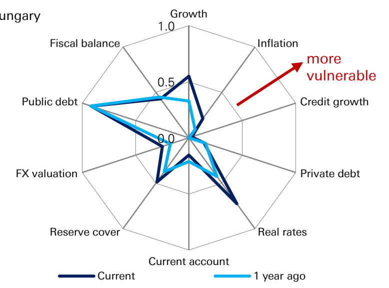
Source: Deutsche Bank

Czech Republic



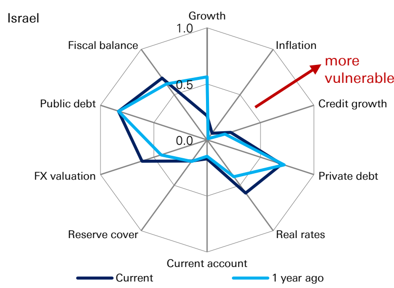
Source: Deutsche Bank

Hungary



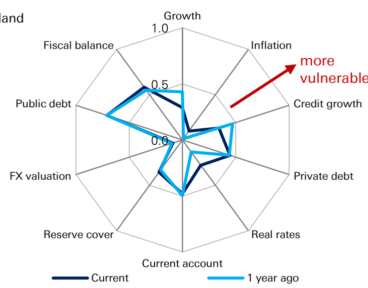
Source: Deutsche Bank

Israel



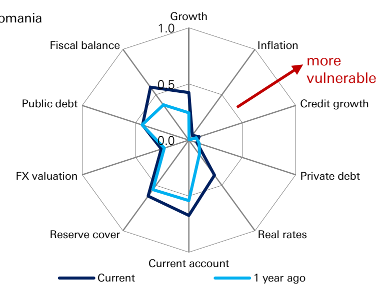
Source: Deutsche Bank

Poland



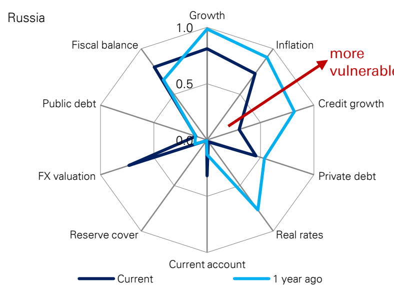
Source: Deutsche Bank

Romania



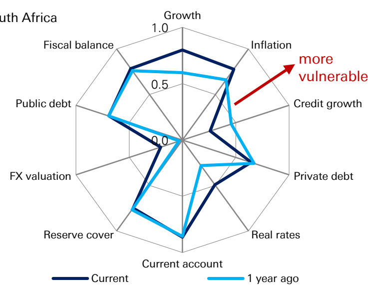
Source: Deutsche Bank

Russia



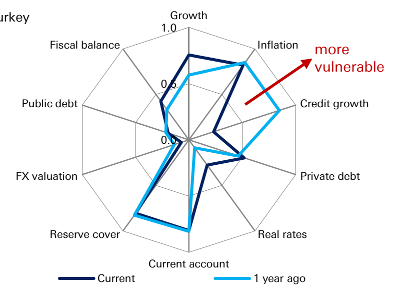
Source: Deutsche Bank

South Africa



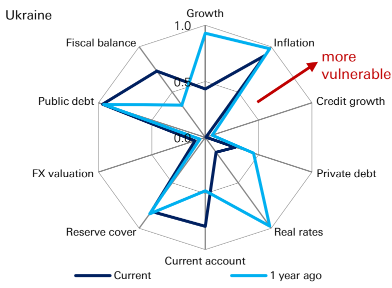
Source: Deutsche Bank

Turkey



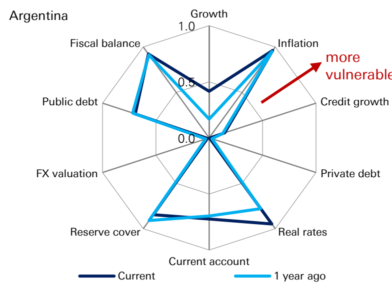
Source: Deutsche Bank

Ukraine



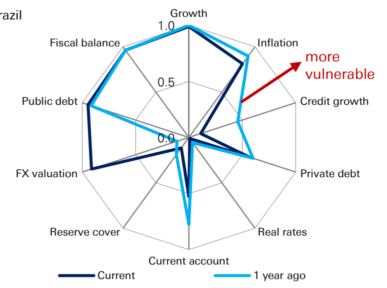
Source: Deutsche Bank

Argentina



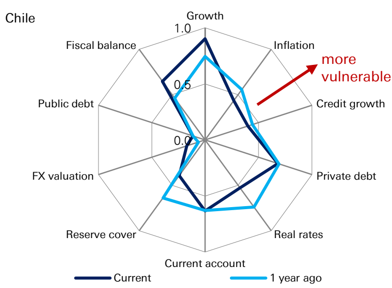
Source: Deutsche Bank

Brazil



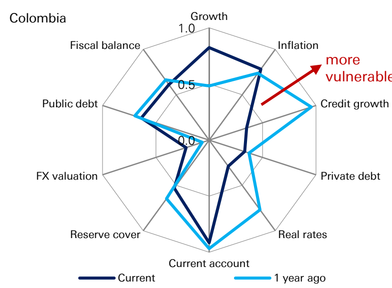
Source: Deutsche Bank

Chile



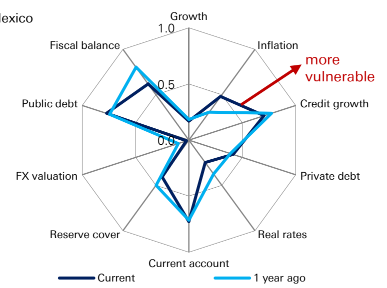
Source: Deutsche Bank

Colombia



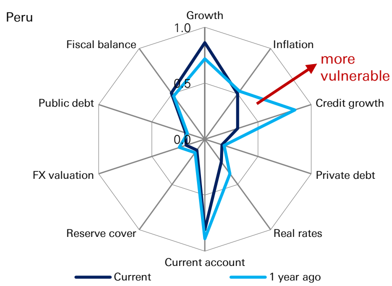
Source: Deutsche Bank

Mexico



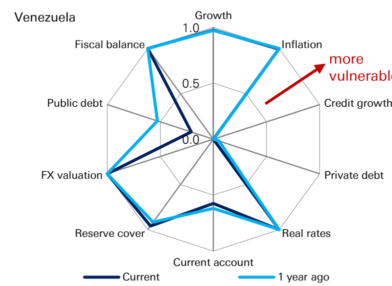
Source: Deutsche Bank

Peru



Source: Deutsche Bank

Venezuela



Source: Deutsche Bank

India's macro improvement in the first 3 years of Modi Government

- The NDA government completed its third year in office last month. During this period, a number of landmark reforms have been implemented, while the macro picture has also improved significantly. In this Special, we take stock of the changing macro landscape by comparing the progress in the last three years with that of the preceding five-year period across 24 key economic indicators. We also provide FY18 and FY19 forecasts for key economic indicators to model what lies ahead.

Taking stock

First, we provide a summary by constructing a macro heat map for India, which provides a useful snapshot of various indicators and risks stemming from the same. The assessment is done on a relative basis, with respect to economy's own history, and the years highlighted in green refer to best performing years across the timeline of study, while yellow and red indicate moderate to low performance, respectively. As can be seen from the chart below, India has recorded a significant improvement across most of the key macro indicators in the last three years.

1) Reform momentum to continue in the period ahead

India has embarked on a journey to transform itself into a STAR (simple, transparent, affluent and resilient) economy, and the progress so far has been impressive.

* Simple – Improve ease of doing business ranking, liberalize and simplify FDI norms further, simplify indirect tax structure by implementing GST.

* Transparent – Fair and transparent method of e-auctioning of national resources, distortion and discretion eliminated through de-regulation of petrol and diesel prices, improved subsidy delivery through direct benefits transfer, bring transparency in the lending process by implementing Bankruptcy Code, demonetization to reduce black money and cash usage, enforcement of Benami Act, ban in cash transaction above INR200,000 and transparency in political funding by capping donation from each source to just INR2,000.

* Affluent – Shift in policy stance with focus currently on wealth creation rather than poverty alleviation; focus on expediting pace of urbanization through Smart Cities mission along with digitization to make India more prosperous.

* Resilient – commitment to keep inflation low, maintain positive real rates in the economy, fiscal consolidation, focus on maintaining rupee stability.

India macro heat map

Economic indicators	Unit	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Real GDP growth	% yoy								
CPI inflation	%, annual avg.								
Food inflation	%, annual avg.								
Real interest rate	Repo rate - CPI, avg.								
Inflation expectations (1 yr ahead)	%								
Total stressed assets (NPA + restructured)	%								
Public sector banks stressed assets	%								
Centre's fiscal deficit	% of GDP								
State fiscal deficit	% of GDP								
General govt. budget deficit	% of GDP								
Current account deficit	% of GDP								
Gross FDI	USD bn								
FX reserves	USD bn								
Import cover	no. of months								
ST external debt as a % of total debt	%								

Source: CEIC, Deutsche Bank

2) Growth-inflation balance has improved and should remain; time now to focus on quality of growth

India continues to be one of the fastest growing economies in the world, but what has changed in recent years is the quality of growth-inflation mix. Currently India's real GDP growth is in the 7-7.5% range, with CPI inflation anchored around 4.5%. This is markedly different from FY10-11 period, when real GDP growth averaged about 9.5%, but with CPI inflation running around 11.5%. While achieving high economic growth is important, it is more important in our view to achieve this along with low or acceptable inflation. In fact we would argue that it is imperative to get inflation and inflation expectations down, to achieve higher (and sustainable) growth and investments. From this perspective, there is no trade-off between growth and inflation in the long term.

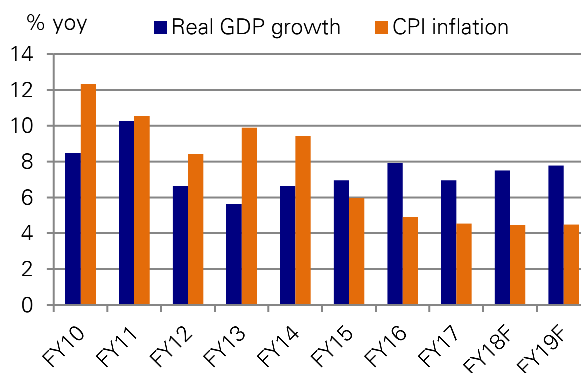
In fact, we believe that today's corporate sector balance sheet stress can be traced back to the developments of the FY10-11 period, when a lot of malinvestments took place, with entrepreneurs believing (wrongly) that high nominal GDP growth, negative real rates and stable rupee environment would continue for the foreseeable period. In reality (and in hindsight), the FY10-11 high growth period was an aberration and led to the formation of macro imbalances, which later would unravel in the form of a currency crisis in mid-2013. In our view, a large part of those malinvestments were caused by persistent and large negative real rates, which gave a false sense of confidence and comfort to the Indian entrepreneurs about potential high return on investments.

We are reasonably certain that similar type of macro imbalances will not be tolerated or allowed to be formed in the first place, given the changes that have taken place particularly with respect to RBI's inflation management policy. With RBI formally committed to keep CPI inflation low, in the 4-5% range, and real rates positive in the 1.5-2.0% range, we believe chance of misallocation of capital, based on faulty market signals remain low in the future and would be dealt with decisively and proactively, if it were to manifest somehow. This would ensure that India's growth-inflation mix remains prudent in the period ahead, which should help investors make decisions regarding long-term investments based on realistic expectations of returns and profit.

India's current growth rate is below potential, as per various metrics, including the composite PMI, which has remained stagnant in the last three years. Furthermore, growth is mainly supported by consumption at this juncture (10.5%yoy real growth in FY17), with private investment remaining anemic due to the high leverage of the corporate sector and weak demand. Or in other words, the quality of growth is not optimal at this stage. In our view, a healthy mix of consumption and investment growth needs to be achieved to prevent macro imbalances and inflationary expectations from building up and monetary actions should be calibrated keeping this in mind. The developments of the last two years, where RBI has cut policy rate by 175bps but private investment momentum has weakened further, have raised doubts about the efficacy of monetary policy action to solve the malaise of the private sector.

We think both RBI and the government have been prudent with their monetary and fiscal policy stance in the past few years, focusing more on sustaining macro stability, rather than choosing the easy way out to prop up growth in the short-term. The strategy instead to focus on long-term structural reforms, like improving ease of doing business conditions in the country, will in our view help support a more robust and sustainable private sector capex cycle in the future, once demand starts coming back. India, in our view, is buying higher growth for the future by adopting a prudent macro policy stance at the current juncture.

Growth-inflation mix has improved since FY15



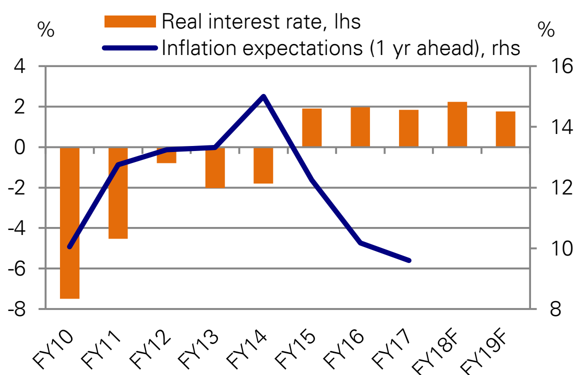
Source: CEIC, Deutsche Bank

3) Era of double-digit CPI inflation over; but inflation expectations need to be pushed down further

With RBI formally committed to an inflation targeting framework, which mandates the central bank to sustain CPI inflation at about 4%, the era of double-digit CPI inflation is clearly behind us. Indeed, post RBI embracing an inflation targeting framework, headline CPI, core CPI and food inflation have eased steadily and substantively since FY15. The moderation in food inflation is particularly impressive, given that this has happened in the backdrop of severe back-to-back droughts in 2014 and 2015. Effective administrative measures taken by the Government of India to dampen food price inflation in the years of drought and keeping the increase in the minimum support prices (MSPs) of key food grains reasonably low have helped to push down food inflation, thereby making it relatively easier for RBI to bring headline CPI inflation below 5%.

The focus on maintaining positive real rates through prudent monetary policy stance should continue. Even if CPI inflation were to unexpectedly rise to high single digits, due to some unforeseen adverse shock, the central bank will likely act decisively, to ensure that real rates remain positive even under such a scenario. This is because of the favorable impact that positive real rates have on inflation expectations. It is not coincidental that India's inflation expectations were uncomfortably high when real interest rates were also persistently negative. Inflation expectations saw a sharp decline only when RBI managed to turn real interest rate positive in India. This implies that in order to lower inflation expectations further, RBI would need to keep real interest rates positive in the range of 1.5-2.0%, as it has done in the last few years.

With real rates turning positive, inflation expectations have started to moderate



Source: CEIC, Deutsche Bank

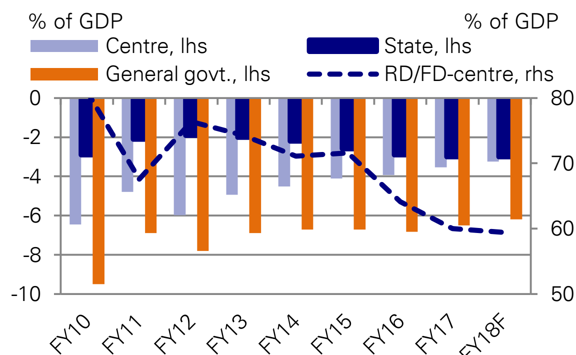
4) Government has shown great resolve to continue with fiscal consolidation despite various competing challenges; but state fiscal finances remain an issue

Despite competing considerations of supporting growth, infusing more capital in the banking sector and accommodating higher wages of public sector employees, the authorities have managed to continue with fiscal consolidation and in this backdrop, the achievement is quite impressive. Of course, global oil prices correcting sharply have helped in a big way to keep the fiscal consolidation agenda on track, but the government has also shown restraint on the expenditure front to achieve the fiscal targets. More importantly, the quality of fiscal consolidation has improved, with revenue deficit/fiscal deficit ratio (which indicates the extent to which borrowings are used to meet current expenditure) coming down to 60% in FY17, from 74.3% in FY13.

The new FRBM committee has recommended the central government to reduce its fiscal deficit to 3% of GDP from FY19 (from 3.2% of GDP target in FY18) and then further to 2.5% of GDP by FY23, so as to drive India's debt/GDP to 60%, from the current 70% levels.

We think the central government will continue on the path of fiscal consolidation, as laid out by the new FRBM committee, with a concerted effort to lower the revenue deficit/fiscal deficit ratio further but the real concern on fiscal, as is evident by now, is related to state government finances.

Pace of fiscal consolidation has been slow at the general govt. level, due to worsening of state finances



Source: CEIC, RBI, Deutsche Bank

State fiscal finances have deteriorated in the last few years for several reasons, resulting in slower pace of fiscal consolidation at the general government level. The need for states to embark on a credible fiscal consolidation plan is critical, but this is likely to be challenging, if demand for higher wages and farm loan waivers need to be accommodated, over and above the compulsion of servicing the interest cost of the UDAY scheme. Of course, the central government can exercise control over the public debt of state governments through the mechanism of Article 293 of the Indian constitution, which requires the state governments that are indebted to the central government to seek the latter's consent before raising additional borrowings, but this carries an unintended risk. Such a forceful move to contain the deficit and debt may compel state governments to reduce the allocation for capital expenditure, thereby leading to deterioration in the quality of fiscal consolidation. Instead, we would prefer to see the state governments, in consultation with the central government, voluntarily chart out a fiscal roadmap, which would help to bring the revenue balance back to positive territory over the next few years.

5) RBI's commitment to keep real interest rates positive along with the central government's push for fiscal consolidation is slowly improving the domestic savings-investment dynamic, thereby reducing the excessive reliance on foreign savings or current account deficit. India's sustainable current account deficit is about 2-2.5% of GDP. A CAD substantially higher than this level reflects possible macro imbalances in the economy, and can potentially lead to

disorderly depreciation of the currency, if capital flows were to fall short to finance the deficit. This is exactly what happened in 2013. A lethal combination of negative real rates in the economy, high fiscal deficit (close to 8% of GDP at the general government level) and large CAD (close to 5% of GDP) in the preceding two years finally resulted in a disorderly depreciation of the rupee in mid-2013, as capital outflows gathered pace due to "taper-tantrum", leading the authorities to announce a number of corrective measures thereafter.

In this respect, it is important to underscore the role that positive real rates play to keep the current account deficit within sustainable levels. Positive real rates help to incentivize higher financial savings in the economy, which is critical for funding domestic investment needs of the economy. If this is complemented by fiscal consolidation, which essentially means less dis-savings in the economy, then the need for borrowing foreign savings (which is current account deficit) to finance the domestic investments gets reduced, helping maintain a reasonable level of current account deficit, which can be financed easily through different sources of capital flows. RBI's positive real interest rate policy is therefore implicitly linked to its objective of maintaining current account deficit below 2.5% of GDP.

We are not arguing for once that India should not run a current account deficit. Indeed, India, being a capital-deficient country, should borrow from foreign savings to fund its substantial investment needs. But we are arguing against being over-reliant on foreign savings (i.e. a high current account deficit) to fund the domestic investment needs, and the way to achieve this balance is to have a healthy positive real interest rate in the economy, which helps to incentivize higher financial savings of the private sector, and continued fiscal consolidation, which helps to reduce public dis-savings. With real interest rates turning positive in India and modest but steady fiscal consolidation complementing the central bank's efforts, financial savings have indeed started rising in India, with a concurrent drop in physical savings. This bodes well for the future investment growth outlook, without having to worry about current account deficit rising beyond RBI's comfort level, which implicitly provides comfort about the prospect of exchange rate remaining stable.

Real interest rate, savings and current account deficit

	Financial savings (% of total household savings)	Physical savings (% of total household savings)	Real interest rate (%)	Current account deficit (% of GDP)
FY12	31.1	68.9	-0.8	-4.3
FY13	32.9	67.1	-2.0	-4.8
FY14	36.5	63.5	-1.8	-1.7
FY15	36.1	63.9	1.9	-1.3
FY16	41.5	58.5	2.0	-1.1
FY17	-	-	1.8	-0.7

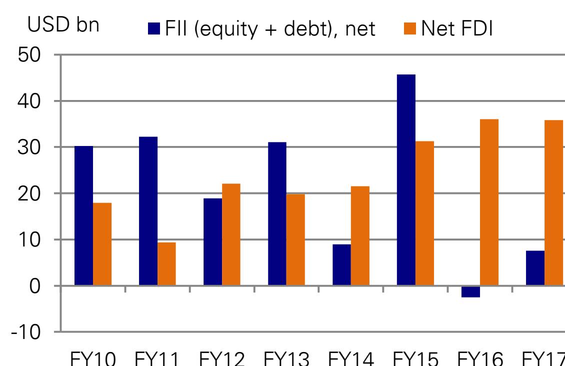
Source: CEIC, RBI, MOF, Deutsche Bank

6) Foreign direct investments into India have increased significantly in recent years, thereby improving the quality of capital inflows; challenge will be to sustain the FDI momentum in terms of % of GDP

In the last three years of the Modi Government, India has seen a surge in FDI inflows into the country, due to perceptible improvement in policy environment and given the significant liberalization of FDI norms. In FY17, gross FDI inflows amounted to USD43.8bn, on the back of USD44.9bn and USD35.3bn in the preceding two years. Interestingly, net FDI inflows have been significantly higher than FII inflows in the last two years, and were more than sufficient to finance the current account deficit. FII inflows picked up sharply in the first quarter of 2017, helped by a reversal in USD strength, positive state election outcome, a prudent budget and a hawkish RBI, but the pace has started slowing once again in the 2Q, particularly on the equities front. We expect FDI flows to continue being the main financing source of the current account deficit in the coming years, with volatile FII flows also adding positively to the capital account side of the BoP.

We however note that gross FDI inflows as a % of GDP have already moderated in FY17 (1.9% of GDP) compared to the FY16 outturn (2.2% of GDP); therefore the challenge will be to maintain the momentum of FDI inflows in line with the pace of nominal GDP growth (12-12.5%) in the years ahead, so as to ensure that FDI into the country increases secularly as a % of GDP. We are forecasting gross FDI inflows to rise to USD45bn in FY18 and further to USD48bn in FY19, but this would be lower in % of GDP terms (1.7% as per our estimate), compared to the outturn in FY17 and FY16.

FDI flows have increased substantially since FY15; outpaced FII flows appreciably in FY16 & FY17

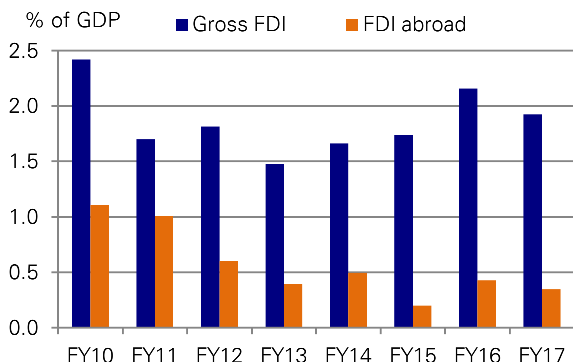


Source: CEIC, Deutsche Bank

7) Foreign direct investments made by Indian companies abroad have fallen, reflecting the improvement in ease of doing business conditions and policy environment in the country. Another positive development is related to the moderation in outward bound FDI in the last three years as a % of GDP,

helping sustain high net FDI inflows in the country. In the last three years, a number of steps have been taken to improve the ease of doing business conditions in the country, which has led to a perceptible change in investor sentiment toward India. It is true that the private corporate sector in India has not been investing meaningfully in the last three years due to their balance sheet stress, but as and when they get ready, we would expect the future investments to be made in India rather than abroad, which will be positive for the growth and employment outlook.

Outbound FDI has fallen with domestic policy environment improving; inflows as a % of GDP slowing



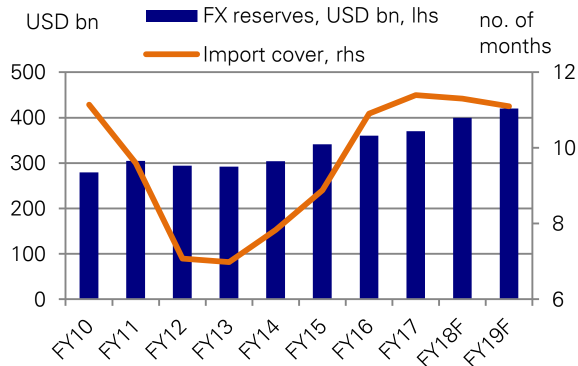
Source: CEIC, Deutsche Bank

8) FX reserves position has improved significantly since mid-2013, but the pace of reserves accumulation needs to be sustained; RBI needs to continue buying at least USD20-25bn each year to maintain import cover over 11 months

Since the currency crisis of mid-2013, the authorities have focused on improving the external outlook. The central bank picked up close to USD100bn FX reserves between 2013 and 2017, while restriction on gold imports and a sharp fall in global oil prices helped reduce the current account deficit appreciably.

Current account deficit (CAD) should be below 1% of GDP in FY17F, thereafter rising to about 1.2% of GDP in FY18F, led by higher global oil prices. But this is hardly an issue for India. In absolute terms, a 1.2% of GDP current account deficit translates to about USD30bn, which can be easily financed by various components of capital flows. As discussed earlier, FDI flow has increased significantly in the last few years and by itself can finance the current account deficit easily. Then there are additional sources of capital flows including FII (equity + debt), external commercial borrowing, NRI deposits, banking loans, etc.

FX reserves need to increase by at least USD20-25bn per year to maintain import cover of 11 months



Source: CEIC, Deutsche Bank

Currently India has sufficient FX reserves to cover 11.4 months' of imports, which makes the economy resilient to potential external shocks. But if the 11+ months' of import cover needs to be maintained, then the central bank will have to continue buying FX reserves (at least USD20-25bn per year, we estimate), assuming imports will increase from FY18 onward on account of higher global oil prices and an incremental recovery in growth.

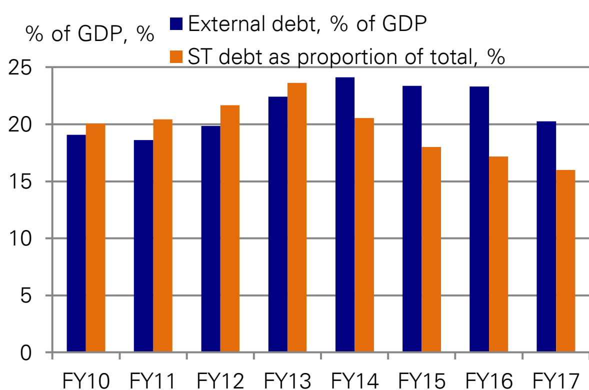
We note that the pace of reserves accumulation has slowed down in FY17 compared to the previous two years, but the import cover has still improved due to a contraction in imports growth. If imports rise by about 8-9%yoy in FY18, in line with our forecast, then the central bank will need to augment FX reserves by another USD20bn over the rest of this fiscal year to maintain 11+ months' of import cover. It is possible that RBI may be comfortable even with a lower import cover of 9-10 months, thereby picking up fewer reserves in the coming months, but this would pose a risk, in the event of any sudden sharp spike in global oil prices, either due to adverse supply or demand dynamic. Moreover, there is a non-trivial risk of the Fed starting to reduce the size of its balance sheet from sometime later this year, which could potentially lead to capital outflows from emerging markets including India. We would expect RBI's reserve management strategy to incorporate the risks mentioned above and aim for a prudent amount of reserves accumulation per year, so as to ensure that reserves adequacy position does not deteriorate materially, even under potential external shock scenarios.

9) External debt including short-term external debt has moderated as a % of GDP, which is comforting; however ECBs still constitute a large portion of external debt and corporates remain exposed to currency risks

Latest external debt data show that India's overall external debt as well as short-term external debt has been falling in the last three years as a % of GDP, which is comforting. We estimate India's external

debt/GDP to have come down to 20% of GDP by end-FY17, down from 24% in FY14. Short-term debt as a proportion of total external debt has also come down to about 16% in FY17, from 23.6% in FY13, as per our estimates. India's ST external debt on a residual maturity basis (up to 1 year) was USD188.8bn as at end-Dec 2016. While NRI deposits (USD75bn), which are sticky in nature, account for bulk of this short-term external debt, external commercial borrowings (ECBs) of corporates at USD25bn are also not trivial. While India has more than sufficient reserves to take care of its short-term obligations (external debt + current account deficit), there are still risks. Many Indian corporates continue to carry unhedged FX exposure, which is a risky strategy in our view. While RBI will continue to manage volatility in the FX market, this should not be taken for granted and it is prudent in our view for corporates to continue hedging in a disciplined manner to avoid disappointment in the future.

External debt & more importantly ST external debt have moderated in recent years, which is comforting

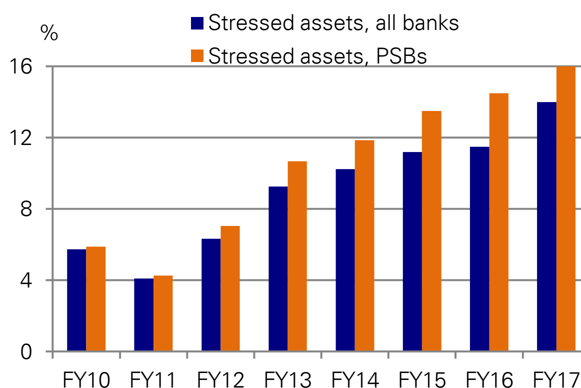


Source: CEIC, RBI, MOF, Deutsche Bank

10) NPA resolution of public sector banks remains work-in-progress; efforts need to be expedited to prevent further escalation of the problem

The problem of high NPAs, particularly in the public sector banks (which constitute nearly 70% of the total banking system) is probably one area where things have worsened significantly over the last few years. Last month, the government passed an ordinance amending the Banking Regulation Act. While this will help to expedite the NPA resolution process, it does not solve the capital shortfall problem of the public sector banks, especially if they have to take significant haircuts going forward. While we agree that injecting large doses of capital in the public sector banks without changing the ecosystem concurrently is probably not a good idea, we however provide a workable solution of how the authorities can consider providing large amounts of capital to the public sector banks, if they want to, without impacting the fiscal consolidation agenda.

NPAs have increased significantly



Source: RBI, Deutsche Bank

In our view, the government should consider recording capital injection in public corporations as a "financial transaction" or below the line item, and do the same for disinvestments receipts, which are currently shown as a revenue item. This would lead to an increase in public debt but would have no impact on the budget deficit and more importantly would be in line with the IMF's 2014 Government Finance Statistics accounting framework (GFS), which is followed by most countries across the world. To raise the funds, the government can issue bonds or issue a long-term promissory note to the RBI, which can then transfer cash to the targeted banks. Typically, central bank financing of public expenditure is seen as poor practice, but in this idiosyncratic case, such reservations should not apply, in our view. Additional capital can be raised if the government considers selling part of its stakes in public sector banks.

The current NPA problem will change India's banking sector landscape in the years to come, in our view. Already private sector banks (and NBFCs) have started to take market share from the public sector banks, a trend which we think will continue in the foreseeable future. It is reasonable to expect some public sector banks to merge in the coming years, with the government also eventually reducing their stakes in many banks. The public sector banks will be compelled to improve their operational efficiency and competitive intensity, which along with the legal provision of Bankruptcy Code, would ensure that credit is allocated to the productive areas of the economy (and to creditworthy entities), at the right price and post proper due diligence. While it is inevitable that the banking sector in India will undergo a material transformation in the period ahead, in our view the need of the hour is to ensure a speedy resolution to the NPA problem, which has been lingering for a long time.

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Mexico's Inflation: The Odd One Out

What's different in Mexico?

Mexican rates have reached levels comparable to 2003 and post-GFC while inflation has also moved up to levels comparable to those times. Banxico had to respond more forcefully – de-coupling from the US cycle and the perception that it reacted mostly to the relative US/Mexico rate. Accordingly the curve has flattened to historical lows. More recently, as the economy grew at a surprisingly fast pace in Q1 and inflation remained upbeat investors have either reduced receivers or opened payers on the view that Banxico will not be able to normalize rates at least before Presidential elections or anytime soon.

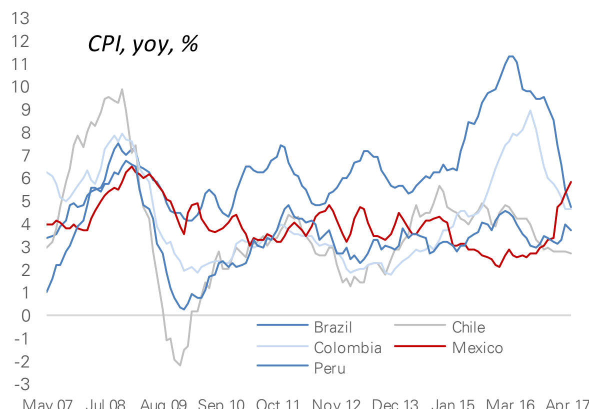
As Banxico has returned to targeting inflation, the pace of disinflation is crucial in forming a view on rates. This task is complicated by the fact that supply shocks are likely to be amplified by strong seasonality, which blurs the estimation of such supply impulses. In this piece we combine two models to estimate the path of inflation through 2018. We first estimate a VARX to capture inflation-output dynamics (augmented by exogenous fuel price shocks), and overlay the results with a separate estimation of dynamics to form our expected inflation path in the near future.

We find that inflation is likely to mean elevated because of both seasonal and supply-driven forces this year but that base effects and the economy underpin a fast disinflation in 2018 – barring another unforeseen supply shock. Comparing forward rates with our estimated inflation path yields a rising real rates path that contrasts with Banxico's range for the neutral rate and thus implies a high likelihood that the Mexican economy is hit again by a shock comparable to those of early 2000s and GFC that produced 25%+ depreciations.

Mexico's monetary policy and inflation in a regional context: Out of synch

Historically, Mexico's inflation rate was more or less synchronized with those of its regional neighbors. And while the levels of headline inflation have always varied significantly across Latin America, historically high inflation countries such as Brazil tended to reach peak rates of inflation more or less at the same time as low inflation economies such as Chile. Yet starting in 2014 Mexico began behaving differently. As the rest of LatAm economies experienced rising inflation during 2014 and 2015 on the back of weaker exchange rates, inflation in Mexico was declining. Furthermore, as year-on-year inflation peaked in late 2015/early 2016 across the region, Mexico's inflation was hitting its lowest ever levels. The divergence between Mexico and its peers continues: currently Mexico is the only Latin American economy experiencing inflation rates above the average inflation registered in 2016.

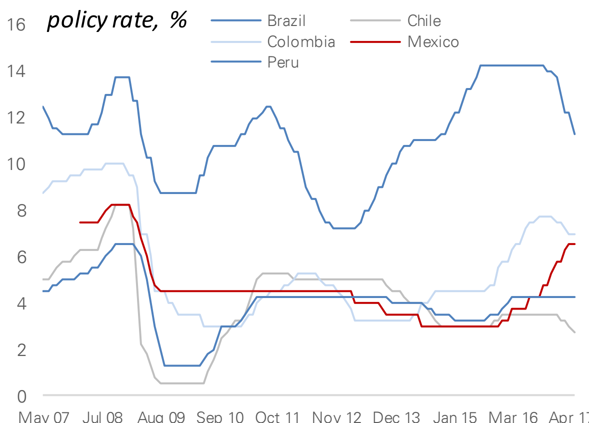
Mexican Inflation: Rising as it falls in the rest of LatAm



Source: Bloomberg Finance L.P., Deutsche Bank

And as one could expect, the diverging paths of inflation across LatAm have resulted in diverging paths for monetary policy rates across the region's countries. While over the past 12 months Brazil, Chile, Colombia, and Peru have engaged in easing cycles of one kind or another, Mexico stands as the only of the region's central banks that continues to tighten monetary conditions.

Banxico: Tightening as neighbors are easing



Source: Banxico, Deutsche Bank

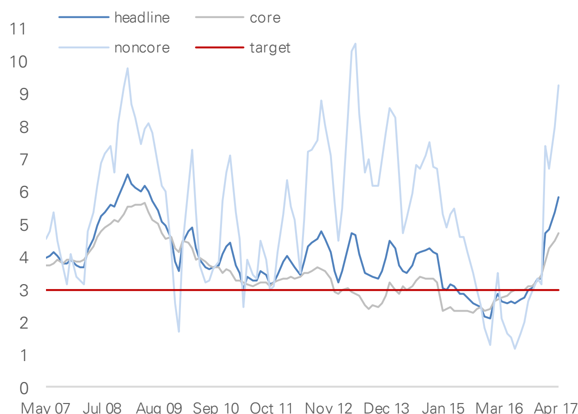
The anatomy of the recent path of inflation

What has happened with Mexican inflation over the last couple of quarters? Well, in a nutshell it has experienced a remarkable increase across measures and sub-indexes.

Inflation (both core and non-core) has been on the rise since July of 2016 and has reached levels last seen only in 2008 and 2001. Headline inflation has risen from an average of 3.24% in Q4 '16 to an average of 4.98% in Q1 '17 and reached 6.2% in the first half of May. Core inflation rose from an average of 3.28% in Q4 '16 to 4.19% in Q1 '17 and reached 4.8% in the first half of May. Non-Core inflation rose from an average of 3.14% in Q4 '16 to 7.38% in Q1 '17 and reached 10.7% in the first half of May. Diffusion indexes show a rising share of products both in the core and non-core baskets with price increases larger than 4%.which now amounts to close to 70% of the basket's products. Finally, trend indicators such as a truncated mean index as an indicator of the medium term trend of inflation we also find increasing inflation pressures both headline and core inflation.

Finally, when we look at seasonally adjusted m/m inflation we see a rising trend across headline inflation and core inflation as well as among its subcomponents.

Headline and core inflation: At historically high levels



Source: Banxico, Deutsche Bank

What has driven inflation in Mexico recently?

The Mexican economy is facing the consequences of several shocks ranging from political uncertainty in the US to higher liquefied gas prices due to the liberalization of market.

However, when thinking of Mexico's inflation it is important to remember that the output gap in the country is negative. Thus, shocks other than demand-side pressures must be behind the recent increase of both headline and core inflation rates. Luckily these other shocks have been fairly visible and hard to miss. So when it comes to the drivers of rising inflation rates there are three shocks that account for the bulk of the adjustment:

1) The roughly 60% depreciation of the nominal exchange rate accumulated since the end of 2014.

2) January's 20% increase of gasoline prices

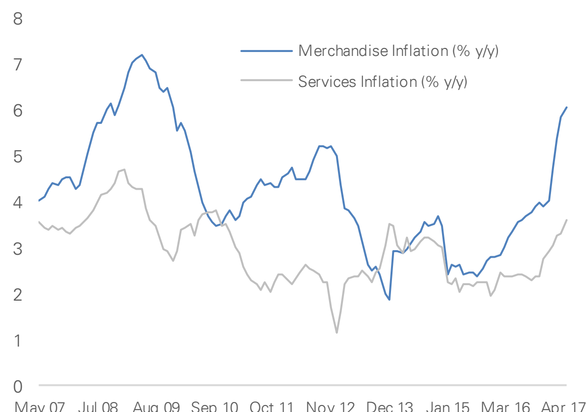
3) The 10% increase of the minimum wage at the end of 2016

While the third shock is likely to have had an impact across prices despite being binding for quite a small share of workers, we find evidence of the importance of the first two shocks listed above when we look at the adjustment of relative prices in Mexico over the past few months.

The role of the FX depreciation

We think that the recent increase of merchandise inflation is a reflection that the FX pass-through into inflation in Mexico is no longer zero. In previous notes we argued that one of the possible reasons behind the historically low exchange rate depreciation pass-through in Mexico was the perception that both nominal appreciations and depreciations of the currency were temporary. Given Mexico's environment of relatively low and stable inflation many producers with USD-costs preferred to accommodate these temporary shocks via profit margin adjustments rather than by changing the price of final goods and risking the loss of market share.

FX pass through no longer zero: Goods & services



Source: Banxico, Deutsche Bank

However, it seems that since the US election last November the perception regarding the nature of the MXN's depreciation changed. In particular, it seems that since then there is a perception that the real exchange rate depreciation is rather permanent and final good producers thus began the process of adjusting the price of final goods. This process pushed merchandise inflation from an average of 3.98 in Q4 '16 to 5.33% in Q1 '17 and a latest print of 6.24% in the first two weeks of May.

Furthermore, we find further evidence of an increasing FX pass-through into inflation when we look at the dynamic of inflation in the services sector. In particular, while the rate at which the price of services has also risen significantly they have not risen as much as that of the price of goods: between Q4 '16 and Q1 '17 average core inflation rose from 2.7% y/y to 3.2% y/y and during the first half of May it reached 3.5% y/y.

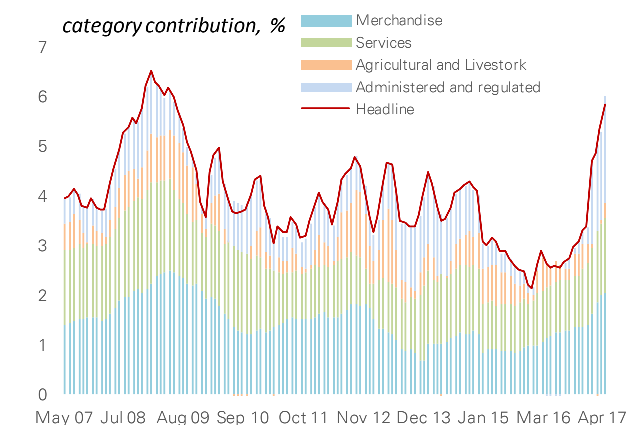
The role of energy price shocks

The surprising decision of the Ministry of Finance to increase gasoline prices by 20% last January has not only proven to be a costly decision from a political standpoint but also from an economic point of view.

Non-core prices have mechanically reflected the higher prices of gasoline. At the same time, some goods that belong to the core have also indirectly suffered from higher gasoline prices as costs of production overall have increased significantly in Mexico as a result of this adjustment.

A further example of the widespread impact of higher gasoline prices on the overall inflation basket in Mexico can be observed on the large price increases of goods that rely on transportation such as food prices and the adjustments on transportation prices. While the sub-index of energy prices registered an average 2% y/y growth rate during Q4 '16 while during Q1 '17 it reached 12.3% y/y and more recently during the first half of May it increased to 13.5% y/y.

FX depreciation and energy prices driving inflation



Source: Banxico, Deutsche Bank

In all, by breaking down the overall contribution of different subcomponents to recent headline inflation prints we can clearly identify the incidence of both the FX depreciation as well as of the higher energy prices on the acceleration of Mexico's inflation rate.

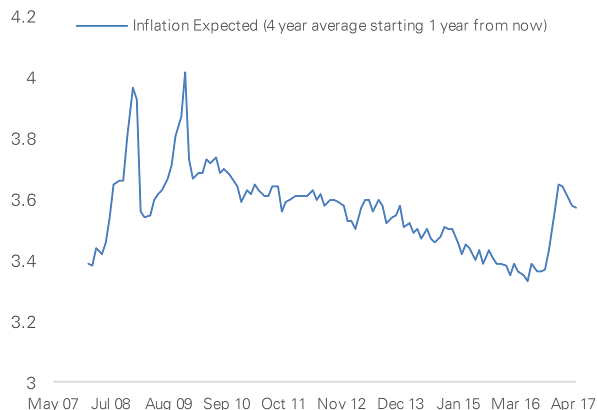
The impact on expectations and monetary policy

While two out of the three shocks driving inflation in Mexico might were relatively large, inflation expectations have been relatively well-behaved.

As we mentioned above, the output gap in Mexico is currently negative. Thus, higher interest rates only tend to have an impact on headline inflation to the extent that they result on either a depreciation of the exchange rate or on a containment of inflation expectations.

While the increase of energy prices significantly short-term and medium-term inflation expectations, Banxico's policy actions during 2017 – which have been solely focused on inflation – have managed to contain a further dislocation of medium term inflation expectations. In fact, during Q1 '16 the policy rate in Mexico has risen 100 basis points and while 2017 inflation expectations continue to rise, the longer term expectations peaked in February.

Medium-term expectations converging to target



Source: Banxico,, Deutsche Bank

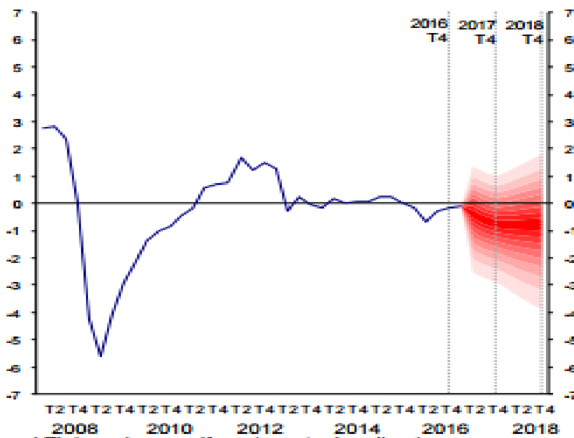
Inflation going forward

Before focusing on inflation, what do we expect for the Mexican economy going forward?

- We expect growth to remain above 2% due to the strength of consumption which is still below the 2.5% to 3.5% range of Banxico's potential growth estimates WHAT IS POTENTIAL FOR BANXICO?
- In part this is due to the relentless growth of consumer credit despite the higher rates.
- The driver behind this is that Mexico's relatively low penetration of banking services can be explained by a highly informal labor market. But as the 2014 labor market reform increases the degree of formalization of employment we expect banks to continue to extend credit.

- However we do not expect a resurgence of inflation which once again declined during Q1 '17 and is unlikely to pick up until both NAFTA uncertainty and next year's Presidential election are behind the rearview mirror
- Therefore, in forecasting inflation we assume GDP growth of 1.7% in 2017 and of 2.1% in 2018.
- Our assumptions imply that the output gap will remain in either negative or near-zero territory during the forecast period which is in line with Banxico's base case scenario

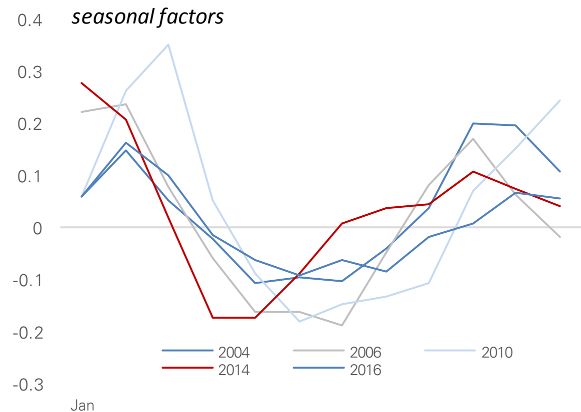
We expect a negative output gap going forward



Source: Banxico, Deutsche Bank

Also, it is important to note that inflation in Mexico has strong seasonal patterns. In particular, we follow Capistran et al. (2007) [6] and show that seasonal dummies alone explain over 80% of Mexico's inflation. In that context it is important to note that the summer are generally the months with the lowest m/m inflation due to energy subsidies.

Mexico's highly seasonal inflation



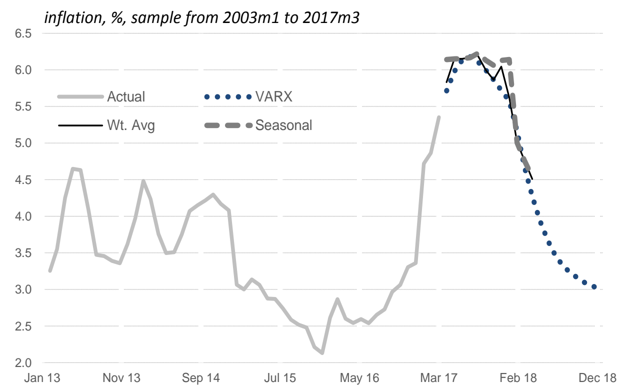
Source: Banxico, Deutsche Bank

Therefore, in order to capture both the seasonal variation of inflation and our expectations regarding the future path of macro variables in the Mexican economy we combine the methodology laid out by the afore mentioned paper (described in an end-note) as and a VARX model (which assumes a fading fuel shocks and an absence of supply shocks going forward) to project the path of future inflation.

The path of inflation in Mexico going forward

Our forecasting model leads us to expect inflation to converge back towards 3% by the end of 2018. And in the near term, we expect y/y inflation to peak in August and reach a level of 6.2%

Our inflation forecast



Source: Banxico, Deutsche Bank

Before discussing the strategy implications of our forecast it is important to note a couple of crucial risks to our methodology and therefore our forecasts.

The main risk is next year's Presidential election. As we have noted in earlier notes, AMLO's fiscally expansionary program as long as the fears many locals harbor regarding the future of the Mexican economy if

[6] Capistrán, Carlos, Christian Constandse, and Manuel Ramos-Francia. 2007. "Multi-Horizon Inflation Forecasts Using Disaggregated Data." Banxico Wokring Paper 2008-11

he were to become Mexico's next President could trigger a significant depreciation of the exchange rate. In that context, resumed pass-through pressures would alter the path of inflation and drive it away from our forecast. However, it seems that locals in Mexico are gradually coming to terms with AMLO's relatively high chances of becoming Mexico's next President and this is anecdotally reflected in editorials in local media. Therefore, we tend to think that an AMLO victory is at least partially priced into the exchange rate and asset prices which would tend to minimize the likelihood of a substantial FX depreciation.

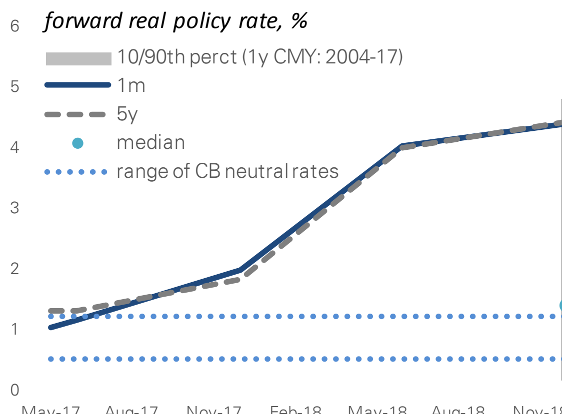
An associated risk to our forecast is the likelihood that the PRI engages in a Presidential campaign with a significant amount of electoral intervention which results in increased fiscal spending and therefore inflationary pressures. This risk can most likely be discarded only after the Executive branch sends a budget proposal to Congress in September this year. While theoretically the budget could significantly expand fiscal spending we perceive that the risks on this front are limited as Mexico's fiscal account are likely to be closely scrutinized by rating agencies given the perception that AMLO could become Mexico's next President. And we believe the PRI will want to avoid a downgrade in the next few months.

The implications of our forecast: Monetary policy

In a nutshell, we find that the combination of our inflation forecast with a constant monetary policy rate implies an increasing (ex-post) real rate. Furthermore, this implied real rate will be increasing well above the upper bound of Banxico's estimate of Mexico's neutral rate. And given that both our assumptions and Banxico's base case scenario expect a negative output gap going forward, the economy requires a real rate that is not contractionary.

We thus expect than in the absence of an massive shock Banxico will begin easing in 2H '18. As the charts below show, the implied rise in rates will push them to the top of the distribution of the past 14 years – and well over the top when expressed as a differential vs. US real rates. If this reflects adverse shocks in the future, these are not factored in the country's CDS. This raises questions about pricing that we tackle next.

Our forecasts imply and increasing real policy rate

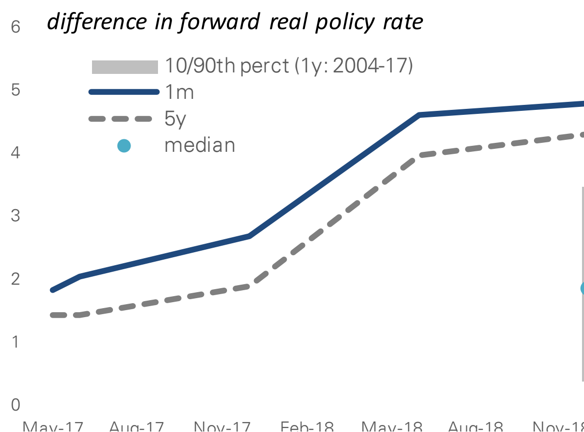


Source: Banxico, Deutsche Bank

Strategy implications

Beyond the macroeconomic arguments the implied rising real rate seems to be inconsistent with recent history on a relative basis when comparing Mexico and the US. In the charts above and below we show 1M and 5Y rates going forward vs. the US. In the case of Mexico, we deflate these forward rates with our inflation path while using the shortest available TIPs for the US. We compare these with the range of rates in Mexico and Mexico vs. US since 2004. Note that the implied real rates are near historical highs for Mexico as we mentioned above and near the top of the historical range when we subtract US from Mexican rates. In the latter projected rates by end-2018 is 170bp higher than the historical peak. Note that these peaks were reached after a nominal exchange rate depreciation of more than 50% in Mexico in the midst of the global financial crisis when inflation rates were also well above 6.5%. Given that our forecast implicitly assume no such large shocks the implied real rates are well above those reached under circumstances comparable to those we assume.

On a relative basis, MXN real rates are also high



Source: Banxico, Deutsche Bank

The sheer level of real rates in Mexico tells a similar story. Linkers are trading at an elevated level vs. the US as well as inflation break-evens which also seem to be well above our estimates. In our view, this suggests that there are more than 100bp worth of premium over the long term of the curve which could be an indication of Banxico’s mandate being compromised.

These estimations and economic considerations underpin our bias to receive in Mexico. However, an inverted curve in a carry-seeking environment is less appealing and we – tactically – take profit in our 3Y receiver in light of the recent rally. Elections next year and possible delays in easing should the electoral process trigger risk aversion bode for a protracted normalization of rates in Mexico and patience. But we would re-enter receivers in spikes as implied real rates seem unsustainable and, as the experience of Brazil and other markets show, repricing can suddenly materialize once inflation eases and we may start to see more clear-cut signs of this happening during the summer. We also believe that inflation breakevens overestimate inflation and favor nominals vs. linkers. As the overall level of rates in Mexico is high, we continue to expect spread compression vs. US.

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For a more detailed view on trade recommendations, please refer to our regional strategy sections of the EM Monthly.

Technical Appendix

We use two models – the seasonal model and VARX (Vector Auto-regression with an exogenous variable) – to capture the seasonal pattern and the equilibrium trend with given shocks, respectively. Then we take as our inflation forecast the weighted average of the two model forecast for each month until 2018m12.

The reason that we add the fuel price to an otherwise standard VAR (inflation, unemployment and policy rates) is the inflation spike since last Jan results mainly from an unexpected policy shock to previously regulated fuel prices. Given the tendency that domestic fuel prices will gradually float freely in accordance with market prices, which are flat until the end of 2018 from future prices, we assume zero month-over-month fuel price change.

We follow a Banxico working paper by Capistran et al. (2009) to conduct the forecasting using seasonal models. To test whether Mexico inflation shows strong seasonality, we first run a linear regression with 12-month dummies and get rolling R^2 over the whole sample. The rolling R^2 is relatively high for all inflation since 2003, with rolling R^2 higher than 70% since 2006. Hence, it is legitimate to use seasonality model to conduct forecasting. For the headline, core, noon-core and each component, we choose from four seasonal models with different specification the one that generates the best out-sample performance on a 12-step forecasting horizon. Then we get inflation forecast for the headline, core, non-core and each component by integrating as much information as possible.

Turkey: CGF, the current account, and TRY

- The Turkish government introduced quantitative measures to revive credit expansion to businesses following the failed coup attempt last year. These include three different schemes extended under the Credit Guarantee Fund (CGF), the Union of Chambers and Commodity Exchanges of Turkey (TOBB), and the Small and Medium Business Development and Support Administration (KOSGEB). The take-up has been remarkable. Trend growth in FX-adjusted commercial credit has jumped from single-digit levels in late September 2016 to nearly 50% in May this year.
- Such explosive credit growth has recently led to elevated concerns over possibility of a larger-than-expected current account deficit this year, given the close relation between credit growth and external balances in Turkey, reflecting the country's low national savings problem. Our findings reveal commercial credit per se does not have a significant impact on the current account. External gap is however fairly responsive to consumer loans, TRY and import prices.
- While the Credit Guarantee Fund per se will not have a meaningful impact on the current account deficit this year, it has however already led to a few dislocations in the banking system, manifested in higher leverage in TRY, increasing cost of off-balance sheet counterparty and rollover risks, and potential rise in more risky loans in total loan book. On the other hand, the gradual yet steady rise in consumer loans has potential to widen the external gap. For now, other alleviating factors, such as weaker TRY (in real terms) and reviving external demand, appear to compensate. Yet, risks are still tilted to the upside on (front-loaded) growth, and the current account deficit this year.
- While we are relatively less worried about the current account dynamics, its funding has been sub-optimal year-to-date with banks' and corporates' roll-over rates having remained relatively subdued in historical context, paving the way for marked depletion of FX reserves until recently. While a less uncertain political outlook following the April referendum and squarely supportive global backdrop may help external financing prospects in the coming period, we remain wary of funding challenges, and still expect TRY to remain weak on a sustainable basis due to continued FX demand by locals, lack of adequate buffer against external shocks, as well as a vicious circle between TRY and inflation under CBT's liquidity-focused policy framework.

Introduction

Nearly a year has passed since the failed coup attempt in July 2016. The foiled putsch had triggered a negative confidence crisis, which later on amplified by an adverse external backdrop in the immediate aftermath of the US elections. The authorities had first treated the shock as if it would have triggered a credit crunch in the economy, and hence opted to provide unlimited liquidity to local banks followed by lower policy rates and easier macro-prudential conditions. Such loose monetary policy stance however backfired when external conditions turned sour after November last year and the Central Bank of Turkey (CBT) in the end resorted to tighter rates and released FX liquidity to stem frontloaded TRY weakening. A tighter monetary policy was then accompanied by a looser fiscal stance, particularly in an expedited fashion ahead of the April constitutional referendum.

In the midst of all these policy actions, the government also introduced quantitative measures to revive credit expansion to real firms to support economic growth. These state-backed steps included three different credit schemes extended under the Credit Guarantee Fund (CGF), the Union of Chambers and Commodity Exchanges of Turkey (TOBB), and the Small and Medium Business Development and Support Administration (KOSGEB). The take-up has been remarkable. Trend growth in FX-adjusted commercial credit has jumped from single-digit levels in late September to nearly 50% in May this year. Total loan growth - in trend terms - exceeded 40% recently, also thanks to rising consumer loan growth. Such explosive credit growth has led to elevated concerns over possibility of a larger-than-expected current account deficit this year, given the close relation between credit and external balances in Turkey, reflecting the country's low national savings problem.

Our findings reveal commercial credit per se does not have a significant impact on the current account, supporting CBT's preceding analyses. This may be due to firms' peculiar ability to contribute to production cycle and export, which later on could compensate for a near-term widening in the current account due to additional demand for imported inputs. Our results also show that external gap responds positively (and robustly) to a weaker TRY (in REER terms), hinting that the core goods deficit could continue to narrow this year, particularly if the European demand remains strong.

Our results also validate CBT's earlier findings that the external balance is fairly responsive to consumer loans, given the latter's direct impact on demand for imported consumer goods. While the recent rise in consumer loans (18.5%WoW) has been overshadowed by the

acute leap in commercial credit, it preceded the latter and was more consistent. Despite CBT tightening this year, deposit and loan rates have risen moderately in comparison to previous hiking cycles. This coupled with recovering demand in light of improved confidence and looser macro-prudential conditions also explain the ongoing steady rise in consumer loan growth. Our findings confirm that impact of consumer credit on both real GDP growth and the current account deficit has been significant in recent history, hence still pointing to upside risks on the external gap in 2017.

While we are relatively less worried about the current account this year, its funding has been fairly sub-optimal so far with banks' and real corporates' roll-over rates having remained relatively subdued in historical context, which paved the way for marked depletion of FX reserves until recently. While a less uncertain political outlook following the April referendum and squarely supportive global backdrop may help external financing prospects in the coming period, we remain wary of funding challenges, and still expect TRY to remain weak on a sustainable basis due to continued FX demand by locals, lack of adequate buffer against external shocks, as well as a vicious circle between TRY and inflation under CBT's liquidity-focused policy framework.

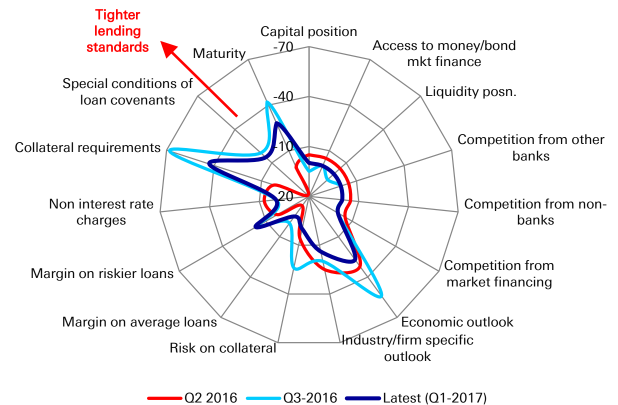
In the rest of this paper, we first provide details of state-backed credit schemes, followed by our study on the relation between credit growth and the current account. We then conclude with our assessment on the outlook for external balances and TRY.

When Turks turn Keynesian

While the CBT's initial policy response to the failed coup attempt was partially to blame for massive TRY sell-off since then, quantitative credit measures introduced late last year and in Q1 2017 have played a major role to induce a meaningful revival in loan growth. The foiled putsch and the ensuing social, political and external shocks led to a great deal of erosion in both consumer and investment confidence. Banks tightened lending conditions; particularly for business loans, by increasing the collateral requirements and cutting down maturities, citing elevated counterparty risks. The authorities decided to alleviate such burden on availability of credit supply by stepping in as an intermediary between banks and corporates, and decided to boost collateral support the Treasury has been providing under different schemes. This was a targeted policy response to take off counterparty risk from local banks' exposure to firms, up to a certain level.

There are three different schemes introduced (or mobilized) since late 2016, the Credit Guarantee Fund (CGF), TOBB's low-rate loan scheme, and KOSGEB's zero-cost credit support. All three include collateral support from the Treasury, low (or zero) lending rates, and favourable risk weightings (i.e. 0% versus 75% or 100% under normal conditions) in capital adequacy ratio calculations. The CGF has become the flagship scheme following the official decree enabling the Treasury to increase its collateral support to as much as TRY250bn (from TRY20bn previously) to small and medium-size enterprises (SMEs) and other larger businesses with a 10% limit on any non-performing segment (i.e. the Treasury's exposure is capped at TRY25bn or 1% of GDP).

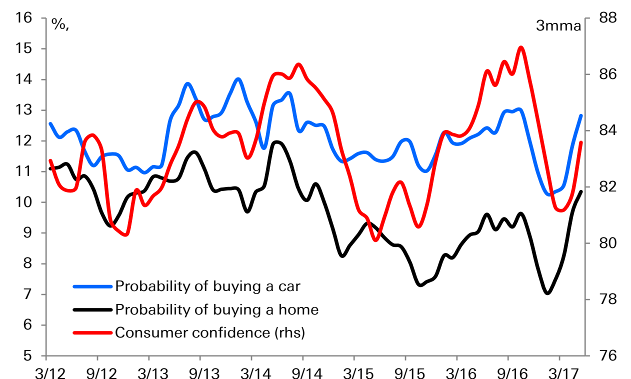
Banks tightened lending standards citing counterparty risks immediately after the failed coup attempt



Source: CBT and Deutsche Bank

According to the formal protocol signed between the Treasury and the CGF in March, the authorities accepted to underwrite TRY200bn worth of collateral initially with a 7% limit for potential defaults. The KOSGEB scheme is envisaged to create TRY11bn worth of SME loans while another TRY5bn is planned to be extended via the TOBB.

Confidence plummeted in Q4 2016

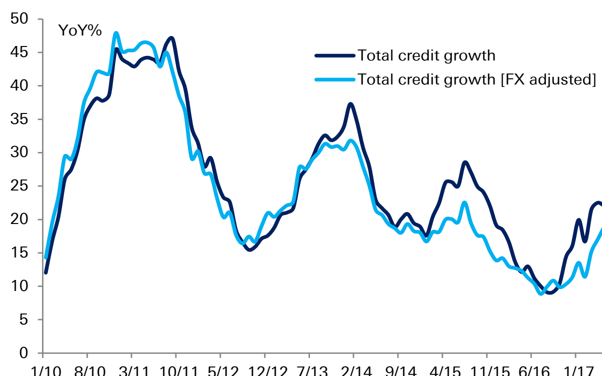


Source: CBT and Deutsche Bank

According to the latest data from the CGF (i.e. as of end-May), banks lent nearly TRY180bn of Treasury-guaranteed credit. Nearly 274k firms took part in the scheme with an average size of TRY0.5bn per loan. 90% of loans were absorbed by SMEs while the rest was taken up by larger firms. Similarly, FX loans only

accounted for 10% in total. 64% (of TRY180bn) has been extended as new loans, 31% were part of an existing facility while 5% was lent for re-financing purposes. Working-capital loans had an average lending rate of 14.4% with an average maturity of 40 months while investment credits enjoyed lower rates at 13.8%. (with 61 months of average maturity). Private banks accounted for 75% of total credit extension followed by public banks at 23% and participation banks at 2%. Nearly 45% of loans were absorbed by retail and services firms, followed by manufacturing (29%) and construction (12%).

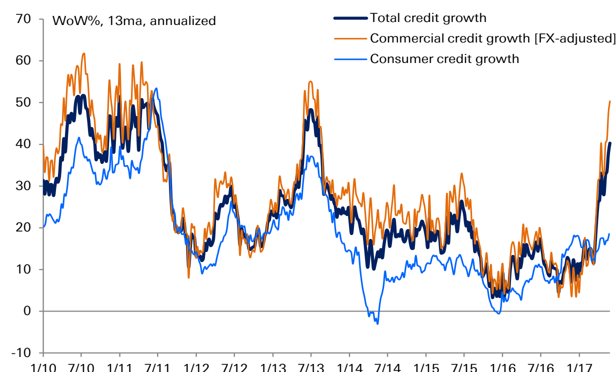
Credit growth has recovered sharply…



Source: Haver Analytics, CBT, and Deutsche Bank

Boosted by the CGF, FX-adjusted annual loan growth has reached c19% in May after having reached as low as 9% in July last year. Impact of the CGF was more visible on trend growth (i.e. FX adjusted and annualized 13-week moving average rate) with total credit having expanded by as much as 40% thanks to nearly 50% rise in commercial credits. Consumer loans also rose during the same period, at a slower yet consistent rate.

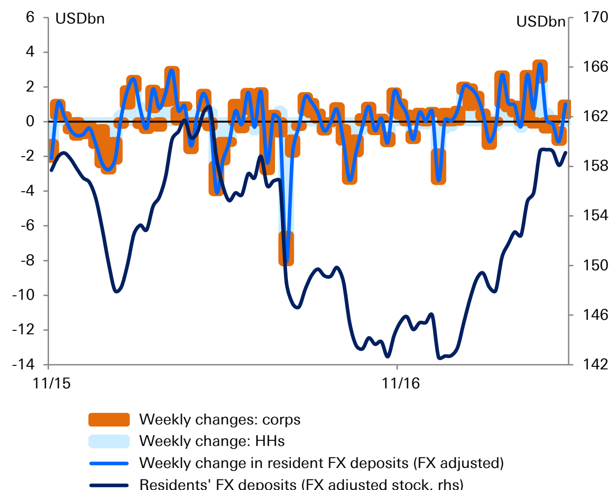
…boosted by the Treasury-backed CGF scheme



Source: Haver Analytics, CBT, and Deutsche Bank

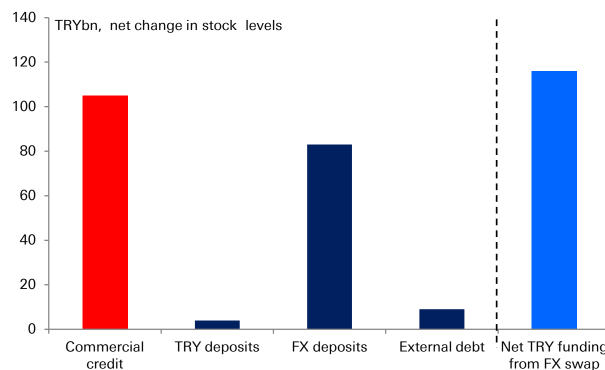
Such explosive credit growth in such a short time span has however caused a few side-effects on the banking system. Given that such rise took place concomitantly with residents' increasing demand for FX deposits and CBT tightening, there was not enough TRY funding. As a result, local banks again had to tap FX swaps to create TRY liquidity against their rising FX liabilities.

Residents replenished FX deposits year-to-date



Source: Deutsche Bank

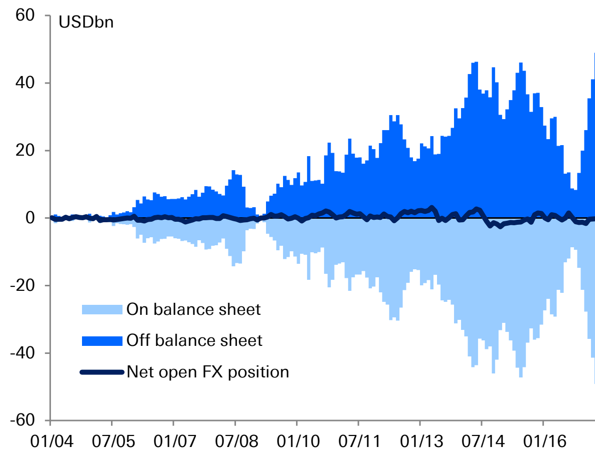
Banks used FX swaps to created TRY funding for commercial credit extension



Source: Deutsche Bank

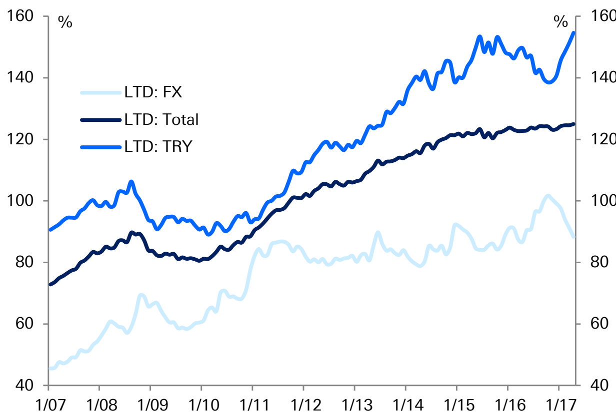
Such dynamics also paved the way for a large rise in banks' on-balance sheet FX liabilities. Their exposure to off-balance sheet instruments has also climbed to its all-time high (USD49bn), pointing increasing cost of counterparty and rollover risks. Another dislocation has been triggered on the leverage side as TRY-denominated loan-to-deposit ratio has exceeded 150%, reflecting overly stretched levels.

Banks' on-balance sheet open FX position…



Source: BRSA and Deutsche Bank

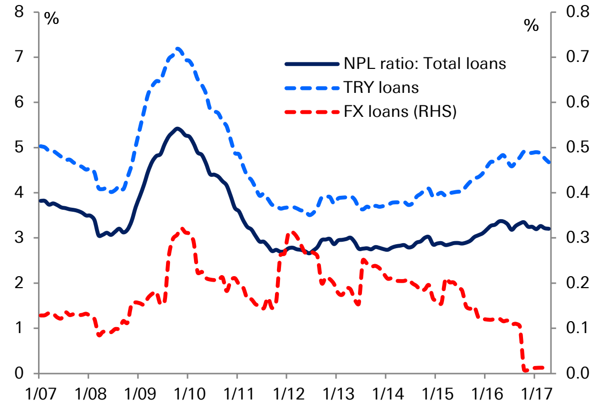
…and the TRY-denominated loan-to-deposit ratio have both reached their all-time high



Source: BRSA and Deutsche Bank

While the fact that the Treasury's exposure to any non-performing segment has been currently capped at 7% (with a potential to go up to 10%) keeps financial stability risks on banking system at bay for now, it remains to be seen whether banks have opted for relatively more risky loans under the current scheme. It is worth noting that current dynamics in official non-performing loans still appear relatively benign, though only time will tell whether the ongoing scheme has created moral hazard issues ahead.

Official NPL ratio still appears benign



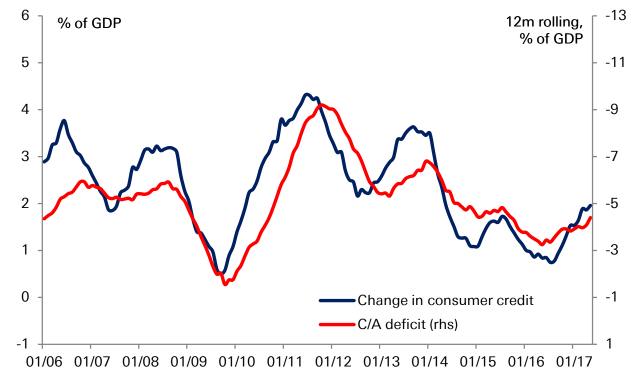
Source: BRSA and Deutsche Bank

Overall, the CGF and other accompanying schemes have been influential to spur credit demand (and supply) in a frontloaded fashion. While this is good (bad) news for growth (inflation) prospects in near term, excessive leverage in TRY loans, and banks' increasing exposure to off-balance sheet FX instruments, and possibility of higher NPL ratios ahead (despite the Treasury's commitment) may turn market attention to financial stability risk at some point particularly if external backdrop turns sour and/or geopolitical risks resurface.

Impact of CGF on the current account deficit

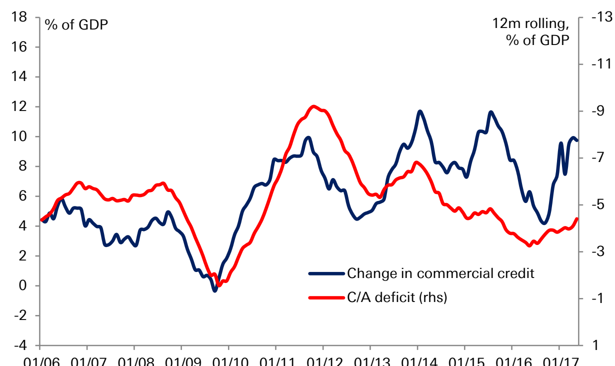
CBT has already well documented the negative impact of rising credit growth, particularly in the consumer segment, on the current account deficit. In fact, simple eye-econometrics also suggests there is a close relationship between consumer loans and external balance - though it is difficult to claim the same for commercial (or business) credits.

There is a close relation with consumer credit growth and the current account deficit



Source: Haver Analytics, CBT, and Deutsche Bank

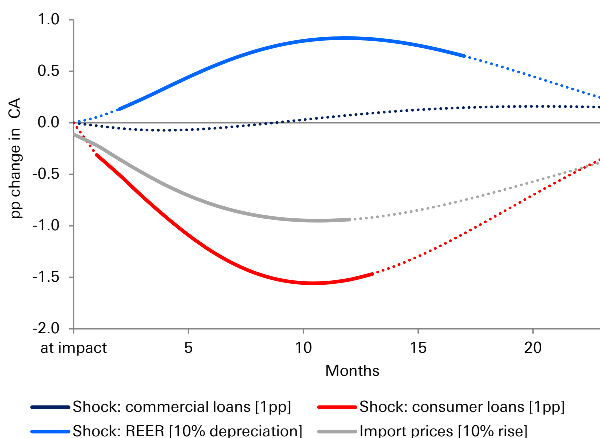
...though it is difficult to claim the same for business loans



Source: Haver Analytics, CBT, and Deutsche Bank

Our simple vector auto-regression (VAR) model also confirms such assessment. Using TRY (in REER terms), import prices (in USD terms), change in commercial and consumer loan stock (measured as percentage of GDP), and policy rates (the weighted average) as explanatory variables, our VAR model reveals that the current account deficit responds significantly to changes in consumer loans, the Turkish lira and import prices, yet is not affected meaningfully by business loans.

C/A deficit: impulse responses



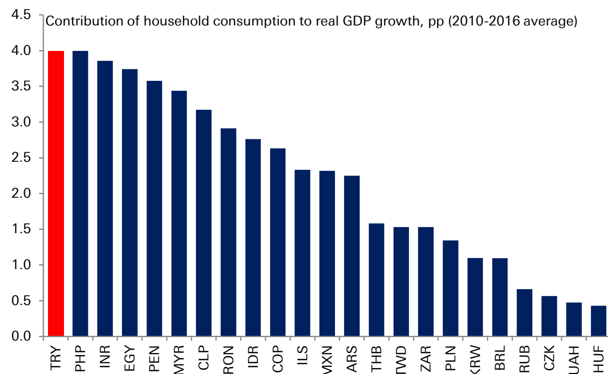
Note: Dotted lines refer to insignificant response at the respective maturity.
Source: Deutsche Bank

According to our results, 12-month rolling current account deficit measured as percentage of GDP could widen as much as 1.5 percentage points (pp) over a year time following a one percentage point rise in consumer credit, again measured as percentage of GDP. Similarly, a 10% rise in import prices leads to around 0.9pp deterioration in the current account deficit (C/A).

An unexpected 10% weakening in real effective TRY meanwhile paves the way for 0.8pp improvement in C/A over a year. Impact from a surprise 1pp rise in commercial credit is limited and statistically insignificant.

One possible explanation for differing impact of different types of credit on C/A could be related to their effect on growth. Accounting for 60% of total nominal GDP, the Turkish economy heavily depends on (credit-fuelled) private consumption.

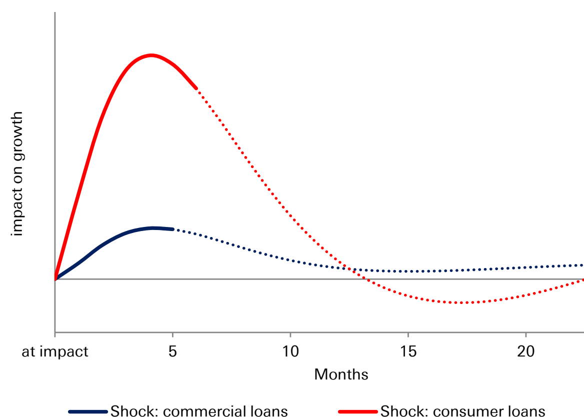
Turkish economy heavily relies on HH consumption



Source: Haver Analytics, National Statistical Agencies, and Deutsche Bank

Our accompanying model using domestic real GDP growth, external demand and credit growth also reveals that consumer loans could stimulate economic activity four times stronger than commercial loans six months after a positive credit shock.

Consumer credit stimulates growth strongly while impulse from business loans are limited

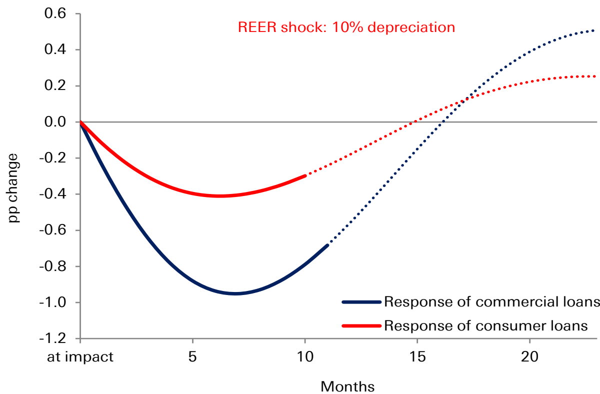


Note: Dotted lines refer to insignificant response at the respective maturity.
Source: Deutsche Bank

Further analysis from our base model also suggests both consumer and business loan growth decline following a negative FX shock (i.e. TRY depreciation). Impact on business loans (from 10% real weakening in

the lira) is however much deeper (nearly -1pp at the peak versus -0.4pp in consumer credits).

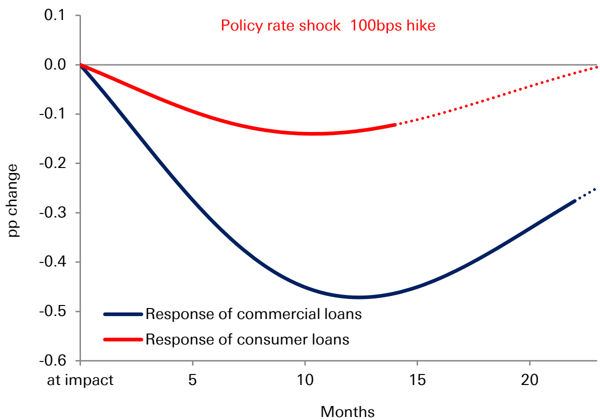
Response of different kinds of credit to FX shock



Note: Dotted lines refer to insignificant response at the respective maturity.
Source: Deutsche Bank

We think this is partially owed to higher policy rates following the adverse FX shock, to which commercial loans react more adversely than consumer credit.

Response of different kinds of credit to policy rate shock



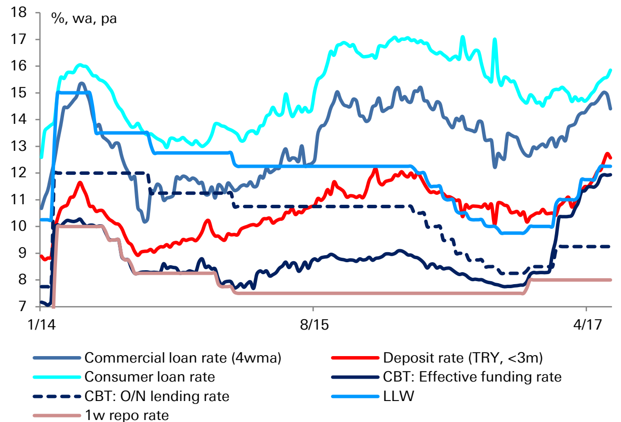
Note: Dotted lines refer to insignificant response at the respective maturity.
Source: Deutsche Bank

There could be also additional burden from tighter collateral requirements on businesses as weaker TRY would worsen firm balance sheets with open FX position. Given that households are generally long in FX (holding USD99bn of FX deposits in end-May), the decline in consumer credit growth could be more related to negative sentiment/confidence associated with the FX shock, higher loan rates or increased risk aversion by banks (i.e. curbed credit supply). Such difference in response of consumer and business loans to various shocks also explains their diverging impact on both real GDP growth and the current account deficit, in our view.

All-in-all, our analysis suggests the direct impact from the explosive growth recently seen in business loans on the current account deficit could be limited. However, it is difficult to claim the same for consumer loans, which have continued to expand gradually albeit consistently year-to-date. We estimate the rise in consumer credit seen until recently, on its own, could add 0.7pp to the current account deficit by end-2017.

Such increase in consumer loans despite monetary tightening delivered by CBT since January begs for additional explanation, in our view. One reason could be looser macro-prudential measures introduced in Q3 2016, including a longer maximum maturity for cash loans, higher number of instalments on credit card payments, and more favourable risk weightings for cash and vehicle loans. Another explanation could be improving confidence, particularly following the turnaround in the lira. Political externality and nation-wide campaigns on residential projects have also kept mortgage rates artificially low, which probably helped to keep loan demand relatively stimulated.

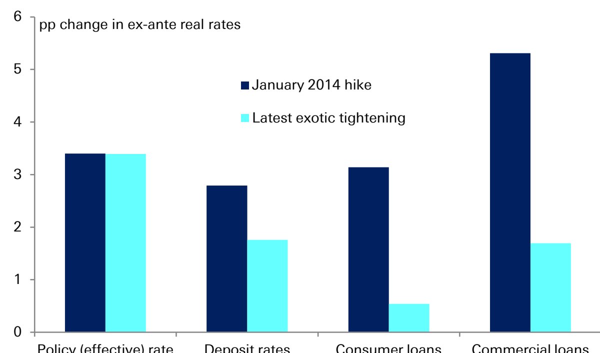
Loan and deposit rates have started responding to the CBT's latest tightening…



Source: Haver Analytics, CBT, BRSA, and Deutsche Bank

The way CBT delivered its latest tightening, i.e. mostly via liquidity tools and the emergency lending rate, and over time, could have an impact, too. Given the temporary nature of recent tightening, its transmission to (real) deposit and loan rates, particularly for the consumer segment, has been much limited compared to that of the front-loaded and orthodox hike delivered back in January 2014. A larger negative output gap than before could however admittedly account for such mooted response by loan and deposit rates in the current cycle.

...but extent of rise (in real terms), particularly in consumer loans, has been shallower in comparison to previous cycles



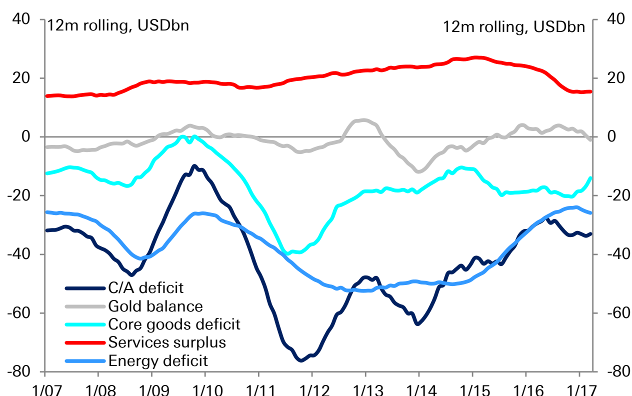
Source: Haver Analytics, CBT, BRSA, and Deutsche Bank

Demand-side arguments only partially dictate the dynamics for the current account balance.

External and nominal factors as well as other idiosyncratic issues, such as tourism receipts and the gold balance, also affect Turkey's net foreign payments. There are counter forces at play. For instance, improving demand in Europe and weaker TRY in REER terms will likely help Turkish exports while dampening impact of rising consumer credit on demand for imported goods.

According to our calculations, over 10% (real) depreciation seen in the lira year-to-date (in annual terms) could lead to 0.8pp improvement in C/A on its own by end-2017, potentially cancelling out the upside pressure from stronger consumer credit impulse this year. 12-month rolling tourism receipts have also reached a welcome plateau year-to-date, and the latest tourist arrivals numbers herald there could be some modest improvement during the rest of year after a dismal performance both in 2015 and 2016.

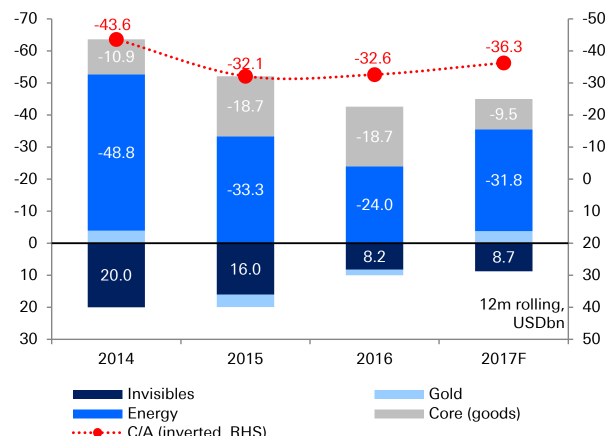
C/A deficit looks set to widen this year...



Source: Haver Analytics, CBT and Deutsche Bank

Against these positive drivers, the gold balance looks en route to make a return to its structural deficit this year. This is probably because holding gold serves as a good hedge for locals against rising inflation and/or rising geopolitical risks while it could also be due to latest policy incentives by the CBT, i.e. recent amendments in the reserve option mechanism encouraging banks to garner more gold from the public, with an aim to replenish reserves. Higher import prices, particularly in energy (up 25% in annual terms), meanwhile looks set to add as much as USD8bn to the annual energy bill this year.

...yet not excessively



Source: Haver Analytics, CBT, and Deutsche Bank

Putting everything together, we expect the current account deficit to moderately widen this year to around USD~36bn from USD32.6bn in 2016. The gap measured as a percentage of nominal GDP looks set to deteriorate more visibly to ~4.6% from 3.8% a year ago.

We think the ongoing explosive growth in business loans is not only unsustainable but also it will not have a direct negative impact on external balances based on our findings. The gradual albeit consistent rise seen in consumer loans year-to-date however points to upside risks on the Turkish growth (DB: 3.4%YoY), inflation, and the current account deficit this year.

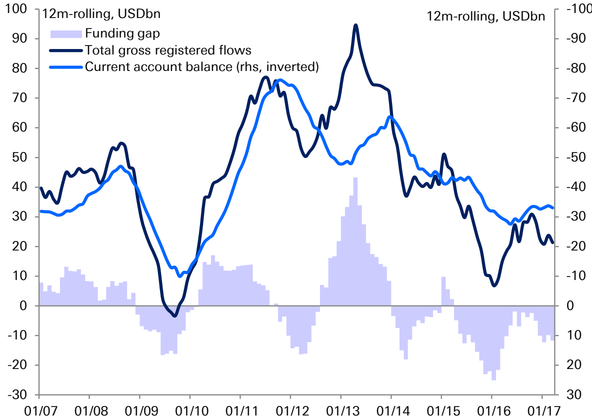
Risks on external front are on the financing side, not the current account

Recent sharp leap in credit growth have turned markets' attention to trajectory for the current account deficit. Our analysis above shows while risks are tilted to the upside they appear manageable for now. Hence, we are not too much worried about the extent of external gap this year. However, we still remain concerned about the financing prospects throughout the year despite better global conditions for EM assets of late.

Funding gap, i.e. the difference between net current account payments and total gross registered flows, has widened (again) in Q1, and reached around USD12bn.

While this is almost half of the peak seen at the height of external and domestic political risks (in late 2015), gross official reserves (USD105bn) are now much lower (by USD~15bn).

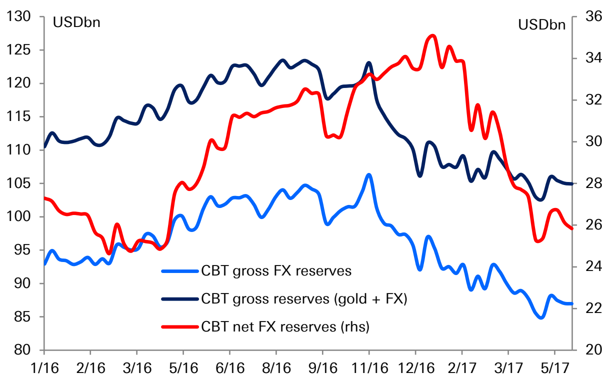
Funding gap has widened year-to-date…



S Source: Haver Analytics, CBT and Deutsche Bank

Net FX reserves, excluding gold and banks' FX deposits, were also worryingly low at USD26bn in end-May, pointing to absence of any meaningful buffer against adverse external shocks. Such levels also explain the Treasury's decision to frontload international bond placements this year (USD6.25bn so far versus USD6bn planned in the 2017 borrowing programme) and possibility of additional issuances in H2.

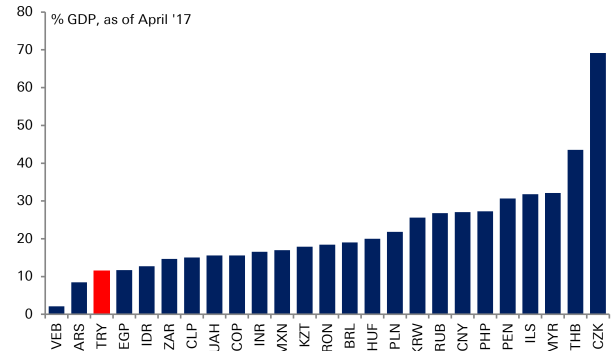
…and led to a drop in FX reserves



Source: Haver Analytics, CBT and Deutsche Bank

A more nuanced look at the decomposition of external funding insinuates net FDI inflows have been stuck not only at a modest 1% of GDP recently but also flows into the construction sector, which contributes the least to the growth potential, accounted for on average nearly 50% of the total since 2014.

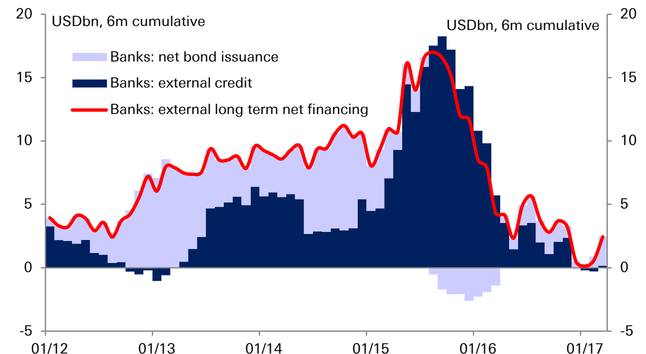
Turkey's FX reserves appear too low

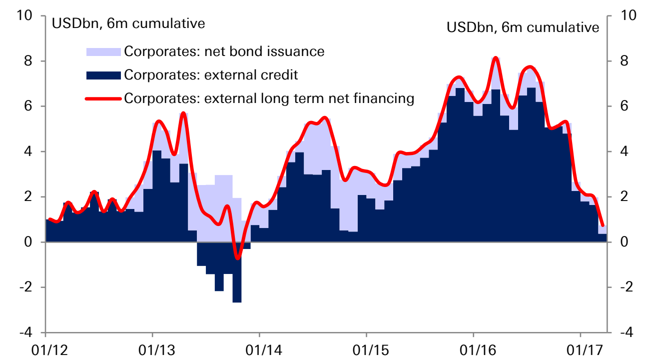


Source: Haver Analytics, national sources, and Deutsche Bank

Other long-term inflows, in the form of cross-border loans and bond issuances by banks and corporates, have also decelerated markedly. Banks' external loan roll-over rate slipped below 100% in Q1, though this has been somewhat compensated by higher bond issuance of late.

Banks' and corporates' long-term debt roll-over rate has declined markedly



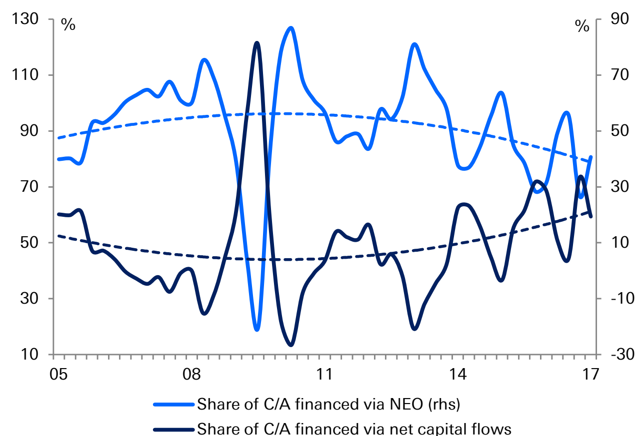


Source: Haver Analytics, CBT and Deutsche Bank

Given their inherently fickle nature, increasing reliance on unregistered flows, i.e. net errors and omissions (NEO), also does not provide comfort ahead. NEO-related flows financed on average over 15% of the current account deficit since mid-2014.

This is hardly a reliable source of funding, which could change tack any time and put further pressure on official reserves.

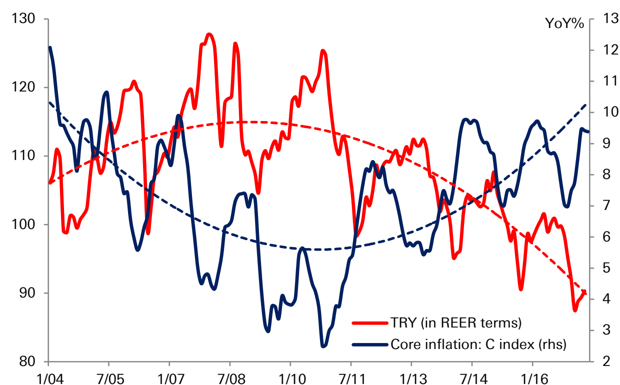
Reliance on NEO funding has increased since 2014



Source: Haver Analytics, CBT and Deutsche Bank

We also think the virtuous cycle between TRY and inflation that had prevailed prior to the Great Financial Crisis - and also a few years afterwards – was supplanted with a vicious one. This means the lira is now on a secular depreciation trend (in real terms) not only due to a fundamental shift in global backdrop but also in absence of a constructive and new domestic story. We believe CBT's liquidity-focused monetary framework also exacerbates the situation by failing to deliver price stability on a sustainable basis. Current strategy mostly concentrates on fending off excessive TRY weakness in short-run with the least possible impact on growth. Such choice amplifies the negative feedback loop between a weaker TRY, followed by sub-optimal monetary response, and an upward-sloping inflation, which later on leads to further currency weakening (to compensate for lack of nominal return and also due to PPP arguments) and aggravates Turkey's weak-fundamentals argument.

A vicious cycle between TRY and inflation



Source: Haver Analytics, TurkStat, CBT, and Deutsche Bank

TRY still remains on a depreciation trend

We think the Credit Guarantee Fund per se will not have a meaningful impact on the current account deficit this year. It has however already led to a few dislocations in the banking system, manifested in higher leverage in TRY, increasing cost of off-balance sheet counterparty and rollover risks, and potential rise in more risky loans in total loan book.

On the other hand, the gradual yet steady rise in consumer loans has potential to widen the external gap. For now, other alleviating factors, such as weaker TRY (in real terms) and reviving external demand, appear to compensate. Risks are however tilted to the upside on growth (and inflation), and the current account deficit this year, in our view.

Notwithstanding possibility of some over-performance in near term thanks to tight monetary conditions - in a la Turca terms, fledgling - albeit shallow - improvement in inflation, supportive external backdrop, and favourable valuation and positioning, we still think the Turkish lira remains on a depreciation trend.

As explained in the paper, we do not think the current account dynamics will be the major factor dictating TRY's momentum this year. Despite some likely uptick in capital flows in late Q2 and during summer months, we remain concerned about possibility of inadequate external funding, which could put further pressure on already scarce FX reserves.

Quality of financing has also deteriorated, as manifested in rising share of FDI inflows to construction, and increasing reliance on fickle unregistered inflows. Vicious circle between inflation and the lira, and the secular shift in global backdrop since 2013, ongoing demand for FX by residents also insinuate TRY looks set to remain on a depreciation trend ahead.

We expect the lira to reach 3.90 against the USD by year-end and then levels well in excess of 4/USD in 2018.

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Tales of Three Cycles: Mexico, Colombia, and Peru Trip Notes

Mexico: Unresolved issues

We visited Mexico only a few days ahead of the State and Local elections that took place in Edomex, Coahuila, Nayarit, and Veracruz on June 4th. Thus many of our conversations with local investors, policy makers, and analysts revolved around the political risks Mexico is currently facing. Yet concerns regarding the future of the Mexican economy and Mexican asset prices are far from being limited to politics and encompass issues like inflation in the near term, the path of fiscal accounts in the medium term, and growth and productivity over the longer run.

No longer deteriorating but far from improving

After last November's election in the U.S, many analysts expected the Mexican economy to experience a very quick deterioration in terms of growth and in terms of asset prices. Yet we have observed that the economy is far more resilient than many had expected. In particular, the low degree of penetration of the financial services industry in Mexico – which many times has been singled out as a driver of the chronically disappointing rate of economic growth – has this time been a blessing in disguise. The economy's relatively low leverage has allowed credit to continue to grow and serve as a pillar of consumption while Banxico continues to increase the policy rate. As a result, Q1 '17 data surprised both us and locals on the upside.

Locals are however relatively more bearish than us when it comes to inflation. In their view, the output gap is a lot closer to zero than Banxico tends to suggest. Many in Mexico believe that it may take years for inflation to converge back to Banxico's target especially given that next year's elections are unlikely to encourage fiscal restraint. On the activity front however, locals tend to be more bullish than we are and many consider the recent surge in exports and the recent recovery of oil prices as a relatively permanent feature of the economic scenario in the near future. We disagree and see ongoing signals of an economy that is unlikely to experience a sustainable, investment-driven growth acceleration. In this context, given that the neutral policy rate is near 1% in real terms we are more dovish than locals in expecting that once base effects of the gasoline price shock fade and the election is on the rearview mirror Banxico is likely to begin normalizing the policy rate (see "Mexico Inflation: The Odd One Out" on this EM Monthly).

In the longer term locals are concerned regarding both fiscal issues and the ability of the economy to achieve growth rates near or above 3%. On the fiscal front the recent improvement of the numbers has been reliant on heavy cuts on infrastructure investment and one-off gains from reserve revaluation. The underlying trend for the fiscal accounts and oil production is likely to continue on weigh on the BoP. We heard of no credible plan to tighten fiscal spending and after the PRI realized it might "intervene its way to victory" like in the Edomex, we are not holding our breath. And while the uncertainty regarding NAFTA is dissipating we are still unlikely to observe a rebound of foreign investments like the one the government seems to be counting on to make up for its cuts in investment spending especially from PEMEX: regulatory uncertainty on the face of a new administration and the relatively unsupportive backdrop for oil prices suggest these inflows are unlikely to materialize.

Local rate implications: Positioning for lower inflation

Local positioning seems relatively light, but pension funds continue to favor foreign assets to diversify away from local fixed income assets (with still accounts for most of their portfolio). Buying foreign assets and selling USD forward has been a profitable (high-carry) strategy that they seem willing to maintain. Bear in mind, that because local pensions have net inflows the above-mentioned strategy does not result in net selling of local fixed income. Going forward we expect limited support from local accounts that seem light on duration and weary of a curve inversion. We think real rates in Mexico are high and given our expectation of inflation peaking this summer we think that barring a political shock Banxico will begin easing in about 12-15 months. We thus favor receivers and nominals vs. linkers. We maintain the spread compression trade in the long end vs. the US and recommend positioning for lower inflation breakevens in the months ahead. We expect range-bound trading with a mild downward bias – at least until inflation peaks by mid-summer.

MXN: The adjustment valve

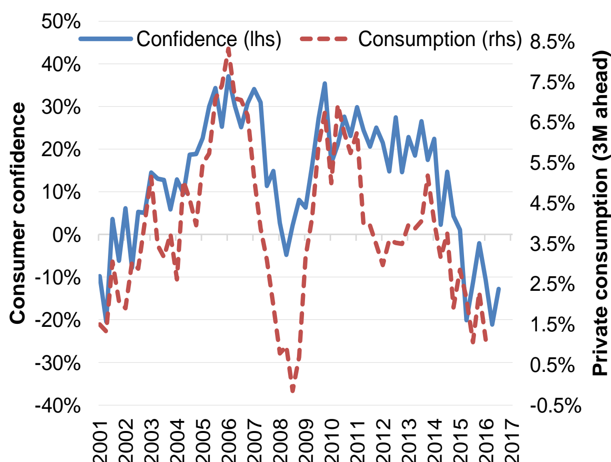
Valuation is less attractive than at the beginning of the year and positioning is now long MXN (due to increased USD selling by locals) NAFTA risks have waned but the burdens on the current account will persist in the medium term. The flow of locals selling USD forward to capture the MXN's high carry buying US equities could vanish if the environment turns less supportive for global equities. Altogether, the favorable forces behind the recent rally in the peso seem weak. These structural hurdles and sensitivity to possible external and local setbacks bode for buying USD/MXN at current levels, in our view.

Colombia: Pessimism weighs on outlook

Weakening consumer and business confidence

Colombians are increasingly bearish about the macroeconomic and political outlook. Consumption tax hikes, tight financing conditions and a cooling labor market are taking a toll on private consumption, as evidenced by the lackluster performance of the economy in 1Q17 (1.1%). Locals highlight that the main challenges are political. Controversies surrounding the implementation of the peace agreements with the FARC, successive corruption scandals, large national strikes and negative spillovers of the Venezuelan crisis are fueling pessimism and uncertainty ahead of what are shaping as the most contested elections for congress (March) and the presidency (May) in recent decades. BanRep revised down its growth forecast to 1.8% from 2.0% in 2017 and less than 3.0% in 2018.

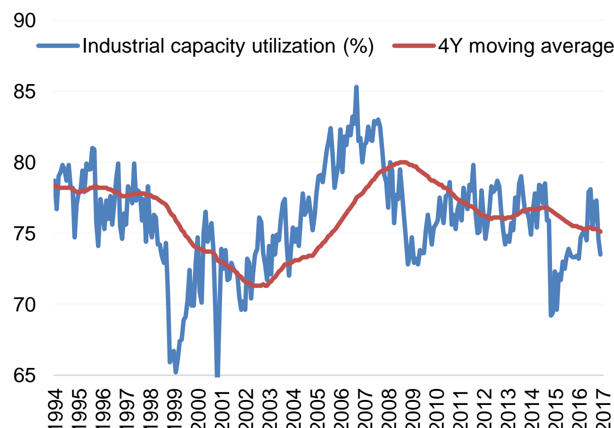
Figure 1: Taxes and politics hurt consumer confidence



Source: DANE, Fedesarrollo, Deutsche Bank

Confidence surveys illustrate the dismal mood of economic actors. Consumer sentiment has been in negative territory in the last 16 months and recorded a historic low of -30% in January (Figure 1). This indicator is a good predictor (0.8 correlation) of future household spending (3 months ahead). Similarly, industrial capacity utilization started to trend downwards in 1Q17 after a year of steady growth (Figure 2). Surveys that track orders, inventories levels and production expectations among manufacturers and retailers receded again in April, signaling that the slowdown could be deeper and the recovery might take longer than the authorities originally anticipated.

Figure 2: Industrial capacity reverses its positive trend

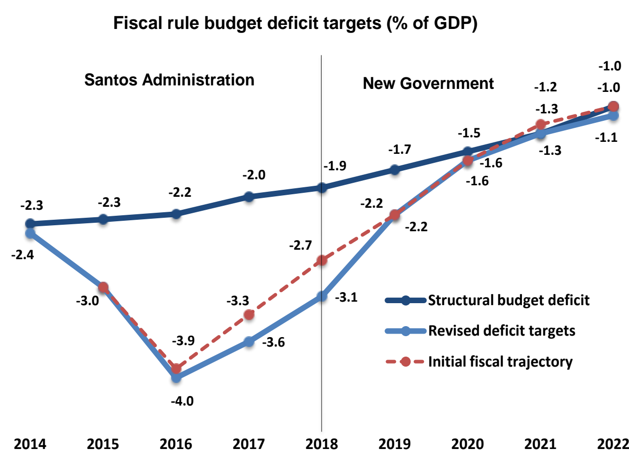


Source: ANDi, Deutsche Bank

Slow growth and peace costs add fiscal risks

Adhering to the revised budget deficit targets mandated by the fiscal rule seems increasingly difficult (Figure 3). A budget amendment submitted to congress allocates all receipts from tax reform (0.7% of GDP) to additional current and capital expenditure in 2017. Slow economic activity and tax evasion resulted in a revenue shortfall of 0.5% of GDP in 1Q17. The gap could widen further as the authorities prepare to cut its 2017 growth forecast to 2.0% from the current 2.5% and the 3.5% assumed last year. Failure to reduce the fiscal deficit and stabilize the debt burden could trigger negative rating actions and a market correction.

Figure 3: Complex fiscal outlook for new government

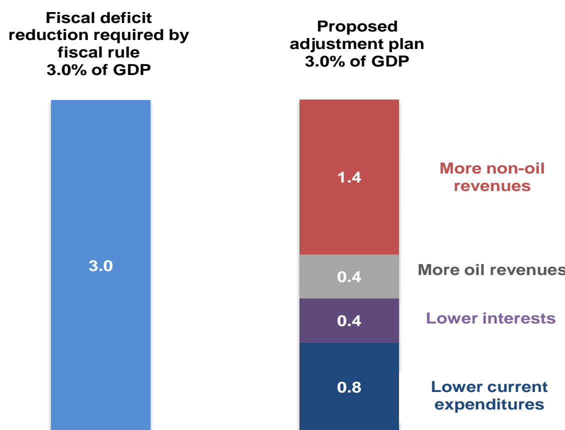


Source: Ministry of Finance, Deutsche Bank

The new government swearing in August 2018 will inherit a challenging outlook for public finances. It would either have to regain political support and market credibility to relax the fiscal rule or enforce a drastic fiscal adjustment (Figure 4). The recent tax reform introduced provisions to boost collection through formalization, stricter compliance, reduction of

loopholes and the strengthening of the tax agency. These measures could yield up to 1% of GDP in additional revenue over the medium-term according to the current official assumptions. Room for spending cuts is more limited, could be recessionary and require difficult entitlement reforms. Mandatory outlays for pensions, sub-national transfers and public wages account for two-thirds of the budget. Honoring the commitments in the peace agreements could entail budget reallocations and fresh resources for up to 2% of GDP annually over the next 15 years.

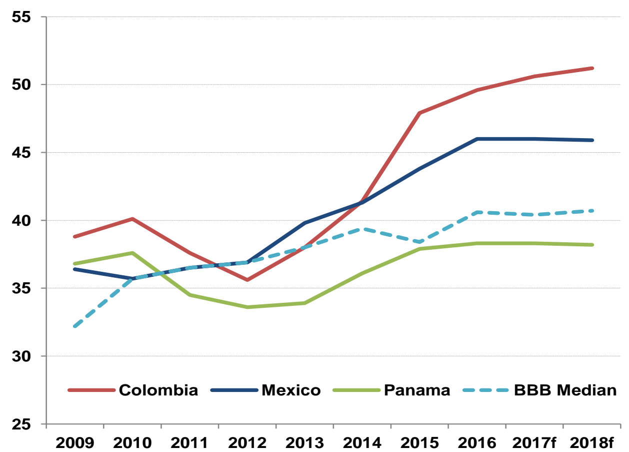
Figure 4: Proposed fiscal adjustment assumes ambitious tax collection targets and spending cuts



Source: Ministry of Finance

Debt dynamics remain negative and sensitive to contingent liabilities. Central government debt surged to 44% of GDP in 2016 from a low of 33% in 2012. We expect the debt burden to exceed 45% of GDP by 2018, rapidly diverging from the median of peer investment grade sovereigns (Figure 5). In our baseline scenario, the latest tax reform would not be enough to reverse the current 1.1% of GDP primary fiscal deficit and the real interest rate – growth differential could average 0.5% in 2017-2018, inconsistent with the stabilization of the debt trajectory. Guarantees for infrastructure projects add upside risks to these projections. The government is committing future budgetary appropriations to pay for infrastructure concessions and provisioning up to 0.4% of GDP per year to compensate private contractors for potential foreign exchange losses, toll collection shortfalls and constructions delays.

Figure 5: Debt burden diverging from rating peers

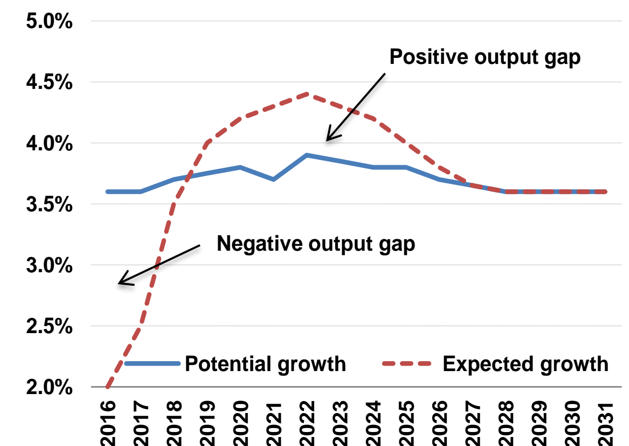


Source: Fitch Ratings, Deutsche Bank

Consensus for rate cuts, speed will be data dependent

There is consensus among policymakers and market participants that falling inflation, real rates in contractionary territory and a rapidly widening negative output gap provide room for further monetary easing (Figure 6). May marked the second consecutive month that all members of BanRep’s board voted unanimously in favor of rate cuts, although the decision was split on the speed of the monetary stimulus: 4 members were in favor of a 25bp rate reduction and 3 opted for 50bp. A favorable reading in May (0.23%mom) brought headline inflation (4.4%yoy) closer to the upper band of the target band of 2% to 4% and allayed concerns about potential second round effects from the strong one-off increases in energy and public transport tariffs in April. We expect consumer prices to bottom out in July, allowing BanRep to accelerate the easing cycle once more in June/July and extend it until August.

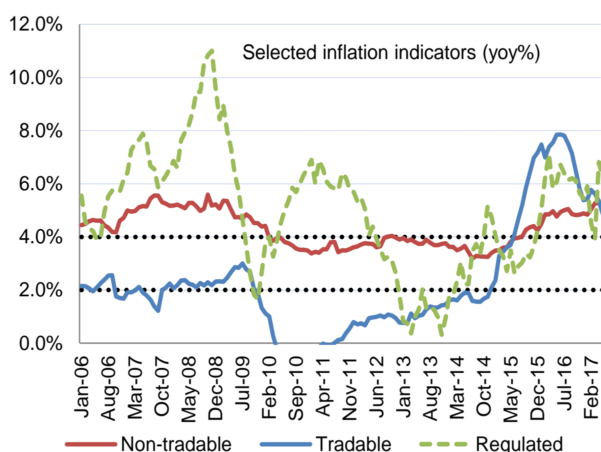
Figure 6: Growth deceleration gains prominence on monetary policy decisions



Source: Ministry of Finance, Deutsche Bank

The window for additional aggressive cuts of 50bp will narrow after the summer due to continued evidence of inflation persistence, wage indexation and the end of favorable base effects. Non-tradable prices have grown uninterruptedly in 5M17 (Figure 7), driven by inertial real adjustments in services costs, primarily housing rent, which has a weight of 27% in the basic basket. Wage indexation is a key risk moving forward. The government has offered to award at least a 6.55% salary increase to public sector teachers retroactive to January 1st in response to a month-long national strike. These concessions add pressure to labor intensive components of the consumer price index such as education and health care. In this scenario, we maintain our terminal policy rate forecast of 5.25% in 2017 and revise it slightly downward to 4.75% in 2018.

Figure 7: Price and wage indexation limits room for an accelerated easing cycle after base effects fade



Source: BanRep, Deutsche Bank

Local rates seem more attractive than FX and credit

The economy is slowing despite fiscal stimulus and the increase in oil prices in 2016, monetary easing and a weaker COP. Political divisions and a highly disputed presidential election will continue to weigh on confidence and extend the easing cycle. In order to avoid multiple downgrades, the next administration will have to finally implement a credible fiscal tightening. Although the economy is probably close to the trough at a growth pace near 1%, containing the fiscal and current account excesses of previous years will likely cap the strength of the upturn and anchor a flat curve.

Inflation is falling, but gradually so on inertial drags. BanRep will likely extend the easing but still cut rates to 4.75% as it trades-off inflation inertia and subdued economic prospect – amplified by electoral uncertainty. As the curve is already pricing terminal rates near our forecast this extended approach also favors flattening, in our view. 4G investments are finally about to pick up, but altogether it seems unlikely that the economy could growth above 2% this year. Inflation breakevens – in contrast with Mexico – are pricing a sharp drop in inflation to target with little premium. This favors linkers vs. nominal local bonds (UVRs vs. Coltes). We also favor switching out of 19s into 26s on this backdrop and valuation.

External accounts limit room for COP appreciation

In line with other pension funds in the region, locals also tend to be bearish FX and local rates. But in contrast with Mexico, yields and FX are closer to recent lows rather than highs. Therefore, we expect little support from locals, especially for the currency. Most find the COP strong given weak export performance, a relatively wide current account and dismal growth. This reflects structural issues in the export sector that would not be solved by devaluation. But as the economy slows, pressure for a weaker COP seems to be rising. Still it seems unlikely that the new members of BanRep will adopt a more interventionist approach as feared. Competitiveness, the business cycle, locals, and politics are hardly supportive of COP longs, but flows remain balanced and we would rather sell USD/COP downside than take a directional call.

Peru: In need of political compromise

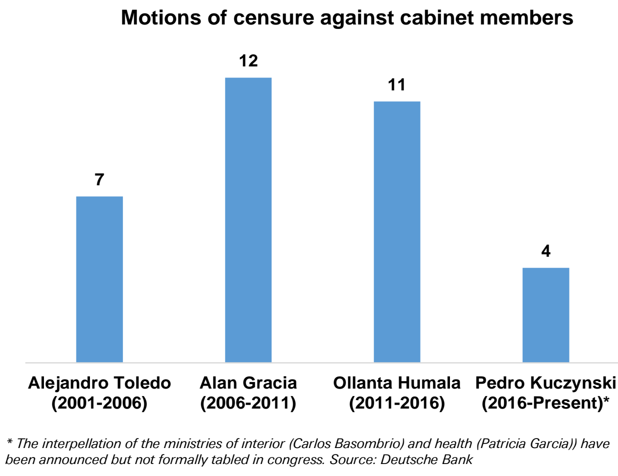
Political conflict slows government’s reform agenda

Conflicts between the executive and the legislative are escalating and slowing down progress on the implementation of the new government’s ambitious pro-growth and structural reform agenda. The opposition controlled congress censored the minister of education in December for alleged weak oversight of procurement officials and a recent report from the general comptroller questioning the financing costs of an airport concession forced the resignation of the minister of transportation and communication in May. Opposition legislators are now targeting the ministries of the interior and health (Figure 8). At the same time, Lima’s Supreme Court rejected a habeas corpus petition submitted by Keiko Fujimori requesting the release of his father and former president Alberto Fujimori (1990 - 2000), who serves a 25-year sentence for homicide and kidnapping since 2009.

There are opportunities for political compromise. The government is open to the idea of a presidential pardon or house arrest for Alberto Fujimori. It has also refrained from seeking a vote of confidence on the full cabinet. If congress denies a vote of confidence twice, the president has the constitutional prerogative to dissolve congress and call for new legislative elections. In a de-escalating scenario, Popular Force, Keiko Fujimori's majority party controlling 72 of the 130 legislative seats, is more likely to lessen pressure on the current cabinet and resort to the vigilant but non-obstructionist stance that it adopted during the first 6 months of the Kuczynski administration. In our view, a governance agreement could cement the incipient

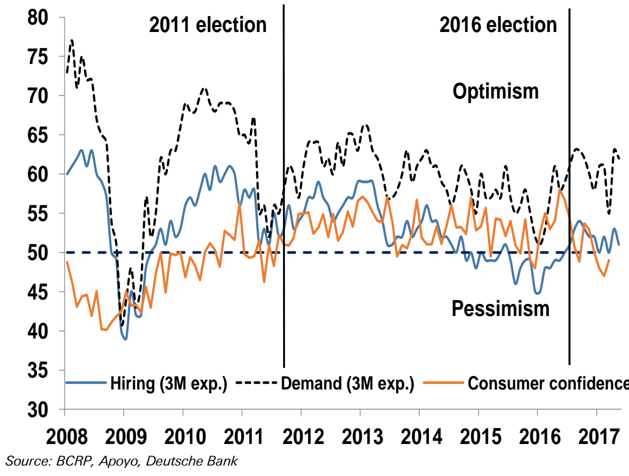
recovery in business confidence and approval ratings that followed the effective emergency response to the Coastal Niño in 2Q17 (Figure 9).

Figure 8: Opposition majority in congress has increased cabinet volatility



* The interpellation of the ministries of interior (Carlos Basombrio) and health (Patricia Garcia)) have been announced but not formally tabled in congress. Source: Deutsche Bank

Figure 9: Improved governance could cement incipient recovery in business and consumer confidence



Source: BCRP, Apoyo, Deutsche Bank

Reconstruction and mining to drive a v-shape recovery

The government revised down its 2017 growth forecast to 3.0% from 4.5% due to flood damage during the Coastal Niño (-1.2pp) and the abrupt exit of Odebrecht (-0.3pp) from key construction projects. We maintain a more conservative growth projection of 2.6% for this year. The impact of the weather shock on fishing, agriculture, trade and transport sectors seem consistent with the most recent GDP data releases (+2.1% in 1Q17) and previous episodes of El Niño. However, in our view, official assumptions may be underestimating the knock-on effects of the protracted paralysis of infrastructure on private investment, formal job creation and household consumption. A pipeline of $18.5 billion, nearly 9% of GDP, in concessions have been awarded but remains stalled due to licensing issues, contractual disputes and the restructuring of failed construction consortiums (Figure 10).

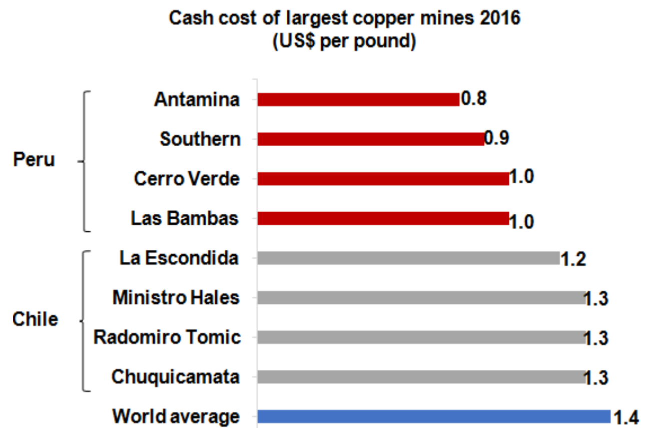
Figure 10: Pipeline of stalled infrastructure projects

Infrastructure concessions	US million	% of GDP
Lima Metro - Line 2	5,600	2.6%
Modernization - Talara Refinery	5,400	2.5%
Southern Peruvian Gas Pipeline	4,600	2.2%
Expansion of Lima Airport	1,200	0.6%
Chavimochic III	590	0.3%
Chinchero Airport	580	0.3%
Majes Siguas II	540	0.3%
Total stalled projects	18,510	8.7%

Source: Ministry of Finance, Deutsche Bank

We are expecting a v-shaped recovery in 2018, with growth rebounding to 4%, driven by reconstruction investment, mining competitiveness and monetary accommodation. To overcome administrative and regulatory bottlenecks, congress approved the creation of new reconstruction agency with financial autonomy, technical discretion and authority to fast-track the execution of public investment in 2018-2020. Moreover, the country's mining comparative advantages – young reserves, low cost structure, energy self-sufficiency and favorable business environment – position it well to continue gaining market share in export markets and benefit from the ongoing upswing in metal prices (Figure 11).

Figure 11: Competitive costs support mining prospects

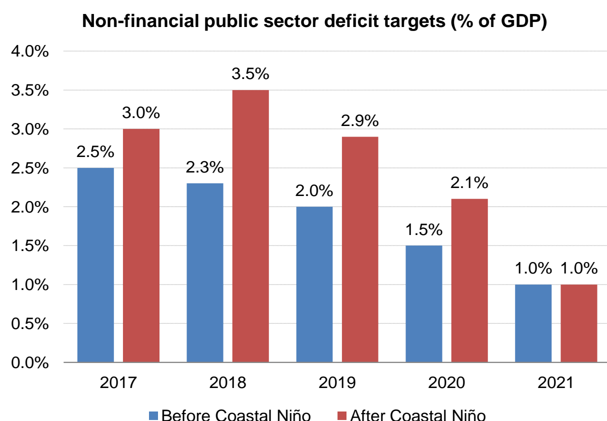


Source: Ministry of Finance based on company reports and the U.S>Geological Survey

Asset drawdown will finance reconstruction costs

The government estimates that restoring infrastructure losses would require additional spending of $6.4 billion, nearly 3.2% of GDP, in 2017-2020. As expected, the ministry of finance submitted to congress a bill requesting authorization to increase the mandatory budget deficit targets during the peak of the reconstruction efforts in 2017-2018. The amendment also proposes a gradual consolidation path in 2019-2020, followed by a sharp reduction in the fiscal deficit in the last year of the current administration (Figure 12).

Figure 12: New budget deficit trajectory after incorporating reconstruction costs



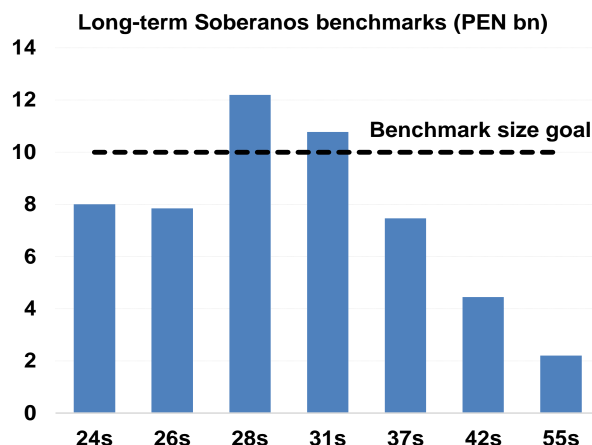
Source: Ministry of Finance

In our view, the size of the reconstruction package is absorbable and could be implemented without compromising fiscal sustainability or exceeding the public debt ceiling of 30% of GDP. Finance Minister Alfredo Thorne outperformed the budget deficit by 0.4% of GDP in 2016, creating room for a more expansionary fiscal stance in 2017. The authorities intend to cover 80% of the financing requirements with the drawdown of assets and only 20% with new issuance. In December 2016, government debt stood at 24% of GDP, the public sector held 8.2% of GDP in bank deposits and 4.2% of GDP in stabilization funds and could tap up to $3.4 billion in contingency credit lines for natural disasters from multilaterals.

Debt strategy focuses on liquidity and lowering costs

Enhancing the liquidity of the local bond market remains a top priority. Weekly auctions tripled in size to PEN12.6 billion in 2016 from PEN4.5 billion in 2013. This year, domestic issuance could increase to PEN14 billion, allowing most long-term benchmarks to reach an outstanding of PEN10 billion (Figure 13). In 2H17, the treasury will introduce a pilot program to make up to PEN7.5 billion of the sovereign curve Euroclearable. If effectively implemented, the new mechanism could improve liquidity, reduce transaction costs and broaden demand from non-resident investors.

Figure 13: Increased size and market liquidity in the Soberanos market



Source: Ministry of Finance, Deutsche Bank

The authorization to conduct up to $6 billion in liability management operations will be used opportunistically. One option could be the issuance of a new Euroclearable Soberanos benchmark to prepay costly multilateral loans in USD. Multilateral obligations amount to PEN23 billion, 15% of public debt, and their equivalent cost in PEN (6.81%) is slightly higher than that of the Soberanos portfolio (6.63%). An alternative could be leveraging on the local market to redeem higher yielding global bonds denominated in USD. External bonds amount to $14.6 billion and their equivalent cost in PEN is 9.6%.

Falling inflation, slow growth pave the way for easing

The BCRP is likely to deliver a second cut of 25bp, taking its reference rate to 3.75% in June. In our view, the swift reversal of inflation after food supply disruptions generated by the Coastal Niño in March contributed to stabilize inflation expectations and provided enough room to the BCRP to increase the monetary stimulus. Consumer prices fell for the second consecutive month to 3% in May from a peak of 4% in March, rapidly converging to the official target band of 1% to 3%. Disinflation forces are likely to continue in 2H17 due to currency appreciation (PEN has gained 3.6% YTD) and weakening economic activity (domestic demand contracted 1% in real terms in 1Q17).

The BCRP might leave the door open for further easing. The board is confident that the reversion of weather shocks would allow inflation to converge to target in 2H17 and stay within the 1% - 3% band in 2018. However, the BCRP's growth outlook remains rather benign (3% in 2017), expecting a swift recovery in the next quarters supported by increased public spending, firmer export prices and still buoyant external liquidity. In our view, by maintaining a focus on falling inflation and a relatively constructive view on economic growth, the BCRP is creating policy space to implement

additional rate cuts if activity disappoints and the reconstruction process takes longer than expected.

External accounts: from trade deficits to surpluses

External accounts continue to benefit from rising mining production, a recovery in non-traditional exports and improved terms of trade. Our baseline projections point to a doubling of the trade surplus to $4 billion (2% of GDP) in 2017-2018 from $1.7 billion in 2016 and a narrowing in the current account deficit to 2.2% of GDP in 2017-2018 from a high of 4.9% in 2015. Under this scenario, foreign direct investment and long-term borrowing, although lower than previous years, would more than cover the external gap, allowing the BCRP to sustain its already robust international reserves position of 32% of GDP.

We are projecting a 3.0% nominal appreciation (USD/PEN 3.26) in 2017 and a mild retracement of 1.7% (USD/PEN 3.31) in 2018. Our forecasts are below consensus and have a neutral balance of risks. Stronger capital inflows, a more rapid rebalancing of pension funds portfolios and large repatriation proceeds from tax amnesty could accentuate the appreciation trend. In such scenario, we expect the BCRP to smooth volatility through spot interventions and use the opportunity to rebuild international reserves. On the contrary, tighter international financing conditions, a correction in commodity prices and a prolonged weather shock accompanied by an aggressive easing cycle could exert upward pressure on the PEN. In this case, the BCRP could lean against through sales of FX swaps in the derivatives market.

Rates and FX: Positioning – fundamentals disconnect

The curve has flattened substantially but it remains one of the curves with most term-premium in emerging markets, according to our estimation. Local pensions seem to have moved to conservative positions and have increased their long USD bets favoring 20Y receivers and cross-currency swaps. In contrast with Mexico, they have been buying USD aggressively but without selling USD forward. Therefore, forward points in cross-currency have been without a counter-point for corporate foreign issuances' hedging into PEN.

What underlies this negative view on local assets seems to be a bearish outlook on the global economy and China – and therefore commodities. In contrast, improving balance of payments, competitiveness in copper production, the possibility of still positive surprises in mining investment (with near USD9bn pending) and overall improving outlook for foreign investment in infrastructure, and falling inflation all seem supportive local rates and FX.

The BCRP seems committed to ease possibly twice as inflation risks have eased. Even if the economy is not leveraged (credit/GDP is just about 40%) and the benefits of cuts are limited, the BCRP is keen on sending a strong signal. Credit has slowed despite cuts in reserve requirements and they expect inflation to converge to the 2% target next year. The BCRP does not seem to put much faith on neutral rate estimations, but they indicate that it is probably near 2%. Foreigners had about 70% of local debt pre-tantrum and this has dropped to 40%. This is seen as supportive, and the same view is held on the hefty allocation to USD in the local pension industry (about 60%). We recommend buying 37s and 5Y cross-currency swaps.

Increasing support for the PEN, especially against EUR

Shrinking current account deficits, upside for growth, and FX intervention aimed at reducing volatility rather than defending levels support the currency. As a low-beta currency and having past the peak of foreign direct investment in mining, we believe that the upside is limited, but PEN could still recover some ground vs. the EUR (and less so vs. the USD), in our view. We recommend short EUR/PEN.

Political noise has been relentless and likely not over, but the incentives (given re-election is not a possibility and agendas are roughly aligned) bode for eventual cooperation. We found that the noise from Odebrecht and also the weather shocks have overshadowed important initiatives to remove red tape, prevent more obstacles to execution, and unleash investment – initially for reconstruction and later for the resumption of the infrastructure plan. Given relatively narrow current account deficits, hefty international reserves, and growth/investment prospects the main risk for the PEN seems to be USD strength.

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Egypt: Staying the course

Egyptian authorities reached a staff-level agreement with the IMF on the first review under the US$12bln EEF . The Current account improved and private sector inflows picked up markedly allowing for FX accumulation by the CBE. Risks stem from persistent inflation and reform fatigue.

- Egypt's gross foreign-exchange reserves rose to a six-year high of USD 30.5bn in May from USD 17bn in end-June 2016, surpassing IMF program requirements so far.
- The fiscal position is gradually improving, but remains a formidable challenge. The draft budget, praised by the IMF, assumes a reduction of overall fiscal deficit to about 9% of GDP in 2017/2018.
- We expect inflation to come off to approximately 20% by end-2017, our forecast is less optimistic than that of the IMF. We therefore do not see the CBE cutting rates in the near term from the current 16.75%.
- We remain constructive on Egypt's T-bill market (1y currently trading near 20%) and expect the currency to remain stable or appreciate moderately in 2017.
- We hold a constructive view on Egypt's sovereign credit, but risk premium has diminished after the rally earlier this year. We take a neutral position and look to add on dips. We believe the Eurobonds curve is too steep relative to peers and the newly issued bonds 47s and 27s offer superior relative value from asset allocations perspective.
- Risks stem from Egypt's ability to stay in the IMF program, still-elevated inflation, and social stability concerns ahead of 2018 presidential elections.

T-bill auction results

	3m	6m	9m	1y	
14/05/2017	19.332		19.479		
18/05/2017		19.814		19.698	
21/05/2017	19.493		19.709		CBE hike
25/05/2017		20.661		20.588	
28/05/2017	20.52		20.478		
1/6/2017		20.441		20.494	
4/6/2017	20.338		20.366		

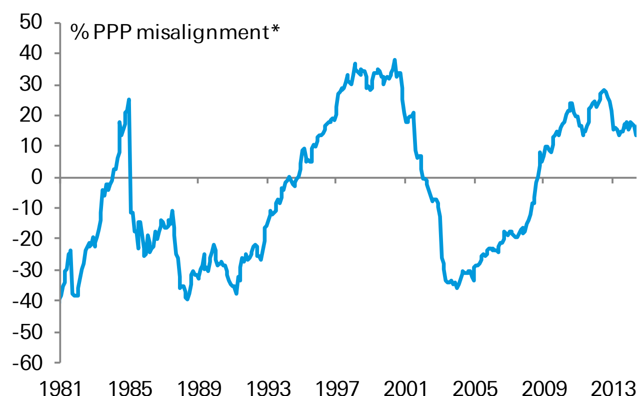
Source: Bloomberg Finance LP

Egypt – the near-term outlook is positive

The near-term outlook for Egypt is positive. There has been a turnaround in Egypt's external vulnerabilities, with strengthening FX reserves accumulation. FX reserves grew to USD 30.5bn in May. EGP has seen a 0.39% qtd gain. In parallel, Egypt's GDP growth is likely to have reached 3.9% in the first quarter of 2017, and the IMF estimates that the primary fiscal deficit has fallen by 2%, from 4% deficit in 2015/2016 (overall deficit stood at 12% in 2015/2016 according to the IMF). The Ministry of Finance (MoF) has drafted an ambitious budget for 2017/18 that is now under review by the Parliament.

Risks to the outlook stem from reform fatigue and high inflation. It is likely growth in 2017 will be below the authorities' 4.6% estimate. Structural reforms supported by the IMF program may run into reform fatigue leading to fiscal slippages, especially ahead of the 2018 presidential elections. Stubborn inflation may force the central bank to continue tightening, especially if EGP underperforms.

PPP-based EGP assessment

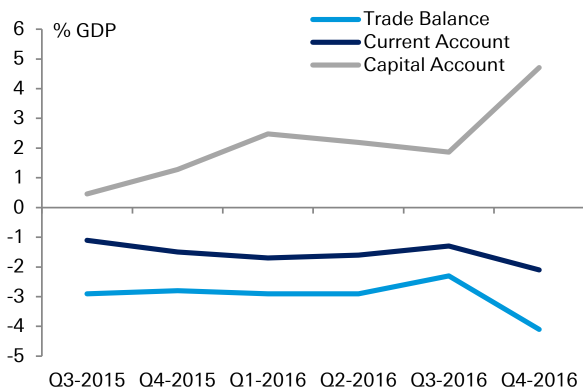


Source: Monthly Statistical Bulletin, CBE; Deutsche Bank

We believe the currency is undervalued using a simple PPP metric as manifested by the CBE's reserve accumulation. PPP implies that nominal exchange rates move in tandem with inflation differentials. In other words, this implies a mean-reverting REER. Hence we define our PPP misalignment as the % difference between REER and its 10 year rolling average. At the end of October 2016, before the exchange rate peg was removed, EGP was overvalued by 24% by our measure. Currently, it is undervalued by 26% following the sharp depreciation.

The IMF program is on track for now. On May 12th, in its first review of the US$12bn extended fund facility (EFF), the IMF provided a positive assessment of the authorities' reform agenda. Subject to IMF board approval, a disbursement of US$1.25bn will be made, bringing the total amount disbursed to US$4bn.

Capital inflows allow for reserve accumulation



Source: Monthly Statistical Bulletin, CBE; Deutsche Bank

Balance of Payments improvement exceeded expectations

The CBE's reserve position has continued to improve. Egypt's gross foreign-exchange reserves rose to a six-year high of USD 30.5bn in May, sufficient to cover more than five months of imports. The CBE is already way ahead of its target to raise foreign-exchange reserves (from end-June 2017 by USD1.92bn end-December 2016 and USD 4.175bn by end-June-2017). However, sustained net inflows are needed to cover the large financing needs in 2017-18 and 2018-19. Egypt needs to raise USD 7 billion in 2017/18 and an additional USD 4 billion in 2018/19 to reach 136 percent of the Fund's reserve adequacy metric for flexible exchange rate regimes.

Current account position is improving. After a prominent plunge in REER (of more than 45% YoY by December 2016), early signs of expenditure switching are starting to occur, with imports nearly flat in 2016Q4, and export up 18% YoY. In addition, quarterly overseas workers' remittances grew more than 10% YoY in the same quarter, following a protracted period of declines. Seasonally adjusted quarterly figures show that the current account deficit, narrowed to USD 4.36bn in the last quarter of 2016, versus a USD 5.47bn deficit in the previous quarter, thanks to inflows and an important recovery in workers' remittances, even as donor support (grants) from the GCC slowed.

Key external sector indicators in (%)

	Q3-2015	Q4-2015	Q1-2016	Q2-2016	Q3-2016	Q4-2016
Trade Balance % GDP	-2.9	-2.8	-2.9	-2.9	-2.3	-4.1
Current Account % GDP	-1.1	-1.5	-1.7	-1.6	-1.3	-2.1
Capital Account % GDP	0.5	1.3	2.5	2.2	1.9	4.7

Source: Monthly Statistical Bulletin, CBE; Deutsche Bank

Further improvements in the current account will likely be less pronounced. Imports of staples (especially food, and energy) tend to be inelastic, limiting the extent to which we can expect a correction in the deficit to happen. Moreover, recent inflows have tended to put appreciating pressure on REER, and exports growth has already decelerated in March, decreasing more than 13% over the previous month, in seasonally adjusted terms.

The authorities are on track with donors' programs. In March, the World Bank disbursed USD 1bn, out of a 3bn loan. The next tranche of USD 1bn is expected by December 2017. World Banks' Takaful and Karama program, with 6.7 million beneficiaries, has disbursed USD 306.21mn so far. Following the completion of the first review, total disbursements from the IMF will reach USD 4bn this fiscal year.

Private sector inflows have exceeded expectations. Egypt raised USD 2bn in financing from international banks in November, followed by a USD 4bn Eurobond in January and USD 3bn in May, far exceeding expectations. Minister of Finance Amr El-Garhy said that Eurobond issuance to "a large extent" covers financing needs for 2017-2018 and next issuance is planned for February-March 2018.

Remarkably, since the CBE hiked interest rates earlier this month, foreign inflows into Egypt's debt and equity have surged. The T-Bill auctions over the last week recorded near USD 1bn in foreign investor inflows. As of May 30, according to the Egyptian Finance Ministry, overseas holdings of Treasury bills rose to USD 7.5bn. Further, in an effort to attract more inflows, Egypt's parliament voted on Monday to extend for three more years a freeze on its capital gains tax.

Foreign direct investment has recovered, but remains below the pre-2011 averages. The discovery of the Zohr offshore natural gas field is expected to attract FDI and bolster exports of natural-gas sometime in 2018. In addition, Egypt secured agreements on coal-fired and renewable plants, which are envisioned to strengthen electricity generation infrastructure. The Egyptian cabinet approved in May six agreements between the Egyptian General Petroleum Corporation and a number of foreign companies on oil exploration in Egypt's western desert.

Selected balance of payments statistics (USD bn)

Further Balance of Payments statistics (US$ bn)

	Q3-2015	Q4-2015	Q1-2016	Q2-2016	Q3-2016	Q4-2016
Trade Balance	-10.0	-9.9	-10.0	-8.8	-8.7	-9.2
Exports	4.7	4.4	4.3	5.3	5.3	5.2
Imports	-14.7	-14.3	-14.2	-14.1	-13.9	-14.4
Investment Income Balance	-1.1	-1.3	-0.7	-1.4	-1.1	-1.1
Current Transfers	4.3	4.0	4.1	4.4	3.4	4.6
Of which: Remittances of Egyptians working abroad	*4.4*	*4.1*	*4.2*	*4.4*	*3.4*	*4.6*
Balance of Current Account	-4.0	-5.4	-5.7	-4.8	-5.0	-4.7
Capital & Financial Account	1.6	4.5	8.4	6.6	7.1	10.5
Capital Account	0.0	0.0	-0.1	0.0	0.0	0.0
Financial Account	1.7	4.6	8.4	6.6	7.1	10.6
Direct investment abroad	0.0	0.0	0.0	-0.1	-0.1	0.0
Direct investment in Egypt (net)	1.4	1.8	2.8	1.0	1.9	2.4
Portfolio investment abroad	0.0	0.1	0.0	0.0	0.0	0.1
Portfolio investment in Egypt (Net)#	-1.4	-0.2	0.1	0.2	-0.8	1.1
Of which: Bonds	*-1.4*	*0.0*	*0.0*	*0.0*	*-0.8*	*0.0*
Other Investments (Net)	1.7	3.0	5.6	5.4	6.1	7.0
Net Borrowing	0.8	3.0	1.5	1.8	1.3	4.7
Medium- and Long-Term Loans	-0.6	0.2	0.2	0.0	0.3	2.7
Disbursements	0.2	0.7	1.1	0.4	1.2	3.2
Repayments	-0.9	-0.5	-0.9	-0.5	-1.0	-0.5
Medium- and Long-Term Suppliers' Credit	0.1	0.1	0.5	0.8	0.6	0.3
Disbursements	0.1	0.1	0.5	0.9	0.6	0.4
Repayments	0.0	0.0	0.0	0.0	0.0	0.0
S .T. Suppliers' Credit (Net)	1.4	2.6	0.8	1.0	0.5	1.7
Other Assets	0.2	-3.2	-1.3	0.8	-0.2	-2.2
CBE	0.0	0.0	0.0	-0.1	0.0	-2.0
Banks	0.8	0.7	-0.3	0.9	-0.2	0.2
Others	-0.6	-3.9	-1.0	0.0	0.0	-0.4
Other Liabilities	0.7	3.2	5.4	2.8	5.0	4.5
CBE	0.0	1.5	3.0	1.4	3.4	4.6
Banks	0.7	1.7	2.5	1.3	1.6	-0.1
Net Errors & Omissions	-1.3	1.1	-3.0	-1.0	-0.2	-0.7
Overall Balance	-3.7	0.3	-0.2	0.8	1.9	5.1

Source: Monthly Statistical Bulletin, CBE, Deutsche Bank

Fiscal position is marginally improving, but challenging

The authorities target overall deficit of 9% of GDP in the 2017/18 budget. In the draft budget interest payments are the largest item, estimated at EGP 381bn (USD 21bn), almost one-third of total expenditure. Debt-service costs therefore remain a challenge, given the recent tightening of monetary policy. On the revenue side, taxes on goods and services are set to rise by 41% in 2017/18, making up 36% of total budget revenue, under the assumption that value-added tax will do most of the job (a hike of 1pp to 14%). However, tax revenue is likely to fall below the government's projections, given the short run impact of the stabilization policies on domestic demand.

On the expenditure side, cuts to fuel subsidies are penciled in, but actual spending on fuel subsidies is likely to be similar to the last year, given that EGP has depreciated below budget assumptions (EGP 16 to USD) and higher commodity prices. Current levels of EGP have also pushed up the budgetary cost of petroleum product subsidies. Early in May, media reports suggested the fuel subsidy bill was already well above EGP 110bn. The 16/17 fuel subsidy budget estimate was of EGP 35.04bn, (with EGP at 9.00 and Brent at $40). IMF's indicative target on that fuel subsidy bill is a ceiling at EGP 62bn by June 2017. The budget also pencils in a 7.6% year-on-year increase in public-sector employee compensation, substantially below the current inflation. Electricity prices are planned to increase from the start of July this year.

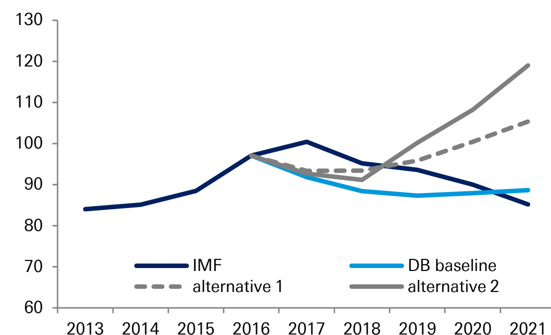
While the IMF gave a positive review of the Egyptian authorities' efforts, it has left the timing of fuel price hikes to Egypt. However, the timing of fuel energy reform may once again turn to be a thorny issue due to their impact on inflation and political concerns as we near 2018 Presidential elections.

Nonetheless, it is unlikely debt will exhibit explosive dynamics in the coming two years, assuming FX remains stable. At current yield levels, under our baseline of high inflation and moderate growth, debt dynamics are set to improve in the next two years. Inflation is doing much of the heavy lifting. The automatic debt dynamics may turn explosive again after 2019, however, with inflation coming off, moderate growth below 4%, and likely higher funding costs.

We consider the following two stress scenarios: [7]

- *Alternative 1* assumes that the inflation comes down, as in the baseline, and GDP growth stays stable around 4%, however, yields spike in 2018 due to US monetary policy normalization. Under this scenario, debt turns explosive already in 2018, creating a turnaround in debt accumulation, and reaching more than 100% of GDP by 2020.
- *Alternative 2* in addition to the above, domestic conditions worsen. Growth deteriorates substantially and inflation comes down faster than the baseline as a result. Under such circumstances, the debt to GDP ratio will reach 100% already in 2019. Although automatic debt dynamics should start marginally improving in 2020, the debt to GDP ratio would have already reached 108% by then.

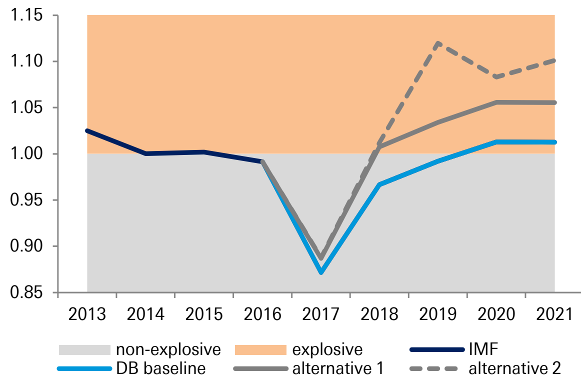
Debt sustainability (baseline and alternative scenarios) debt-to-GDP



Source: Deutsche Bank

[7] For simplicity, we assume here that the share of foreign denominated debt is zero. Note that the share of foreign to domestic interest payments in the budget expenditures of Egypt has steadily declined and was 2.1% in 2016.

Automatic debt dynamics (ϕ)



Source: Deutsche Bank

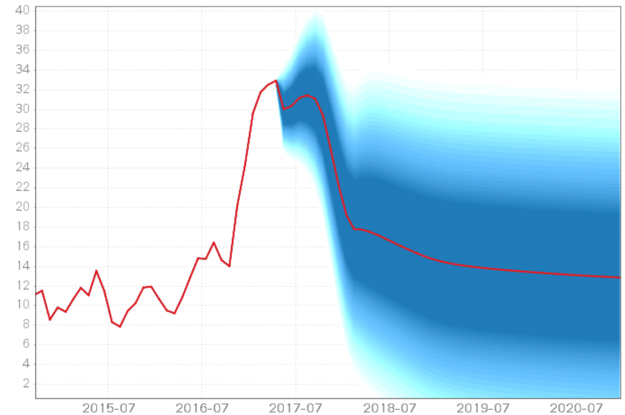
We expect inflation to come off to about 20% by end-2017

The central bank has moved to a dirty peg FX regime supported by goals for both monetary aggregates and inflation levels, and recently has been forced to pre-empt second-round effects on inflation expectations, arising from supply shocks, by hiking the policy rate by 200bps to 16.75% on 21 May.[8] The CBE communicated in its MPC press release that despite the moderation of monthly inflation rates of late, risks related to inflation expectations had already materialized. In addition, the committee also cited demand pull forces on core inflation.

The recent hike may take a long time to transmit into the real economy and inflation is likely to stay elevated for a while. In addition, while reserve accumulation is desirable to build buffers against a BoP crisis, CBE may be running into the limits of sterliziation. FX accumulation over time could pose a threat to the monetary aggregates' targets. The YoY growth of the ratio of M2-to-GDP stood at 34% in 2016 Q4.

The CBE may also be forced hike in response to second round effects of subsidy removal and VAT hike. The IMF sees 24.8% and 11.6% average headline CPI in 2017 and 2018, respectively. In our view, average inflation could hover around 30% in 2017 and 16.9% in 2018[9]. We see asymmetric upside risks in the near term, derived from the uncertain effects of price liberalization and VAT reforms, and commodity price recovery in 2018.

Headline CPI projections and uncertainty (yoy%)



Source: Haver Analytics, Deutsche Bank

Improving ratings outlook

Fitch has the most bullish view on Egypt, rating them one notch higher than Moody and S&P at B (Stable outlook) since Dec-2014. S&P recently affirmed their B- rating and their next review will take place in November. Moody's next review is due on 18th August. Fitch doesn't have a specific date, but we expect the next review to happen sometime in June/July 2017.

Moody's might consider upgrading Egypt's ratings to B2 from B3 in their upcoming review (18th August) given the accelerated build-up of FX reserves and prospects of lowering fiscal deficit as per the draft

[8] http://www.cbe.org.eg/en/Pages/HighlightsPages/MPC-Press-Release-21-May-2017.aspx

[9] We use a multifactor model that takes into account a common factor from inflation and commodity prices in global markets, in conjunction with an idiosyncratic factor from local price dynamics, including Egyptian monetary aggregates. For the exercise, we assume that the global component is driven by an initially flat global commodity price path (including oil); we then assume a gradual recovery of oil starting in 2018. The latter further prevents the headline finding a lower steady state, as for example envisioned by IMF projections.

Egypt - Key rating agency rating drivers and sensitivities

Rating agency	Current Rating	Next review dates	Upward drivers	Downward drivers
Moody's	B3 (Stable)	18-Aug-17, 08-Dec-17	(1) An accelerated implementation of measures to lower fiscal deficits and government debt; (2) a sustained growth recovery to pre-revolution levels, combined with a sharper reduction in inflation rates; (3) a faster-than-envisaged build-up of FX reserve buffers, driven by less reliance on external donor support; and/or (4) further improvement in the domestic security situation.	(1) A renewed intensification of political turmoil and instability; (2) a significant deterioration in the external payments position; (3) a slippage or reversal of fiscal and economic reforms, which leads to a sharp rise in the government's funding costs; and/or (4) diminution in the banking system's capacity to fund government
S&P	B- (Stable)	10-Nov-17	1) If GDP growth picks up beyond our expectations, and 2) if Egypt improves its fiscal and external positions substantially.	1) If current account financing, including from GCC, became less forthcoming ; 2) Deterioration in domestic fiscal funding options; 3) Increased political risk or a weaker institutional environment.
Fitch	B (Stable)	*June/July 2017 and Dec-2017	1) A track record of progress on fiscal consolidation leading to declining government debt/GDP. 2) Sustained stronger economic growth supported by reforms to the business environment leading to increased investment and employment and 3) Significant accumulation of international reserves following a sustained narrowing of the current account deficit and higher net foreign direct investments.	1) Failure to narrow the fiscal deficit and put government debt/GDP on a downward trend. 2) Reversal of fiscal and/or monetary reforms, for example in the face of social unrest. 3) Renewed downward pressure on international reserves due to further strains on the balance of payments, including weaker access to foreign financing.

Source: Deutsche Bank, Moody's S&P and Fitch. Notes from latest reports

budget plans. However, high inflation and risks to growth outlook might act as potential deterrents.

Fitch, we believe are most likely to affirm the ratings at B and at best might upgrade their outlook to Positive from Stable. Unlike Moody's and S&P, Fitch doesn't have a specific date for its next review on Egypt's sovereign rating, however, looking at historical timelines and the upcoming key events (budget as well as the IMF board meeting), we expect the next review to happen sometime in June/July 2017. We believe that Fitch would like to see more sustainable progress on all of the following criteria to be able to consider a rating upgrade: 1) progress on fiscal consolidation, 2) economic growth and reform measures and 3) accumulation FX reserves. Amongst all these, we note that Egypt's reserve position has improved significantly (up 68% YoY at April end), and the draft budget proposal was also praised by the IMF, which is an encouraging sign.

Credit market valuation – risk premium has diminished

We hold a constructive view on Egypt credit given the positive outlook, but at the current valuation we would take a neutral position and look to add on dips

If credit market valuation on Egypt's Eurobonds is slightly on the rich side based on spread / credit rating relationship (first graph below), it does not appear overtly expensive[10].

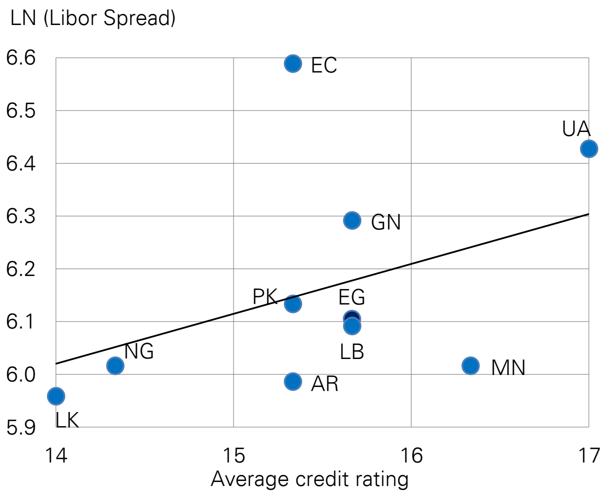
The credit market has generally rewarded sovereigns that are perceived to be on a positive path in their credit standings (e.g. Argentina, Mongolia), but it has punished the ones that are not (e.g. El Salvador, Ecuador). While fiscal outlook remains challenging due to the large deficit, high debt repayment burden, high inflation, various structural issues, supports from the IMF and other official sources have helped prevent a balance of payment crisis while the associated fiscal consolidation efforts and reforms (as mandated by the IMF program) help restore Egypt's macroeconomic stability, putting its debt dynamic on an improving path. The improving outlook has been recognized by markets, as Egypt's eurobonds were among the best performers in the past six months, with its subindex having tightened by 90bp year-to-date. The IMF agreement (November), the floating of currency (December) and successful bond issuances (January) all contributed to positive performance. However, after a significant rally, Egypt's outperformance has stalled since April, as the risk premium in the credit had been all but removed by then (second graph below).

Credit relative value–the new 27s and 47s remain cheap; curve looks too steep

Egypt has issued a total of USD11bn of Eurobonds over the past six months (USD4bn in November 2016, USD4bn in January 2017 and USD3bn added on 24 May through taps). While the issuances were generally met by strong demand, the sheer amount of supplies has added some pressure to the curve. Significant levels of concessions were offered in January issuances of 17s, 27s and 47s (see Trade Recommendation – Buy new Egypt $2047s vs. $2040s,

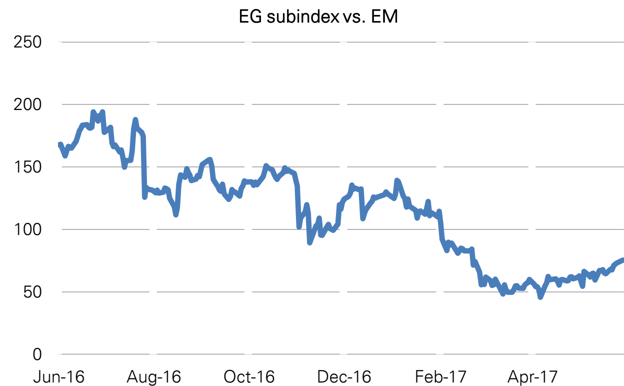
[10] The spreads are shown in log scale. For fair comparison, the spread for each curve is defined as the libor spread of a hypothetical bond with duration matching that of EM average (around 7.2 years), and derived through curve fitting as employed in our *implied rating model*. Credit rating measures are on a linear scale (14=B+/B1, 17=CCC+/Caa1).

Egypt's Eurobonds are on the expensive side in comparison with peers, but not overtly so.



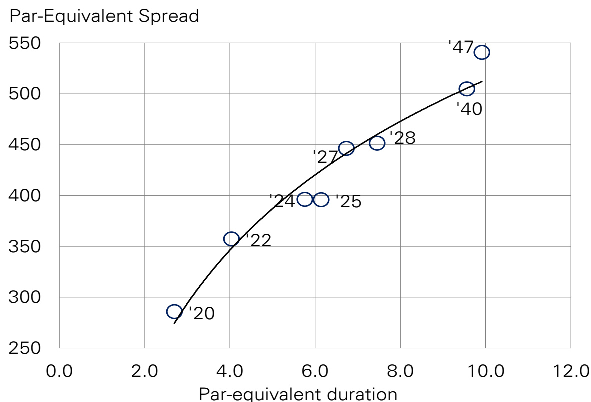
Source: Deutsche Bank

Outperformance has stalled since April, after a significant rally in January through March



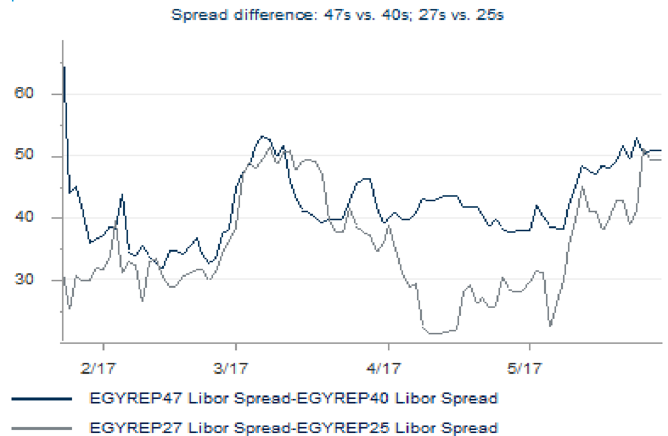
Source: Deutsche Bank

Par-equivalent spread curve of Egypt Eurobonds - the 47s are cheap to 40s, 27s cheap to 25s



Source: Deutsche Bank

Relative values in the 27s (vs. 25s) and 47s (vs. 40s) have been restored recently, thanks in part to the retaps



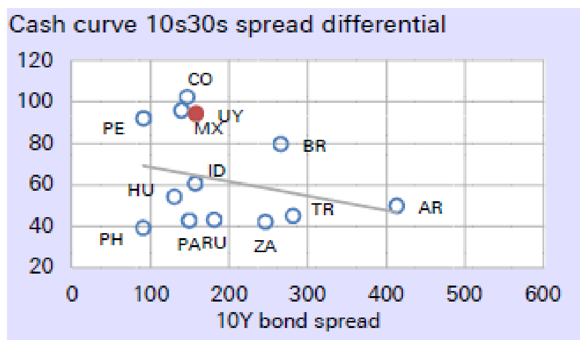
Source: Deutsche Bank

25 January 2017). These new bonds were gradually catching up, but the 24 May retaps helped cause some re-cheapening. Currently, the 27s are 20-25bp cheap to the 25s (the latter look particularly rich,) while the 47s are about 15bp cheap to the 40s, according to our term structure model. While investors continue to digest the recent taps, we expect the cheapness in these bonds to be gradually removed. We do not expect Egypt to issue any more bonds this year.

Therefore, we recommend switching from 25s to 27s (current spread differential: 50bp; target: 25bp) and from 40s to 47s (we note that the 40s have limited liquidity given their small size – only USD500m). The main risk to these switch recommendations is that some investors favor low-priced bonds on the curve and ignore the valuation disparity between these bonds.

Finally, the 10s30s curve in Egypt appears very steep from a cross-sectional point of view. Typically, EMEA curves and higher yielding curves in LatAm features a flatter 10s30s slope (see graph below), but Egypt's slope - measured at around 100bp – look very out of place; it is in fact comparable with LatAm low beta names. Among credits with a similar credit rating, only Argentina and El Salvador have 30Y bonds but both have a much flatter curve (50bp and 10bp, respectively). From an asset allocation perspective, we favor the long end of the curve, especially the 47s.

EM 10s30s curve slope vs. spread – slopes should be flatter for higher spread names



Source: Deutsche Bank

What to watch in the coming 12 months

While the near-term outlook is positive, there are important milestones in the coming year: the passage of the 2017/2018 budget, deceleration in inflation towards end-2017, and continued compliance with the IMF program. Presidential elections will take place by mid-2018, but we believe risks of social instability are low. While President Abdul Fattah al-Sisi has significantly tightened security, two attacks on the Coptic Christian community since the beginning of the year will weigh on tourism, but unlikely to put a significant dent in president's popularity as opposition is limited.

1. End-June passage of the 2017/2018 budget that is in line with the IMF program and includes further reduction in energy subsidies.

2. Payment of the arrears to international oil companies expected in June of $750mio (total outstanding US$3.5bln). Paid as of early June.

3. Fitch (June/July) and Moody's (18 August) may consider improving their rating/outlook.

4. June/July IMF disbursement following staff-level agreement on the first review reached in May 2017.

5. Second review by the IMF for end-June performance criteria.

6. Further relaxation of the FX regime, reduction in capital controls by end-2017.

7. Presidential elections by mid-2018. Nominations will begin in March 2018, election process to begin 120 days before the end of the current presidential term.

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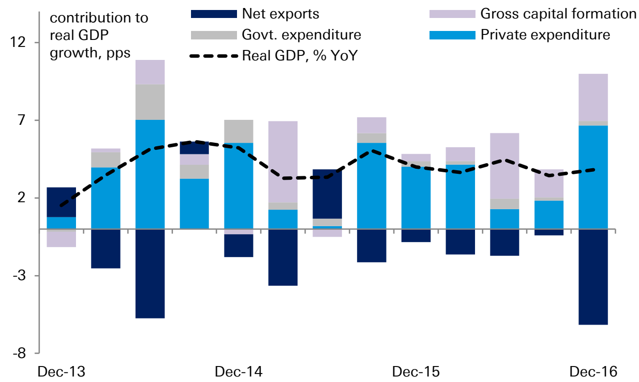
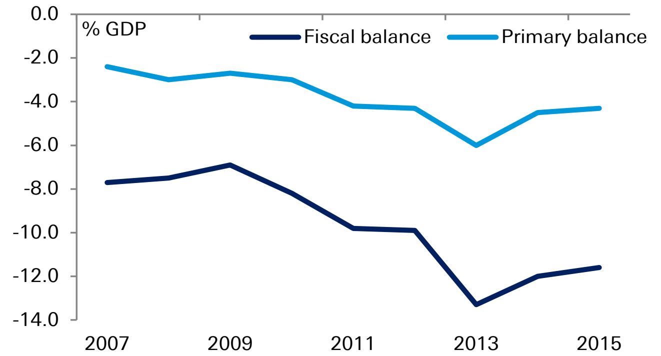
Private consumption driving growth



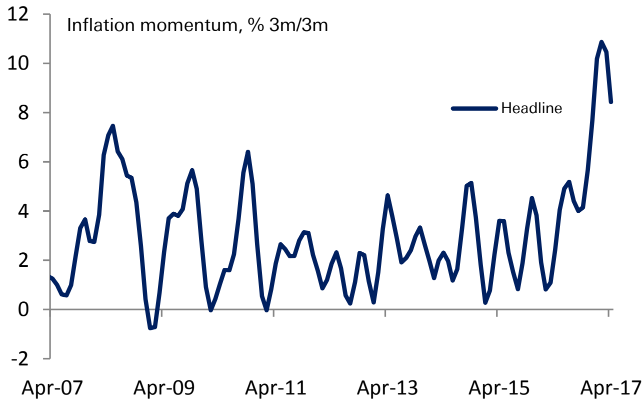
Source: Haver Analytics, Deutsche Bank

Fiscal and primary balance – gradual improvement



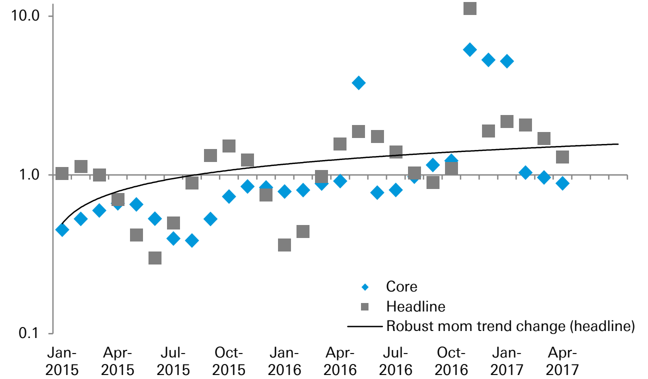
Source: Haver Analytics, Deutsche Bank

Inflation momentum off its peak …



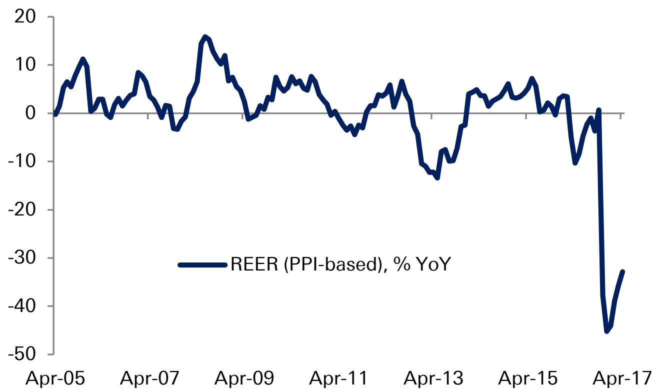
Source: Deutsche Bank

…but the sequential change in the trend of headline and core inflation are still on a general upward trajectory



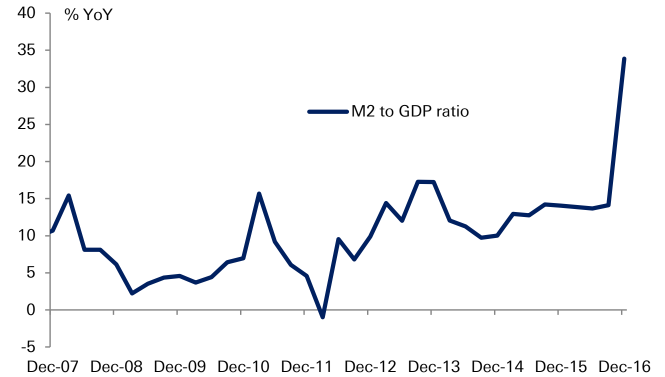
Note: x100 and Log base 10 scale
Source: Deutsche Bank

Recent REER appreciation may pose a threat to further import compression



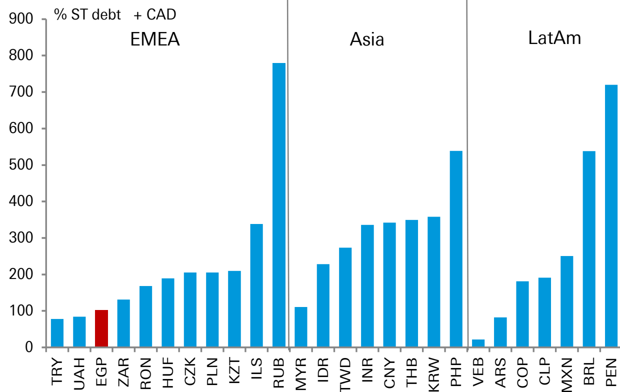
Source: Haver Analytics, Deutsche Bank

Growth in M2 to GDP ratio may pose challenges to the new eclectic targeting framework of CBE



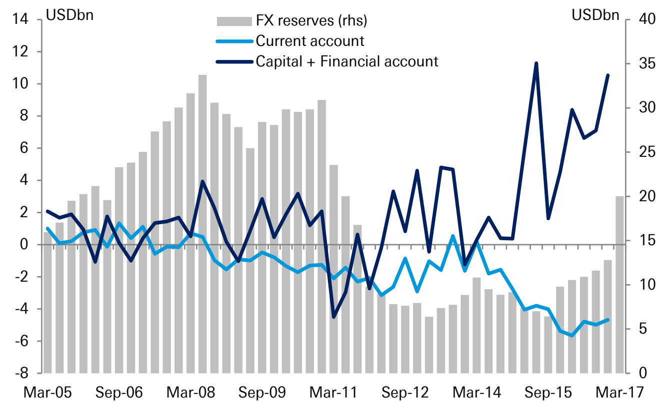
Source: Haver Analytics, Deutsche Bank

FX reserves one of the lowest in EM



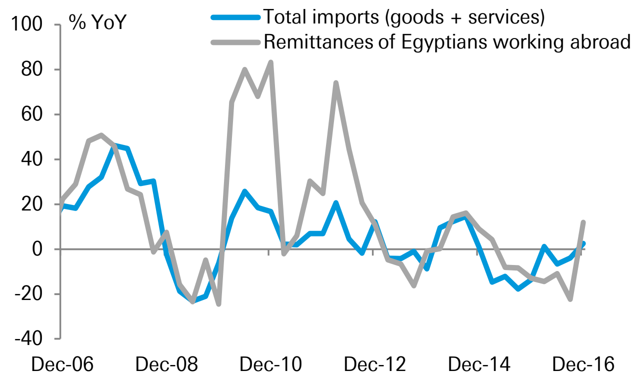
Source: Haver Analytics, Deutsche Bank

Strong financial inflows



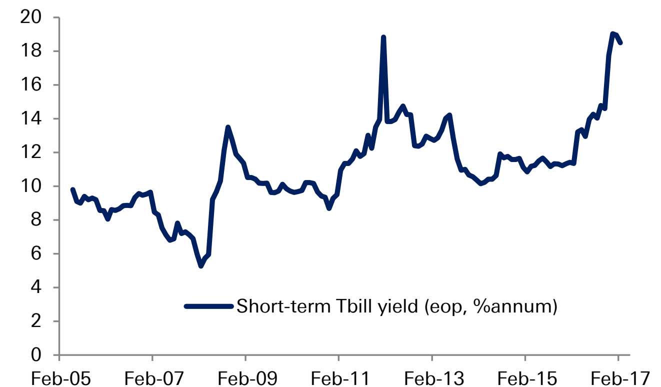
Source: Haver Analytics, Deutsche Bank

Imports and remittances responded to FX depreciation



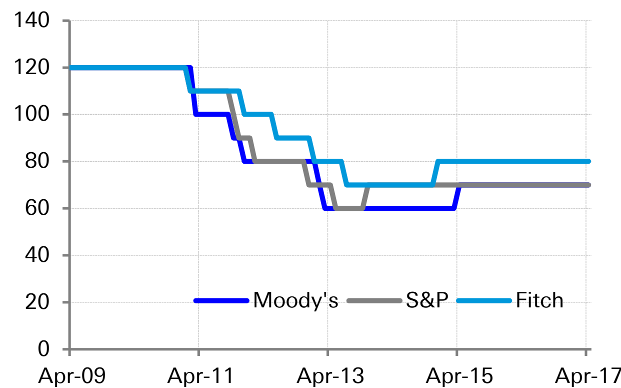
Source: Haver Analytics, Deutsche Bank

As the hunt for yield environment warrants it, investors seem attracted by the positive carry



Source: Haver Analytics, Deutsche Bank

History of credit ratings



Source: Bloomberg Finance LP, Deutsche Bank

Current credit ratings and scheduled announcements

Egypt Sovereign credit ratings

	Current	Announcements in 2017		
S&P	B- (Stable)	12-May	10-Nov	-
Fitch	B (Stable)	-	-	-
Moody's	B3 (Stable)	21-Apr	18-Aug	8-Dec

Source: Bloomberg Finance LP, Deutsche Bank

Key Macroeconomic data

	Q1-2015	Q2-2015	Q3-2015	Q4-2015	Q1-2016	Q2-2016	Q3-2016	Q4-2016	Q1-2017
Nominal GDP (USDbn)	78.2	76.7	90.8	87.4	80.4	74.4	94.8	59.1	-
Real GDP (% YoY)	3.3	3.3	5.1	4.0	3.6	4.5	3.4	3.8	-
Private consumption	1.5	0.3	6.6	4.8	5.0	1.7	2.1	7.9	-
Public consumption	4.2	3.3	5.7	3.0	2.0	4.8	1.8	2.5	-
Gross capital formation	39.0	-3.0	8.7	3.6	4.9	26.0	15.0	22.7	-
Exports	-14.2	-2.4	-25.0	-12.0	-18.7	-2.4	0.6	68.5	-
Imports	6.1	-14.4	-6.8	-3.7	-3.2	6.9	2.5	66.1	-
Prices (pavg, % YoY)									
CPI	10.6	11.8	8.5	10.6	9.4	12.2	14.5	18.8	29.8
o/w food	7.7	11.8	9.2	14.0	12.6	14.9	17.5	21.1	39.9
Core CPI*	7.1	7.8	5.9	7.0	7.9	11.4	13.2	20.8	32.1
PPI	-3.8	-1.7	-5.7	-1.3	-0.1	2.8	9.2	20.4	37.3
Money & Banking (eop, % YoY)									
Reserve money	17.9	33.3	13.3	15.9	13.1	-1.6	19.7	18.5	22.6
Domestic private credit	16.1	16.7	15.3	17.5	15.6	14.2	15.6	43.4	39.9
Fiscal accounts (% GDP)**									
Fiscal balance	-	-12.0	-	-	-	-11.6	-	-	-
Revenues	-	24.4	-	-	-	22.0	-	-	-
Expenditure	-	35.7	-	-	-	33.0	-	-	-
Primary balance	-	-4.5	-	-	-	-4.3	-	-	-
External accounts (USDbn)									
Current account balance	-4.0	-3.8	-4.0	-5.4	-5.7	-4.8	-5.0	-4.7	-
% GDP	*-5.2*	*-5.0*	*-4.4*	*-6.1*	*-7.0*	*-6.4*	*-5.3*	*-7.9*	-
Balance of goods	-9.2	-9.5	-10.0	-9.9	-10.0	-8.8	-8.7	-9.2	-
Exports	4.8	5.1	4.7	4.4	4.3	5.3	5.3	5.2	-
Exports of Petroleum	1.6	2.0	1.7	1.5	1.1	1.5	1.5	1.4	-
Other exports	3.2	3.2	3.1	2.9	3.2	3.8	3.7	3.8	-
Imports	13.9	14.7	14.7	14.3	14.2	14.1	13.9	14.4	-
Imports of Petroleum	2.2	3.1	2.8	2.6	1.6	2.2	2.6	2.5	-
Other imports	11.7	11.5	11.9	11.6	12.6	11.9	11.3	11.9	-
Balance of services	1.6	1.9	2.8	1.8	0.9	1.0	1.4	1.0	-
Exports	4.3	5.1	5.0	4.0	3.4	3.6	3.8	3.5	-
Transportation	2.2	2.5	2.6	2.4	2.2	2.3	2.3	2.0	-
o/w Suez Canal	1.2	1.3	1.4	1.3	1.2	1.2	1.3	1.2	-
Travel	1.5	1.9	1.7	1.0	0.6	0.5	0.8	0.8	-
Other	0.6	0.7	0.7	0.7	0.6	0.8	0.7	0.7	-
Imports	2.7	3.2	2.2	2.2	2.6	2.6	2.4	2.5	-
Income balance	-1.5	-1.1	-1.1	-1.3	-0.7	-1.4	-1.1	-1.1	-
Transfers	5.0	4.9	4.3	4.0	4.1	4.4	3.4	4.6	-
Capital account	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	-
Financial account	5.9	11.3	1.7	4.6	8.4	6.6	7.1	10.6	-
Net FDI	2.6	1.3	1.4	1.8	2.8	1.1	1.9	2.5	-
Net FPI	0.0	1.3	-1.4	-0.2	0.0	0.2	-0.9	0.9	-
Net other investment	3.4	8.6	1.7	3.0	5.6	5.4	6.1	7.0	-
Net E&O	-1.9	-2.7	-1.3	1.1	-3.0	-1.0	-0.2	-0.7	-
Change in CBE's reserves	0.0	-4.8	3.7	-0.3	0.2	-0.8	-1.9	-5.1	-
Reserves (USDbn)	15.3	20.1	16.4	17.4	18.0	18.0	19.6	24.6	31.3
% GDP	4.6	6.1	4.9	5.2	5.4	5.4	6.2	8.4	11.3
% ST Debt	517.1	782.4	586.8	392.6	263.8	256.3	246.7	205.9	261.9
% CAD + ST Debt	106.2	123.2	85.8	76.5	68.5	65.4	69.4	78.4	101.0
% 20% of M2	34.8	43.6	34.7	35.7	40.3	38.1	40.0	84.2	102.6
Months imports	2.5	3.1	2.5	2.8	3.1	3.4	3.8	5.2	6.6
% IMF Metric (floating exchange rate)	85.9	110.5	88.8	90.9	87.3	84.5	89.4	138.1	172.1
Debt Indicators (% GDP)									
Government debt	80.0	81.8	69.6	75.2	93.2	94.5	76.7	96.0	-
Domestic	72.6	73.9	62.8	68.4	85.3	86.6	70.2	81.3	-
External	7.4	7.9	6.8	6.8	7.9	7.9	6.5	14.7	-
Foreign holding of govt. securities (% total)	0.0	0.1	0.1	0.0	0.1	0.1	0.1	1.5	-
Total External debt	12.3	14.8	13.2	13.6	17.3	18.1	16.3	37.6	-
in USDbn	39.9	48.1	46.1	47.8	53.4	55.8	60.2	67.3	-
Short-term (% of total)	7.4	5.4	6.1	9.3	12.8	12.6	13.2	17.7	-
General (pavg)									
IP (% YoY)	1.0	-5.5	-3.5	-6.8	-9.7	-15.3	-9.9	1.8	17.4
Unemployment rate (%)	12.8	12.7	12.8	12.8	12.7	12.5	12.6	12.4	12.0
Tourist arrivals (% YoY)	6.9	9.3	-5.0	-28.9	-46.5	-55.1	-42.8	-18.3	51.0
Total Suez canal reciepts (% YoY)	1.8	-4.0	-7.8	-6.1	-0.5	-3.4	-4.1	-5.1	-2.9
Financial markets (%, eop)									
CBE O/N deposit rate (Policy rate)	8.75	8.75	8.75	9.25	10.75	11.75	11.75	14.75	14.75
CBE O/N lending rate	9.75	9.75	9.75	10.25	11.75	12.75	12.75	15.75	15.75
CBE Discount rate	9.25	9.25	9.25	9.75	11.25	12.25	12.25	15.25	15.25
O/N interbank rate	8.88	8.91	8.83	9.78	10.89	11.98	11.84	14.97	15.69
10y government bond yield	14.45	14.65	15.10	15.54	17.15	17.97	17.50	17.15	17.42
EGP/USD (pavg)	7.51	7.63	7.82	7.89	8.05	8.88	8.88	14.47	17.80
EGP/USD (eop)	7.63	7.64	7.83	7.83	8.88	8.87	8.88	18.13	18.05
JP Morgan REER (CPI based) (2010=100)	115.70	115.43	116.54	121.40	121.59	111.98	117.06	87.28	71.66

Source: Deutsche Bank

Asia Strategy

- Flow remains firmly in the driving seat for Asian macro returns. May (with $12.5bn) was the third successive month of $10bn+ portfolio inflows into the region (ex-China). In fact, the month (once we know the Malaysia debt numbers) will likely be the biggest since July of last year. We are now tracking $53bn year to date, with $28bn into equities and $25bn into local debt. With the Fed almost fully priced in for June, data surprises having moderated to more neutral territory, and Trump expectations having unwound; it is tempting to think that this carry/flow dynamic remains the path of least resistance for over the summer months. There are three reasons though for why we feel the medium term risk-reward is beginning to turn for the Asia macro trade, One, the best of the China lift to the Asian export story (and which had contributed more than US and Europe combined) is likely behind us. Two, the market is going into the June meeting with a very benign outlook on the Fed trajectory; and to that extent, there is little further room for Fed dovishness to support Asia. And three, the inflow momentum (3m rolling sum basis) is at a level now from which we have typically seen the trend reverse in the past.
- Our recommended portfolio is therefore a mix of a) extension trades (USD/INR puts, India bonds, short USD/TWD, long MYR exposure, short USD/THB); b) reversion trades (long CNH/KRTW, short SGD/PHP); c) hedge trades (USD/SGD call); and d) relative value trades (pay Korea swap spreads; HK vs US).
- One of the key developments over the last month has been also the change in FX fixing methodology by the Chinese. In the near term, the new construct should allow for greater pass through of the softness in the dollar into the RMB complex, supporting risk overall. More medium term, in allowing more discretion on the pass through, it should allow the authorities to be able to lean against any Fed driven vol, though how credibly it is able to do so remains to be seen.
  - In external markets, we have reached the point where the markets became completely agnostic to the idiosyncratic fundamental developments but still went longer Asia sovereign credit. We see no material fundamental catalysts that could help Asia sovereign bonds outperform rest of EM that are currently not priced in, even on volatility-adjusted basis in 2H17. We recommend use of the market strength to selectively reduce holdings in such curves as Philippines & Sri Lanka, put on cheap hedges via China & Korea 5Y CDS, reduce duration in Malaysia and go long Mongolia 2021s.

Local Markets

CHINA

- FX: Long 3M CNH/KRW NDF, target 175 (spot)
- Rates: Moderately bearish

Opportunities to add risk amid bond market consolidation. In June , there are domestic and external factors which could cause interbank liquidity to tighten and both PBoC's short term liquidity operations and the month end fiscal spending will be key to smoothing money market volatility. Domestically, the quarter end Macro Prudential Assessment would drive term funding demand from commercial banks, deleveraging by financial institutions continues to be carried out. Away from China, the Fed's policy rate action (DB expects a 25bps hike in June) and possible discussion on its balance sheet reduction outlook, as well as the ECB and BOJ policy decisions are key risk events; following which we can't rule out the risk of "mini hikes" by the PBoC. Having said that, we believe recent developments indicate that financial regulators are keen to stabilize the liquidity and financial market condition. Firstly, given the MPA, the market already saw term funding demand picking up --1M Shibor rose from the start of June by 32bps to 4.43% currently. On June 6th, the PBoC conducted RMB498bn 1Y MLFs vs. RMB431bn MLF redemption this month. The 67bn net liquidity injection and the duration extension of the central bank's liquidity accommodation in our view is to ease term funding pressure due to seasonal half year end and MPA. Secondly, it seems the banking regulator may extend the grace period for financial institutions to conduct internal reviews and adjust over-levered positions (the previous deadline for submitting reports of internal reviews by the mid of June). Considering the concentration of risk events in June, we think the stability in money market liquidity and the somewhat moderating regulatory pressure for deleveraging should help RMB rates and cash bond yields to consolidate around the current levels. We expect the benchmark 7D repo rate to trade within the 2.45-3% range and the 7D repo fixing rate at 3-3.5% in June. In the cash bond market, in the addition to liquidity risk, supply pressure will keep CGB/CDB yields level soft and we recommend allocation based investors to add CGB duration risk. We expect a pause of the recent bull flattening trend in the IRS/NDIRS curve and expect uncertainties in June interbank liquidity will keep IRS rates volatile.

HONG KONG

- FX: Moderately bearish
- Rates: Pay 5Y HKD vs. USD IRS at -33bp, target 0bp

Paying HK-US spread. The HKD swap curve has outperformed the USD IRS curve since last December with the 5Y HKD-USD IRS spread having narrowed sharply from around +30bp to -33bp currently. The strong outperformance in the HK market over the past six months can be attributable to two factors: (a) HKD liquidity has been quite flush supported by inflows of capital to the HK property market and to the equity market; (b) the relative low yield of HKD-denominated fixed income assets has been driving asset swap flows out of HKD assets into other foreign currency assets (primarily USD assets) by commercial banks and insurance companies for asset and liability management purposes. The balances between the supply and demand of HKD liquidity caused the narrowing in Hibor- USD Libor spread, and the ASW flows have resulted in the recent weakening of HKD and depressed the HKD IRS curve. As HKD continues to weaken towards the upper bound of the convertibility undertaking (7.85), we would expect the HKMA to drain HKD liquidity which will help renormalize the money market condition and renormalize the Hibor – USD Libor rates spread which has narrowed from flat to -47bp since the start of 2017. We recommend paying 5Y HK–US IRS spread at around -33bp, with a target exit at par for the spread, and a stop loss of -50bp. The trade has a carry of -0.5bp/mth.

INDIA

- FX: Long 6M USD/INR puts
- Rates: Long 3Y-6Y bonds, currency unhedged

Responsible dovishness. RBI shied away from any explicit easing at its policy meeting this week, but in what we read as a fairly constructive statement, showed its dovish bias. The shift lower in its inflation projections for the year (H1 now at 2-3.5% and H2 at 3.5-4.5%), along with the adjustments to the fan chart on confidence intervals around the same, clearly point to greater comfort for the CB that its medium term target will be met, and possibly undershot, this year. At the same time, in emphasizing that it does not want to go for 'premature action' and risk 'disruptive reversals later' and 'the loss of credibility'; RBI should have left the markets more assured that it won't acquiesce to pressure (there were questions at the RBI press conference about the government looking to meet with the MPC members), and that even if it eases down the line, it would do so cautiously, and without risking its focus on inflation targeting. DB Economics feels that given in particular the likely very low readings on CPI in the next couple of months, there is a 50:50 chance now for a rate cut at the August or October meetings. We suspect that the markets would have priced this in by the August meeting. Bonds have rallied in response to the same. India is one of our favorite longs in the region, though we remain keener on the currency and carry propositions, and still a bit reluctant to add significantly to the duration risk. The fundamental case for the India macro trade is well known. In a recent note, we also argued about why India should also be seen as offering an attractive 'defensive' carry-vol proposition to those worried about stress in EM ahead driven by Fed balance sheet normalization and/or accelerated tightening. It has delivered – in both local bonds and FX - among the best combination of absolute returns and volatility across the EM local markets peer group in the period since the EM cycle peaked in 2013. And has seen smaller drawdowns compared with its peers during multiple episodes of EM stress during this period.

INDONESIA

- FX: Neutral

Holding a steady course. In going by vol adjusted carry, Indonesia has ranked close to the top among emerging markets for most of this year, with a range inside of 200rup for spot (and around similar levels for NDF outrights) year to date. And the underlying story gives cause for comfort that this trend could persist, at least until we see more pronounced global headwinds, possibly later this year, from factors like normalization of balance sheet by the Fed. A combination of near 19% growth in exports over the past six months, and nearly $8bn in portfolio inflows year to date, make for a strong domestic story – though one which is more supportive of duration than currency gains, given that Bank Indonesia continues to accrete reserves at a consistent pace (~$12bn in the last five months). The icing on the cake – and just when the markets had begun to give up – was the upgrade from S&P last month, which brought Indonesia into investment grade across the major rating agencies for the first time. Like we had noted in these pages earlier, our meetings with the central bank in Indonesia has left us comfortable with their guard against signs of economic and financial imbalances. In preserving value of the IDR by lagging the move in other regional peers, and in the process building reserves, Bank Indonesia is effectively preparing itself for when there is more stress from global factors.

MALAYSIA

- FX: Tactically long MYR through front dated bonds (MGS Sep-18)
- Rates: Marketweight duration

Catching up. From a standout underperformer in Q1 to the catch up star of Q2 – it's been a big turnaround for MYR and Malay assets overall, and which has validated our tactically constructive view on the same since end of March. Some of it has been fortuitous, in that the carry/risk positive global backdrop has kept the momentum of flows into EM debt funds relatively healthy, and encouraged at least some of the dedicated money to reduce/close their underweights on allocation from over the past few months. Some of it is owed to a strong macro performance (Q1 GDP beat expectations handsomely, exports have averaged 20%+ y/y since start of 2017). And some to a positive policy response to concerns around the regulations relating to FX hedging put in place late last year. So while Malaysia witnessed outflows of $13.5bn between November and March this year (split between asset swap unwinds of around $5.7bn in the initial couple of months, and unwind by index money of around $8bn in Q1 this year); the flow picture has since turned around, including after the dynamic hedging regulations were liberalized. Malaysian debt markets recorded their first monthly inflow in April (+$1.6bn), and given the near $2bn increase in reserves reported for the month of May, we suspect last month was the second successive month of inflows. Equity markets have seen a more consistent, though modest, pace of inflows since start of the year. It seems, and particularly given the adjustment to asset swap and index ownership positions, that the worst of outflow pressure is behind us for now. Note also that there are no major redemptions lined up in the MGS market until August (the unwinding by AMCs, we believe, was in good part through lack of rollover on maturities); and that exporter conversion riles appear to have made a meaningful difference to net USD supply in the onshore markets. The currency is still undervalued, and BNM we suspect will welcome a slightly stronger currency still, if only to encourage a positive spiral of confidence, and to keep check on inflation. So we are happy to keep with our tactical long bias on the currency, expressed via front dated bonds. We are not convinced about much space for duration to perform, except for beta to UST moves in the event we were to see a break lower toward (and possibly through) 2% on the latter. More medium term, we still see several challenges, including in particular that the level of reserves – having been used to meet the drawdowns from late last year – stand inside of $80bn, and with net reserve coverage down to less than 6x monthly imports.

PHILIPPINES

- FX: Short 3M SGD/PHP NDFs, target 34 (spot)
- Rates: Modest underweight

Playing for some catch-up. We turned relatively more positive on the PHP last month, targeting a catch-up to regional FX strength this year through SGD/PHP shorts. Technically, USD/PHP has struggled to gain ground above 50 which has thus become a good resistance level, and we like to sell bounces in USD/PHP towards 50 as well. There have been a few constructive developments in recent months. The appointment of BSP Deputy Governor Espenilla to replace Tetangco was welcome, reinforcing the idea that Duterte has largely left economic positions to technocrats. While inflation has missed expectations slightly, and remains comfortably within the bounds of the 2-4% target corridor, we think the BSP should still be the first in Asia to hike given robust growth and underlying price pressures. There has been some positive momentum on tax reform, with an initial version of the first tax package passing the House of Representatives. It will go to the Senate next where it may be further revised, but Duterte has made it a priority. If it passes, it is being hailed by credit rating agencies as a potential positive. Fundamentally speaking, the currency's overvaluation has corrected on two out of our three models (PPP and BEER), with the pending FEER overvaluation a stubborn symptom of current account compression. Indeed the current account has been the peso's Achilles heel, and while we don't expect much of an improvement, the worst of the negative delta could be behind us with the imports-exports gap closing. The risks are that significant infrastructure spending raises capital imports or that Middle East tensions dampen remittance flows. The PHP offers positive carry and positioning is light both on the speculative and real-asset side with Philippines having seen very little offshore money in recent years. It is thus notable that some equity flows are starting to return with asset valuations less prohibitive. SGD/PHP is trading near post-crisis highs offering a good entry point for a retracement lower towards an initial target of 34, and stretch target of 33.

SINGAPORE

- FX: Short 3M SGD/PHP NDFs, target 34 (spot). Keep USD/SGD 1.42/1.4550 RKO calls. Receive 3X6 SGD offshore forwards
- Rates: Marketweight duration.

The low carry funder. USD/SGD has largely been driven by broad dollar weakness this year, with domestic policy expectations not in the driving seat as much. However, we think SGD NEER should be trading near the mid-band after the last MAS meeting in which they were dovish, choosing not to upgrade growth forecasts or signal scope for future tightening this year. We thus like to use SGD as a funder for relative value mean reversion trades. We are currently short SGD against the PHP as a positive carry catch-up play (see Philippines section). We also think SGD vols offer good value. We thus like to use USD/SGD topside options as

a cheap hedge for any reversal higher in the USD over the summer months should China data slow, and the market accelerate its pricing on the Fed. The other startling development in Singapore this year has been the outperformance of Singapore rates, as flush local currency liquidity has pushed SOR below 1% support levels recently. A continuation of the trend of regional inflows, coupled with weak credit growth, and only partial sterilization for any intervention could keep liquidity ample. We like to receive SGD forwards playing for a continued move lower in forward points.

SOUTH KOREA

- FX: Long 3M CNH/KRW NDF, target 175 (spot)
- Rates: Pay 10Y swap spread, target -20bp.

Scale into 10Y bond swap tightener. We were in Korea last week to meet with the central bank, government officials and local market participants to discuss the outlook post the Presidential elections, and with particular reference to the expectations around the new government's economic policies. The mood seems fairly constructive onshore, and given the resolution of the political logjam. In nearly every arena - from macro to micro policies - there seems an intent to maintain continuity and avoid significant disruption. Indeed, except for a Supplementary Budget, which will be mostly funded from an improved tax surplus, there is little by way of expectation on new policy measures/tools related to issues like household debt, capital flows, current account recycling (through NPS, lifers and others), at least at this juncture. In a bid to cool down the property market, the authorities are likely to tighten macro prudential measures on household debt (i.e., lower LTV, DTI ratio). Nonetheless, more market influential measures such as a mortgage conversion program (switching short term bank loan to long term mortgage) in 2015 are not on the table yet. While the local press will likely focus on the more controversial parts of the policy agenda; the new government looks better prepared to pursue its top economic policy objective - job creation - than we initially anticipated. On the currency front, while the new government's focus on domestic income growth could be interpreted as a policy preference towards a stronger Korean won; the authorities are keen to emphasize that their immediate priority is to continue with managing market volatility. Our reading is that while in the near term, the momentum in offshore inflows (particularly in equity markets) could open up some further downside for USD/KRW; it would be premature to read the new government as having an unlimited appetite for currency appreciation. On the rates front, an expected large tax surplus should allow the MOSF to avoid issuing additional bonds to fund a Supplementary Budget of KRW11.2tr, and which should therefore be neutral for the curve.

In part due to the continuity in economic policies, the reaction in financial markets to the government transition has been mostly orderly. Looking forward, however, policy makers as well domestic market participants are deeply conscious of the challenges from the global backdrop, and in particular that Fed driven (interest rate differentials, balance sheet adjustment) and China driven (the new fixing methodology, growth slow down) volatility might add up in the months ahead. In particular, we suspect an inversion in yield differentials in policy rates - likely by early next year - will be closely watched by domestic markets. With concerns about additional DV01 supply easing, we like to scale into 10Y bond swap tightening trade at +35bp (i.e., pay 10Y swaps and buy 10Y KTBs/KTB futures) with target of -20bp.

THAILAND

- FX: Short 3M USD/THB, target 33 (spot)
- Rates: Marketweight duration. Long 5Y (ILB217A) linkers, target 1.20% on real yield and +100bp on the 5Y break-even.

Batting on the baht's team. We have been holding THB longs as a good vol-adjusted beta to dollar weakness. The THB's fundamental underpinnings are defensive: a large current account surplus (>10% of GDP), foreign underweights on the market, and subdued politics. Talk of regulatory pushback to capital flows and FX strength has been a red herring, as the origins of THB strength are from the current account surplus which is harder to fight. For context, Thailand has received $2.5bn in foreign bond inflows, and $0.4bn in equity inflows this year, but the current account surplus has been more than $16bn. Over the last two and a half years, the current account surplus has been a cumulative $100bn, but net portfolio flows have been flat. In short, THB strength has not been about foreign money. Indeed, when BoT announced some reforms to FX regulations earlier this week, there was no mention of foreign capital constraints, with the emphasis on loosening channels for domestic capital to flow out with an "ease of doing business" spin. Some changes included allowing retail investors to invest overseas through a wider range of intermediaries, allowing FX payments for imports even if goods are not brought onshore, and increasing ability of non-residents to borrow in THB, amongst others. The likely hope is that the private sector will do more to recycle the surplus through outflows, reducing the need for the central bank to intervene to buy USD onto their reserves. Indeed, this year, the central bank has accumulated more than $12bn, or an annualized pace of 8% of GDP, well in excess of levels that could attract US scrutiny around intervention intensity. The hurdle for private sector outflows to lift the burden is very high, so we think the BoT will be forced to allow more FX gains, and remain bullish the baht targeting a move to 33.

TAIWAN

- FX: Short 6M USD/TWD NDFs, target 29 (spot)
- Rates: Marketweight duration

TWD appreciation ain’t over yet. Our view of a stronger TWD has panned out well since the beginning of the year. Equity inflows have been exceptionally strong, with Taiwan receiving $8.7bn of inflows YTD. The ongoing rise in hedging activities by Lifers has diminished their ability to recycle Taiwan’s large current account surplus (13.5% of GDP), adding to the appreciation pressure. We don’t think this is over yet, despite the recent pullback. Following our recent trip to Taiwan, we strongly believe that, in the coming weeks, USD/TWD will again test and break decisively below the 30 level. Why?. Historically, the central bank has always tried to keep the USD/TWD in check with its fundamentals by managing the TWD real effective exchange rate (REER) in some kind of band to ensure Taiwan’s economic stability. However, this has not been the case in recent months. Why? Findings from our recent visit, coupled with senior government officials’ comments in the international press, suggest that the authorities are shifting their thinking around FX policy, and becoming increasingly more tolerant of TWD appreciation. For example, during a recent Legislative hearing, the Deputy Governor of the CBC, Mr Yang Chin Long, stated “*Companies must be vigilant about currency hedging, and the central bank will not intervene if foreign fund inflows continue*”. This message was echoed by the Premier in a Bloomberg interview, where he stated that he respected the market setting the value of TWD. Given the shift, it is likely that the improving fundamentals and ongoing equity inflows should be supportive of TWD appreciation.

Another reason is increase in Lifer’s hedging activities. As we have written over the past few months, following the strong TWD appreciation, Lifers have been actively raising their hedge ratios – from 70% levels to 80% levels – as of 4Q16. From our recent visit, we note that the ratio had been pushed up to as high as 90% for some companies in 1Q, and the risk is for a further increase still. This is particularly the case given the notable depletion in the Lifers’ FX volatility reserves fund this year. Findings from our recent trip suggest a number of Lifers have already depleted 80% of the reserves, owing to the strong TWD appreciation. In other words, any future losses the Lifers incurred will be directly hitting on their income statement. Assuming Lifers have around $420bn of foreign assets and hedging ratio is around 90%, Lifers have about $42bn of assets that are still exposed to FX risk and a 1% appreciation in TWD would result in $420m of FX losses. Hence the need to increase the hedging ratio further, or halt overseas investments Either way, this would mean Lifers’ overseas investments would no longer have much of an impact in limiting TWD appreciation, and the ongoing increase in the hedge ratio would further depress DF and NDF points particularly in the 3-6M forward curve portion.

On the back of these factors we see value in selling USD/TWD particularly given the pullback recently. We recommend selling USD/TWD 6M NDF with a spot target of 29 and a stop loss at 30.7.

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Credit

Asia sovereign credit space YTD has been quite rich in idiosyncratic developments, some of which were widely anticipated (e.g. Indonesia's upgrade to IG by S&P, India's approval of GST Law, IMF signing a deal with Mongolia), while some came as a surprise (e.g. China's ratings downgrade by Moody's, severe drought in Sri Lanka in 1Q which by now has been followed by very strong flood). Looking back at the performance of Asia sovereigns overall we can conclude that at the end of the day whether the underlying individual catalysts were positive or negative investors used all of them to mostly go longer this asset sub-class. This was predetermined by two major trends: (i) macro-dynamics in wider EM becoming more volatile (e.g. geopolitical developments in Brazil); (ii) investors continued to see fund inflows. These both factors appear to be subsiding in their intensity, which could in turn impact the appetite for Asian sovereign credit as a whole. Besides, **we see no material fundamental catalysts that could help Asia sovereign bonds outperform rest of EM** that are currently not priced in, even on volatility-adjusted basis in 2H17 given their increasingly expensive valuations for most curves either in relative or stand-alone historical terms. **We believe that it does not make sense at either current valuations or fundamental dynamics to go increasingly long Asia sovereign credit** and would, instead, use the market strength to selectively reduce holdings in such curves as Philippines and Sri Lanka and put cheap hedges on via China and Korea 5Y CDS. **Our Neutral stance on Asia sovereigns** is balanced by RV-based buys in the belly of Malaysia and MONGOL 21s.

CHINA & S. KOREA – buy cheap CDS hedges

Although macro-dynamics of this country has been relatively stable YTD, China remains, in our view, the largest source of idiosyncratic risks for Asia in 2H17. In our view China's risks mainly stem from within. This does not necessarily mean unexpected volatility in GDP growth or RMB/USD fixes, but rather concentrates around the domestic credit conditions and money market rates. Both have generally been tightening YTD despite the regulators still maintaining de-facto accommodative credit policy stance. This in turn impacts local companies' appetite for external borrowings and, at the same time, spurs the demand of local investors for external credit investments. Local banks in China are still not rushing to lend at a higher pace vs. 2015-16 despite various measures recently announced by the regulators in an attempt to clamp down on off-balance sheet financing. Earlier in our publications we already expressed our cautious stance on the aforementioned factors. The peculiar market reaction (or rather lack of) to China's credit ratings downgrade by Moody's tells us that investor positioning is very polarised: those who are UW - are not willing to go increasingly short and those who are OW – are not willing to go even longer. In the worsening credit market liquidity conditions and primary supply being China-heavy, we believe it makes sense to hedge the risk and **Buy China 5y CDS at current 76**. *Main risks: a potential spike in EM investor credit appetite, persistent demand for Asia risk against the global rates volatility, lack of new bonds supply, visible recovery in global commodity prices.*

In S. Korea, where economic recovery is arguably the most prominent in DM Asia, the investor sentiment has been driven by headline risks, especially those related to its neighbour in the north. According to our economists, the combination of stronger exports, accelerated GDP expansion and negative real interest rates, could force S. Korea to become the first developed economy in Asia with rising policy rates. The latter is estimated to be ~125bp too low currently, which in conjunction with greater focus by the recently elected President on fiscal stimulus vs. monetary one, support the argument of higher probability for rate hikes in the near term. DB economists believe that this is likely to be a story of 2018, but the risks are to the upside. Banks would benefit the most, in our view, with a positive impact on NIM and slower growth in household debt. Given both interest rate and geopolitical risks associated with S. Korea, we believe **it makes sense to Buy KOREA 5Y CDS at current 56** and add it to the list of cheap hedges in Asia credit space. *Risks: global rates trending lower for longer, geopolitical concerns subside, economic performance exceeds expectations.*

PHILIPPINES – Sell long-end

If S. Korea could become the first DM economy in Asia to hike rates in the next 6 months or so, in EM part of the region Philippines is becoming the most obvious candidate for the similar action. The pressure is mounting high for BSP to deliver its first rate hike as soon as Aug-17, according to our economics team. Interestingly enough, the pressure in Philippines is building up not so much from the inflationary concerns, but more from the overheating credit demand and strong domestic consumption that are driving imports' growth. We still believe that Philippines will once again become a dual-deficit economy by the year end. Coupled with the recent stumbling on the policy making front (e.g. Tax reform, especially on the part of VAT) and widening fiscal deficit, the trend does not bode well from the credit ratings perspective. Although we do not expect any negative ratings actions on Philippines in 2017, the near term upwards pressure will be absent, in our view. Rising local rates should also cool-off the domestic investors' appetite towards PHILIP external debt. Hence in the environment of expected rising UST rates and the recent underperformance of belly of PHILIP's curve (the G-spread differential between PHILIP 4.2% 24s and

PHILIP 42s have compressed to ~20bp vs. ~40bp three months ago), we would recommend using the market strength to reduce holdings in the long-end of PHILIP curve (**Sell PHILIP 42s at 102/94bp bid-price/Gspr**). *Key risks: Better than expected fiscal performance, prolonged weakness in oil prices, CA remaining in surplus.*

MALAYSIA – deploy curve steepener

Malaysia's CDS and bond spreads have been very resilient lately, despite continued weakness in commodity complex, especially oil. Fundamentally, Malaysia's economy has been doing slightly better than expected, which even resulted in MoF upgrading the GDP growth forecast for 2017 by 30bp to 4.5-4.8% range. Exports dynamics and consumer spending have remained strong YTD and the currency (MYR) has been quite strong lately. We believe that the next tangible turning point for Malaysia would come in the form of potential early general elections, which could be interpreted positively as they could result in the incumbent PM remaining in the office. In terms of bond valuations, Malaysia's curve has lost its investment appeal earlier in the year and we remain of the view that it does not make sense to go long this risk outright at current junction – whether via cash or CDS. However, we do notice material flattening of the curve vs. most of its peers both in Asia and EM. In our view, the investor sentiment from now on would be largely hinged on the direction of global rates, which in the mid-run are bound to rise. In addition to the flattening of MALAYS yield curve we also observe a visible outperformance of Malaysia's longer-dated bonds vs. quasi-sovereign peers as opposed to those in the belly (e.g. 10Y). **We believe it makes sense to tactically sell MALAYS 46s (104.16/105bp bid price, Gspr) vs. buying MALAYS 26s (101.7/87bp ask price/G-spr).** We target 20-25bp spread differential widening in this trade. This view is also supported by the fact that MALAYS 26s have underperformed vs. MALAY 5Y & 10Y CDS with Z-spread differential now being 25bp lesser vs. mid-Mar-17 (currently ~5bp and ~55bp respectively). *Key risks: worse than expected economic growth, aggressive new bonds supply, plunge in oil prices, spike in currency volatility, political instability.*

Frontier markets – prefer MONGOLIA over SRI LANKA

With Mongolia going into the IMF programme two weeks ago, which had been widely anticipated, investors are now left with a dilemma which of the two frontier curves in Asia provides better return proposition in 2H17. Instead of simply looking at the RV yield/spread differentials between the two, we believe it always makes sense to bring the fundamental considerations into such a discussion. Despite Sri Lanka displaying signs of inflation peaking, FX reserves bottoming and GDP growth still lagging behind potential, the sheer magnitude of expected upside in fundamental changes in Mongolia will be more pronounced in the next 6-9 months, in our view. In addition, Mongolia is currently restricted from increasing its net government debt, while Sri Lanka is still in need to attract international funding. Although the commitment to fiscal consolidation in Sri Lanka has been strongly expressed by the government, history shows that when they incur shortfalls in revenues, the government prefers to borrow rather than cut spending. The recent news [EconomyNext] on Sri Lanka's government unaccounting for ~USD2.1bn of government debt not only adds 4 percentage points to government debt/GDP ratio (now at 83%),. But will also likely cause tensions with IMF and increase cost of debt servicing for the government. With MONGOL's belly of the curve vs. SRILAN 21s & 22s and MONGOL 24s vs. SRILAN 6.125% 25s seemingly underperforming and with all things being equal, we believe there are more reasons for investors to stay OW Mongolia, rather than Sri Lanka in 2H17. Given more attractive YTM for MONGOL 21s vs. 22s we prefer the former. **We recommend Buying MONGOL 2021s (at current 116.5/6% ask-price/YTM) vs. Selling SRILAN 6.125% 25s (at 103.6/5.6% bid-price/YTM) and SRILAN 2026s (at 107.5/5.8% bid-price/YTM)**. *Key risks for Mongolia: Slippage from IMF programme targets, sharp downward move in global coal and copper prices, spike in MNT volatility, instability within the new government. Key risks for Sri Lanka: better than expected economic growth, prolonged absence of new bonds supply, replacement of more costly debt, material u/p of bonds while EM peer assets rally.*

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EMEA Strategy

EMEA FX: The weaker-than-expected NFP has certainly extended the window of opportunity for EM FX, as it is unlikely now that the Fed is going to provide a major hawkish surprise. With US rates range-bound/weaker, global growth potentially peaking but at a high level and EM inflows continuing, there is likely still room to rally. However, we prefer to still be somewhat selective given stretched valuations and positioning in some currencies (like RUB). We focus our longs in currencies which still have attractive valuations, like TRY (vs. USD) and CE3 (vs. EUR). In the case of CE3, better euro area activity provides another kicker. We also recommend buying USDRUB 3m call spreads.

EMEA Fixed Income: In Russia stay in short-end OFZs best expressed in May-19. On the local swap curve keep 1Y IRS receivers while in cross-currency swaps dissuade from short-end receivers given high negative carry but enter flatteners to benefit from the shape of the curve best expressed through carry/roll optimized 1Y – 2Y2Y XCCY flatteners. In Turkey switch from 1Y XCCY receivers into 5Y XCCY receivers given better carry/roll characteristics. In bonds, we see selective value mostly in the belly of the curve best expressed via Feb-20. In Israel keep short-end fwd starting receivers best in being long the 3Y fwd 1y rate with 15bp of 3m roll. Remain long 5Y5Y IRS vs US-swaps and on the curve remain positioned into long end bonds (best Oct-26/Mar-27) vs paying 2Y ILS. As a cross-country trade enter 5Y ILS receivers vs 5Y CZK. In Romania keep an overweight on long-end bonds best expressed in Feb-25. On the back of the recent short-end flattening switch back from 6x9 FRA payers into 6x9 FRA – 1Y1Y IRS steepeners in Czech. Also keep 5s10s IRS steepeners. In South Africa keep hybrid trades by being long in (>)10Y bonds while paid in 5Y. We keep our bias that the market is too aggressively priced on cuts in the short-end of the curve. In Hungary keep a flattener bias being paid in 5Y IRS while received in long-end bonds (best 25/B or 27/A). In IRS enter 2Y short-end outright payers.

EMEA Credit: we retain our core underweight on South Africa, on the view that the recent recovery is unjustified given the country's negative trajectory – politically and economically. While we do not have a core overweight in the region, we continue to favor Russia, Turkey, Ukraine (marketweight) on relative basis vs. South Africa, Hungary and Poland (underweight) – we underweight the latter two solely due to their tight valuation. In relative value, we retain Turkey 26s vs. South Africa 26Ns, long South Africa 24s vs. 5Y CDS, and switching to Azerbj 24s from SOIAZ 23s, switching from 40s to 47s and from 25s to 27s in Egypt.

EMEA FX: Focusing on value

Trades: short USDTRY, buy USDRUB topside options, long PLN, HUF, CZK (equally weighted) vs. EUR

Short USDTRY

TRY is cheap: On the aggregate of our three fundamental valuation metrics (DBeer, PPP, FEER), TRY is the now the cheapest currency in the world (chart 1). On our preferred DBeer model, TRY is the most undervalued it has been since 2003 at -15% (chart 2).

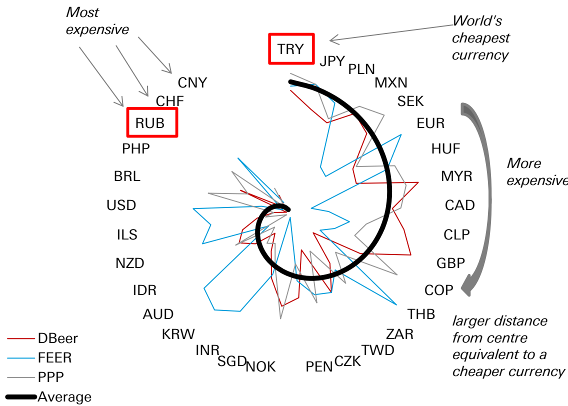
Positioning is still light, but the flow dynamics are improving. The foreign ownership share of Turkish local currency bonds remains near the lows, pointing to light positioning (Figure 3). But the flow picture has improved, with the debt outflows turning into inflows recently and our CORAX monitor highlighting a return of TRY buying. In combination, light positioning and a positive flow picture is conducive to further currency strength.

Relative attractiveness and lower vulnerability compared to other high yielders: Most of the main carry trades in EM are either very well positioned already and have unattractive valuations (RUB), or have even more near-term political risk than Turkey (ZAR, BRL). It is important to assess vulnerability to a potential deterioration in risk sentiment, given that EM has already rallied significantly over the past 6 months, positioning in certain EM currencies has built and expectations of the Fed (on both rates and balance sheet reduction) are benign. TRY is one of the least exposed currencies on 'internal' risk metrics – valuation and recent performance. It is very cheap versus fundamentals, and has also underperformed the rest of the EM FX complex since the US elections (Figure 4). Two key sources of 'external' risk are a further decline in commodities prices and higher US real rates (Figure 5). TRY has little exposure to commodity prices, and while there is some exposure to US rates, it is less so than for other high yielders like ZAR and BRL; meanwhile, light positioning, cheap valuation and high vol-adjusted carry (among the highest in EM) should provide some insulation.

Monetary conditions are tight: The CBT's weighted average cost of funding is near all-time highs (11.9%). Monetary conditions are therefore tighter than they had been at the start of 2012 and 2014, after similar TRY depreciation shocks (Figure 6). In those two instances, monetary tightening led to a prolonged period of TRY stabilization/ appreciation. The CBT has committed to maintaining sufficiently tight liquidity conditions in the near term, which leads us to believe a similar period of TRY stabilization is likely.

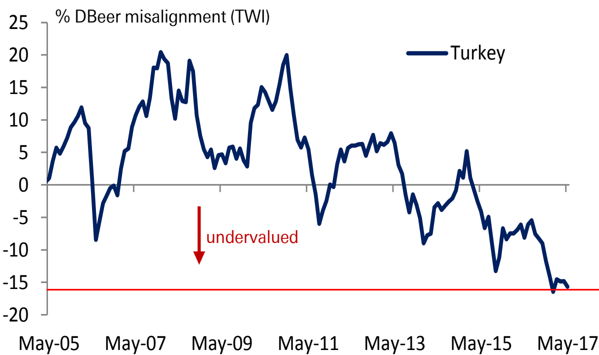
Politics: no news is good news: A major political risk event – the referendum on executive presidency – was completed in April, and early elections in the near term are unlikely. Therefore, we could have a period of stability on the political front, especially relative to other high-yield peers like Brazil and South Africa. Political stability will allow the price action to be driven by the other positive factors noted above.

Chart 1: TRY is the cheapest currency in the world on the average of our three fundamental valuation metrics, while RUB is one of the most expensive



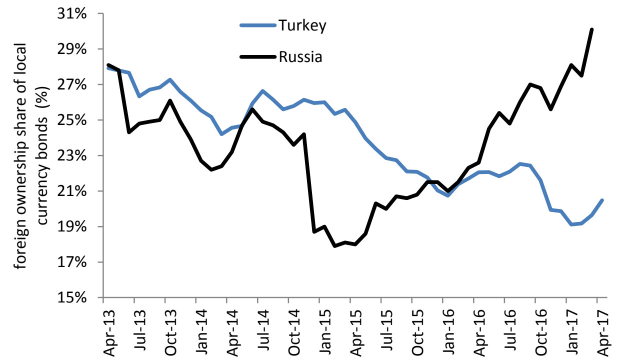
Source: Haver Analytics, Deutsche Bank

Chart 2: TRY is now at 'extreme' undervaluation levels (15% cheap) on our fundamental DBeer model



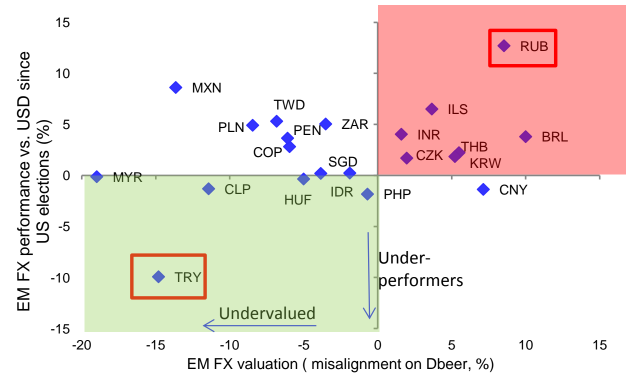
Source: Haver Analytics, Deutsche Bank

Chart 3: Foreign positioning in Turkish local currency bonds is light, while that in Russian bonds is heavy



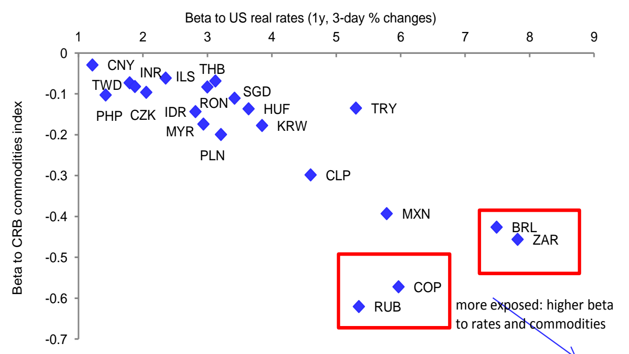
Source: Deutsche Bank

Chart 4: 'Internal' vulnerabilities: TRY is attractive on the valuation-performance dimensions, while caution is warranted on RUB



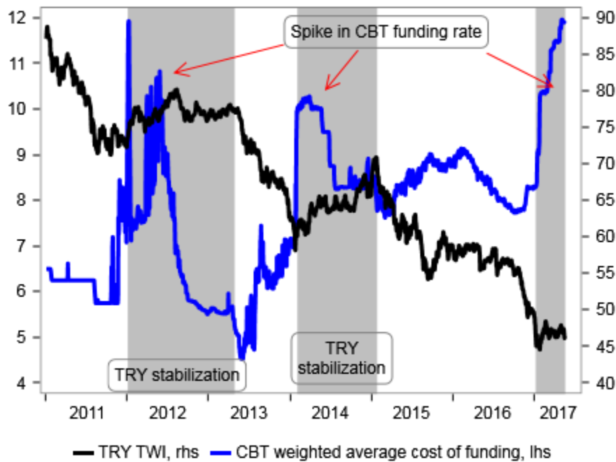
Source: Deutsche Bank

Chart 5: RUB is exposed to the key external risks – rising US real rates and commodity price declines; TRY is comparatively less exposed



Source: Deutsche Bank

Chart 6: Monetary conditions are tight, as highlighted by the spike in the CBT average funding rate



Source: Deutsche Bank, Bloomberg Finance LP

Buy USDRUB topside options

RUB is expensive: On our preferred longer-term fundamental valuation model (DBeer), RUB is close to 10% overvalued in trade-weighted terms. This overshoot has meant considerable resistance in the past (Figure 7). On the average of our three fundamental valuation metrics (DBeer, PPP, FEER), RUB is now the third-most expensive currency in the world (Figure 1). RUB is also overvalued vs. oil, consistent with the falling correlation between RUB and crude earlier this year (Figures 8-9). In recent weeks, however, bouts of risk-off sentiment and falling commodity prices have triggered an increase in the correlation. While RUB has been 'expensive' vs. oil for the past 2 months, if this re-coupling of RUB and crude continues, it could push USD/RUB closer to the fair value implied by crude (62).

RUB is vulnerable to deterioration in risk sentiment: If we re-enter a risk-off phase, as observed intermittently in recent weeks, RUB is vulnerable. It appears exposed on both the 'internal' and 'external' dimensions. Internally, RUB has been the best performer in EM since the US elections and positioning is significantly long, both in FX (IMM shows that net long positioning is still near historical highs) and in bonds (Figure 3), raising the risk of 'payback' depreciation and position squaring. It is also overvalued on fundamentals (Figure 4). Externally, RUB has the highest beta to commodities and a relatively high beta to US rates, thus exposing it to two key near-term sources of risk for EM (Figure 5).

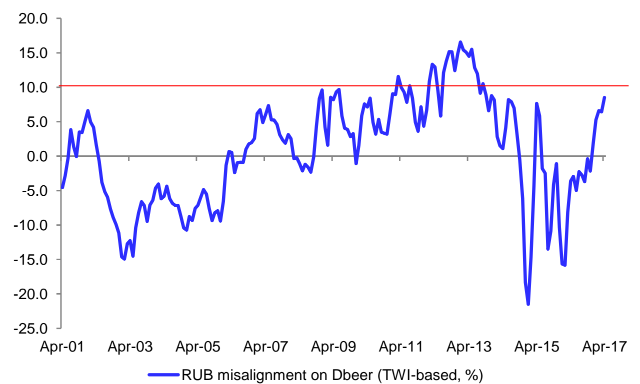
Moreover, Russia's balance-of-payments dynamic tends to weaken in Q2 and Q3, which generally leads to worse FX performance than in Q1 (Figures 10 and 11). We expect the current account to weaken due to import seasonality and a pickup in domestic demand. Dividend payments and foreign travel-related seasonal demand for FX will also likely weigh on the currency in the coming months.

Authorities' views on RUB a headwind: Rhetoric from government officials around RUB being 'too strong' has been ongoing for some time. We had comments from the EconMin and FinMin on RUB being '10-12% stronger than its fundamental level'. However, President Putin has recently come to the defence of the CBR's stance thus far of maintaining 'comfort' with RUB strength. However, with inflation now back at the 4% target for the first time since 2012, and inflation expectations also declining, there is more reason for the CBR to 'loosen' its stance on the currency. The first step in this direction is a faster-than-expected easing cycle (which has likely begun with the latest 50bps cut). Should oil remain at or above USD 55, the CBR will also look to rebuild reserves. The bottom line is that with inflation at target and RUB-OIL currently below the budgeted level (Figure 12), policymakers could, at least at the margin, welcome some RUB weakness.

US-Russia relationship remains a risk. Pressure on the White House to disclose the full extent and nature of its interaction with Russian officials has intensified in recent weeks following Trump's dismissal of FBI director Comey. Investigations continue into the Trump-Russia connection, and potentially negative news flow could contribute towards investor concerns.

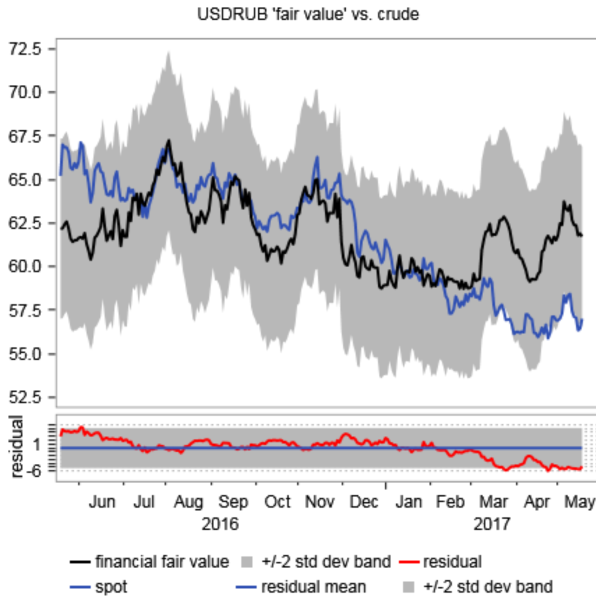
We express our view via limited loss options structures (given relatively low vol). e.g. 3m 59:62.5 USD/RUB call spread, for 1.05% (lev 5.3x, spot ref 56.1).

Chart 7: In TWI terms RUB is near 10% overvalued on our fundamental DBeer model – it has faced resistance at this overvaluation level in the past



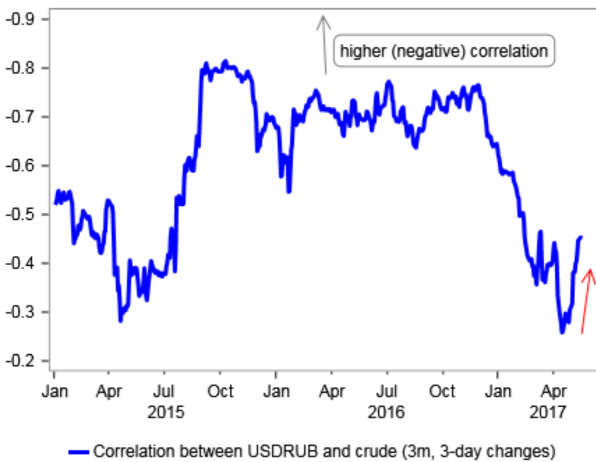
Source: Deutsche Bank, Haver Analytics

Chart 8: RUB is overvalued vs. oil on a simple regression of USDRUB on crude (12m, daily data)



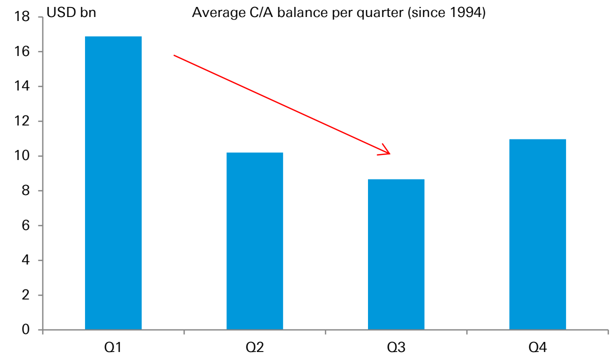
Source: Deutsche Bank

Chart 9: RUB-crude correlation declined sharply at the start of the year but is now starting to recover



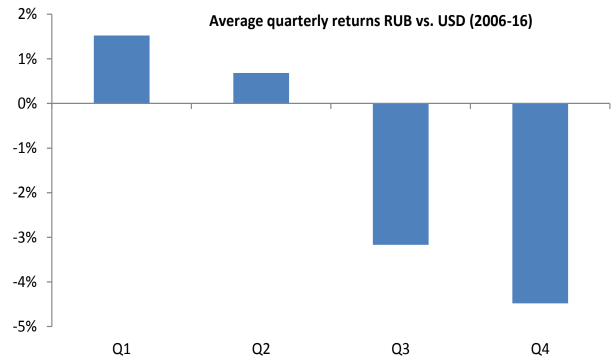
Source: Deutsche Bank, Macrobond

Chart 10: Russia's current account surplus tends to weaken in Q2 and Q3...



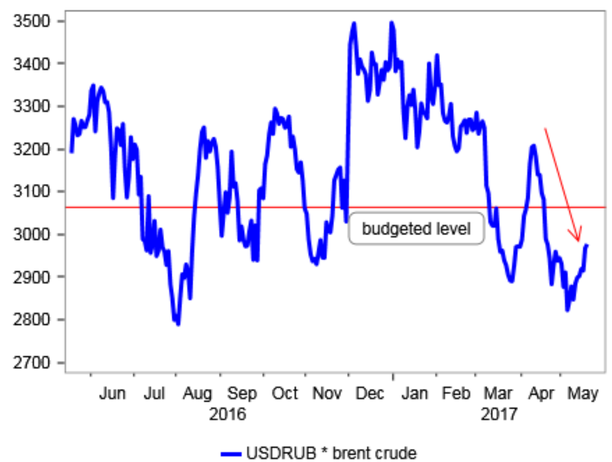
Source: Deutsche Bank, Haver Analytics

Chart 11: ... which tends to lead to worse FX performance than in Q1



Source: Deutsche Bank, Macrobond

Chart 12: RUB has outperformed crude, taking oil in RUB terms below the budgeted/forecasted level



Source: Deutsche Bank, Macrobond

Long PLN, HUF, CZK (equally weighted) vs. EUR

CE3 is cheap. PLN, HUF and CZK are all cheap on all our fundamental valuation approaches (Figure 13). This is because these currencies have weakened steadily over the past 5 years despite improving fundamentals. They are therefore within only a handful of countries that are cheap on all three models.

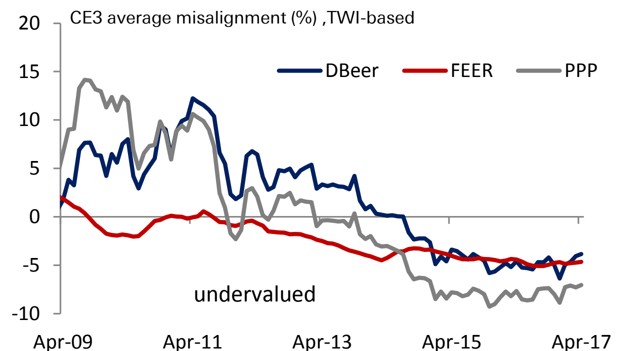
Improved trade flows: The steady FX weakness in recent years has led to increasing competitiveness of CE3. On a REER basis, CE3 currencies have depreciated significantly vs. Asian manufacturing currencies, for example, enabling the Central European region to gain market share in global trade (Figure 14). This has led to vast improvements in the current account balances of all three countries – from deep deficits in 2008, current accounts are in surplus for Hungary and Czech Republic, and close to flat for Poland (Figure 15). These current account improvements also explain why the currencies are undervalued on the CA-based FEER model.

Growth is robust: Despite limited global growth over the past few years, growth in Central Europe has remained strong, broadly in the 3-4% range. The region is currently growing faster than trend, another rarity in EM (Figure 16). This can be partly explained by increasing integration into the European (and particularly German) supply chain (which has also been a driver of improving exports/current account). As a result of these supply-chain links, the recent solid activity data and positive economic surprises in the euro area bode well for CE3 exports and activity (Figure 17). Meanwhile, low real rates, strong labour markets and EU funds absorption keep domestic demand well supported. Therefore, CE3 growth should remain strong in the coming quarters, driven by both net exports and domestic demand.

Reflation is here. After a prolonged period of subdued inflation, and even deflation in some cases, CE3 price growth has accelerated. Inflation picked up in the second half of 2016, and is now around 2% in all three countries, close to (or at) target (Figure 18). There are three key drivers of CE3 'reflation': tight labour markets (unemployment is at record lows and wage growth is robust), narrow output gaps, and imported inflation from a 'reflating' euro area. As a result of these internal and external drivers, inflation should remain supported in the coming quarters. As such, the central banks – which have broadly already moved from a dovish to neutral stance – should begin rotating towards a more hawkish stance (Czech Republic is likely to be the first to hike rates, possibly as soon as later this year). This hawkish drift is particularly likely given expectations for the ECB to announce tapering soon.

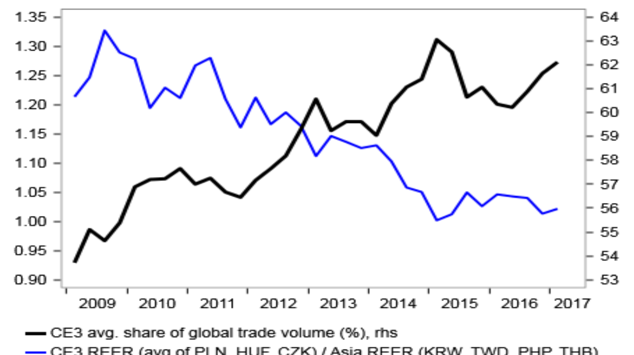
Lastly, the CE3 region is also a relative safe haven within EM, with a limited beta to external risks, low macro vulnerability, a robust growth outlook and relatively low political risk. This is a positive from a capital flow standpoint, as these countries are attractive destinations for EM investors looking to benefit from the improving global growth and reflation environment with limited risk (for example as an offset to riskier positions in the high yielders). CE3 is also attractive for crossover investors looking to express a higher carry bullish view on Europe and the euro. As a result, CE3 currencies tend to outperform during periods (like the current one) of euro bullishness.

Chart 13: The CE3 currencies are undervalued on all 3 fundamental valuation models, which is a rarity



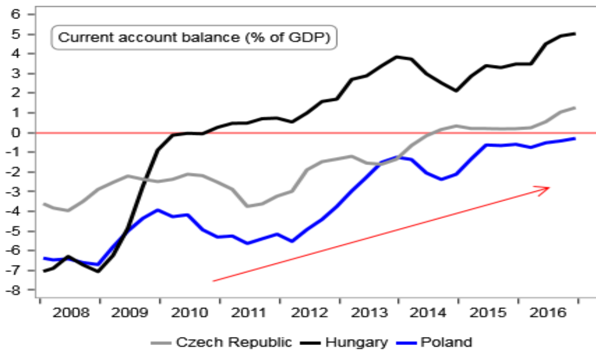
Source: Deutsche Bank

Chart 14: CE3 REER has depreciated significantly vs. Asian manufacturing REER, enabling an increase in CE3's market share of global trade



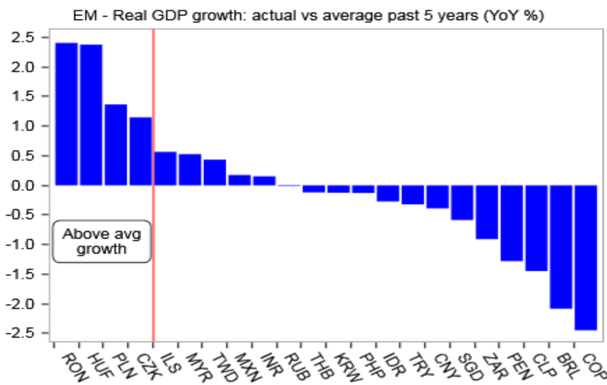
Source: Deutsche Bank, Macrobond

Chart 15: Increasing competitiveness on the FX front has contributed to sharp current account improvements



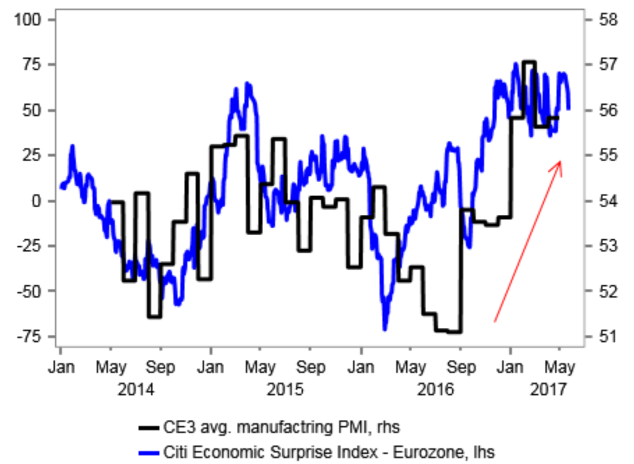
Source: Deutsche Bank, Macrobond

Chart 16: Growth in CE3 is above trend, another rarity in EM



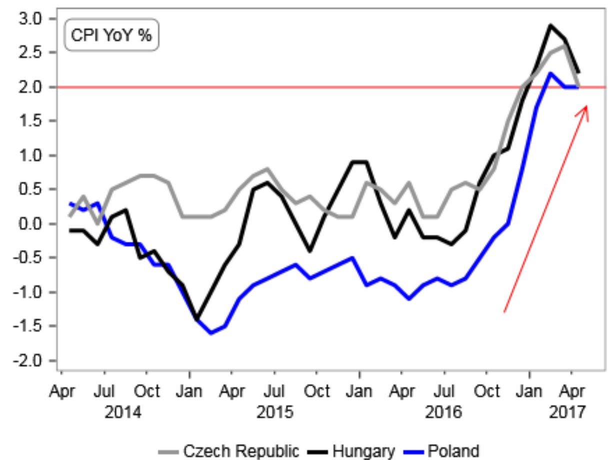
Source: Deutsche Bank, Macrobond

Chart 17: Solid euro area activity and positive economic surprises have contributed to improving CE3 PMIs



Source: Deutsche Bank, Macrobond

Chart 18: Inflation has picked up appreciably since H2 2016, and is now near 2% for all three countries



Source: Deutsche Bank, Macrobond

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EMEA Fixed Income – squeeze it...

Russia: Stay in short-end OFZs best expressed in May-19 (current: 8.07%, entrance: 8.31%, target: 7.50%, new stop: 8.40%). On the local swap curve keep 1Y IRS receivers (vs Mospime - current: 9.01%, entrance: 9.65%, new target: 8.50%, new stop: 9.50%). In cross-currency swaps dissuade from short-end receivers given high negative carry but enter flatteners to benefit from the shape of the curve best expressed through carry/roll optimized 1Y – 2Y2Y XCCY flatteners with 3m carry/roll of 57bp (current: -204bp, target: -210bp, stop: -150bp).

Rationale: The most recent inflation print came in a touch higher than expected mainly due to food inflation; however, core-CPI undershot the CBR target (4.0%) and reached with 3.7% the lowest level since the start of the series (2004). We expect headline inflation to remain close to the target with room to undershoot over the next few months, further supporting fixed income but not necessarily providing another significant boost. Macro data continue to improve, however, as expected rather gradually while on the other hand the fiscal side remains challenging. Russia already issued 12bn USD in local debt this year which is ~1.6x more than at the same time in 2016. We expect gross issuances to reach 25bn this year. Nevertheless despite the higher issuance amount appetite for local debt remains strong with the share of foreign holdings now above 30% - the highest level since Jan-13. Overall, Russian local bonds saw 10bn of net-inflows since the start of the year – well compensating for the additional issuance amount.

On the monetary policy front the CBR cut more than expected at the last two meetings – clearly justified by the upcoming inflation dynamics – nevertheless somewhat surprising given the rather hawkish stance of the CBR in the first few months of the year. We expect the CBR to ease further over the next few months most likely by 25bp at each meeting to 8.00% by year-end (-125bp), however, also 50bp at next week’s meeting are without a doubt possible – and not yet fully priced in.

What’s next: Our view on fixed income has not changed, while bond yields continue to grind lower supported by stabile FX, foreign inflows, better fundamentals, supportive inflation prints and a lack of core rate repricing, valuation looks now (once again) a touch richer, however, not yet unattractive. Our OFZ May-19 trade recommendation rallied by 50bp over the month, 1Y IRS moved 65bp lower while 5Y OFZs even 70bp. We don’t see any reason to change our overweight on short-end bonds. The CBR will continue to easy – with the risk of a front-loaded easing cycle not yet fully priced into bonds or local IRS curve, term-premia on the local bond curve remains low – favouring short-end bonds, and the inversion of the curve in combination with additional supply should further lead to a steepening of the curve.

Given that the local swap curve is pricing a more gradual easing cycle compared to the XCCY swap curve, we expect the basis to tighten further which has historically been the case during easing cycles. Hence, remain received in 1Y IRS (vs Mosprime) while dissuade from XCYY short-end receivers. 1Y XCCY provides 60bp of negative carry/roll over 3m which we still find from a risk-reward perspective as too much to express a bullish view on Russian rates.

On the other hand the shape of the XCCY curve provides attractive opportunities to earn high carry while being less dependent on the pace of the easing cycle. We highlight here, in particular, short-end flatteners best expressed via 1Y – 2Y2Y XCCY. Despite the inversion of the curve and our view that we will hardly see a further inversion, the position provides almost 20bp of carry/roll each month and rolling the curve provides, therefore, a good risk-reward going into the summer.

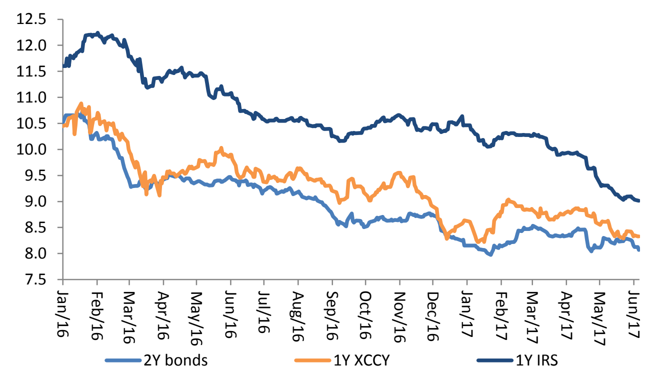
1Y – 2Y2Y XCCY provide a higher z-score and carry/roll compared to a simple 1Y-5Y XCCY flattener - this said, both trades look from steady-state return characteristics attractive

Top Flatteners

Flatteners	Level	change since 1d	7d	1m	z-score	beta	corr	Breakeven over 3m B/E	Vol	Ratio
Carry/Roll and z-score optimized trades for 1Y - 5Y flatteners										
1Y - 5Y XCCY	-160	-6	-7	-5	0.05	1.00	1.00	46.4	41.6	1.12
1Y - 2y2Y XCCY	-204	0	9	-2	0.53	1.51	0.98	57.1	61.0	0.94

Source: Deutsche Bank, Bloomberg Finance LP

Russia: Local curve remains the most attractive to position for additional rate cuts



Source: Deutsche Bank, Bloomberg Finance LP

Turkey: Switch from 1Y XCCY receivers (entered: 11.80, current: 11.27%) into 5Y XCCY (current: 10.71%, target: 10.25%, stop: 11.25%) given better carry/roll characteristics. In bonds, we see selective value mostly in the belly of the curve best expressed via Feb-20 (current: 10.78, target: 10.00, stop: 11.25).

Rationale: Over the last couple weeks local assets have been well supported in particular driven by the tight CBT monetary policy stance leading to stabilization in FX and consequently foreign inflows into bonds. In fact, since the multiple year trough in foreign bond holdings at the end of January (19.1%), we saw net-inflows of 4.5bn USD with the share of foreign holdings increasing to 21.5% - the highest level since Oct-16. Although the share is still well below the peak seen in May-13 (28%) we believe that positioning is not “super”-light anymore another rally purely driven by flows less likely.

What’s next? We believe that the CBT reaction function is once again the key variable for the development in local markets over the next few weeks. As yet we positioned into 1Y XCCY receiver (entrance 11.80) not despite but given the expectations of tighter monetary policy. We argued that tighter liquidity should improve the credibility of the central bank, re-anchor medium-term inflation expectations and reduce the high term-premia in short-end funding. In addition, a tighter front-loaded monetary policy approach would provide the CBT with more room to gradually ease in the 2nd of the year.

As yet, the strategy has worked, however, on the back of the recent rally in short-end rates the spread between CBT average funding (~11.98%) and 1Y XCCY (11.34%) reached the most inverted level since Jan-15. Hence we see the spread as stretched and a further inversion as very unlikely. Another rally in short-end rates has to come from looser monetary policy condition via a reduction in the average funding rate. Although this is a likely scenario we don’t expect this to significantly materialize prior to the next two inflation prints (DB expects a decline to 11.2% and 9.9% in June and July, respectively compared to 11.7% in May). The decline provides a window of opportunity for the CBT and we see room for 1Y to move below 11.0%, however, the time window is rather limited given the expected spike in inflation back into double digits from August onwards.

In addition, the shape of the curve has also changed and steady state return characteristics are less favourable in short-end rates. While 1Y XCCY receiver provided only 10bp of negative 3m carry a couple weeks back it has now increased to -40bp. Hence, while an immediate trigger for a rally in short-end rates is limited by the still tight liquidity management, the rally is also still questionable in the medium-term and periods of tighter liquidity could indeed keep short-end rates at elevated levels with the XCCY inverted for longer than priced by markets.

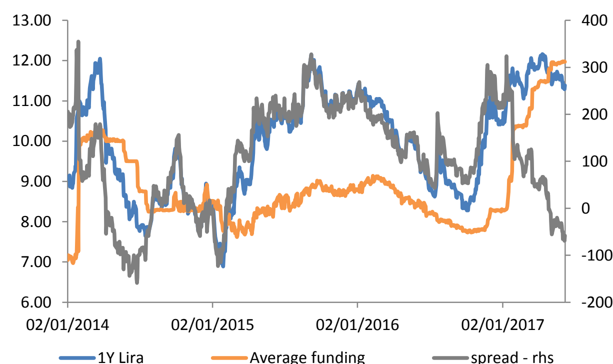
Given our fundamental view and the unfavourable steady-state return characteristics, we close our short-end receiver and express a bullish view on Turkish rates somewhat further out the curve – most preferable in 5Y XCCY with only 8bp of negative carry. Risks: inflation not coming down as expected

Turkey: short-end receivers with high negative carry

Contracts	Level	change since 1d	7d	1m	z-score (1Y)	Carry/Roll (B/E) over 3m B/E	Vol
3m FX Implied Yield	11.50	5	0	44	1.33	-	-
3m3m	10.99	0	-28	-16	0.85	-51.0	104
1Y XCCY	**11.36**	**4**	**-27**	**-4**	**0.84**	**-36.8**	**110**
2Y XCCY	11.07	4	-26	-11	0.67	-12.7	108
5Y XCCY	**10.71**	**2**	**-17**	**-14**	**0.54**	**-7.9**	**87**
10Y XCCY	10.25	2	-11	-15	0.38	-7.4	69

Source: Deutsche Bank, Bloomberg Finance LP

Average funding vs 1Y XCCY has reached the tightest level since Jan-15



Source: Deutsche Bank, Bloomberg Finance LP

Israel: Keep short-end fwd starting receivers best in being long the 3Y fwd 1y rate with 15bp of 3m roll (entrance: 1.37%, current: 1.25%, new target: 1.00%, new stop: 1.50%). Remain long 5Y5Y IRS vs US-swaps (entrance: -50bp, current: -50bp, new target: -0.20, new stop: -75bp. On the curve remain positioned into long end bonds (best Oct-26/Mar-27) vs paying 2Y ILS (vs Oct-26 current: 160bp, entrance: 178bp, target: 125bp, new stop: 180bp). As cross-country trade enter 5Y ILS receivers vs 5Y CZK with 6bp of positive carry/roll (current:0bp, target: -30bp, stop: +25bp).

Rationale: Israeli local rates remain the sweet spot for receiving rates in EMEA markets. While already benefitting from a very gradual inflation turnaround the now somewhat weaker growth outlook in combination with the still strong currency should further reduce any possibility of interest rate hikes over the next few quarters. Although with only 25bp of hikes priced by end-18 the market remains on the dovish side the current outlook with inflation expected well below the 2% target by end-18 and the further decline in oil prices all point towards room for the market to fully price out all rate hikes until end-18. The forward curve remains steep in particular compared to the Czech swap curve.

Steady-state return characteristics are most favourable in 3Y fwd 1y rates, however, also spot 5Y IRS look attractive. Risk: central bank does not hike rates at all until end 2018.

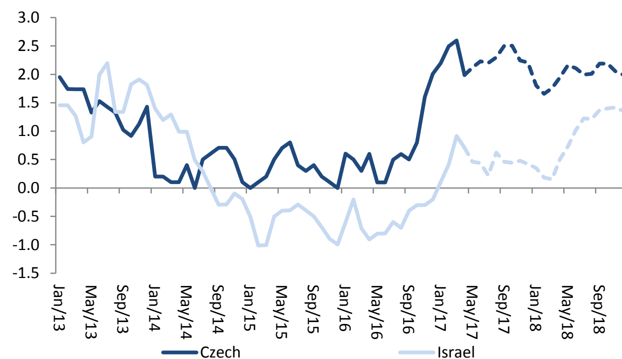
While the short-end receiver is clearly a bullish trade for core-rates we also expect Israel to outperform US rates during a bearish period. Hence, we keep our 5Y5Y ILS receiver vs US swaps (also attractive from a carry perspective). Last but not least the high risk-premia in the curve in combination with the light positioning and subdued inflation outlook also still favour flatteners. For more details on the trade please see EMEA Fixed Income – Top Trades into the summer (Israel)

Israel: Rolling down the curve remains favorable in Israel in particular compared to Czech…

Contracts	Level	change since 1d	7d	1m	z-score (1Y)	Carry/Roll (B/E) over 3m B/E	Vol	Ratio
Israel								
3m Fixing	**0.10**	**0**	**0**	**0**	**0.60**	**-**	**-**	**-**
1Y IRS	0.12	0	0	-1	-0.38	2.2	3	0.82
2Y IRS	0.22	0	-1	-5	-0.62	4.4	6	0.75
5Y IRS	0.82	0	-3	-12	-0.25	9.4	18	0.52
1y1Y IRS	0.32	1	-2	-9	-0.64	5.9	10	0.61
3y1Y IRS	**1.26**	**1**	**-2**	**-17**	**-0.07**	**14.9**	**29**	**0.52**
Czech								
3m Pribor	**0.29**	**0**	**-1**	**0**	**0.42**	**-**	**-**	**-**
1Y IRS	0.37	0	-2	0	1.80	5.7	7	0.82
2Y IRS	0.57	0	-2	-7	1.38	6.1	10	0.61
5Y IRS	0.81	2	-4	-13	1.03	3.9	11	0.37
1y1Y IRS	0.58	1	-3	-16	1.20	4.9	16	0.31
3y1Y IRS	**1.00**	**4**	**-4**	**-16**	**0.94**	**3.3**	**15**	**0.22**

Source: Deutsche Bank, Bloomberg Finance LP

Price pressure remains significantly lower in Israel compared to Czech – CPI YoY in %



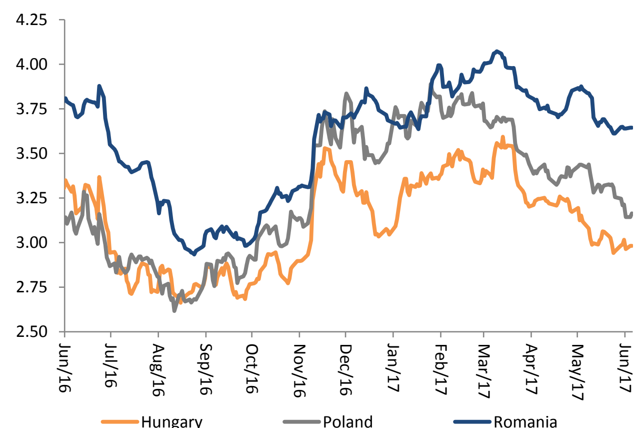
Source: Deutsche Bank, Bloomberg Finance LP

Romania: Keep an overweight on long-end bonds best expressed in Feb-25 (entrance: 3.60%, current: 3.34%, new target: 3.25%, new stop: 3.75%).

Rationale: We argue that lower core-rates and cautious global central banks in combination with lower oil prices benefit in particular countries with high risk-premia priced, steep local curves, recent underperformance, light positioning, but on the other hand robust growth dynamics. In CEE in particular Romania is the country that ticks all the boxes. Despite some recent inflows positioning remains light historically and compared to peers (foreign holdings at 18.5%). Further, the inflation turnaround is less aggressive than previously feared and, therefore, leaves the BNR with room to delay rate hikes into 2018 - despite remarkable growth data (Q1 GDP at 5.7%). Fiscal remains the main concern and over the last two quarters the treasury failed to reach its set issuance targets (4.2bn USD issued YTD vs 5.5bn YTD in 2016). Nevertheless we see this as well priced into the curve (high term-premia) and additional supply (another ~7bn USD expected for this year) should be absorbed by foreigners as long as the external environment remains favourable. While long-end bonds rallied around 30bp over the last month valuation still looks attractive in particular compared to Hungary or Poland and we see room for an outperformance compared to peers in H2-17.

However, despite our bullish view on Romanian fixed income we also see risks to our call. While one is obviously the fiscal side also underlying price pressure - further supported by strong wage growth - should not be underestimated and watched closely. Last but not least political risks have once again increased in recent days. Although the outcome is yet unclear a forced government reshuffle initiated by the PSD party leader Dragnea could increase political uncertainty and create negative headlines. Regardless of any resignations, the PSD-ALDE government would most likely still have the majority in parliament which would support a muddle through rather than an immediate government break-up. However, developments should be closely watched over the next few weeks. For more details on the trade please see EMEA Fixed Income – Top Trades into the summer (Romania)

Romanian bonds continue to lag the rally already seen in Hungary or Poland – 10Y bonds (constant maturity)



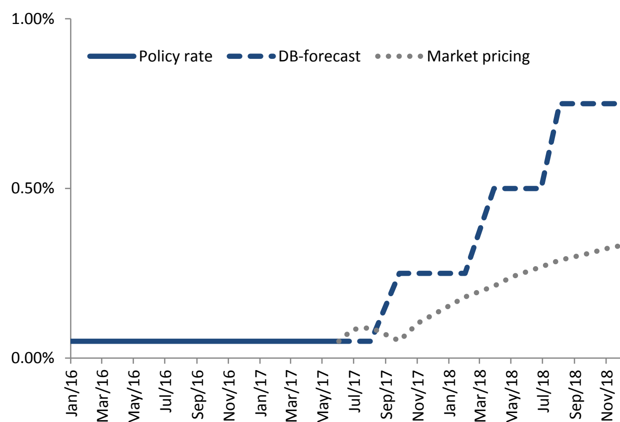
Source: Deutsche Bank, Bloomberg Finance LP

Czech: On the back of the recent short-end flattening switch back from 6x9 FRA payers into 6x9 FRA – 1Y1Y IRS steepeners (currently: 16bp, target: 40bp, stop: 5bp). Keep 5s10s IRS steepeners (entrance: 35bp, current: 31bp, target: 75bp, stop: 20bp) with flat 3m carry/roll.

Rationale: Despite robust growth data (as late PMIs at 56.4 and Q1-GDP at 2.9%) the local swap curve continues to price a very gradual hiking cycle with rates expected to reach 15bp by year-end (+10bp) and 35bp (+30bp) by end-18. This is well below DB forecast (rates at 25bp by year-end and 75bp by end-18). The repricing has been lagging and short-end rates remained well supported among others driven by the recent decline in oil prices and lower risk-premia across core-rates. In addition the expected bond outflows have not been as aggressively as feared. Following the FX floor removal foreign holdings declined from 47.3% to only 45.4% (end April) – although the largest mom decline since 2012 – however, the share remains the highest across EM.

Given the favourable external environment, we continue to expect the curve to bear-steepen driven by inflation prints somewhat above target and strong wage growth. Given the recent short-end flattening we once again see more value in short-end steepeners compared to payers. The 6x9 – 1Y1Y IRS spread flattened by 20bp over the month and is now back at attractive levels to position into steepeners. The position provides marginally positive roll. We also keep our 5s10s IRS steepeners given historically low term-premia compared to peers and compared to the local bond curve. Risk: more aggressive hikes in Israel compared to Czech.

Czech: The market remains too dovish priced in the short-end of the curve



Source: Deutsche Bank, Bloomberg Finance LP

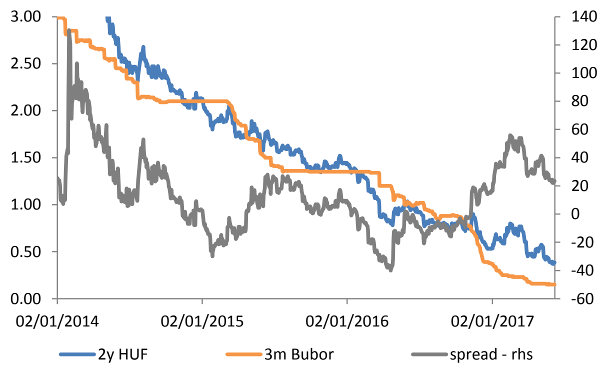
Hungary: On the curve keep a flattener bias being paid in 5Y IRS while received in long-end bonds (best 25/B or 27/A). In IRS enter 2Y short-end outright payers (current: 37bp, target: 90bp, stop: 25bp) with 3m carry/roll of -5bp.

Rationale: Another sizeable PMI print last week, a strong GDP print and various very robust data out confirming the strong growth dynamics in Hungary. However, this week’s inflation print at 2.1% well below the target (3.0%) further supports the dovish stance of the NBH. While the print was in line with expectations and the NBH forecast the decline compared to April (2.2%) was purely driven by energy prices with the "transportation" component (16% of basket) declining to 2.7% YoY from 5.8% in April. On the other hand, most of the other components increased compared to the previous reading most importantly "Food" (+2.6% YoY vs 1.8%). While strong domestic demand is not yet fully evident in the inflation details the gradual increase in service costs (among others Restaurants 3.5% YoY vs 3.3%) shows that underlying price pressure is slowly building up. Core CPI also further increased and - although with 2.1% still well below target - has now been on the rise since Mar-16 (1.2%).

What’s next? Headline CPI sharply declined over the last few months from 2.9% in Feb to now 2.1%. This obviously helped the NBH to keep its dovish stance. DB Economics sees this reading as the trough in the cycle and headline CPI slowly moving back up to the 3% target in the 2nd half of the year. Although low energy prices are clearly helping right now we believe increasing underlying domestic related price pressure could further weigh on headline CPI and is still underestimated (we expect significant improvement in retail sales over the next few months). This could push CPI to the target already in Q4. GDP is above 4%, Credit growth >5%, nominal wage growth >10% and the unemployment rate at historically low levels - without immigration. While this is not enough to cause a NBH U-turn, we nevertheless believe that we should see a gradual tightening by the NBH in the 2nd half of the year.

How to position? It’s time to enter short-end payers Current market pricing with 3m Bubor at ~15bp and 2Y IRS at 37bp is already well reflecting the dovish stance of the NBH and pricing the expected additional unorthodox monetary policy measures (some additional reduction in depo cap, FX swaps). Hence we keep our flattener bias expressing the view via bonds in the long-end (given higher term-premia on the bond curve) while being paid in 5Y IRS. Regardless of this long-term trade we find current valuation from a risk-reward as finally attractive enough to position into short-end IRS outright payers. Inflation has bottomed, additional NBH measures are well priced and the economy is operating at full capacity. Further 2Y IRS provides only 5bp of negative 3m carry/roll which we see as a cheap hedge.

Hungary – time favorable for short-end outright payers



Source: Deutsche Bank, Bloomberg Finance LP

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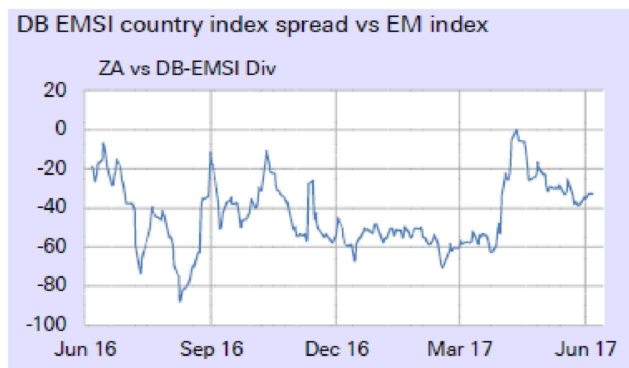
EMEA Credit: Everything is relative

South Africa – Stay underweight

Due in part to a supportive external environment, South Africa credit has recovered most of its underperformance vs. broader EM since late March when political noise increased, which led to it losing investment grade.

We stay underweight. We believe politics and policy in the country will likely continue to shift towards more populism in the coming years, with growth outlook remaining fragile and likely in an extended economic downturn. We also expect fiscal conditions to continue to deteriorate. After losing IG, South Africa remains on a slow-burning deterioration path. The disappointing Q1 GDP release shows the economy is in recession for the first time since 2009, and it raises the likelihood of further downgrades.

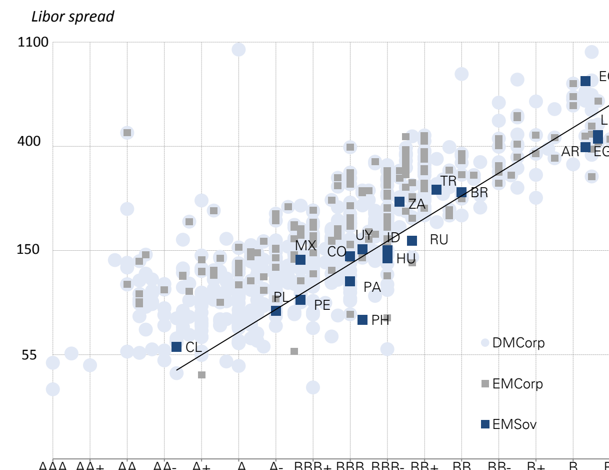
South Africa credit has recovered more than half of its underperformance in March/April



Source: Deutsche Bank

Current market pricing (at BB+/BB) does not represent a significant overshooting. The optical cheapness of South Africa credit shown in the graph below is somehow exaggerated, considering that Moody's still rates the credit at Baa2, two notches above its peers (although this is about to change, as the agency put South Africa on watch for downgrade two months ago; we believe Moody's will likely downgrade by only by one notch to Baa3, but with a Negative outlook). The risk of a credit downgrade by S&P has also grown higher after the disappointing Q1 GDP release. We maintain our switch recommendation Turkey 26s vs. South Africa 26Ns (entry: 42bp; current: 27bp; target: 0bp).

The market is pricing BB+/BB for South Africa

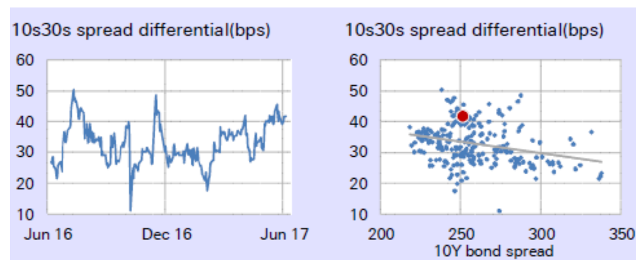


Source: Deutsche Bank

Focusing on relative value in South Africa, we remain long on 24s vs. 5Y CDS (entry: 46bp; current: 36bp; target: 10bp; stop tightened to 40bp). Negative basis was a natural reaction to credit losing IG due to forced selling, but such dynamics typically eventually correct(as is the case with Turkey). We recommended taking profit on switching from 22s/25s to 24s on 18 May.

In terms of asset allocation, we shift our preference towards the long end, as the curve has recently materially steepened. The 46s are the cheapest bonds at the long end of the curve, while the 28s are the richest bonds in the 10Y sector of the curve, according to our term structure model.

South Africa 10s30s have recently materially steepened



Source: Deutsche Bank

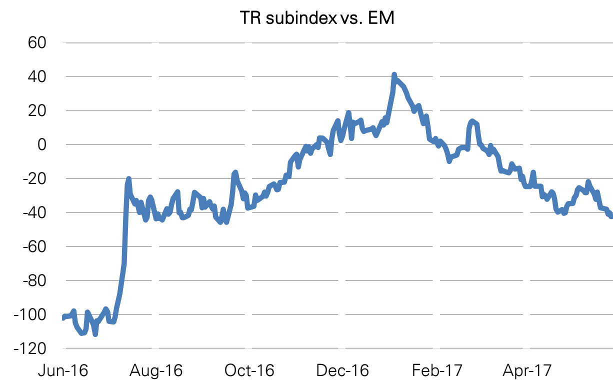
Turkey: continues to stabilize

After another month of outperformance, Turkish bonds have become the best performing EM sovereign curve year-to-date, especially in spread terms. However, priced on the cheap side vs. its credit rating, Turkish bonds still embed sizable risk premium, which we see as fair, especially given lingering political uncertainty and heightening geopolitical concerns (as manifested

in recent Qatari crisis). Economic activity continues to improve, inflation seems to have peaked, and fiscal deficit, while deteriorating, still compares favorably with most other EM sovereigns. Credit ratings' trend remains negative for Turkey given the Negative outlooks ratings agencies hold. However, there are signs of stabilizing, as S&P affirmed its rating of BB(u) in May.

Overall, we see risk/reward as largely balanced given the current valuation under a supportive external backdrop (lower core yields, weaker commodity prices), receded political risk premium since April's referendum and relative stability by Turkish standards. Therefore, we stay neutral for now but remain in favor of Turkey vs. South Africa (on which we stay underweight), and we believe their 10Y bonds could converge to parity. A main near-term risk stems from geopolitics, as further deterioration of the Qatari crisis could weigh on the performance of Turkish assets.

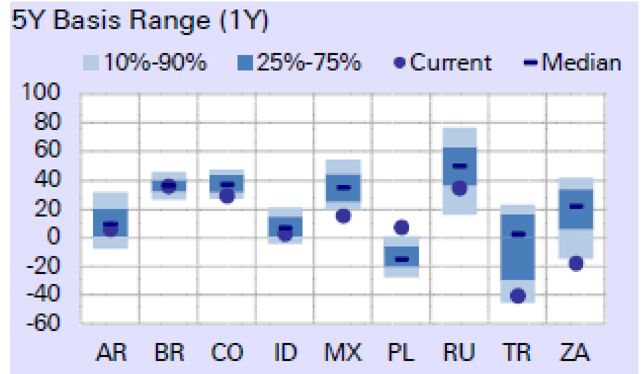
Incessant recovery of Turkey credit



Source: Deutsche Bank

In relative value, we are neutral in terms of the 10s30s slope. While CDS/bond basis at the 5Y sector remains significantly negative, it has widened to a more normal range. Hence, the entry level for being long on basis does not look very attractive.

5Y basis in Turkey has normalized somewhat, but remains significantly negative

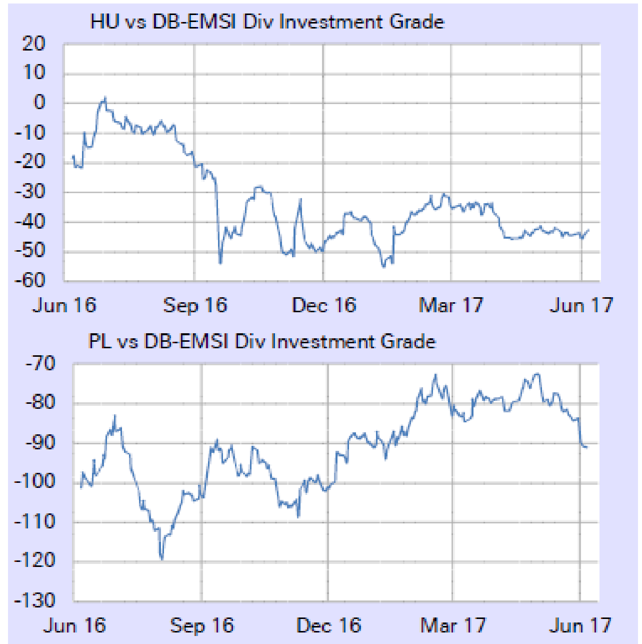


Source: Deutsche Bank

CEE: underweight

Hungary credits have recently performed in line with the EM IG average, while Poland outperformed. While external risks stemming from uncertainties in continental Europe have receded, and domestic political backdrops remain relatively stable, we do not see a strong fundamental impetus driving spreads to tighten further for either sovereign. For both, the spreads are simply too tight to offer any value in the current environment where carry is sought.

Hungary has recently traded within a narrow range vs. EM IG average while Poland outperformed



Source: Deutsche Bank

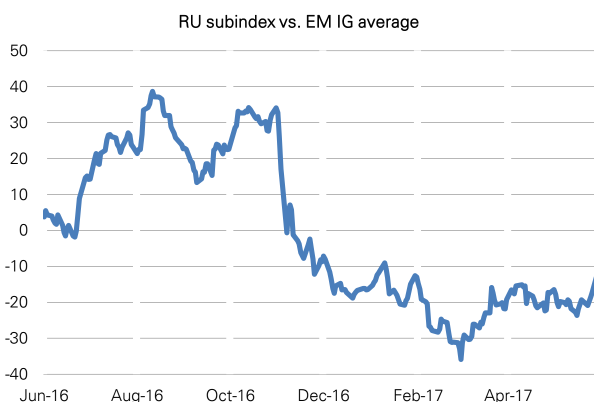
In relative value, Hungary 5.375% 23s are clearly cheap to the 24s (5bp wider in spreads but one year shorter in duration), but the relatively tight range (within 10bp) it is probably not worth switching.

Russia: improving fundamentals, tight valuation, and rising geo-political risk

A key debate on Russia credit remains whether the recovery in macroeconomic conditions and positive budget will lead to a return to investment grade this year. We believe the chance is significant – Russia only needs a one notch upgrade from either S&P (BB+/Positive) or Moody's (Ba1/Stable) to be considered IG for most benchmark purposes (Fitch rates Russia at BBB-). Recently, there have been positive actions by rating agencies as a result of improving macroeconomic fundamentals and fiscal conditions. Especially, the government's plan to pare the 2017 budget deficit to 2.1% (3.2% planned earlier) is a strong positive for investors and ratings outlook. S&P is due to review Russia's rating again in September, while Moody's will likely review in August.

However, geopolitics, oil prices, and the prospect of structural reforms (or lack thereof, especially considering 2018 elections) continue to pose key risks to Russia's return to IG. Specifically, the increasing risk of US codifying existing sanctions and posing additional sanctions are a major source of concern.

Russia – underperformed recently, but still tighter than IG average



Source: Deutsche Bank

We moved Russia to neutral from overweight in our credit recommendations in the beginning of March, taking profit from the overweight call after outperformance. The prospect of return to IG later this year is more than priced in, as the Russia sub-index has traded significant tighter than the EM IG average since the US election. While still very rich, a correction of about 20bp has taken place since March after hopes of sanctions relief was thrown out (and risks of new sanctions on the rise), making valuation more amenable. Given technicals strength in the curve (there is scarcity of Russia sovereign bonds for offshore investors), we remain neutral at this point.

We are currently neutral in terms of CDS/bond basis and curve slope in Russia - our recommendation of 10Y CDS vs. 43s reached target on 5 May.

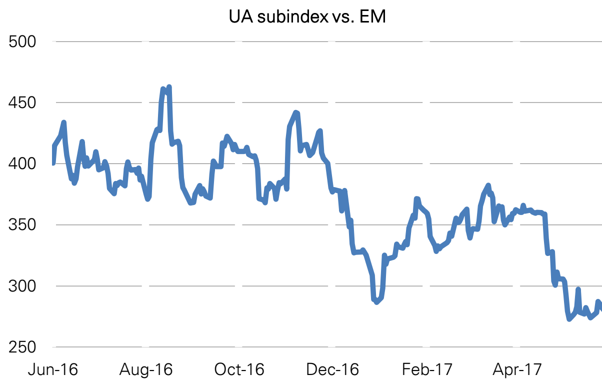
Ukraine: outperformance stalls, but yield on offer still attractive

The strong outperformance of Ukraine after the last IMF disbursement came to an end recently as positive news has been priced in. After a significant improvement in 2016, fundamentals have deteriorated again. In 2017, growth is set to be significantly lower than that of 2016 (which was 2.3%), while current account and fiscal account deficits are rising. There are not many signs that the country can stand on its own after the current IMF program expires in 2019. On the political and policy front, the risks of early elections remain a source of concern, and the government is struggling with pension reforms. However, we believe it will likely pass some lenient test by the IMF and unlock the next tranche of financial support (with some delay), getting by in the near term. Concerns of fiscal sustainability beyond the current IMF program, which had always been a question mark, will likely become a more binding issue as we move closer to the end of the program. For now, we believe that the continued high yields offered by Ukraine bonds will likely remain appreciated by investors, and we remain marketweight on Ukraine.

We closed out long 23s vs. (19s + 27s) on 30 May, as the position moved very close to target. With the recent rally, the hump on the curve (previously the 23s) has significantly reduced and shifted towards the 24s, which are now the cheapest bonds on the curve.

We remain neutral on Ukraine's GDP Warrants, having shifted from a more constructive position in April as a result of a quick run-up in the prices. Warrants have underperformed bonds over the past two months, but from a historical perspective, it still looks quite expensive vs. bonds at the current level. In our view, it is reasonable to ignore the value of the holder-put option (whose theoretical value is about 8pts out of 65pts total for the warrants), as Ukraine will most likely not default before the end of the current IMF program. Overall, we still see value in the instrument, but its attractiveness has significantly reduced after the run-up in prices in March/April.

Ukraine's outperformance has recently stalled, but carry value remains



Source: Deutsche Bank

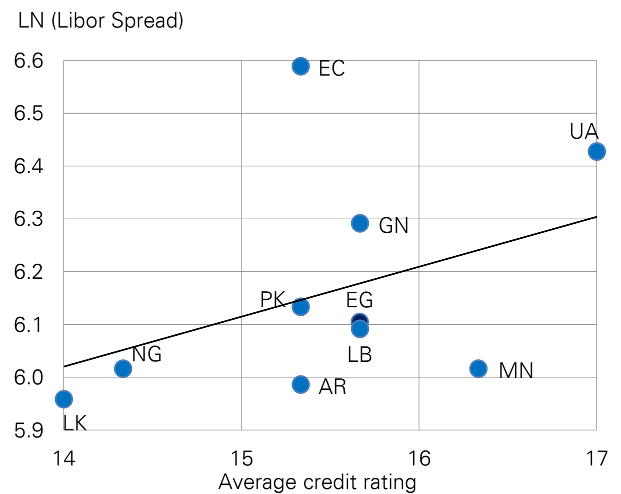
CIS quasi-sovereigns

We recommended switching from SOIAZ 23s to AZERBJ 24s last week and maintain this position. The former has significantly outperformed the latter. This can somewhat be explained by the negative perception about Azerbaijan's ability to support IBAZAZ. However, we see no specific positive catalyst driving this outperformance of SOIAZ and expect the spread differential to mean revert. SOIAZ's rating has recently been placed on review for downgrade by Moody's which seems to have gone unnoticed and could exert additional negative pressure. Moreover, SOIAZ heightened exposure to IBAZAZ is also a credit negative in our view. Accordingly, we highlighted in our recent 'Russia and CIS sovereign and quasi-sovereign focus' report, that we expect spreads of Azerbaijani quasi sovereigns to remain under pressure in the near term due to reduced likelihood/ability/willingness of sovereign support as implied from IBAZAZ restructuring. The main risk to this switch is that negative perception on the Azerbaijan complex stemmed from recent IBA-related events may cause investors to further reduce sovereign risk, with sovereign bonds suffering more losses given their better liquidity.

Egypt – Staying the course

We hold a constructive view on Egypt's sovereign credit given the improving outlook (see Special Report – Egypt: Staying the course), but risk premium has diminished after the rally earlier this year. At the current valuation, we would take a neutral position and look to add on dips. We believe the Eurobonds curve is too steep relative to peers, and the newly-issued 47s and 27s bonds offer superior relative value from an asset allocation perspective. We recommend switching from 40s to 47s and from 25s to 27s in Egypt. The recently-issued 47s and 27s remain substantially cheap to the curve.

Egypt's Eurobonds are on the expensive side in comparison with peers, but not overtly so



Source: Deutsche Bank

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LatAm Strategy

- **LatAm FX**: Buy 1M USD/BRL DNT (3.19/3.40) @20% BBG indicative (~5:1 payout ratio, ref FX 3.27); maintain recommendation of buying 2M USDp/CLPc @ATMS with AKO @645 ~0.4% BBG indicative; sell 1M USD/COP strangle (2850/3000) ~1.2% BBG indicative, ref. FX 2915; sell 3M USDc/COPp @2800 ~0.8% BBG indicative, ref. FX 2915; buy USD/MXN (i: 18.25, t: 18.8, s: 18.05); buy ARS/MXN (i: 1.141, t: 1.175, s: 1.123); buy 3M USDc/MXNp @ATMF, WKI @18.00 ~1.23%, ref FX 18.23; sell EUR/PEN (i: 3.683, t: 3.560, s: 3.730)
- **Rates**: In Brazil: Receive Jul18 (target 8.80%), in Chile: favor Jan22 vs 3M NDF (target 45 bp), long 5Y BEI (target 300), In Colombia switch from the front end (TES 19s/TES20s) into TES26s (target 30 bp of rally) and favor the UVRs21s in the BEI (target 330 bp in BEI), in Mexico receive TIIE1Y10Y vs US1Y10Y (target 480 bp), favors MBONO vs MUDI and TIIE in the 3Y sector. In Peru favor 2Y-sector of the cross currency swaps (target 485 bp), buy Soberanos 26s (target 5.10%)
- **Credit**: We cover our underweight in Brazil as markets are turning a blind eye on lack of reforms and explosive fiscal accounts. We move both Argentina and Ecuador back to overweight and cover underweight on Colombia given the improvement in valuation over the past two months but move Peru to underweight purely due to the negative carry it offers vs. the benchmark. We are increasingly cautious on Venezuela given the political and financing situation, and focus on recovery value than potential profit on survival, and recommend investors position for price equalizations. We stay marketweight on Mexico. In relative value, we recommend entering EUR Discounts vs. USD Discounts and 36s vs. 28s, while keeping long Pars vs. 5Y CDS in Argentina, favor PDVSA 35s and Venezuela 28s within the Venezuela complex, and maintain Ecuador 27s vs. 24s and YPF 25s vs. 24s.

Local Markets

BRAZIL

- FX: Buy 1M USD/BRL DNT (3.19/3.40) @20% BBG indicative (~5:1 payout ratio, ref FX 3.27)
- Rates: Receive Jul18(target 8.80%).

FX: Over the last few weeks the price action of Brazilian assets has been almost entirely dominated by politics and roughly in line with the scenarios we delineated in our note "Brazil: What's Next?" The situation though remains extremely volatile although currently it seems that the likelihood that President Temer might remain in power is growing. If that were to happen the government would attempt to pursue the economic reforms yet in all likelihood Congress would only approve heavily diluted versions of the necessary changes to the pension system leading only to a delay of Brazil's fiscal woes.

It is still however, difficult to recommend a directional play on the BRL at this stage. As we have noted before, it seems to us that both regardless of what happens on the political front over the next couple of months the BRL is relatively limited in its potential to either rally or selloff.

While the BRL could weaken if the reforms continue to be at risk or Temer pushes very diluted versions of the bills now in Congress, there are several reasons that lead us to expect a relatively limited USD/BRL upside. The first factor we see limiting the USD/BRL upside is the BCB's commitment to keeping FX volatility under control so that inflation expectations remain stable and the easing cycle can continue. The BCB's balance sheet has room: in 2015 it showed a short-USD position of 120bn, while today it reaches only 23bn. A second factor is the healthy state of Brazil's external accounts. Since 2015 the CA deficit has gone from 4% to 1% of GDP. Over the last 12 months, Brazil has accumulated a trade surplus of USD 60bn. FDI inflows are projected to be twice as large as the CA deficit. From a financial standpoint, unlike 2015, portfolio inflows have shrunk over the past few months, which lowers the BRL's exposure to sudden capital flight. Finally, from a valuation point of view, the BRL seems to us a lot closer to its fair value than in 2015, when the BRL was more than 10% overvalued.

And whereas up to a few days ago we would have taken advantage of a selloff in order to enter long BRL positions that would benefit from President Temer being replaced by a pro-reform transitional government that would lead to a rally, that scenario seems now less likely. Thus, we think that the best way of taking advantage of the current scenario via the BRL is to buy 1M USD/BRL DNT (3.19/3.40) @20% BBG indicative (~5:1 payout ratio, ref FX 3.27) as the currency is most likely to trade within that range at least in the near term.

Rates The developments in the last 2 weeks were in line with the scenarios delineated in our note "Brazil: What's Next?"

1- Despite worsened prospect for reforms, the market moved quickly to re-price the sharp sell-off in the front end of the DI curve reaffirming the belief that the BCB will "do its job" given the scenario of sluggish activity and collapsing inflation.

2- The rally was violent and significant. Rates however still traded above their pre sell-off levels as markets seemed to re-priced the probability of a lower "neutral rate" given the rising political risks around the reforms.

3- The latter took its toll on the long end. Despite the retracement from the highs, the long end did not enjoy the same "sympathy" extended by the markets to the short end leading the curve to trade close to the steepest levels of recent history

4- As a result our recommendation – a receiver in the Jan18|Jan19 FRA (re-entered at 10.35%) – pierced our proposed target of 9.65%, trading as low as 9.35% previously to the COPOM meeting but giving up some of the gains after the BCB suggested a cautious cycle

Brazil's COPOM decision – 100bp cut - confirmed our suspicions of a more cautious CB going forward, with the communiqué highlighting the political (and fiscal) risk as a factor to be reckoned in monetary policy decision going forward. Although not explicitly mentioned, we strongly believe that the communiqué hints precisely at the aforementioned re-pricing of the neutral rate. Accordingly, as previously published here, improving the state of the fiscal (and ultimately reducing the debt to GDP ratios) is in our view a necessary condition to bring neutral rates to say 4% (and terminal rates to the 7/7.5%). Without the latter we see the "neutral" around 5.5/6% - and with inflation undershooting to 3% the terminal rate would sit around 8.5%/9.00% which is around where the market is pricing (8.75% to be more precise).

So what should one do going forward? Unfortunately the answer to this question falls once again in the political realm – where we see 2 scenarios:

1- The current administration remaining in office but with weaker negotiation power in Congress

2- Transition to a new president who would govern until general election in 2018

The first scenario seems to be gaining momentum, with indications from the TSE that it could vote in favor of the incumbent. The government is announcing it will pursue reforms to appease markets, but the governing base is sending strong signals that it has little appetite to vote unpopular measures. The latter has been the norm when the President is weak and this would be the case if he stays in power – as highlighted in the local press. This would likely mean a much diluted pension reform – if it passes. It would yield small short-term savings and would not prevent spending to hit the ceiling already during the next government – amid escalating debt/GDP. This should weigh on growth and still permit more moderate easing as we discuss below – but amid a steep curve given fiscal prospects. It is worth noting that the changes in the BNDES point to loser credit, which has been one crucial driver of high neutral rates in Brazil.

We see the second scenario materializing only if stronger names to replace the government gain momentum in congress. In this case political tensions could ease and the case for pursuing reforms under a "caretaker" President without election ambitions could gain traction. But, this scenario has failed to gain momentum. In all, it seems that confidence and investment – and thus growth – will be the main casualties despite limited market pressure. The CB could continue to ease and bring the Selic to 8.5%, in our view, but fiscal deterioration will continue to weigh on credit and the longer end of the curve.

DB's official call is for a terminal rate of 8.50% with a pace 75/50/25/25 which assuming significant premium on the curve (premium that would bring 2s5s to ~200 bp by the end of the cycle) and accrual from mid-2018 on would imply the July 18 ~ 8.80%

CHILE

- FX: Maintain recommendation of buying 2M USDp/CLPc @ATMS with AKO @645 ~0.4% BBG indicative
- Rates Neutral duration. Favor 5Y cash (Jan22) vs 3M NDF as an RV/carry play (target 45 bp), buy 5Y BEI (target 300).

FX: From a fundamental point of view the CLP no longer seems to be as overvalued as it was only a few weeks ago. While the recent USD-selloff has pushed the USD/CLP back below the 670 level, we think these fluctuations are relatively temporary and the USD/CLP is likely to gradually move back towards the 675-680 range. Despite the weaker exchange rate the economy has not yet adjusted: the pace of output growth is unlikely to recover before November's Presidential election. However, unlike what we observed last month, the risks to monetary policy are no longer as skewed to the downside as the BCCh has increased the hurdle that negative surprises will need to clear before triggering further interest rate cuts.

The CLP is still attractive as a funding currency due to its very low carry and the very limited upside risks for the currency over the next few months as any positive shock is bound to be limited and temporary in the absence of fundamental drivers that could justify a stronger Chilean peso. In the absence of any currencies in the region that we consider attractive as longs (other than the Argentinean peso), we continue to recommend expressing our view that any dips of the USD/CLP are likely to be temporary via options. Thus, we maintain our recommendation of buying 2m USDp/CLPc @ATMS with AKO @645 for 0.4%.

Rates: A cycle that is likely over and a relatively steep curve: in our view a recipe for (forward starting) flatteners and breakeven wideners. We continue to be on the camp that prospects of Pinera's election could potentially boost some of the forward looking indicators in Chile and lead to higher nominal rates/flatter curves in the future. On the latter it is interesting to notice that while rates are indeed higher beyond the front end, the curve keeps on steepening bring 2s10s to its highest levels in 3Y (and making CLP one of the steepest curves in the world). Low yielders have been less favored in the "search for yield" mode of recent which in our view helps to dissociate the slope of the curve from for example CDS or inflation risks (both low) in a place like Chile. While tempting to scale into flatteners (especially forward starting) we believe that slope compression will likely be driven by expectations on growth (and inflation) and the CB tightening. As we approach the election that is likely to happen but it will be a slow grind until then – like in the case of Mexico's front end it is more a question of timing than the fundamental story. BEIs have in our view undershot – we favor long in the 5Y sector. Finally the steep curve favors some carry capturing trades for NDF funded cash (which in some sectors are cheap vs swaps): as a carry/RV trade we like buying the 5Y (Jan22) sector of nominals vs 3M NDF (level 78 bp, target 45 bp)

COLOMBIA

- FX: Sell 1M USD/COP strangle (2850/3000) ~1.2% BBG indicative, ref. FX 2915; sell 3M USDc/COPp @2800 ~0.8% BBG indicative, ref. FX 2915; buy USD/MXN (i: 18.25, t: 18.8, s: 18.05)
- Rates: Switch from the front end (TES 19s/TES20s) into TES26s (target 30 bp of rally) and favor the UVRs21s in the BEI (target 330 bp in BEI)

FX: Our fundamental views on Colombia have not changed much. The growth outlook continues to deteriorate and as the backdrop for oil prices does not seem to be likely to recover in the near term, we do not have many reasons to make a bullish case for the Colombian peso.

In addition to the COP's fundamental weakness we also find that its short-term drivers are also deteriorating. In particular, while Colombia still exhibits relatively high interest rates, the risks to the current BanRep policy stance seem to be skewed to the downside. Yields in Colombia are closer to its historical lows than to its highs which leas locals to be less supportive of both local rates and the currency.

Many in Colombia argue that the COP is overvalued as an explanation for the weak performance of exports and the widening current account deficit in a low growth environment. Generally, these are the conditions under which a nominal exchange rate should weaken. Yet the deterioration of the trade balance is more of a reflection of structural issues of the export sector that would not be improved if the currency was weaker. Thus, the prospects of a rapid COP selloff are also limited.

Thus, the economy seems to be slowly building up the pressure for a weakening of the COP. Yet as long as flows remain balanced and the appetite of foreigners for COP-denominated assets remains stable the COP-negative features of Colombia's economy such as the business cycle, local investor sentiment, and politics will not be enough to make long USD/COP positions attractive.

Instead of taking an outright directional view, we prefer to take advantage of the relative stability of the USD/COP to sell 1M USD/COP strangle (2850/3000) ~1.2% BBG indicative, ref. FX 29 and also to sell USD/COP downside (sell 3M USDc/COPp @2800 ~0.8% BBG indicative, ref. FX 2915; buy USD/MXN (i: 18.25, t: 18.8, s: 18.05)

Rates: : Another month of rally in Colombia. In spite of the somehow disappoint 25bp cut during the May meeting (we were positioned for a 50 bp, recommending longs both in TES19s and IBR6M3M) the market never stopped rallying. The latest inflation print suggest that some of the indexation rigidities (that first motivated the 25 bp cut) could be behind which fueled the rally to what in our opinion could be a point of overshooting. With a terminal rate priced ~4.75 we see little value left in front end receivers – however the relatively high nominal yields (Colombia actually is a mid-yielder) could still continue to attract flows especially if the carry friendly environment persist and COP remains range bounded. At the current levels we would favor:

- either extending duration from the front end into either IBR10s or C26s (the former is cheaper than the latter but also less liquid)
- or switching into real bonds (UVRs20s for example)
- synthesize a local bond using a COLOM's and long NDFs

On the first point we see the "payer" leg as a cheap insurance to a re-bounce in inflation/correction to what we believe to be expectations undershooting. We believe that BEIs are cheap hence the second point (see note in this publication). The third point characterizes the classical richness of locals vs USD bonds and aims to capture the disparities in credit qualities between the local law and USD bonds (local is normally significantly richer than globals after cash flows are swaped into USD and vice versa)

MEXICO

- FX: Buy USD/MXN (i: 18.25, t: 18.8, s: 18.05); buy ARS/MXN (i: 1.141, t: 1.175, s: 1.123); buy 3M USDc/MXNp @ATMF, WKI @18.00 ~1.23%, ref FX 18.23
- Rates: Receive TIIE1Y10Y vs US1Y10Y (target: 480 bp), Favor cash vs TIIE (and UDIs) in the 3Y sector (buy M20s vs TIIE3Y)

FX: The MXN's price action in the aftermath of the Edomex election has further stretched the Mexican peso's value in our view. Fundamentals continue to be less than supportive in Mexico and the exchange rate seems to be the only available. The economy is currently struggling with high inflation despite rising rates and a slow deterioration of consumption which has been the main driver of Mexican growth over the last few months. And while the high interested rates has prevented an large reversion of portfolio flows in Mexico, the decline of FDI is worrisome.

The oil auctions scheduled to take place later this year are likely to be touted as a great success by the government. And when the U.S. Trade Representative publishes the goals the United States will pursue in the re-negotiation of NAFTA we are likely to see an improvement of sentiment towards Mexico due to the dissipation of uncertainty. However, it is important to keep in mind that none of these shocks are likely to result in Mexico becoming a more attractive locale for longer-term, less volatile investment flows. The oil projects that will be auctioned off will only result in increased inflows after the two to three year exploration phase is concluded. Until then, the deficit on the oil trade balance will continue to widen as Mexico's oil production capabilities continue to fall. And while knowing what NAFTA will look like in the future will dissipate uncertainty, the shadow of profound changes to Mexico's investment environment on the back of a possible AMLO administration will continue to loom over Mexican assets in general and the MXN in particular.

From a valuation perspective the MXN is not as attractive as it was earlier in the year. And it is important to note that some of the support for the MXN has come on the back of local pension funds selling USD forward to capture the high carry when buying USD-denominated assets which is a inherently unstable flow likely to dry out if the environment for global equities deteriorates at the margin.

Altogether, the favorable forces of the recent rally of the MXN seem weak and unlikely to result in an even stronger peso due to the limited room for a rally that the already heavy positioning seems to suggest. The structural hurdles to stronger investment inflows into Mexico and the sensitivity of the currency to the materialization of possible external or domestic risks lead us to recommend selling USD/MXN at current levels.

In particular we recommend buying USD/MXN (i: 18.25, t: 18.8, s: 18.05) outright. Alternatively, we also suggest expressing our view in a carry-positive cross by buying ARS/MXN (i: 1.141, t: 1.175, s: 1.123) as the Argentinean peso spot will remain well behaved at least until the October elections. Finally, for those investors who want to position for a possible MXN-rally followed by a retracement once the US governments reveals its NAFTA-negotiation goals we recommend buying 3M USDc/MXNp @ATMF, WKI @18.00 ~1.23%, ref FX 18.23 and to consider financing that call option with the COP strangles suggested below.

Rates: It was a round trip for rates during the month of May. More than May hike itself (which caught part of the markets by surprise), the combination of Banxico's bullish statement (where targeting of spot inflation was explicitly mentioned) and the built up of political risk premium into Mexico's state election led rates their highest levels since February. Rates quickly reverted after PRI's victory in EDOMEX and are now trading close to the lowest levels in the year a couple of days after touching the highs. This month's price action lead us to believe that:

- while it is somehow consensual that the end of the current cycle is near and that spot inflation I bound to reverse, the whole curve (and not only the stub) is still sensitive to the next couple of steps to be taken by Banxico
- rates seem to have been the instrument of choice for the "worsening in politics" trade likely due to lower carry (and sometimes positive) associated with payers especially when compared to FX
- on the latter, uncertainty regarding Banxico's next steps in face of next year's election might prevent the front end from significantly rally even if a pause indeed ensue
- that said high real rates and the likely convergence of inflation to target support nominal receivers as a theme in general (outright, vs linkers since BEI seem high and vs the US where the TP is negative)

Regarding monetary policy the market is pricing approximately 50 bp by September (next 3 meetings) which happens to be slightly above DB's forecast but not inconsistent with the current inflation path. If like we believe, inflation does peak in July we see this 50 bp as an upper-bound to Banxico's actions. The key question for the front end is therefore what will happen to the path expectations if inflation does stabilize and/or, say Banxico's deliver the 7.25% implied by the curve. Without the political premium we believe that cuts would soon be priced – the rationale behind our outstanding 1Y2Y receiver recommendation with the latter being somehow insensitive to the last couple of

hikes. However political risk and the perception that Banxico might stay on hold for a prolonged period of time might prevent the curve to bull-steepen right after a pause even if spot inflation subsides. The latter is predicated on the possible spill-overs of political/fiscal uncertainties on inflation expectations and, as mentioned above, the use of the nominal payers as political hedges due to its favorable cost. That does not mean that we do not believe in the eventual correction in nominals but uncertainty on Banxico ahead the election might slow down the convergence to the potential for the (already negative carry) front end receivers. That said the receiver theme is in our view still strong given

- how high real rates are
- how rich BEIs seem to be
- how low US TP seems to be (a benchmark to US rates seem to be)

We expect a slow grind with a likely downward path at least until the inflation path stabilizes. With that in mind:

- we take profit in our 1Y2Y (20 bp shy of our 6.80 target) looking to add back at 7.30. At the current levels we would favor cash in the M19s-M20s sector given the significant tightening in ASW.
- keep our TIIE-US spread compression in the 1Y10Y sector as a way to play the high real rates angle without dealing with Banxico's short-term uncertainty while taking advantaged of US's low TP
- keep receiver swaption in the 5Y5Y sector initiated in January despite the time decay

PERU

– FX:: Sell EUR/PEN (i: 3.683, t: 3.560, s: 3.730)
– Rates: Buy Sobranos 26s (target 5.10) Receive 2Y xccy swaps (target 4.85).

FX: Peru's economy features a shrinking current account deficit and a balance of risks for growth that continues to look skewed towards the upside. And while the Central Bank is fairly active in the FX market it seems to intervene with the sole aim of reducing volatility rather than attempting to maintain a particular level of the currency. While the PEN is a low beta currency and while the peak of foreign investment inflows might already be in the rearview mirror, we still expect the PEN to recover some ground especially against the EUR. We recommend selling EUR/PEN (entry: 3.683, target: 3560, stop: 3.730). The cross has limited spot potential but is a carry positive recommendation and is likely to perform as many of the idiosyncratic shocks that have hit the Peruvian economy dissipate. Political noise in Peru has been a risk-negative factor over the recent past. And while it is unlikely to be over yet, the incentives of local politicians seem to be aligned in a way that fosters cooperation. While the media has been largely focused on the Odebrecht scandal and the weather shocks, there have been important policy initiatives that investors might have not noticed. In particular, the government seems to be succeeding in its efforts to remove obstacles to investments that include red tape and execution-related inefficiencies. We expect investment to recover as the reconstruction plan gets under way and for the momentum to continue on the back of the Govenrment's infrastructure plan. Public and private infrastructure investment could set the economy on the growth path possibly surpassing 3.5-4.0% next year as the 2pp negative shocks from floods and Odebrecht fade. Given relatively narrow CAD, hefty reserves, and growth/investment prospects the main risk for the PEN seems to be USD strength

Rates: We have been recommending exposure to Soberanos for a while but with Soberanos 26s hovering around 5.40 we favor switching some of the exposure across the curve. Soberanos 37s seem to be the sweet spot to receive and we would favor the latter versus other point in LatAm (even the expensive long end of MBONOs where the foreign participation had sky-rocketed). The 26s sector still optimally combine exposure to term-premium compression and monetary policy exposure. Finally the front end exposure seem best implanted through cross currency swaps as NDF implieds continue to lag local rates. In particular we favor receiving the 2Y point.

High NDF rates however suggest a different/hybrid implementation of the rates/FX view: receive PEN cross currency swaps in the 2Y sector. The trade benefits from the points compressions on accommodative monetary policy stance, but suffers from issuance in USD from foreigners and lacks the Peru's Pension fund support which differently than Mexico favors directs USD exposure. We believe that the distortions in cross currency will eventually fade and favor front end positioning using the 2Y sector.

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Credit

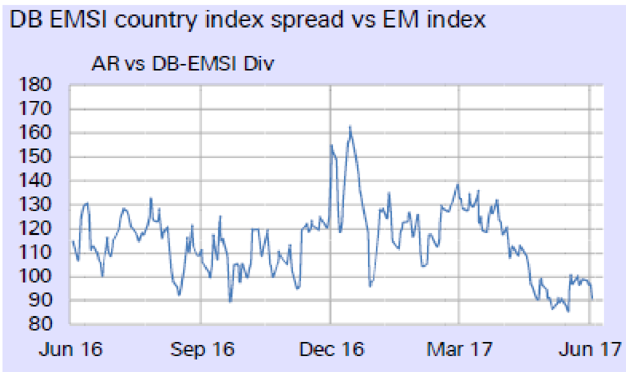
Argentina: back to overweight

We reduced Argentina to marketweight on the 18th of May when Brazil's latest political crisis broke out. We took this cautious step because of Argentina's growth correlation with Brazil, as well as our intention of taking a more hedged view before the mid-tem election campaign starts. We now move Argentina back to overweight, as the market impact of Brazil's crisis has not been as significant as we anticipated. We are also less concerned about the mid-term elections, given the latest developments related to the local elections this past weekend (e.g. the election for mayor of Corrientes), which turned out to be encouraging for Cambiemos. In

addition, many locals seem to hold an optimistic view on the midterm. Argentina sharply underperformed following the Brazil selloff, but recovered quickly.

Argentina recovered quickly from the Brazil-related selloff

DB EMSI country index spread vs EM index

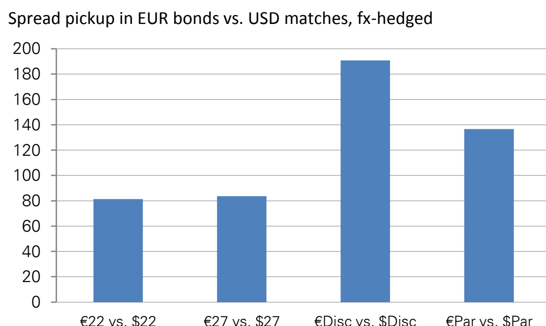


Source: Deutsche Bank

In terms of relative value, we have the following recommendations:

- Retain preference of EUR-denominated bonds, especially the EUR Discounts and Pars. While the spread premium of the bullet bonds have compressed (on FX-hedged basis), its remains elevated for the Discounts and Pars (especially the Discounts). We take profit in our long-standing recommendation of EUR 22s vs. USD 21s (FX-hedged, entry 155bp, current 130bp) and long EUR 22s (base rate hedged, entry 405bp, current 342bp vs. target 325bp), but swap these positions into EUR Discounts vs. USD Discounts (FX-hedged, entry 190bp; target 140bp; stop 210bp).

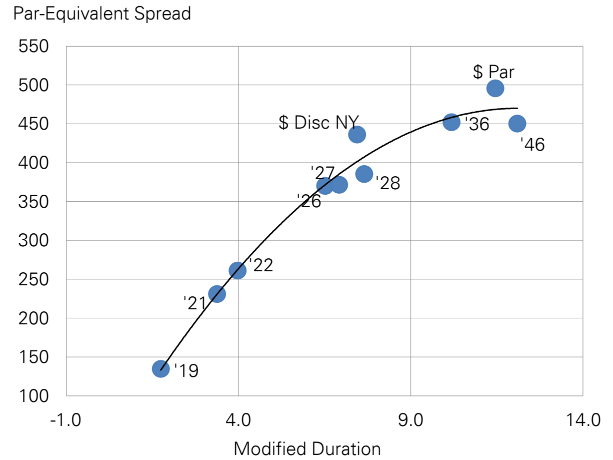
EUR Discounts and Pars remain excessively cheap to USD counterparts (FX-hedged).



Source: Deutsche Bank

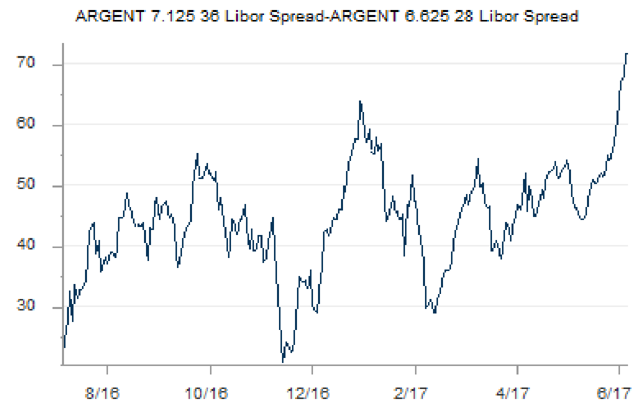
- Among the bullet bonds on the dollar curve, we recommend switching to the 36s from 28s, with 25bp convergence potential. The 36s have recently extended their cheapness vs. 28s and 46s (see chart). Our term structure model suggests that the 36s are 10bp cheap, while 28s are 10bp rich to the curve. In the meantime, the recent sharp steepening of the curve, while helping bring the slope to a normal range in comparison with peers, looks excessive and is subject to a partial retracement.

Argentina USD bonds par-equivalent spreads – 28s and 46s look rich while 36s look cheap



Source: Deutsche Bank

36s have excessively cheapened to the 28s



Source: Deutsche Bank

- We also remain long on Argentina Pars vs. 5Y CDS (1 bond x 1.25 CDS, entry 163bp; current 163bp; target 120bp). Meanwhile, investors should also consider long EUR Pars vs. 5Y CDS to capitalize on (or benefit from) potential corrections due to: a) EUR bonds are cheap to USD bonds, b) Pars are cheap to bullet bonds in the USD curve, c) CDS/bond basis is still tight in Argentina, and d) long convexity.

- Finally, we note that we exit out long positions in GDP Warrants last month mostly due to growth concerns and stay on the sideline on this instrument.

Brazil: the evidence of market complacency

Our economist, Jose Carlos Faria, has always stressed that social security reform is a necessary, but not sufficient, condition to stabilize Brazil's public debt. This is because the economy would have to resume growing and the government would have to raise taxes and find more expense cuts in order to produce a primary fiscal surplus by 2020 to stabilize debt dynamics. Outlook for the reforms has significantly deteriorated as a result of the political crisis. As we argued in our last *weekly*, the market has been very complacent about this risk. It seems to have focused more on a comfortable situation in balance of payments and repeatedly positive news on inflation, and it has given Brazil the benefit of doubt – too much so, in our view.

Brazil's credit rating was stabilizing before this crisis, but now negative momentum has been re-established, and it is most likely headed back to BB- (S&P has already put it on watch for downgrade). In our view, market repricing on Brazil (only +30bp vs. broad EM) merely removed its previous richness; it has not reflected renewed downgrade risk.

However, the market seems to be taking all of this in stride. While we believe the ominous trajectory of debt dynamics will likely come back in a negative way sometime in the future, the market seems to be satisfied with the relative stability with some superficial reforms for now, and Brazil is unlikely to significantly underperform under the current benign international environment. Therefore, we cover underweight on Brazil and move to neutral.

In terms of asset allocation and relative value, we turn neutral in terms of 10s30s curve slope, as the curve has recently steepened. Cross-sectionally, Brazil 10s30s no longer look obviously flat for its spread level. We maintain selling 10Y CDS vs. 47s (current: -15bp; target: -40bp), as basis is still at the higher end of its historical range.

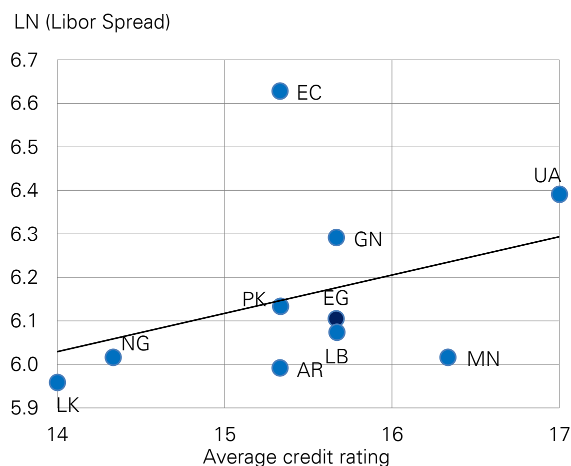
Finally, we remain constructive on the Petrobras 5Y sector vs. sovereign, despite a prolonged period of outperformance.

Ecuador: Time to re-engage

As we suggested in our last *Weekly*, signals from the Moreno government have been skewed to the positive side, but economic and fiscal outlook remains challenging. We believe Ecuador's credit rating is stabilizing. The ratings are unlikely to change this year, but we see a fair chance for the Negative outlook held by Fitch to be removed later this year if fiscal deficits narrow from last year's level, and the economy is growing again. Valuation looks attractive as Ecuadorean bonds are trading at a much wider spreads than comparably-rated credits – see graph below. We understand that some of the credits that are on the rich side either have a much better story to tell (e.g. Argentina) or are recovering from crisis conditions with the help of the IMF and other multilaterals (e.g. Mongolia and Egypt); Ecuador has neither. Yet, if the elevated spreads reflect the market's concern that the same policy framework of past eight years could continue under Moreno, recent developments suggest a fair chance that it will likely gradually shift towards more pragmatism (see discussions above).

We moved to overweight on Ecuador (from marketweight) last week given attractive valuation, positive policy signals, supportive external backdrop, and the removal of near-term issuance risk, and we retain this position. The main risks to our view include: a) further fall in oil prices; b) political risks (especially stemming from potential implications of VP Jorge Glas from the Odebrecht scandal, leading to political uncertainty); c) policy disappointment; and d) potentially more supplies.

Ecuador bonds are trading much wider than comparably-rated credits



Source: Deutsche Bank

On the latter, we note that following the recent issuances of the new 23s and 27s, Finance Minister Carlos de la Torre said that Ecuador is currently not planning "another issue of bonds". However, we take this with a grain of salt, and would not rule out Ecuador coming back to market again later this year, given its financing need. Nevertheless, last week's issuance removes a potentially negative situation for the market for the near term.

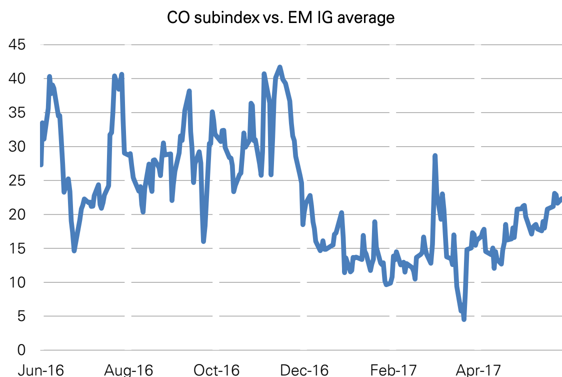
Where to position? We prefer the newly issued bonds (23s and 27s) as the new issue premia have remained. If oil prices find a bottom, these bonds should catch up soon. Last week, we recommended that investors switch from the more expensive 24s to the 27s, and we maintain this position (targeting a 30bp convergence in spreads from the entry libor spread differential of 64bp; current: 61bp).

Colombia: Cover underweight as improved valuation cushions fiscal woes

Ongoing deceleration in economic activity, challenges in consolidating fiscal accounts after the approval of tax reform, and tight valuation have made investors re-focus on deteriorating debt dynamics and turn to a more cautious view on its credit performance, as evidenced in the recent underperformance of Colombia credit. Indeed, the glow of the tax reform has faded, as low growth aggravates fiscal woes – the government will likely underperform the already revised fiscal deficit of 3.6%. In February, S&P affirmed the BBB ratings, but kept a negative outlook, warning of the risk of slippage during the implementation of the tax reform and the peace accord in 2017-2018. We see that mild downgrade pressure is being rebuilt in Colombia. The recent slide in oil prices also did not help. While S&P will likely wait till next year to review again, Moody's is likely to render its review in July, when the agency could revise the outlook to negative.

However, in light of the improved valuation following the recent correction in which Colombia has underperformed the EM IG average by 20bp from recent tights, we cover underweight on Colombia at the current levels.

Correction in Colombia's credit spreads over the past two months



Source: Deutsche Bank

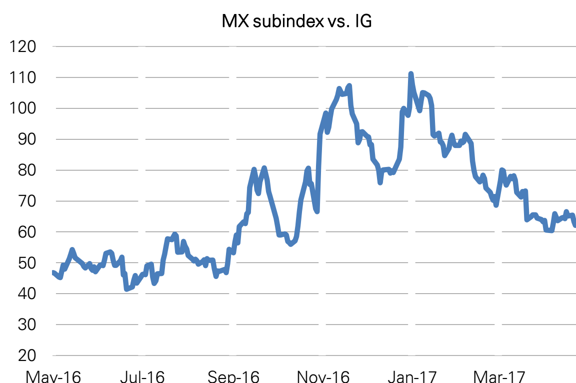
The 10s30s curve in Colombia is one of the steepest in EM. US rates seem to be anchored at lower levels. Yet, we do not see a strong reason for long duration on the curve given our fiscal concerns. Thus, we stay neutral in terms of the slope. We had taken profit in our short 10Y basis (10Y CDS vs. 26s) two weeks ago as basis had moved to a neutral range.

Mexico: stay marketweight; favor Pemex on valuation

Last week, Mexico underperformed moderately as investors took some caution ahead of the Edomex election, but it recovered quickly as PRI claimed a narrow victory over the weekend. We unwind our hedge-oriented long on Mexico 5Y CDS vs. Peru (entered at 18bp; current: 22bp), as the risk scenario which the position hedged against has been removed.

Nevertheless, we believe that the Mexico complex (including Pemex and a few other quasi-sovereigns) should maintain the current risk premium of about 60bp vs. the EM sovereign IG average. Recent economic releases have been mostly on the positive side (especially in the April fiscal results released by FinMin), leading many to believe that Mexico will likely meet this year's fiscal target. Nevertheless, uncertainty regarding the future of NAFTA, still weakening fundamentals (weak growth, high inflation, a deteriorating external account, structural fiscal issues, and contingent liabilities related to Pemex), and strong likelihood of a leftist victory in next year's presidential election (AMLO remains the front runner at this point) will likely continue to weigh on the performance of Mexico credit.

The recovery of Mexico credit has run its course; sizeable risk premium to likely remain



Source: Deutsche Bank

In terms of asset allocation, we note that its 10s30s slope remains steep but flatter than that of Peru and Colombia. While we are neutral in terms of Mexico's 10s vs. 30s at the current levels, we retain dv01-neutral curve steepeners in 27s vs. 47s for further gain (entry: 70bp; current: 80bp; target: 90bp; stop: 60bp).

Finally, we remain constructive on the relative value of Pemex bonds vs. the sovereign in general at the current spread to sovereign of around 150bp on average, especially the belly of the curve (6.9% 26s and 27s). PEMEX bonds' spread to sovereign remains much wider than pre-commodity correction levels (2014 or before), whereas other main regional large O&G names (e.g., Petrobras, Ecopetrol, YPF, etc.) bonds are trading at historical tights vs. their respective sovereign curves. While fundamentals issues with Pemex (especially in terms of its declining production and significant financing needs, etc) are well documented, the scarcity of IG names among LatAm corporates, the completion of market financing this year, much more attractive carry compared to the sovereign, and our integral view on Pemex/Mexico support our positive view on Pemex vs. Mexico.

Peru: Move to underweight on tight valuation

After the Odebrecht’s scandal and the Coastal Niño led to significant revisions in growth forecasts in 2017-2018, investors have become more cautious about Peru’s economic outlook. But the economy is close to the trough after absorbing the negative shocks, and our economist Cesar Arias, expected a V-shaped recovery in 2018. Favorable initial conditions – low debt, moderate budget deficits, and single digit inflation – provide room to adopt countercyclical policies. We are not overly concerned with the widening of fiscal deficit over the next couple of years. Despite recent setbacks, Peru continues to feature one of the best credit fundamentals among EM peers.

However, with 10Y bonds at 80bp and 5Y CDS at 90bp, Peru has little to offer in terms of total return from this point on. Therefore, we move to underweight on Peru given our preference of carry under the current low volatility environment. We continue to favor the long end of the curve (favoring the 50s), where valuation looks more attractive.

Venezuela: Flattening out the price curve

There remain three pertinent themes in Venezuela that are very relevant for asset allocation considerations within the Venezuela complex: a) the higher likelihood of political transition; b) increasing constraint on creative financing; and c) related to the previous one, risk of supply at fire-sale prices.

Political tensions are set to further intensify. Mass protests organized by the opposition continue, while the government is pressing ahead with its constituent assembly process. In addition, President Maduro also announced a referendum to approve the new constitution. External pressures also mount. According to a Reuters report, the Trump administration is considering sanctioning Venezuela’s oil sector. While it seems unlikely that the US will shut down oil imports from PDVSA, some other (milder) types of sanctions are possible. In our view, the chance for a political transition before the 2019 presidential election, even some time this year, has significantly increased with the recent developments.

On the other hand, we have highlighted increasing difficulty for the authorities in engaging in creative re-financing schemes in order to raise fresh money that it desperately needs. Recent news reports that Venezuela is in talks to restructure its debt with Russia debt, showing increasing financing strain. The backlash that Goldman Sachs has received related to the purchase of PDVSA 5% 2022s indicates that it would be harder to monetize any bonds that the government or government-controlled entities still hold, especially the USD5bn Venezuela 36s, which are still in physical delivery form.

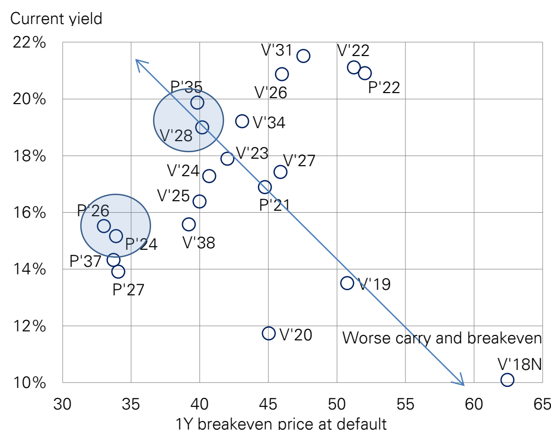
On the flip side of this coin, if those bonds do come out, they will most likely come out at fire-sale levels, pressuring the markets.

We believe that these dynamics, on top of falling oil prices, should lead to continued weakness on the bond curve over the near term, but an equalization of bond prices over a longer term. We have seen little evidence of the latter in the market so far. Bonds at the front end of the curve, especially the 17Ns, are still trading at significantly higher prices than those of the rest of the curve.

With these in mind, and until oil prices rebound, we believe investors should become more defensive in the near term. Our asset allocation strategy remains focused on bonds that are on the more defensive end (to limit loss at default) while still offering a decent level of carry. However, compared to last month, we lean towards the more defensive side. We have the following recommendations:

- At the longer end of curve, PDVSA 35s and Venezuela 28s continue to offer the best combination of relatively high carry and low loss at default – see graph below. Yet, “haven” bonds, such as PDVSA 26s and PDVSA 24s, should be strongly considered by investors with a more defensive position in mind.
- At the front end, while we continue to see good collateral value in the PDVSA 20s, political risk related to potential US measures regarding Rosneft, which now owns close to 50% of CITGO, will likely continue to concern investors. Therefore, we take profit in 20s vs. 21s (entry: 21.8pts; current: 26.5; target: 28pts) and also exit from 20s vs. 17Ns (entry: -11.6pt; current: -11.7pts). Nevertheless, we believe that the market is too complacent about near-term default risk, with 17Ns trading a touch below 90.

PDV 35s and VEN 28s offer the best combo of carry and default breakeven, while PDV 26s and 24s offer the most defensive allocation



Source: Deutsche Bank

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China

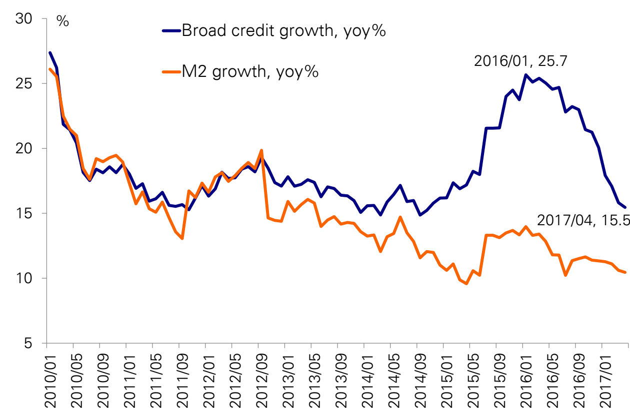
Aa3/AA-/A+
Moody's/S&P/Fitch

- Economic outlook: Growth should slow moderately in the next few quarters, but is unlikely to collapse. The property cycle remains strong with land sales booming. This helps to mitigate the negative impact from tightening of financial regulation.
- Main risks: Tightening of financial regulation may cause volatility in the financial market and liquidity risks for leveraged institutions.

Growth will slow but unlikely to collapse

Regulators tightened controls in the financial sector. Growth of broad credit, defined as total credit extended by the banking sector to the rest of the economy, slowed to 15.8% by the end of March from its peak of 25.7% in early 2016. This has caused some concerns in the market as to whether China's economy may face a sharp slowdown as well. The recent corrections in commodity prices and stock market in China reinforced such concerns.

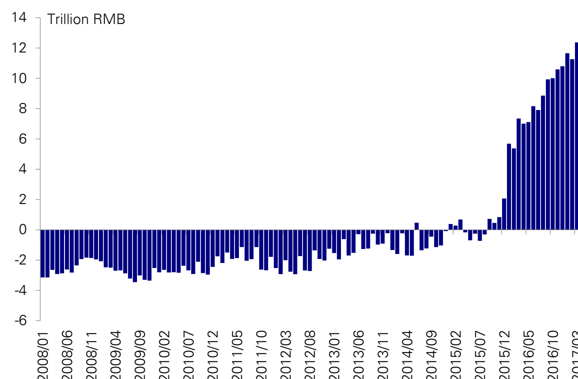
Broad credit and M2 growth



Source: Deutsche Bank, WIND

From a macro perspective, we view the recent deleveraging in the financial sector as a positive development. Almost exactly a year ago we highlighted the widening gap between broad credit and M2 growth as an alarming sign of financial risks (see our report China tail risk series III: Hidden risks in the financial sector, May 5, 2016). The gap indicated that the banking sector was expanding its lending activities aggressively, but much of the new credit went to non-bank financial institutions (NBFIs) rather than forming support to the real economy. The decline of broad credit growth shows that the PBoC and other regulators have made some progress in reducing potential risks in the financial sector. We believe the current policies are conducive to China's longer term financial stability.

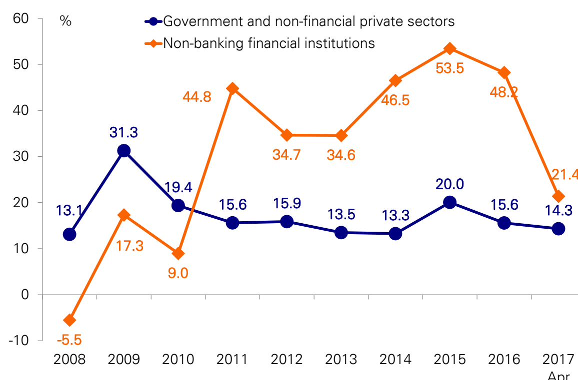
Commercial banks' net claims on NBFIs



Source: Deutsche Bank, WIND

We expect GDP growth to slow in the rest of the year but only moderately: from 6.9%yoy in Q1 to 6.8%, 6.6% and 6.5% in Q2, Q3 and Q4 respectively (see our report China: Growth may have peaked in Q1, April 17). The plummet in broad credit growth is mostly driven by the credit to NBFIs, which include trust companies, insurance companies, brokers, and asset management firms. The credit to government, corporate and household sectors paints a much more stable picture, growing at 14.4%yoy in March compared with 15.6% in 2016.

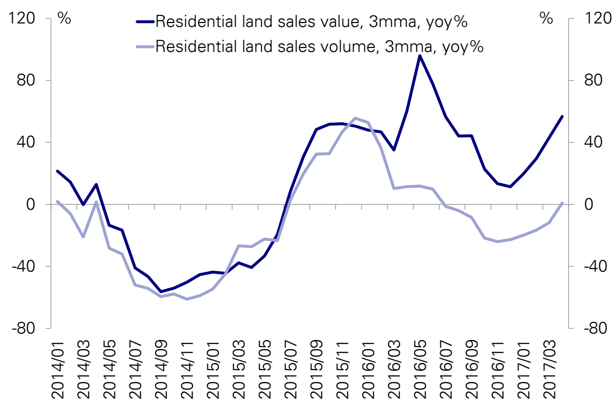
Broad credit growth, by borrowers



Source: Deutsche Bank, WIND

Why has credit growth to NBFIs slowed so much? It is largely because of the government's tightening of regulations in the financial sector. However we note that the government is targeting the NBFIs, not corporate or households; and it seems so far it is only trying to prevent further leveraging up rather than pushing for drastic deleveraging. The squeeze on the NBFIs partly explains the sharp corrections in commodity prices and the stock market, but the rest of the economy has not been affected much. Take the property market as an example: land auctions picked up in recent months.

Growth of residential land sales, 3mma



Source: Deutsche Bank, CREIS

We acknowledge the negative impact of higher market rates on the real economy: it is partly why we expect growth to slow in the rest of the year. However such impact should only play out gradually and moderately in the rest of the year, more likely in H2. Moreover, if growth were to weaken sharply, the government would most likely loosen credit control again to keep it from falling below 6.5% before the important CCP national congress in Q4.

Monthly activity data in April reinforce our view. Growth of industrial production (IP) dropped from 7.6%yoy in March to 6.5%. Growth of fixed asset investment (FAI) slowed from 9.2%ytd to 8.9%. Retail sales growth was 10.7%yoy, slightly weaker than the 10.9% in March. Looking into the breakdown of FAI, manufacturing growth declined from 5.8%ytd in March to 4.9%, and infrastructure remained virtually flat at 23.3%ytd vs. 23.5% in March. Property investment, however, edged up from 9.1%ytd in March to 9.3%.

Property investors' enthusiasm didn't seem to be dampened by the government's tightening measures either as can be seen from the latest credit data. In April, the total amount of new RMB loans was 1.1 trillion, of which around 400 billion was new mortgage loans per our estimate (Figure 5). Although the share of new mortgage loans (around 36%) was lower than some months in 2016 when mortgages accounted for over half of new RMB loans, it's still a staggeringly high number.

We are more concerned about risks in 2018 than this year. High CPI inflation is unlikely to be a problem for the PBoC this year, due to low food prices. The market interest rates are high now, but the government has the option to bring them down if necessary. However the PBoC may have less room to maneuver in 2018. The CPI inflation may move to above 3% sometime in 2018, partly due to the low base effect this year. Moreover, the cumulative effects of the Fed rate hikes will constrain the PBoC's policy scope as well.

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China: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USD bn)	11,065	11,207	11,510	11,407
Population (m)	1,375	1,382	1,388	1,394
GDP per capita (USD)	8,041	8,107	8,291	8,185
Real GDP (YoY%)[1]	6.9	6.7	6.7	6.3
Private consumption	8.8	8.2	7.8	7.8
Government consumption	9.0	8.5	8.2	8.0
Gross capital formation	3.5	4.5	4.5	4.0
Export of goods & services	-1.0	-7.9	10.5	6.4
Import of goods & services	-9.7	-3.5	15.2	8.9
Prices, Money and Banking				
CPI (YoY%) eop	1.6	2.1	2.1	2.6
CPI (YoY%) ann avg	1.4	2.0	1.7	2.7
Broad money (M2) eop	13.3	11.3	10.9	10.5
Bank credit (YoY%) eop	16.5	10.9	12.2	11.8
Fiscal Accounts (% of GDP)				
Budget surplus	-3.4	-3.8	-4.0	-4.0
Government revenue	22.1	21.4	22.1	22.3
Government expenditure	25.5	25.2	26.1	26.3
Primary surplus	-2.9	-3.3	-3.5	-3.5
External Accounts (USD				
Merchandise exports	2,273	2,098	2,307	2,446
Merchandise imports	1,680	1,588	1,826	1,991
Trade balance	594	510	481	455
% of GDP	5.4	4.5	4.2	4.0
Current account balance	330.6	184.6	149.6	125.5
% of GDP	3.0	1.6	1.3	1.1
FDI (net)	62.1	-42.5	-100.0	-150.0
FX reserves (eop)	3,330	3,011	2,850	2,500
FX rate (eop) USD/CNY	6.5	6.9	7.4	8.1
Debt Indicators (% of GDP)				
Government Debt[2]	39.9	41.1	41.6	42.1
Domestic	39.7	40.9	41.4	41.9
External	0.2	0.2	0.2	0.2
Total external debt	12.8	12.8	13.0	13.2
in USD bn	1,416	1,434	1,496	1,506
Short-term (% of total)	65.0	60.0	60.0	60.0
General (YoY%)				
Fixed asset inv't (nominal)	10.0	8.1	8.8	8.2
Retail sales (nominal)	10.7	10.4	10.8	10.8
Industrial production (real)	6.1	6.0	6.5	5.6
Merch exports (USD nominal)	-2.9	-7.7	10.0	6.0
Merch imports (USD	-14.3	-5.5	15.0	9.0
Financial Markets (eop)	**Current**	**17Q3F**	**17Q4F**	**18Q1F**
1-year deposit rate	1.50	1.50	1.50	1.50
10-year yield (%)	3.63	3.70	3.70	3.80
USD/CNY	6.80	7.21	7.40	7.58

Source: CEIC, DB Global Markets Research, National Sources
Note: (1) Growth rates of GDP components may not match overall GDP growth rates due to inconsistency between historical data calculated from expenditure and product method. (2) Including bank recapitalization and AMC bonds issue

Hong Kong

Aa1/AAA/AA+
Moody's/S&P/Fitch

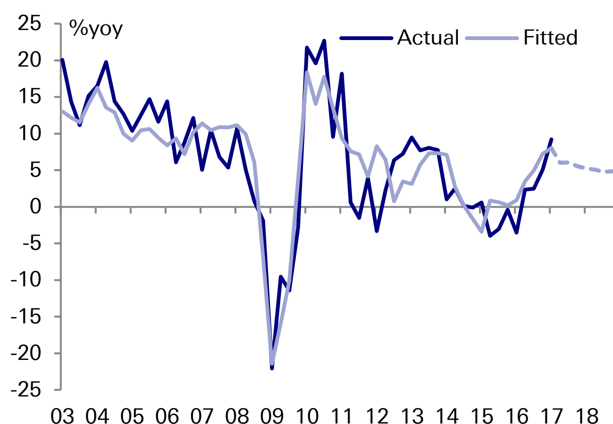
- Economic outlook: We have revised up significantly our forecast for 2018 GDP growth, but taken 2019 down as we now expect falling property prices but rising ex-housing inflation to erode consumption growth.
- Main Risks: While risks of serious trade barriers between the US and China may have receded, they remain and this is perhaps the most important – and most likely – external threat to growth.

Positive near-term, less so in 2018

We have revised up 2017 growth substantially, from 2.5% to 3.8%, but have lowered 2018 growth to 3.0% as we expect the cyclical downturn to come earlier than we'd previously forecast. First quarter GDP growth of 2.9%QoQ(saar) was in line with our forecast on the day but well above what we'd expected earlier in the year and therefore what was implicit in our 2.7% forecast for 2017 growth. At 4.3%yoy, growth is the strongest since mid-2011 and the best leading indicators – manufacturing orders in the US and Europe, and asset prices in Hong Kong – suggest growth could be higher still in Q2. We're not expecting it will be.

An important source of the upside surprise was exports of goods and services which in real terms rose 8.0%yoy, the fastest growth in exactly four years and well explained by the recovery in US and EU growth, the pickup in activity in China and rising commodity prices. As our first chart shows, our expectation is that export growth will be slightly weaker from here on as the commodity price effect wanes and Chinese growth moderates. But it'll probably be a very gradual slowdown, leading to probably the fastest growth in exports in 2017 since 2013 and possibly even 2010.

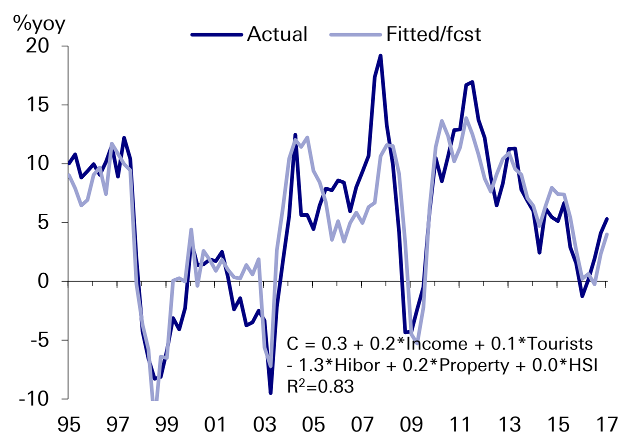
Real exports of goods and services



Sources: CEIC and Deutsche Bank Research

Consumption growth has also picked up nicely. We'd commented in past months that tourist arrivals had bottomed out earlier than expected and with non-residents accounting for 15% of domestic spending that's important. Real consumption spending by non-residents fell for a twelfth consecutive quarter, but a decline of 0.3%yo was a significant improvement from the previous quarter's -3.3%. With real equity and property prices rising at their fastest pace in more than a year, the wealth effect was significant as well.

Real consumption in HK



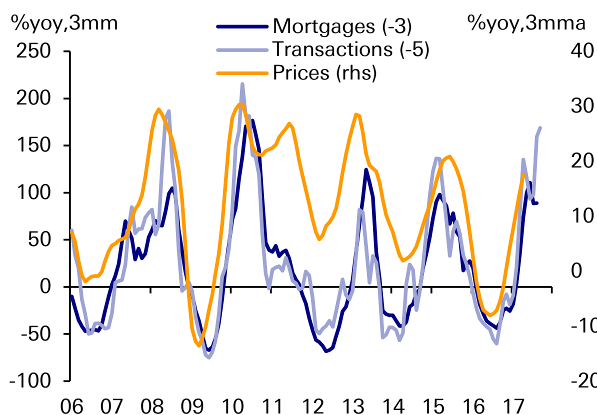
Sources: CEIC and Deutsche Bank Research

But as we have noted before, the Hong Kong labour market has been very tight in recent years. Indeed, the unemployment rate has bounced between 3.2% and 3.5% for six years, as the labour supply has risen and fallen with labour demand over that period. So with the economy essentially at full employment wage growth has risen. Over the past two years, average real income growth has been about 6%. Of course, therefore, Hong Kong should be tightening monetary policy.

It's a problem, we think, that they aren't. Sure, the Fed rate hikes eventually get passed on to borrowers in Hong Kong, but by leaving an extraordinary surplus of liquidity in the banking system – the HKMA hasn't issued Exchange Fund Bills or Notes for nine months – the HKMA has allowed HKD interest rates to fall to post-crisis lows relative to USD rates. Just as the Fed is deliberating when to shrink its balance sheet, the HKMA should be thinking of resuming EFBN issuance, which we think may be necessary to normalize the relationship between USD and HKD yields.

Growth considerations do not warrant an easy monetary policy stance, and neither does the property market. The property price index rose to a new all-time high in April and at 19.8%yoy property prices are looking very frothy. We'd expected a more sedate rate of increase. Transactions data also suggest the market is becoming very speculative and we now expect that property prices will start to decline before too long and expect a 14% decline in the index in 2018. We're not concerned that rising interest rates pose a great threat – real rates are likely to decline over the next 18 months as nominal rate rises lag the rebound in inflation. Income growth will hold up well, but prices have risen much faster than incomes and another pullback in prices seems likely.

Private property prices, transactions and new mortgages



Sources: CEIC and Deutsche Bank Research

Falling property prices will remove one prop for consumption growth. Equity prices, about which we are more positive, have in recent years offered much less support to consumption than property prices. Household income growth should rise over the next few quarters, and we expect tourism to continue to recover slowly.

Consumer price inflation has recently been very low in large part because of the way housing is measured in the CPI – it lags market prices by almost 18 months. Food price inflation has also been surprisingly low so far this year. But as the housing effect reverses we expect headline and core inflation to rise later this year and through 2018. The property price we forecast for next year will only show up in CPI in 2019.

So next year will see falling property prices, rising inflation (even ex-housing) and a moderation of export growth. All of that adds up to weaker GDP growth but still, we think, a pace somewhat above long run potential reflecting above-potential growth in major export markets.

Michael Spencer, Hong Kong, +852 2203 8305

Hong Kong: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	309.4	320.9	349.7	377.2
Population (mn)	7.3	7.4	7.4	7.5
GDP per capita (USD)	42325	43516	47137	50543
Real GDP (YoY%)	2.4	2.0	3.8	3.0
Private consumption	4.8	1.8	4.0	2.0
Government consumption	3.4	3.4	3.6	2.5
Gross fixed investment	-3.2	-0.3	5.1	6.3
Exports	-1.4	0.9	6.2	4.6
Imports	-1.8	1.2	6.6	4.6
Prices, Money and Banking				
CPI (YoY%) eop	2.3	1.2	1.3	4.6
CPI (YoY%) ann avg	3.0	2.4	1.0	3.8
Broad money (M3, eop)	5.5	7.7	10.4	6.8
HKD Bank credit (YoY%, eop)	3.8	7.9	10.9	3.7
Fiscal Accounts (% of GDP)[1]				
Fiscal balance	0.6	4.4	2.0	2.5
Government revenue	18.6	22.7	19.7	20.4
Government expenditure	18.0	18.3	17.7	17.8
Primary surplus	0.6	4.4	2.0	2.5
External Accounts (USD bn)				
Merchandise exports	501.7	502.5	546.6	589.0
Merchandise imports	524.6	520.1	564.5	602.5
Trade balance	-22.9	-17.6	-18.0	-13.5
% of GDP	-7.4	-5.5	-5.2	-4.7
Current account balance	10.3	14.9	18.8	25.5
% of GDP	3.3	4.6	5.3	6.7
FDI (net)	-78.5	-71.4	-6.0	-25.0
FX reserves (USD bn)	358.8	386.3	407.1	430.5
FX rate (eop) HKD/USD	7.75	7.76	7.79	7.80
Debt Indicators (% of GDP)				
Government debt[1]	6.3	5.9	5.2	4.6
Domestic	5.6	5.1	4.5	4.0
External	0.8	0.7	0.6	0.6
Total external debt	420.3	414.4	410.0	400.0
in USD bn	1300.3	1330.1	1436.3	1514.6
Short-term (% of total)	69.3	68.9	70.0	70.0
General				
Unemployment (ann. avg, %)	3.3	3.4	3.2	3.1
Financial Markets	**Current**	**17Q3F**	**17Q4F**	**18Q1F**
Discount base rate	1.25	1.50	1.75	2.00
3-month interbank rate	0.94	1.50	1.75	2.00
10-year yield (%)	1.14	1.30	1.40	1.40
HKD/USD	7.79	7.80	7.80	7.80

Source: CEIC, DB Global Markets Research, National Sources
Note: (1) Fiscal year ending March of the following year. Debt includes government loans, government bond fund, retail inflation linked bonds, and debt guarantees.

India

Baa2/BBB-/BBB-
Moody's/S&P/Fitch

- Economic outlook: We think the recently released Jan-March'17 GDP data (6.1%) is exaggerating the extent of weakness, particularly when measured in real terms. We therefore keep our FY18 real GDP growth forecast unchanged at 7.5%, which would constitute 40bps improvement from the FY17 outturn.
- Main risks: The need to accommodate demands for farm loan waivers from different states could put further pressure on state fiscal finances and offset the fiscal consolidation that is happening at the central government level.

RBI raises hope of rate cuts, but uncertainty remains

As expected, the Reserve Bank of India kept the policy repo rate unchanged at 6.25% in the June policy meeting, stating that premature action at this stage risks disruptive policy reversals later and the loss of credibility. The central bank however decided to cut the statutory liquidity ratio (SLR) by 50bps to 20%, effective from fortnight starting 24 June. One interesting feature of this policy was that for the first time there was a dissent by one of the MPC members who was in favor of a rate cut.

It was evident from the April inflation data and the outlook for the next few months, that the central bank would sound less hawkish in this policy meeting and would revise their inflation forecasts downward. Indeed, the inflation forecasts were revised downward with the new forecasts showing CPI likely to be in 2.0-3.5% range in the 1H of FY18 (earlier estimate was 4.5%) and in 3.5-4.5% range (earlier estimate was 5.0%) in the 2H of FY18. This forecast does not incorporate one-off inflation risks from HRA allowances, which is likely to be implemented sometime during this fiscal year. We are forecasting CPI inflation to average 3% in 1H of FY18, and slightly lower than 5% in the 2H of FY18, resulting in an average inflation of 4% for FY18. We have factored in some incremental inflation uptick from HRA allowances in the 2H of FY18.

The central bank also revised its growth estimate for FY18 downward, but only modestly to 7.3%, from 7.4% earlier. Our own forecast is 7.5% growth for FY18, reflecting a 40bps improvement from last year's outturn.

The sharp downward revision to inflation forecasts, particularly for the 1H of FY18 has raised expectations of a possible rate cut in the period ahead, contingent on incoming inflation data. While we do not rule out the possibility of a 25bps rate cut in the August or October policy meeting (we think there is a 50% chance), we are however not changing our rate call (no further rate cuts in this cycle) at this juncture, for the following reasons:

* An additional token 25bps rate cut by itself will be meaningless; if the central bank decides to cut rates it should be at least 50bps or more, and at this point we are not confident that the central bank would like to ease rates that much. Also it is not clear whether there has been an adequate structural shift in the economy, which would help sustain CPI inflation at 4% levels on a durable basis, beyond the below-trend inflation outturn that is expected in the 1H of FY18.

* As per our own baseline estimate, CPI inflation rises to 4.5% (average) in FY19, from a likely 4.0% outturn in FY18. So in case RBI decided to cut rates by 50bps this year, it could possibly lead to rate hikes next year, if inflation were to rise to 4.5% or slightly higher in FY19, as per our forecast. Or in other words, the central bank, in our view, should only consider going for deeper rate cuts, if data were to suggest persistently that India has managed to achieve its goal of containing CPI inflation at 4% on a durable basis. This should also reflect in household inflation expectations easing consistently from current levels.

* We think the recent Jan-March GDP data is exaggerating the extent of weakness, particularly when measured in real terms. We note that nominal GDP growth improved to 12.5% in Jan-March (up from 10.4% in the previous quarter), but real GDP growth was pulled down due to i) higher GDP deflator; ii) an unfavorable base and iii) possibly some spillover from demonetization. With GDP deflator expected to be lower in April-June, real GDP growth should return to the 7-7.5% range, even if the last quarter's nominal GDP growth rate is maintained.

* It should be noted that the slowdown on the private investment front is despite RBI having cut rates by 175bps in this cycle. Of course, one could argue that this means RBI should be cutting rates even more, but it is quite evident by now that monetary easing is not the panacea for private investment recovery; on the contrary, it could fuel stronger consumption growth, which could lead to higher inflation expectations in the future. The limited role that monetary policy can play at this juncture to rekindle private investment growth was made amply clear in RBI's statement today.

* At a time when the general government fiscal deficit is likely to come under further pressure due to potential accommodation of farm loan waivers, higher wages of state government employees (though staggered over a period of time) and given the compulsion of servicing the interest cost of the UDAY scheme, it is probably a risky strategy for the central bank to consider going for deeper rate cuts, as it might have adverse repercussion for inflation and inflation expectations in the period ahead.

* There is a non-trivial risk of the US Fed to start reducing the size of its balance sheet, probably starting from the 4Q of 2017, which could potentially lead to capital outflows from emerging markets including India. RBI will have to keep this risk in mind, while deciding on the future course of monetary policy action. RBI's conservative but prudent policy on rates so far has helped maintain rupee stability, which has provided confidence to offshore investors to look favorably at India. Having not cut rates since December of last year, we are not sure whether the central bank will like to take the risk of venturing into a rate cut mode once again, especially at a time when global policy and political risks remain high.

* In our view, preserving some buffer, in terms of slightly higher-than-warranted real rates (on an annual average basis), would provide flexibility to RBI to defer any potential risk of rate hikes, if they were to arise sometime later next year. In this context, we would prefer the central bank to remain on an extended pause at the current juncture, and wait for more evidence to ascertain how much of the current disinflation is owing to transitory and durable factors.

India remains an investor favorite

During last month's dbAccess Asia 2017 conference (held in Singapore, May 15-17), investors were significantly upbeat on India, despite expensive valuations in the equity market, and felt that any potential correction should be used as an opportunity to increase India related exposure with a 1-2 year view. The sentiments expressed at the conference matched with the views of the US equity investors whom we met in early May (more in details below), some of whom admitted that they would have preferred to be more overweight India than what they currently are. We highlight below the key takeaways of polls that we conducted related to the Indian and global economy:

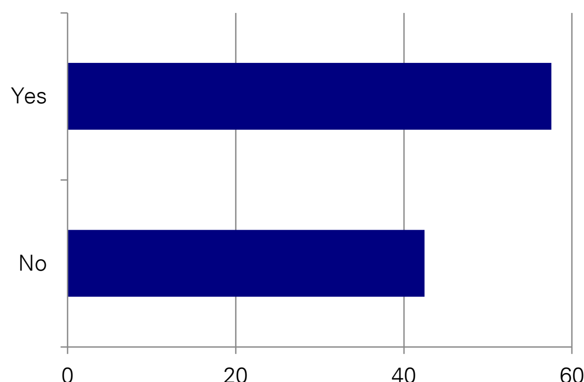
Global

* 46% of the respondents felt that there is only a 25% probability of President Trump to deliver on his bullish policy promises (tax cuts, infrastructure spending, tax repatriation), while 37% felt that the probability is higher at 50%.

* 57% of the respondents felt that a potential shrinking of the Fed balance sheet by the end of this year will create disruptions in financial markets; interestingly, a larger proportion of respondents (68%) believed that a tapering signal by ECB will cause disruptions in the financial markets.

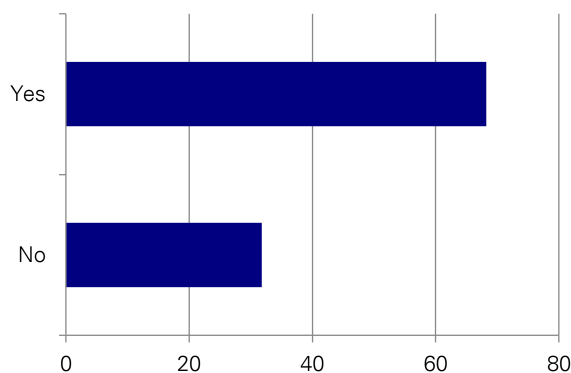
* Almost 70% of the respondents believed that quarterly GDP growth in China will drop below 6.5% some time in 2018, while 33% believed that there was a 5-10% chance of the authorities to raise the benchmark interest rate in 2017.

Will shrinking the Fed balance sheet later this year create any disruptions in financial markets?



Source: Deutsche Bank

Will the ECB tapering signal later this year create any disruptions in financial markets?



Source: Deutsche Bank

India

* 40% of respondents felt the potential disruption related to GST will only last for 3-6 months, while 33% respondents felt that the disruption could last for 9 months or more. Our conversation with investors however gave us a sense that most of them are ready to look through the potential near-term disruption and in fact may look to increase their India exposure, if the equity markets corrected as a result of potential earnings downgrade following the implementation of the GST.

* 37% of respondents felt that the rupee will mean revert and end in the range of 65-67 against the USD by end-December 2017. 31% felt that rupee will end between 63-65, but most interestingly more number of respondents (20%) expected rupee to end below 63, than ending the year in the range of 67-69 (12%).

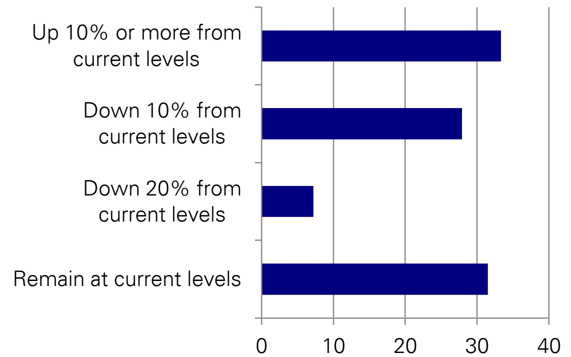
* An overwhelming 57% of respondents expected RBI to keep the repo rate unchanged in 2017, while 17% felt that the central bank will hike the policy rate by 25bps this year. Interestingly, 18% respondents still felt that there was a chance for RBI to cut the repo rate by 25bps in 2017, while only 7% believed that RBI will be hiking by 50bps in 2017.

* So far as 2018 is concerned, 39% of the respondents believed that RBI will hike the repo rate by 25bps next year, while 28% expected RBI to hike by 50bps. Interestingly, a larger proportion of respondents (32%) expected the central bank to remain on the sidelines next year compared to hiking rates by 50bps.

* The poll related to equity markets outlook revealed that, 33% of respondents expected the stock market to be up 10% or more from current levels by end-2017, while 28% of respondents expected markets to be down 10% from current levels. Only 7% of the respondents expected equity markets to be down 20% from current levels, while 32% believed the equity markets to remain at current levels.

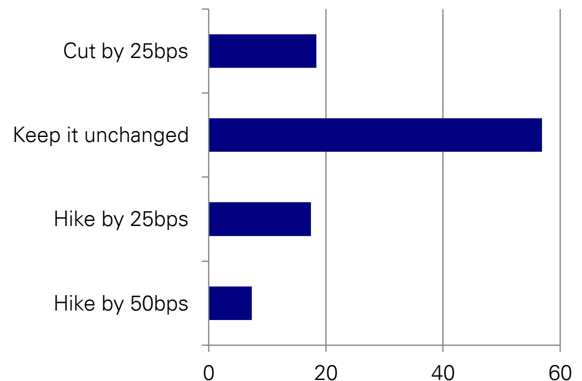
* 34% of the respondents thought that India will not get a sovereign ratings upgrade before the 2019 general elections, while 28% respondents expected India to get an upgrade. 25% respondents thought there was a 50:50 chance, while 14% of the respondents were not sure.

EQUITIES: By end 2017, do you expect Indian stock markets to be?



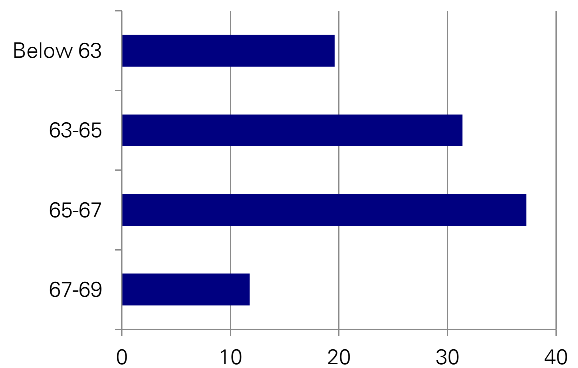
Source: Deutsche Bank

FIXED INCOME: What will RBI do with the policy repo rate in the rest of 2017?



Source: Deutsche Bank

FX: Where will INR/USD be by end December 2017?



Source: Deutsche Bank

Weakness in real GDP exaggerated by unfavorable base and high deflator

India’s national accounts data for Jan-March’17 and FY17 were released recently, using the new series of IP and WPI (with 2011-12 base). After all the adjustments and revisions, the data showed that India's real GDP grew by 6.1%yoy in Jan-March’17, lower than our (6.4%) as well as Bloomberg consensus estimate (7.1%). GVA growth in real terms was weaker at 5.6%yoy, lower than 6.7% outturn in the previous quarter. FY17 real GDP growth was 7.1% (8.0% in FY16 post revisions), while GVA growth was 6.6% vs. 7.9% in FY16. The data showed that there has been a sequential slowdown in GDP growth through FY17, with 1HFY17 growth averaging 7.7%, while 2H growth being weaker at 6.5% average.

The expenditure side GDP data, which is volatile and less reliable, showed private consumption growth moderating to 7.3%yoy in Jan-March’17 (vs. 11.1%yoy in Oct-Dec’16), while government consumption growth rose at an even faster pace (31.9%yoy) from the previous quarter (21.0%yoy). Worryingly, gross fixed capital formation contracted 2.1%yoy in Jan-March’17, versus modest growth of 1.7% and 3.0% in the previous two quarters. Net exports subtracted marginally from growth, with imports (11.9%yoy) outpacing exports (10.3%yoy) growth in Jan-March’17. For FY17 as a whole, government consumption growth (in real terms) was the strongest (20.8%yoy), followed by private consumption (8.7%yoy) while investment growth (2.4%yoy) slowed down sharply from the FY16 outturn.

We think the recent Jan-March data is exaggerating the extent of weakness, particularly when measured in real terms. We note that nominal GDP growth improved to 12.5% in Jan-March (up from 10.4% in the previous quarter), but real GDP growth was pulled down due to i) the higher GDP deflator; ii) an unfavorable base and iii) possibly some spillover from demonetization. With the GDP deflator expected to be lower in April-June, real GDP growth should return to the 7-7.5% range, even if the last quarter’s nominal GDP growth rate is maintained.

Going forward, we think growth momentum will likely stabilize and pick up particularly from the second half of FY18, as the economy re-monetizes completely and as the favorable base effect kicks in. We therefore keep our FY18 real GDP growth forecast unchanged at 7.5%, which would constitute 40bps improvement from the FY17 outturn. We expect a gradual pick up in investment growth in FY18 (4.0%yoy) along with strong consumption growth (8.7%yoy), which should help support a 7.5% headline real GDP growth, under a normal monsoon scenario.

US trip notes: Six questions

We met up with a host of equity clients in the US last month. Investors seemed comfortable with India’s overall macro outlook and reforms momentum, while admitting that valuations in the equity market remain expensive. Almost all investors remain overweight India, with some investors admitting that they would have preferred to be more overweight than what they currently are. On the macro front, discussions centered around six broad questions apart from inflation and monetary policy outlook, which we have already outlined in details in the first section:

1) GST - will the potential near-term disruption provide a buying opportunity in the equity market?

With GST scheduled to be rolled out from 1 July, most investors wanted to know the likely impact on growth and equity markets post its implementation. There was a general consensus that the GST will prove to be transformational for the Indian economy in the medium to long term, helping simplify indirect tax structure, reducing geographical fragmentation, broadening the tax base and increasing the potential growth rate of the economy. But most investors felt that some amount of disruption is inevitable in the very short-term post the likely implementation of the indirect tax reform from 1 July. While large companies are ready to move to the new tax structure, small and mid-sized firms, especially those in the unorganized sector, are not fully prepared to transition into the new GST network. Consequently, many investors felt that there could be some disruption in the payment cycle, which in turn could potentially lead to some businesses facing cash flow problems in the immediate near-term.

But we got a sense that most investors are ready to look through this near-term disruption and in fact may look to increase their India exposure, if the equity markets corrected as a result of potential earnings downgrade following the implementation of the GST. In fact, some investors told us that they had increased their India exposure last year, when equity markets had come off due to demonetization and US election outcome related volatility.

Quantifying the short-term impact of GST on growth is difficult, as was also the case post demonetarization. Our FY18 real GDP growth forecast is 7.5%, assuming a normal summer monsoon. The impact on economic momentum will depend on how fast and how smoothly Indian companies, especially in the informal/ unorganized sector, manage to transition in the new tax system, which is difficult to guess at this stage. Moreover, improving exports momentum, some recovery on the private investment front and pent-up demand coming back post full re-monetization could

offset the potential negative impact and lead to an overall improvement in growth compared to the last year's outturn. We are of the view that under a normal monsoon scenario, the Indian economy will record a higher growth in FY18, possibly closer to the 7.5% mark (vs. 7.1% in FY17).

2) NPA resolution – will the amendment of the Banking Regulation act make a big difference?

Last month, the government passed an ordinance amending the Banking Regulation Act. This envisages (i) empowering the RBI – with govt. authorization – to direct banks in initiating insolvency resolution proceedings in 'specific' cases under the Insolvency and Bankruptcy Code, (ii) the RBI giving directions to banks for the resolution of stressed assets, and (iii) the RBI specifying where authorities/ committees (such as multi-disciplinary oversight committees) should be set up for the resolution of stressed assets.

While this will help to expedite the NPA resolution process, it does not solve the capital shortfall problem of the public sector banks, especially if they have to take significant haircuts going forward. While we agree that injecting large doses of capital in the public sector banks without changing the ecosystem concurrently is probably not a good idea, we however provide a workable solution of how the authorities can consider providing large amount of capital to the public sector banks, if they want to, without impacting the fiscal consolidation agenda.

In our view, the government should consider recording capital injection in public corporations as a "financial transaction" or below the line item, and do the same for disinvestments receipts, which are currently shown as a revenue item. This would lead to an increase in public debt but would have no impact on the budget deficit and more importantly would be in line with the IMF's 2014 Government Finance Statistics accounting framework (GFS), which is followed by most countries across the world.

Beyond the issue of fiscal accounting, it should be appreciated that augmentation of banking capital can be done without impacting the economy's supply/demand of goods/services/funds or the inflation dynamic, unlike typical spending. To raise the funds, the government can issue bonds or issue a long-term promissory note to the RBI, which can then transfer cash to the targeted banks. Typically, central bank financing of public expenditure is seen as poor practice, but in this idiosyncratic case, such reservations should not apply, in our view. Additional capital can be raised if the government considers selling part of its stakes in public sector banks.

3) 2017 south-west monsoon – will it be normal as per the IMD's forecast?

Recently the IMD sounded more confident regarding monsoon prospects, stating that India could receive rains that exceed its provisional forecast. The IMD also mentioned that risks of El Nino (generally associated with sub-normal monsoon) have reduced compared to last month. While IMD's forecast record has improved since 2010, we note that the big misses have been more when actual rainfall has been deficient, rather than being excess. This remains a key risk to the IMD's normal monsoon forecast for 2017 (for more details, see http://pull.db-gmresearch.com/p/4548-0377/207053444/DB_IndiaEconWkly_2017-04-20_de73a908-202f-11e7-b056-165e898358c6_604.pdf).

4) Farm loan waiver – will it delay fiscal consolidation at the general government level?

The new BJP government in Uttar Pradesh has announced a loan waiver for 21.5mn small and marginal farmers amounting to INR354bn, as per its pre-poll promise. The farm loan waiver will be financed by issuing bonds, which will add to the fiscal cost of the state as and when the bonds mature. Historically, Uttar Pradesh has been a fiscally weak state and the current move will put further pressure on its finances (please see "The Economic Effects of a Borrower Bailout: Evidence from an Emerging Market http://ibread.org/bread/system/files/bread_wpapers/433.pdf" for an account of the adverse impact of the 2008 farm loan waiver).

Indeed, state fiscal finances pose the biggest risk to the overall fiscal consolidation target that has been set by the FRBM committee (for more details, see: http://pull.db-gmresearch.com/p/9134-6D66/18507088/DB_SpecialReport_2017-05-18_0900b8c08cf65944.pdf). State fiscal finances have deteriorated in the last few years, with the overall state fiscal deficit having already risen above 3% of GDP currently, as per RBI's latest data. Interest burden of UDAY scheme, possible increase in contingent liability on account of prospective farm loan waivers and pressure to raise salaries and wages of state government employees may pose a risk to meaningful fiscal consolidation at the state government level in the years ahead, in our view.

However our debt sustainability analysis (for more details, see http://pull.db-gmresearch.com/p/9220-4AF1/228048373/DB_SpecialReport_2017-04-26_0900b8c08cd7eb1e.pdf) reveals that even under a modest fiscal consolidation scenario (under which state fiscal deficit remains at the current level of 3.0% of GDP as against the FRBM committee's recommendation of bringing it down to 2.0% of GDP by FY23 and centre's fiscal deficit is also maintained at

3.0% of GDP from FY19 onward), it is possible for India to lower its debt/GDP to 60% of GDP by FY23, provided nominal GDP growth averages about 12.5-13% during the forecasting period, which is achievable in our view.

5) Demonetization dividend – will the government get some windfall from demonetization?

The de-monetization move improves the fiscal outlook of the central government, in our view, as an increase in tax collection through better reporting and audit is likely. Indeed, the FY18 budget has projected income tax collection to rise 25%yoy (2.6% of GDP in FY18 vs. 2.3% of GDP of FY17), which basically reflects expectations of higher tax mobilization post demonetization. But there could potentially be two other sources of windfall arising on account of demonetization (i) higher than budgeted dividend from RBI; ii) some proceeds from the second voluntary income disclosure scheme announced post demonetization). The good news is that the government has not factored in potential revenue arising from the one-offs in the FY18 budget; therefore any windfall accruing will be a net positive for the budget, ceteris paribus.

6) Fed, Dollar and Rupee – will rupee continue to appreciate?

The rupee has appreciated by 6% against the USD in 2017 so far, led by robust FII inflows (particularly in the month of March) and a reversal of broad USD strength. However the pace of FII inflows have reduced post March, especially related to equity. Consequently the pace of rupee appreciation has also eased, albeit supported to some extent by RBI's FX intervention. Apart from domestic factors, the future course of the rupee will depend primarily on the DXY trajectory. We remain of the view that broad USD strength will make a comeback in the second half of 2017, which should lead to mean reversion of EM FX including the rupee. Also there is a non-trivial risk of the Fed to start reducing the size of its balance sheet from sometime later this year, which could potentially lead to capital outflows from emerging markets including India (see The Unkind Unwind: What happens when the Fed stops reinvesting http://pull.db-gmresearch.com/cgi-bin/pull/DocPull/2884-B213/249270065/Asia_Macro.pdf). With current account deficit expected to rise from current levels, any material outflows on account of the Fed's balance sheet and/or rate policy would naturally lead to some depreciation of the rupee.

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India: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	2069	2186	2499	2747
Population (mn)	1271	1289	1307	1325
GDP per capita (USD)	1628	1697	1912	2073
Real GDP (YoY %)	7.5	7.9	7.0	7.8
Private consumption	4.9	9.4	8.1	8.4
Government consumption	1.1	15.4	14.0	10.0
Gross fixed investment	5.4	4.4	2.2	4.0
Exports	-6.4	1.4	7.8	7.3
Imports	-6.4	-1.6	8.0	7.0
Real GDP (FY YoY %) [1]	8.0	7.1	7.5	7.8
Prices, Money and Banking				
CPI (YoY%) eop	5.6	3.4	5.1	3.5
CPI (YoY%) avg	4.9	5.0	3.6	4.8
Broad money (M3) eop	10.7	6.6	12.0	13.0
Bank credit (YoY%) eop	10.5	4.9	12.0	12.0
Fiscal Accounts (% of GDP) [1]				
Central government balance	-3.9	-3.5	-3.2	-3.0
Government revenue	9.2	9.8	9.5	10.0
Government expenditure	13.2	13.4	12.7	13.0
Central primary balance	-0.7	-0.3	-0.1	0.0
Consolidated deficit	-6.5	-6.5	-6.2	-6.0
External Accounts (USD bn)				
Merchandise exports	272.4	268.6	291.8	312.2
Merchandise imports	409.2	376.1	418.0	448.3
Trade balance	-136.9	-107.5	-126.2	-136.2
% of GDP	-6.6	-4.7	-4.9	-5.0
Current account balance	-22.4	-11.9	-29.2	-40.7
% of GDP	-1.1	-0.5	-1.1	-1.5
FDI (net)	36.5	39.4	40.0	45.0
FX reserves (USD bn)	350.4	360.3	390.0	410.0
FX rate (eop) INR/USD	66.3	67.9	67.5	69.5
Debt Indicators (% of GDP)				
Government debt	70.4	70.1	69.1	67.4
Domestic	67.2	67.0	66.0	64.5
External	3.2	3.1	3.0	2.9
Total external debt	23.2	20.9	19.1	18.1
in USD bn	479.2	456.1	476.6	498.0
Short-term (% of total)	17.0	18.4	18.1	17.9
General				
Industrial prodn (YoY%, avg.)	2.6	5.8	4.1	5.9
Financial Markets	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
Repo rate	6.25	6.25	6.25	6.25
3-month treasury bill	6.28	6.30	6.30	6.30
10-year yield (%)	6.64	6.80	7.00	7.20
INR/USD	64.4	66.0	67.5	68.0

Source: CEIC, Deutsche Bank. Forecasts (1) Fiscal year ending March of following year.

Indonesia

Baa3/BB+/BBB-
Moody's/S&P/Fitch

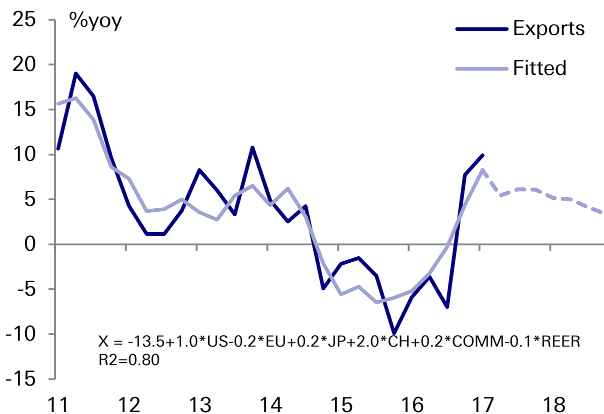
- Economic outlook: While we have slightly lowered our growth forecasts, we still expect growth to rise in 2017 and taper off a bit in 2018 to rate closer to potential growth. Inflation, we think, could surprise to the upside in the near-term, but rate hikes from BI would help bring inflation back down.
- Main risks: Foreign investors have a large impact on the economy through spillovers from rising US yields on the domestic capital markets and the currency. We continue to see important negative risks via this avenue.

Steady growth with some upside risks

First-quarter GDP growth was slightly weaker than we'd expected at 4.5%QoQ(saar)/5.0%yoy but only by enough for us to take 10bps off our GDP forecast. The attraction of Indonesia as an investment destination is the stability of growth at a relatively high rate. And after three years of growth ranging from 4.7% to 5.1% the economy seems to be humming along at a comfortable pace. Indeed, 5.0% is our estimate of potential growth in Indonesia. We expect growth to be a little higher for next couple of quarters and then return to 5.0% next year.

The stability of GDP growth is all the more remarkable because exports – more than a fifth of GDP – are anything but. Exports of goods and services rose 8.0%yoy last quarter up from -5.6% two quarters ago and the fastest growth in just over three years.

Real merchandise exports model

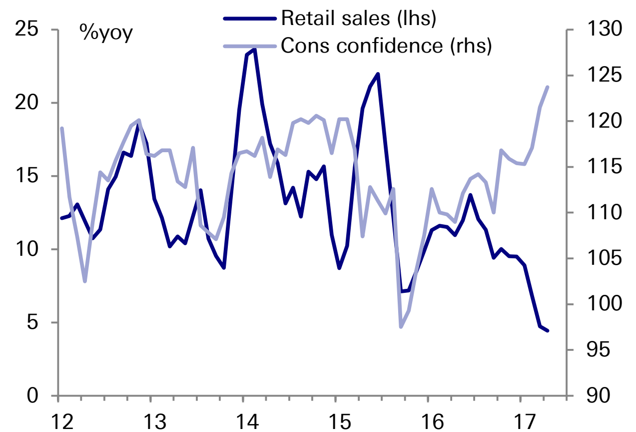


Sources: CEIC and Deutsche Bank Research

As we have seen in the rest of the region, the rebound in exports was driven mainly by surging commodity prices – restoring purchasing power in commodity-exporting markets – but underpinned by rising growth in the G3 economies and in China. Since we expect commodity price inflation to wane but growth in the advanced economies to be a little higher over the next year, export growth is likely to decline very gradually. 2017 will likely be the best year in six for exporters.

Household consumption is what gives the economy its stability – ten years of consumption growing between 4.7% and 5.5% per year and Q1 growth was an unexceptional 4.9%. But while retail sales (and vehicle sales) have slowed in recent months, consumer confidence has soared to all-time highs. We expect is that rising commodity prices will give enough of a boost to rural demand that consumption growth will be a little stronger over the coming year or more.

Retail sales and consumer confidence

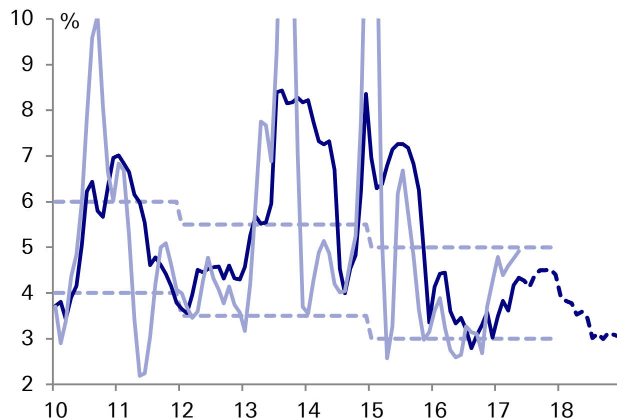


Sources: CEIC and Deutsche Bank Research

Interestingly, in that consumer expectations survey the one-year-ahead price expectations index (and also the employment outlook index) rose in April to a 28-month high. Households are not only bullish, they expect better job prospects and higher prices.

We also expect higher inflation over the coming year. Inflation has risen from 3.0% at the end of last year to 4.3% in May but most of that was due to higher electricity prices. Core inflation has barely moved. Food prices jumped a little more than we'd expected in May but that may just be a Ramadan effect. But inflation expectations rising to a three-year high signify to us that there are upside risks to our forecast that inflation peaks at 4.5% in Q3.

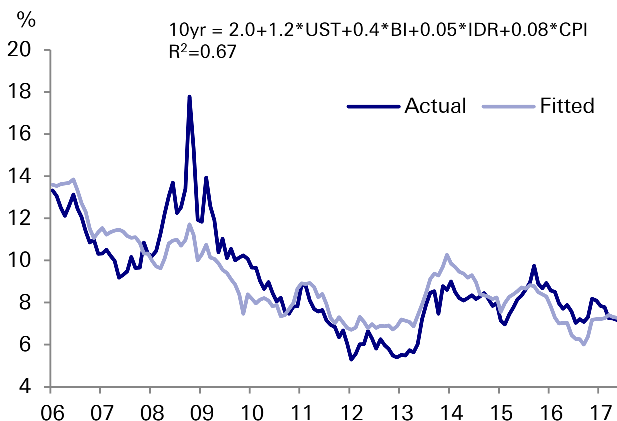
Headline inflation



Sources: CEIC and Deutsche Bank Research

One potential source of upside risk to inflation is the currency. While our strategists have pared back somewhat their bullish dollar view, we remain in the strong-dollar camp. We've scaled back a bit our IDR forecast but still see the exchange rate crossing 14,000 late this year as the Fed delivers balance sheet tapering and rate hikes.

Indonesian bond yields



Sources: CEIC and Deutsche Bank Research

Indonesian bond yields have fallen this year because US yields have. Higher US yields will, we think, lead to capital outflows from Indonesia, driving the IDR weaker, bond yields higher and contributing to BI's decision in Q4 to start raising rates. Four rate hikes in a year should, we think, turn the currency around by Q2 next year, dampening inflation and helping to stabilize longer-term yields.

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Indonesia: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	861.2	932.7	998.3	1,056.9
Population (mn)	255.5	258.7	261.9	265.0
GDP per capita (USD)	3,371	3,605	3,812	3,989
Real GDP (YoY%)	4.9	5.0	5.2	5.0
Private Consumption	5.0	5.0	5.2	5.4
Government consumption	5.3	-0.1	3.4	2.0
Gross fixed investment	5.0	4.5	4.3	3.4
Exports	-2.1	-1.7	6.2	4.7
Imports	-6.4	-2.3	3.6	2.5
Prices, Money and Banking				
CPI (YoY%) eop	3.4	3.0	4.4	3.0
CPI (YoY%) ann avg	6.4	3.5	4.2	3.4
Core CPI (YoY%)	4.9	3.4	3.3	3.0
Broad money (M2)	12.8	7.9	9.2	4.4
Bank credit (YoY%)	11.8	11.8	11.8	11.8
Fiscal Accounts (% of GDP)				
Budget surplus	-2.6	-2.5	-1.6	-1.4
Government revenue	13.1	12.5	13.4	13.9
Government expenditure	15.7	15.0	15.0	15.2
Primary surplus	-1.2	-1.0	-0.3	-0.1
External Accounts (USD bn)				
Merchandise exports	149.1	144.4	167.5	180.6
Merchandise imports	135.1	129.0	149.3	160.9
Trade Balance	14.0	15.4	18.1	19.7
% of GDP	1.6	1.7	1.8	1.9
Current Account Balance	-17.5	-16.9	-14.4	-8.2
% of GDP	-2.0	-1.8	-1.4	-0.8
FDI (net)	10.7	16.0	8.5	16.0
FX Reserves (eop)	105.9	116.4	110.8	106.9
FX rate (eop) USD/IDR	13,855	13,417	13,900	13,100
Debt Indicators (% of GDP)				
Government Debt	27.4	27.5	28.1	26.3
Domestic	15.2	16.6	17.7	17.2
External	12.2	11.0	10.4	9.1
Total external debt	36.1	34.0	32.0	28.7
in USD bn	310.7	317.1	319.0	303.3
Short-term (% of total)	12.5	12.9	13.0	12.0
General				
Industrial Production (YoY%)	4.2	4.3	4.4	4.3
Unemployment (%)	6.0	5.9	5.8	5.7
Financial Markets (eop)	**Current**	**17Q3F**	**17Q4F**	**18Q1F**
BI 7d reverse repo	4.75	4.75	5.00	5.25
10-year yield (%)	6.92	7.00	7.25	7.50
USD/IDR	13,307	13,600	13,900	14,000

Source: CEIC, DB Global Markets Research, National Sources

Malaysia

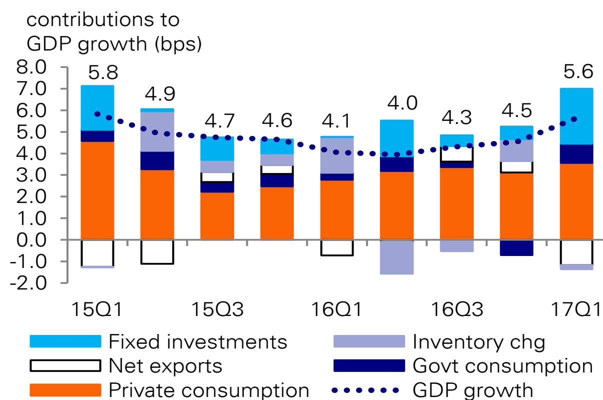
A3/A-/A-(Neg)
Moody's/S&P/Fitch

- Economic outlook: We upgraded our 2017 GDP growth outlook by 30bps to 4.8%, following the strong first quarter reading. This means growth could ease past Q1, owing to a likely pullback in government spending, but the sustained exports rebound and bottoming out of private sector demand could still support growth of about 4.5% for the rest of the year. Meanwhile, core inflation has been subdued, in line with the early-stage recovery of domestic demand, and thus, is unlikely to prompt near-term rate hikes by Bank Negara.
- Main risks: Downside risks to our growth outlook stem from the cooling of external demand due to China's slowdown and perhaps from the US economy, given the recent disappointment in jobs market data.

Cyclical recovery continues

Since bottoming out in mid-2016, the Malaysian economy had been on a gradual recovery mode, inching higher from 4.0% in the first half towards 4.5% by end-2016. But the start of 2017 saw the economy sharply accelerate to its fastest pace in two years at 5.6%yoy. Sequentially, national output expanded 1.8%qoq(sa) in the first quarter, gaining pace from 1.3%qoq(sa) in the preceding quarter. Thus, the acceleration in first quarter growth was not just because of a low base.

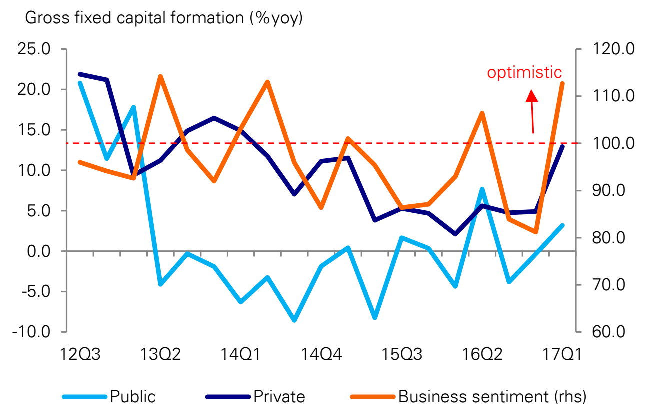
Government spending and private sector investment led the growth acceleration in the first quarter of 2017



Source: CEIC and Deutsche Bank

The upside surprise to growth largely stemmed from the strength in capital formation and government consumption. Investments in machinery and equipment sharply accelerated to 21.8%yoy in Q1 from 2.9%yoy in 2016Q4, thereby guiding the pace of private sector capital formation to rise to 12.9%yoy (vs. 4.9%yoy)—in line with the improvement in business sentiment in the same quarter—and of public sector investments to rebound to 3.2%yoy from -0.4%yoy previously. To some extent, construction also contributed to the strength of investment activity in the quarter, as it quickened pace to 3.8%yoy from 2.8%yoy in the preceding quarter. Meanwhile, spending on supplies and services caused government consumption to revert from contraction (-4.2%yoy) in 2016Q4 to expansion (+7.5%yoy) at the start of 2017.

Capital formation, esp. by the private sector, appears to be bottoming out in line with improving sentiment



Source: CEIC and Deutsche Bank

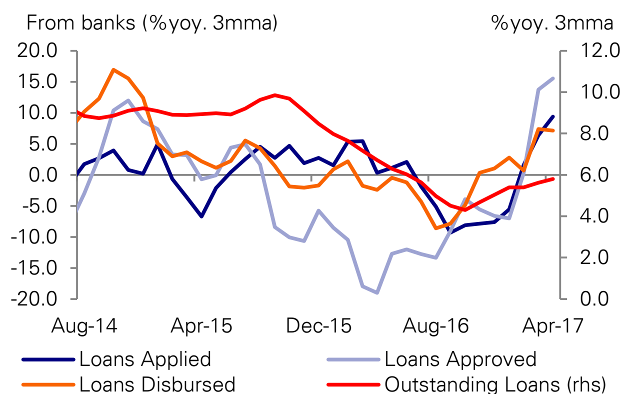
And as in the past, private consumption continued to be the primary driver, contributing over 60% of growth (i.e., 3.6ppts out of 5.6%yoy in Q1). Consumer spending gained pace in Q1, up 6.6%yoy from 6.1%yoy in 2016Q4, particularly on demand for food-related products and motor vehicles. Buoyant spending can be explained by sustained increases in employment and wages, allowing Malaysia to reap the remaining few years of its demographic dividend, as well as by supportive government measures, such as the increase in cash transfers to low-income households this year.

It is notable that private consumption started to advance towards the end of last year, when it began to grow 2.0%qoq(sa) in Q4 and 2.8%qoq(sa) in 2017Q1 and after slowing down to 1%qoq(sa) or less in the first half of 2016. This could have related to a steady decline in the unemployment rate, which after peaking at 3.6% (seasonally adjusted) in November, fell to 3.3% in March on the back of a stronger pace in jobs creation, particularly in the manufacturing sector (17% of total employment). Meanwhile, consumer sentiment remains weak and is still below the optimism threshold, as is

evident in modest increments in core inflation. But sentiment has likewise exhibited a modest turnaround such that we think this pick-up in the pace of consumer spending may be sustained for the rest of the year, especially as the recovery in global demand, albeit cooling as the base effect on crude oil prices dissipates, carries on.

Recent loan dynamics also bode well for domestic demand, especially in the private sector. In line with the pick-up in business and consumer sentiment, loans applications, approvals and disbursements have bounced back after gaining momentum in late 2016. Loan approvals were up 15%yoy (3mma) in April, led by lending towards both households and corporates, against -3%yoy in January, suggesting buoyant domestic activity in the near term.

Bank loan dynamics bodes well for domestic demand



Source: CEIC and Deutsche Bank

Against these favorable developments, we are revising our 2017 GDP growth outlook 30bps higher to 4.8%, while keeping our 2018 outlook intact at 4.7%. This implies that growth could ease past Q1 – that is, given the strength in government disbursements early in the year, a pullback in succeeding quarters is likely in order to meet the government's self-imposed deficit target. Nonetheless, we think a sustained exports rebound and the bottoming out of private sector demand could support growth of about 4.5%yoy for the rest of 2017 and through 2018. Meanwhile, core inflation has been subdued, in line with the early-stage recovery of domestic demand, and thus, is unlikely to prompt near-term rate hikes by Bank Negara.

Downside risks to the outlook stem from exports cooling due to a slowdown in China and perhaps the US economy, given the recent disappointment in jobs market data. Conversely, a slower pace of Fed policy normalization may cause the MYR, already up 5% against the USD to date, to strengthen further.

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Malaysia: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	296.5	297.1	307.0	326.5
Population (mn)	31.2	31.7	32.1	32.6
GDP per capita (USD)	9,509	9,382	9,551	10,006
Real GDP (YoY%)	5.0	4.2	4.8	4.7
Private consumption	6.0	6.0	6.7	5.6
Government consumption	4.4	0.9	6.9	1.0
Gross fixed investment	3.6	2.7	8.1	4.9
Exports	0.3	1.1	11.9	7.9
Imports	0.8	1.1	16.2	8.4
Prices, Money and Banking (YoY%)				
CPI (eop)	2.7	1.8	3.6	3.0
CPI (ann avg)	2.1	2.1	4.2	2.7
Broad money (eop)	2.6	3.1	5.4	6.4
Private credit (eop)	8.4	5.7	5.0	6.4
Fiscal Accounts (% of GDP)				
Central government surplus	-3.2	-3.1	-3.0	-2.9
Government revenue	18.9	17.3	17.0	17.2
Government expenditure	22.1	20.4	20.0	20.1
Primary balance	-1.1	-1.0	-0.8	-0.6
External Accounts (USD bn)				
Goods exports	174.5	165.7	192.8	202.9
Goods imports	146.5	141.2	171.0	179.7
Trade balance	28.0	24.5	21.8	23.2
% of GDP	9.4	8.2	7.1	7.1
Current account balance	9.0	7.0	5.0	7.1
% of GDP	3.0	2.4	1.6	2.2
FDI (net)	-0.5	3.4	4.3	4.5
FX reserves (eop)	95.3	94.5	98.2	98.0
MYR/USD (eop)	4.29	4.49	4.40	4.50
Debt Indicators (% of GDP)				
Government debt[1]	69.8	67.9	68.3	68.4
Domestic	52.8	50.6	50.7	50.7
External	17.1	17.3	17.6	17.7
Total external debt	65.8	68.7	69.2	71.2
in USD bn	195.0	204.2	212.4	232.5
Short-term (% of total)	42.0	41.8	42.6	41.2
General (ann. avg)				
Industrial production (YoY%)	4.7	3.8	4.4	4.5
Unemployment (%)	3.2	3.5	3.4	3.3
Financial Markets (%, eop)	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
Overnight call rate	3.00	3.00	3.00	3.25
3-month interbank rate	3.39	3.43	3.43	3.68
10-year yield	3.87	4.10	4.20	4.30
MYR/USD	4.27	4.34	4.40	4.43

(1) Includes government guarantees
Source: CEIC, DB Global Markets Research, National Sources

Philippines

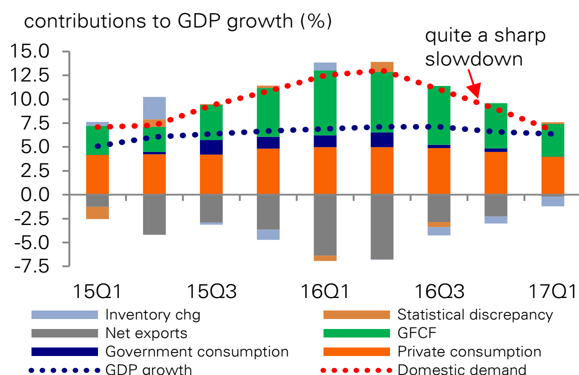
Baa3(Pos)/BBB-/BBB-
Moody's/S&P/Fitch

- Economic outlook: We expect the modest growth slowdown in Q1 to continue as the economy returns to normal after last year's elections.
- Main risks: Declining inflation momentum alongside fresh downside risks to growth from the spate of attacks within and outside the country, as well as from Qatar's diplomatic crisis, could prompt the BSP to delay rate hikes.

A delay in BSP lift-off?

Moving past the stimulus from last year's elections, which brought growth to 7.1%yoy at the peak, the Philippine economy slowed to a 6.4%yoy rate in 2017Q1. The slowdown is by no means alarming, as the Philippines remains one of the fastest growing economies globally, but it highlights the importance of a timely, accelerated government spending program to counter downside risks and guide annual growth towards the government's 7-8% medium-term target. As envisioned under the Philippine Development Plan 2017-2022, achieving the annual target will promote the Philippines from lower to upper middle-income status by 2022, with a per-capita income of USD5000, compared with less than USD3000 currently.

Domestic demand expansion has slowed quite sharply



Source: CEIC and Deutsche Bank

The growth slowdown last quarter was due to a weaker pace of domestic demand, as the drag from net exports eased. This in fact is typical post-elections, as economic activity goes back to normal conditions. But the pace of domestic demand has actually slowed quite sharply; from a peak of 13%yoy in mid-2016, it steadily eased to 6.8%yoy in 2017Q1, the slowest in nine quarters. In fact, comparing the three-quarter average before and after the May 2016 elections, we find that domestic demand slowed more sharply after than it gained pace approaching the elections (8.9%yoy vs. 10.9%yoy).

Deceleration in durable equipment purchases and weaker consumer spending are primarily behind the slowdown in domestic demand. Acquisition of durable equipment decelerated to growth of 12.5%yoy in Q1 from 26.3%yoy in the preceding quarter, causing its contribution to GDP growth to drop 1.3ppt to 2.2ppt. Private consumption also slowed, expanding only 5.7%yoy in the quarter after growing 6.2%yoy previously. Sequentially, spending actually gained pace, although just not as strong as it did a year ago during the election campaign season. As a result, the contribution of private consumption to the 6.4% GDP growth fell 0.5ppt to 4ppt.

Government spending also had something to do with the domestic demand slowdown. Government consumption pulled down GDP growth by 0.4ppt in Q1 as its growth fell to 0.2%yoy from 4.5%yoy in the previous quarter. But public construction decelerated even more sharply to 2.0%yoy, against 19.2%yoy in the quarter earlier, pulling down GDP growth by 0.3ppt (thanks to acceleration in private sector activity, overall construction sustained nearly 10%yoy growth for another quarter). Weak government spending could have also contributed to the deceleration in durable equipment purchases.

In fact, the government's spending rate in the first four months of 2017, at 23.8% of the budget, is the lowest in five years. But this could improve from here on, given that the Department of Budget and Management reportedly released 82.1% of the budget in May.

Amid fresh headwinds from the spate of attacks both domestically and globally, and Qatar's diplomatic crisis, it is important for the government to be able to deliver timely and strategic countercyclical fiscal policies. The time to act is now – the government just needs to deliver on its loose fiscal stance. And it will have to expedite the execution of quality infrastructure projects that stand to attract private sector investments and generate sufficient domestic employment.

As domestic demand normalization after the elections continues, we see growth easing through the rest of the year to average 6.2% in 2017. As we wrote in *Martial law in Mindanao, and then what?* (25 May), the Marawi crisis and martial law declaration in Mindanao may have only a limited impact on economic growth, primarily via weaker tourism and investment sentiment amid security concerns.

A bigger near-term concern to us is the potential downside impact on spending from the recent wave of attacks within and outside the country. To ensure safety, people may refrain from travel and hanging out in public spaces such as malls and restaurants. This would hurt consumer spending, particularly in countries where e-commerce is just at an early stage of development, such as the Philippines.

Meanwhile, we regard Qatar's diplomatic crisis as a medium-term concern for the Philippine economy. Following the decision of Saudi Arabia, the UAE, and five other countries to sever ties with Qatar, the Philippine government has temporarily halted the deployment of Filipinos to Qatar (at least 100,000 annually) amid fears that the blockade could lead to food shortages and riots, as Qatar's food requirements are largely sourced from its bigger neighboring countries, such as the UAE and Saudi Arabia. The deployment ban, and even an increasing number of returning Filipino workers going forward, could hurt spending, given the Philippine economy's reliance on remittances and that about 4% of the total is sourced from Qatar. But we think the impact will likely have a lagged effect of six months or more, as returning workers (especially the higher-skilled) are likely to tap into their savings while those hit by the ban are currently not contributing to remittance inflows anyway.

These headwinds alongside the decline in inflation in May, could give the BSP room to delay rate hikes (say, for another month), a key risk to our August call. But provided that growth remains buoyant and inflation elevated (i.e. above 3%), we are still keen to believe that the BSP will hike the policy rate at least once in the latter half of the year to guard against the demand-induced inflationary impact of the tax reform, of which the first package would involve substantial cuts in personal income tax rates.

Lastly, the odds of the first package of tax reform being implemented in January 2018 have increased after the bill cleared the lower house on 1 June. The passage of the first package, likely in October, would send a positive signal of the government's ability to deliver sustainable economic reforms. The latest version of the bill, albeit slightly diluted (DOF estimates revenues of PHP130bn in year 1 against PHP162bn – 1% of GDP – in the earlier version), stands to help finance the government's medium-term spending program. Provided that revenues come as projected, government debt as a share of GDP may rise only marginally over the medium term (see Tax reform delay – weighing the risks, 11 April 2017, for a worst-case scenario).

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Philippines: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	292.8	304.9	**308.0**	**328.1**
Population (mn)	101.0	102.6	104.1	105.4
GDP per capita (USD)	2,899	2,971	**2,959**	**3,113**
Real GDP (YoY%)	6.1	6.9	6.2	6.5
Private consumption	6.3	7.0	**5.5**	**5.8**
Government consumption	7.6	8.4	**1.5**	**9.1**
Gross fixed investment	16.9	25.2	**9.7**	**13.4**
Exports	8.5	10.7	**16.6**	**10.0**
Imports	14.6	18.5	**14.4**	**12.7**
Prices, Money and Banking (YoY%)				
CPI (eop)	1.5	2.6	3.0	**3.3**
CPI (ann avg)	1.4	1.8	**3.2**	3.3
Broad money (M3, eop)	9.4	12.8	**12.8**	**11.5**
Private credit (eop)	12.1	16.6	14.4	13.3
Fiscal Accounts (% of GDP)[1]				
Fiscal balance	-0.9	-2.4	-3.0	-3.0
Government revenue	15.8	15.2	15.6	17.1
Government expenditure	16.8	17.6	18.6	20.1
Primary surplus	1.4	-0.3	-0.9	-1.0
External Accounts (USD bn)				
Goods exports	43.2	43.4	51.1	56.7
Goods imports	66.5	77.5	88.3	98.9
Trade balance	-23.3	-34.1	-37.1	-42.2
% of GDP	-8.0	-11.2	-12.1	-12.9
Current account balance	7.3	0.6	-0.2	-3.9
% of GDP	2.5	0.2	-0.1	-1.2
FDI (net)	0.1	4.2	4.6	5.3
FX reserves (eop)	80.7	80.7	79.2	76.6
PHP/USD (eop)	47.2	49.8	**51.2**	**52.0**
Debt Indicators (% of GDP)				
General government debt[2]	48.8	45.6	46.3	46.0
Domestic	31.0	28.8	30.1	29.3
External	17.8	16.8	16.2	16.7
External debt	26.5	25.1	**25.5**	**24.2**
in USD bn	77.5	76.6	78.6	79.3
Short-term (% of total)	19.5	18.4	19.7	19.5
General (ann. Avg)				
Industrial production (YoY%)	2.5	**14.8**	**8.5**	**7.0**
Unemployment (%)	6.3	5.7	**6.4**	**6.0**
Financial Markets (%, eop)	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
Policy rate (BSP o/n repo)	3.50	3.75	4.00	4.00
Policy rate (BSP o/n rev repo)	3.00	3.25	3.50	3.50
3-month T-bill rate	2.18	2.53	2.78	2.93
10-year yield (%)	4.40	4.65	4.75	4.90
PHP/USD	49.8	50.5	51.2	51.0

(1) Refers to general government. (2) Includes guarantees on SOE debt.
Source: CEIC, Deutsche Bank forecasts, national sources

Singapore

Aaa/AAA/AAA
Moody’s/S&P/Fitch

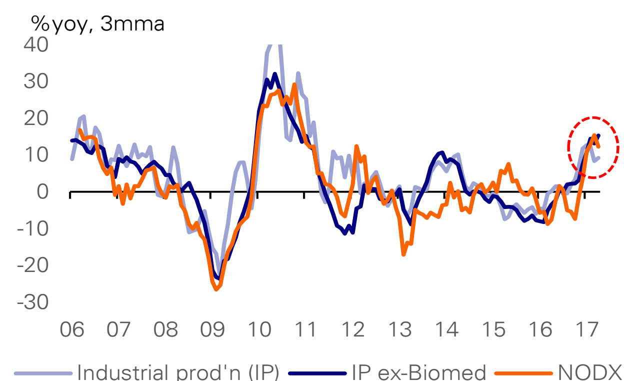
- Economic outlook: After the soft patch in Q1, growth could again decline in the current quarter because of a low base on imports. But as key export segments other than biomedical manufacturing continue to hold up, a turnaround is likely in the second half for growth to average 2.5% this year, up 50bps from 2016.
- Main risks: A slowdown in China, given the decline in broad credit growth, and in the US, given the recent disappointment in the labor data, could disrupt the buoyant growth outlook for Singapore.

Hold your horses

It is easy to lose hope on Singapore’s cyclical turnaround given the downside surprises on the data over the past month. Hold your horses, as the underlying data continue to support improving macro fundamentals.

Yes, the city-state’s economy contracted 0.3%qoq(sa) at the start of the year after expanding 2.9%qoq(sa) in the preceding quarter, paring off 20bps in its annual growth to 2.7%yoy (after having been revised 20bps higher from the advance estimate). Per our estimates, growth could continue to decline in the current quarter, pulled down by a low base on imports. However, it could again turn around in the second half, to record an average growth of 2.5% for 2017, a 50bp improvement from last year. The MAS, in its June report, also shares the view of above-2% growth this year, barring the realization of downside risks. We believe this development could pave for a modest monetary policy tightening in October.

Soft prints in April are unlikely to disrupt Singapore’s buoyant growth outlook, in our view

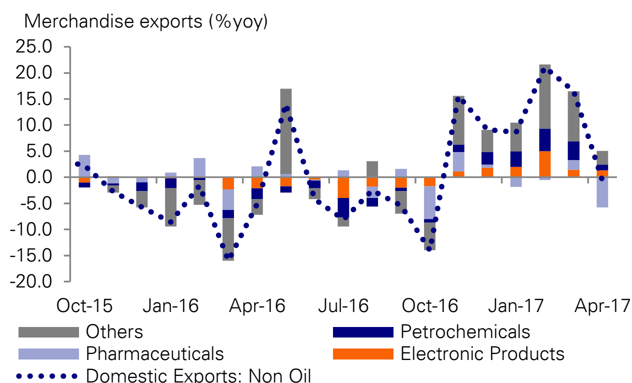


Source: CEIC and Deutsche Bank (NODX = non-oil domestic exports)

Our optimism derives from the details. Year-on-year growth moderated last quarter as manufacturing output slowed to 8.0%yoy from 11.5%yoy in the preceding quarter. Construction, on the other hand, continued to decline but to a lesser degree (-1.4%yoy vs. -2.8%yoy). Looking beneath the data, it was the contraction of biomedical manufacturing output, a reversal from expansion in the preceding quarter, and a segment that tends be volatile, that drove the slowdown in the manufacturing sector. Other important segments such as electronics, chemicals, and precision engineering actually accelerated in the first quarter. Meanwhile, transport engineering and general manufacturing industries saw another quarter of contraction, but to a lesser extent compared to the preceding period. These suggest that the underlying support to the economy remains evident, and even strengthened last quarter.

Many of the first batch of Q2 indicators are out. And at first glance, some are also worrisome. Industrial production decelerated from 11.0%yoy in March to 6.7%yoy in April. However, excluding biomedical manufacturing, industrial output gained pace to grow 15.5%yoy in April from 13.5%yoy in March. Note that while electronics accelerated and precision engineering sustained about the same growth, chemicals actually reverted to contraction while general manufacturing dropped more sharply. We will have to watch out for a few more data points to revisit our view.

April was likely a blip for exports, as segments such as electronics continued to hold up



Source: CEIC and Deutsche Bank

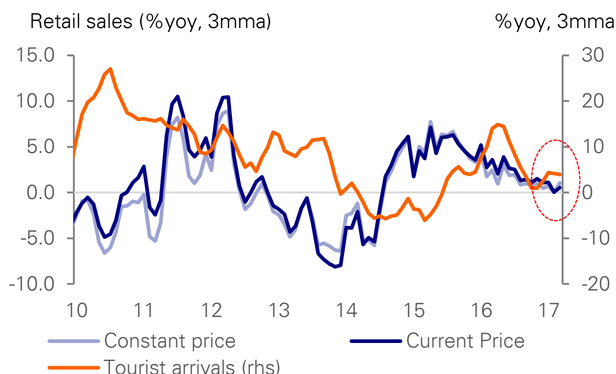
The exports print in April also aroused concerns over Singapore’s near-term economic prospects. Non-oil domestic exports fell 0.7%yoy in April after expanding on double-digit rates two months earlier. The downturn was again largely due to the sharp drop in

pharmaceutical shipments, while exports of electronics, petrochemicals, and others recorded weaker but arguably healthier rates of expansion of at least 5%yoy.

Likewise, PMI prints from two different survey bodies showed slight declines in April and May, but nonetheless continued to indicate an expanding manufacturing sector. Meanwhile, credit growth further inched higher in April, after bottoming out in late 2015.

On the domestic front, the condition is dull. Annual growth in retail sales had been on a decline since mid-2015 in line with the slump in global trade. But it may have already reached a trough in February, finally turning around, albeit slowly, after a couple months of rebounds in exports and sustained increases in credit growth. Wage growth has also been elevated in Singapore, settling between 3-4%yoy in the past two years before dropping to 1.9%yoy in Q1, while further growth in tourist arrivals, which were up 4.0%yoy in Q1 against 2.5%yoy in 2016Q4, could also provide support to the retail segment. However, a skills mismatch in line with the ongoing economic transition is likely to place upward pressure on the unemployment rate and consequently weigh on consumer sentiment. As such, we expect only a modest turnaround in retail sales, to growth of about 5%yoy on average this year.

The slowdown in retail sales may have already reached a trough, in part supported by faster tourist arrivals.



Source: CEIC and Deutsche Bank

Meanwhile, the construction sector remains in contraction. However, the plan to bring forward public infrastructure projects could help ease the drag of the sector on economic growth going forward. The acceleration in contracts awarded to the private sector in recent quarters also bodes well for the sector. Given the acceleration in residential property transactions, we do not see the need for the MAS to relax property cooling measures in the near-term despite the 12% drop in prices from the peak in 2013.

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Singapore: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	296.8	297.0	303.3	322.3
Population (mn)	5.5	5.6	5.7	5.8
GDP per capita (USD)	53,629	52,961	53,242	55,625
Real GDP (YoY %)	1.9	2.0	2.5	3.0
Private consumption	4.6	0.6	1.4	2.8
Government consumption	8.0	6.3	4.5	4.3
Gross fixed investment	1.1	-2.5	0.1	4.8
Exports	2.6	1.6	5.7	4.4
Imports	2.9	0.3	5.9	4.9
Prices, Money and Banking				
CPI (YoY%) eop	-0.6	0.2	1.1	2.5
CPI (YoY%) ann. avg	-0.5	-0.5	0.9	2.1
Broad money (M2, eop)	1.5	8.0	5.2	4.9
Bank credit (eop)	2.5	5.5	7.1	8.1
Fiscal Accounts (% of GDP)[1]				
Fiscal balance	-1.0	1.3	0.4	1.2
Government revenue	18.1	20.1	19.7	19.3
Government expenditure	19.1	18.8	19.2	18.1
External Accounts (USD bn)				
Merchandise exports	379.7	361.7	387.0	414.1
Merchandise imports	296.9	278.8	296.8	315.9
Trade balance	82.9	82.9	90.3	98.2
% of GDP	27.9	27.9	30.1	31.0
Current account balance	53.7	56.7	63.1	67.7
% of GDP	18.1	19.1	21.0	21.4
FDI (net)	39.0	37.7	15.0	10.0
FX reserves (USD bn)	247.7	246.6	245.9	246.6
FX rate (eop) SGD/USD	1.41	1.45	1.41	1.38
Debt Indicators (% of GDP)				
Government debt	103.2	112.9	117.8	121.7
Domestic	103.2	112.9	117.8	121.7
External	0.0	0.0	0.0	0.0
Total external debt[2]	444	452	451	443
in USD bn	1,281	1,284	1,339	1,402
Short-term (% of total)	62.6	61.7	64.1	63.9
General				
Industrial production (%YoY)	-5.7	1.3	8.7	7.2
Unemployment (%) (eop)	1.9	2.1	2.2	2.2

Financial Markets	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
3-month interbank rate	1.00	1.04	1.08	1.14
10-year yield (%)	2.06	2.30	2.45	2.60
SGD/USD	1.38	1.40	1.41	1.39

(1) Fiscal year ending March of the following year; (2) Includes external liabilities of ACU banks.
Source: CEIC, DB Global Markets Research, National Sources

South Korea

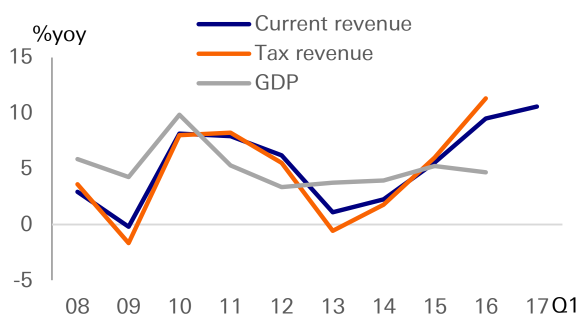
Aa3/A+/AA-
Moody's/S&P/Fitch

- Economic outlook: The government has proposed a KRW11.2tn extra budget, as expected, to be financed by larger-than-expected tax revenue, with a view to boosting 2017 GDP growth by 0.2ppts.
- Main risks: With much of the extra spending dedicated to job creation and welfare services, it hints at a permanent increase in current spending.

Prioritizing job creation

Seeking a supplementary budget to create more public jobs, without needing additional financing… The new administration under President Moon has proposed KRW11.2tn in extra spending for 2H. In line with our view, the government expects to fully finance this extra budget with better-than-expected tax revenue (KRW8.8tn), government surplus (KRW1.1tn) and national funds surplus (KRW1.3tn). Recall that tax revenue also surprised to the upside last year, fully financing that year's extra budget. As far as spending details are concerned, much of the extra budget (about KRW4.2tn) will be spent on directly creating jobs; KRW1.2tn, largely to provide financial allowances to promote women and youth employment; KRW2.3tn, to improve the livelihood of working class (increase dementia care centers and special hospitals, expand benefits to the old and disabled, and install fine dust monitors at schools); and, KRW3.5tn will be allocated to local governments (for education, for example). Together with a strong Q1 GDP growth, we see this fiscal stimulus boosting this year's GDP growth to 2.8%.

Surge in tax revenue



Sources: CEIC, Deutsche Bank

While a supplementary budget is nothing new to Korea – this would be its sixth supplementary budget since the GFC (2008) – it hints at a permanent increase in current government spending, as much of it is dedicated to job creation and welfare services, which may not be rolled back at a later date. Given such spending focus, the opposition parties may find it difficult to reject the supplementary budget, despite potential negative effects on Korea's fiscal health over time. Assuming that the budget gets passed, it is likely to prompt the government to propose about a 5% rise in spending for 2018, vs. the preliminary plan of a 3.5% increase. In the absence of unexpected economic shocks, we do not expect the government to propose a 7% rise in the 2018 budget, as President Moon campaigned earlier, given that the ruling Democratic Party of Korea does not have enough votes (180 required) to push the budget through the National Assembly without support from other parties. Also, recall Korea's history of fiscal discipline. (See our *Special Report: Korea's challenge to fiscal stimulus*, published on 29 November 2016, for details.)

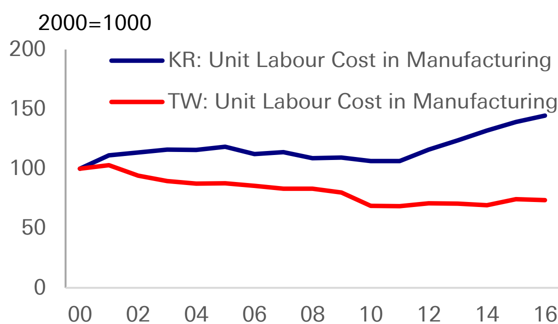
A 5% rise in spending in 2018 is unlikely to lead to a meaningful rise in government debt, given the economic recovery – we expect Korea's nominal GDP growth to hover around 5% in 2018, barring external shocks. The robust rise in Korea's corporate profits in Q1 hint at sustained strong growth in tax revenue next year. If the new administration seeks to keep its medium-term spending growth at 5%, however, the government would need to find the means to raise tax revenue in the medium-term, to keep government debt in check. In fact, the government is mulling over increasing taxes on corporates and the rich. Only last year, the National Assembly agreed to yet another (its top sixth) income bracket, KRW500mn or more, and impose a higher tax rate of 40%. We expect the government to be cautious on the property tax front, given the economy's dependence on construction growth at the moment. The government also has the difficult task of reining in household credit growth, by reconsidering the LTV/DTI ratios, for example.

…seeking means to narrow the income gap… The government is also seeking to narrow the income gap by promoting conversion of temporary workers to permanent ones. According to data from the Ministry of Employment and Labour, permanent wage workers earned about 2.5 times more than non-permanent wage workers in 2015. Even when comparing workers with the same types of jobs, a similar level of education, work experience, etc., there is at least a 10% wage gap between regular and non-regular wage workers. Having said that, however, although Korea still has a relatively large share of non-permanent workers, their share of total employment has declined steadily, falling to 25% in 2016 from 33% in 2006. (See *Special Report: South Korea: Labour Challenge*, 19 July 2016.) The government is also considering the imposition of penalties on large corporations (over 300 employees)

for hiring an "excessive" number of temporary workers, to promote permanent employment. The previous administration also promoted permanent jobs but by providing financial subsidies.

Other than reducing the work hours, the government also seeks to hike Korea's minimum wage to KRW10,000 from KRW6,470, raising concerns on the part of SMES that reply on cheap labour. To reach such a level by 2022, it would need to rise by 9% annually. This would certainly exceed the 6% rise reported from 2009 to 2017, vs. the 3.8% increase reported for average wages. Note that Korea's minimum wage stood higher than Japan's (when accounting for its progressive tax and social contribution policies) and better than half of the 27 OECD members surveyed in 2013. However, there is an issue of adherence to rules and structural nature of Korea's labour market. The share of workers earning minimum wage or lower stood high at around 30% in 2013, according to the Korea Labour & Society Institute.

Korea's labour cost rising fast, while Taiwan's falling



Sources: CEIC, Deutsche Bank

Financial penalties and minimum wage hikes needs to be carefully considered, as it raises input costs on Korean firms, rendering them less competitive against their foreign peers. Already, Korea's manufacturing ULC stood far higher in 2016 vs. 2000, while Taiwan's fell. While we also see the need to reduce the income gap, we think it is critical to enhance Korea's labour productivity. With Korea's labour market facing competitive challenges from abroad, its internal rigidities must be addressed. There is also much to be done to improve Korea's economic dynamism by reform and deregulation. It was during the Kim DJ administration that Korea benefited from sweeping reform and deregulation, albeit prompted by a crisis, and built the foundation for its ICT boom. Such a grand policy by the new administration is required to support the 4th industrial revolution in Korea.

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South Korea: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USDbn)	1,384	1,412	1,477	1,496
Population (m)	50.6	50.8	51.0	51.1
GDP per capita (USD)	27,332	27,786	28,976	29,259
Real GDP (yoy %)	2.8	2.8	2.8	2.6
Private consumption	2.2	2.5	1.9	2.3
Government consumption	3.0	4.3	3.1	4.6
Gross fixed investment	5.1	5.2	7.7	1.3
Exports	-0.1	2.1	4.2	4.3
Imports	2.1	4.5	7.4	3.8
Prices, money and banking				
CPI (yoy %) eop	1.1	1.3	2.1	2.7
CPI (yoy %) ann. Avg.	0.7	1.0	2.2	2.3
Broad money (Lf)	8.9	7.8	7.5	7.8
Bank credit (yoy %)	9.5	8.5	7.5	7.5
Fiscal accounts (% of GDP)				
Central government surplus	0.0	1.0	0.4	0.1
Government revenue	21.7	22.7	22.6	22.3
Government expenditure	21.7	21.6	22.2	22.2
Primary surplus	1.2	2.3	2.1	2.3
External accounts (USDbn)				
Merchandise exports	542.9	511.8	545.0	566.8
Merchandise imports	420.6	391.3	445.2	472.8
Trade balance	122.3	120.4	99.8	93.9
% of GDP	8.8	8.5	6.8	6.3
Current account balance	105.9	98.7	68.6	62.8
% of GDP	7.7	7.0	4.6	4.2
FDI (net)	-19.7	-16.4	-17.0	-17.0
FX reserves (USDbn) [1]	368.0	371.1	381.2	378.9
FX rate (eop) KRW/USD	1,172	1,209	1,200	1,190
Debt indicators (% of GDP)				
Government debt[2]	37.3	37.6	37.8	38.3
Domestic	36.8	37.1	37.3	37.9
External	0.5	0.5	0.4	0.4
Total external debt	28.6	27.0	25.0	25.5
in USDbn	396.1	380.9	370.0	360.0
Short-term (% of total)	26.3	27.6	27.8	27.8
General				
Industrial production (yoy %)	-0.6	1.1	2.5	2.0
Unemployment (%)	3.6	3.7	3.8	3.8
Financial markets	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
BoK base rate	1.25	1.25	1.25	1.25
91-day CD	1.38	1.48	1.50	1.48
10-year yield (%)	2.18	2.35	2.60	2.70
KRW/USD	1121	1,190	1,200	1,210

Source: CEIC, Deutsche Bank estimates, Global Markets Research, National Sources
Note: (1) FX swap funds unaccounted for, (2) Includes government guarantees

Sri Lanka

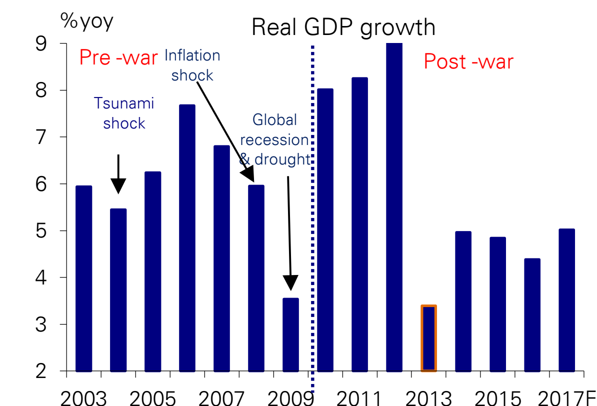
B1(stable)/B+/BB-
Moody's/S&P/Fitch

- Economic outlook: Downside risks to growth have increased given the recent severe flooding; headline CPI inflation is moderating but food inflation remains high.
- Main risks: Fiscal consolidation targets may become even more difficult to achieve, if growth turns out to be lower than anticipated, which could in turn impact the external outlook adversely.

Weather plays spoilsport

The Sri Lankan economy will be affected by the recent severe flooding which has affected more than 650,000 people. Apart from the social cost, there is likely to be significant economic cost, which is difficult to estimate at this stage. The worrying part is that even before the flooding, growth remained weak and below potential, and the recent flooding incident therefore clearly increases the downside risks to growth (our estimate is 5.0% real GDP growth for 2017). However, this is not the first time that the Sri Lankan economy has been affected due to weather related disruptions. Sri Lanka was hit by a tsunami in 2004 and then a severe drought in 2009, and in recent times the country has faced severe flooding in 2016. Past evidences have shown that the economy is generally resilient to weather related disruptions and bounces back gradually in subsequent years, helped by policy support. However, this time growth may remain weak for a longer period, given that the economy is going through a macro adjustment process, supported by both monetary and fiscal tightening.

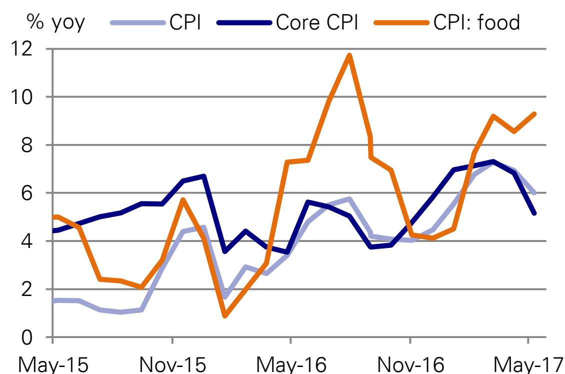
Sri Lanka's growth remains below normal; downside risks have increased post the recent flooding



Source: CBSL, CEIC, Deutsche Bank

CPI inflation eased to 6.0%yoy in May'17, from 6.9% and 7.3% in the previous two months, with core inflation also moderating to 5.2%. However, food inflation remained high and firmed further to 9.3%yoy in May, from 8.6% in April. We note that following severe flooding in May last year, food prices had gone up +5.0%mom in June'16 and +2.3%mom in July'16. We fear that the same trend might follow through in June and July of this year as well, which is likely to keep food price inflation elevated. As per our current estimate, we expect CPI inflation to average 6.0% in 2017, 200bps higher than the 2016 outturn.

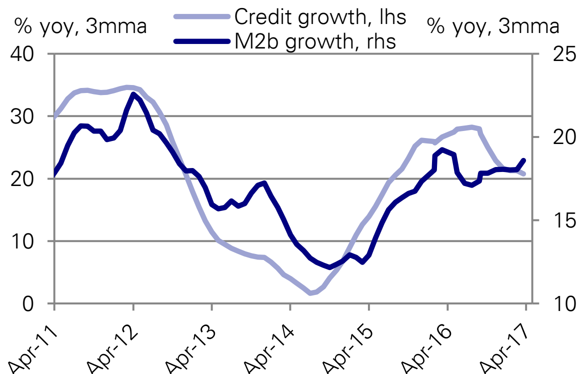
Food inflation remains high; headline CPI and core CPI inflation are moderating



Source: CBSL, CEIC, Deutsche Bank

In our baseline estimate, we have one more rate hike of 25bps factored in for September. The next few months will be crucial to evaluate the changes in the growth-inflation dynamic as well as the trend in credit and money supply growth. Despite rate hikes from the CBSL, broad money supply growth (M2b) has increased to 20.1%yoy in April, from 17.7%yoy in Jan'17 and continues to be significantly higher than the nominal GDP growth. Credit growth has moderated somewhat, but only modestly. As on end-March'17 credit growth was 20.4%yoy, a tad lower than the 20.9%yoy growth recorded in the beginning of the year. In our view, an economy with 10-11% nominal GDP growth should not have money supply and private sector credit growing at 20%yoy. Therefore some more monetary tightening may be required with the objective of pushing growth rate of money indicators lower. A rate hike would also help enhance the central bank's credibility of maintaining a low inflation environment, which indirectly should bode well for foreign investment flows and the rupee.

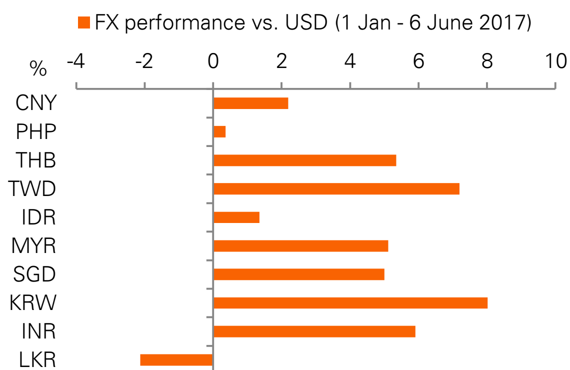
Money supply and credit growth have not moderated sufficiently thus far



Source: CBSL, CEIC, Deutsche Bank

The Sri Lankan rupee has depreciated about 2% in 2017 so far, when all other Asian currencies have appreciated against the USD. With headline FX reserves remaining uncomfortably low and primarily supported through borrowed financial assistance, it is imperative for the CBSL to actively engage in augmenting FX reserves. Indeed, latest data show that the central bank has net purchased USD257.9mn from the FX market in April 2017 (with no sales) to prevent any potential appreciation of the rupee. We expect the CBSL to remain a net purchaser of USD for the foreseeable future, until the central bank derives comfort from its reserves adequacy strength. With this view, we forecast LKR/USD to touch 155 by the end of this year and depreciate further to 159 by the end of 2018.

Year to date FX performance vs. USD



Source: Bloomberg Finance LP, Deutsche Bank. Note: Negative sign denotes depreciation against the USD

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Sri Lanka: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	80.3	80.7	85.1	91.6
Population (mn)	20.8	21.0	21.1	21.3
GDP per capita (USD)	3857	3849	4024	4298
Real GDP (YoY %)	4.8	4.4	5.0	5.5
Total consumption	8.8	0.9	3.7	4.3
Total investment	1.2	18.1	8.0	8.5
Exports	4.7	-0.7	4.0	5.0
Imports	10.6	7.9	5.0	6.0
Prices, Money and Banking				
CPI (YoY%) eop	4.6	4.5	4.9	4.5
CPI (YoY%) avg	2.2	4.0	6.0	4.5
Broad money (M2b) eop	17.8	18.4	15.5	16.0
Bank credit (YoY%) eop	25.1	21.9	13.0	16.0
Fiscal Accounts (% of GDP)				
Central government balance	-7.4	-5.5	-5.0	-4.5
Government revenue	13.5	13.0	14.0	14.5
Government expenditure	21.0	18.5	19.0	19.0
Primary balance	-2.7	-0.8	-0.3	-0.3
External Accounts (USD bn)				
Merchandise exports	10.5	10.3	10.7	11.3
Merchandise imports	18.9	19.4	20.6	21.8
Trade balance	-8.4	-9.1	-9.8	-10.5
% of GDP	-10.5	-11.3	-11.6	-11.5
Current account balance	-1.9	-1.9	-2.3	-2.5
% of GDP	-2.3	-2.4	-2.7	-2.7
FDI (net)	0.7	0.9	0.9	1.0
FX reserves (USD bn)	7.3	6.0	7.5	9.0
FX rate (eop) LKR/USD	144.2	149.7	155.0	159.0
Debt Indicators (% of GDP)				
Government debt	77.6	78.5	77.9	76.4
Domestic	45.3	46.3	45.2	43.5
External	32.4	32.2	32.7	32.9
Total external debt	55.8	57.1	58.6	59.8
in USD bn	44.8	46.1	49.8	54.8
Short-term (% of total)	16.9	17.1	16.4	15.5
General				
Unemployment (%)	4.5	4.5	4.5	4.5
Financial Markets	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
Reverse Repo rate	8.75	9.00	9.00	9.00
LKR/USD	152.6	154.0	155.0	156.0

Source: CEIC, DB Global Markets Research, National Sources

Taiwan

Aa3/AA-/A+
Moody's/S&P/Fitch

- Economic outlook: Despite stronger growth and tighter labour market conditions, wage increase remains elusive in Taiwan, limiting consumption growth.
- Main risks: Taiwan would see a precipitous fall in growth if the US and/or China turn to broad-based punitive trade measures.

Wage challenge

Stronger GDP growth point to tighter labour market conditions… Taiwan's Q1 GDP growth was 0.2ppts stronger than its first estimate, at 0.9% qoq sa, up from 0.4% (revised down from 0.5%) in 4Q16. On a yoy basis, high base effects guided Taiwan's GDP growth slightly lower, to 2.6% (unchanged) in 1Q17 from 2.8% (2.9%) in 4Q16. As expected, with 1Q growth coming in better than its own forecast, the DGBAS raised its 2017 growth forecast by 0.2ppts to 2.1% when it released the final 1Q GDP report late last month. While we expect growth to moderate ahead, we also see the slowdown to be limited, reflecting the trend in exports. The latter likely peaked in April, with growth slowing to 10.3%yoy 3mma in May from 16.7% in April.

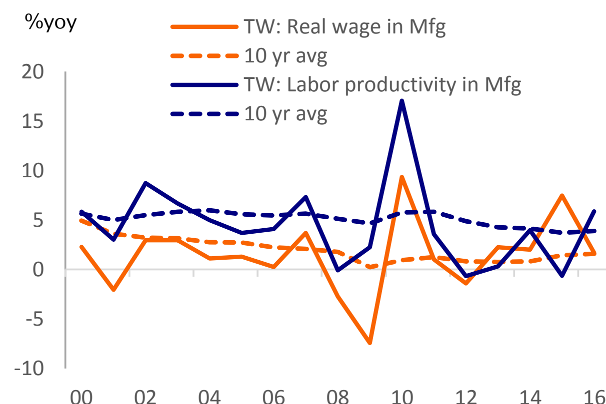
Tightening labour market

Sources: CEIC, Deutsche Bank

Meanwhile, employment growth continued to accelerate, to 0.7% yoy 3mma in April 2017 after bottoming at 0.56% in September 2016, guiding Taiwan's unemployment rate lower to 3.67% from 4% during the same period, its lowest almost two years ago. Chinapost cited the DGBAS, noting that the "Taiwan workforce shortage was more than 230K at the end of February, with the job vacancy rate at 3%, as the economy conditions recovered." Having said that, however, Taiwan's labour participation rate stood relatively low, at 58.7% in April vs. its peers. Korea's, for example, stood at 63.5% in April. According to the manpower survey, "housekeeping" was the leading reason (over a third) for not participating in the labour force, followed by old age (about a third). Like Japan and Korea, Taiwan also needs to adopt policies to narrow the gender gap in its labour market. The labour participation rate for women, for example, stood low at around 51% vs. men's 67% and the OECD average of 63% for women. Meanwhile, about a quarter of potential workers did not participate due to schooling.

…but wage growth remains elusive… There is also the issue of wage growth. Survey results published by the Ministry of Labour (cited by Chinapost) showed that university graduates earn a monthly wage of NTD28,116 on their first job, largely unchanged from NTD28,016 received in 2000, suggesting an actual decline in real terms.

Wage vs. productivity



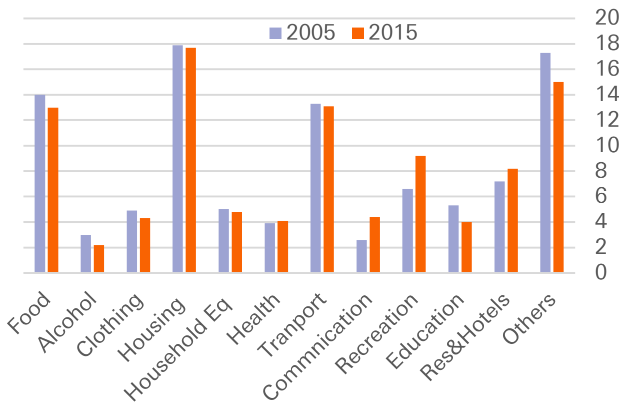
Sources: CEIC, Deutsche Bank

While tighter labour market conditions would normally point to higher wage growth, the fact remains that Taiwan's wage growth has barely matched inflation since 2000, pointing to stagnation in real wages since. This is in sharp contrast to Korea's wage growth, which rose 42% during the same period, suggesting improved competitiveness in labour costs for Taiwanese firms. Indeed, in the manufacturing sector, Taiwan's ULC fell more than 26%, while Korea's rose by more than 44%. (Please see Korea country section for chart.)

…while the likely rise in CPI inflation ahead, led by food price inflation, may weigh on consumer purchasing power… Although CPI inflation has surprised to the downside since February, falling to 0.1% yoy in April,

we are cautious, as much of this was driven by volatile food prices, which fell 2.4% in April. Ex-food, the CPI index rose 1.1% yoy in April, vs. 1% in March. Given recent bad weather conditions, we could see this reverse rather sharply in the coming months, weighing further on consumer purchasing power. Despite the likely rise in CPI inflation, however, we see the Central Bank of China (CBC) delaying normalization of its monetary policy until next year to ensure durability of its economic recovery, especially if the TWD continues to strengthen. Sustained low policy rates, in turn, may support the housing market recovery, prices of which appear to have bottomed, with housing transactions also rising sharply, to the highest levels since May 2016. The wealth impact from higher housing and TWSE could certainly make up for higher inflation. About 41% of Taiwan's households held their wealth in real estate assets in 2015, vs. ~15% in portfolio assets.

Changing consumption patterns



Sources: CEIC, Deutsche Bank

...but Taiwanese consumers take time to enjoy life. Taiwan reported a relatively notable rise in the share of recreation & culture in total private consumption, to 9.2% (5-yr avg) in 2016 from 6.6% a decade earlier, at the expense of food and beverages, the share of which fell to 15.2% from 17% during the same period. This was followed by communication and restaurant & hotels, the share of which rose by 1.8ppts and 1ppt, respectively, in a decade to 4.4% and 8.2% in 2016. Interestingly, there has been little change in the health care share, which stood at 4.1% in 2016 vs. 3.9% in 2006, despite Taiwan's ageing population. In contrast, Korea (with similar demographics changes) reported a sharp rise in the health care share to 5% in 2016 from 3.2% in 2006. This hints at a significant potential for rise in health care spending in Taiwan.

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Taiwan: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USDbn)	528.3	530.8	562.3	555.0
Population (m)	23.5	23.5	23.6	23.6
GDP per capita (USD)	22,517	22,578	23,869	23,512
Real GDP (yoy %)	0.7	1.5	2.3	2.3
Private consumption	2.7	2.2	2.0	2.2
Government consumption	-0.3	3.1	-0.3	0.5
Gross fixed investment	1.6	2.5	2.5	2.1
Exports	-0.3	2.1	4.1	4.1
Imports	1.2	3.4	4.0	3.8
Prices, money and banking				
CPI (yoy %) eop	0.1	1.7	1.8	1.1
CPI (yoy %) annual average	-0.3	1.4	1.1	1.7
Broad money (M2)	6.4	4.5	3.5	4.5
Bank credit[1] (yoy %)	3.1	3.0	3.5	4.5
Fiscal accounts (% of GDP)				
Budget surplus	0.1	-0.2	-0.2	-0.4
Government revenue	15.9	15.8	15.9	15.9
Government expenditure	15.8	16.0	16.1	16.2
Primary surplus	1.0	0.7	0.6	0.5
External accounts (USDbn)				
Merchandise exports	335.5	312.3	327.0	343.7
Merchandise imports	262.9	242.9	267.7	288.1
Trade balance	72.6	69.4	59.3	55.5
% of GDP	13.7	13.1	10.6	10.0
Current account balance	75.5	72.3	61.4	57.1
% of GDP	14.3	13.6	10.9	10.3
FDI (net)	-12.4	-9.6	-13.0	-12.0
FX reserves (USDbn)	426.0	434.2	447.5	450.5
FX rate (eop) TWD/USD	33.1	32.3	31.7	32.0
Debt indicators (% of GDP)				
Government debt[2]	37.3	37.3	37.7	38.1
Domestic	37.3	37.3	37.7	38.1
External	0.0	0.0	0.0	0.0
Total external debt	34.7	35.6	34.6	36.1
in USDbn	183.3	188.8	194.4	200.3
Short-term (% of total)	91.8	90.0	88.2	88.2
General				
Industrial production (yoy %)	-1.6	1.4	2.5	2.0
Unemployment (%)	3.8	3.9	3.9	3.8
Financial markets	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
Discount rate	1.38	1.38	1.38	1.50
90-day CP	0.48	0.56	0.58	0.65
10-year yield (%)	1.05	1.10	1.20	1.35
TWD/USD	30.1	31.0	31.7	32.3

Source: CEIC, Deutsche Bank Global Markets Research estimates, National Sources
Note: (1) Credit to private sector. (2) Including guarantees on SOE debt

Thailand

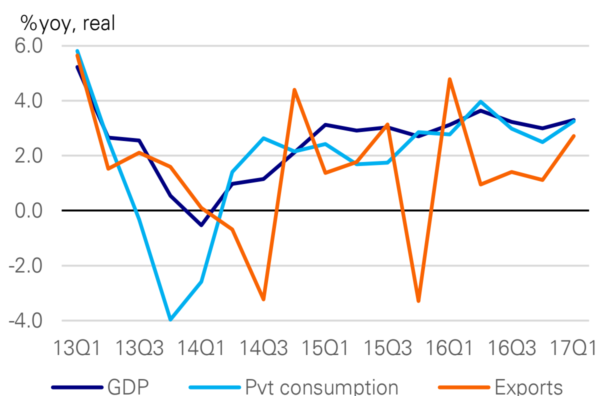
Baa1/BBB+/BBB+
Moody's/S&P/Fitch

- Economic outlook: With consumer spending further gaining pace in April and the drag on private investment easing, against tailwinds arising from the sustained pick-up in business sentiment and sharp increases in approved investments, we believe it is feasible for Thailand to pose at least 4.0%yoy growth in the second half as the private sector adds to the growth impulse already provided by fiscal spending and the recovery in exports.
- Main risks: Apart from the downside risk to growth from trade protectionism, the BOT may decide to cut policy rates to guide inflation within its target.

Slowly gaining momentum

Thailand continued to make modest strides towards its economic recovery at the start of 2017. In the first quarter, output expansion gained pace to 3.3%yoy against 3.0%yoy in 2016Q4. Sequentially, the Thai economy grew by 1.3%qoq(sa), accelerating from the 0.4-0.5%qoq(sa) growth 1-2 quarters earlier.

Higher Q1 growth led by consumer spending & exports



Source: CEIC and Deutsche Bank

The pick-up in Q1 growth was led by private consumption and exports, while anchored by another quarter of buoyant public sector capital formation. On the production side, favorable outturns in the agriculture sector as well as in the wholesale & retail trade, hotels & restaurants, and transport, storage & communication facilitated faster growth in the quarter.

Private consumption last quarter got a boost from the agriculture sector, where robust yields, such as of paddy, maize, and palm oil, alongside higher agri prices led to an acceleration in farm incomes and sector wages. As a result, spending on durable goods, especially on motor vehicles and furniture items, gained pace in the quarter. Double-digit growth in car sales was also facilitated by the fading overhang of the first-car buyer scheme implemented between October 2011 and December 2012, which required buyers to keep the vehicle for at least five years.

Meanwhile, spending on services did not expand as strongly as durables last quarter, but it nonetheless remained buoyant, sustaining 5% growth as in the previous quarter. Modest improvements in the growth of wholesale and retail trade as well as hotels and restaurants, and transport can be largely attributed to the increased number of tourists to Thailand despite the crackdown on illegal tourism businesses.

Thailand's G&S exports, likewise, gained pace to grow 2.7%yoy (real) in Q1 against 1.1% in the preceding quarter, owing to stronger earnings from shipments of agriculture and manufacturing products, particularly in the US, EU, and China markets. But the low base on fuel prices as well as the pick-up in demand for capital goods, as supported by the faster expansion rate of public construction particularly of SOEs, caused imports to outpace exports last quarter, guiding net exports to contribute negatively to GDP growth.

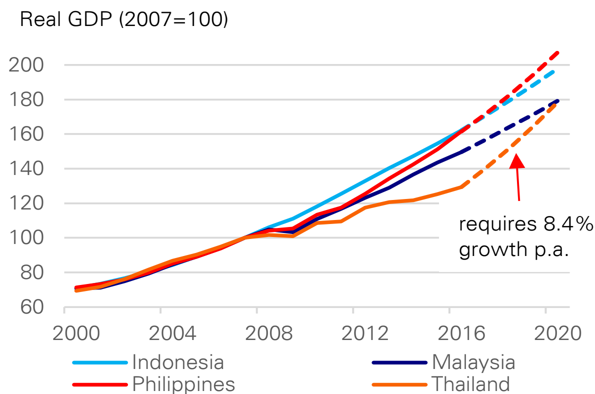
Moving past the first quarter, April data continue to support a modest ascent in Thailand's growth momentum. Both consumer sentiment—guided by another month of favorable returns in the agricultural sector and a sustained exports rebound—as well as the pace of tourist arrivals continued to improve in April, guiding spending particularly on durables and services (including non-resident expenditures) to advance faster relative to the first quarter (3.6%yoy vs. 2.6%yoy).

Meanwhile, high excess capacity continued to weigh on private investments, which dropped again in April (-0.2%yoy vs. -1.3%yoy in Q1). But positive signs are emerging, given the sustained pick-up in business sentiment in the first five months of 2017 and the sharp increases in the value of projects approved and promotion certificates issued by the Bureau of Investments in the past quarter or two. For instance, imports of capital goods began to expand in April after 10 straight months of year-on-year contractions. To us, these developments on top of a supportive fiscal policy, should make it feasible for the Thai economy to post at least 4% growth in the second half of the year.

Annual growth of 4% though is far from an economic recovery. This is because Thailand has increasingly trailed behind its ASEAN peers over the past nine years. And so for Thailand to catch-up with ASEAN's growth

by 2020, the economy would have to grow by at least 8% per annum from this year onwards. This is a tall order, in our view, despite Thailand's low government debt and thus ample fiscal space, as a number of factors—indebted households, rapid population aging, lack of investment appetite given both domestic and external political uncertainties, and a new normal of more subdued export earnings amid lower growth potential in the advanced economies and China—are likely to weigh on Thailand's economic prospects.

Thailand would have to grow by at least 8% per annum to catch up with Malaysia's economic growth by 2020



Assuming 5.1% avg growth for Indonesia, 4.6% for Malaysia, and 6.4% for Philippines in 2017-20.
Source: Haver Analytics and Deutsche Bank

It is the risk of being trapped in a low-growth, low-inflation environment that the IMF is advising Thai authorities to deploy *'a mutually reinforcing policy mix of fiscal and monetary stimulus, coupled with structural reforms and a flexible exchange rate,'* according to its latest assessment in June. To the IMF, monetary easing, alongside an expansionary fiscal policy, would prevent inflation from becoming entrenched. There is scope to do so as risks to financial stability are seen contained.

Given that inflation has been on a decline since February and is likely to fall short of the BOT's 1-4% target this year, the BOT may carry out policy rate cuts to fuel inflation alongside the slow pick-up in domestic demand. This is currently not our baseline scenario, as we expect inflation to rise from here on, but we will be closely watching price developments going forward especially after the dip to deflationary territory in May.

One major factor that is holding back the BOT from cutting rates is the baht, which has outperformed ASEAN currencies since 2016. The BOT has just eased FX rules primarily to encourage outward flows to dampen the baht's strength. While the baht has instead strengthened since the ruling, ensuing currency weakness in tandem with a lack of inflation momentum would raise the odds of rate cuts, in our view.

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Thailand: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	399.3	407.3	439.8	464.5
Population (m)	65.7	65.9	66.2	66.4
GDP per capita (USD)	6,075	6,177	6,640	6,995
Real GDP (yoy %)	2.9	3.2	4.0	4.0
Private consumption	2.2	3.1	3.3	4.0
Government consumption	3.0	1.7	3.4	4.1
Gross fixed investment	4.4	2.8	4.6	4.4
Exports	0.7	2.1	6.8	6.6
Imports	0.0	-1.4	8.1	7.2
Prices, Money and Banking				
CPI (yoy %) eop	-0.9	1.1	0.8	1.8
CPI (yoy %) ann avg	-0.9	0.2	0.8	2.0
Core CPI (yoy %) ann avg	1.1	0.7	0.7	1.4
Broad money	4.4	4.2	5.9	7.1
Bank credit (yoy %)	2.7	3.1	5.5	7.5
Fiscal Accounts[1] (% of GDP)				
Central government surplus	-2.9	-2.8	-2.8	-2.8
Government revenue	16.3	16.7	16.9	16.8
Government expenditure	19.2	19.5	19.6	19.6
Primary surplus	-1.6	-1.5	-1.5	-1.5
External Accounts (USDbn)				
Merchandise exports	214.1	214.1	230.8	247.3
Merchandise imports	187.2	178.4	198.1	215.4
Trade balance	26.8	35.8	32.7	31.9
% of GDP	6.7	8.8	7.4	6.9
Current account balance	32.1	46.8	44.3	46.8
% of GDP	8.1	11.5	10.1	10.1
FDI (net)	4.0	-11.7	2.0	3.5
FX reserves (USDbn)	156.5	171.9	192.7	216.1
FX rate (eop) THB/USD	36.1	35.8	35.5	36.5
Debt Indicators (% of GDP)				
Government debt[1,2]	37.1	37.5	39.7	39.4
Domestic	35.7	36.1	38.2	38.0
External	1.4	1.4	1.5	1.5
Total external debt	32.9	32.3	31.8	31.6
in USDbn	131.4	131.4	138.0	144.3
Short-term (% of total)	60.0	59.8	59.9	59.9
General				
Industrial production (yoy %)	0.0	1.6	3.6	5.2
Unemployment (%)	0.9	1.0	1.2	1.2
Financial Markets	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
BoT o/n repo rate	1.50	1.50	1.50	1.50
3-month Bibor	1.59	1.62	1.61	1.61
10-year yield (%)	2.55	2.85	3.00	3.15
THB/USD (onshore)	34.1	34.7	35.5	34.6

Source: CEIC, Deutsche Bank Global Markets Research, National Sources
Note: (1) Consolidated central government accounts, includes central government guaranteed debt; fiscal year ending September. (2) excludes unguaranteed SOE debt

Vietnam

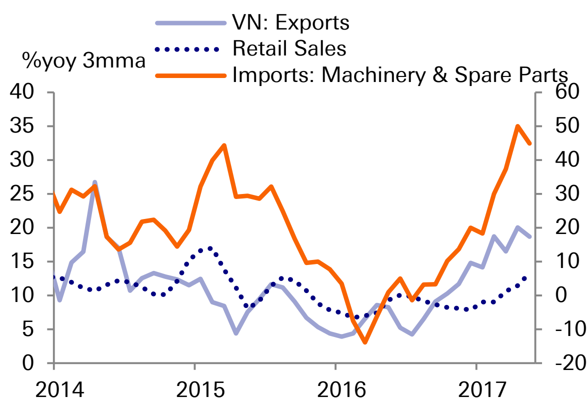
B2/BB-/B+
Moody's/S&P/Fitch

- Economic outlook: GDP growth is likely to accelerate to 6.3% in Q2, from 5.1% in Q1, led by stronger private consumption, while inflation falls.
- Main risks: Although positive for Vietnam's fiscal health, weak public investment weighs on growth.

Sweet spot: Better growth, lower inflation

Vietnam enjoyed stronger growth in Q2, led by private consumption… High-frequency data suggest that the economy grew 6.3% in Q2, up sharply from 5.1% growth in Q1, thanks largely to stronger private consumption. In particular, retail sales growth accelerated to 13.3% yoy in April/May, from the 10.7% growth reported in Q1. When adjusted for inflation, this rebound was even more impressive, at 9.6% in April/May vs. a 5.7% rise in Q1. Meanwhile, imports of machinery and spare parts continued to print impressive growth of 45.1% in April/May, up from the 37.3% rise in Q1, suggesting stronger facility investment in Q2.

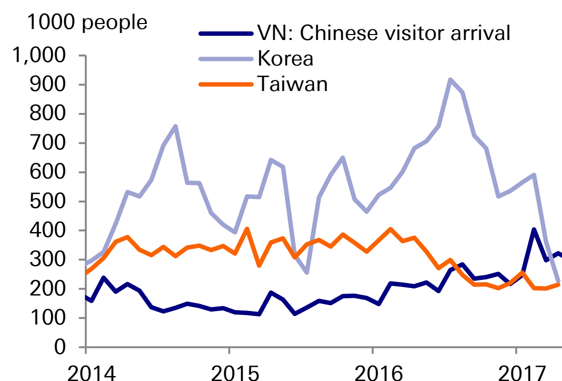
Pick-up in domestic demand



Sources: CEIC, Deutsche Bank

On the external front, like its peers in Asia, Vietnam saw continued strength in export growth in Q2, albeit reporting its peak in April. Exports rose 18.7% yoy in April/May, vs. 16.5% in Q1. Computer/electronics and telephone/spare parts surged 39.5% in April vs. 10.2% in Q1, guiding the contribution to overall export growth sharply higher to 12ppts for April/May vs. 3.3ppts for Q1, while textile/footwear export growth decelerated to 8.2% in April/May from 12.9% in Q1, contributing far less to overall growth at 1.6ppts in April/May vs. 2.4ppts in Q1. Meanwhile, import growth continued to outpace export growth, at 23.2% in April/May, albeit down from 26% in Q1, leaving Vietnam with a monthly trade deficit of USD0.3bn in the first two months of Q2, narrowing from a monthly deficit of USD0.7bn in Q1.

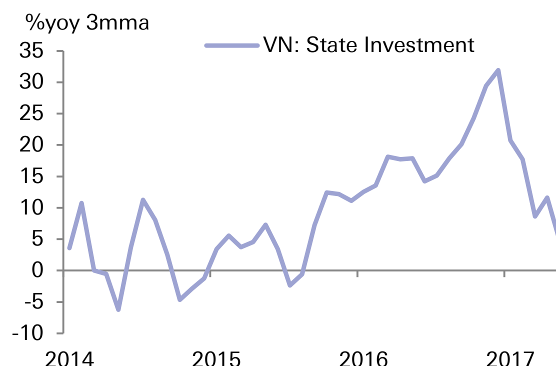
Rebound in electronics/telephone exports



Sources: CEIC, Deutsche Bank

On the tourism front, Vietnam continued to enjoy robust growth. In particular, the number of tourist arrivals continued to rise at a rapid pace, at 32.1% yoy in April/May, up from 30.5% in Q1. With Chinese tourists shying away from Taiwan and South Korea, for political reasons, their arrivals in Vietnam surged 44.9% in April/May, albeit down from the 63.8% rise in Q1. Tourism retail sales growth accelerated to 12.6% in April, from 11.1% in Q1 -- discounted by inflation, tourism sales growth accelerated to 8.9% from 6.1%.

Weak public investment

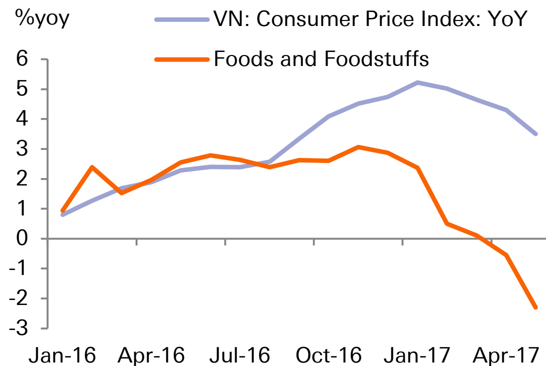


Sources: CEIC, Deutsche Bank

…despite weak public investment… Data on public domestic demand remained weak, albeit the pending MPI plan to bolster public investment points to a rebound in public investment contribution to growth in 2H. Public investment growth stood relatively low, at 7.1% yoy in April/May, vs. 18% in Q1 this year. This is in sharp contrast to a notable rebound in implemented FDI growth, which accelerated to 10% in April/May vs. the 3.3% growth reported in Q1. This relative weakness in public investment expenditure resulted, in turn, in a

fiscal surplus of VND3.1tn ytd in April 2017, vs. a deficit of 0.4% of GDP in Q1. Reflecting Vietnam's efforts to limit public debt, the National Assembly kept the debt ceiling at 65% of GDP. Meanwhile, the NA is also considering, among other things, excluding SBV and SOE debt (not explicitly guaranteed by the government) from public debt. It is also seeking to set criteria that local government need to meet before issuing hard currency debt.

Inflation eases, as food prices fall



Sources: CEIC, Deutsche Bank

To expedite bad debt resolution, the National Assembly is considering giving creditors greater discretion over control and resolution of bad debt. For example, creditor banks or VAMC may sell bad debt at market price, even at below the book value and collect the proceeds first, then pay tax at a later time. The provisions for fees and interest receivables related to bad debt may also be spread over a 10-year period. For its part, the State Bank of Vietnam (SBV) has kept monetary conditions supportive of growth, with credit growth accelerating to 6.5% ytd in May, up from 5.5% in the same period last year.

…as inflation remains contained around the government target of 4%. CPI inflation unexpectedly eased to 3.7% in April/May, from 5% in Q1, amid the unusually low food price inflation. The latter fell 3% in April/May, vs. a 0.4% rise in Q1. As pork prices plunged on the back of a positive supply shock, the government sought to provide loan relief to the affected farmers. Vietnam also enjoyed a decline in inflationary pressure in other items, such as health and personal care. However, we see inflation rebounding ahead, on the back of economic recovery and administrative price hikes on education and electricity in 2H.

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Vietnam: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USD bn)	193	205	213	231
Population (m)	91.7	92.7	93.7	94.8
GDP per capita (USD)	2,109	2,214	2,273	2,438
Real GDP (yoy %)	6.7	6.2	6.4	6.5
Private consumption	9.3	7.8	8.0	8.2
Government consumption	7.0	6.5	6.0	6.0
Gross fixed investment	9.4	9.6	9.0	9.2
Exports	8.9	9.0	10.0	12.0
Imports	16.4	10.8	11.4	13.5
Prices, money and banking				
CPI (yoy %) eop	0.6	4.7	3.9	8.0
CPI (yoy %) ann avg	0.6	2.7	4.1	6.1
Broad money (yoy %)	16.8	19.0	20.0	22.0
Bank credit (yoy %)	17.0	18.5	19.5	21.0
Fiscal accounts[1] (% of GDP)				
Federal government surplus	- 6.4	- 6.0	- 5.4	- 5.0
Government revenue	22.2	22.3	22.8	23.2
Government expenditure	28.6	28.3	28.2	28.2
Primary fed. govt. surplus	- 4.4	- 3.9	- 3.1	- 2.4
External accounts (USD bn)				
Merchandise exports	162.0	175.9	195.0	220.0
Merchandise imports	154.7	165.0	193.0	220.0
Trade balance	7.3	10.9	2.0	0.0
% of GDP	3.8	5.3	0.9	0.0
Current account balance	0.9	7.9	- 1.0	- 2.0
% of GDP	0.5	3.8	- 0.5	- 0.9
FDI (net)	11.8	15.8	8.0	10.0
FX reserves (USD bn)	28.6	36.9	38.0	38.0
FX rate (eop) VND/USD	22405	22724	23800	24200
Debt indicators (% of GDP)				
Government debt[2]	58.5	63.5	65.0	66.0
Domestic	38.0	42.5	44.5	45.0
External	20.5	21.0	20.5	21.0
Total external debt	41.4	40.9	41.3	40.7
in USD bn	80	84	88	94
Short-term (% of total)	18.1	19.0	19.3	19.1
General				
Industrial production (yoy %)	10.0	7.3	8.5	11.0
Unemployment (%)	2.1	2.3	2.1	2.1
Financial markets	*Current*	*17Q3F*	*17Q4F*	*18Q1F*
Refinancing rate	6.50	6.50	6.50	6.75
VND/USD	22671	23500	23800	23900

Source: CEIC, Deutsche Bank Global Markets Research, National Sources
Note: (1) Fiscal balance includes off-budget expenditure, while revenue and expenditure include only budget items. (2) Government, publicly-guaranteed, and local government.

Czech Republic

A1(stable)/AA-(stable)/A+(stable)
Moody's/S&P/Fitch

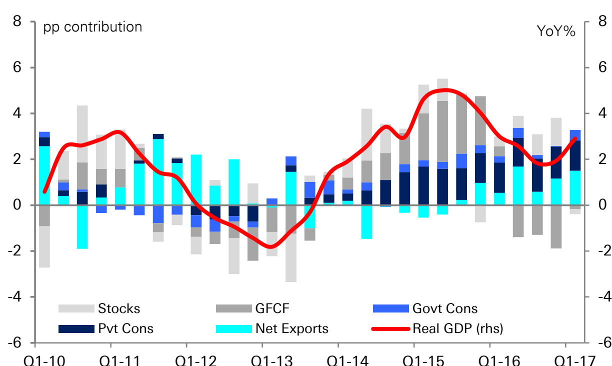
- Economic outlook: We expect inflation to stabilize at target in 2018 and exchange rate to reach 26.00 vs EUR by end-2017. Growth is expected to gather speed in 2017.
- Main risks: Disinflation has mostly been imported; therefore uncertainty around ECB policy is the key concern for Czech central bank policy. With elections this October, politics is back in focus, but we see limited market implications for now.

Growth gaining speed

Growth to gain speed this year

The CZSO has reported Q1 GDP growth at 1.3% QoQ, up from 0.4% QoQ in Q4-16. This took the YoY growth to a four quarter high of 2.9% YoY (previous 1.9%). The reading beat the CNB's projections, from May, of a 2.5% YoY Q1 reading. According to the details, the strong GDP growth can be attributed to strong external demand supported by growing consumption of households. Household consumption improved by 2.8% YoY, supported by a tight labour market, characterized by robust growth in wages and one of the lowest unemployment rates in the EU. Exports growth also improved in Q1 and outstripped a sharp increase in imports on the back of strong domestic demand with net exports contributing positively to overall growth. Investment growth is yet to post a noticeable recovery.

Private consumption and exports hold up growth in Q1



Source: CSO, Haver Analytics, Deutsche Bank

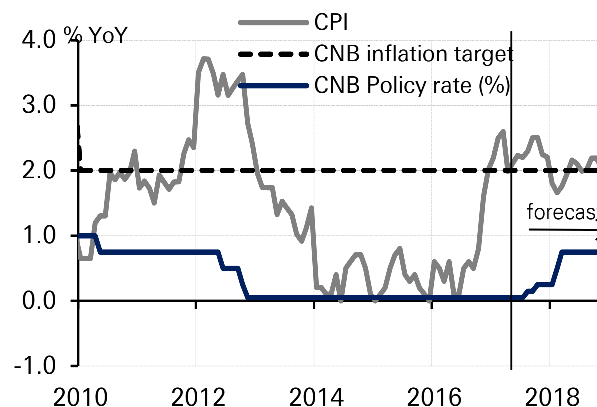
We expect growth to gain speed into 2017 thanks to increased absorption of EU funds and resilient private consumption despite some tapering-off in employment growth. Positive contribution from net exports is likely to turn negative in 2017 and 2018 due to rising demand for investment-related imports. While tight labor conditions continue to support growth via enhanced disposable income and resilient consumer demand, rising differential between wage and productivity growth rates could weigh on Czech exports' competitiveness in the coming years.

Inflation declined faster than expected in April

CPI inflation in the Czech Republic declined to 2.0% YoY (CNB target at 2%), faster than expected by markets. The deceleration was mainly a result of base effects as the impact of previous commodity price increases fade out. Indeed, headline prices have remained constant on the month in April and the largest YoY declines have been registered by the food and transport components.

We continue to expect headline inflation to remain mostly above target through the year and to stabilize at 2% only in the beginning of 2018. Inflation is likely to be driven higher by a slight inflationary impact of import prices in the first half the year along with growth of the domestic economy and wage growth pressures emerging from a tight labour market and the increase in minimum wage introduced in April. Impact of CZK appreciation post floor-removal is likely to arrive with a lag, likely from mid-2017 onwards. The decline in inflation in the later part of the year will be supported by fading out of base effects and declining cost pressures due to recovery in labour productivity.

Inflation already above CNB target



Source: CSO, CNB, Haver Analytics, Deutsche Bank

CNB: FX floor removal done, focus shifts to rate hikes

Since the removal of the floor on the euro exchange rate, the CZK has strengthened, but only slightly. Investors are holding onto their long CZK positions for now. The CNB bought over EUR 70bn in interventions previously. The CNB acknowledged this at their May meeting, with "*the appreciation may also be strongly dampened in the coming quarters by market*

"overboughtness"". Nonetheless, the CNB expect CZK to appreciate due to real convergence of the Czech economy to euro area countries, positive interest rate differential with the euro area and the ECB's continued asset purchases. The CZK gathered strength in May, appreciating by about 1.9% (vs. 0.4% in April) and we expect the exchange rate to reach 26.00 vs EUR by end-2017.

The CNB expects domestic market interest rates to increase in Q3-17 and later in 2018. The CNB has kept rates on hold at 0.05% for now and Governor Rusnok called out against any "hasty" tightening or "impatience" on the MPC's part. Rusnok has said that while normalisation of monetary policy was desirable, the CNB was willing to tolerate an overshoot on the inflation target for the time being. Governor Rusnok has also been quoted recently as saying that rate hikes are likely towards the end of the year or beginning of 2018. While a weaker crown for longer could hasten the rate hikes from the current 0.05%, a stronger currency could push back hikes into 2018. We expect the first rate hike to come in Q3-17, which is line with Governor Rusnok's comments as well the CNB's current expectation of interest rate path. We expect the policy rate to reach 0.25% by year end.

Ivan Pilny was appointed as the Finance Minister on 25th May bringing to an end the political deadlock. The stand-off between the PM Sobotka (head of CSSD party) on one side and the ex-Finance Minister Babis (head of ANO party) on the other was finally resolved as Sobotka accepted the ANO party's nomination of Pilny as a replacement. The PM had called for then FinMin Babis' resignation or removal by the President as Babis, a billionaire businessman, faces criticism for conflict of interest over his business conglomerate, tax savings through bond issues, and inappropriate communication with the press. Babis had refused to resign initially, but following weeks of internal strife in the cabinet he backed down and agreed to step aside if his party was allowed to choose a successor. Babis had first nominated his deputy Alena Schillerova to the post in a bid to end the impasse, but Sobotka rejected the proposal saying that Schillerova is too close to Babis.

The opinion polls (TNS Kantar, Focus, CVVM etc) predict an easy victory in the legislative elections in October for the ANO party which the ex-Finance Minister Babis heads. The CSSD trail ANO by a double-digit margin in polls and has seen their support steadily declining while that of ANO goes up despite the allegations against Babis.

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Czech Republic: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	185	193	188	199
Population (mn)	10.5	10.5	10.6	10.6
GDP per capita (USD)	17 594	18 290	17 806	18 868
Real GDP (YoY%)	4.6	2.3	2.8	2.1
Private Consumption	3.1	2.8	3.8	3.3
Government	2.0	1.2	3.1	2.0
Gross Fixed Investment	10.2	- 1.0	0.5	4.1
Exports	7.9	4.0	3.6	3.3
Imports	8.4	3.0	3.6	4.8
Prices, Money and Banking (YoY%)				
CPI (eop)	0.0	2.0	2.2	2.0
CPI (period avg)	0.3	0.7	2.3	2.0
Broad money (eop)	8.4	6.6	6.2	5.9
Fiscal Accounts (% of GDP)				
Overall balance	- 0.6	0.6	- 0.6	- 0.6
Revenue	41.4	40.5	41.4	41.6
Expenditure	42.1	39.9	42.0	42.2
Primary Balance	0.5	1.5	0.4	0.5
External Accounts (USD bn)				
Goods Exports	128.4	131.0	122.8	141.0
Goods Imports	120.8	120.8	113.6	131.6
Trade Balance	7.6	10.2	9.2	9.4
% of GDP	4.1	5.3	4.9	4.7
Current Account Balance	0.4	2.2	2.1	1.9
% of GDP	0.2	1.1	1.1	1.0
FDI (net)	- 2.0	5.8	3.4	4.3
FX Reserves (eop)	61.3	82.8	105.6	103.1
USD/CZK (eop)	24.82	26.07	25.49	27.05
EUR/CZK (eop)	27.0	27.5	26.0	25.7
Debt Indicators (% of GDP)				
Government Debt	40.3	37.2	36.6	36.2
Domestic	23.0	18.8	17.2	17.9
External	17.3	18.4	19.4	18.4
External debt	69.5	71.4	71.2	65.1
in USD bn	128.7	137.6	133.8	129.7
Short-term (% of total)	44.4	48.1	44.1	45.5
General (ann. avg)				
Industrial Production	4.7	3.0	4.0	3.5
Unemployment (%)	6.5	5.5	5.3	5.2

	Spot	17Q3F	17Q4F	18Q1F
Financial Markets				
Key official interest rate	0.05	0.15	0.25	0.75
USD/CZK (eop)	23.39	24.81	25.49	25.90
EUR/CZK (eop)	26.3	26.3	26.0	25.9

Source: Haver Analytics, CEIC, DB Global Markets Research, NBP

Hungary

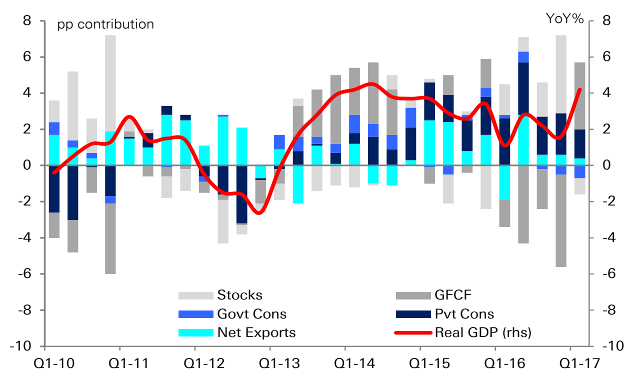
Baa3(stable)/BBB-(stable)/BBB-(stable)
Moodys/S&P/Fitch

- Economic outlook: Domestic absorption is set to remain strong thanks to accommodative macro policy mix. Headline CPI has softened recently and is expected to reach target-compliant levels on a sustainable basis from late H1 2018 onwards. NBH retains bias for additional unconventional easing, though room for further rate stimulus is inherently lower.
- Main risks: External risks include repercussions from a disorderly Brexit or a slowdown in Europe, while any adverse spillover from political uncertainty in continental Europe has likely receded. Domestic political backdrop remains relatively stable. Return to the investment grade is likely to have strengthened Hungary's resiliency against shifts in global risk appetite.

A good start to 2017

According to the final estimate by KSH, Hungarian economy expanded by 4.2%YoY in Q1 2017 after a dismal performance throughout 2016 (2.0%). Seasonally adjusted sequential growth accelerated to 1.3%QoQ, its highest level since early 2015. Expenditure-side breakdown confirmed domestic absorption was the main driver, having accounted for 3.8 percentage points (pp) of the annual rise. While slightly softer than in Q4 2016, household consumption was resilient at 2.4%YoY, supported by tight labor market and also higher minimum wages. Government consumption was again a drag (-4.5%YoY) on growth, while the main stimulus within domestic demand arrived from a welcome leap in fixed investments (8.8%QoQ), led by construction and machinery, heralding a recovery in EU funds absorption rate.

Strong GDP growth in Q1

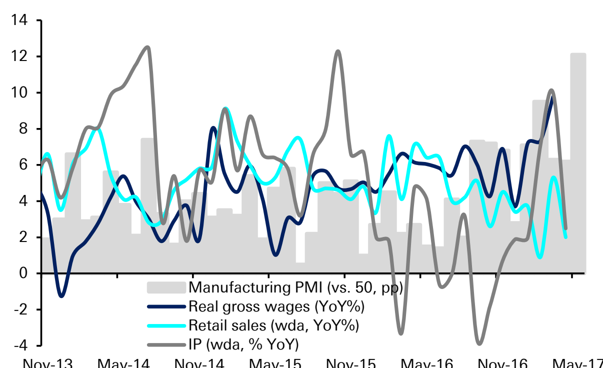


Source: Haver Analytics, CSO and Deutsche Bank

Meanwhile, the contribution of inventories turned negative for the first time since late 2015. Yet this was partially compensated by net exports, which added 0.4pp to the annual headline thanks to a marked improvement in exports.

Notwithstanding a marginal rise in unemployment rate (to 4.6%) in April from its all-time low, the continued rise seen in real wages (9.8%YoY) – also thanks to the strong minimum wage hike – points to tight conditions in the labor market into Q2. Higher disposable income for households however has yet to be fully transmitted to final consumption as (working-day adjusted) retail sales decelerated to 2%YoY in April. That said, recent softening was mostly on the back of food-related purchases, while durables demand, which is inherently more income-elastic, remained resilient at 5.2%YoY. Manufacturing PMI meanwhile rose to a record level (62.1) in May, thanks to acute leaps in new orders and employment. Industrial production however lost steam in April (2.5%YoY, in working-day adjusted terms), despite better Euro-zone demand and confidence levels.

Despite a mixed picture into Q2, we expect Hungarian economic momentum to remain resilient this year



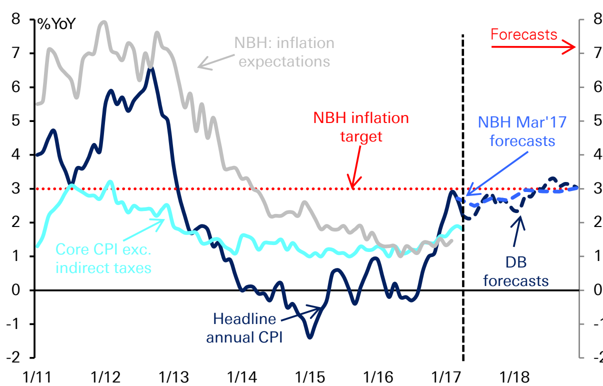
Source: Haver Analytics, CSO and Deutsche Bank

Given the fiscal stimulus, household consumption is set to stay as the main driver of growth in 2017, buttressed further by a likely recovery in capital formation on the back of improved absorption of EU funds, large investments planned in the automotive sector as well as National Bank of Hungary's (NBH) long-standing stance to support growth. We now expect the 2017 full-year real GDP growth to transpire better at 3.5%YoY. This compares to NBH's and the government's projections at 3.6% and 4.1%, respectively.

Inflation to remain relatively soft in immediate term

Annual CPI has decelerated slightly since February and reached 2.2%YoY in April due to some tapering-off in unsupportive base effects (in energy), a lower excise tax on fuels, and softer food prices on the back of tamer weather conditions. At 1.8%YoY, core inflation, excluding indirect taxes, remained close to its highest level since early 2013, yet was still well below the 3% target. The NBH revised up its 2017 estimate by 0.2pps to 2.6% YoY (DB: 2.5%) in its latest forecasting round, and envisages a sustainable fulfillment of the target only in the first half of 2018. Assumption for core CPI was slightly upgraded in light of rising wage-cost pressure as well as higher imported inflation, whose combined impact was envisaged to be partially dampened by a lower rate on employers' social contribution and corporate income tax. Barring adverse oscillation in energy prices, NBH's inflation outlook seems plausible, in our view.

Headline CPI has softened following the sharp rise in late 2016/early 2017



Source: Haver Analytics, NBH, CSO and Deutsche Bank

NBH retains ultra-dovish bias

NBH kept its base rate unchanged at its all-time low of 0.9% in May. The Bank meanwhile unveiled Phase 2 for Market-based Lending Scheme (MLS), which aims to keep credit growth within the 5-10% band in order to support economic activity. NBH will continue to provide risk and liquidity management instruments as in Phase 1, yet this time it enables banks to raise their lending commitments while offering incremental access to its preferential deposit facility to banks with a higher undertaking. Next decision on the limit for three-month deposits will be this month and we believe the Bank looks set to limit the cap further given its expectations for declining liquidity in the banking system and also policy-makers' inclination to keep monetary conditions as loose as they are now. Room for additional easing is however inherently limited, given that 3-month Bubor rates have already retreated to their all-time low at 15bps.

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Hungary: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	122	124	128	124
Population (mn)	9.9	9.8	9.8	9.8
GDP per capita (USD)	12 348	12 639	13 047	12 655
Real GDP (YoY%)	3.1	2.0	3.5	3.3
Private Consumption	3.0	4.1	4.9	3.8
Government	0.9	0.1	1.6	1.3
Gross Fixed Investment	1.9	- 15.5	11.2	7.9
Exports	6.1	5.7	7.2	7.1
Imports	7.7	5.8	7.7	7.1
Prices, Money and Banking (YoY%)				
CPI (eop)	0.9	1.8	2.5	3.0
CPI (period avg)	- 0.1	0.4	2.5	2.9
Broad money (eop)	6.3	6.8	6.4	6.2
Fiscal Accounts (% of GDP)				
Overall balance (ESA 2010)	- 1.6	- 1.9	- 2.5	- 2.3
Revenue	48.5	45.8	48.3	48.3
Expenditure	50.0	47.6	50.8	50.6
Primary Balance	2.0	1.3	0.6	1.1
External Accounts (USD bn)				
Goods Exports	88.4	91.6	94.9	93.7
Goods Imports	83.5	85.8	90.5	90.1
Trade Balance	4.9	5.8	4.4	3.7
% of GDP	4.0	4.7	3.4	2.9
Current Account Balance	4.1	6.1	4.1	3.4
% of GDP	3.4	4.9	3.2	2.8
FDI (net)	1.2	3.5	3.1	2.3
FX Reserves (eop)	32.7	25.4	23.4	21.4
USD/HUF (eop)	287	294	306	326
EUR/HUF (eop)	313	311	312	310
Debt Indicators (% of GDP)				
Government Debt	74.7	74.1	73.0	71.7
Domestic	48.4	52.8	52.7	51.9
External	26.4	21.3	20.3	19.8
External debt	107.5	96.1	95.0	94.0
in USD bn	131	119	122	117
Short-term (% of total)	12.1	11.9	11.5	11.0
General (ann. avg)				
Industrial Production	7.4	1.2	4.7	4.9
Unemployment (%)	6.9	5.3	4.3	4.2
	Spot	**17Q3F**	**17Q4F**	**18Q1F**
Financial Markets				
Key official interest rate	0.90	0.90	0.90	0.90
USD/HUF (eop)	274	292	306	314
EUR/HUF (eop)	309	310	312	314

Source: Haver Analytics, CEIC, DB Global Markets Research, NBP

Poland

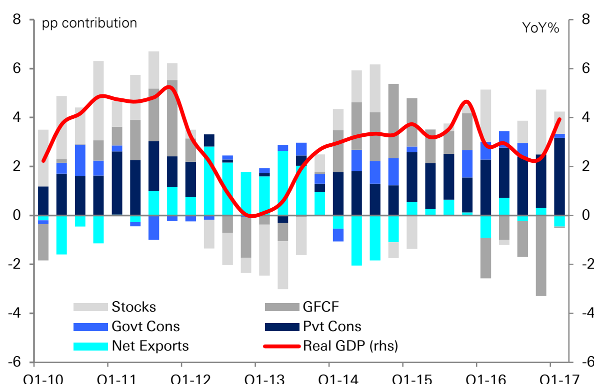
A2(stable)/BBB+(stable)/A-(stable)
Moodys/S&P/Fitch

- Economic outlook: Growth outlook is improving. Headline CPI has moderated recently on commodity price stabilization, and core is still low. We now expect no hikes from NBP until end-2018.
- Main risks: Worries over relations with EU and fiscal dynamics will persist, but it seems a lot is already in the price.

Macro resiliency versus political volatility

Real GDP growth accelerated on the back of a lower base to reach 4.0% YoY in Q1 (prev. 2.5% YoY), the highest reading since end-2015. The higher annual growth came despite a slower growth in sequential terms as the QoQ reading slipped by 0.6pps to 1.1% QoQ. As anticipated, private consumption was the main driver of growth with a 4.7% YoY increase, the highest since Q4-08. Strong wage growth, record low unemployment rates, low interest rate environment along with the government's fiscal transfer to households via the Family 500+ programme have successfully lifted domestic demand. Gross fixed capital formation has also recovered, declining by 0.4% YoY, after having declined by a total of 7.9% in 2016. The recovery in investment growth is mainly due to a combination of slight improvement in business sentiment and a very low base. It has come despite no meaningful improvement in EU funds absorption yet compared to last year. Net trade contributed negatively to growth in Q1, as we had expected, as growth in imports on the back of strong domestic demand conditions outstripped growth in exports.

Domestic demand leads recovery in real GDP in Q1

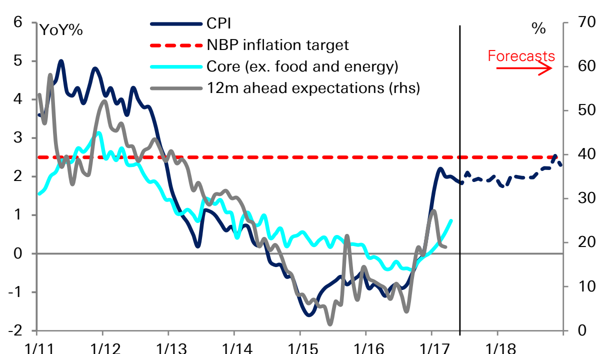


Source: Haver Analytics, CSO, and Deutsche Bank

Activity indicators (retail sales, IP, PMI) have slowed slightly into the beginning of Q2. However, we expect real GDP growth to recover this year to 3.4%, primarily due to improving domestic demand. Labor market remains tight, fiscal transfers to households also are expected to support disposable income throughout the year, and the low interest environment should aid consumption through borrowing. Investments meanwhile are likely to recover in Q2-Q3 due to higher absorption of EU funds.

Inflation risks are still low. CPI inflation slowed by 0.1pps to 1.9% YoY in May, as price levels remained unchanged on the month. The details of components, to be released with the final print, are likely to show that YoY inflation in food and transport has declined, similar to April, in line with global commodity price inflation. Underlying inflation still remains subdued, with three of the four measures still below 1.5% in YoY terms and core CPI (ex. food and energy) at a small 0.9% YoY in April. Apart from the fading effect of global commodity prices, we believe that headline inflation is also likely to be constrained for the rest of the year by low inflation in the euro area and Poland's exchange rate appreciation, keeping import price growth at moderate levels. Having depreciated throughout 2016, PLN in REER terms has already appreciated by about 5% ytd.

Inflation likely to stabilise around 2%



Source: Haver Analytics, CSO, and Deutsche Bank

The main upside risk to inflation is from domestic demand growth, which though still low, is expected to pick-up this year on the back of continued fiscal transfers to households, the low interest rate environment and tight labour market conditions. We thereby expect headline inflation to stabilise around 2% (NBP target 2.5%) for the rest of 2017.

The NBP retains neutral bias. The NBP left rates on hold at 1.50% at its June meeting. The MPC see very little risk of inflation running persistently above target and expect it to remain moderate in the coming quarters. Governor Glapinski reiterated that he sees no possibility of a rate change this year and would be surprised to

see a hike in 2018 as well. He noted that the MPC are closely monitoring wage growth and the recent sharp PLN appreciation but are not concerned about either as of now. He noted that the appreciation had the effect of effectively tightening monetary policy. He also repeated that he sees no risks from negative real rates in Poland, adding to our belief that the NBP is likely to remain in a 'wait-and-see' mode, keeping rates steady at 1.50% in the coming months. Only after seeing a fairly important and permanent change in external backdrop, in either direction, such as a global (or European) recession/boom or a negative/positive commodity shock, NBP would consider lower/higher rates in the coming months.

Fiscal deficit is likely to widen this year (MinFin has set target at 2.9%), with rising expenditures due to higher EU co-financed investments, full year payments on the Family 500+ programme and expected impact of lower retirement age. However, the current fiscal plan is based on a slight overreliance on recovery in tax revenues. Impact of one-off factors, like receipts from the LTE auctions and transfer from the 2015 NBP profits, that boosted revenue in 2016 will not be available to the government this year. The government already recognizes the risks to their budget and is trying to boost its fiscal position by encouraging workers to work past the official retirement age and also plans to further reduce tax avoidance.

Relations between Poland and the EU were in the limelight again as the EC declared a June deadline to comply with the refugee relocation programme or face legal proceedings. Poland and Hungary are the only two countries not to have relocated any refugees under this programme. Polish PM Szydlo reacted by saying that her government will not accept the EU's mandatory quotas on refugee relocation. The Constitutional Court crisis has also reached an uneasy stalemate, with Polish authorities still awaiting an official response from the EC to their latest letter to Brussels. According to a Bloomberg story, a number of EU governments including France and Germany have called for the EC to maintain pressure on Poland regarding Rule of Law. The same story also quoted EC vice-President Timmermans as saying that talks with the Polish government must continue and that the EC has all the tools required to take action against Poland if required. If the EC remain unsatisfied, they could potentially decide to move to the last phase in the framework, i.e., 'Article 7 Procedure', which triggers either a preventive or sanctioning mechanism. Any eventual sanction, however, seems unlikely given Hungary's inclination to vote against it on the European Council. The strained relationship with EU not only has the potential to negatively affect investor sentiment, concerns have emerged that Poland may have to cope with a smaller inflow of EU funds in the new EU budget cycle that will start in 2021.

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Poland: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	477	469	499	477
Population (mn)	38.0	38.0	38.0	38.0
GDP per capita (USD)	12 557	12 350	13 135	12 546
Real GDP (YoY%)	3.8	2.7	3.4	3.2
Private Consumption	3.0	3.8	4.2	3.4
Government	2.4	2.8	5.3	3.8
Gross Fixed Investment	6.1	- 7.9	5.8	5.2
Exports	7.7	9.0	6.9	6.0
Imports	6.6	8.9	7.5	6.5
Prices, Money and Banking (YoY%)				
CPI (eop)	- 0.5	0.8	2.0	2.3
CPI (period avg)	- 0.9	- 0.6	1.9	2.1
Broad money (eop)	9.6	9.7	9.9	9.3
Fiscal Accounts (% of GDP)				
Overall balance (ESA 2010)	- 2.6	- 2.5	- 3.0	- 2.9
Revenue	39.0	38.8	38.4	38.7
Expenditure	41.6	41.3	41.4	41.6
Primary Balance	- 0.8	- 0.8	- 1.0	- 0.8
External Accounts (USD bn)				
Goods Exports	191.0	195.6	201.5	198.4
Goods Imports	188.6	193.4	202.4	200.1
Trade Balance	2.5	2.2	- 1.0	- 1.7
% of GDP	0.5	0.5	- 0.2	- 0.4
Current Account Balance	- 2.9	- 1.4	- 5.7	- 5.8
% of GDP	- 0.6	- 0.3	- 1.1	- 1.2
FDI (net)	9.8	5.0	4.8	7.7
FX Reserves (eop)	89.4	109.5	108.6	105.9
USD/PLN (eop)	3.90	4.18	4.02	4.68
EUR/PLN (eop)	4.25	4.41	4.10	4.45
Debt Indicators (% of GDP)				
Government Debt	48.8	52.1	53.3	53.9
Domestic	31.7	34.0	34.1	35.0
External	17.1	18.1	19.2	18.9
External debt	69.1	71.6	71.8	71.4
in USD bn	330	336	358	340
Short-term (% of total)	11.1	15.4	12.1	12.3
General (ann. avg)				
Industrial Production	4.8	2.9	4.0	4.3
Unemployment (%)	10.5	9.0	8.4	8.1
	Spot	**17Q3F**	**17Q4F**	**18Q1F**
Financial Markets				
Key official interest rate	1.50	1.50	1.50	1.50
USD/PLN (eop)	3.73	3.90	4.02	4.20
EUR/PLN (eop)	4.19	4.13	4.10	4.20

Source: Haver Analytics, DB Global Markets Research, NBP

Russia

Ba1 (stable)/BB+ (positive)/BBB- (stable)

Moody's / S&P / Fitch

- Economic outlook: We expect growth of 1.6% in 2017 and 2% in 2018. We continue to expect another 125bps in cuts this year (200bps cumulative in 2017). We see the revised 2017 budget (deficit 2.1% GDP) as a positive.
- Main risks: stem from commodity price jitters. Russia-US relationship will continue to be volatile. Should the CBR signal increase in FX reserves to US500bn it would weight on Ruble.

Strong macro in focus

Russia's gradual growth recovery remains on track. Real GDP growth accelerated to 0.5% YoY in Q1 from 0.3% YoY previously. The gradual growth recovery remains on track as GDP has now recorded two consecutive quarters of positive growth and reached a ten quarter high. Though component-wise data has not been released yet, we believe that a lower decline in private consumption along with positive contributions from net exports and investment are likely to have driven GDP growth in Q1. Improvement in real wages and disposable income accompanied by a broad-based increase in consumer sentiment in March has likely helped the slight recovery in domestic demand in Q1.

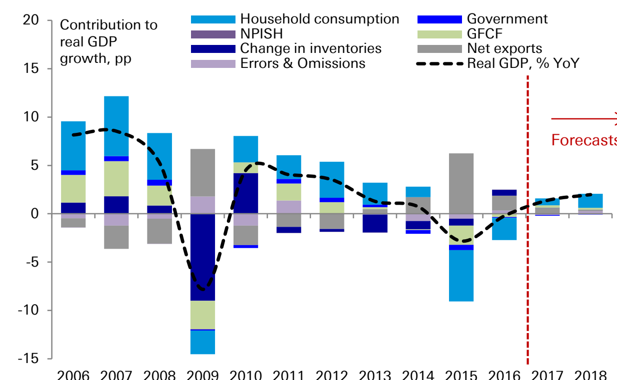
Contribution from GFCF is likely to have turned positive in Q1 as both public and private investments are expected to have been strong. Consolidated government budget data shows that government expenditure has been particularly high in capital intensive sectors like transportation, communication & information and housing & communal services compared to the previous year. Moreover, over 40% of imports in Jan-Mar have been in investment goods, i.e. machinery and transport. Strong corporate profits and positive growth in credit to NFCs through Q1 is also likely to have provided a boost to private investment.

Net export is expected to have contributed positively as exports growth is expected to have outstripped imports growth. However, the contribution from net export is likely to have declined in Q1 as exports suffered from oil production cuts and imports growth improved on the back of recovering domestic demand, a strong ruble and high demand for investment goods.

Short-term indicators suggest that activity continued to improve in 2Q, aided by transportation, construction, and retail sales. Index of regional economic performance (Development Center, HSE) also confirms that the economy is on the mend. In March the aggregate index across the five short-term indicators of economic activity continued to improve. Retail sales and services showed the most improvement in March compared to the previous month. The number of regions where economic activity showed improvement, on average, over the last three months (January-March) has reached 42, which is just over half the regions.

We continue to expect growth of 1.6% in 2017 and 2% in 2018. We expect a moderate recovery in domestic demand in 2017 on the back of real wage growth and accommodative monetary policy. Investment is likely to remain robust while government consumption may suffer slightly due to planned cuts in expenditure. Contribution from net export is likely to be lower in 2017 as exports are curtailed by oil production quotas and domestic demand boosts imports.

Growth recovery on track



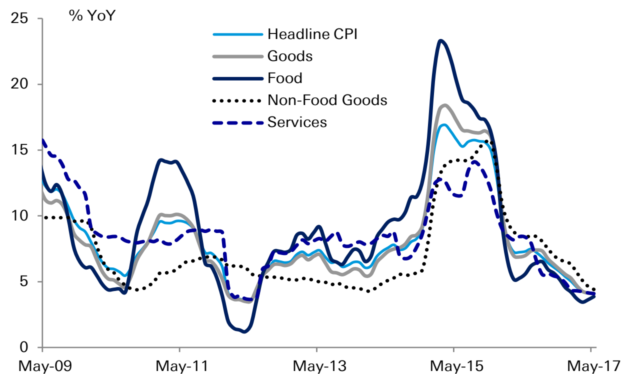
Source: Rosstat, Haver Analytics, Deutsche Bank

Inflation surprised on the upside in May as prices increased by 0.4% MoM, the highest in four months. The increase in prices in monthly terms nullified the effect of a higher base keeping the annual rate unchanged at 4.1% YoY in May, just 0.1pps short of the CBR's 4% target. The decline in headline YoY was supported by a decline in non-food goods inflation as well as services inflation. On the other hand, food price inflation posted a second consecutive increase in May, reaching a four month high of 3.9% YoY, as the effect of the bumper harvest in 2015-2016 begins to fade. The CBR expects the disinflationary impact on food prices of the bumper harvest to run its course in Q2.

We believe that the CBR's 4% target will be breached soon driven lower by base effects as well as the disinflationary impact of the appreciating ruble in YoY terms. In fact, we continue to believe that risk of a continuous undershoot on the target has emerged. Inflation expectations have declined to 10.3% in May (lowest since beginning of data series). Global commodity price inflation has also been decelerating since March and muted domestic demand growth is also supportive of further disinflation. The main upside

risks, however, include volatility in inflation expectations and faster-than-expected recovery in domestic demand. An external shock to the ruble, could also push inflation higher, albeit pass-through on average is relatively low (around 0.13).

Food price inflation accelerating, headline stable in May



Source: Rosstat, Haver Analytics, Deutsche Bank

CBR to maintain accommodative policy stance. We believe that the CBR's aggressive 50bps cut in April (a non Q&A meeting) is a strong signal from the CBR that they are unlikely to tolerate a sustained undershoot on the inflation target. We believe there is room for the CBR to deliver 200bps in cumulative cuts this year to 8% by end-2017 (9.25% now after 75bps in cuts already this year). However, the path is not certain. We currently forecast 5X25bps cuts in the remaining meetings but could see the CBR getting cuts out of the way sooner than we expect, depending on how data on inflation vs. inflation expectations pan out. The CBR will also likely start discussing introduction of a band around the 4% target, as inflation undershoots its target in the coming months. The CBR may also start calibrating communication on outlook beyond end-2017 target to anchor inflation expectations.

The government's plan to pare the 2017 budget deficit to 2.1% (3.2% planned earlier) is a strong positive for investors and ratings outlook. The government has submitted to the State Duma amendments to the 2017 budget. The government now expects an oil price of 45.6 (40 earlier), GDP growth of 2% and inflation of 3.8% by end-2017. Most of the targeted reduction to the deficit comes from higher revenues as nominal expenditure should remain practically unchanged (RUB 16,556tn vs. RUB 16,241tn). The Reserve Fund should be fully spent in 2017, as earlier budgeted; however, the MinFin expects replenishment of the Reserve Fund in the 2018 budget. The MinFin expects to accumulate RUB 623bn from extra oil and gas revenues in 2017, to be transferred in 2018.

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Russia: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	1 366	1 283	1 575	1 667
Population (mn)	146.5	146.8	146.7	146.6
GDP per capita (USD)	9 312	8 759	10 731	11 367
Real GDP (YoY%)	- 2.8	- 0.2	1.6	2.0
Private consumption	- 9.8	- 4.5	1.5	3.0
Government consumption	- 3.1	- 0.5	- 0.5	- 0.5
Gross fixed investment	- 9.9	- 1.8	1.4	1.1
Exports	3.7	3.1	2.3	1.4
Imports	- 25.8	- 3.8	0.8	2.1
Prices, Money and Banking (YoY%)				
CPI (eop)	12.9	5.4	4.0	4.0
CPI (period avg)	15.5	7.1	4.1	4.3
Broad money (eop)	11.3	9.2	8.0	8.0
Credit growth (eop)	8.4	- 1.6	10.0	10.0
Fiscal Accounts (% of GDP)				
Fiscal balance	- 2.4	- 3.4	- 3.0	- 2.2
Revenue	16.4	15.6	15.5	15.1
Expenditure	18.8	19.1	18.5	17.3
Primary balance	- 2.1	- 3.0	- 2.6	- 1.9
External Accounts (USDbn)				
Goods Exports	341.5	281.7	327.8	357.5
Goods Imports	193.0	191.7	202.8	223.6
Trade balance	148.5	90.0	125.1	133.9
% of GDP	10.9	7.0	7.9	8.0
Current account balance	68.9	25.0	45.5	54.3
% of GDP	5.0	1.9	2.9	3.3
FDI (net)	- 15.2	- 22.4	- 6.3	- 4.2
FX reserves (eop)	368.4	387.0	413.6	446.7
RUB/USD (eop)	72.93	60.66	59.50	57.50
Debt Indicators (% of GDP)				
Government debt [1]	13.2	12.9	15.1	15.5
Domestic	8.8	9.3	11.2	11.8
External	4.4	3.6	3.9	3.7
Total external debt	38.0	40.0	33.2	30.1
in USD bn	519	513	526	543
Short term (% of total)	9.4	9.9	9.9	9.9
General (ann. avg)				
Industrial production (YoY)	- 0.8	1.3	1.0	1.5
Unemployment (%)	5.6	5.5	5.5	5.5
Financial Markets (eop)	**Current**	**17Q3F**	**17Q4F**	**18Q1F**
Policy rate (repo)	9.25	8.50	8.00	7.50
10-year bond yield (eop)	7.63	7.50	7.30	7.20
RUB/USD (eop)	56.67	58.70	59.50	59.00

Source: Deutsche Bank, National Sources.

South Africa

Baa2 (negative)/BB+ (negative)/BB+ (stable)

Moody's/S&P/Fitch

- Economic outlook: The economy fell unexpectedly into a recession in Q1, leaving the growth outlook more fragile and likely in an extended economic downturn for now.
- Main risks: Implications of this weak number could now raise the likelihood of further downgrades by S&P this year, leading to an exit of SA from IG-constrained indices. The likely implication for Moody's could lead to a downgrade to Baa3, but with negative rather than stable outlook.

An extended downturn?

In the previous monthly, we discussed our revised GDP growth forecast for the year of 0.6%, resulting from very weak Q1 figure, which turned out to be even lower than our below consensus forecast (DBe 0.6% qoq saar vs -0.7% actual). This puts the economy officially in a technical recession, the first after entering a business cycle downturn – a period of extended below-trend growth weakness – some 46 months ago. The longest business cycle downturn lasted over 51 months leading up to the 1994 regime change. That a technical recession has been recorded this late into the downturn is fairly unique as it comes from an already low base. An important repercussion is that there is actually very little room for significant cutbacks by the private sector, which are fairly lean on employment, fixed capital investment and other operating costs. That said, we conclude that there for now there appears to be no 'circuit breaker' to propel the economy into an upswing phase, as previously expected. Confidence remains the main trigger on both sides of the spectrum for now. The big risk to growth contracting this year rests on decisions to liquidate fixed capacity and plunging public sector investment spend.

Forecast revisions following the Q1 outcome.

Owing to the lower starting point in Q1, envisaged GDP growth for 2017 is now marked for 0.4%. There is very little room for slippage, as our preliminary sequential GDP profile assumes a fairly strong recovery of 0.3%, 0.8% and 1.1% qoq saar over the next three quarters. This could be difficult to reach if domestic demand remains weak. Household demand contracted by a significant 2.3% qoq saar (from 2.2%), while capex growth slowed (albeit remaining positive). Against the backdrop of political and policy uncertainty, it is not unlikely that growth fails to reach this momentum. However, we continue to believe that much lower consumer inflation, rate cuts a fairly valued exchange rate (c. R12.5-R13/USD) will support the demand side economy.

The implications of the Q1 figures for the demand breakdown of GDP are significant mainly for household consumption. In the event that another contraction is on the cards for Q2 – taking into account weak confidence, deleveraging etc – consumption growth is seen sliding to 0.3% in real terms from 0.8% last year.

Cycle bottoming or scope for further deterioration?

So far, it appears that both the durable goods and private sector investment cycle have reached their lowest points. The pace of contraction in household demand for durable goods has slowed from -15.3% 1Q16 in to -0.2% in Q1, while for private sector investment the comparable levels are -13.7% and 1.2% (1Q16 and 1Q17). Judging from other demand components, it would appear that household demand faltered in semi-durable goods (-10.2% qoq from 6.8% in Q4) as well as non durable goods (-4.6% vs 0.3%), which are respectively a function of more restrictive credit lending practices and negative real compensation growth.

Based on recent updates, we believe that consumer credit (i.e. unsecured credit) will remain weak, but there are signs of improving growth in mortgage loans. House prices, measured by FNB have begun to mirror this moderate uptake, which is a good sign of an impending recovery in household demand, mainly in upper income categories. In turn, lower inflation of some 4.3% to 5.3% over the next few quarters would begin to start providing some relief for more price sensitive consumers. This should imply that the dramatic contraction in household demand in Q1 is unlikely to be sustained.

As it stands, preliminary data for April shows that the slide in disposable income growth of salaried individuals improved to 7.3%. Net of inflation (5.3%), this would reflect a 2% real increase in disposable income, which if sustained should cap the pessimism on household demand outlook. However, much will depend on consumers' confidence and willingness to spend. Banks have reported a significant increase in the pace of credit repayments, suggesting that a rapid revival of consumer spending is unlikely. The good news is that households will have even stronger balance sheets and pent-up demand to underpin the cycle when it does eventually turn.

Weakness in compensation growth explains a great deal of the softness in household demand in Q1. Growth in total employee compensation – a function of headcount and salary growth – slowed to 6% yoy in Q1 (from 7%), the lowest in record dating back to 1993. Inflation registered 6.3% in Q1, suggesting an outright decline in real compensation. A combination of record

high unemployment (27%), further job losses in the local and provincial government space, and wage restraint has contributed to this outcome. The concern is that these trends may continue for a few quarters, before stabilising. Sectors that had large labour contingents relative to weak output include the finance and business services and broader trade sectors. The moderation in compensation growth outside of the public sectors was chiefly driven by these sectors. We have flagged this before as posing a significant risk to the middle to high income earners generally employed in these sectors.

Gross operating surplus growth (profit proxy) posted somewhat better growth of 6.6% yoy in Q1 (from 6.7%). These rates compare to nominal GDP growth of 4.9%. However, profit growth still fell short of our expectations as we believed the positive terms of trade growth of 7% yoy in Q1 would have boosted the number significantly more. As highlighted last month, terms of trade gains only lift the bottom line if this also coincides with growth in export volumes. The SARB reported that export volumes contracted by 3.5% in Q1, thus partly explaining the underperformance. This is corroborated by the sectoral breakdown of income growth, which shows that profit growth slowed sharply in mining and agriculture sectors (despite significantly better output) in Q1.

While profit growth is barely positive in real terms, the adjustment should help to lift investment intentions at the margin. Indeed, one would expect that real returns to capital investment is improving slightly, but may not be large enough yet to compensate investors for policy and political unknowns. Thus we expect investment growth – and by extension import volumes to remain – weak for the time being.

In conclusion, our hopes for an economic revival this year have been dampened by ongoing political and policy uncertainty. There are mixed signals at this stage that provide some scope for a recovery but this could be outweighed by lingering low, if not deteriorating, confidence levels – Q2 business confidence surveys are due next week, which could make a detailed sector analysis possible.

Weak growth is commonality between agencies credit reviews and future downgrade triggers:

Both Fitch and S&P recently affirmed their credit ratings at BB+ (stable) and BB+ (negative outlook).

- The negative outlook from S&P remained intact owing to the perception that political risks remain elevated, which in turn could undermine growth and fiscal outcomes more than the base line forecasts. New spending priorities are seen to be accommodated within the existing expenditure ceiling to accommodate for some of the slippage expected in tax revenues.
- According to S&P's revised forecast deck, growth is seen rebounding from 0.3% in 2016 to 1% in 2017 (was 1.4%), averaging 1.5% from 2017 to 2020 (was 1.8%). This has led to moderate revisions to fiscal deficits (-3.4% and -3% in 2017 and 2018), which are now seen declining marginally slower than previous forecasts (-3.2% and -2.8%). The change in government debt ratio was revised moderately up from 4.2% to 4.3% over this horizon, while net debt is expected to stabilise near 50% (gross debt to peak below 55% next year). S&P also expects per capita GDP of $6 000, moderately lower than before (below DBe).
- The triggers for a downgrade included a "substantial deterioration" in fiscal and macroeconomic performance relative to the base case – in our view; this is usually of the magnitude of around 0.5% of GDP. It could thus be a very close call in November when S&P next reviews the economy, if growth does indeed slip to 0.4% as we now expect. Moreover, it may require significant traction on reform agendas (e.g. mining and labour), political stability, and reasonable public sector wage grants to disprove the agency that policy responses have become unpredictable.
- A return to stable outlook would require a moderation in political risks and stronger growth and fiscal outcomes than the base line projections. This could be a tall order to prove in the next year or so.
- Fitch, in turn, kept the outlook stable since it reduced the rating in April, with positives such as deep capital markets, a favourable debt structure and prudent fiscal and monetary policies balanced by the negatives of low trend growth, sizeable contingent liabilities and deteriorating governance. Fiscal expenditure ceilings are not seen increasing.
- Fitch expects economic growth to recover to 1% and 1.8% respectively in 2017 and 2018, which before the recent GDP print seemed achievable. The lofty growth and fiscal multipliers that the Treasury assumed in February was doubtful. On fiscal targets, Fitch sees a potential reduction in expenditure ceilings come October, but insufficient to cover the expected tax shortfall. As such a wider consolidated deficit of 3.3% and 3.1% is forecast for FY17/18 and FY18/19. Gross government debt is seen rising to 55.1% of GDP in FY19/20.
- Ratings sensitivities that could trigger negative action include a significant increase in debt/contingent liabilities; further deterioration in trend growth; and rising net external debt. Positive triggers include a substantial strengthening in trend GDP growth; improving governance reflecting better public finances; a marked narrowing in the budget deficit, or reduction in government debt ratio.

Judging from these assessments, we see the risk of a credit downgrade by S&P as higher than before. A growth shortfall vs recent forecast revisions is likely to be the main trigger for this. In contrast, we would assess the bar to further downgrades from Fitch as somewhat higher, especially since triggers include deterioration in *trend growth* rather than shorter-term growth. Further, Fitch has baked in more "fat" to its fiscal forecasts than we expect could be the case.

Moody's is yet to complete its credit review. Whereas before the Q1 GDP data, we expected a credit downgrade to Baa3 with a stable outlook, we now fear that the data may have upped the risks of a negative outlook. This will be more damaging to the market than originally perceived. Moody's holds the key to South Africa's inclusion in the Citigroup World Government Bond Index – the most significant of international bond indices.

The index inclusion criteria require **both S&P and Moody's assessment of LC debt to remain in investment grade status.** But assuming that forced selling is a direct function of funds tracking the index (c. $2.5-3tn) and South Africa's weight in the index (c. 0.44%) may be too simplistic. Based on this information, forced selling of local rand bonds could come to $8-12bn (R100- 150bn). It is our understanding that the WGBI is not frequently used outside of Japan. This makes it questionable whether investors really bother tracking countries with such small shares. In our understanding, exit from this index doesn't technically translate into immediate forced selling, as the local market will be moved to the WGBI Additional Market Indices – which still gives investors the option to track the bonds, but doesn't force such holdings.

Moreover, since South Africa remains a highly traded market – longest duration etc – funds may still up their stake in non-IG constrained indices that are tracked mainly by EM-dedicated funds. This could considerably lower the eventual selling pressure estimated by market participants, making us cautious to extrapolate potential downgrade implications to our rand and other forecasts.

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South Africa: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	236	299	352	388
Population (mn)	55.0	55.9	56.8	57.7
GDP per capita (USD)	4327	5 354	6 201	6 728
Real GDP (%)	1.3	0.3	0.4	1.7
Priv. consumption	1.7	0.8	0.3	1.9
Gov't consumption	0.5	2.0	0.1	0.4
Gross capital formation	2.3	- 3.9	0.3	2.5
Exports	3.9	- 0.1	1.8	3.2
Imports	5.4	- 3.7	1	3.4
Prices, Money and Banking				
CPI (YoY%, eop)	5.3	6.7	4.3	5.3
CPI (YoY %, pavg)	4.6	6.4	5.3	4.8
Fiscal Accounts (% of GDP) [1, 2]				
Overall balance	- 3.9	- 3.6	-3.3	-2.8
Revenue	29.8	29.4	29.7	30.3
Expenditure	33.6	33.0	33.0	33.1
Primary balance	- 0.8	-0.2	0.1	1.0
External Accounts (USDbn)				
Goods exports	80.5	76.2	87.6	94.6
Goods imports	83.1	75.2	84.8	92.6
Trade balance	-2.7	1.0	2.7	2.0
% of GDP	-0.9	0.3	0.8	0.5
Current account balance	-13.5	-9.8	-9.1	-10.9
% of GDP	-4.4	-3.3	-2.6	-2.8
FDI (net)	- 3.5	5.0	- 3.8	0.0
FX reserves (USD bn)	45.8	47.0	48.0	48.5
ZAR/USD (eop)	15.6	13.5	12.5	12.0
ZAR/EUR (eop)	16.9	14.2	11.9	12.0
Debt Indicators (% of GDP)				
Government debt [1]	50.5	51.3	50.2	49.6
Domestic	44.8	44.8	44.0	44.0
External	5.7	6.5	6.2	5.6
Total external debt	46.1	44.4	36.3	30.4
in USD bn	144	132	129	120
Financial Markets (eop)	**Current**	**17Q2**	**17Q3**	**18Q1**
Policy rate	7.00	7.00	6.75	6.5
3-month Jibar	7.35	7.35	7.05	6.65
10-year bond yield	8.80	8.70	8.60	8.50
ZAR/USD	12.83	13.0	12.75	12.40
ZAR/EUR	14.45	14.0	12.38	11.90

(1) Fiscal years starting 1 April.
(2) Starting with the November2013 EM Monthly, numbers are presented using National Treasury's new format for the consolidated government account.
Source: Deutsche Bank, National Sources.

Turkey

Ba1 (negative)/BB (negative)/BB+ (stable)

Moody's / S&P / Fitch

- Economic outlook: Economic activity continues to improve in light of frontloaded demand thanks to credit and fiscal impulse. CPI appears to have finally peaked yet the forthcoming slowdown will likely be shallow and cyclical. CBT's exotic tightening is over. Pro-growth fiscal stance will likely be maintained.
- Main risks: Political uncertainty receded in the aftermath of the April referendum, yet geopolitical risks are seemingly on the rise, as manifested in recent Qatari crisis. Given Turkey's structural bottlenecks, such as large external financing requirements, further rapid TRY depreciation and/or too much slippage in growth could propagate a negative feedback loop between real and nominal economy.

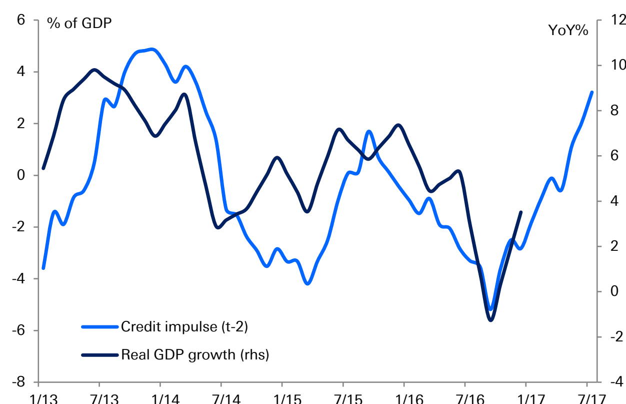
In search of momentum

Domestic political backdrop has relatively calmed down recently with immediate risks of early elections having faded following approval of the constitutional amendments in the April public referendum with a narrow lead. President Erdogan was re-elected as the AKP chair in the Extraordinary Congress held on May 21. Erdogan's immediate move was to go for an overhaul in the party's Central Decision and Executive Board (MKYK) by replacing almost 40% of its 50 members. The ensuing change in the core party management, i.e. Central Executive Committee, was however limited (to only three members). Despite earlier comments in local press, such as Hurriyet and Haberturk (on April 25), there has been no cabinet reshuffle. Still, some local dailies, for instance Dunya (on June 07), claim a limited amendment could be in the cards to be announced during Eid al-Fitr, which will take place in the final week of June. If this happens, markets will probably keep a close eye on any change in the economy management to gauge President Erdogan's and AKP government's approach to much-needed reforms (on the labor market, low savings issue as well as the tax system) ahead of the heavy election cycle (municipal, Parliamentary and Presidential) in 2019.

Risks on growth are tilted to the upside

The sequential growth in real GDP has lost some momentum in Q1, as signaled by slower expansion in industrial production during the quarter (1.4%QoQ versus 4.2% in Q4 2016). Recent high-frequency indicators however point to a likely improvement in economic momentum into Q2. White goods sales, for instance, grew by c45%YoY in April thanks to extended tax cuts, while house sales remained resilient at 7.6%YoY supported by artificially low mortgage rates and nationwide campaigns. FX-adjusted credit growth reached 40% (WoW, 13wma, annualized) in end-May on the back of a rapid rise in commercial credit thanks to the Credit Guarantee Fund. Manufacturing PMI meanwhile climbed to its highest level over the last three years in May, also reflecting support from better external demand. Accordingly, risks to our growth forecast for 2017: (3.4%YoY) are tilted to the upside as countercyclical policies, i.e. credit and fiscal impulse, are apparently doing their trick. It is however worth noting that this is mostly frontloaded demand from future and the latest levels in credit growth are unlikely to be sustainable in absence of additional policy measures.

Credit impulse strengthened markedly year to date



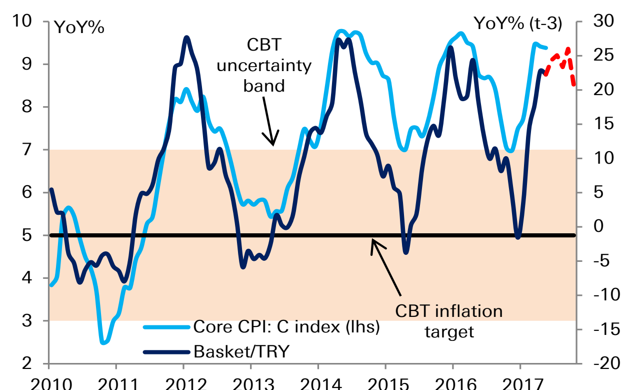
Source: Haver Analytics, CBT, TurkStat, and Deutsche Bank

Inflation: a shallow and cyclical slowdown begins

Headline annual CPI came in at 11.7%YoY in May after 11.9% previously and hence retreated for the first time since November. Main upside driver – in annual terms – was again food. FX pass-through impact, while still evident, was partially softer in absence of further TRY weakening. Core inflation, C index, was marginally lower again in annual terms.

Base effects would remain supportive until July, hinting that headline CPI could continue to recede, barring a major upside surprise in food during Ramadan. Despite further deceleration in May and dwindling impact of FX pass-through, slowdown in core CPI could prove more gradual than expected in light of high and sticky services inflation (9.1%YoY) and lagged wage-cost pressure. While the May print could represent beginning of a cyclical slowdown in headline CPI, which could last until mid-Q3, we still expect headline CPI to remain at double-digit levels for most of 2017 (10.6% on average) due to higher trend inflation and consistent FX pass-through throughout the year.

Much-awaited decline in core could be more gradual than expected



Source: Haver Analytics, CBT, TurkStat, and Deutsche Bank

When will CBT change course?

We think CBT is already done with its exotic tightening and await the right timing to normalize rates. MPC's recent forward guidance and aim to recoup some credibility suggest CBT could wait until fledgling (cyclical) improvement in headline CPI becomes more visible, which we expect to take place with the July print. Until then, CBT looks set to keep monetary conditions tight and the effective rate close current levels (c12%).

One thing to watch closely however is recent rise in deposit and loan rates, reflecting enhanced demand emanating from improving confidence as well as the Credit Guarantee Fund. While still remaining short of extent of tightening delivered in policy rates, any further meaningful rise in deposit and commercial/consumer cash loans rate could prompt CBT to ease liquidity conditions slightly sooner. First sign for any easing will probably come via the FX swap facility, where the Bank could opt for lower auction amounts (currently at USD1.25bn), citing dampened need for FX liquidity in the system. This will first help some TRY liquidity remain in the system. If conditions remain right, it could be followed by more funding from the O/N lending rate (9.25%), which would mean a lower weighted average rate. We believe CBT will still label such effective easing as part of its renewed 'simplification' efforts. Barring a major change in the external backdrop, we expect steady one-week repo, O/N lending and the late liquidity window rate in the foreseeable future.

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Turkey: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	857	856	798	807
Population (mn)	77.7	78.6	79.4	80.2
GDP per capita (USD)	11 023	10 901	10 047	10 059
Real GDP (YoY%)	6.1	2.9	3.4	3.7
Private consumption	5.5	2.3	4.8	3.5
Government consumption	4.1	7.3	9.3	6.4
Gross fixed investment	9.2	3.0	3.6	4.1
Exports	4.2	- 2.0	6.9	5.4
Imports	1.7	3.9	5.6	7.4
Prices, Money and Banking (YoY%)				
CPI (eop)	8.8	8.5	9.7	8.6
CPI (period avg)	7.7	7.8	10.6	8.5
Broad money (eop)	17.1	18.3	14.4	15.1
Bank credit (eop)	19.3	15.3	15.7	17.2
Fiscal Accounts (% of GDP)				
Overall balance [1]	- 1.0	- 1.1	- 2.9	- 2.1
Revenue	20.7	21.4	20.9	20.6
Expenditure	21.7	22.5	23.8	22.7
Primary balance	1.3	0.8	- 0.7	0.0
External Accounts (USDbn)				
Goods Exports	152.0	150.2	162.7	168.6
Goods Imports	200.1	191.0	207.7	217.8
Trade balance	- 48.1	- 40.8	- 45.0	- 49.2
% of GDP	- 5.6	- 4.8	- 5.6	- 6.1
Current account balance	- 32.1	- 32.6	- 36.3	- 38.9
% of GDP	- 3.7	- 3.8	- 4.5	- 4.8
FDI (net)	12.5	9.1	6.4	9.0
FX reserves (eop)	92.9	92.2	82.2	78.0
TRY/USD (eop)	2.91	3.54	3.90	4.30
Debt Indicators (% of GDP)				
Government debt [1]	29.0	29.3	30.0	30.0
Domestic	18.8	18.1	19.0	19.2
External	10.2	11.2	11.0	10.8
Total external debt	46.2	47.2	52.1	53.4
in USD bn	396	404	415	431
Short term (% of total)	25.7	24.2	23.0	22.7
General (ann. avg)				
Industrial production (YoY)	2.9	1.8	3.4	3.3
Unemployment (%)	10.3	10.9	11.2	10.9
Financial Markets (eop)	**Current**	**17Q3F**	**17Q4F**	**18Q1F**
Policy rate (repo)	8.00	8.00	8.00	8.00
Overnight lending rate	9.25	9.25	9.25	9.25
10-year bond yield	10.50	10.10	9.90	9.70
TRY/USD (eop)	3.55	3.74	3.90	4.04

(1) Central government
Source: Deutsche Bank, National Sources.

Argentina

B3(positive)/B(stable)/WD(stable)
Moodys /S&P /Fitch

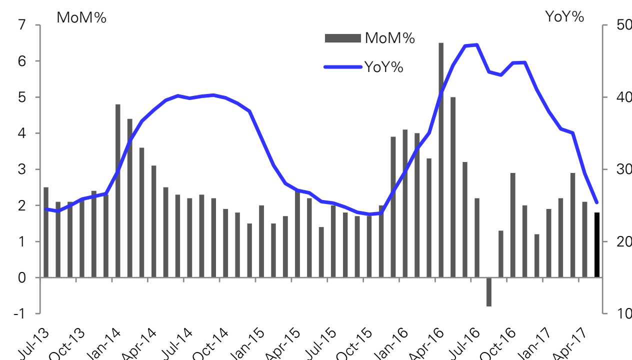
- Economic outlook: Although inflation has decelerated more slowly than the authorities hoped and prompted the central bank to raise interest rates, we expect inflation to slow further, allowing the monetary easing to resume. The slow economic recovery increases the pressure for a more expansionary fiscal policy.
- Main risks: The sharp increase in utility prices and the slower-than-expected economic recovery have taken a toll on the government's popularity. Despite the gains from the tax amnesty program, the budget deficit remains large and the mid-term elections could have negative implications for economic policies.

Brazilian contagion

Inflation remains high but is declining

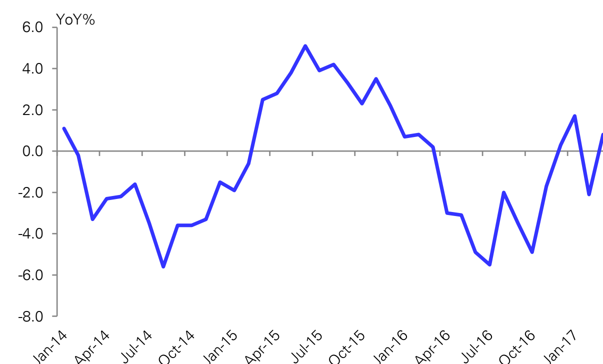
After rising a higher-than-expected 2.4% MoM in March, the GBA (Gran Buenos Aires) CPI surprised on the upside again and climbed 2.6% MoM in April, more than the consensus forecast of 2.0%, as utility prices rose a hefty 3.7% MoM. In 12 months, the CPI climbed 27.5%, led by a 35.6% surge in regulated prices. Reacting to a slower-than-expected decline in inflation and deterioration in inflation expectations, the BCRA surprisingly tightened monetary policy in April, raising its benchmark 7-day repo rate to 26.25% from 24.75%. While the authorities have reinforced their commitment to make inflation converge to the target, we still forecast inflation of 22.0% for 2017 (in Buenos Aires), as prices have increased by more than we had expected so far this year. However, we do not believe that missing the inflation target will prevent the central bank from easing monetary policy ahead. We still expect the benchmark interest rates to resume falling in 2H17 and reach 22.0% at the end of the year (although the risk is that the BCRA could take longer than we expect to resume cutting rates). We believe the authorities will minimize the results obtained so far and focus on current inflation, which will likely decelerate in the next months. The latest data available, for example, suggest that inflation slowed to approximately 1.8% MoM and 25.4% YoY in May. It is also important to highlight that official statistics institute INDEC will begin to publish a national consumer price index in July, which will probably show inflation slightly lower than in Buenos Aires, where utility prices rose by more than in other regions. Furthermore, the slow pace of economic recovery will provide the authorities with a strong incentive to resume easing monetary policy as soon as possible, in our opinion.

Argentina: Consumer price index (Buenos Aires)



Source: City of Buenos Aires, DB forecast for May

Argentina: INDEC index of economic activity



Source: INDEC

Data suggests positive growth in 1Q17

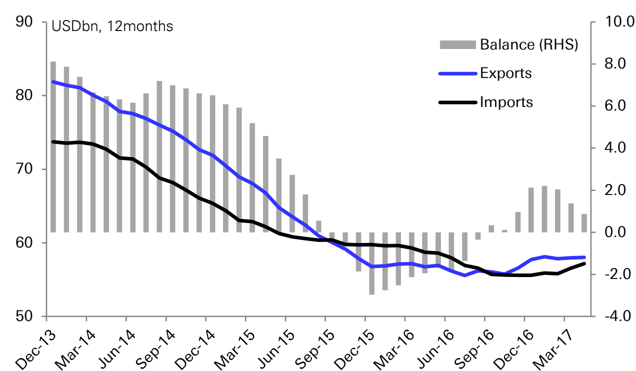
The INDEC index of economic activity grew a seasonally-adjusted 1.9% MoM in March, after plunging 2.6% MoM in February. The index rose 0.8% YoY, led by a 7.8% YoY surge in construction (mainly due to public works), a 5.8% YoY increase in agriculture (reflecting the strong harvest) and a 5.2% YoY gain in financial intermediation. On the other hand, mining fell 4.0% YoY and manufacturing declined 0.2% YoY. Although the increase in the INDEC index in March was mainly a pay-back to the sharp decline posted in February, the indicator still rose 0.6% QoQ, suggesting that GDP posted positive QoQ growth for the third consecutive quarter in 1Q17. Nevertheless, we are keeping our 2017 GDP growth forecast unchanged at 2.4% for now. Although consumer confidence improved in April and consumers tend to benefit from the decline in 12-month inflation, the existing data still shows a slow recovery in private consumption. Household consumption remains weak: supermarket sales fell 17% YoY in real terms in March according to

INDEC, while shopping mall sales in Greater Buenos Aires declined 24% YoY in real terms. And although investment seems to be improving due to a strong rebound in construction led by public works, it could suffer contagion from Brazil, where the latest political developments could jeopardize the economic recovery of Argentina's main trading partner.

Peso affected by Brazilian crisis

The peso depreciated sharply in May, jumping above ARS16.0/USD from ARS15.4/USD in response to renewed political turbulence in Brazil. Although contagion from Brazil will likely be transitory, we are keeping our year-end FX forecast unchanged at ARS17.5/USD, as we believe the nominal exchange rate has to keep up with inflation in order to prevent an excessive appreciation in real terms, which is already taking a toll on the trade balance. The trade balance posted a deficit of USD1.2bn in 4M17, compared to a zero deficit in 4M16, as exports rose 1.8% YoY (as a decline in exports of fuel and energy offset increases in manufactures and agricultural products) and imports surged 9.1% YoY.

Argentina: Trade balance



Source: INDEC

Keep an eye on politics

It is important to monitor the political situation in light of the mid-term elections to be held in October, when roughly half of the 257 Lower House representatives and 1/3 of the 72 senators could be replaced. The deadline for candidates to apply for candidacy is June 24. While the election is unlikely to change the balance of power in Congress (President Mauricio Macri will hardly obtain majority), a negative outcome for the ruling party – especially in the province of Buenos Aires – could undermine political support for current policies and jeopardize much-needed fiscal consolidation. The good news, for Macri, was a significant rebound in his approval rating in April following negative readings in March.

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Argentina: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	633.3	545.5	621.2	625.3
Population (m)	43.1	43.6	44.1	44.6
GDP per capita (USD thousand)	14.7	12.5	14.1	14.0
Real GDP (YoY%)	2.6	-2.3	2.4	2.8
Priv. consumption	3.5	-1.4	3.0	3.2
Gov't consumption	6.8	0.3	2.8	1.0
Gross capital formation	3.8	-5.5	1.9	4.0
Exports	-0.6	3.7	4.2	2.0
Imports	5.7	5.4	2.6	3.2
Prices, Money and Banking				
CPI (YoY%, eop)	27.7	41.1	22.0	13.0
CPI (YoY%, avg)	28.3	41.3	26.6	15.4
Broad money (M2, YoY%)	37.0	19.1	16.0	10.0
Bank credit (YoY%)	34.9	34.0	20.0	12.0
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-5.6	-5.8	-6.2	-5.5
Government spending	39.5	39.5	38.2	37.5
Government revenue	33.9	33.7	32.0	32.0
Primary surplus	-4.2	-4.3	-4.2	-3.5
External Accounts (USDbn)				
Merchandise exports	56.8	57.7	60.0	61.5
Merchandise imports	59.8	55.6	61.0	64.0
Trade balance	-3.0	2.1	-1.0	-2.5
% of GDP	-0.5	0.4	-0.2	-0.4
Current account balance	-16.4	-15.1	-18.7	-20.7
% of GDP	-2.6	-2.8	-3.0	-3.3
FDI (net)	11.8	5.7	9.0	10.0
FX reserves (USDbn)	25.6	38.8	58.8	68.8
ARS/USD (eop)	11.4	15.9	17.5	19.8
Debt Indicators (% of GDP)				
Government debt	35.2	39.9	45.3	50.2
Domestic	14.4	16.3	18.5	20.5
External	20.8	23.6	26.8	29.7
Total external debt	26.9	35.3	31.4	32.0
In USDbn	170.4	192.5	195.0	200.0
Short-term (% of total)	8.4	9.5	9.3	9.0
General				
Industrial production (YoY%)	0.5	-4.7	0.8	1.5
Unemployment (%)	6.5	8.5	8.8	8.6
Financial Markets (eop)	**Current**	**17Q2**	**17Q3**	**17Q4**
7-day repo rate (% p.a.)	26.3	26.3	23.5	22.0
1 month BADLAR	19.2	18.5	18.5	18.0
ARS/USD	16.0	15.9	16.7	17.5

Source: DB Global Markets Research forecasts, National Sources

Brazil

Ba2(negative)/BB(negative)/BB(negative) Moody's/S&P/Fitch

- Economic outlook: Although the economy is struggling to recover amid a very unstable political environment, a sharp decline in inflation is allowing the BCB to ease monetary policy, which will ultimately drive growth. However, the fiscal imbalance remains a serious risk as the public debt will not stabilize in the absence of structural reforms.
- Main risks: Another political scandal has triggered renewed volatility and could prevent Congress from passing critical reforms required for long-term fiscal consolidation. While low inflation and a comfortable situation in the balance of payments help explain market complacency, Brazil is becoming more vulnerable to shocks.

With or without Temer

Political scandal clouds economic outlook

Brazilian markets were rocked in May when Joesley and Wesley Batista, the owners of giant meat-packing conglomerate JBS, reached a plea bargain agreement with federal prosecutors, providing not only a list of politicians that they allegedly bribed over several years, but also taped conversations with prominent politicians. Joesley Batista secretly recorded a conversation with President Michel Temer on March 7, telling the president that he was paying a monthly allowance to former Lower House Speaker Eduardo Cunha, currently in jail, so that Cunha would not implicate more people in the political scandal. Batista also described to Temer his efforts to thwart an investigation into his companies, including bribing court officials. Although President Temer has denied any wrongdoing and has pledged not to resign, his political situation remains very fragile, as the Supreme Court (SFT) has opened a formal investigation of the president. Should Temer resign, he would be replaced by Lower House Speaker Rodrigo Maia, who would have to call for an "indirect election" in 30 days. In that case, Congress would elect a new president to replace Temer and remain in office until the end of 2018. Temer's mandate could also be abbreviated by the TSE electoral court, which could invalidate the elections on the grounds that the Dilma Rousseff/Michel Temer winning ticket was financed by illegal funds disclosed by the *Lavajato* investigation. Until last month, government officials were quite confident that the TSE would acquit Temer (accepting the thesis that the campaign for vice president was independent from the campaign for president) and keep him in the presidency so as not to produce excessive political instability. In light of the latest developments, however, the risk of a TSE ruling against Temer has increased significantly. There is some legal controversy as to how Temer's successor would be chosen in this case, but we believe the most likely scenario would be an indirect election by Congress as well. The opposition parties have stated that they would prefer a direct election, mainly because the latest polls indicate that former president Lula da Silva would be the strongest presidential candidate today. However, we believe direct elections are unlikely. First, a direct election would probably require a constitutional amendment, and the opposition does not have enough votes to pass one. Second, the country's establishment favors the path of least resistance to navigate until 2018, and electing former president Lula now could aggravate the economic crisis, in light of his interventionist stance and strong opposition to reforms. Third, it would not make much sense to have a presidential election in 2017 and another in 2018. That said, indirect elections would be a challenging endeavor as well. As it has never happened before, Congress would have to pass legislation defining the main rules (establishing, for example, the criteria for who could be the candidates) before actually electing the new president. The silver lining, on the other hand, is that an indirect election could pave the way for a caretaker government supported by Congress and able to ensure minimal governability conditions to stabilize the country until the 2018 elections.

The outlook for reforms has deteriorated

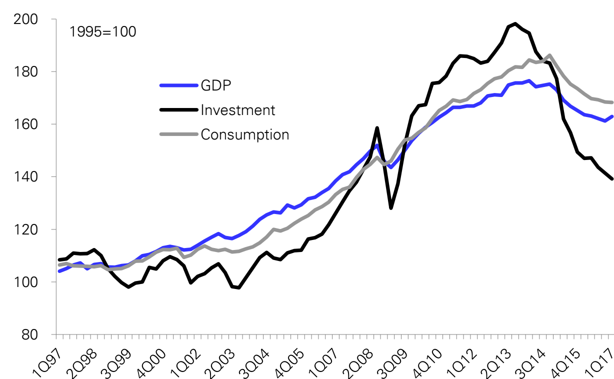
Congress has been reluctant to pass the reforms and the strong political leadership of Temer and his close allies until now has been paramount to push them forward. The scandal has undermined Temer's leadership, so even if the president manages to survive the turmoil, he will have less political capital to pass unpopular reforms. Alternatively, should Temer resign or be ousted by the TSE, his successor would also face obstacles in such a volatile political environment and, in the best case scenario, there would be delays. That said, the country's establishment is pushing very hard to pass the reforms, so there is a good chance that something will be approved with or without Temer. Given the complex political situation, according to newspaper *Estado de S.Paulo*, congressmen are discussing the possibility of passing a minimal social security reform, a "mini-reform." There could be two options. The first would be to pass only the minimum retirement age, which is the reform's cornerstone and requires a constitutional amendment. Given the transition mechanism proposed, such reform would have no impact in the near term, so it would not help solve the short-term fiscal imbalance. The second would be to pass the parts of the reform that do not require changing the constitution and could be done by provisional decrees, which require fewer votes than amendments. In this case, some measures (changes to the BPC welfare program, time of contribution for

retirement, survivor pensions, etc.) could have a positive effect in the near term but would not fix the system's main structural problems. We have always stressed that the social security reform is a necessary but not sufficient condition to stabilize Brazil's public debt, as the economy will have to resume growth and the government will eventually have to raise taxes and find more expenses to cut in order to produce a primary fiscal surplus by 2020. A mini-reform would further postpone fiscal consolidation and additional measures would be even more necessary to stabilize the fiscal accounts. Nevertheless, given the comfortable situation in the balance of payments and repeatedly good news on inflation, market participants (especially foreign investors) seem to believe that current yields are high enough to cover the risks, and recent price action suggests that Brazil will be given the benefit of the doubt and more time to implement its fiscal adjustment. Consequently, assuming the continuation of a benign international environment (especially low interest rates in the US) and the absence of additional domestic shocks, Brazil might be able to pull it off and maintain economic stability even if it manages to implement only superficial reforms before the 2018 elections.

GDP posts positive growth after two years.

GDP grew 1.0% QoQ in 1Q17, roughly in line with market expectations (our forecast was 1.2% QoQ). Growth in the first quarter interrupted a sequence of eight consecutive quarterly declines. As expected, the increase in GDP was led by the agricultural sector, which surged 13.4% QoQ due to a record harvest. The industrial sector grew 0.9% QoQ as mining rose 1.7% QoQ and manufacturing expanded 0.9% QoQ. Services remained unchanged as transportation grew 2.8% QoQ and information services expanded 1.6% QoQ, but retail fell 0.6% QoQ and financial intermediation declined 1.2% QoQ. On the demand side, the only positive contribution came from the external sector, as exports climbed 4.8% QoQ, surpassing the 1.8% QoQ increase in imports. Investment posted another dismal performance and fell 1.6% QoQ (fixed-asset investment has declined in every quarter since 4Q13, except for the meager 0.1% QoQ increase posted in 2Q16). Household consumption fell 0.1% QoQ – its ninth consecutive decline – still reflecting dire labor market conditions and credit constraints. Government consumption fell 0.6% QoQ. On a year-on-year comparison, GDP fell 0.4% YoY, as investment plunged 3.7% YoY, household consumption fell 1.9% YoY, government consumption declined 1.3% YoY, exports inched up 1.9% YoY and imports advanced 9.8% YoY. We expect GDP growth to decelerate significantly and forecast almost no growth in 2Q17, as consumption and investment continue to recover slowly amid high unemployment, credit rationing and political uncertainty, and we do not expect the same boost from the agricultural sector. We are keeping our 2017 GDP growth forecast unchanged at 0.7% for now, but we believe that there is a risk that the economy could go into a "double dip" if the political situation fails to stabilize, dashing any hopes for a quick recovery in investment. For 2018, we lowered our forecast to 2.4% from 2.8%.

Brazil: Real GDP



Source: IBGE

The disinflation process continues

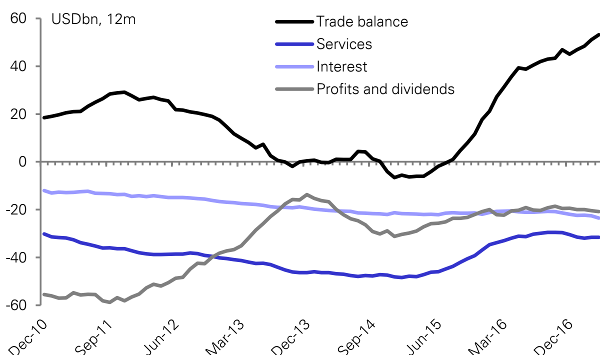
Inflation continues to decelerate, reflecting not only weak economic activity (i.e. a negative output gap), but also a sharp correction in agricultural prices (wholesale agricultural prices have fallen 14% since they peaked in June 2016). The IPCA consumer price index rose only 0.14% in April and we forecast a 0.50% increase in May, mainly due to the unwinding of a temporary reduction in electricity rates in the previous month. However, we expect inflation to decline again to zero or even slightly below zero in June, reflecting the latest cut in fuel prices and a decline in electricity prices due to the elimination of the "red flag" surcharge in response to increased rainfall. Thus, despite the ongoing political turbulence and potential effect on the FX, we are keeping our 2017 IPCA forecast at 3.8%. Consequently, there still seems to be plenty of room for the BCB to cut interest rates.

BCB signals slower pace of easing

The COPOM repeated the dosage and cut the SELIC overnight interest rate by 100bps to 10.25% at the end of May. The official communiqué highlighted the increase in uncertainty resulting from the latest political developments and potential implications for the economic reforms. According to the authorities, the increase in uncertainty could have a negative effect on economic activity and inflation. Assuming a SELIC rate at 8.5% at the end of 2017 and 2018 (which is now more important than the current year), the BCB forecasts inflation of 4.0% for 2017 (down from 4.1%) and 4.6% for 2018 (up from 4.5%). Thus, the BCB is now indicating that the SELIC rate will probably fall to 8.5% and not below that. The authorities stress that the increase in uncertainty about the reforms and necessary adjustments in the economy makes it more difficult for the estimates of the economy's structural interest rate to fall. Consequently, "a moderate reduction in the pace of monetary easing relative to the pace adopted today should be appropriate at the next

meeting," even though the pace will continue to depend on the economic recovery, balance of risks and inflation expectations. Thus, we expect the BCB to reduce the pace of easing and cut the SELIC rate by 75bps to 9.50% at the next meeting scheduled for July 26. We have raised our year-end SELIC forecast to 8.5% from 8.0% and we still expect no change in rates during 2018, which will be an election year.

Brazil: Current account components



Source: BCB

Low current account deficit supports BRL

The deterioration in the outlook for reforms due to the political crisis is negative for the BRL. However, given the very comfortable situation in the balance of payments, we revised our year-end FX forecast just slightly to BRL3.20/UDS from BRL3.10/USD. The trade surplus totaled USD29.0bn in 5M17, compared to USD19.7bn in 5M16, as exports surged 18.5% (mainly due to higher commodity prices) and imports rose 8.4%. Exports of raw materials grew 27.1% YoY and total exports to China jumped 36.9% (China purchased 26.2% of Brazilian exports in 5M17, up from 22.7% in 5M16). While imports seem to be recovering due to stronger FX and the gradual improvement in economic activity, exports are clearly benefiting from higher commodity prices (especially of oil and iron ore) and a strong agricultural harvest. We have further raised our 2017 trade surplus forecast to USD65bn from USD60bn (compared with USD47.7bn in 2016, according to SECEX data). The large trade surplus will contain the current account deficit (an estimated USD17bn or 0.8% of GDP this year), which we expect to be easily financed by approximately USD60bn in foreign direct investment. Having said all that, we stress that failure to pass the reforms and buck the negative fiscal trend could make Brazil more vulnerable to external shocks such as another "taper tantrum" in the United States.

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Brazil: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	1,798	1,799	2,054	2,098
Population (m)	204	206	207	209
GDP per capita (USD)	8,792	8,735	9,899	10,043
Real GDP (YoY%)	-3.8	-3.6	0.7	2.4
Private consumption	-3.9	-4.2	0.3	2.5
Government consumption	-1.1	-0.6	-0.2	0.9
Gross capital formation	-13.9	-10.2	-1.4	4.1
Exports	6.3	1.9	3.5	3.0
Imports	-14.1	-10.3	4.5	3.0
Prices, Money and Banking				
CPI (YoY%, eop)	10.7	6.3	3.8	4.4
CPI (YoY%, avg)	9.0	8.7	3.8	4.2
Money base (YoY%)	3.4	1.9	3.0	6.0
Broad money (YoY%)	-1.6	-0.5	2.5	5.0
Fiscal Accounts (% of GDP)				
Consolidated budget	-10.2	-9.0	-8.2	-7.8
Interest payments	-8.4	-6.5	-6.0	-6.0
Primary balance	-1.9	-2.5	-2.2	-1.8
External Accounts (USDbn)				
Merchandise exports	190.1	184.5	207.0	215.0
Merchandise imports	172.4	139.4	142.0	160.0
Trade balance	17.7	45.0	65.0	55.0
% of GDP	1.0	2.5	3.2	2.6
Current account balance	-58.9	-23.5	-17.0	-35.0
% of GDP	-3.3	-1.3	-0.8	-1.7
FDI (net)	57.2	49.5	60.0	65.0
FX reserves (USDbn)	368.7	372.2	372.2	372.2
FX rate (eop) BRL/USD	3.90	3.26	3.20	3.40
Debt Indicators (% of GDP)				
Government debt (gross)*	65.5	69.9	75.7	79.1
Domestic	61.1	66.2	72.2	75.7
External	4.4	3.6	3.4	3.4
Total external debt	30.1	30.7	26.9	26.6
in USDbn	540.5	552.3	552.3	557.3
Short-term (% of total)	10.6	10.2	10.5	10.0
General				
Industrial production (YoY%)	-8.2	-6.6	1.5	3.5
Unemployment (%)	8.5	11.5	13.1	12.8
Financial Markets (EOP)	**Current**	**17Q2**	**17Q3**	**17Q4**
Selic overnight rate (%)	10.25	10.25	9.00	8.50
10-year Pré-CDI rate (%)	11.0	10.8	10.5	10.0
BRL/USD	3.24	3.15	3.20	3.20

(*) Includes central government, states, municipalities and some SOEs.
Source: National Statistics, Deutsche Bank forecasts

Chile

Aa3 (stable)/AA- (stable)/A+ (stable)
Moodys /S&P/ /Fitch

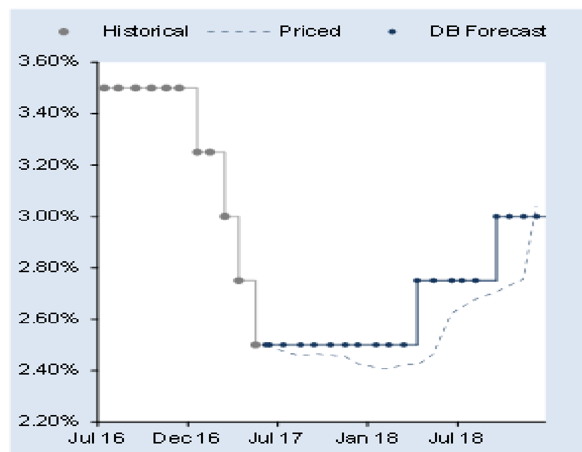
- Economic outlook: The BCCh has put an end to its easing cycle. The post-meeting statement, the minutes, and the quarterly inflation report published after the meeting all suggest that the central bank expects inflation to print below target at least until the end of 2018 and for GDP to grow below 2% in 2017. Therefore, a further reduction of the TPM is likely only in the event of shocks severe enough to deteriorate the outlook for either growth or inflation even further. We expect a recovery of investments on the back of the dissipation of political noise after November. And we therefore expect the BCCh to begin normalizing the policy rate late in Q2 '18.
- Main risks: The main risk in the near term is that the inflation rate accelerates its decline, dragging inflation expectations below the lower bound of the BCCh's inflation target tolerance range of 2%. Also, a further weakening of the USD leading to a real appreciation of the CLP poses another deflationary risk. And just as we highlighted last month, on the activity front the main risk to our view is that the new labor legislation results in longer strikes. Until November's election, we do not see any significant upside risks to our activity expectations.

The easing cycle ends on a dovish note

The outcome of the BCCh's May monetary policy meeting was a reduction of the TPM from 2.75% to 2.5%. We had expected the central bank to drive the monetary policy rate down to 2.5% after its June meeting and to remain on hold in May. However, despite the "dovish surprise" we believe that the post-meeting statement indication that the BCCh now has a neutral bias in its stance is a strong indication that the easing cycle has concluded (at least, for now). And while the timing might have surprised us, the TPM's level at the end of the cycle is consistent with our expectations.

The minutes of May's meeting show that the decision to reduce the policy rate was not unanimous, as one of the five members of the board voted to keep the TPM at 2.75%. Beyond the timing of the cut, there were some other indications that the BCCh's board might remain relatively dovish despite their official change in policy stance. For example, whereas in previous publications and statements the BCCh had suggested that Chile's neutral interest rate was between 4% and 4.5%, the discussion now suggests that the range over which policy rates neither stimulate nor curtail activity is between 3.75% and 4.25%. And while the majority of the board members are comfortable with the current level of the TPM despite their expectation of very feeble activity data going forward, there are at least two members who appear to be more data-dependent and therefore willing to switch to a dovish stance if either activity or inflation expectations data are below expectations.

BCCh: The end of the easing cycle



Source: BCCh, Deutsche Bank

The publication of the BCCh's quarterly inflation report (IPoM) for Q2 '17, however, strongly suggests that the central bank will now remain on hold for a few meetings before altering their neutral stance. The BCCh first hinted that the Chilean economy could be in need of easier monetary conditions in December 2016, when the policy rate stood at 3.5%. Since then, the BCCh has reduced the rate by 100bp whenever data has not been in line with the baseline scenario the central bank periodically divulges in its quarterly inflation report.

The baseline scenario of the latest IPoM is almost unchanged relative to the previous publication. The working assumption behind the different forecasts is that the monetary policy rate remains at 2.5% and that the real exchange rate remains near its current levels. With that in mind, the BCCh expects 2017 GDP to grow between 1% and 1.75%. Previously, growth was expected to be between 1% and 2% and it is customary for the BCCh to reduce their interval forecast by 25bp as they get closer to the end of the year, so the reduction of the interval's upper bound is hardly reflective of a significant deterioration of growth expectations. On the other hand, the central bank's growth forecast for 2018 improved from a range of 2.25%-3.25% to 2.5%-3.5%. Inflation expectations have deteriorated, as headline inflation by year end is now expected to print at 2.6% instead of 2.7%. The forecast for core inflation for 2017 has also declined from 2.3% to 2.1%. For 2018, inflation is expected to reach 2.8%.

In all, the BCCh considers that the balance of risks to both activity and inflation are balanced.

BCCh: The hurdle for additional cuts is relatively high

BCCh's Base Case Scenario	2017	2018
GDP (y/y)	1.0% - 1.75%	2.5% - 3.5%
Internal demand (y/y)	2.50%	3.90%
Gross fixed capital formation	-0.90%	3%
Total consumption	2.60%	2.90%
Exports	0.70%	3.90%
Imports	4.30%	6.60%
Avverage headline inflation	2.60%	2.90%
Average core inflation	2.10%	2.50%

Source: BCCh, Deutsche Bank

In our view, the IPoM signals that despite the expectation of below-target inflation prints in both headline and core measures for both the end for 2017 and 2017 they are comfortable with the current level of the policy rate. Therefore, unless the economy suffered a significant negative demand shock or that inflation expectations pierce through the 2% floor of the inflation target's tolerance band, we expect the BCCh to remain on hold at least until the central bank's base case scenario is again updated in September. We continue to expect the BCCh only to begin normalizing monetary policy conditions by the end of Q2 '18.

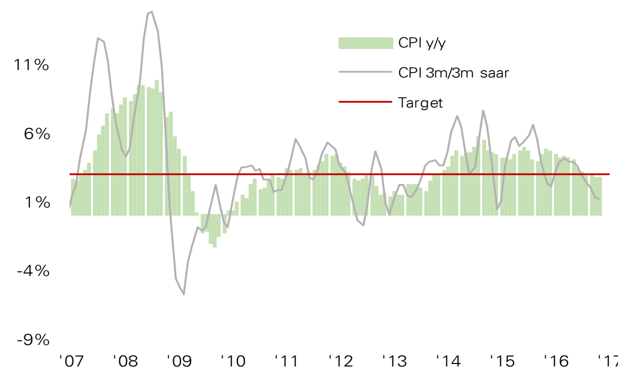
Activity and inflation data continue to disappoint

Early Q2 '17 activity and inflation indicators recently published do not change our overall assessment of the current state and near future of Chile's overall macro picture. In particular, April's economic indicators were less than inspiring. Labor market data shows that unemployment is slowly ticking up and now stands at 6.7%. This compares unfavorably with the previous 6.6% print, although it is important to note that this is driven by labor force growth outpacing that of new jobs rather than by a decline or a stagnant rate of employment levels. Payrolls appear to have stabilized after declining towards the end of 2016.

In April, industrial production surprised on the downside and contracted 4.2% y/y. Among the components of the index, the main driver of the negative surprise was a 7.5% y/y decline of manufacturing, which was a reflection of an across the board reduction of production. Finally, retail sales for the month also surprised on the downside and registered a 0.4% y/y decline despite an 8.9% y/y expansion of the sales of durable goods.

In line with these weak activity indicators, Chile's monthly GDP proxy (IMAcEc) registered a 0.1% y/y decline during April. It is important to note however that much of the weakness observed in industrial production and retail can be attributed to calendar effects as in 2016, April had three additional business days than in 2017. Also, the census carried out in Chile on April 19th entailed an extra holiday in which activity across sectors came to a halt. But the bottom line regarding activity data is that while we expect that at the margin growth will recover in the second half of the year, GDP will only manage to expand by 1.6%.

Inflation likely to remain below target until 2018



Source: BCCh, Deutsche Bank

Finally, April's inflation data is consistent with the trend we have observed in previous months, although it is no longer surprising the market on the downside. In particular, headline inflation in April reached 2.7% y/y, which was the same rate registered in March. On the other hand, core inflation in April only rose by 2.1% y/y after having registered a 2.2% y/y expansion in March. Over the next few months, we expect both core and headline inflation to remain near current levels.

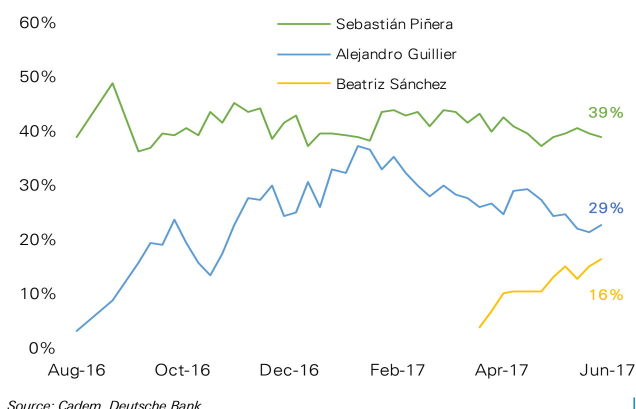
An update on November's election

Over the last month Chile's political landscape has experienced changes that could have repercussions on the outcome of November's Presidential election. Weekly polls (see http://bit.ly/2qZQ9Rf) show that within the coalition of center-right parties, former President Sebastián Piñera continues to be well ahead of his closest potential challenger M.J. Ossandón. Among the center left coalition of parties currently in power, Alejandro Guillier also remains the front-runner in the race to clinch the nomination. When it comes to a hypothetical first round, Piñera continues to increase his advantage over Guillier.

The main development is the surprising growth of the popularity of Beatriz Sánchez, who is poised to become the Presidential candidate of the left-leaning Frente Amplio. The Frente Amplio is a coalition of left-wing

parties critical both of the current government and more generally of the policies of the broad center-left coalition of parties (which includes Christian Democrats, Socialists, and even Communists) that has governed Chile for all but four years since the return of democracy in 1990. Sánchez is, like Guillier, a journalist who has a high degree of name recognition and a low degree of rejection among the population as she is not considered to be a politician.

B. Sánchez is shaking up Chile's pre-election landscape



Source: Cadem, Deutsche Bank

In first round simulations, Piñera continues to obtain between 43% and 45% of the votes. While not enough to avoid a runoff, at this stage it seems pretty clear that Piñera will get to the second round as the victor of the first stage of the election. Guillier's share however has fallen from around 32% to about 25%, while Sánchez has quickly risen from 11% to 19%. The deterioration of Guillier's poll results and the quick ascent of Beatriz Sánchez have materially increased the likelihood of a Piñera-Sánchez second round. It is important to note however, that while over the last two months polls show that the share of respondents who think Guillier will be Chile's next President has fallen from 22% to 17%, the 3% who think Beatriz Sánchez will succeed Michelle Bachelet has not changed. Respondents who think Piñera will win the Presidency for the second time on the other hand has increased from 47% to 53%.

In sum, Chile's political landscape has been altered by the growing popularity of a left-wing candidacy. However, both weekly polls as well as lower-frequency ones (see http://bit.ly/2s20yvV) show that the main beneficiary of these developments might be the right wing candidate Sebastián Piñera. The equity market's year-to-date double-digit rally seems to indicate that investors believe that a Piñera administration would be good for business. If this assessment were correct we expect that investments could expand significantly in 2018 (after four consecutive years of contraction) and push GDP growth back towards 3%.

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Chile: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USD bn)	243	247	267	277
Population (mn)	18	18	18	19
GDP per capita (USD)	13	14	15	15
Real GDP (YoY%)	2.3	1.6	1.5	2.8
Private Consumption	2.0	2.4	1.8	2.7
Government consumption	4.5	5.1	3.5	4.0
Gross Investment	-0.8	-0.8	-0.5	2.6
Exports	-1.8	-0.1	1.5	2.5
Imports	-2.7	-1.6	4.2	1.5
Prices, Money and Banking				
CPI (eop)	4.4	2.7	2.7	2.9
CPI (annual avg)	4.3	3.8	2.7	2.8
Broad money (avg)	11.3	9.7	9.3	11.1
Credit Growth (avg)	10.0	8.5	9.1	11.1
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-0.4	-2.1	-3.2	-3.2
Revenue	19.9	20.1	20.5	21.1
Expenditure	20.3	22.3	23.7	24.4
External Accounts (USD bn)				
Goods Exports	62.2	60.6	65.1	71.9
Goods Imports	58.7	55.3	56.7	60.9
Trade balance	3.5	5.3	8.4	11.0
% of GDP	1.4	2.1	3.1	4.0
Current Account Balance	-4.7	-3.6	-3.6	-2.7
% of GDP	-1.9	-1.4	-1.3	-1.0
FDI (gross)	20.5	12.2	11.3	11.7
FX Reserves (eop)	38.6	40.5	40.5	40.5
USD/CLP (eop)	707.3	667.3	680.0	675.0
Debt Indicators (% of GDP)				
Government Debt	17.4	21.3	24.3	26.3
Domestic	14.2	17.5	20.0	21.7
External	3.2	3.8	4.4	4.5
External debt	68.4	77.9	91.9	94.8
in USD bn	153	195	223	239
Short-term (% of total)	13.7	13.7	13.7	13.7
General (ann. avg)				
Industrial Production (YoY%)	0.6	-1.5	-2.9	0.8
Unemployment (%)	6.3	6.5	6.8	6.6
Financial Markets (eop)	*Spot*	*17Q2F*	*17Q3F*	*17Q4F*
Overnight rate (%)	3.00	2.50	2.50	2.50
3-month rate (%)	3.00	2.73	2.66	2.65
USD/CLP	659.01	668.66	674.66	680.00

Source: Deutsche Bank Forecasts and National Statistics

Colombia

Baa2 (stable)/BBB (negative)/BBB (stable)
Moody's / S&P / Fitch

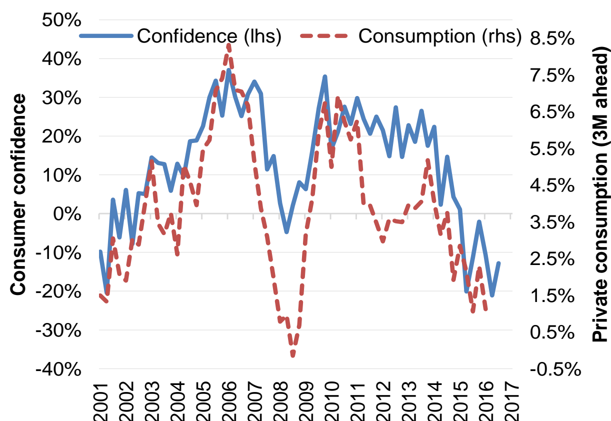
- Economic outlook: Growth printed a dismal 1.1% in 1Q17. Subdued business confidence, setbacks in the oil industry and delays in infrastructure investment point to a feeble and slow recovery in 2H17. On the political front, corruption scandals, peace controversies, national strikes and negative spillovers from the Venezuelan crisis are polarizing public opinion in the run-up to highly contested congressional and presidential elections in 2018.
- Main risks: Slow growth, weak fiscal accounts and electoral uncertainty will weigh on sovereign ratings and credit. We doubt a significant re-pricing is in the making since markets seem willing to wait for signals from the next administration. Most candidates are supportive of fiscal discipline. More than an upside scenario, this is the minimum requirement to maintain investment grade status.

Colombia: Pessimism weighs on outlook

Weakening consumer and business confidence

Consumption tax hikes, tight financing conditions and a cooling labor market are taking a toll on private consumption, as evidenced by the weak performance of the economy in 1Q17 (1.1%). Yet, the main challenges are political. Controversies surrounding the implementation of the peace agreements with the FARC, successive corruption scandals, large national strikes and negative spillovers of the Venezuelan crisis are fueling pessimism and uncertainty ahead of what are shaping up to be the most contested elections for congress (March) and the presidency (May) in recent decades. BanRep revised down its growth forecast to 1.8% from 2.0% in 2017 and less than 3.0% in 2018.

Figure 1: Taxes and politics hurt consumer confidence



Source: DANE, Fedesarrollo, Deutsche Bank

Confidence surveys illustrate the dismal mood of economic actors. Consumer sentiment has been in negative territory in the last 16 months and recorded a historic low of -30% in January (Figure 1). This indicator is a good predictor (0.8 correlation) of future household spending (3 months ahead). Similarly, industrial capacity utilization started to trend downwards in 1Q17 after a year of steady growth. Surveys that track orders, inventories levels and production expectations among manufacturers and retailers receded again in April, signaling that the slowdown could be deeper and the recovery might take longer than the authorities originally anticipated.

Slow growth and peace costs add fiscal risks

Adhering to the revised budget deficit targets mandated by the fiscal rule seems increasingly difficult. A budget amendment submitted to congress allocates all receipts from tax reform (0.7% of GDP) to additional current and capital expenditure in 2017. Slow economic activity and tax evasion resulted in a revenue shortfall of 0.5% of GDP in 1Q17. The gap could widen further as the authorities prepare to cut its 2017 growth forecast to 2.0% from the current 2.5% and the 3.5% assumed last year. Failure to reduce the fiscal deficit and stabilize the debt burden could trigger negative rating actions and a market correction.

The new government swearing in August 2018 will inherit a challenging outlook for public finances. It would either have to regain political support and market credibility to relax the fiscal rule or enforce a drastic fiscal adjustment. The recent tax reform introduced provisions to boost collection through formalization, stricter compliance, reduction of loopholes and the strengthening of the tax agency. These measures could yield up to 1% of GDP in additional revenue over the medium-term according to the current official assumptions. Room for spending cuts is more limited, could be recessionary and require difficult entitlement reforms. Mandatory outlays for pensions, sub-national transfers and public wages account for two-thirds of the budget. Honoring the commitments in the peace agreements could entail budget reallocations and fresh resources for up to 2% of GDP annually over the next 15 years.

Debt dynamics remain negative and sensitive to contingent liabilities. Central government debt surged to 44% of GDP in 2016 from a low of 33% in 2012. We expect the debt burden to exceed 46% of GDP by 2018, rapidly diverging from the median of peer investment grade sovereigns. In our baseline scenario, the latest tax reform would not be enough to reverse the current 1.1% of GDP primary fiscal deficit and the real interest rate – growth differential could average 0.5% in 2017-2018, inconsistent with the stabilization of the debt

trajectory. Guarantees for infrastructure projects add upside risks to these projections. The government is committing future budgetary appropriations to pay for infrastructure concessions and provisioning up to 0.4% of GDP per year to compensate private contractors for potential foreign exchange losses, toll collection shortfalls and constructions delays.

Consensus for rate cuts, speed will be data dependent

There is consensus among policymakers and market participants that falling inflation, real rates in contractionary territory and a rapidly widening negative output gap provide room for further monetary easing. May marked the second consecutive month that all members of BanRep's board voted unanimously in favor of rate cuts, although the decision was split on the speed of the monetary stimulus: 4 members were in favor of a 25bp rate reduction and 3 opted for 50bp. A favorable reading in May (0.23%mom) brought headline inflation (4.4%yoy) closer to the upper band of the target band of 2% to 4% and allayed concerns about potential second round effects from the strong one-off increases in energy and public transport tariffs in April. We expect consumer prices to bottom out in July, allowing BanRep to accelerate the easing cycle once more in June/July and extend it until August.

The window for additional aggressive cuts of 50bp will narrow after the summer due to continued evidence of inflation persistence, wage indexation and the end of favorable base effects. Non-tradable prices have grown uninterruptedly in 5M17, driven by inertial real adjustments in services costs, primarily housing rent, which has a weight of 27% in the basic basket. Wage indexation is a key risk moving forward. The government has offered to award at least a 6.55% salary increase to public sector teachers retroactive to January 1st in response to a month-long national strike. These concessions add pressure to labor intensive components of the consumer price index such as education and health care. In this scenario, we maintain our terminal policy rate forecast of 5.25% in 2017 and revise it slightly downward to 4.75% in 2018.

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Colombia: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USD bn)	292	282	306	323
Population (m)	48	49	49	50
GDP per capita (USD)	6,048	5,791	6,198	6,484
Real GDP (YoY%)	3.1	2.0	2.0	3.0
Private consumption	3.2	2.1	1.9	2.5
Government consumption	5.0	1.8	1.7	2.3
Gross Investment	1.8	-3.6	1.1	4.0
Exports	1.2	-0.9	3.3	5.5
Imports	1.4	-6.2	1.2	3.8
Prices, Money and Banking				
CPI (eop)	6.8	5.8	4.3	3.7
CPI (annual avg)	5.0	7.5	4.5	3.6
Broad money (eop)	11.7	7.1	6.8	9.5
Private Credit (eop)	14.2	7.2	7.0	9.7
Fiscal Accounts (% of GDP)				
Fiscal balance	-3.0	-4.0	-3.9	-3.6
Revenue	16.2	14.9	15.0	15.4
Expenditure	19.2	18.9	19.0	19.0
Primary Balance	-0.4	-1.1	-0.9	-0.6
External Accounts (USD bn)				
Goods Exports	38.1	33.0	35.9	39.5
Goods Imports	52.0	43.2	45.2	48.3
Trade balance	-14.0	-10.3	-9.2	-8.8
% of GDP	-4.8	-3.6	-3.0	-2.7
Current Account Balance	-18.8	-12.5	-11.4	-11.3
% of GDP	-6.4	-4.4	-3.7	-3.5
FDI (net)	7.5	9.1	8.2	9.5
FX reserves (eop)	46.7	46.7	46.6	47.1
USD/COP (eop)	3,179.5	3,000.7	3,015.7	3,051.9
Debt Indicators (% of GDP)				
Government Debt	42.7	43.7	44.9	45.7
Domestic	26.5	28.2	29.0	29.5
External	16.2	15.5	15.9	16.2
External debt	37.9	42.5	41.0	39.9
in USD bn	110.5	120.0	125.2	129.1
Short-term (% of total)	13.2	12.1	12.6	13.0
General (ann. avg)				
Industrial Production (YoY%)	1.7	3.9	3.5	4.0
Unemployment (%)	8.9	9.5	9.7	9.3
Financial Markets (eop)	*Spot*	*17Q2F*	*17Q3F*	*17Q4F*
Overnight rate (%)	7.20	5.75	5.25	5.25
3-month Interbank rate (%)	7.20	5.44	4.99	5.04
USD/COP (eop)	2,861	2,945	3,012	3,016

Source: Deutsche Bank estimates, and National Sources

Mexico

A3 (negative)/BBB+ (stable)/BBB+ (stable)
Moody's/S&P/Fitch

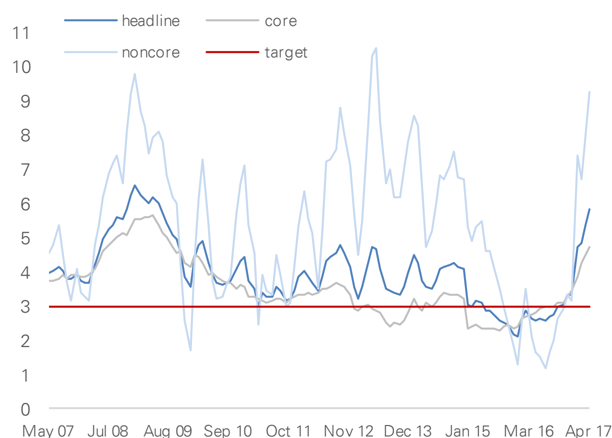
- Economic outlook: After the Edomex election the focus is back on economic issues. Economic data is likely to continue to slowly deteriorate after a more resilient than expected Q1 '17. In particular we expect the high inflation prints to result in weaker retail sales and for external demand to play less of a positive role given the weaker pace of exports. Inflation will remain the main concern when it comes to Mexico's economy. In our view, Banxico sounds increasingly worried regarding the rate at which prices are rising. We expect headline inflation to nevertheless peak this summer and for Banxico to be able to conclude its tightening cycle after another 25bp rate hike in June. Finally, despite our expectation of a decrease of uncertainty regarding NAFTA in the near future, we think domestic sources of political uncertainty are likely to remain a drag on investment growth in the near term.
- Main risks: Inflation has now become an increasingly important source of risk to the Mexican economy and to our outlook. In particular, if inflation does not peak during the summer we expect Banxico to continue increasing the policy rate in its August and perhaps even in its September meetings. On the other hand, the heavily contested local elections are an indication that domestic political noise will become a more important source of risks than US-related concerns. In particular, the NAFTA renegotiation process expected to begin in August should materially decrease the importance of trade policy as a source of risks to the Mexican economy.

The focus is now back on economics

After the June 4th elections in the Edomex, Coahuila, Nayarit, and Veracruz we shift our focus back to economics. Over the last month, the deluge of political headlines ahead of the afore-mentioned electoral races was enough to relegate some relatively auspicious data releases to the background. Yet despite higher than expected growth during Q1 '17, our outlook for the Mexican economy this year has not changed much. The balance of risks to activity is relatively stable when compared to where it was when we last published the EM Monthly. However, risks to inflation continue to increase as neither headline nor core inflation have yet peaked. To us, Banxico's language sounds increasingly concerned and while medium-term inflation expectations remain relatively subdued short-term inflation expectations continue to rise.

Over the next month we expect inflationary concerns to dominate the Mexico-relevant news flow. Because while during May we also learned that the United States Trade Representative had formally decided to trigger the process for a renegotiation of NAFTA, we are unlikely to get any news on that front until at least July. In particular, according to the timetable for renegotiations laid out by the law that in 2015 gave the U.S. President Trade Promotion Authority (TPA), the U.S. trade representative must publish specific negotiation objectives 30 days before negotiations begin. While the publishing of these objectives is likely to materially reduce the uncertainty associated with the future of NAFTA, this will most likely take place in late July.

Banxico's inflation worries are on the rise



Source: INEGI, Deutsche Bank

For Banxico, inflation is a growing concern

There is little doubt that Mexico is facing a particularly challenging environment when it comes to inflation. After registering below-target prints for the first time ever during 2015 and early last year, headline inflation began increasing in July of 2016. After years of a near-zero pass-through from the exchange rate to inflation, last November's election in the U.S. seems to have changed the way final good producers dealt with fluctuations of the exchange rate. In particular, until the election businesses in Mexico seemed to consider exchange rate fluctuations as temporary and rather than adjusting prices and risking losing market share they would tolerate fluctuations on their profit margins. However, the U.S. Presidential election seems to have driven businesses to suddenly consider the sustained MXN depreciation over the previous two years as a permanent shock and they began to adjust prices accordingly. In addition to the FX-driven adjustment of

merchandise prices, inflation in Mexico was also hit by a sizeable and unexpected increase of gasoline prices in January.

As a result of these two shocks average headline inflation rose from 3.24% in Q4 '16 to 4.98% in Q1 '17. Over the same period both average core and non-core inflation also increased from 3.28% to 4.19% and from 3.14% to 7.38% respectively. Despite Banxico's decision to increase its policy rate by 100bp over the last 5 months inflation continues to rise and data for the first two weeks of May shows headline, core, and non-core inflation rates of 6.2% y/y, 4.8% y/y, and 10.7% y/y respectively.

Until its May monetary policy meeting Banxico had maintained a relatively dovish rhetoric that had lead us to expect increases of the Mexican policy rate only to follow the Fed. Yet Banxico's decision in May to increase the reference rate by 25bp to 6.75% as well as the hawkish tone of the statement are indicative of growing concerns regarding the rate at which prices are increasing in Mexico.

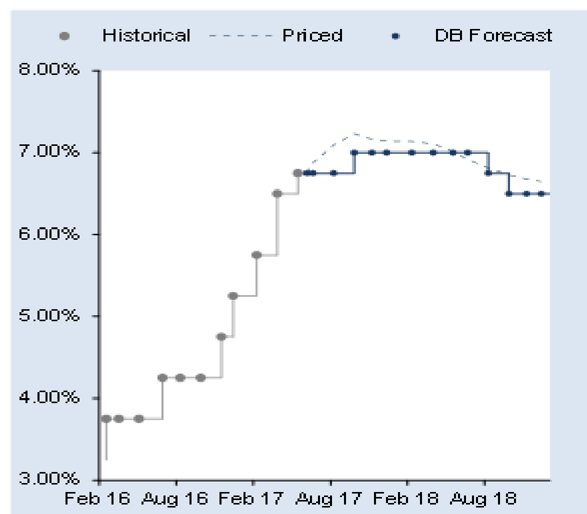
The meeting's minutes are also consistent with our view of a Central Bank that is increasingly worried about inflation. In particular, board members discussed the rising trend of both headline and core inflation. Also, when a board member suggested that Banxico could decouple from the Fed, the rest of the board emphasized that such a discussion would only be appropriate once inflation in Mexico peaks. Furthermore, some members seem to be reconsidering their assessment of Mexico's potential GDP as they seemed to think that there was very little slack in the labor market. The decision to hike rates was unanimous.

A final piece of evidence regarding Banxico's inflation-related concern was the publication of the Quarterly Inflation Report (QIR). The central bank had been relatively optimistic regarding the extent to which the increase in gasoline prices would impact inflation in the near term. However, the QIR contained Banxico's updated inflation forecasts and these show an expectation of significantly higher inflation than only a few months ago. While Banxico still expects inflation to converge to 3% in 2018, the central bank now expects the peak of headline inflation to be above 6% this year while it had previously expected a maximum of only 5.5%.

Our expectations are similar to Banxico's when it comes to inflation. We also expect inflation to peak later this year (possibly in July) and to converge towards its 3% target in 2018. And while we currently expect Banxico to hike another 25bp when it meets in June, the risks to our forecast are on the upside. In particular, if inflation data were to continue to surprise on the upside or if the y/y inflation print continued to increase in August we do not discard further interest rate hikes when Banxico meets in August and September.

Yet regardless of whether the terminal rate of the current hiking cycle proves to be 7% or ends up reaching 7.5%, we will expect Banxico to begin normalizing its policy rate after next year's Presidential election in July. As we have explained in previous notes and as we argue in "Mexico's Inflation: The Odd One Out" included in this EM Monthly, unless the nominal rate begins to decline next year our inflation forecasts imply an increasing real rate well above the upper bound of Banxico's range of neutral rate estimates for Mexico. In line with Banxico's view (published in its latest QIR) we expect the output gap to remain negative until late 2018. So we think that in the absence of a large MXN selloff or an additional supply side inflation shock the Mexican economy will require an easier monetary policy stance in the second half of next year.

Despite inflation, we expect lower rates in H2 '18



Source: Banxico, Deutsche Bank

Activity: Was Q1 '17 nothing but a temporary surprise?

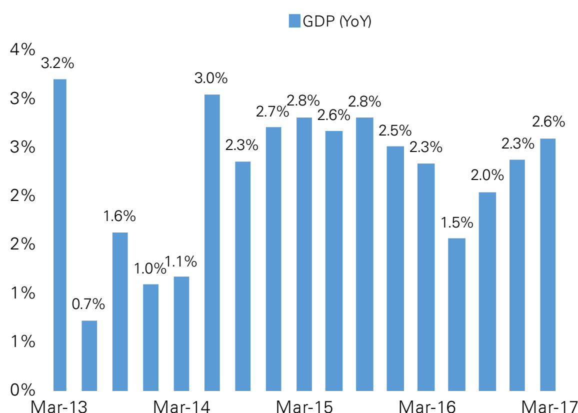
In the first few months of the year activity seemed very resilient to the negative shocks that hit Mexico-related asset prices towards the end of 2016. And some of the data released over the last month was in line with this relatively optimistic growth scenario for Mexico's economy.

During May both consumer and business confidence indicators recovered in m/m terms despite being well below their values a year ago. As we have noted in previous publications consumer sentiment in Mexico is highly sensitive to the exchange rate. And the stability of both the USD/MXN and gasoline prices might have contributed to a recovery of consumer confidence

which registered an increase for the fourth consecutive month.

GDP growth during Q1 '17 was well above what most analysts would have expected at the beginning of the year. Mexico's economy expanded by 2.8% y/y between January and March driven mostly by internal demand as can be inferred by the strong growth of the services sector. And while we do not yet know the demand-side breakdown of GDP for Q1, monthly trade data and the good performance of the manufacturing sector suggest that a rebound of manufacturing exports has also contributed to Mexico's economy growing faster than expected. Finally, the IMEF's PMI surveys were also favorable both for the manufacturing and non-manufacturing sectors. In particular, we observed a turnaround of the "new orders" subindex of the manufacturing PMI which could be indicative of a more sustainable recovery of the manufacturing sector.

The GDP surprise might prove to be short-lived

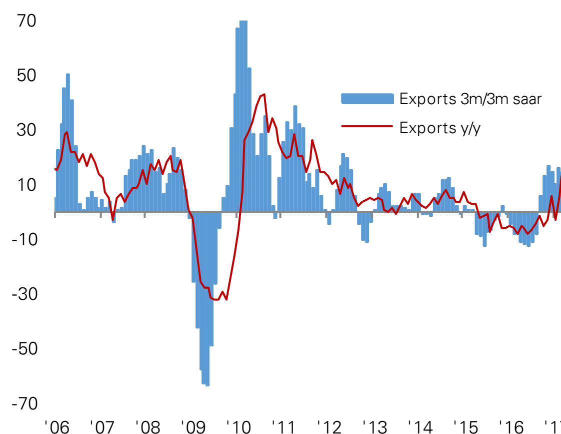


Source: INEGI, Deutsche Bank

But May's data releases were not all as auspicious when it came to leading indicators. First, retail sales continue to decelerate. Despite a 3.3% y/y expansion during March, retail sales decreased during the third month of the year by 1.3% m/m in seasonally adjusted terms. In particular, durable goods and more specifically motor vehicle and auto-part sales contracted during the month. We believe that going forward the relatively high levels of inflation registered this year will continue to weigh on retail sales due to their effect on real wages. And given that growth in Mexico has been driven mainly by internal demand we expect the gradual yet sustained deterioration of retail sales figures to be a relatively negative omen for growth going forward.

In addition to our relatively pessimistic interpretation of recent retail sales data, we also have a less than optimistic view on Mexico's recent balance of payments figures. Trade balance numbers show that during April exports declined 2.5% m/m in seasonally adjusted terms. Imports declined at an even more accelerated rate so that Mexico's trade balance registered a surplus of USD 617m in April. Year-to-date the trade balance exhibits a healthy USD 2.1bn surplus which has been a boost to GDP growth during Q1. However, early Q2 data shows not only a moderation of the pace of manufacturing export growth but also an important contraction of imports of intermediate inputs. In general, a decline of intermediate inputs is associated with a decline or a moderation of future output. So despite the still positive trade balance we think that external demand has a relatively limited potential to drive growth in the near future.

Exports might have peaked



Source: INEGI, Deutsche Bank

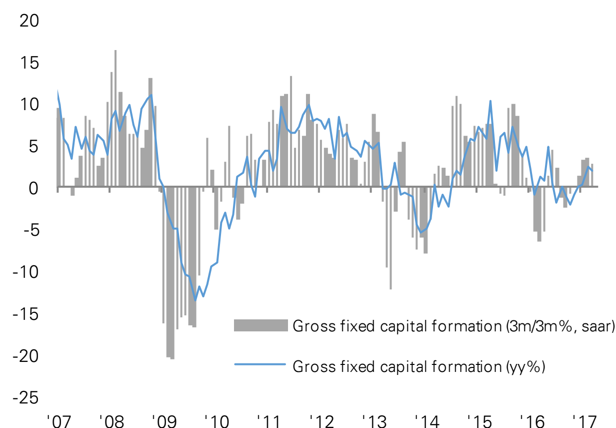
A brief note on (the lack of) investments

Gross fixed investments posted a 2% y/y contraction during Q1 '17 and monthly data shows that this crucial component of GDP growth maintains a downwards trajectory. In 3m/3m seasonally adjusted and annualized terms GFI registered a contraction of 6.2% during March. Similarly, balance of payments data for Q1 '17 show that FDI inflows reached only USD 7.9bn which is well short of the USD 10.7bn of accumulated foreign investment flows that Mexico attracted during Q1 '16.

Overall, the recently released macroeconomic indicators strongly suggest that despite an improvement of sentiment when it regarding Mexico the economic outlook remains challenging. After the Edomex election we expect political uncertainty to continue to weigh on investments in Mexico. The PRI's victory in the Edomex might convince some members of the ruling party that if the Federal government uses its power and resources to try to influence the election the party might stand a chance of holding on to the Presidency. And if such a scenario were to materialize, the prospects of an improvement of Mexico's fiscal accounts would evaporate while inflationary pressures

would increase further in the near term and downgrade risks would rise in the longer term.

Investments are unlikely to recover in the near-term



Source: Banxico, Deutsche Bank

In sum, the lack of a recovery of investments in Mexico is in our view an indication that the likelihood of an investment-driven growth acceleration before the 2018 elections is very small. Over the next few months as the details regarding the renegotiation of NAFTA come to light we expect domestic risks to become a more relevant source of overall uncertainty. The investment climate is likely to remain less than ideal which will weigh on GDP.

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Mexico: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USD bn)	1,153	1,047	1,287	1,274
Population (mn)	121	122	124	125
GDP per capita (USD)	10	9	10	10
Real GDP (YoY%)	2.6	2.3	1.8	2.4
Private Consumption	2.3	2.8	2.2	2.6
Government consumption	2.3	1.1	1.0	2.5
Gross Investment	4.2	0.4	-0.3	2.2
Exports	10.3	1.2	6.7	7.1
Imports	8.6	1.1	3.7	4.3
Prices, Money and Banking				
CPI (eop)	2.1	3.4	5.9	3.5
CPI (annual avg)	2.7	2.8	5.8	4.6
Broad money (period avg)	20.1	15.9	12.1	5.4
Credit Growth (period avg)	11.6	15.6	14.9	15.0
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-3.5	-3.0	-2.6	-2.4
Revenue	23.4	21.3	19.5	19.8
Expenditure	26.8	24.2	22.1	22.2
Primary balance	-1.2	-0.6	0.2	-0.1
External Accounts (USD bn)				
Goods Exports	380.5	373.9	399.7	426.1
Goods Imports	395.2	387.1	415.8	447.0
Trade balance	-14.7	-13.1	-16.1	-20.9
% of GDP	-1.3	-1.3	-1.2	-1.6
Current Account Balance	-28.2	-22.4	-34.8	-33.1
% of GDP	-2.4	-2.1	-2.7	-2.6
FDI (net)	33.3	27.4	34.9	26.4
FX Reserves (eop)	187.5	176.4	167.1	161.4
USD/MXN (eop)	17.2	20.7	19.0	18.5
Debt Indicators (% of GDP)				
Government Debt	43.8	47.7	47.2	47.0
Domestic	29.5	30.0	30.2	30.1
External	14.4	17.6	16.0	15.1
External debt	25.5	30.4	25.9	24.8
in USD bn	294.3	317.9	309.9	330.3
Short-term (% of total)	15.8	15.5	15.6	15.6
General (ann. avg)				
Industrial Production (YoY%)	1.0	0.0	0.8	1.3
Unemployment (%)	4.4	3.9	3.8	4.1
Financial Markets (eop)	*Spot*	*17Q2F*	*17Q3F*	*17Q4F*
Overnight rate (%)	6.50	6.75	6.75	7.00
3-month rate	6.78	7.01	7.54	7.82
USD/MXN	18.85	18.50	18.80	19.00

**Corresponds to PSBR*
***Corresponds to PSBR accumulated balance*

Source: DB Global Markets Research, National Sour

Peru

A3 (stable)/BBB+ (stable)/BBB+ (stable)
Moody's /S&P/ /Fitch

- Economic outlook: The economy is close to the trough after absorbing the negative shocks from Odebrecht and the Coastal Niño. We are expecting a v-shaped recovery in 2018, driven by reconstruction investment and mining competitiveness. Falling inflation and a negative output gap paved the way for monetary policy accommodation. The treasury will drawdown assets to fund reconstruction costs and continue boosting the liquidity of the local bond market.
- Main risks: Political compromise has become imperative to cement business confidence and growth prospects. Conflicts between the executive and the legislative are escalating and slowing progress on the new government's ambitious pro-growth and structural reform agenda. Sluggish growth, commodity price corrections and optimistic revenue assumptions could pose fiscal risks and exert pressure on sovereign ratings.

Peru: In need of political compromise

Political conflict slows government's reform agenda

Conflicts between the executive and the legislative are escalating and slowing down progress on the implementation of the new government's ambitious pro-growth and structural reform agenda. The opposition controlled congress censored the minister of education in December for alleged weak oversight of procurement officials and a recent report from the general comptroller questioning the financing costs of an airport concession forced the resignation of the minister of transportation and communication in May. Opposition legislators are now targeting the ministries of the interior and health. At the same time, Lima's Supreme Court rejected a habeas corpus petition submitted by Keiko Fujimori requesting the release of his father and former president Alberto Fujimori (1990 - 2000), who serves a 25-year sentence for homicide and kidnapping since 2009.

There are opportunities for political compromise. The government is open to the idea of a presidential pardon or house arrest for Alberto Fujimori. It has also refrained from seeking a vote of confidence on the full cabinet. If congress denies a vote of confidence twice, the president has the constitutional prerogative to dissolve congress and call for new legislative elections. In a de-escalating scenario, Popular Force, Keiko Fujimori's majority party controlling 72 of the 130 legislative seats, is more likely to lessen pressure on the current cabinet and resort to the vigilant but non-obstructionist stance that it adopted during the first 6 months of the Kuczynski administration. In our view, a governance agreement could cement the incipient recovery in business confidence and approval ratings that followed the effective emergency response to the Coastal Niño in 2Q17.

Reconstruction and mining to drive a v-shape recovery

The government revised down its 2017 growth forecast to 3.0% from 4.5% due to flood damage during the Coastal Niño (-1.2pp) and the abrupt exit of Odebrecht (-0.3pp) from key construction projects. We maintain a more conservative growth projection of 2.6% for this year. The impact of the weather shock on fishing, agriculture, trade and transport sectors seem consistent with the most recent GDP data releases (+2.1% in 1Q17) and previous episodes of El Niño. However, in our view, official assumptions may be underestimating the knock-on effects of the protracted paralysis of infrastructure on private investment, formal job creation and household consumption. A pipeline of $18.5 billion, nearly 9% of GDP, in concessions have been awarded but remains stalled due to licensing issues, contractual disputes and the restructuring of failed construction consortiums.

We are expecting a v-shaped recovery in 2018, with growth rebounding to 4%, driven by reconstruction investment, mining competitiveness and monetary accommodation. To overcome administrative and regulatory bottlenecks, congress approved the creation of new reconstruction agency with financial autonomy, technical discretion and authority to fast-track the execution of public investment in 2018-2020. Moreover, the country's mining comparative advantages – young reserves, low cost structure, energy self-sufficiency and favorable business environment – position it well to continue gaining market share in export markets and benefit from the ongoing upswing in metal prices.

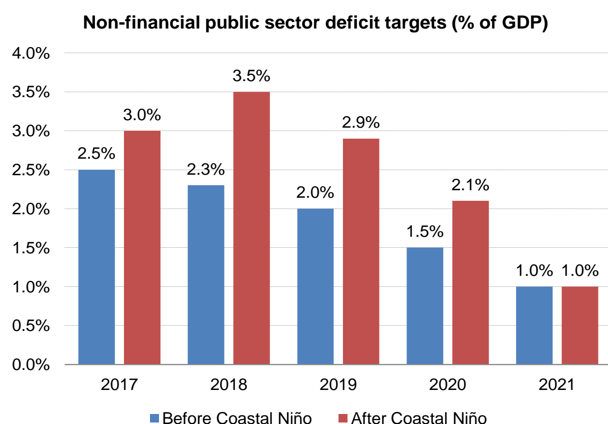
Asset drawdown will finance reconstruction costs

The government estimates that restoring infrastructure losses would require additional spending of $6.4 billion, nearly 3.2% of GDP, in 2017-2020. As expected, the ministry of finance submitted to congress a bill requesting authorization to increase the mandatory budget deficit targets during the peak of the reconstruction efforts in 2017-2018. The amendment also proposes a gradual consolidation path in 2019-2020, followed by a sharp reduction in the fiscal deficit in the last year of the current administration (Figure 1).

In our view, the size of the reconstruction package is absorbable and could be implemented without compromising fiscal sustainability or exceeding the

public debt ceiling of 30% of GDP. Finance Minister Alfredo Thorne outperformed the budget deficit by 0.4% of GDP in 2016, creating room for a more expansionary fiscal stance in 2017. The authorities intend to cover 80% of the financing requirements with the drawdown of assets and only 20% with new issuance. In December 2016, government debt stood at 24% of GDP, the public sector held 8.2% of GDP in bank deposits and 4.2% of GDP in stabilization funds and could tap up to $3.4 billion in contingency credit lines for natural disasters from multilaterals.

Figure 1: New budget deficit trajectory after incorporating reconstruction costs



Source: Ministry of Finance

Debt strategy focuses on liquidity and lowering costs

Enhancing the liquidity of the local bond market remains a top priority. Weekly auctions tripled in size to PEN12.6 billion in 2016 from PEN4.5 billion in 2013. This year, domestic issuance could increase to PEN14 billion, allowing most long-term benchmarks to reach an outstanding of PEN10 billion. In 2H17, the treasury will introduce a pilot program to make up to PEN7.5 billion of the sovereign curve Euroclearable.

The authorization to conduct up to $6 billion in liability management operations will be used opportunistically. One option could be the issuance of a new Euroclearable Soberanos benchmark to prepay costly multilateral loans in USD. Multilateral obligations amount to PEN23 billion, 15% of public debt, and their equivalent cost in PEN (6.81%) is slightly higher than that of the Soberanos portfolio (6.63%). An alternative could be leveraging on the local market to redeem higher yielding global bonds denominated in USD. External bonds amount to $14.6 billion and their equivalent cost in PEN is 9.6%.

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Peru: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USD bn)	192	195	211	226
Population (mn)	31	31	32	32
GDP per capita (USD)	6,175	6,198	6,626	7,030
Real GDP (YoY%)	3.3	3.9	2.6	4.0
Private Consumption	3.4	3.4	2.8	3.4
Government consumption	9.8	-0.5	3.2	2.2
Gross fixed investment	-5.0	-5.0	0.5	5.0
Exports	3.5	9.7	4.5	5.5
Imports	2.5	-2.3	3.4	3.8
Prices, Money and Banking				
CPI (eop)	4.4	3.2	2.6	2.4
CPI (annual avg)	3.5	3.6	3.2	2.4
Broad money (eop)	6.5	5.0	6.9	7.2
Private credit growth (eop)	6.5	5.0	6.9	7.2
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-2.1	-2.6	-3.1	-3.5
Revenue	20.0	18.5	19.2	19.3
Expenditure	22.3	21.0	22.2	22.7
Primary balance	-1.1	-1.5	-1.8	-2.2
External Accounts (USD bn)				
Goods Exports	34.2	36.8	41.8	44.0
Goods Imports	37.4	35.1	37.4	39.4
Trade balance	-3.1	1.7	4.4	4.6
% of GDP	-1.6	0.9	2.1	2.0
Current Account Balance	-9.4	-5.5	-4.6	-5.1
% of GDP	-4.9	-2.8	-2.2	-2.3
FDI (net)	8.1	6.6	5.7	6.0
FX Reserves (eop)	61.5	61.7	64.0	65.9
USD/PEN (eop)	3.4	3.4	3.3	3.3
Debt Indicators (% of GDP)				
Government Debt	23.3	23.8	25.7	27.7
Domestic	12.2	13.5	14.9	16.3
External	11.1	10.3	10.8	11.4
External debt	38.1	38.2	36.1	34.4
in USD bn	73.3	74.7	76.1	77.7
Short-term (% of total)	9.3	9.6	9.8	10.0
General (ann. avg)				
Industrial Production (YoY%)	-1.6	-1.4	3.0	3.7
Unemployment (%)	6.5	6.7	6.9	6.6
Financial Markets (eop)	*Spot*	*17Q2F*	*17Q3F*	*17Q4F*
Policy rate	4.25	3.75	3.50	3.50
3-month rate	5.18	4.60	4.38	4.39
USD/PEN (eop)	3.25	3.28	3.27	3.26

Source: DB Global and national sources

Venezuela

Caa3 (negative)/CCC (negative)/CCC

Moody's/S&P/Fitch

- Economic outlook: The economy heads for a possible fourth consecutive year of recession with inflation growing at triple digits. Strict price, foreign exchange and import controls hamper domestic production, exacerbating shortages and speculation in parallel currency markets. Heavy bond repayments, dwindling foreign reserves and looming contingent liabilities could intensify balance of payment pressures and refinancing risks despite the recovery in oil prices in 2017-2018.
- Main risks: Oil price dependence, susceptibility to production shocks and recent technical difficulties servicing external bond obligations maintain a high probability of a credit event by Venezuela/PDVSA in 2017-2018. Intensification of international sanctions, political polarization, shortages, violence and repression could exacerbate social unrest and lead to a disorderly government transition.

Government prepares for longer battle

New constitution, regional elections will test opposition

A negotiated solution to the ongoing political standoff and social protests still lies several months away. President Nicolas Maduro advanced the convening of an assembly to redraft the 1999 constitution. The decision took place despite an adverse concept from the general attorney Luisa Ortega, who advocated that the population should be consulted first, as was the case during the previous reform in 1998. The National Electoral Council (CNE) opened candidate registrations and scheduled the election of 545 delegates to the assembly for July 30th: 364 will be selected in local jurisdictions and 181 from indigenous, workers, pensioners and other communal organizations. Leaders from the opposition majority in congress will not participate. Instead, they will maintain pressure through street demonstrations.

The start of the constituent assembly process came with two enticements that will test the cohesiveness, endurance and mobilization capacity of the opposition movement. First, the CNE announced that regional elections will take place on December 30th, a year later than legally stipulated. Opinion polls suggest that the opposition could regain significant ground relative to the results of the 2012 elections, when the ruling coalition led by former President Hugo Chavez swept to victory in 20 out of the 23 governorships of the country. Second, President Maduro offered to subject the final text of the new constitution for approval in a popular referendum. Participation in this consultation will be trickier. Not only it could diminish the hard-won momentum in the streets, but it could also re-open divisions between the institutional and more radical factions of the opposition.

Bond sales, FX auctions provide only short-term relief

The authorities continue with their strategy of selling public sector USD-denominated securities that have been previously transferred to the Central Bank (BCV) and the Development Bank of Venezuela (Bandes) in order to obtain fresh FX liquidity. In early June, the asset management arm of Goldman Sachs confirmed the purchase of $2.8 billion of the $3.0 billion in PDVSA notes maturing in 2022 through a broker domiciled in Panama. According to the Wall Street Journal, the transaction raised only $865 million, implying a deep discount (31 cents on the dollar). Nomura Securities and a third unidentified financial institution would have acquired $100 million of the same securities each. More recent news reports indicate that there has been interest in liquidating the $5 billion in Venezuela notes maturing in 2036 at discounts as low as 20 cents on the dollar. These securities are less liquid (physical delivery form).

At the same time, the BCV launched a system of weekly auctions of FX. The results of the first auction in June showed that only $24.2 million were awarded, just 55% of the demand by individuals and 59% of the bids by businesses. As with previous schemes, the sustainability of the new DICOM system is called into question by the limited FX supply and its expected strong inflationary impact. If the auction allocations remain at the same frequency and size, the BCV would be able to inject $750 million in FX liquidity. This represents just 10% of our public and 7% of our private sector import forecasts for 2017. The exchange rate set in the auction was 2,010 VEF/USD. This implies a 176% increase in the DICOM rate and a 64% devaluation of the Bolivar. In sum, with few additional USD-denominated bonds in the public sector, the strategy of liquidating assets is getting close to its limit, provides only short-term relief and continues to transform a FX liquidity crunch into a bigger solvency problem down the road.

Humanitarian aid, an opportunity for compromise

In our view, while the two parties are far apart and it would be difficult to find new credible mediators, there is still room for a negotiated solution. The starting point could involve the opening of a humanitarian channel for food and medicine in exchange for the release of political prisoners. The non-governmental organization Penal Forum reported that 68 people were arrested in Venezuela for political reasons last month, taking the number of such prisoners to 185. Agreement on a calendar for regional, local and presidential elections could be the second step. The opposition could capitalize on public discontent with the administration to increase institutional representation. The ruling

coalition could gain time to incline the electoral field and come up with a competitive candidate for the presidency in 2018.

A bill tabled in the U.S. Senate on May 3rd by a bipartisan group of nine legislators represents an opportunity for compromise, even if a third party has to take ownership given the weak state of diplomatic relations between the U.S. and Venezuela. The project would provide $10 million in humanitarian aid and another $500,000 for international election assistance in return for the release of political prisoners and concrete steps towards a negotiated solution. The bill also calls the U.S. State Department and intelligence agencies to prepare a classified report on the involvement of Venezuelan officials in corruption and the drug trade, a prelude to tougher targeted sanctions. The likelihood of this legislation being passed is uncertain, but it could serve as reference for other multilateral institutions such as the United Nations, which Venezuela approached for assistance earlier.

Political stalemate could block new debt issuance

In late 2015, an officially controlled National Assembly approved the 2016 budget and public borrowing laws, providing ample authorization for the two largest public sector issuers to contract new debt and conduct liability management operations. With this legal backing, Venezuela privately placed $5 billion in 2036 amortizable bonds in December (Reg. S). A few months earlier, PDVSA issued $3.3 billion as part of a global bond swap and borrowed $1.5 billion from Rosneft, both operations collateralized with its full equity stake at Citgo. As a state-owned corporate, PDVSA has traditionally enjoyed a greater degree of operational and financial autonomy than the government.

The lack of legislative authorization, as stipulated in the constitution, is raising doubts about the legality of new financing transactions in 2017 and risks of selective debt repudiation by future administrations. Last October, President Maduro opted out of the congressional route. Instead he relied on extraordinary powers and a Supreme Court's decision to approve the 2017 budget law. If the legal uncertainty is not resolved promptly, the sovereign could have difficulties in rolling over $2.1 billion in external debt maturities coming due in 2017. Since Venezuela does not have global bond repayments until August 2018, we assume that these are official obligations, most likely with traditional allies such as Russia and China. Together bilateral and multilateral creditors account for 20% of total government external debt.

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Venezuela: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USD bn)	260	334	314	210
Population (mn)	31	31	32	32
GDP per capita (USD)	8,494	10,755	9,993	6,603
Real GDP (YoY%)	-6.2	-10.0	-4.5	-2.5
Private Consumption	-4.0	-11.5	-10.3	-4.9
Government consumption	4.5	-6.5	-7.0	-3.0
Gross fixed investment	-7.0	-10.0	-9.4	-6.7
Exports	-5.0	-12.0	3.0	7.5
Imports	-5.5	-18.0	-4.5	-5.5
Prices, Money and Banking				
CPI (eop)	180.9	460.0	650.0	250.0
CPI (annual avg)	121.7	320.4	555.0	350.0
Broad money (eop)	104.4	140.2	450.0	250.0
Private credit growth (eop)	103.0	120.0	150.0	250.0
Fiscal Accounts (% of GDP)				
Fiscal balance	-23.1	-25.7	-26.1	-23.8
Revenue	25.3	15.8	14.1	15.6
Expenditure	48.4	41.5	40.1	39.4
Primary balance	-21.0	-24.8	-25.9	-23.6
External Accounts (USD bn)				
Goods Exports	39.2	28.2	31.3	37.1
Goods Imports	36.8	24.4	27.7	33.2
Trade balance	2.4	3.8	3.6	3.9
% of GDP	0.9	1.1	1.1	2.0
Current Account Balance	-20.4	-11.2	-2.7	1.4
% of GDP	-7.8	-3.4	-0.9	0.7
FDI (net)	2.6	3.5	4.5	2.5
FX Reserves (eop)	16.4	9.5	4.5	2.5
USD/VEF (eop)	6.3	10.0	15.0	30.0
Debt Indicators (% of GDP)				
Government Debt	41.5	32.8	28.2	25.0
Domestic	29.0	23.0	19.8	17.5
External	12.5	9.9	8.5	7.5
External debt	54.3	57.7	72.2	72.0
in USD bn	138.6	133.0	130.0	128.0
Short-term (% of total)	14.4	15.0	15.0	16.5
General (ann. avg)				
Industrial Production (YoY%)				
Unemployment (%)	6.8	7.4	8.0	8.5
Financial Markets (eop)	*Spot*	*17Q2F*	*17Q3F*	*17Q4F*
Lending Rate	21.00	30.00	30.00	30.00
USD/VEF (eop)	9.98	15.00	15.00	15.00

(*) Non-Financial General Public Sector
Source: Deutsche Bank Global Markets Research, National Sources

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Policy Rate Forecast

Projected Policy Rates in Emerging Markets

Policy Rate Forecasts

-	Current policy rate	Q2-2017	Q3-2017	Q4-2017	Q1-2018	Q4-2018
Emerging Europe, Middle East & Africa						
Czech	0.05	0.05	0.15	0.25	0.75	0.75
Hungary	0.90	0.90	0.90	0.90	0.90	1.05
Israel	0.10	0.10	0.10	0.10	0.10	0.50
Poland	1.50	1.50	1.50	1.50	1.50 ↓	1.50 ↓
Russia	9.25	9.00	8.50	8.00	7.50	6.50
South Africa	7.00	7.00	6.75	6.50	6.50	6.50
Turkey	8.00	8.00	8.00	8.00	8.00	8.00
Asia (ex-Japan)						
China	1.50	1.50	1.50	1.50	1.50	1.50
India	6.25	6.25	6.25	6.25	6.25	6.25
Indonesia	4.75	4.75	4.75	5.00	5.25	5.75
Korea	1.25	1.25	1.25	1.25	1.25	1.75
Malaysia	3.00	3.00	3.00	3.00	3.25	3.25
Philippines	3.00	3.00	3.25	3.50	3.50	4.00
Taiwan	1.375	1.375	1.375	1.375	1.500	1.875
Thailand	1.50	1.50	1.50	1.50	1.50 ↓	2.00 ↓
Vietnam	6.50	6.50	6.50	6.50	6.75	7.50
Latin America						
Brazil	10.25 ↓	10.25 ↑	9.00 ↑	8.50 ↑	8.50 ↑	8.50 ↑
Chile	2.50 ↓	2.50	2.50	2.50	2.50	3.00
Colombia	6.25 ↓	5.75	5.25	5.25	4.75 ↓	4.75 ↓
Mexico	6.75 ↑	6.75	6.75 ↓	7.00	7.00	6.50
Peru	4.00 ↓	3.75	3.50 ↓	3.50 ↓	3.50 ↓	3.50 ↓

↑/↓ Indicates increase/decrease in level compared to previous EM Monthly publication; a blank indicates no change

Source: Deutsche Bank

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Appendix 1

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