Deutsche Bank
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Economics
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Emerging Markets Monthly

Stretching Thin

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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**	**3.5**	**3.8 ↓**	**4.2**	**5.1 ↓**	**4.4**	**0.4**	**0.3**	**0.1 ↑**	**-3.3**	**-3.2**	**-3.1 ↓**
US	**1.6**	**2.3 ↓**	**2.6 ↓**	**1.3**	**2.3 ↑**	**2.1 ↓**	**-2.6**	**-2.9 ↑**	**-3.2 ↑**	**-3.1**	**-2.9**	**-2.9 ↓**
Japan	**1.0**	**1.1**	**1.2**	**-0.1**	**0.7**	**1.1**	**3.8**	**3.8**	**3.9**	**-3.4**	**-3.6**	**-3.3**
Euroland	**1.7**	**1.3**	**1.5**	**0.2**	**1.4**	**1.5**	**3.3**	**2.8**	**2.5**	**-1.5**	**-1.5**	**-1.5**
Germany	1.8	1.1	1.6	0.4	1.7	1.6	8.5	8.0	7.8	0.8	0.5	0.2
France	1.1	1.3	1.1	0.3	1.2	1.3	-0.9	-0.3	-0.1	-3.4	-3.2	-3.1
Italy	0.9	0.7	0.7	-0.1	1.0	1.2	2.6	2.7	2.3	-2.4	-2.3	-2.3
Spain	3.2	2.5	2.2	-0.3	1.7	1.7	2.0	1.7	1.7	-4.5	-3.2	-2.8
Netherlands	2.1	2.1	1.5	0.1	1.0	1.2	8.4	10.2	10.2	0.4	-0.7	-0.5
Belgium	1.2	1.1	1.3	1.8	2.0	1.8	-0.4	1.0	1.0	-2.6	-2.5	-2.6
Austria	1.5	1.5	1.6	1.0	1.8	1.6	1.7	2.8	3.1	-1.6	-1.2	-1.0
Finland	1.4	1.2	1.5	0.4	1.3	1.4	-1.1	-0.4	-0.3	-1.9	-2.2	-1.7
Greece	-0.1	1.4	1.6	0.0	1.3	1.0	-0.6	1.2	1.5	0.7	-2.4	-2.2
Portugal	1.4	1.6 ↑	1.2 ↑	0.6	1.4	1.5	1.0	0.7	0.7	-2.0	-2.0 ↑	-2.0 ↑
Ireland	5.2	2.8	3.0	-0.2	1.1	1.4	4.7	10.0	8.0	-0.6	-1.1	-1.0
Other Industrial Countries	**1.8**	**2.0 ↑**	1.9 ↑	**1.0**	**2.0 ↑**	2.2 ↑	**-1.9**	**-1.2 ↑**	-0.8 ↑ -	**-1.3**	**-1.5**	**-1.2**
United Kingdom	1.8	1.7	1.1	0.7	2.3	2.7	-4.4	-4.8	-4.0	-3.3	-2.9	-2.5
Sweden	3.1	2.0	2.3	1.0	1.7	1.9	4.6	4.2	4.4	2.0	-0.2	0.0
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	1.4	2.3	2.2	1.4	1.7	2.0	-3.6	-2.7	-2.1	0.0	-1.2	-1.3
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	3.5	2.7	0.6	1.0	1.5	-3.4	-3.5	-3.3	0.3	0.6	1.3
Emerging Europe, Middle East & Africa	**1.4**	**2.5 ↓**	**2.8**	**6.3**	**5.5 ↓**	**5.4**	**-2.1**	**-1.0 ↑**	**-1.0 ↑**	**-4.7**	**-4.0**	**-3.7**
Czech Republic	2.3	2.1 ↓	2.8	0.7	2.3 ↓	2.0 ↓	1.1	1.1 ↓	1.0 ↓	0.6	-0.6	-0.6
Hungary	2.0	3.3 ↑	3.1 ↑	0.4	2.6 ↓	3.0 ↓	4.9	3.4 ↓	3.1 ↓	-1.9	-2.5	-2.3
Israel	4.0	3.4	3.5	-0.5	0.7 ↑	1.1 ↑	4.4	4.1	4.4 ↓	-2.6	-2.9	-2.8
Poland	2.7	2.7 ↓	3.4	-0.6	1.9	2.1 ↓	-0.3	-1.1 ↑	-1.3 ↑	-2.5	-3.0	-2.9
Russia	-0.2	1.6	2.0	7.1	3.8 ↓	4.2 ↓	1.9	2.9 ↑	3.3 ↑	-3.4	-3.0	-2.2
South Africa	0.3	0.6 ↓	1.7 ↓	6.3	5.5	4.9	-3.3	-2.6 ↓	-2.9 ↑	-3.4	-3.0	-2.8
Turkey	2.9	3.4	3.7	7.8	10.6	8.5 ↑	-3.8	-4.3 ↑	-4.7 ↓	-1.1	-2.9	-2.1
Asia (ex-Japan)	**6.2**	**6.2 ↑**	**6.1 ↑**	**2.6**	**2.5 ↓**	**3.2 ↑**	**2.0**	**1.5 ↓**	**1.3 ↓**	**-3.2**	**-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	1.9	2.8	3.5	2.4	0.0	3.0	4.5	5.4	6.4	3.7	1.6	2.1
India	7.5	7.3	7.8	5.0	4.1 ↓	4.7 ↑	-0.5	-1.1	-1.5	-3.5	-3.2	-3.0
Indonesia	5.0	5.3 ↓	5.1 ↓	3.5	4.1	3.8	-1.8	-1.4	-0.7	-2.5	-1.6 ↑	-1.4 ↑
Korea	2.8	2.5	2.6	1.0	2.1	2.3	7.0	6.2	5.6	0.1	0.0	-0.2
Malaysia	4.2	4.5	4.7	2.1	4.2 ↑	2.7	2.0	2.9	2.4	-3.1	-3.0	-2.9
Philippines	6.9	6.2	6.5	1.8	3.3	3.3	0.2	-0.1	-1.2	-2.4	-3.0	-3.0
Singapore	2.0	2.5	3.0	-0.5	1.6	2.5 ↓	19.1	21.0	21.4	1.3	0.4 ↓	1.2 ↑
Sri Lanka	4.4	5.0	5.5	4.0	5.7 ↑	4.5	-2.4	-2.7	-2.7	-5.5	-5.0	-4.5
Taiwan	1.5	2.3	2.4	1.4	1.3	1.5	13.9	11.5	9.9	-0.2	-0.2	-0.3
Thailand	3.2	4.0	4.0	0.2	0.9 ↓	2.1 ↓	11.5	9.2	9.3	-2.8	-2.8	-2.8
Vietnam	6.2	6.4	6.5	2.7	4.9	6.0	3.8	-0.5	-0.9	-6.0	-5.4	-5.0
Latin America	**-1.1**	**1.1 ↑**	**2.5 ↑**	**27.4**	**36.0 ↑**	**22.5 ↓**	**-2.2**	**-2.0 ↑**	**-2.2 ↑**	**-6.8**	**-6.4 ↑**	**-5.9 ↑**
Argentina	-2.3	2.4 ↓	2.8	41.3	26.6 ↑	15.3 ↓	-2.8	-3.0 ↓	-3.3 ↓	-5.8	-6.2 ↑	-5.5 ↑
Brazil	-3.6	0.7 ↑	2.8 ↑	8.7	3.9 ↓	4.1 ↓	-1.3	-1.0 ↑	-1.8 ↑	-9.0	-8.1 ↑	-7.7
Chile	1.6	1.5 ↑	2.5 ↑	3.8	2.8 ↓	3.0 ↓	-1.4	-1.3 ↓	-1.0 ↑	-2.1	-3.1	-3.0 ↑
Colombia	2.0	2.0	3.0	7.5	4.5 ↑	3.7 ↓	-4.4	-3.7	-3.4	-4.0	-3.7	-3.5
Mexico	2.3	1.5 ↑	2.4 ↑	2.8	5.5 ↓	3.8 ↓	-2.1	-2.7 ↑	-2.6 ↑	-3.0	-2.6	-2.4
Peru	3.9	2.8 ↓	4.0	3.6	3.6 ↓	2.7 ↑	-2.8	-2.4	-2.5	-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**	**1.8 ↓**	**2.0 ↓**	**0.8**	**1.8 ↑**	**1.8 ↓**	**-0.4**	**-0.5 ↑**	**-0.5 ↑**	**-2.6**	**-2.5**	**-2.5 ↓**
Advance Economies	**1.6**	**1.8 ↓**	**2.0 ↓**	**0.7**	**1.8 ↑**	**1.8**	**0.1**	**-0.1 ↑**	**-0.3 ↑**	**-2.4**	**-2.3**	**-2.3 ↓**
Emerging Markets	**4.1**	**4.7**	**5.0 ↑**	**6.7**	**7.5 ↓**	**6.1**	**0.6**	**0.5 ↓**	**0.3 ↓**	**-4.0**	**-3.8**	**-3.6**
BRICs	**5.2**	**5.8 ↑**	**5.9 ↑**	**3.8**	**2.7 ↓**	**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.

Source: Deutsche Bank

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This Month's Special Reports

Emerging Markets and the Global Economy in the Month Ahead

- Political noise – in focus last month – has eased, but it has not been replaced with positive policy initiatives. Absent support for any meaningful stimulus we expect markets to focus on country specifics – bracing themselves for trend-growth rather than acceleration.
- In our view, China poses a temporary – not structural - risk for commodities, with the rest of Asia securing 6% growth in the region in 2017 and 2018. Political risks will remain in focus in South Africa, Turkey, Ukraine, Brazil and Mexico.
- The gap between soft and hard data in the US and EU is closing in an orderly way. This, more balanced growth, measured CBs and reduced political risk are crucial for global markets to hold and to anchor volatility at low levels.
- Inflation and growth paths remain quite diverse across EM, with Asia clearly ahead when it comes to rates normalization. Monetary policy easing or on hold remains the norm in EMEA and LatAm.
- EM FX remains in our view the asset class with most potential for appreciation this year, but we wait for broad-based growth reassurance to refocus on directional trades. Position for BRL outperformance vs. MXN and CLP. Keep long TRY/ZAR, ILS and CZK. Concentrate Asia exposure in INR, IDR, THB and KRW – with SGD as funding.
- Front-end premium has been squeezed across EM with few exceptions. Reduced term-premia also bode for lowering duration exposure. Keep short-end receivers in Brazil Russia, and Turkey, long bonds in Malaysia, India, and steepeners in China, and Korea. Receive in the belly of Israel and Poland, and in the long end of Mexico and Israel vs. the US.
- We stay constructive EM credit as a more defensive asset class and on supportive technicals and cyclical growth recovery. Valuation, while very tight, is more supportive if scaled by currently low vols – now a key driver of inflows.
- Overweight Argentina, Brazil, and Mongolia, underweight South Africa, Poland and Colombia. In relative value, we favor PDVSA 20s vs. 17Ns in Venezuela, EUR bonds in Argentina, long 5Y basis in South Africa, maintain 10s30s curve steepeners in Mexico and Malaysia, and switch from South Africa 26s to Turkey 26Ns

Diverging reflation

Political noise – in focus last month – has eased, but it has not been replaced with positive policy initiatives. Absent any meaningful stimulus we expect markets to focus on country specifics – bracing themselves for trend-growth rather than acceleration. Still, there is plenty of room for (less contentious) deregulation to support investment and productivity in coming years, and current conditions seem solid enough to tame the risk of the more pronounced correction in equities we feared last month. Even net of the energy sector, margins near record highs (with no sign of cost pressures), sales above 5% and a contained USD have reaffirmed DB's 13% EPS growth for the year. Given US companies' exposure to the rest of the world, this also suggests sound current conditions outside of the US.

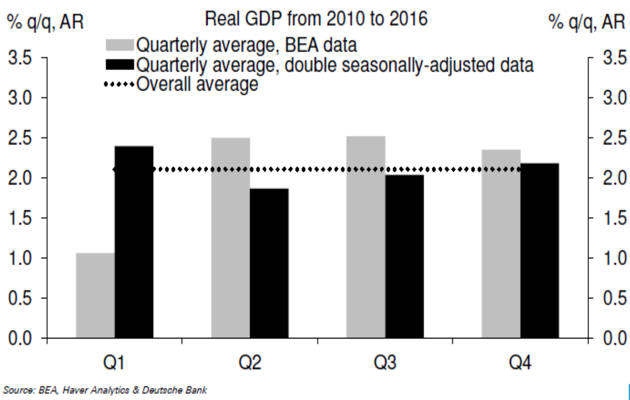
China poses a temporary risk for commodities, but not a structural one, in our view. First, we see recent tightening as a response to higher-than-expected growth in Q1 while low inflation allows financial conditions to remain easy for the bulk of lending. Second, we expect growth in the region near 6 per cent in 2017 and 2018, as China's slowdown is offset by stronger growth on average in the rest of the region – helped by export volumes running at multi-year highs.

EM headlines have turned more mixed, but systemic risks remain quite low. Default risk in Venezuela has eased after the recent payment with amortizations peaking again in October/November. Political risk in South Africa could rise again while Turkey enjoys a period of a relative stability by its own standard. Meanwhile, in Ukraine, the market has yet to shift its focus towards fiscal sustainability and political developments that may lead to early elections. May is the key month for Social Security Reform in Brazil, where we expect a narrow favorable margin. The opposite may be true in the State of Mexico, where the race is very tight.

Global growth and expectations normalization

The gap between soft and hard data is closing in an orderly way. Final sales of private domestic purchasers (hovering at 2.2%), tax receipts, the steady pace of payroll gains (around 175k over the past six months) and sound jobless claims ease concerns about the dismal pace of PCE growth in Q1 (0.3% in real annualized terms). Meanwhile, the pace of business spending in Q1 (equipment and structures spending up 9.1% and 22%) was consistent with strong business surveys. Also, surveys themselves have been incorporating a more realistic view on the potential impact and timing of US policies. In all, hard and soft data seem to be converging to 2%+ trend-growth in the US – in line with the underlying trend of the past few years (chart). Accordingly, assuming limited fiscal stimulus DB now foresees 2.5% growth in 2017 and 2.3% in 2018.

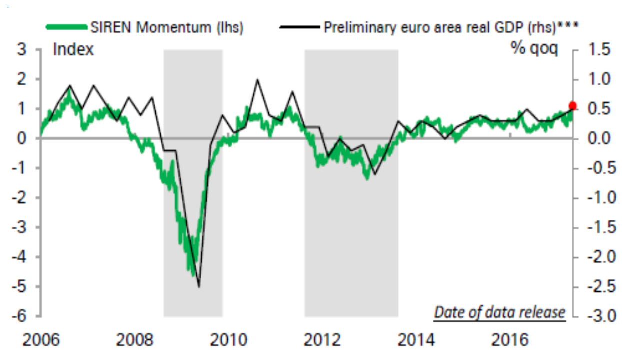
US growth: Back to trend



Source: Deutsche Bank.

Growth normalization and reduced political risk are crucial for global equities to hold and to anchor volatility at low levels. The underlying pace of growth in the EU has also been reassuring – completing 12 consecutive quarters above potential – even if below surveys-based estimates (0.5% vs. 0.6-0.7%). Also, latest data are still running near the post-crisis peak (chart). In politics, centrist, reformist, pro-European centre-left and centre-right parties have signaled they could govern with Macron, while US markets have become less sensitive to political headlines. In both cases there is plenty of room for deregulation to boost growth regardless of fiscal stimulus.

EU growth: Keeping the "momentum"



*Source: Deutsche Bank, Haver Analytics, National Statistical Offices, Bloomberg Finance LP, various statistical sources *At any date on the horizontal axis no ex-post data were employed, we only used information that had already been published. Grey shaded areas in charts above represent declining qoq GDP. ***Data for Q1-17 based on advance print of euro area real GDP.*

In terms of core rates, DB now foresees UST10Y yields at 2.75% by year-end while maintaining 10Y Bunds at 75bp. Contained wage pressures (with average hourly earnings running at 2.5% oya and U-6 at 8.6%) support DB's view of hikes in June and September and the announcement of balance sheet unwinding in December – with a pause then. Although the shorter end of the curve is consistent with the latest Fed estimate of r* (zero), premium in the long-end of the curve seems too low (also around zero after dipping to about -20bp according to the ACM model). The risk of fiscal shocks has been priced out, but short positions have been reduced substantially. This, the prospect of balance sheets unwinding, more elevated inflation breakevens and above-potential underlying growth suggest that US term premium is on the low-end of the distribution and thus a potential negative shock to EM.

EUR/USD risks now seem more balanced. We saw upside risks for the EUR and EUR/EM FX last month, and valuation suggests that EUR/USD could still move higher. But convergence in growth around 2% and defensive CBs support a narrower range. The Fed maintains a dovish tone and the risk of its composition turning more hawkish seem now lower. Meanwhile, the ECB has turned its communication to minimize the risk that markets re-price "exit" too soon. DB sees inflation rising in H2, paving the way for tapering to be announced in September (to be implemented in 1H18) and a 15-20bp hike in the deposit rate in December. The risk is that these signals come later than sooner.

EM is turning the corner, slowly

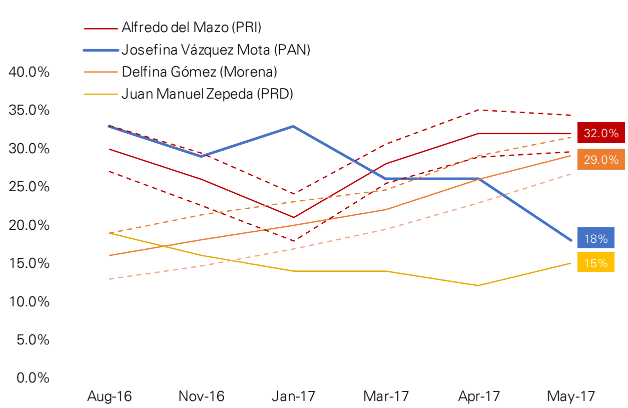
Asia is leading the pack; with an export-led rebound in growth, pointing to higher rates ahead. Both South Korea and Taiwan impressed the market, reporting stronger-than-expected GDP growth of 2.7% yoy and 2.6%, respectively, in Q1. We expect Hong Kong to do the same, with 4.3% growth in Q1. Although less pronounced, both China and Indonesia also saw growth momentum trend higher, rising by 0.1ppts to 6.9% and 5% respectively, in Q1. However, enthusiasm over China's stronger growth momentum was short-lived with renewed concerns over rising credit risks, amid a continued surge in loans that supported a real estate boom.

In EMEA, growth trends are uneven. In Turkey, short-term indicators (white goods sales and consumer confidence) point to continued cyclical growth following fiscal and credit stimulus, although the effects are beginning to taper off. We continue to expect growth to surprise to the upside and maintain our out-of-consensus call for 2.8% GDP growth in 2017. In Russia, we are keeping growth forecast unchanged at 1.6% in 2017, broadly in line with consensus, with recent demand and production indicators supporting our view. In South Africa, economic growth momentum has weakened significantly. Our preliminary GDP growth forecast for Q1 is 0.6% qoq saar – about 0.5% below our original forecast. Weakness seems broad based and likely extended into Q2. We have revised annual growth down for the second time since March, from 1% to 0.7% in 2017. In

CEE, growth continued to accelerate driven by a combination of stronger exports and domestic demand. Pick-up in EU-financed projects will also support recovery in investments in 2H2017.

In LatAm, growth paths are similarly showing differentiation. Methodological changes underpin our upward revision of Brazil's 2017 GDP forecast to 0.7% from 0.3%, but we maintain our 2.5% forecast for 2018. In light of the delayed monetary easing in Argentina and given the latest lackluster economic indicators, we have revised our 2017 GDP growth forecast to 2.4% from 2.7%. Growth has disappointed in Peru as well on Odebrecht's abrupt exit of infrastructure projects and Coastal Nino, but we see this as temporary. We are most concerned about Colombia, where similar headwinds for infrastructure investment have hit the economy when policy ammunition is already running low (in light of slippages in tax reform and resilient inflation). In Mexico, politics will become increasingly relevant both for asset prices and future growth prospects. The rising likelihood of the State of Mexico electing a non-PRI governor for the first time on June 4th could increase the visibility of political risks outside of Mexico (chart).

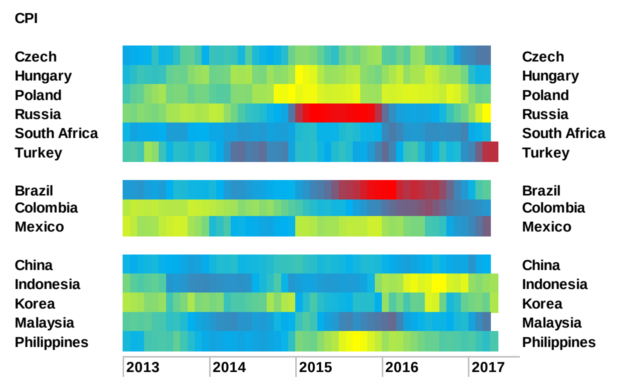
Mexico: Domestic politics gain relevance



Source: CEIC, Deutsche Bank.

With inflation on divergent paths, we see Asia moving ahead with policy tightening ahead of other emerging market Central Banks. We welcome the recent shift in China's macro policy priority to rein in credit growth while the PBoC sticks to targeted, mini rate hikes. After the new leadership takes over in Q4, however, we cannot rule out the PBoC turning in favor of a more aggressive monetary tightening. By contrast, we think the Philippines is ripe for a rate hike, amid sustained strength of growth (likely to print 6.4%yoy growth in Q1), rising inflation (above the mid-BSP inflation target) and double-digit credit growth. We expect the BSP to hike rates twice in 2H, starting in August. We see Indonesia following, with a 25bps rate by BI in October, although political risks have risen. We do not think higher rates pose risks to those economies given their relatively low debt levels. We see limited negative consequences of lower oil prices for Indonesia to be limited given it has (almost) eliminated related subsidies and significantly reduced its dependency on oil revenue. Same goes for Malaysia, where we expect the BNM to be patient with rate hikes, given the more highly indebted household sector. We also see South Korea opting for slow normalization of monetary policy, as the highly leveraged private sector poses risks to economic recovery. Should the new administration seek to support the marginalized with debt restructuring, this would ease the constraints on the BoK hiking rates.

EM inflation on divergent trends (CPI indicators)



In the above heatmap for selected emerging markets, yellow stands for low and red stands for high value of inflation with respect to historical averages (blue)
Source: Deutsche Bank, Haver Analytics LP, National Statistics.

In contrast, in EMEA, we do not see central banks moving with hikes in the near term, with the exception of "dynamic optimization" of the average funding rate by the Central Bank of Turkey and possibly one hike by the Czech National Bank. In Turkey, we are still forecasting the policy rate at 9.25% for end-2017 and end-2018. But we now expect the CBT to tweak the average rate funding rate (in 11.50-12 range) depending on external conditions and inflation outlook. We are still expecting one hike from 0.05% to 0.25% by the Czech National Bank, but there is a risk that the hike will be shifted to early 2018. Elsewhere in EMEA, cuts are more likely. In Russia, inflation decelerated faster than CBR expectations and we maintain our call for 200bps cumulative cuts in 2017 (125bps remaining). In South Africa, we are bringing back our somewhat out of consensus call for a 50bps cut in 3Q on the back of the recent large inflation surprises, deteriorating growth and contained ZAR reaction since the cabinet reshuffle and sovereign downgrades. Some of the SARB members still appear dovish and worried about recession risk.

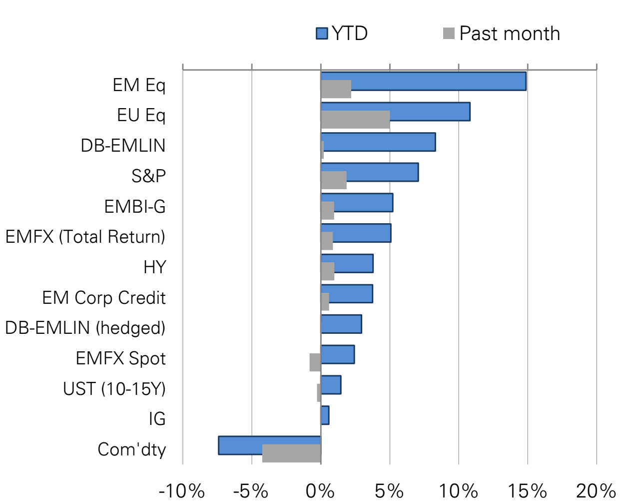
We see diverging trends in inflation also within LatAm. Disinflation is most notable in Brazil, as a sharp correction in agricultural prices is amplifying the benefits of a still large output gap. We lowered our

2017 IPCA forecast to 3.8% and cut our year-end SELIC rate forecast to 8.25% from 9.00% on the view that the BCB is poised to cut rates below the natural level to stimulate the economy. The main risk continues to be a possible rejection of the social security reform by Congress later in May (not our baseline scenario), as the government continues to post large primary deficits and the reform would be a crucial condition for long-term fiscal consolidation. Benign inflation in Chile will keep the BCCh on a dovish stance as well as pave the way for upcoming easing in Peru. It has also allowed Colombia's CB to accelerate its cycle as we expected. In contrast, inflation in Mexico continues to print above expectations, which strengthens the case for Banxico to remain relatively hawkish. We expect the Mexican CB to follow the Fed in June and hike the policy rate by 25bps in an attempt to keep medium term inflation expectations stable as price increases accelerate. Having hiked in April by 150bp, we see Argentina's CB to resume cutting interest rates in June, as the inflation surge driven by utility prices subsides.

Strategy: Stretching thin

The rotation from growth-sensitive into (local) fixed income that we expected to take place in April has largely run its course, in our view. The CBs in Brazil, Russia, and Colombia have taken the opportunity to accelerate their easing cycles while some others have sent more dovish signals. Monetary policy and term-premia across local curves have compressed, but low volatility has underpinned continued inflow into hard-currency debt and even lower spreads.

Unwinding of reflation trades evens out performance



Source: Deutsche Bank; Bloomberg Finance LP

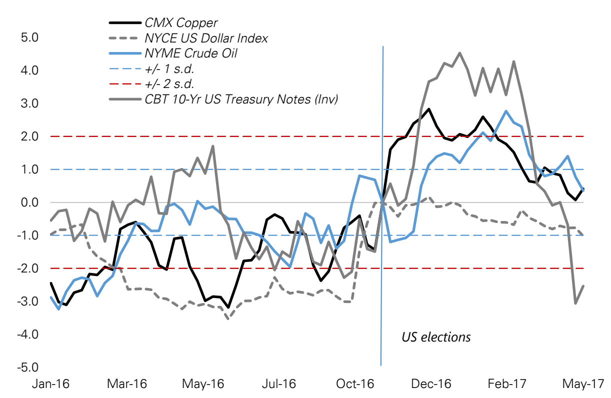
Valuations across EM fixed income are not extreme, but they are mostly unappealing and hinging on volatility staying near record lows for longer. Rather than focus on rotation this month we would rather scale back on EM positions that have performed well and focus instead on relative value and laggards where local dynamics have improved.

We have been of the view that EM FX offers the most room for appreciation across EM assets, but we prefer to wait for data to reaffirm our view that trend growth across DM and China supports the reloading of reflation trades.

EM FX: Focus on relative value

We are reluctant to recommend retracement trades, since valuation has not improved markedly and headwinds remain. Several factors will likely continue to prevent EM FX revaluation, in our view, hindering the trend that started late last year. To start, the recent tightening measures in China have cast renewed doubts on the strength of global reflation – the crucial input for the appreciation cycle we foresee over the next 1-2 years. We don't expect these to be disruptive, as discussed, but the chart below shows that positioning in important commodity markets remains long (in contrast with the more aggressive deleveraging in USD and UST positions).

Commodities: The risk of further unwinding

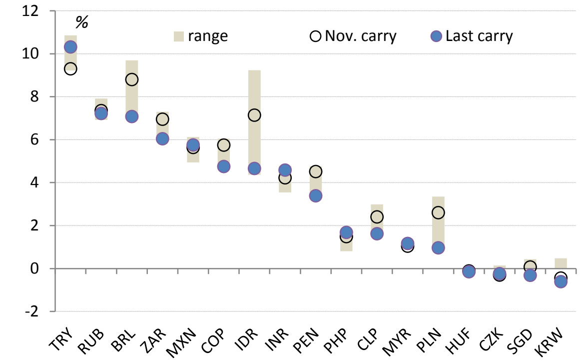


Source: Deutsche Bank Bloomberg Finance LP; z-scores based at election date..

EM FX carry has dropped while risks to growth have inched up. Even if still attractive vs. developed markets, the chart below shows that – with the exception of TRY – carry is hovering near the low-end of the range of the past six months for all other currencies.

In addition, high carry in absolute terms tends to be accompanied by high exposure to commodities (more below). To add to this headwind, carry-seeking flows seem bound to slow in the coming months. Portfolio inflows in Q1 were running at a pace consistent with significantly faster growth than even the bullish consumer and business surveys of early 2017 implied.

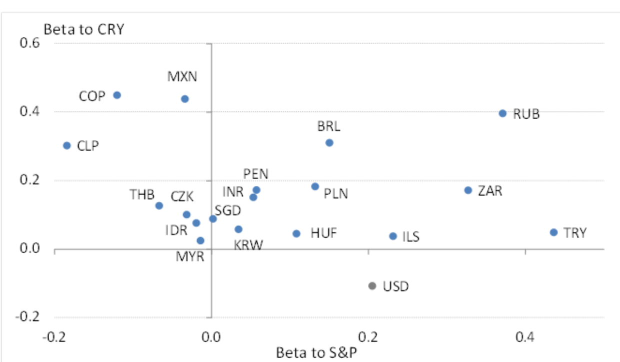
EM FX: Reduced carry margin

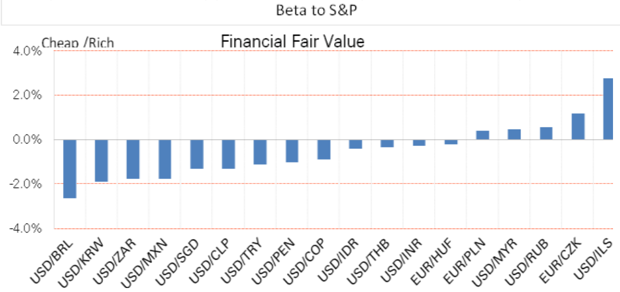


Source: Deutsche Bank. Sample truncated with highest R-squares.

The main source of FX risk seems to have rotated from the USD and US equities to commodities for now. We expect EM FX betas to USD and S&P to remain subdued on both sound earnings and the narrower range we foresee for the USD. The commodity betas – which have been dormant thus far in the year – have resurfaced, however (chart). Also, although most pairs have lagged their "financial" drivers, the cushion offered by valuation seems small. Naturally, the higher carry currencies tend to be those with higher betas. But if we narrow our focus on commodity betas, we still find some positive-carry, low-beta crosses attractive.

EM FX: Better valuation, but higher betas





Source: Deutsche Bank; Bloomberg Finance LP.

Having taken profit in long COP and PEN vs. CLP, we still favor CLP as funding for BRL (on positive carry and reduced commodities exposure), and we now also expect BRL to outperform MXN. In BRL/MXN, we see diverging political risks, with the approval of the social security reform in Brazil vs. increasing likelihood of a PRI defeat in the state of Mexico.

We maintain long TRY/ZAR. Net short (CORAX) positioning, increasing inflows, still attractive valuation, tight monetary conditions (near 12%, with commitment from CBT to maintain this in the near term) support TRY longs, while ZAR is one of the most exposed EM currencies to commodities and other external risks, and it also seems more exposed to political risk than TRY.

In low-yielding EMEA we continue to favor long ILS and CZK. In addition to their low-betas, rebounding exports and a 4% CA surplus have reduced ILS intervention risk, where we find overvaluation to be mild and positioning still light. Positioning has improved in CZK, where valuation and the business cycle are both supportive.

We concentrate exposure in INR, IDR, THB and KRW – with SGD our favorite funding. Asia FX had a good run thus far, and the hurdle on data surprises is likely moving higher. Unless export data continue to surprise we may see Asia FX more vulnerable to possible refocus on potential trade barriers and balance sheet unwinding by the Fed[1].

- **Asia**: Buy 6M USD/INR puts; short 6M SGD/IDR NDFs (target 9,000 spot), short 3M USD/THB (target 33 spot); buy USD/KRW leveraged put spreads (1X2 3M 1,130/1,100).
- **EMEA**: Long TRY/ZAR (target 4.0); hold short USD/ILS (target 3.55), short EUR/CZK (target 800 in 9M forward pts).
- **LatAm**: Buy BRL/MXN (target 6.18), maintain long BRL/CLP (target 214); hold 3M USD/BRL DNT (3.00,3.30) and short 3M USD/BRL vol swap. Sell 2m USDc/MXNp @18.50 vs. buy 3m USDc/BRLp @3.167 with EKO @ 3.0 ref FX 19.02/3.17.

Local rates: Chasing the left-over

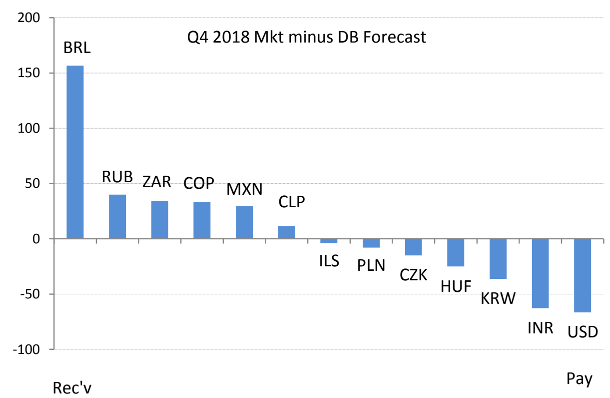
EM curves are priced roughly in line with our monetary policy forecasts, with few exceptions. In most cases the differential between what is priced for policy rates and our forecasts for 2018 are within 50bp (chart) – except for Brazil. We recommend receiving into the recent front-end steepening in Brazil (via Jan18/Jan19), since we doubt the usual uncertainty around elections will provide any meaningful policy and thus market direction before the last two months of the year.

We believe Turkey's CB will maintain liquidity tight, but the back-loaded normalization path priced supports 1Y receivers. Elsewhere we need to move further down the curve to find better valuation vs. our policy views –

[1] See our special report on this issue in this Monthly.

under the assumption that rates vols will remain low. We continue to favor receiving in Poland vs. Hungary on our view on relative paths of normalization. We see residual value in receiving in Colombia and Peru

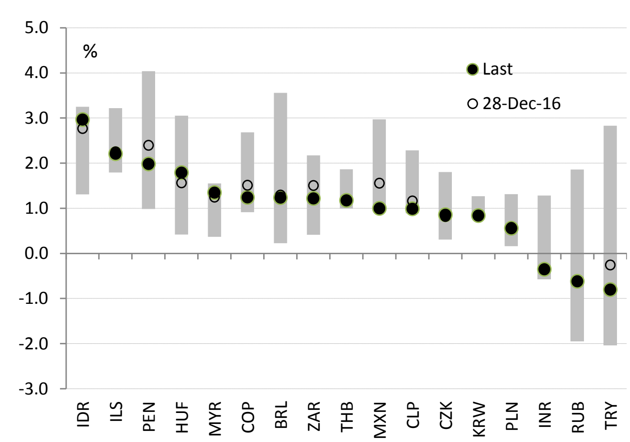
Short-end pricing aligns with monetary policy forecasts



Source: Deutsche Bank

We maintain a steepener bias in Asia – in China, Korea, and Singapore. Deleveraging weighs on duration in China, while a more constructive tone in Korea post-elections supports our steepener, while outperformance in Singapore vs. UST bodes well for spread widening. We see limited room for India to rally and remain marketweight favoring the 3-6Y sector. But light positioning and liberalization in "dynamic hedging" support MGS. Technicals also benefit 10Y receivers in Thailand.

Local fixed income: Lower premium

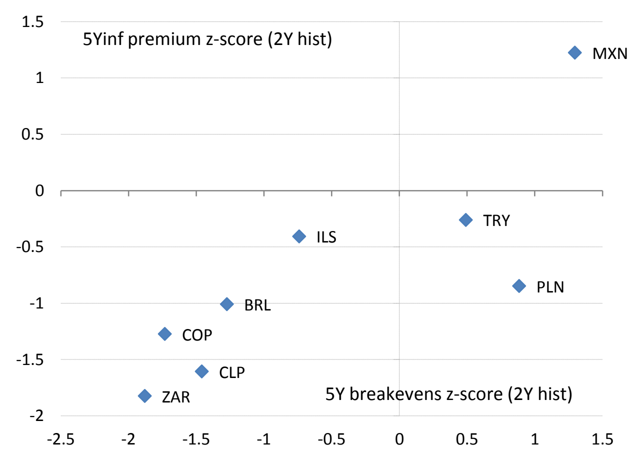


Source: Deutsche Bank

We prefer to reduce duration and favor carry in the belly of selected curves on lower term-premium but low rates volatility. We hold short-end receivers in Russia and 3s7s steepeners on aggressive easing and tight valuation in longer tenors. Favor receivers in the belly of Israel and Poland (on carry and delayed normalization vs. pricing) and Israel vs. US in 10Y. Premium is still relatively high in Hungary (10Y).

Linkers have cheapened – in relative terms – as a by-product of the unwinding of reflation trades and thus the strong performance of nominal rates of the past month. This has been the case in Brazil, Colombia, Chile, and South Africa, while the opposite holds in Mexico. We continue to expect further spread compression in the long end of TIIE vs. US swaps, but we believe that – with negative inflation premium and reduced breakevens (chart) – risk-reward for linkers has improved in the other cases.

Inflation premium has also compressed



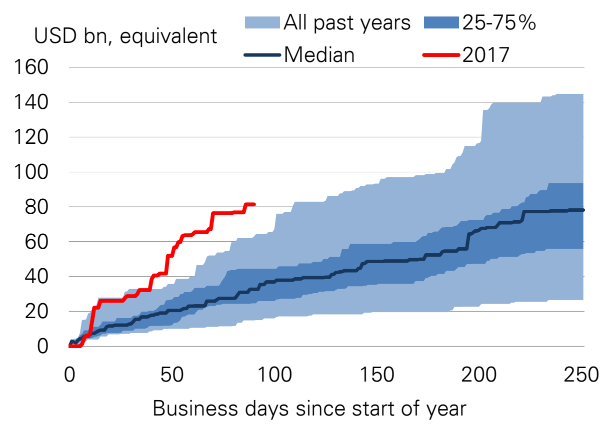
Source: Deutsche Bank, z-scores of past year.

- **Asia**: Pay CNY NDIRS 2Y/5Y steepener (target +50bp); pay KRW IRS 2Y/10Y steepener (target +60bp); pay 5Y SGD swaps (target 2.3%); buy 10Y Thai GBs vs. swaps (target spread to par); buy Sep-2018 MGS and 3Y-6Y India GBs, currency unhedged.
- **EMEA**: Pay 2Y HUF vs. PLN (target: 1.00%); pay HUF 5Y IRS against HGB 25Bs (target: 115bp). Buy RUB OFZ May-19 (target 7.50%); receive 1Y RUB IRS (vs. Mosprime – target 8.75%); keep RUB 3s7s XCCY steepeners (target: -25bp). Receive PLN 2Y2Y (target: 2.5%). Receive ILS 2Y fwd 1Y rate (target 75bp); receive ILS 5Y5Y IRS vs. USD (target -25bp); buy ILGOV Oct-26 vs. 2Y IRS (target 125bp). Receive TRY 1Y XCCY (target 11.00%). Pay ZAR 12x15 FRAs (target 7.30%) or pay ZAR 1Y1Y IRS (target 7.40%).
- **LatAm**: Receive Jan18|Jan19 (target 8.50%); keep IBR 6M3M receiver in Colombia (target 4.70%). Receive TIIE10s vs. US10s (target 485bp), and receive TIIE 1Y2Y (target 40bp upside) in Mexico. Hold Soberanos 26s (target 5.30%) in Peru.

Credit: Inflows to continue on low volatility

Despite steady inflows and supportive risk sentiment, EM Credit benchmark has moved only slightly tighter over the past month, having traded in a narrow range over the past three months. The main drags on the performance are two-fold, in our view. First, supply accelerates: EM Sovereign issuers have sold a record USD82bn bonds year to date, the fastest run rate to this date of the year on record. Second, the selloff in Venezuela and underperformance of South Africa on political turmoil and subsequent loss of IG added to EMBIG spreads.

Record EM sovereign issuance



Source: Deutsche Bank, Bloomberg Finance LP

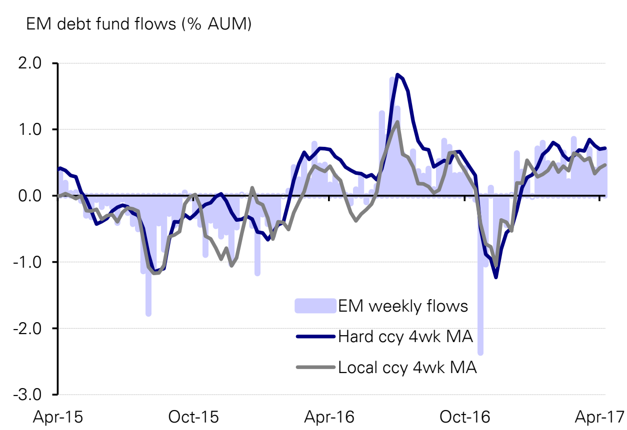
While some idiosyncratic risks continue to be key considerations, we see enough reasons to stay constructive EM credit. Not only it is less sensitive to commodities and growth fears, but it also benefits from supportive technicals and the continuation of cyclical growth recovery across EM. Global growth remains strong enough to avoid recession and more aggressive tightening by core CBs; and the European political risks have diminished after the French election.

The recent tightening in China, while having caused a correction to commodity prices, is seen as a temporary balancing act to reign in credit risk and it is not expected to cause a sharp slowdown in growth and risk aversion. The tail risk of an (unforeseen) geo-political event aside, we do not see an obvious catalyst to disturb this dynamics in which volatility is exceptionally low and yields continue to be sought.

Investors' preference of EM yields also finds justification from the cyclical growth recovery among EM economies (the IIF's EM growth tracker has moved to a five year high). Also, EM economies' external deficits have adjusted since 2013 to "safe" levels. There are clear problems in select countries, such as Venezuela and South Africa, but they are seen as idiosyncratic rather than systematic.

Technicals continue to be strong, anchored by robust inflows. EM hard currency funds had taken in another USD4.4bn (2.7% AUM) in April according to EPFR reports, extending the streak of consecutive inflows to 17 weeks and brining YTD total to USD15.5bn (10.5% AUM). Strong inflows, together with large repayments during the past three months helped markets absorb the impact of the hefty primary supply year-to-date. As long as volatility stays low we expect inflows into EM to remain strong, helping EM credit withstand the negative impact of some EM idiosyncratic shocks and potentially increased risk aversion.

Robust inflows



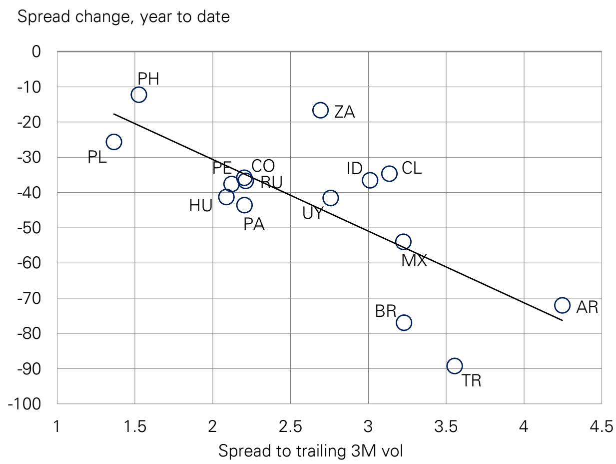
Source: EPFR, Deutsche Bank

Valuation, while indeed very tight, looks more attractive if seen in the context of low vols. In a recent EM Sovereign Credit Weekly, we point out that EM credit benchmark spread-to-vol ratio is at its highest in more than two years, even as the spread is almost at the tightest during the same period of time. 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.

Year-to-date, market has generally favored credits with a higher spread-to-vol ratio, as shown in the following graph. Venezuela is shown as a notable exception for obvious reasons. The graph also shows that the market has disfavored the likes of the Philippines and Poland (and to a lesser extent Hungary, Peru and Colombia), which offer a very low spread to vol ratio, given tight valuation. Spread-to-vol continues to be an important consideration in our country allocation strategy.

We retain a marginal regional bias in favor of Latin America, but it is mostly due to the (good) yields offered by corporate and sovereign entities in Argentina and Brazil. In Asia, we remain committed to Mongolia vs. Sri Lanka in frontier markets, while in EMEA, we favor Turkey on relative stability vs. South Africa (on policy shifting towards populism) and CEE (tight valuation).

Credits with higher spread/vol ratio have generally outperformed year to date, with notable exception of Venezuela (not shown)



Source: Deutsche Bank

Idiosyncratic risks continue to play a key role in asset allocation considerations. Most notably, heightened political turmoil in Venezuela, lower oil prices, and speculated supplies from locals has caused a sharp selloff of Venezuela/PDVSA bonds. We believe a higher likelihood of political transition and increasing refinancing difficulties justify an allocation towards more defensive assets on the curve, in which we favor PDVSA 20s at the front end and PDVSA 35s and Venz 28s at the long end. Political risk in South Africa is still entrenched, as no confidence vote on President Zuma will be attempted, and has limited likelihood of succeeding without a secret ballot process. The risk remains that an outright collapse in growth this year could bring on further domestic currency credit downgrades, which the market doesn't appear to be pricing.

In relative value, we retain a neutral position in terms of duration exposure overall, although we favor curve steepeners in Mexico and Malaysia. Meanwhile, we favor long basis in Argentina (via long end bonds) and South Africa.

Summary of key recommendations

- Overweight: Argentina, Brazil, Mongolia
- Underweight: South Africa, Poland, Colombia, Sri Lanka
- Inter-credit: Turkey 26Ns vs. South Africa 26s
- Curve trades: Malaysia 26s vs. 46s. Mexico 27s vs. 47s.
- CDS/Bond basis: Buy Argentina Pars vs. 5Y CDS, Buy 24s vs. 5Y CDS in South Africa, Sell 10Y CDS vs. 47s in Brazil
- Cash RV: PDVSA 20s vs. 17Ns, YPF 25s vs. 24s, Argentina EUR 22s vs. USD 21 (fx-hedged); PDVSA 35s vs. 21s
- Other: Long Argentina EUR 22s (base-rate hedged).

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EM's Slow Turn: The Green Shoots

- We highlighted early last year EM's leverage as a persistent drag on growth. The outlook has improved since, with progress on deleveraging, a possible pick-up in cross-border claims, and more supportive external prices.
- There are encouraging signs of deleveraging and that borrowing constraints may be easing, but elevated stocks in several large economies point to a protracted process.
- We have seen progress across several economies (especially in Russia, Brazil, South Africa, and Hungary, with Turkey as an important exception outside Asia). Debt burdens are closer or below the median for many EM. These have been reduced more aggressively in DM, but they still tend to be a lot higher than in EM.
- Repricing of collateral values could ease the burden. EM equities have lagged substantially the rally in US equities. Also, EMEA and LatAm FX are in the bottom half (in real terms) of their ranges of the past 25 years.
- The room for appreciation in housing and fixed income, however, seems limited. The average ex-ante real rate differentials vs. US across the main local currency markets are within the lowest 5%. Also, EM housing prices tend to be above the median of the distribution for most EM. As exceptions, we have seen meaningful corrections in Brazil, Russia, and South Africa.
- Focusing on corporates, we have seen several green shoots amid lingering challenges: First, corporate leverage (net debt to EBITDA) has continued to increase in 2016 in LatAm and EMEA due to further commodities/FX weakness (at a lower pace in LatAm since 2016 on cost cuts), but profitability has picked up in the most affected LatAm corporates on efficiency and lower funding.
- Second, the share of corporate weak links (companies with leverage above 5x and profitability below 4% for two consecutive years) in EM ex-China has reduced further in 2016 (to just under 18%), and the profitability of EM ex-China corporates excluding the weak links has improved.
- Risk to monitor: FX corporate debt-exports ratio is highest (and above 130%) in Turkey, Brazil, Chile and Peru. International bonds-to-exports ratios have continued to increase in LatAm (to near 35% vs. less than 10% in other EM regions). Brazil, Chile and Peru (along with China) also have higher average corporate leverage and lower average profitability than other EM countries.

Reassessing EM's leverage cycle

As we approach mid-year, and with important political and policy changes in hindsight, we take stock of recent economic performance and update our outlook for EM. Our focus is on credit and indebtedness, since we have been of the view that EM's (and also DM's) growth over the past couple of decades has been largely dictated by their leverage cycles.

Early last year[2] we highlighted the challenges that the fast pace of leveraging post-GFC had imposed on EM – especially once external credit conditions tightened and commodity prices weighed on the finances of primary goods exporters. Some healing has clearly taken place since then. EM's growth outlook has improved – as so has the outlook for DM economies. Progress on deleveraging has been made and cross-border claims seem to have bottomed. We have also seen some pick up in both commodity prices and exports (especially in Asia when it comes to volumes).

Despite these green shoots, debt burdens, corporate leverage, and reduced policy ammunition still seem poised to remain important drags on EM growth for years to come. We are encouraged by the global backdrop – low volatility, gradual rates normalization and a weaker/range-bound USD. But more than a boost, these conditions have become strictly necessary to facilitate orderly deleveraging and recovery in EM.

EM to grow, albeit slower than pre-GFC

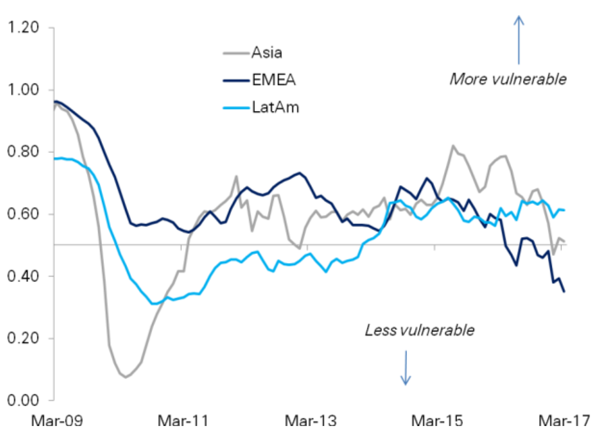
Growth is slowly returning to EM, driven by pick-up in global trade, most notably in Asia, and stabilization in commodity exporters, as policies turned less restrictive in these countries following the adjustment of 2015-16. Stronger growth momentum in Asia has been led by the recent rebound in exports, while domestic consumption remained weak. Credit growth slowdown in the region will likely continue to be a drag on domestic demand, however.

In EMEA, in CEE output gaps have been closed, while recession ended in Russia. Turkey's growth will likely hold up in 2017 due to the significant fiscal and credit stimulus unleashed by the authorities. In South Africa, recent soft data is not encouraging; we expect poor business confidence due to political uncertainty to weigh further on investment and activity. On the positive side both Turkey and South Africa's exports

[2] See EM's Corporate Challenge and EM's Slow Turn: Unwinding the Glut, published in January and March 2016.

are showing sign of improvement. In LatAm, data have confirmed a shallow recovery with political uncertainty or setbacks in infrastructure spending (as in Peru and Colombia) capping the region's growth to only 1% this year. Altogether rather the usual fiscal or BoP crisis, EM continues to face a "growth crisis".

Growth improving in Asia, but more mixed in EMEA and LatAm (average percentile growth momentum)

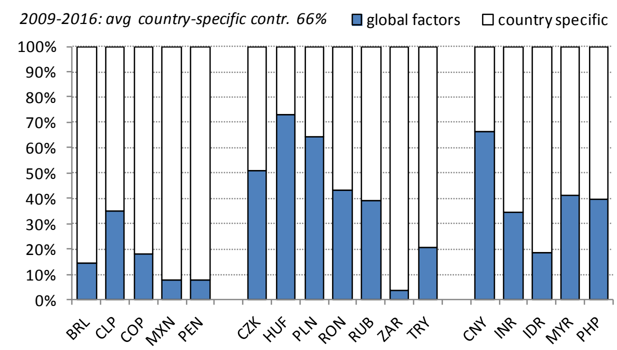


Source: Deutsche Bank, Haver Analytics

EM inflation remains largely idiosyncratic and it does not yield itself to a cross-EM "reflation" theme. As we showed earlier[3], inflation has been driven by EM specifics – even more so in recent years vs. pre-GFC. In Asia, stronger growth momentum and higher inflation point to imminent normalization of policy rates, posing risks to the highly leveraged economies. In EMEA, inflation in CEE and Israel is picking-up with higher exposure to global factors. However, deleveraging in CEE was completed much sooner after the GFC and policy tightening in Israel is expected to be fairly gradual due to ILS strength and unlikely to be a cause of concern.

The takeaway from recent years is that it will take stronger reflationary forces in DM to act as a coordination device across EM cycles. Different stages in the business cycles, base effects from FX pass-though, refocusing on inflation targets (as in Russia and Brazil), food prices, and weather shocks such as Coastal Nino have accounted for a large share of activity and inflation dispersion elsewhere across EMEA and LatAm. If cross-border claims improve and external prices improve as we expect, we will likely see a more concerted EM cycles over the next couple of years.

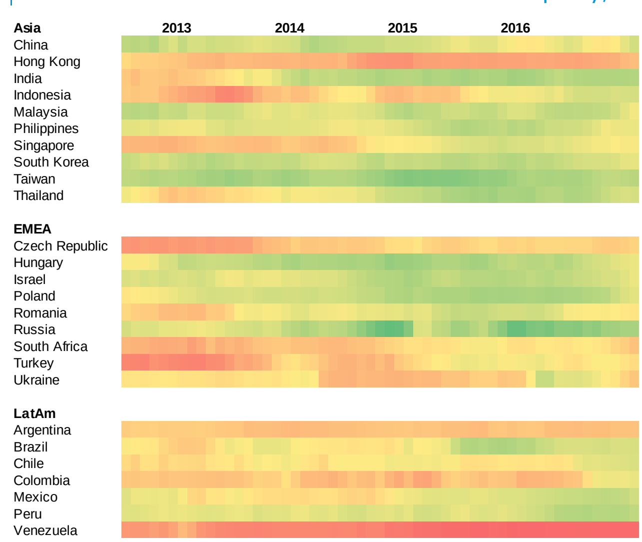
Variance explained by First two PCs from global factors (DXY, G3 inflation, oil)



Source: Deutsche Bank, Haver Analytics.

As we discuss below, excessive local credit creation rather external vulnerability seems more binding for growth. Most emerging economies have shown improvement on traditional metrics, such as FX valuations, current account adjustment and reserve coverage compared to 2013. Current accounts have also been improving and are back to lows (ex-commodity exporters). Foreign participation in the local markets is high, but still a few percentage points below earlier peaks.

External vulnerability off its peak (combined real rates, FX valuation current account and reserves adequacy)



Red indicates higher vulnerability
Source: Deutsche Bank, Haver Analytics.

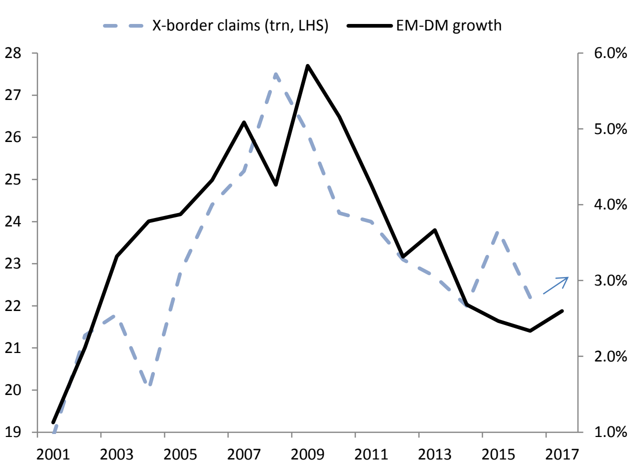
[3] See our October 2016 Monthly for a decomposition between domestic and common drivers of inflation across EM.

Unwinding the Credit Glut will take time

- There are encouraging signs of deleveraging and that borrowing constraints may be easing, but elevated stocks in several large economies point to a protracted process.

Cross border bank claims on EM dropped off significantly in the immediate aftermath of the GFC, but recent data shows some signs of pick-up. As the chart below suggests this tightening appears to have been an important driver of the narrower EM vs. DM growth observed post-GFC. As we discuss below, USD credit and domestic lending have attenuated or even reversed this tightening credit trend in some cases, but these substitutes have also shown signs of exhaustion along the way. If cross-border claims have indeed bottomed as we believe, this should provide an important relief – supporting our view of continued pick-up in EM vs. DM growth in the coming years.

Cross-border claims may be turning supportive



Source: Deutsche Bank

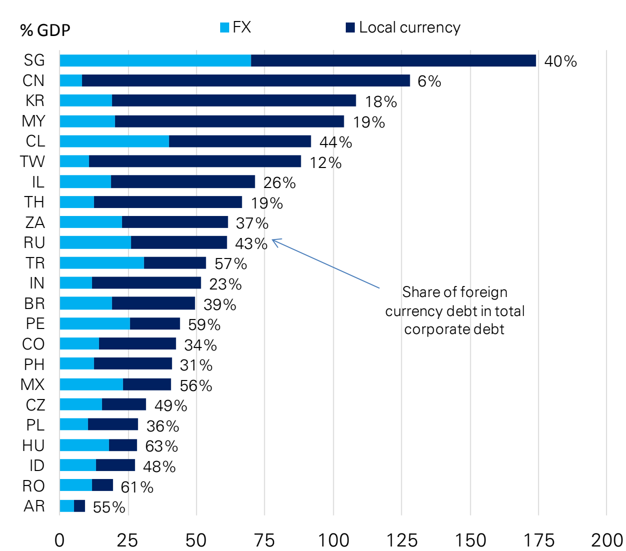
USD flows seem to have also turned more supportive over the past year. The pace of USD-denominated credit (bank lending and bond flows) to EM picked up strongly after 2008 (to mid-teens, annually) and it hovered mostly in double-digit territory before slowing substantially once the Fed signaled tapering in 2013. Corporates, in particular, have also accelerated their pace of external issuance in this period. Although tapering had an important impact on USD credit this shock has waned post 2015. Since then, the USD credit impulse has turned positive again. This seems likely to remain the norm unless the pace of normalization in the US accelerates and USD resumes.

However, the build-up of meaningful local imbalances has been a binding constraint for many and an important source of differentiation within EM. Total (bank and capital markets) credit expansion has been a meaningful countervailing force of tighter credit conditions post-GFC – especially in Asia and LatAm. Several governments in these regions opted for smoothing the external credit cycle by expanding local lending aggressively.

In LatAm, local claims increased by USD13.5trn from the end of 2008 through mid-2014 – about twice the pace of local credit expansion seen from 2000 through end-2007. In Asia – with the boost from China – it has increased since 2008 by 40trn, while they remained roughly stable in EMEA. Although local credit expansion has shown clear signs of exhaustion in LatAm since commodity prices dropped in 2014 – especially in Brazil, this has yet to happen in Asia.

Local bond issuance has also been particularly active, especially in China (where it is showing no sign of abating). Although local bond issuance in principle limits FX risk, large foreign investor participation has become a concern. After the US election FX depreciations have been closely correlated with the share of foreign ownership in domestic markets. On the positive side, corporate FX exposure has been falling – but it remains elevated in Argentina, Hungary, Mexico, Peru, Romania, and Turkey.

Share of FX debt in total corporate debt

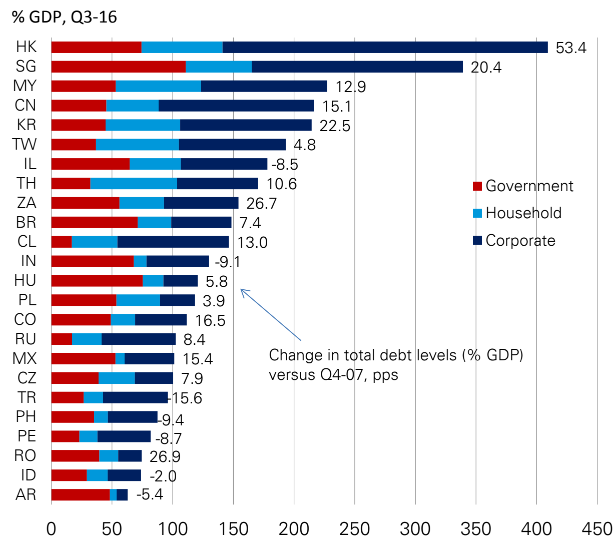


Source: Deutsche Bank, Haver Analytics.

More specifically, we have seen meaningful progress in deleveraging in Russia, Brazil, South Africa, Hungary and more recently in the rest of LatAm – amid lower pace of credit expansion elsewhere (except in China). This adjustment has been concentrated in household credit, while deleveraging for many corporates has been hindered by external shocks – particularly for commodity exporters. We will return to corporate leverage in the next sub-sections.

How far in the leverage cycle we are is difficult to judge as tolerance for debt depends on expectations of growth, financial, and domestic conditions, but debt burden and collateral prices serve as a hint.

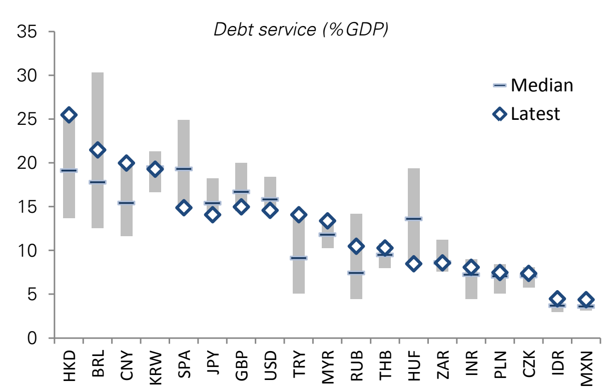
Large stocks of debt remain a drag on EM recovery



Source: Deutsche Bank, Haver Analytics. As of 3Q 2016.

The chart below shows some progress in reducing debt burdens, which remain elevated in Brazil and other important parts of Asia. In terms of distribution, we have seen progress across several economies with debt burdens closer or below the median for many emerging economies – with Turkey as one important exception. Although debt burdens have been reduced more aggressively in DM on record low interest rates (they are hovering at historical lows in the selected countries we include in the chart) they still tend to be higher than in EM.

Debt burdens: Some progress but still elevated



Source: Deutsche Bank

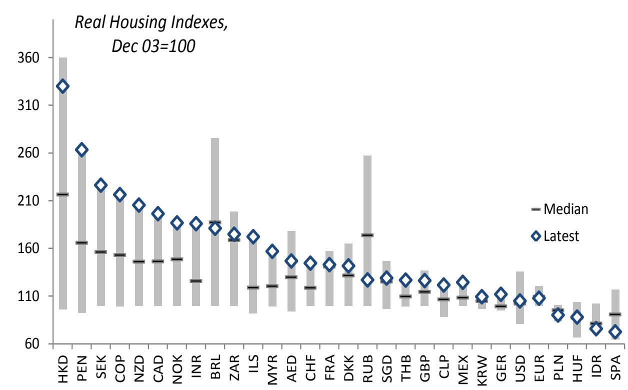
Interest rates still have some room to fall mostly in LatAm and EMEA and this should facilitate further reduction in debt burdens. But since they are already close to historical lows, growth will and continued deleveraging in some cases will have to bear the brunt of further adjustment going forward.

Asset appreciation could also be supportive – within limits. We have limited information on aggregate collateral values in EM, since both housing and stock tend to account for a much lower share of wealth in these countries. Still, as DM/EM equities are trading near double the level just pre-GFC, there is likely upside – even with EM-DM growth differentials recovering only partially.

With EMEA and LatAm FX hovering near the mid and the low end of the range of the past 25 years, respectively (in real, effective terms), there is also space for local assets to appreciate in hard currency. The room for appreciation in housing and fixed income, however, seems limited. The average ex-ante real rate differentials vs. US across the main local currency markets is within the lowest 5% of the distribution since 2010 and the same applies to nominal yield differentials.

Also, as the chart below shows, housing prices are still highest (from a distributions standpoint) in DM, but they also tend to be above the median in most EM. As exceptions, we have seen meaningful corrections in Brazil, Russia, and South Africa.

Housing prices still relatively high in EM



Source: Deutsche Bank

EM's "Corporate Challenge" – Part II

In January of 2016 we looked into non-Asian EM corporates to gauge their leverage ratios and profitability to get a better sense of their ability to invest in thus contribute to EM growth. We were concerned then about the oil sector – particularly in LatAm, due to fears about its ability to generate cash at lower oil prices and sizable near-term debt maturities. But most oil companies managed to significantly improve/optimize their cost and capex structures and kept their ability to refinance debt/tap the debt markets.

Corporate leverage growth has decelerated in LatAm (thanks to efficiency gains), while profitability in EM ex-China has recovered and pressure points have eased. The latest annual corporate leverage data (measured as net debt-to-EBITDA) and profitability (measured as ROIC less a funding cost proxy) for a large sample of relatively large EM corporates indicates that:

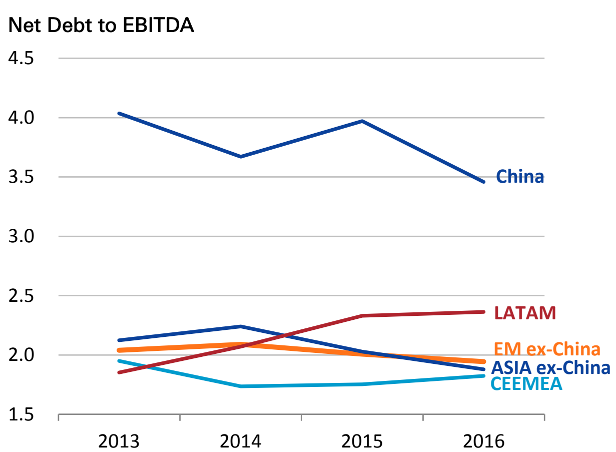
1) Leverage has continued to increase in 2016 in LatAm and EMEA due to further commodities/FX weakness. But this happened at a slower pace in LatAm (vs. 2015) due to strong cost-cutting efforts, and despite the recessions in Argentina and Brazil;

2) LatAm's profitability has recovered in 2016 by about half the ground lost in 2015 on cost-cutting and lower funding (led by Brazil and Colombia);

3) The share of weak links (companies with leverage above 5x and profitability below 4% for two consecutive years) in EM ex-China has reduced further (to 17.6% of total debt in our sample);

4) The profitability of EM ex-China corporates excluding the weak links has improved (to 14.2%).

Asia ex-China driving EM ex-China corporate leverage

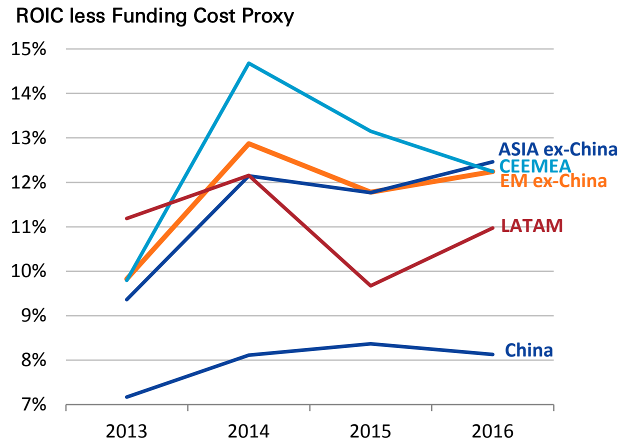


Source: Deutsche Bank, Bloomberg Finance LP

Although the ratio of international bonds outstanding to total exports has continued to increase in LatAm (now at a historical high near 35%), and so has corporate leverage in the region (to an average of 2.4x net debt to EBITDA), we take comfort in the region's recovery in profitability in 2016 (to about 11%).

Also encouraging is the relatively small total debt-to-GDP of our weak links' in LatAm and EMEA (about 2.2%), while Asia's higher share of weak links (18.5% of GDP in China and 5.1% ex-China) is mitigated by the region's higher growth, better ratings and predominance of low, local funding.

Returns have recovered meaningfully in LatAm



Source: Deutsche Bank, Bloomberg Finance LP

A deeper dive across EM corporates.

In order to measure the recent trends in EM corporate leverage and profitability, we looked at a sample of about 1,900 (listed and non-listed) EM companies with revenue above USD750m and with annual financial data already reported for 2016, and compared it with a sample of about 2,400 EM (listed and non-listed) companies (also with revenue above USD750mn) and with financial data for 2015, 2014 and 2013. The samples had about USD5.0tn (USD3.0tn ex-China) of debt for the 2016 set and USD9.0tn (USD3.5tn ex-China) of debt for the more complete set with data for 2013-2015 – equivalent to about 27% of EM GDP (16% of GDP for EM ex-China).

We then created a proxy of 2016 leverage (measured by net debt-to-EBITDA) and profitability by applying the 2015-2016 variation of these metrics in the 2016 sample to the 2013-2015 sample on a proportional basis (by the amount of debt outstanding on each sample). The samples exclude outliers in terms of leverage and returns and we have used simple average of leverage and returns to aggregate the data.

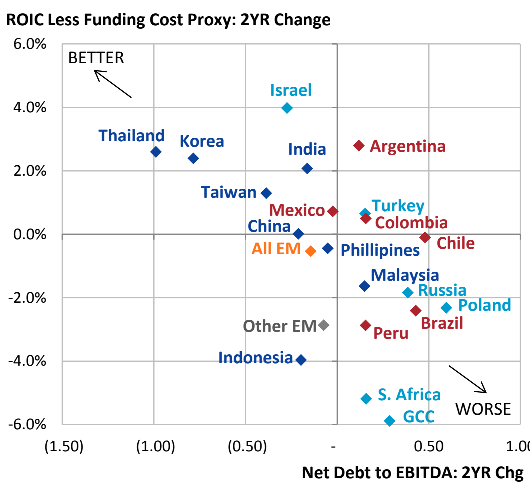
We measured profitability by calculating pretax ROIC less a funding cost proxy. We defined pretax ROIC as EBIT divided by the sum of the average net debt and equity book value, and we calculated the funding cost proxy by using the average of local interest rates and international government bond yields for the company's key country of risk.

The analysis of our EM corporate samples shows that:

- Two years of good earnings performance in Asia have offset the two-year increase in corporate leverage in LatAm and EMEA due to commodities and FX weakness after 2014. But the annual increase in corporate leverage in LatAm was more muted in 2016, thanks to efficiency gains (cost savings).

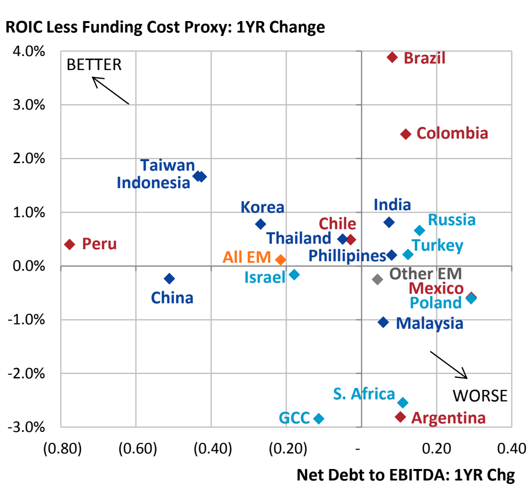
- LatAm's profitability has regained in 2016 about half of what it lost in 2015, led mainly by significant cost-cutting efforts and lower funding costs (primarily in Brazil); while Argentina's two-year improvement in returns was driven mainly by lower funding costs (partially offset by recession in 2016). Brazil, Chile and Colombia stand out as having (along with China) one of the weakest combinations of corporate leverage and ROIC net of funding costs in EM.
- Despite South Africa's deterioration in corporate leverage and returns in the last two years (due to lower commodities and weaker FX), these metrics remain quite strong when compared to other EM countries; while Turkey's corporate returns have proved quite resilient despite FX weakness.

Diverging exposure to commodities and FX exposure have benefited Asian industrial countries in last 2 years



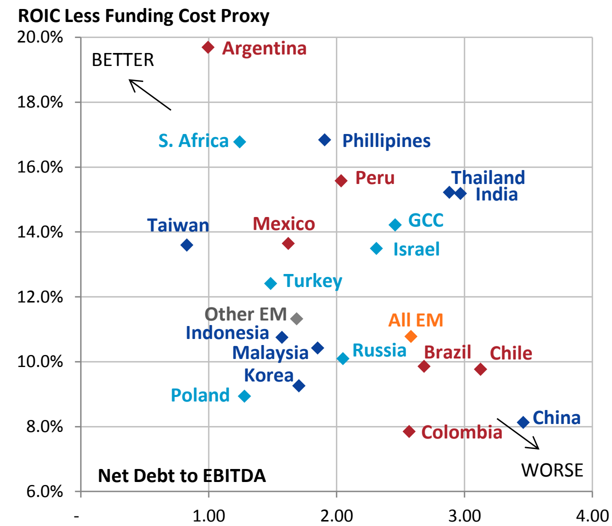
Source: Deutsche Bank, Bloomberg Finance LP

Cost cutting and lower funding costs have benefitted Brazil and Colombia in 2016



Source: Deutsche Bank, Bloomberg Finance LP

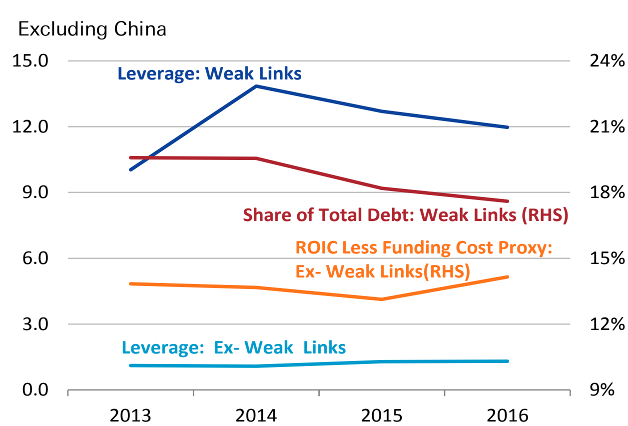
Brazil, Colombia, Chile and China rank poorly in terms of corporate leverage and returns after funding proxy



Source: Deutsche Bank, Bloomberg Finance LP

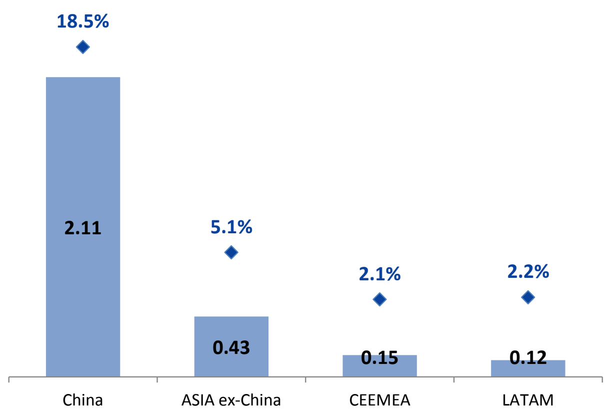
The weaker links in terms of high corporate leverage and low profitability are concentrated in Asia. However, this is mitigated by the region's higher growth, better ratings and predominance of local funding. If we exclude China (which has a higher share of more levered SOEs) from our analysis and separate the weak corporate links (from the rest of EM corporates) – which we define as companies with at least two consecutive years of leverage above 5x and profitability below 4%, we see an improved picture in 2016 vs. 2015 due to 1) a 60bp reduction in the share of weak corporate links, to 17.6% of total debt; and 2) a 0.7x reduction in the average leverage of weak corporate links, to 12.0x; and 3) a 100bp increase in the average profitability excluding the weak links, to 14.2%.

EM ex-China corporate performance has improved in 2016



Source: Deutsche Bank, Bloomberg Finance LP

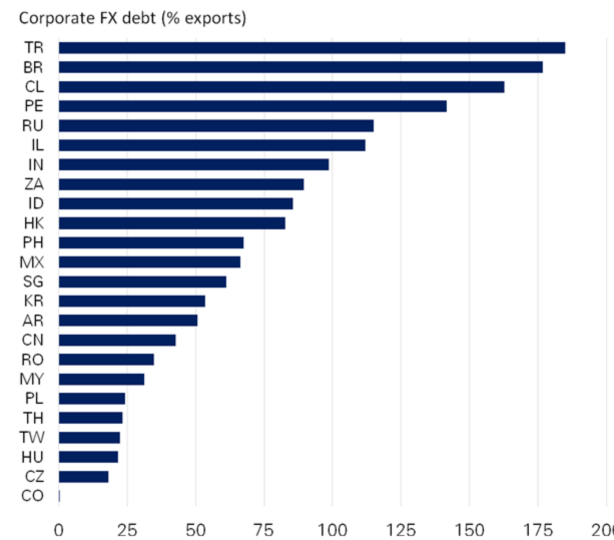
High-leverage and low-ROIC corporates are concentrated in Asia, but funding there is mostly local



Source: Deutsche Bank, Bloomberg Finance LP

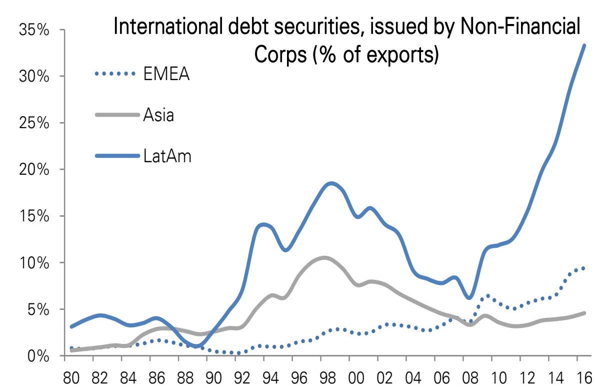
Turkey, Brazil, Chile and Peru have high external corporate leverage to exports, which could become an important funding challenge for these countries, but there are mitigating factors. These countries stand out within EMs as having a ratio of FX corporate debt to exports above 130%, and as high as 180% (Turkey). However, mitigating factors include the presence of intercompany loans to DM parent companies in the ratio's numerator and dollarized local revenue not captured by the ratio's denominator (which considers only exports). If we consider only international bonds outstanding over exports, LatAm stands out with a historical high of close to 35% in 2016, compared to less than 10% for Ceemea and Asia.

High FX corporate debt to exports in Turkey, Brazil, Chile and Peru



Source: Deutsche Bank

LatAm's international bonds to exports keeps increasing



Source: Deutsche Bank

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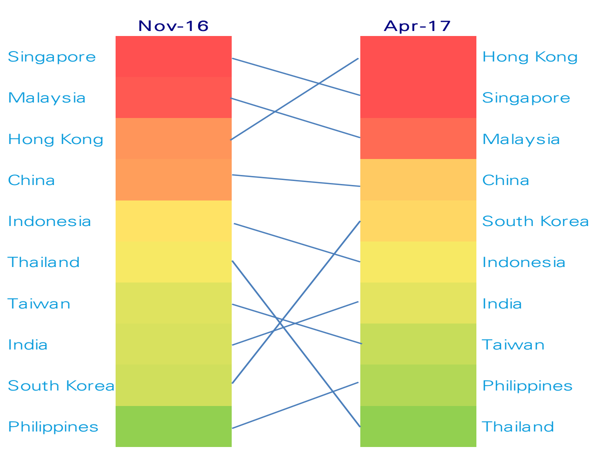
Asia Vulnerability Monitor: Caution over higher rates

EM Asia's vulnerability has decreased with an export-led rebound in growth. Stronger growth and higher inflation, in turn, point to the normalization of rates, hinting at increasing pressure on those EM Asian economies with high leverage and rapid credit growth.

- Stronger growth momentum has been led by the recent rebound in exports, despite weak domestic consumption, as credit growth slowed.
- EM Asia has seen a general slowdown in credit growth, except in China and the Philippines, with particular concerns regarding the former's rapid increase in debt.
- A growth recovery and higher inflation point to the normalization of policy rates, posing risks to highly leveraged economies. Hong Kong and Singapore remain the most exposed, followed by China, Korea and Malaysia.
- Property prices in Hong Kong and India have risen the most since 2009 in the region, despite their increases in household debt lagging behind those in China, Korea and Malaysia.
- From a historical valuation perspective, while ASEAN equity markets look stretched, there seems to be further headroom for NE Asian markets, especially against the backdrop of a tech-driven export rebound.
- Hong Kong and China have the most overvalued currencies in the region, while the Malaysian ringgit is the most undervalued.

From highest to lowest risk scores



Source: Deutsche Bank

Hong Kong has moved to the top of our risk ranking, as its property price inflation headed higher owing, in part, to a rebound in credit growth. As a highly open economy, Hong Kong is susceptible to adverse external shocks, while a sharp rise in rates poses risks to its highly leveraged private sector. Singapore shares Hong Kong's vulnerabilities, but it looks safer in terms of its currency and asset market valuations.

Malaysia's vulnerability has eased, thanks to stronger growth. However, it still ranks third, largely due to its high household debt, undervalued currency, and low reserves coverage. Although we think the BNM would likely be patient with rate hikes, an unexpected surge in core inflation or strong pressures on the ringgit to weaken might force its hand.

China has enjoyed an improvement in its risk score; thanks largely to stronger growth, supported by a rebound in exports and rapid credit growth. With China's relatively high debt posing risks to its long-term growth and financial stability, the authorities is trying to rein in credit growth.

Despite political and geopolitical headwinds, South Korea's economic risks have eased. A surge in exports points to further improvement in external fundamentals, while the won looks slightly overvalued. A highly leveraged household sector remains a serious challenge to the BoK's monetary policy.

Indonesia's fundamentals have improved with a rebound in commodities and overall exports, resulting in improved external metrics. Stronger growth and rising inflation point to BI rate hikes, starting in Q4. But, higher rates should not threaten its economic recovery, in our view, given Indonesia's relatively low leverage.

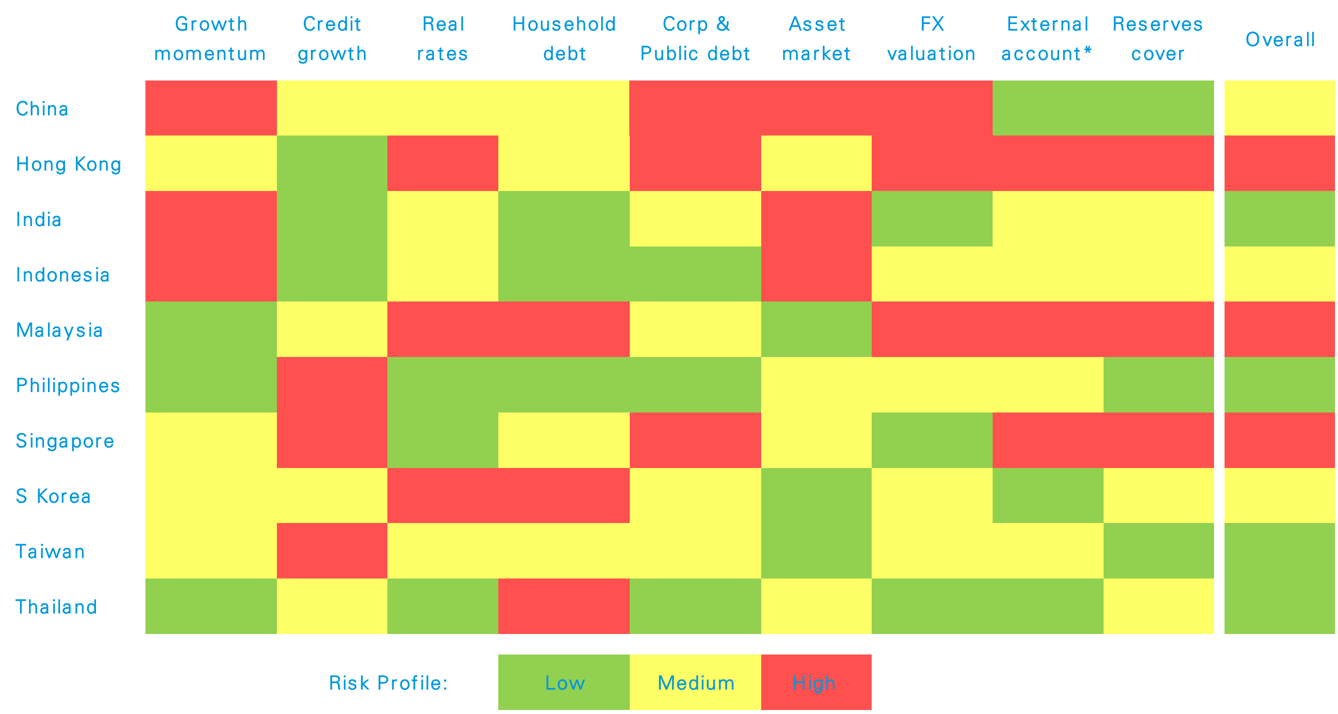
India's growth momentum has not been disrupted significantly by demonetization; albeit with continued negative output gap. While the ongoing structural reforms bode well for its long-term growth, India's equity market valuation appears to be stretched, with balance of risks to our steady policy rates view tilted to the upside.

Taiwan is benefiting from a strong rebound in tech demand, supporting its tech-heavy stock market and guiding the TW dollar closer to its fair value. Inflation remains volatile, but contained below 2%.

The Philippines is likely to deliver rate hikes in 2H, given the recent jump in inflation, alongside robust economic growth and rapid credit expansion. But, higher rates do not pose a threat to the economy's positive prospects, given its low leverage.

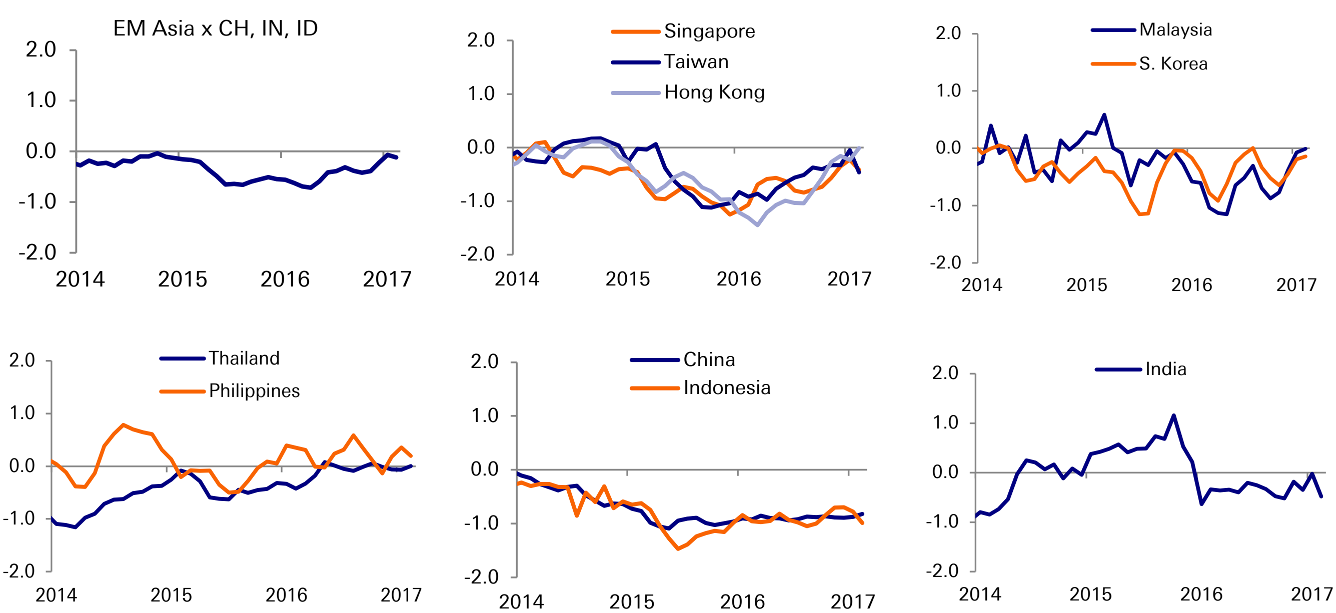
Thailand is the least vulnerable in our overall risk ranking. Growth momentum remains stable, while inflation is hovering around the lower end of the BoT's target range. Given the limited pressure on rates, risks to highly leveraged households look contained.

A heat-map of vulnerability



Note: A heat map provides a useful snapshot of various risks. The assessment is done on a relative basis, both with respect to an economy's own history and its Asian peers. Indicators span growth (output gap and z-score of high frequency indicators), credit, external sector (FX valuation, external funding needs, reserves cover), interest rates, debt (household, corporate, and public), and asset markets (property and equity). Arrows pertain to a change in score and not necessarily a change in risk category (or color).
**External account refers to a country's ranking in terms of Reserves against Gross External Funding Needs.*
Source: CEIC, Haver Analytics, Bloomberg Finance LP, Deutsche Bank

Growth momentum continued to trend higher, for most economies in EM Asia



Source: CEIC and Deutsche Bank.

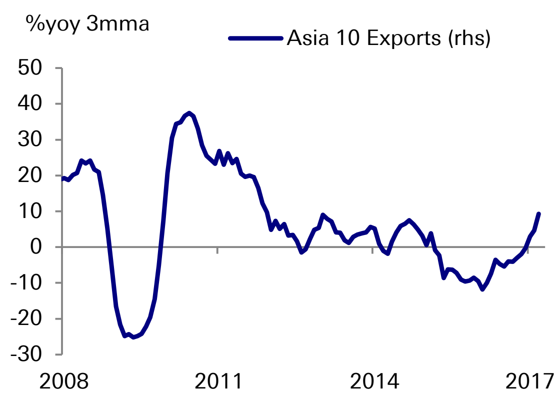
For technical details, please refer to Appendix of [Asia Vulnerability Monitor published on 26 April 2017](#).

Details

Growth momentum

EM Asia has enjoyed a rise in exports, supporting stronger growth momentum, despite weak private consumption and credit growth. Indeed, our model suggests that we should see Asia ex-China export growth to US, EU and Chinese GDP growth return to nearly its pre-crisis average of 1.6x, at around 5% this year and 6% next year, assuming no major disruptive trade policies. (See our April Asia Economic Monthly for details.) We expect EM Asia's negative output gap to close by year-end.

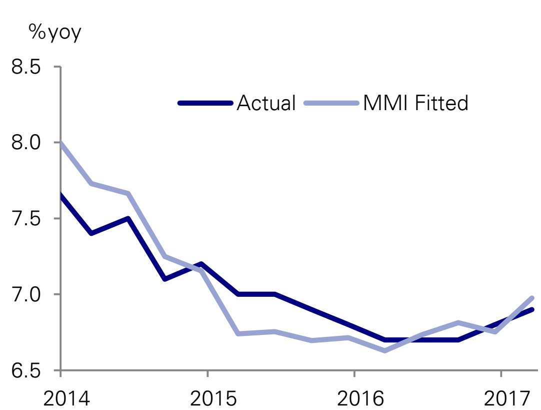
Exports rebound



Source: CEIC and Deutsche Bank

Hong Kong, Malaysia, Singapore, South Korea, and Taiwan have reported significant improvements in growth momentum from their troughs, with more notable support from exports in recent months. Both South Korea and Taiwan impressed the market, reporting a stronger-than-expected GDP growth of 2.7%yoy and 2.6%, respectively.

China GDP growth rebounds



Source: CEIC, Deutsche Bank

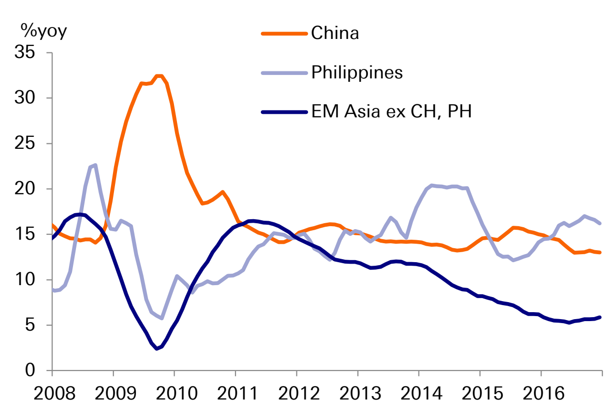
Although far less pronounced, both China and Indonesia also saw their growth momentum trend higher after hitting troughs in mid-2015. Although strong credit growth supported the rebound in growth for China in Q1, to 6.9%yoy, its relatively high indebtedness remains a source of serious concern. Meanwhile, the demonetization exercise in November did not materially disrupt India's growth momentum, despite fears to the contrary. As for the Philippines, growth momentum eased only slightly from elevated levels, while Thailand's has moved sideways since mid-2016, after recovering from its trough in mid-2015.

Credit cycle

EM Asia's credit growth has eased to single digits, despite low interest rates, in part due to macro-prudential measures adopted by various governments to stem further increases in their respective economy's indebtedness.

China and the Philippines stand out as exceptions on this front. Despite having eased slightly by its own historical standards, we think China's still-buoyant credit expansion, in the context of already high leverage, requires tighter financial oversight. An unexpected spike in inflation would complicate the PBoC's monetary policy as higher rates would threaten the property market, which has enjoyed a significant boost of late, and in turn pose risks to China's growth and financial stability. In contrast, despite its robust credit growth, we do not see higher rates posing a threat to the Philippine economy given relatively low debt. Nonetheless, we think such rapid credit growth requires stronger financial oversight, to minimize the potential buildup of risks. Against this backdrop of strong credit growth, rising inflation and robust economic growth point to BSP rate hikes ahead. We see the BSP hiking rates twice in the latter half of 2017.

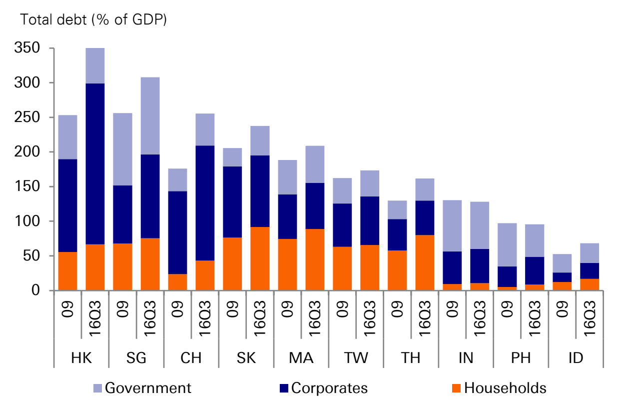
Relative strength of credit growth in CH and PH



Source: CEIC and Deutsche Bank

Although India and Indonesia could afford to see their credit growth rebound, especially given their relatively low indebtedness, this could fuel further rises in their asset markets, which look stretched.

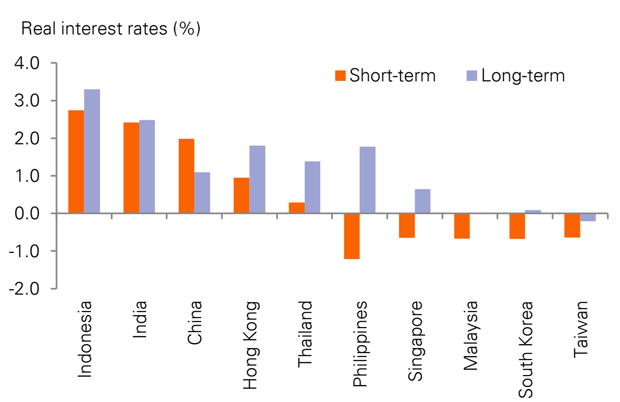
EM Asia more leveraged than before



Source: BIS, CEIC, Haver Analytics, and Deutsche Bank

Despite Hong Kong's relatively low credit-to-nominal-growth ratio (0.6 in Q4 2016), we remain wary of its high indebtedness. Having said that, we note that Hong Kong's indebtedness does not look any worse than China's if we discount non-resident loans. Indeed, this adjustment would bring down Hong Kong's own debt to around 270% of GDP in Q3 2016, from 370%. While similar data are not available for Singapore, we believe it would also enjoy a meaningful adjustment to its own indebtedness. Aside from Hong Kong and Singapore, China, Korea and Malaysia stand out as the most exposed to higher rates.

Real rates negative or too low vs. growth

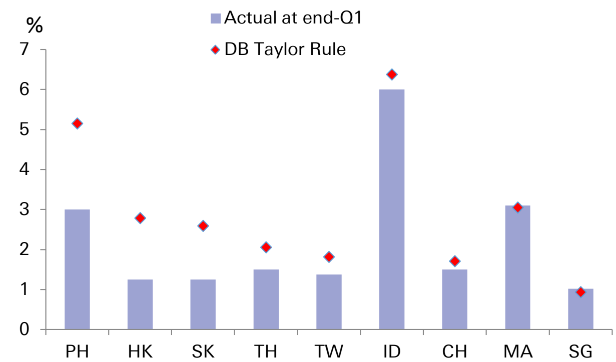


Note: Short-term real rates are computed as the difference between 3-month T-bill rates and corresponding year's (2017) average inflation forecast. Long-term real rates are the difference between 10-year bond yields and corresponding year's (2017) average inflation forecast.
Sources: CEIC and Deutsche Bank

Real rates

The rebound in EM Asia growth and inflation points to the normalization of policy rates going forward. Real rates in EM Asia look too low when compared to growth. Indeed, our Taylor rule model suggests that EM Asia's policy rates are about 75bps too low, on average, with the largest gap between the actual and model-generated policy rates observed in the Philippines.

Actual vs. DB Taylor Rule model suggested policy rates



Note: To estimate Taylor Rule model rates, we use $i_t = c + (1+\alpha_\pi)\pi_t + \alpha_y(y_t-y^*) + \alpha_\varepsilon\varepsilon + \alpha_i i^*$, where π_t is the inflation rate; ε, the rate of FX depreciation; and i^*, the Federal Funds rate. We estimate the underlying level of output, y^*, with a Hodrick-Prescott filter.
Sources: CEIC and Deutsche Bank

Based on this model, the Philippines is ripe for a rate hike given the pace of growth and consumer price increases. Our model suggests that South Korea's policy rate could be sharply higher. However, given its highly leveraged private sector (households in particular), we expect the BoK to err on the side of caution in monetary tightening, tolerating higher inflation, if need be.

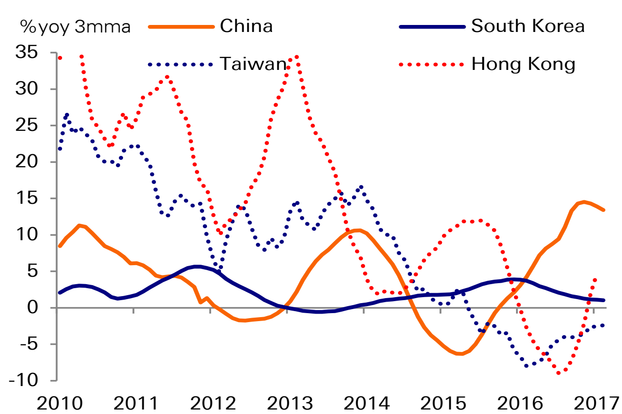
In contrast, our model suggests that policy rates in China and Malaysia are at appropriate levels. This is positive for these economies, which have a high degree of vulnerability to rising rates. We are cautious on Malaysia, however, with real rates already in the negative territory. If core inflation, which has thus far remained subdued, does surprise to the upside, then we could see Bank Negara hike rates earlier than we expect, i.e. before 2018.

We expect a limited impact from rate hikes on Indonesia given its relatively low leverage and already weak credit growth. Although India's credit growth is also weak, its leverage is higher than Indonesia's and has relatively high debt servicing costs (the highest after China, and followed by Malaysia and South Korea). See our Asian Banks report, China Debt: Testing the "Impossible Trinity," dated 7 April 2017. Moreover, India has observed a relatively sharp rise in its property prices, when compared to its peers.

Property markets

In general, EM Asia residential property price inflation has eased, helped by property cooling measures imposed over the years. Although accelerating sharply over the past year, after netting out inflation, China's residential property prices have risen only by about 10% since 2009. Meanwhile, South Korea and Indonesia saw little, if any, change in their residential property prices, in real terms, during the same period. Hong Kong and India reported the strongest rise in residential property prices in EM Asia since 2009, albeit the pace of increase has also trended lower. In real terms, Hong Kong's residential property prices more than doubled, while India's increased by 86%. Taiwan and Malaysia followed, with 66% and 59% rises in real residential property prices, respectively.

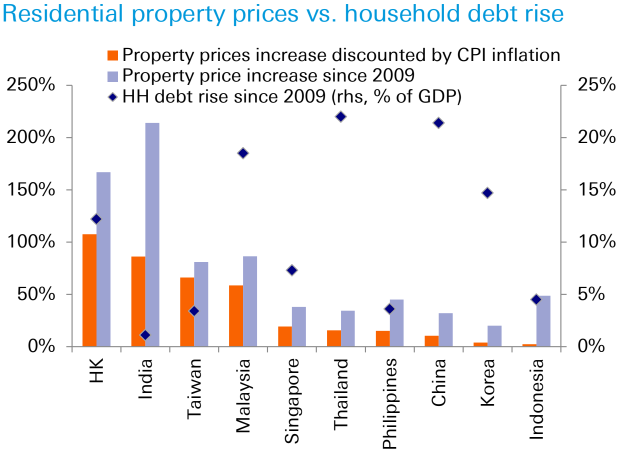
China's nominal property price inflation stands out now



Source: BIS, CEIC, Haver Analytics, and Deutsche Bank

Since 2009, Hong Kong has not reported the largest increase in household debt. Instead, China, Malaysia and Thailand have witnessed the largest build-up in household debt during the same period, up by about 20% of GDP.

Residential property prices vs. household debt rise

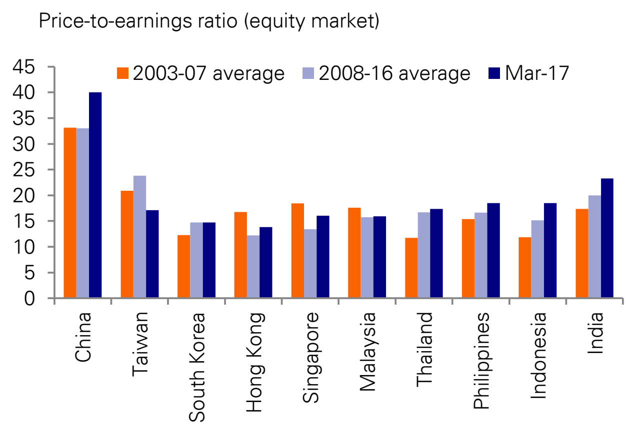


Note: India's data as of 2016Q3
Source: BIS, CEIC, Haver Analytics, and Deutsche Bank.

Equity markets

From a historical valuation perspective, ASEAN equity markets look stretched, while there seems to be further headroom for NE Asian markets against the backdrop of a tech-driven export rebound. The divergence in their performances may be further amplified by higher US interest rates, assuming trade policy and geopolitical risks remain contained. See our [Asia Equity Strategy report, dated 13 March 2017](), for further details.

Still headroom for some

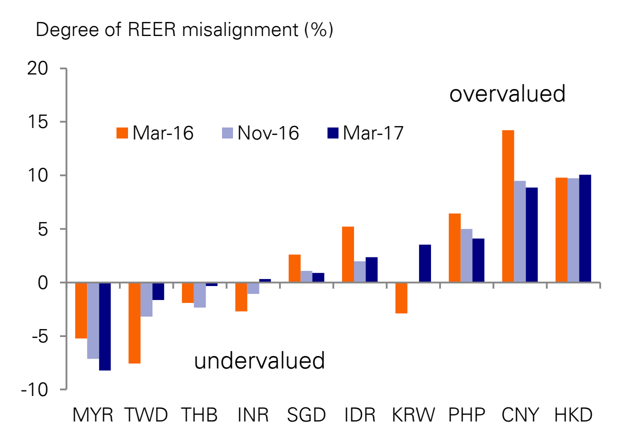


Note: Data as of Feb 2017 for Indonesia, Malaysia, Philippines, and Taiwan.
Source: CEIC and Deutsche Bank

FX valuation

The current levels of the RMB and HKD point to 9% and 10% overvaluation in inflation-adjusted trade-weighted terms. In contrast, the Malaysian ringgit looks undervalued, by about 8%. Despite its relatively low vulnerability, the peso is the Philippines' weak link, given its valuations (5% too strong) and emerging twin deficits.

CNY and HKD remain in over-valued territory



Note: Please refer to appendix for technical explanation
Source: CEIC, Haver Analytics, and Deutsche Bank

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GCC: Incomplete transformation

- With oil testing new YTD lows, hydrocarbon economies are back in focus. Large non-oil deficits, lack of diversification, and appreciating real effective exchange rates are some of the concerns raised by investors. Last time the oil price fell to sub-USD30 towards end-2015, GCC countries drew on buffers built up in recent years, with the decline of USD239 billion in SAMA assets from the peak-to-trough (Sep-15 to Mar-17) particularly in spotlight.
- Since then GCC countries have taken steps to put their economies on a stable footing: reducing subsidies (Bahrain, Oman, Qatar, Saudi Arabia), controlling spending (Bahrain, Oman, Qatar, Saudi Arabia), and implementing measures to increase non-oil revenues (Oman, Saudi Arabia; all GCC introduce VAT in 2018). But more needs to be done and reform fatigue is emerging.
- We see Bahrain, Oman and Saudi Arabia in the weaker category according to our rankings. These countries either have limited oil resources (Bahrain and Oman) or relatively large populations (Saudi Arabia), albeit Saudi Arabia has large, but finite sovereign resources. Fiscal adjustment needs are the highest in these three countries.
- By contrast, the other three GCC states (Kuwait, UAE and Qatar) are in relatively stronger position. Current oil prices are at or near their fiscal breakevens. However, even there, with growing populations and sometimes limited diversification, (particularly Kuwait) economic reforms are important. They also have large sovereign wealth funds which afford them the luxury of reforming at their own pace.
- In the near term, we are less concerned about current account deficits' and capital outflows' potential to imperil dollar pegs, partially due to the ability of the Sovereign Wealth Funds (SWFs) to provide buffers. The exceptions are Bahrain and Oman, but we nevertheless conclude that broader GCC interests will likely protect this peg for the time being.
- During our recent trip to the region, we learned that investors agree there is no imminent threat to the FX pegs as long as oil remains above USD40/barrel. For Saudi Arabia, vulnerabilities from the high fiscal breakeven were seen as somewhat offset by high FX buffers and recent measures as outlined in the Vision 2030 and the National Transformation Program 2020. Most investors voted Oman as the weakest out of GCC and Kuwait the strongest.

Commodity price jitters return

Is this 2015 all over again for the Gulf? Not in our view

With oil testing new YTD lows, hydrocarbon economies are back in focus. Cradle-to-grave social security, high-paying non-productive public sector employment, and lack of diversification are the key concerns raised by investors. Last time the oil price fell to sub-USD30 towards end-2015, GCC countries drew on buffers built up in recent years, with the decline of USD239 billion in SAMA assets from the peak-to-trough (Sep-15 to Mar-17) particularly in spotlight.

Since then, GCC countries have taken steps to put their economies on a stable footing. Fiscal adjustment needs are largest in Bahrain, Oman and Saudi Arabia. Authorities have taken steps to reduce subsidies (Bahrain, Oman, Qatar, Saudi Arabia), control spending (Bahrain, Oman, Qatar, Saudi Arabia), and to increase non-oil revenues (Oman, Saudi Arabia; all GCC introduce VAT in 2018). But more needs to be done and reform fatigue is emerging.

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Countries ranked by most to least exposed

Country	Aggregate Brittleness Ranking
Bahrain	1
Oman	2
Saudi	3
Qatar	4
Kuwait	5
UAE	6

Source: Deutsche Bank

Who is particularly exposed?

Bahrain and Oman are the weak links, while Kuwait and UAE have the strongest positions

We rank hydrocarbon economies on a scale based on the following four factors: current fiscal breakeven levels, potential to improve fiscal position in the future, economic sensitivity to oil price changes and existing buffers to look the economy through the painful adjustment.

The six countries naturally fall into two broad categories: more brittle economies and the hydrocarbon-rich economies on the way to diversification. In the weaker category are Bahrain, Oman and Saudi Arabia. These countries either have limited oil resources (Bahrain and Oman) or relatively large populations (Saudi Arabia), albeit Saudi Arabia has large, but finite sovereign resources.

By contrast, the other three GCC states (Kuwait, UAE and Qatar) are already at or near oil price fiscal breakeven. However, even there, with growing populations and sometimes limited diversification, (particularly Kuwait) economic reforms are important. They also have large sovereign wealth funds which afford them the luxury of reforming at their own pace.

Brittleness rankings

In general, our measure of brittleness has a high correlation with the sovereign credit ratings provided by the rating agencies. Bahrain and Oman have high Fiscal Breakevens (FBEs), with limited ability to lower these breakevens. In the case of Bahrain they have negligible SWF assets to act as a buffer, and rising hydrocarbon prices are unlikely to significantly change that (although falling ones will not significantly worsen that). The result is that Bahrain is highly dependent on external support both economically and financially.

Oman is in a slightly better position with some cushion of finite SWFs, enabling them to absorb short term short falls. However, Oman's recent lack of progress may move it somewhat closer towards Bahrain in credit ratings. Also, Oman has a high level of hydrocarbon sensitivity, with 75% of revenue coming from hydrocarbons. Consequently, while there is currently space for reforms, a sharp deterioration in oil prices would significantly affect that. Oman is due for review by S&P on 12th May; S&P have them on BBB- with negative outlook and there is high risk of going to HY.

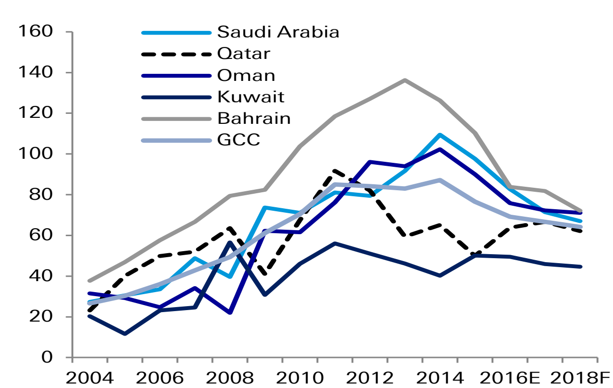
Saudi is of course the bellwether for the region, with a still elevated breakeven despite aggressive measures for revenue diversification. Many of these are expected to bear fruit only in 2018 and beyond, though we assign KSA high potential to reduce its fiscal breakeven. Saudi itself forecasts a balanced budget for 2020, and while we are somewhat more skeptical about this, the imposition of VAT, removal of fuel subsidies and additional expat fees could reduce the budget deficit by SAR270 billion by 2020, compared to the 2016 figure of SAR297 billion (13.6% of GDP). While social protection and some back-sliding are likely to mean a somewhat lower figure, the scope for improvement is significant. Also of note is the fact that while the social reform plan is ambitious, from a fiscal point of view, stability can be achieved with relatively few successes.

For other hydrocarbon intensive economies, the concerns are largely limited to whether they will make policy mistakes which will be costly to the economy. In Qatar, the infrastructure boom is now coming to an end, and that is more likely to have an impact on slowing growth rates than concerns about the fiscal stability of the country. In addition, Qatar has throttled the economy by removing liquidity from the market at the same time as implementing a project review. Relaxation of liquidity through on-shoring SWF assets would seemingly boost growth, but facilitating the soft infrastructure for economic diversification should also be a priority.

Kuwait is similar to Qatar, in that it has ample SWF assets to fund any issues, but in contrast to Qatar it has yet to build the hard infrastructure required for basic diversification. This provides a challenge, in that it has high exposure to potentially falling hydrocarbon prices, but also an opportunity in that the rewards for diversification are readily available. In Kuwait more than 40% of nominal GDP comes from hydrocarbons and nearly 60% of real GDP. Yet evidence for aggressively seizing the opportunity is still scant.

The UAE is perhaps best placed. Not only does it have a low fiscal breakeven, but it also has very high SWF assets to act as a buffer. The scope for reducing the fiscal breakeven significantly is limited by the fact that it is a relatively diversified economy and is already the most efficient in the region. The principle challenges for the UAE are rather maintaining a high level of growth without the luxury of substantial low-hanging fruit.

GCC Fiscal breakevens



Source: CBB/MoF, CBI, CBK, CBN/MoF, CBO/MoF, CIO, FOS/CBN, GASTAT, IMF, MDPS, MoFSA, NCSI, QCB/MoF, IIF, Haver Analytics, Deutsche Bank.

Brittleness rankings and Credit Ratings

Country	Fiscal B/E (FBE)	FBE potential	Hydrocarbon sensitivity	SWF % GDP	Aggregate Brittleness Ranking	Credit Rating		
						M	S	F
Bahrain	High	Low	Low	Neg	1	Ba2	BB-	BB+
Oman	High	Medium	High	Low	2	Baa1	BBB-	BBB
Saudi	Medium	High	Low	Medium	3	A1	A-	A+
Qatar	Low	Medium	Medium	High	4	Aa2	AA	AA
Kuwait	Low	Medium	V High	High	5	Aa2	AA	AA
UAE / AD*	Low	Low	Low	High	6	Aa2*	AA*	AA*

Key: Red = negative outlook
** UAE data at sovereign level but credit rating at Abu Dhabi level*
Source: Deutsche Bank, Moody's, S&P, Fitch

For Key Macroeconomic indicators, please refer to the Apendix section.

Views from GCC investors

We recently visited EM investors in GCC, based in Saudi Arabia, Qatar and Abu Dhabi to get a sense of their views on a range of issues impacting the region - oil prices/fiscal breakeven, progress on fiscal and structural reforms, and likelihood of the FX de-peg. Fed balance sheet adjustment was mentioned as one of the risks in addition to oil.

Most investors believe that there is no imminent threat to the FX pegs in the region – as long as oil remains above USD40/barrel fiscal position can be managed. A few expected Oman's peg to be the first to come under pressure, if at all. All GCC economies are pegged to the dollar, with the exception of Kuwait that is pegged to the basket of currencies. While the weights are not made public, it is most likely that the share of the USD is significant.

For Saudi Arabia, investors are of the view that vulnerabilities from the high fiscal breakeven are somewhat offset by its high FX buffers and recent measures as outlined in the Vision 2030 and the National Transformation Program 2020. Most investors believe that Saudi authorities will resort to FX de-peg as the last option and might consider it only if current fiscal reforms are not found to be productive (to be assessed by the end of 2018).

Although the vulnerability varies from country to country, surprisingly it was Oman, not Bahrain, which was unanimously voted by investors as the most vulnerable. Investors cited weak fiscal prudence, heavy borrowing and macro-economic fundamentals not fully justifying Oman's current rating. In our assessment, Oman ranks as marginally better than Bahrain as Bahrain's SWFs are negligible compared to Oman's USD 31 billion, Bahrain's fiscal deficit and break-even are also higher.

Kuwait was cited as the least vulnerable given its lowest fiscal breakeven and high FX buffers.

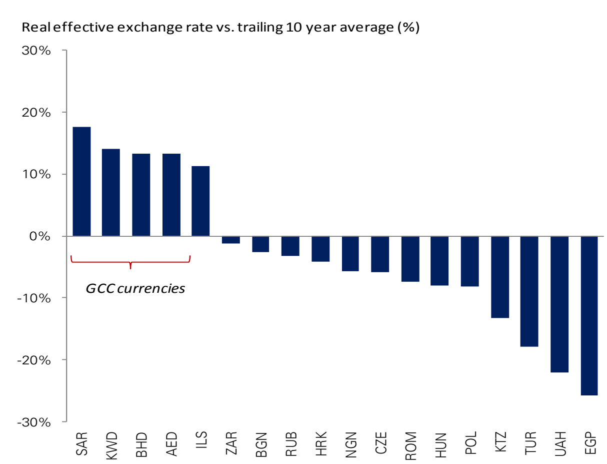
For more colour on the trip, please refer to our report GCC investor pulse.

What can GCC do to reduce its reliance?

Fiscal adjustment needs are particularly significant in Bahrain, Oman and Saudi Arabia

Fiscal adjustment is the key to preserving pegs, in our view. As most exports are commodities and therefore inelastic to exchange rate movements, fiscal policy is more effective in containing imports. As most of the GCC countries are fixed to the dollar, their REER have appreciated in recent years, raising demand for imports. Furthermore, in some countries capital outflows continued even after current accounts turned form surpluses to deficits, making domestic adjustment even more pressing.

REER appreciation in the region



Source: BIS, Deutsche Bank

On the revenue side, most important adjustment is the introduction of a 5% VAT region-wide from 1st January 2018. This is expected to raise revenues by 2.0% (+/- 0.1%) of nominal GDP according to IMF expectations, for every country except Qatar (1.2% due to lower consumption-to-GDP ratio), although not necessarily in the first year. The exact amount will depend on the scope of exemptions as well as on consumer behavior. In addition, excise duties particularly on tobacco and sweet beverages have been talked about in a number of countries, with potential implementation from 2017 in Saudi Arabia and Qatar. Corporate taxes may raise by similar amounts, although evidence from Oman (where corporate taxes were recently raised from 12% to 15%) suggests otherwise. Other taxes such as an income tax for expats or a remittance tax would likely be self-defeating, but Saudi is implementing a staged fee hike for expatriate labour and dependents in the corporate sector. With the exception of the latter we believe most of these will only have an incremental impact.

The focus on fiscal expenses has fallen mostly on cuts in capital spending, where most countries still have further room to cut despite significant adjustments so far, particularly in Saudi Arabia. Small capex, potentially representing merely deferred consumption benefits to public sector employees has been slashed, notably in Qatar. There have also been efforts at wage control, including the cuts to the civil service salaries in Saudi, the Strategic Wage Alternative in Kuwait, and restriction on non-wage remuneration in Qatar, but this has been met with varying degrees of success across the region. Cuts to discretionary areas of remuneration have met some success, but constraints on wages or even wage progression for Nationals have generally met significant push back.

Increasing the relative size of the private sector is another key aim. This removes a central cost item for the fiscal account as fewer nationals are employed by the non-productive public sector. However, as the private sector expands it also creates space for an improved trade/current account balance, as well as creating a taxable activity that feeds back to a stable fiscal account. While it is the key to long term stability, it generally falls into 2030 plans (rather than 2020). In development of non-oil economy, the focus has frequently been to maximise downstream industries such as plastics or petrochemicals. However, in places like Kuwait, infrastructure construction is also a priority. Although there may be some concerns that this represents repackaging old hydrocarbon product in new (PVC) boxes, we believe this is only partially true. Based on a gross margin review of peers, we believe the hydrocarbon element is likely to be less than 50%, depending on the nature of the product and the type of technology, although a more precise analysis is beyond the scope of this document.

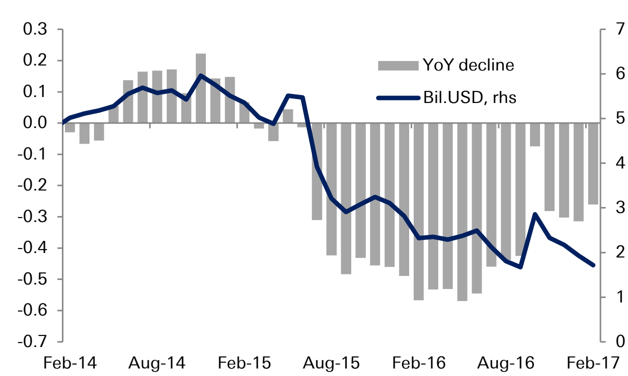
In the short term, there are a number of options for financing deficits, with the countries largely falling into three groupings. In the first group: we have rich hydrocarbon economies with substantial SWFs, over 200% of GDP, (Kuwait, Qatar and UAE – Abu Dhabi). These rich countries have been reluctant to finance deficits out of SWF assets, to drive fiscal reforms and benefit from more favourable market access. This has resulted in Kuwait resorting to only halting PPP financing, and Qatar suffering a funding squeeze, in our opinion. In the second group: there are mid-ranking countries with finite 40-80% of GDP SWFs, that provide some reform flexibility, but for less than 10 years without reforms (Saudi Arabia, 81% of GDP, and Oman 49% of GDP). In the third group: Bahrain's position on a stand-alone basis looks precarious, with few assets beyond the government-owned commercial holdings. Also, Bahrain has been depleting its Central Bank FX reserves in recent months, while it has been arranging other financing.

Bahrain – relying on external support

Most fiscally exposed, lacking SWF savings, falling reserves

With an elevated oil-price breakeven (USD80-100), Bahrain is the most fiscally stressed economy in our universe (2016: 17.7% budget deficit), exacerbated by the lack of a substantial SWF. Its strategic interest to Saudi and recent success in balancing the current account are likely to support stability, but reforms are likely to be toughest to implement here.

Bahrain's central bank FX reserves



Source: CBB, Deutsche Bank

Bahrain's non-hydrocarbon current account deficit peaked at USD9.6 billion in 2013 as solid oil prices and rising production delivered strong hydrocarbon revenues. While oil prices continued to be strong through 2015, rising contribution of net services and rapid non-hydrocarbon exports helped bring down the breakeven oil price. 2015 saw continued strong improvements in non-hydrocarbon drivers, while gas volumes continued to expand. Consequently, despite the collapse in the oil price, the current account remained broadly in balance. Further declines in 2016, combined with stabilisation of other factors pushed the balance firmly into the red, but the expected price recovery to early 2015 levels in 2017 should keep the current account on track.

The fiscal balance is more stressed. This was already substantially in negative territory during the 2012-14 peak oil price period, but drifted further into negative territory with the decline in the oil price. The delayed 2017-18 budget might provide further details on fiscal consolidation, but the scope for real wage reductions are constrained by political frictions. Subsidies and transfers declined 24%, capital spending 31% and even the wage bill 3.1%. The focus is rather on revenue maximization through cutting subsidies and diversification, particularly when funded by GCC infrastructure funds.

On the revenue side, utility price adjustments and subsidy reform has followed the pattern we see elsewhere. A number of fee adjustments have also sought to raise additional non-hydrocarbon revenue. Additionally, the 2018 imposition of VAT will go some way in addressing the 18% 2016 budget deficit. Revenue or capital support from other GCC states in the form of additional contributions from the jointly-owned (with Saudi) Abu Sa'afa field, capital transfers or loans are likely to act as a back stop to market flows, in our opinion.

Major projects include a new 400 kbpd pipeline from Saudi Arabia providing refining feedstock for re-export, modernisation of the refinery, and expansion of the aluminium smelter. In each case, the investment is likely directly linked to increased revenue, with rather high likelihood of financing being assisted by GCC infrastructure funds.

Financing is likely mostly through debt issuance, with somewhat larger share of external financing. In addition, Bahrain has USD5 billion of debt maturing in 2017, making for a busy year of issuance. Bahrain is the only GCC country rated at junk despite the likelihood of Saudi and possible other GCC support, making debt issuance comparatively expensive.

Sovereign assets include Mumtalakat Holding Company (BHD2.4 billion or 20% of 2015 GDP), which invests primarily in domestic industrial assets. Asset disposals are not viable short of a privatisation drive, but the government has already started raising secured financing, including the recent USD1.5 billion for the expansion of Aluminium Bahrain. Central Bank Reserves have dropped to USD1.9 billion (1.4 months of CA receipts) by Jan-2017, with other assets tied up already in fiscal funding. With debt to GDP amounting to a likely 72% as at Dec-16, the flexibility for funding the existing current account and fiscal deficit out of own resources is minimal.

In addition to domestic resources, Bahrain has access to the USD7.5 billion GCC Development Fund, including a recent Kuwait-funded USD1 billion loan to fund a housing program, with similar loans from the Saudi Fund for Development and the Abu Dhabi Fund for Development. Saudi also has flexibility to provide an increased proportion of revenues from the Abu Sa'afa field. In short, on its merits Bahrain seems able to achieve stability in the short term only with Saudi and GCC support, but that support is highly likely to be maintained, even in a somewhat adverse scenario.

Oman – Still vulnerable

A devaluation would seem a policy option, but seems still unlikely

Oman has had success bringing its fiscal breakeven oil-price down to USD70-80range, although this still left it with a 20.6% budget deficit in 2016. Like Bahrain, Oman has limited SWF resources, but some prospects for economic diversification. Real exchange rate devaluation given the large current account deficit would seem to be a policy option, but one unlikely to be pursued in the short term.

Oman, together with Saudi Arabia and Bahrain, has a relatively stressed fiscal position, with a USD79 fiscal breakeven estimated by the IMF and somewhat lower by our estimates. However, oil production at 880 kbpd is currently significantly short of the 990 kbpd level anticipated in the 2016-20 9th 5-year plan. In addition, production from the Khazzan Gas Field should come online in 2018, adding 25% or an annual USD5 billion to total gas production, bringing down breakeven prices. However, with only 15 years of reserves for both oil and natural gas, in the absence of significant discoveries, Oman is at risk of production shortfalls jeopardising long term financial stability and is dependent therefore on sharply reducing hydrocarbon dependency.

Going forward a strong program of diversification is required, with the government notably aiming to bring oil dependency down from 44% of GDP to 26% by 2021. The focus for this diversification is to expand the manufacturing (from 10 to 15% of GDP), transport & logistics (5% real annual growth) and natural tourism sectors.

In terms of specific projects, the opening of the USD6.5 billion Liwa Plastic Industries Complex in 2020 (ground broken 16Q4) is expected to add 13,000 jobs and 2-3% to GDP, equivalent to half the total manufacturing sector increment. In transport & logistics, the opening of Duqm Special Economic Zone as a target for East African re-distribution services aims to double employment and GDP contribution to OMR 3 billion. While the non-hydrocarbon economy has been already growing more quickly than the hydrocarbon sector, first overtaking it in 2006 (based on 2000 prices), significant acceleration is required particularly if efforts to maintain/extend the hydrocarbon production horizon disappoint.

On the fiscal side, Oman embarked on a program of fiscal reform in 2014, including a public sector hiring and remuneration freeze with suspension of bonuses, but has so far realised limited progress on revenue. Subsidy reform is driving electricity tariff hikes for large consumers, but only from 2017. Oman is the only GCC country with significant corporate tax, and removal of exemptions and raising of the rate, from 12% to 15% will make a positive development, although this may raise revenue of only USD100 million (0.15% of GDP). By contrast, the implementation of VAT in 2018 is expected to raise perhaps 2% of GDP, both according to the IMF and our own simple cross-country analysis.

In terms of resources, Oman has been able to draw on its USD25 billion (2015) State General Reserve Fund, and its USD6 billion Oman Investment Fund, making total SWF assets equivalent to 47% of GDP. Drawings totalled some USD4 billion in 2016, leaving resources equivalent to 5 years of funding at the 2017 level. However, Oman also successfully returned to the bond market in 2016, most recently issuing a USD5 billion international bond in March 2017, largely financing the international portion of its USD7.8bn budgeted needs for the year.

Saudi Arabia – large buffers buy time

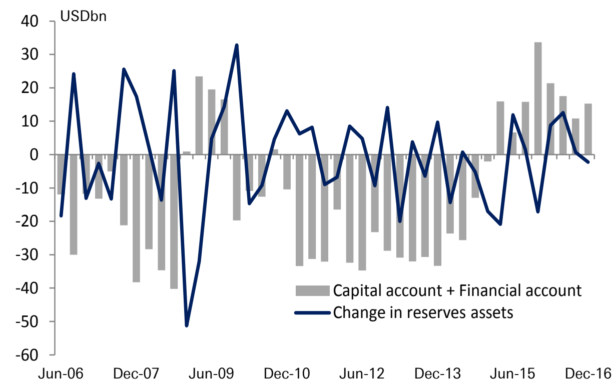
Large FX buffers buy time despite high fiscal breakeven

KSA also has a high fiscal breakeven, expected to reach USD84 in 2017 according to the IMF and somewhat lower according to our estimates at USD72. As such fiscal reform is a priority, but over USD500 billion of SAMA reserves and the potential for part-sale of oil assets give flexibility of timing. However, arguably, the size and conservative nature of the Kingdom makes early reform a necessity.

Saudi Arabia's approach to breaking its hydrocarbon habit has been to undertake something akin to a revolution in the country, as outlined in the Vision 2030 document and the shorter-term National Transformation Program 2020. The challenges are significant, given the elevated fiscal breakevens, delivering 11% budget deficit in 2017. Ambitions for achieving a balanced budget by 2020 ("Fiscal Balance Program 2020"), suggests the bulk of the social and economic overhaul should be front-loaded.

The National Project Management Office (NPMO), announced in September 2015 and tasked with moving projects forward in a coordinated fashion, has stalled. Furthermore, headline projects such as the Makkah Metro or the North-South rail line have been pushed out. Of the USD1 trillion pipeline, the only actual new project awards have been limited to Aramco investments. Until the NPMO is fully in place, any major project awards will be exceptions.

Saudi reserves vs. capital account



Source: Haver Analytics, Deutsche Bank

By contrast the establishment of the Bureau of Capital and Operational Spending Rationalization – an entity aimed at reviewing the feasibility of projects less than 25 per cent complete has moved forward with a review of some of the SAR1.4 trillion of projects in development. On the first round, approximately SAR100 billion of costs have been cut. Some projects will be cancelled, others retendered or converted to self-financing PPP-style contracts, but the certainty is that these cannot continue to be financed substantially from the public purse. There has also been additional controls on current spending with cuts in civil service allowances. The switch from an Islamic contract year to a slightly longer Gregorian one amounts to a 3% pay cut.

Fuel and electricity price increases raised an additional SAR30 billion of revenue in 2016, with further price adjustments rising to SAR59 billion in 2017, SAR107 billion in 2018 and SAR142 billion in 2019. Other fees may raise a further SAR42 billion, rising to SAR152 billion in 2020. A new excise tax on soft drinks (50%) and tobacco (100%) is expected to raise SAR10 billion of revenue. However, given these are strongly regressive taxes, poor households are being compensated with an allowance of SAR60-70 billion.

On the current account side, there is significantly less pressure, with a current account breakeven of just USD53 (IMF). In principle this means that the external funding of the budget is more than enough to finance the current account, which is expected to be a manageable USD26 billion in 2017. However, a key uncertainty is the huge BOP losses to net errors and omissions (NE&O), which we attribute to informal remittances for the large part, although payments related to foreign policy objectives may be a possibility. NE&O have peaked in periods of financial stress like 2008-12 and 2016 at annual outflows of USD40-50 billion.

While the plans are there for addressing hydrocarbon dependency, the reality is that these are stretch goals, with a balanced budget by 2020 highly improbable under reasonable oil price assumptions. We expect that Saudi faces a number of economic challenges in realising their diversification and revenue raising targets, social challenges in driving the conservative population towards a modern labour force, and political challenges with the next transition of power. These have been underlined by the reversal of some civil service pay cuts.

For the moment, financing the twin deficits is well within reach. Debt levels remain low, amounting to just 8.9% as at end 2016 according to budgetary estimates. SAMA reserves amounted to some 84% of GDP at the same point. Sovereign assets also exclude commercial entities, the most salient of which is Aramco, where the placing of a 5% stake is aimed at raising USD100 billion (15% of GDP), although if the stock trades at multiples closer to Russian (rather than international) oil companies', a figure as low half of that is more likely. Either way, the presence of a cushion cannot justify delays to reforms, but reform is likely to balance erosion of the nest egg against social and political constraints. Reform is necessary, and inevitable with the current pricing outlook, but that doesn't mean it will be easy.

Recent data has been very positive, with the government announcing that the 1Q17 budget deficit was half of the targeted SAR50billion. This was put down to SAR17 billion of accelerated cost cuts, and 4-5 billion of additional non-oil revenue. Extrapolating this would provide strong evidence for a balanced 2020 budget, but for the moment we believe this would be unreasonably positive: expenditure is highly seasonal in GCC countries that disclose this, like Kuwait, and has significant large items where the timing of procurement is discretionary, such as military expenditure. Consequently, a strong quarterly result may only have limited applicability for the full year.

Qatar – fiscal restraint continues

Less exposed due to fiscal adjustment and substantial SWF

Typically the smaller states report budget balances which exclude investment income from their SWF, but IMF estimates a lower fiscal breakeven of USD53 (our estimate at USD67) for Qatar in 2017, enabling a small surplus. Sharp deficits in 2015-16 made the spending review in 2014-15 look pre-emptive, but having born the pain, Qatar is in a position to smooth the cycle. Growth expectations post-infrastructure spending are, however, weak.

Fiscal adjustment has been a focus since Sheikh Tamim took over the national leadership from his father in 2013. Even after two years of restraint, spending in 2016 is expected to be 20% lower due particularly to the consolidation of ministries, public sector wage freezes, constraints on small capital spending, and a headcount reduction for expatriate workers. On the revenue side, cuts to subsidies for fuel and utilities have also served to raise revenues as prices have moved closer to opportunity cost. Capital spending has also been under the spotlight with QAR350 billion of projects under review.

Despite the production cuts agreed with OPEC, these combined are likely to move the budget deficit back into surplus in 2017. Nationally reported budget deficit (which excludes QIA financial gains amounting to 5% of GDP) are still likely in the red, but this does not create an unstable situation.

Does this relatively benign situation mean current oil prices will impose minimal stress on the Qatari economy? Qatar has been reluctant to dip into QIA's estimated assets of USD335 billion despite the apparent head-room, instead issuing USD9 billion of debt in May-16 following on from a USD5.5 billion loan syndication in 2015. In addition, in terms of raising liquidity, the top 5 banks have issued QAR87 billion (USD24 billion) of debt.

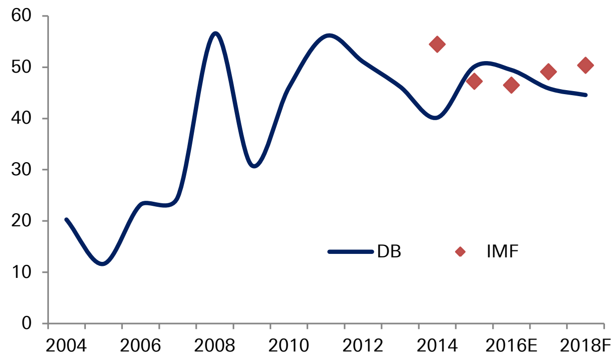
With access to market and a substantial SWF, why is Qatar facing tight liquidity and stalling growth? We believe tight liquidity is partially a voluntary factor, aimed at imposing fiscal discipline on the country and to be used as a stick for driving change and diversification. Qatar has been through two spending cycles already, the first a hydrocarbon build and the second an infrastructure build focused culminating around the 2022 World Cup. The challenge for Qatar is to demonstrate that the latter investment has economic as well as social value.

Kuwait – least exposed

Lowest breakevens, but long term rebalancing is necessary

Kuwait is perhaps the most comfortable of the GCC states, with a fiscal breakeven of about USD46-49, budget and the current account are in surplus, and substantial SWF provides an additional buffer. Nevertheless with costs growing, Kuwait is determined to continue savings for its Future Generations Fund, particularly given its high oil dependency, necessitating a course correction.

Kuwait's fiscal breakeven oil price below USD50/barrel



Source: IMF, Deutsche Bank

Despite its oil price fiscal breakeven rising steadily over the last decade, Kuwait remains one of the best placed oil exporters to withstand a drop in oil prices. The fiscal breakeven price of USD49 in 2017 remains the lowest in the GCC, while the current account breakeven (also USD43) is also better than average. In addition, KIA assets of USD550 billion (SWF Institute) ensure that there is sufficient capability to fund any deficit in the long term.

Fuel price increases from Sept-16, utility price increases except for Nationals' primary residences likely from August 2017 are targeted to raise KWD960 million. Restraints on central government spending and services may net KWD1.5 billion over 2 years but getting such resolutions passed by parliament has proven challenging in the past.

While Kuwait is sitting relatively comfortably from a solvency point of view, there are nevertheless areas of concern. Fiscal expenditure is on a rising trend, as the young growing population matures, but unlike elsewhere, the government has faced popular and parliamentary constraints in being able to address the issue. Kuwait is the least diversified country in the region, and employment is heavily focused on the public sector or public sector entities. Indeed, Kuwait is alone in the region to not even being able to address its basic infrastructure needs. While 2017 is likely to see both deficits turn back into surpluses, no immediate challenge is on the horizon, but longer term the rebalancing of the economy is still a necessity.

In addition, while total SWF assets remain ample, Kuwait conservatively separates its sovereign assets into two sub-funds, a Future Generations Fund (FGF) and a General Reserve Fund (GRF). The former by law accumulated 10% of all government revenues including investment income from the GRF. Meanwhile the General Reserve Fund is allocated to addressing any budget shortfall, including that allocated to funding the FGF. Spending also typically undershoots forecasts, but has come closer to budgeted levels in 2015/16.

There are two issues here, which provide behavioural constraints: (1) the shrinking General Reserve Fund, perhaps down to USD120 billion representing less than 5 years of 2016-sized deficits, (2) the domestically published deficit numbers, which exclude investment income, but is after charging the 10% transfer to the Future Generations Fund. The division is artificial, but it would take a significant political effort with long term implications for policy credibility to alter this division.

To ease pressure on the general reserve fund, Kuwait aims to issue local bonds on top of the recent USD8 billion debut international bond in March 2017.

UAE – pre-emptive reforms

Progress in diversification, fiscal and current account surplus

For the smaller GCC states with large hydrocarbon endowments, substantial SWF's and small National populations, the urgency of reform is not really there. In addition, the UAE has done a good job of diversification, ensuring that reforms are pre-emptive rather than necessary.

The UAE has also been addressing its fiscal stability, with a similar mix of revenue raising and cost cutting. After spending cuts amounting to 18.1% in 2015 and a further 10.3% in 2016, the direction of fiscal expenditure is expected to reverse in 2017. However, fiscal rationalisation remains the order of the day, with Abu Dhabi's Department of Finance working on a medium-term budgeting framework, aimed at giving increasing control over public sector and GRE entities. Further savings came from addressing the low-hanging fruit of military equipment spending and international aid, both of which also directly help the current account, without having a meaningful impact on the domestic economy.

On the revenue side, the UAE has been one of the most pre-emptive, fully liberalising the fuel price in July-2015. Similarly to its peers, the UAE is likely to implement a soft drinks and tobacco tax in 2018, with the latter expected to raise an incremental AED2 billion (USD550 million), while more impressively a 5% VAT will also be applicable from 2018 that could add up to USD8 billion to government revenues once fully implemented.

While corrective actions have already taken place aimed at addressing the relatively small fiscal deficit (which peaked at 3.9% of GDP), the current account is already in surplus, spending is on a rising trend, liquidity it broadly stable and total reserve assets well over USD600 billion make the economy shock proof. Meanwhile, with 77% of the economy coming from established non-hydrocarbon sectors, particularly in Dubai, the economy is notably defensive from declining prices.

As an economy diversified out of the hydrocarbon industry the main concern is anything affecting the three main non-hydrocarbon streams: finance, property and tourism. All three took a significant hit in 2008, and a recovery of alternative tourism markets, a reduction in the viability of secondary financial centres or reduced demand for new property perhaps due to changing immigration or shifting geopolitical stresses are likely alternative concerns.

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APPENDIX – Key Macroeconomic Indicators

Key macroeconomic indicators

	Period	Bahrain	Oman	Saudi Arabia	Kuwait	Qatar	UAE
Population (mn)	2015	1.3	3.8	31.0	4.1	2.4	9.6
Nominal GDP (USDbn)	2016	31.9	63.2	639.6	109.9	156.7	371.4
GDP per capita (USD)		24658	16451	20622	26730	64739	38759
Current account balance (USDbn)	2016	-1.5	-9.8	-24.9	3.0	-3.5	8.8
	2017	-1.2	-8.8	-25.5	10.4	1.2	14.4
Gross official reserves (USDbn)	2016	2.4	20.3	533.6	31.9	33.5	83.1
Fiscal balance (% GDP)	2016	-17.7	-20.6	-12.4	-3.6	-4.1	-3.9
	2017	-12.2	-10.1	-10.7	3.5	-3.1	-2.6
SWF assets (USDbn) [1]		-	31	516	592	335	792
SWF assets % GDP		-	49%	81%	539%	214%	213%
Share of hydrocarbon in real GDP (%)	2016E	19.4	42.0	44.0	58.7	49.5	31.2
Share of hydrocarbon in nominal GDP (%)	2016E	10.9	30.1	24.5	40.8	30.3	19.9
Share of hydrocarbon in fiscal revenue(%)	2016E	63.2	75.5	62.3	67.6	49.5	46.8
Share of hydrocarbon in exports (%)	2016E	47.6	54.9	74.7	89.0	102.1	17.0
Fiscal capital expenditure % GDP	2016	3.8	16.9	9.6	8.1	14.3	2.6
	2017	-	-	8.8	7.8	14.4	2.7
Fiscal current expenditure % GDP	2016	26.6	34.1	26.1	45.6	20.0	27.3
	2017	-	-	24.0	43.1	17.9	25.6
Hydrocarbon fiscal sensitivity*		2.9	5.5	3.3	7.3	4.2	2.7
DB estimates of fiscal breakeven oil price	2017	81.8	72.3	71.5	45.9	66.7	62.1
IMF fiscal breakeven oil prices	2017	101.1	79.2	83.8	49.1	52.9	67.0
Fitch Fiscal breakeven oil price	2017	84.0	75.0	-	46.0	-	-

** 2015 data for Bahrain and Oman*
*** the percentage point deterioration of the fiscal account for a USD10 movement in prices*
For UAE, data is for Abu Dhabi Investment Authority (ADIA)
2017 forecasts for CAB, fiscal balance, fiscal expenditure from IMF. 2016 estimates of share of hydrocarbon sector is DB calculations.
Source: National sources, IMF, Fitch Ratings, SWFI, Deutsche Bank

The Unkind Unwind: What happens when the Fed stops reinvesting

- The normalization of the Fed balance sheet is very likely to get more airtime in Fed speeches and the Fed minutes later this month. We believe the Fed's upcoming retreat from reinvestment is a theme markets can no longer ignore.
- Flows to emerging markets since GFC – and to Asia in particular – have had a striking relationship with the Fed balance sheet. As a rough rule of thumb, every $100 increase in Fed QE has driven $15 into Asian equity and debt, with more than $500bn in cumulative flows to the region. This tight relationship is best thought of within the portfolio balancing construct, with changes in US term premia having been correlated to regional inflows and FX performance. As a corollary, a reduction in the size of the Fed balance sheet could see a reversal of part of these flows.
- The scenario of a complete halt to Fed reinvestment in January 2018, for example, would be consistent with $60bn in outflows from Asia over the following 18 months, given $420bn in maturing Treasuries. If this continues till 2020, the Fed balance sheet would have shrunk by about $1tn, which could mean $150bn of outflows from Asia, or over a quarter of cumulative inflows since 2009.
- There are offsetting factors to consider of course, namely the pull forces for money going into Asia, ranging from stronger growth to diversification demand. Our model shows that while a 100bp rise in US 10Y yields could lead to $28bn in outflows from Asia over six months, this pressure can be counteracted by stronger regional growth. Every 1 point that average Asian manufacturing PMIs are above 50 is associated with $17bn of inflows. There is also a natural bid for Asian assets – call it, diversification demand - of close to $40bn a year.
- Policy normalization is inevitable. But the Fed balance sheet unwind need not be all bad news for flows into Asia. In a modified model, we find that a path of faster rate hikes is more damaging to Asian flows, compared with if the sell-off in US rates is felt across both the front-end and term premium. To the extent that the Fed balance sheet unwind slows the pace of rate hikes, this could be a better relative scenario for Asian flows.
- ECB and BoJ balance sheet policies have had a weaker relationship to Asian portfolio flows, but a stronger direct relationship to Asian external bond issuance, which has continued to reach new heights. With balance sheets in Europe and Japan slated to grow at a slower rate, the pace of Asian offshore debt issuance might have peaked.

A world of declining balance sheets

Asia has repriced to a few significant dynamics over the past few months. First, a strong and broad-based global macro momentum. Second, reduced fear of trade wars – with the risk of an abrupt shift in terms of trade getting diffused into a more political economy negotiation around specific sectors and products. Third, a pull back in central bank intervention, which has thus far left currency politics more beneficial than not for Asian FX. With European political risks on the wane, and with even the North Korea risk subject to time decay, the positive momentum for Asia could be set to extend.

With growth though comes the need to normalize policy settings. The peak on central bank easing is likely past us, and we could soon be hitting the peak even in terms of size of balance sheets. We think the next theme for emerging markets to price in over the coming months is a world with flatter, and then declining, central bank balance sheets.

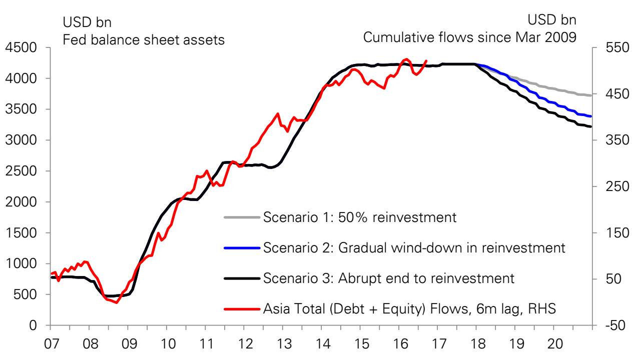
We believe this change is coming, and most critically in the US, even if the timing is uncertain. Fed minutes from their March meeting revealed that "most participants...judged that a change to the Committee's reinvestment policy would likely be appropriate later this year" and a number of Fed speakers have commented publically to the same effect. Fed members likely discussed their balance sheet policy when they met earlier this month, even if we will probably only learn the details when the Minutes are released. The Europeans and Japanese are clearly behind the Fed, but still on track to announce – or effect – some form of tapering of their QE programs later this year.

What would a world with declining central bank balance sheets mean for portfolio flows into emerging markets, and Asia in particular?

Asia portfolio flows have had a striking relationship with the Fed balance sheet

Cumulative inflows into emerging markets have had a strong relationship with the size of the Fed balance sheet. We focus in this note on inflows into Asia in particular, where the relationship has been striking, with inflows following Fed QE addition by roughly 6 months (Figure 1). The Fed has grown its balance sheet by $3.5tn since March 2009, a period over which Asian equity and debt markets have received a cumulative $520bn in flows[4]. As a rough rule of thumb, every $100 of increase in the Fed's balance sheet has driven $15 into Asian equity and debt markets.

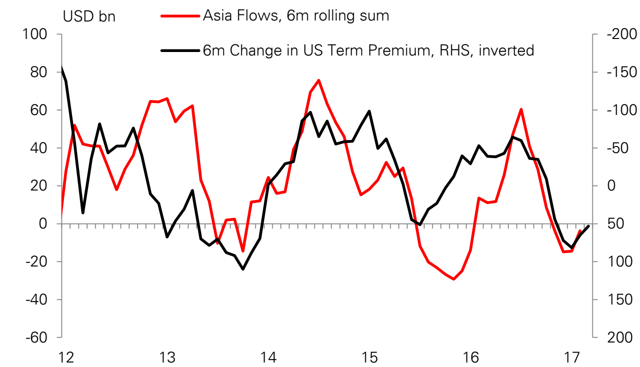
1. Asian flows have had a striking relationship with the Fed balance sheet



Source: Deutsche Bank, Bloomberg Finance LP, Federal Reserve, Thai BMA, Korea FSS

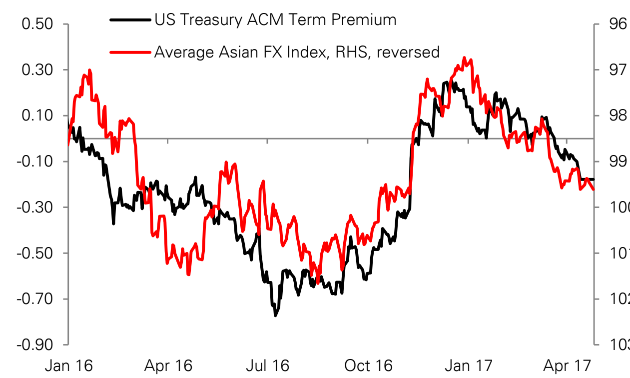
The tight optical relationship between the Fed balance sheet and flows into EM is perhaps best thought of within the portfolio balance construct – by raising the price, and reducing the return on longer-dated US Treasuries and MBS, the Fed has pushed additional dollar liquidity into higher-return assets in EM. The Fed estimated in a recent paper that the cumulative effect of their QE purchases is currently depressing the 10 year Treasury term premium by about 100bp[5]. As Figure 2 illustrates, changes in the US term premium have had a close relationship with flow changes to Asia, with a reduction in term premium driving inflows and vice versa. As a corollary, Asian FX has had a negative correlation to the US term premium, with lower term premia driving FX strength – this relationship has tightened in recent months (Figure 3).

2. Lower US term premium has driven Asian inflows



Source: Deutsche Bank, Bloomberg Finance LP

3. ...and been correlated to strength in Asian FX



Source: Deutsche Bank, Bloomberg Finance LP

Fearing the unwind

The above relationships suggest that a reduction in the size of the Fed balance sheet, and consequent rise in US term premium, could see a reversal of portfolio flows to the region. The Fed estimates that term premium will rise 15bp by year-end, reflecting the reduction in duration of the Fed's portfolio, and the market preparing for the end of reinvestment.

Of course, the manner in which the Fed approaches balance sheet reduction will be key. In their March minutes, the Fed noted a preference for a "passive and predictable" approach, and thought that "end[ing] reinvestments all at once" could be "easier to communicate." One could however consider a few different scenarios. Figure 1 plots three possible variations on the pace of unwind, each assuming that reinvestment starts getting altered in January 2018 (DB assumptions).

[4] We consider inflows into all markets with publically available high-frequency portfolio flow data. Equity flow data is available for Korea, Taiwan, India, Indonesia, Thailand, Philippines, Malaysia, and debt flows for India, Indonesia, Malaysia, Korea, Thailand, Philippines. China data for equities and bonds is only available from 2014 onwards and is thus not included in the analysis

[5] Bonis, Ihrig, Wei, "The Effect of the Federal Reserve's Securities Holdings on Longer-term Interest Rates," April 20, 2017

Scenario 1: Fed cuts down its reinvestment to 50%

Scenario 2: Gradual wind-down of reinvestment (75% reinvestment in Q1 2018, 50% in Q2, 25% in Q3, no reinvestment from Q4 2018 onwards)

Scenario 3: Abrupt end to reinvestment – Fed cuts down reinvestment to 0%

The most extreme of these scenarios (Scenario 3), would be consistent with about $60bn in outflows from Asia next year, given about $420bn in maturing Treasuries in 2018, based on historical relationships. If this continues till 2020, the Fed balance sheet will have shrunk by about $1tn over this period, which would be consistent with roughly $150bn of outflows from Asia, or nearly 30% of cumulative net inflows since 2009. The less aggressive scenarios – 1 & 2 – could take away $30bn and $40bn respectively out of Asia in 2018 (and $76bn and $126bn cumulatively by 2020).

There are of course other permutations that could be considered depending on the level of Fed aggressiveness. Many academics and policy commentators - including former Fed Chairman Ben Bernanke – have argued that there is “no need to rush the process” and it is better initiated when short-term rates are meaningfully higher, which could suggest postponing the unwind further[6]. A benign option compared with Scenarios 1-3 above could be, for example, to reinvest maturing debt into shorter tenor paper (reverse Twist) to simply reduce the duration of the portfolio instead of cutting down the size of the balance sheet. In contrast, a more aggressive option could be a move to actively sell down the Fed MBS portfolio at some stage (note that MBS maturities are not imminent given the very long-dated nature of this paper).

It is not just what the Fed does, but how it communicates the process which will be important. After the experience of the taper tantrum, the Fed is likely to be more cautious, transparent, and predictable about their balance sheet policy, which could lessen market turmoil. Nevertheless, we believe market should not underestimate the impact of the first actual withdrawal of US dollars in the post-crisis era. The unwind will matter.

[6] Ben S. Bernanke, “Shrinking the Fed’s balance sheet,” Brookings (blog post), 26 Jan 2017

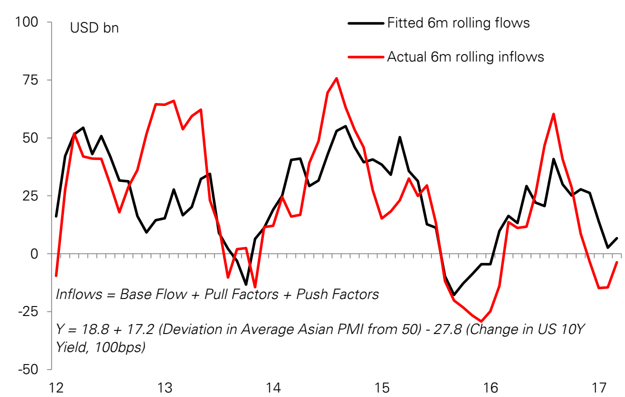
This is not the entire story, of course

1. What about pull factors?

Fed QE policy has clearly been a strong push factor for flows by creating a new source of liquidity. But what about the other drivers of money to the region, and how can we control for them? One can think of a number of drivers: stronger growth, reform stories, valuation gaps, diversification requirements, to name a few.

We consider a very simplified model to explain Asian flows in which we introduce a growth pull factor, alongside a Fed push factor. The pull factor is proxied by the average Asian manufacturing PMI (deviation from 50), while the Fed QE factor is proxied by the 6m change in the US 10Y yield. We run a regression on Asian inflows (6m rolling sums) against these explanatory variables, which are both introduced with a 2 month lead. The betas are intuitive and significant at the 1% level, with the model explaining about half of the variation in Asian flows over the past five years (Figure 4).

4. Stronger regional growth can help offset some of the flow impact of higher US rates



Source: Deutsche Bank, Bloomberg Finance LP, Haver Analytics

We find that every 100bp rise in US 10Y yields leads to $28bn in outflows over the following few months. But interestingly, the effect of tighter US monetary conditions can be offset by a stronger regional growth impulse, with every 1 point deviation in Asian PMIs associated with $17bn of inflows over a similar period. In other words, if the Fed balance sheet unwind is happening in a positive regional growth environment, outflows may not be as bad as feared, with every 1pt rise in average Asian PMIs offsetting the negative flow effect associated with 60bp rise in US 10Y yields.

The intercept term in our model is also positive ($19bn over 6 months), which could indicate a natural bid for Asian assets, and underlying momentum to inflows.

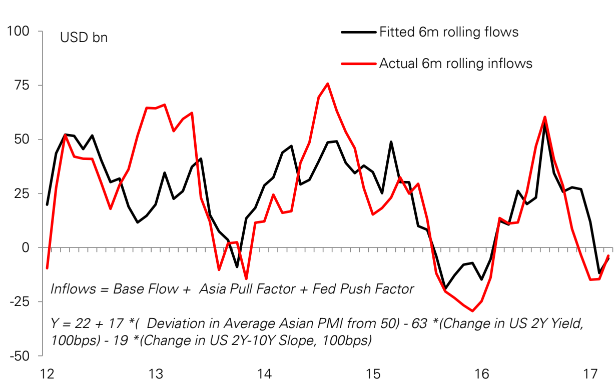
This could be capturing the diversification element. One could argue that the diversification driver is set to change in the future as China opens access to her equity and bond markets. This could draw money out of the rest of the region as global indices are reweighted away from rest of EM towards China – potentially turning this intercept term negative in the relationships above (which are ex-China). For Asia overall though, including China, this should be a net positive in terms of flows

2. Which is worse - balance sheet reduction or policy rate tightening?

There is an ongoing debate about whether the unwind of the Fed balance sheet, and higher long-end yields, could be a substitute for front-end tightening. Our US economists expect the Fed to hike rates two more times in June and September, but to skip hiking in the December meeting when they formally announce balance sheet reduction. It is thus worth questioning which type of tightening is worse for Asia flows.

We stick with the simple model presented above with growth pull and Fed push factors, but we split the latter into two variables to try and differentiate between Fed Funds Rate and balance sheet tightening. The first factor is the change in the US 2Y yield which better captures rate policy, while the second is the change in the US 2Y/10Y yield slope, or the term premium, which captures QE policy. The explanatory power of the model improves slightly; the intercept and beta on the Asian PMI variable do not change much; and the betas on the new disaggregated Fed factors are both significant at 1% level (Figure 5).

5. If the balance sheet unwind slows the pace of Fed hikes, it is not necessarily all bad news for flows



Source: Deutsche Bank, Bloomberg Finance LP, Haver Analytics

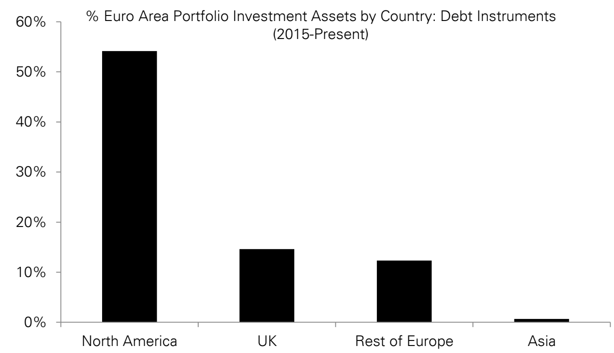
The results are telling and we use them to compare two alternative tightening scenarios. Both feature a 100bp sell-off in US 10Y rates, but which are achieved differently. In the first scenario, we assume the Fed hikes quickly and delays their balance sheet unwind – or simplistically that the entire 100bp move is driven by the 2Y point, with no change in term premium. In the second scenario, we assume a slower pace of Fed hikes as the Fed unwinds the balance sheet – or that the 100bp sell-off in 10Y yields is half driven by the 2Y point (+50bp) and half by a steepening in the 2Y/10Y curve (+50bp). We find that the path of faster policy rate hikes (front end moves) is more damaging to Asian flows, driving $62bn in net outflows from the region, while a slower pace of rate hikes accompanied with balance sheet unwind actually leads to a smaller scale of outflows of around $40bn. Therefore, to the extent that the Fed balance sheet unwind slows the pace of rate hikes, this could in fact be a better relative scenario for Asian flows.

3. Don't the ECB and BoJ matter?

The combined size of the ECB and BoJ balance sheets is now close to double the size of the Fed's, and thus their evolution should not be ignored in the flow debate. Neither central bank is expected to shrink their balance sheets anytime soon, but their incremental moves will be towards less liquidity addition. We expect the ECB to begin to taper their asset purchase program in January 2018 (likely to be announced in H2 this year), flattening out their balance sheet by mid-2018. Large TLTRO maturities that will shrink the balance sheet are not due till 2020. BoJ is likely to continue expanding its balance sheet, but at a reduced rate in the coming years. The transition to yield-targeting under YCC has made balance sheet growth a dependent variable (price over quantity). We think the BoJ could drop the reference to Y80tn in balance sheet expansion by September, and effectively expand only Y60tn this year, falling further in future years.

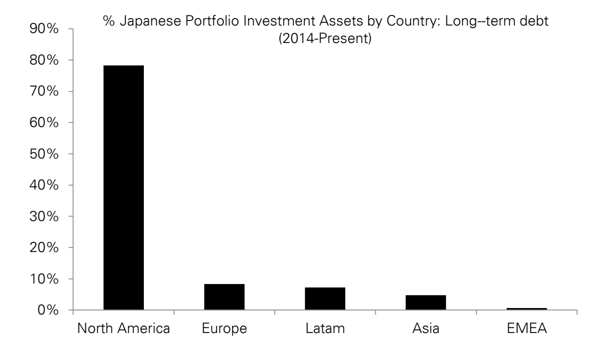
We find that combined G3 balance sheets tally less well with offshore portfolio flows to Asia, compared with just the Fed balance sheet. This might suggest that ECB and BoJ liquidity addition matter less for local currency flows to Asia. We can confirm this hypothesis by turning to balance of payments data from the Euro Area and Japan which split portfolio investment assets by the geography of their destination. As Figure 6 and 7 illustrate, the majority of debt outflows from Europe and Japan over their QE periods have gone to North America, with very little coming to Asia or other emerging markets.

6. Most European debt outflows have gone to US fixed-income...



Source: Deutsche Bank, Haver Analytics

7. The Japanese too have bought mostly US assets

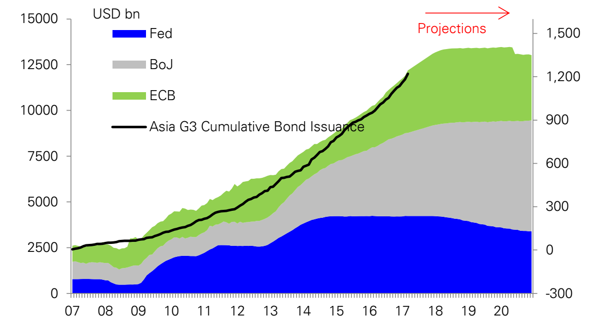


Source: Deutsche Bank, Bank of Japan

The above suggests that the ECB and BoJ have mattered, but more by way of impacting the US term structure, rather than directly the pace of flows into Asia. European and Japanese buying of higher-yielding Treasuries has contributed to a lower US term premium as well, which in turn has indirectly driven flows to Asian assets through the relationships discussed earlier. Even with the Fed balance sheet having flattened out since 2014, ECB and BoJ QE have held down US term premia through their money printing. The potential combination of a Fed unwind, and ECB and BoJ taking their feet off their own QE pedals could thus be a potent mix for EM flows.

One area where we find a more direct relationship between ECB & BoJ balance sheets and Asian flows is in external bond issuance (Figure 8). Even with the Fed balance sheet flattening out in 2014, Asia ex-Japan G3 debt issuance has continued to make new highs, hitting a peak of $204bn last year, and on track for a $300bn year in annualized terms YTD (Source: Bloomberg). This suggests that the continued addition to global liquidity from Europe and Japan has played an important role. This may be because – unlike the Fed - the ECB and BoJ programs have taken place in the presence of negative rates, are now larger in % GDP terms, and have absorbed a greater proportion, if not all, of available net sovereign issuance in their markets.

8. Continued growth in ECB and BoJ balance sheets has supported growth in Asian external debt



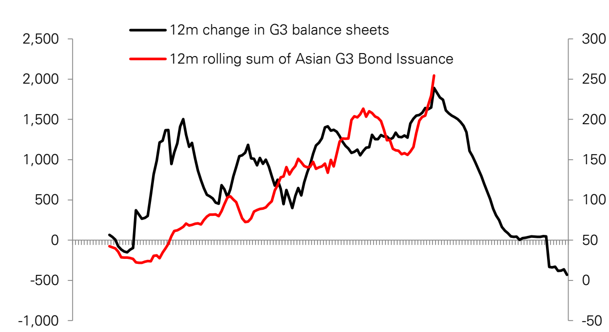
Source: Deutsche Bank, Fed, ECB, BoJ, Bloomberg Finance LP

There are two possible theories in the literature which explain the relationship between QE and increased external bond issuance. The first is the "market-timing" hypothesis, which suggests that global QE programs - by lowering expectations of G3 interest rates - encourage corporates and governments to "time the market" and issue more bonds to lock in low rates. Another theory argues that corporates "fill the gap" in supply of paper. With BoJ and ECB withdrawing larger amounts of developed market government bond supply from the market, EM corporates and sovereigns have stepped up to offer their paper as an alternative asset.

Another reason why external issuance might have had a better relationship with G3 balance sheets in the post Fed QE era, is that foreign investors do not take on currency risk when buying external debt, but do carry EM FX risk in portfolio inflows to Asian equity and debt. With the backdrop for EM currencies having been a rocky since the Fed taper, this might have skewed the relationship towards hard currency paper.

With balance sheets in Europe and Japan slated to grow at a slower rate in the coming months, and the Fed balance sheet set to shrink, this could impact the pace of Asian external issuance, with Figure 9 suggesting we may have already reached the peak.

9. We may have reached the peak in Asian external debt issuance



Source: Deutsche Bank, Fed, ECB, BoJ, Bloomberg Finance LP

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Philippines: Tax reform delay – weighing the risks

- The Duterte administration's comprehensive tax reform program, the first component of which is scheduled to be implemented in early 2018, poses upside risks to our inflation and rates outlook. Note that we already expect the BSP to deliver two 25bp rate hikes in 2017H2.
- Such a tax reform is growth supportive, without undermining the fiscal health of the Philippines, while boosting investor confidence over the Duterte administration's ability to implement meaningful economic reforms.
- With the tax reform package progressing through the national legislature rather slowly, however, we estimate the potential impact on fiscal health in the absence of a tax reform. Although the government debt is likely to remain below 50% of GDP over the medium term, even under the assumption of a loose budget plan, the pace of debt increases may provoke concerns over growth sustainability and the economy's buffer against shocks.

Economic implications of a prolonged delay to Duterte's tax reform program

"The CTRP is an indispensable component of the Duterte administration's economic strategy. It is an audacious strategy that seeks to lift our country to upper middle-income status by 2022 and high-income status by 2040." – Finance Secretary Carlos Dominguez III

The comprehensive tax reform program (CTRP) is the cornerstone of the Duterte administration's vision of an upper middle-income country by 2022. According to the Department of Finance (DOF), eradicating poverty and achieving the vision of a prosperous nation would require some PHP366bn per year of investments in infrastructure, education and training, health, and social protection, welfare, and employment between 2016 and 2022, for a total of PHP2.2trn. The additional revenues generated from the CTRP would better enable the government to spend on these much-needed investments.

Current and additional investment needed per year

Investment category (figures in PHP bn)	2016 Budget	2022 target	Additional over the next 6 years
Infrastructure	759	1,832	1,073
Education and Training	551	1,269	718
Health	133	272	139
Social protection, welfare, employment	242	509	267
Total	*1,685*	*3,882*	*2,197*

Source: Department of Finance

The passage of Package 1 of the CTRP is most crucial, as it stands to generate the greatest amount of additional revenues, per DOF's projections. It also establishes the momentum for subsequent packages, which involve reduction in the corporate income tax and restructuring of the real property tax, among others. More importantly, it would be a testament to the Duterte administration's commitment to delivering sustainable economic reforms.

We agree with the DOF and the BSP's assessment that Package 1 would have a net positive impact on economic growth, as the reduction in personal income tax rates for nearly all taxpayers, despite upward adjustments in fuel and car prices, would boost disposable incomes. According to the BSP's estimates, the tax reform would add 0.6ppt to the government's 6.5-7.5% GDP growth forecast in 2017, if implemented this year, and another 0.2ppt to the 7-8% growth outlook for 2018. And as demand gains pace, inflation could also see a 0.5ppt increment to the BSP's 3.3% inflation forecast for 2017 (it has since been adjusted to 3.4% of late), and another 0.7ppt to the 2018 inflation forecast of 3.0%.

Estimated revenue impact of Package 1

Package 1 provisions	PHP bn
Personal income tax adjustments	(137.9)
Lower estate and donor taxes to a 6% flat rate	(1.7)
Fuel excise tax	120.9
Auto excise tax	31.4
VAT base expansion	92.5
Other measures	57.4
Net increase in revenues	**162.5 (~1% of GDP)**
Additions based on May 3 House Committee approval	
Tax on sugar and sugar-sweetened beverages	40.0

Note: Estimates may not be based on latest version of HB 4774.
Source: Various media reports as reported relayed by the Department of Finance

But Package 1, also known as House Bill 4774, is progressing slowly in the national legislature, relative to the DOF's earlier projections. It failed to clear the Lower House Ways and Means Committee before Congress went into recess in March, although the bill has since cleared the Committee level on May 3. Because of the delay in Congress, the bill is now unlikely to be passed into law by June 2017 and implemented shortly thereafter. Instead, the DOF now expects its passage in October, given the Congressional calendar, and to be implemented in early

2018[7]. This new timeline would still keep the current administration on track with its fiscal program, in our view. But the more lawmakers prolong the passage of the bill, the higher the likelihood that the whole package will not be passed, as Congress approaches elections in May 2019. Passing a watered-down, populist version without compensating revenue-generating measures could undermine the government's financial position.

In the paragraphs below, we assess the economic impact of a prolonged delay in the passage of Package 1. As the current fiscal program assumes successful implementation of the CTRP, we consider two medium-term scenarios with its absence. In particular, without the additional revenues, we see the government having to choose between a) cutting back on its overall spending target and maintain the same budget deficit ceiling – the fiscally conservative government, or b) adjusting its budget deficit ceiling 1ppt higher to 4% of GDP – or what we refer to as the populist government.

We note our medium-term baseline assumptions in analyzing the two scenarios. We have recently bumped up our GDP growth forecasts to 6.2% in 2017 and 6.5% in 2018, owing to the stronger-than-expected export rebound at the start of 2017. Growth is expected to stabilize at 6.5% through 2022. Our forecasts do not explicitly take into account the impact of the CTRP, although they do incorporate the positive sentiment from prospects for the CTRP's implementation.

Baseline assumptions

	2017	2018	2019-22
GDP growth (%yoy)	6.2	6.5	6.5
Fiscal balance (% of GDP)	-3.0	-3.0	-3.0
Primary balance (% of GDP)	-0.9	-1.0	-0.9
Inflation (%yoy)	3.3	3.3	3.0
PHP/USD (eop)	52	52.7	52
10-year yield (%, eop)	4.6	5.5	6.5

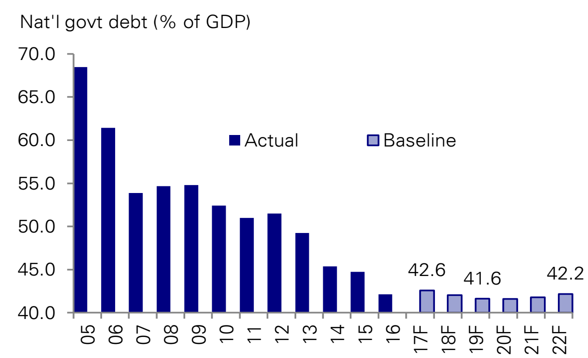
Source: Deutsche Bank

Our growth outlook also takes into account the loose fiscal stance of the current administration. Note that the government has decided to widen the deficit ceiling 1ppt from the previous administration, to 3% of GDP, as it looks toward the implementation of the CTRP according to its timeline. By widening the deficit 1ppt, one can assume that the government intends to double spending for every 1% of GDP increase in revenue.

Without Package 1, our baseline inflation outlook should be unchanged. Odds of the BSP hiking policy rates in 2017-18 would fall with one less inflationary pressure from the tax reform. However, the central bank may still be prompted to hike at some point, should reform delays place more depreciation pressure on the peso.

We use the IMF's debt sustainability framework to derive the Philippine government's projected debt ratios over the next six years. We additionally assume interest rates to rise150bps on average (across tenors) between 2017 and 2022, while the PHP/USD is expected to stabilize at 52 from 2019-22, after depreciating to 52.7 by end-2018.

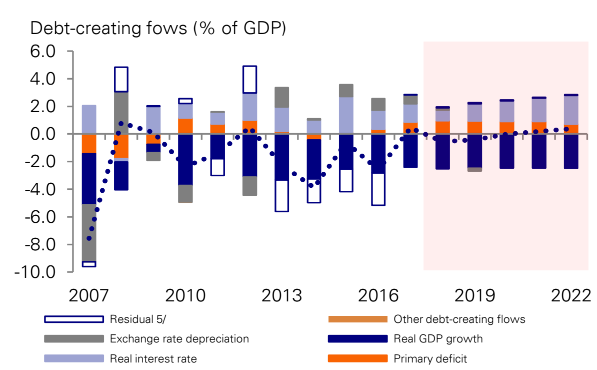
Baseline debt-to-GDP projections



Source: CEIC and Deutsche Bank

Under our baseline scenario, the national government debt would initially fall from 42.1% of GDP in 2016 to 41.6% in 2018-19 as robust GDP growth outweighs the upward pressure on the debt from higher interest rates and wider primary deficits. The debt ratio then rises slightly to 42.2% in 2022, owing to persistent increases in the real interest rate.

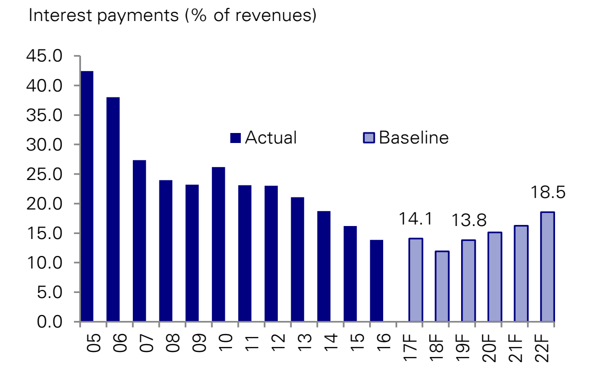
Higher deficits, rates pace upward pressure on debt



Source: CEIC and Deutsche Bank

[7] Please refer to our more detailed report on this issue for the Philippines' Congressional calendar and legislative process (*Philippine Strategy: Tax reform delay – weighing the risks* by Rafael Garchitorena and Diana del Rosario, published on 10 April 2017).

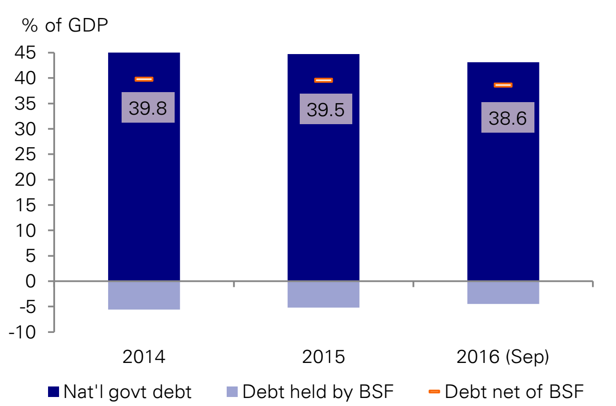
Debt interest payments under baseline scenario



Source: CEIC and Deutsche Bank

Note that if we net out holdings under the Bond Sinking Fund, which was initially created to cover maturing debt obligations, the national government debt would actually be taking off from a much lower base of 38.6% of GDP (per latest data as of September 2016), instead of 42.1%. This implies ample scope for the government to augment spending.

Lower debt if Bond Sinking Fund is taken in



Source: Department of Finance and Deutsche Bank

Scenario A: A fiscally conservative government

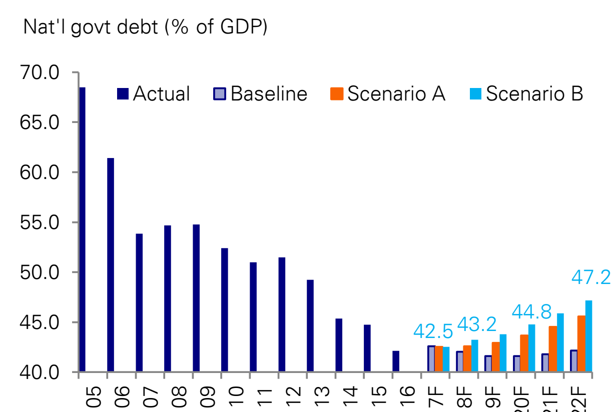
The government risks foregoing about PHP162.5bn per annum in additional revenues, equivalent to nearly 1% of GDP, without Package 1 in 2018 or later. Should the government decide to hold back spending by an equivalent amount, the budget deficit should remain at 3% of GDP, while GDP growth could fall directly by 1ppt from our baseline to 5.5% in 2018.

The absence of concrete reforms could also dampen private investor sentiment, thereby pulling down growth further. We assume growth falls slightly below 5% per annum in the succeeding years towards the end of the current administration in 2022, as private investment slows down. With slower growth, inflation is slated to weaken, pulling down nominal GDP growth. In turn, government debt would rise faster than nominal GDP growth, thereby raising the debt-to-GDP ratio from 42.1% of GDP in 2016 to 42.9% in 2019 and then to 45.6% by 2022. In addition, as revenues would be dampened by slower economic growth, interest payments as a fraction of total revenues are projected to steadily rise, from 13.9% in 2016 to 20.0% in 2022.

Scenario B: A populist government

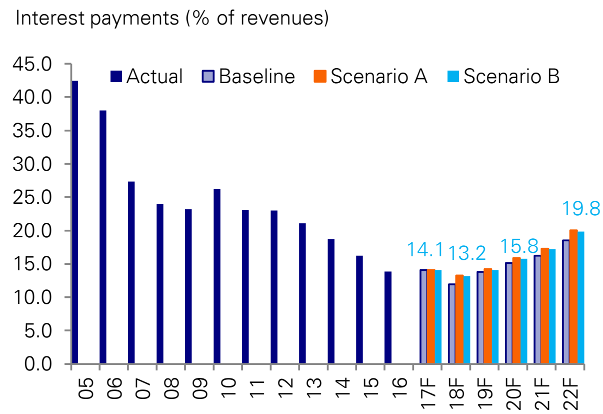
Scenario B entails a budget deficit that is 1ppt wider (i.e. 4% of GDP), as the medium-term fiscal program is maintained despite the absence of revenue-enhancing tax reforms. Accordingly, our medium-term growth and inflation outlook should be fairly intact, although we have tapered growth slightly by 30bps to 6.2% to account for dampened investor sentiment from the lack of traction on economic reforms. But as the deficit rises, cost of borrowing would also rise. In turn, government debt would rise to 43.8% of GDP in 2019 and then to 47.2% in 2022. Interest payments would also rise in line with the wider budget deficit. But as revenues are fairly buoyant in line with robust GDP growth, interest payments as a share of revenues would remain below 20%, lower than under Scenario A.

Projected debt-to-GDP ratio under Scenario A & B



Source: CEIC and Deutsche Bank

Debt interest payments under Scenario A and B



Source: CEIC and Deutsche Bank

Debt burden to rise, in either scenario

Whether the government holds back on spending or widens the budget deficit, the debt burden would rise without a revenue-enhancing tax reform. But if faced with these two options, with robust growth maintained and the debt service burden slightly less or practically the same, Scenario B would clearly be the more politically appealing option. The danger, however, lurks in complacency. Yes, the country's debt-to-GDP ratio would be taking off from very comfortable levels. However, rising debt service burdens would also erode the government's ability to counter adverse shocks to the economy.

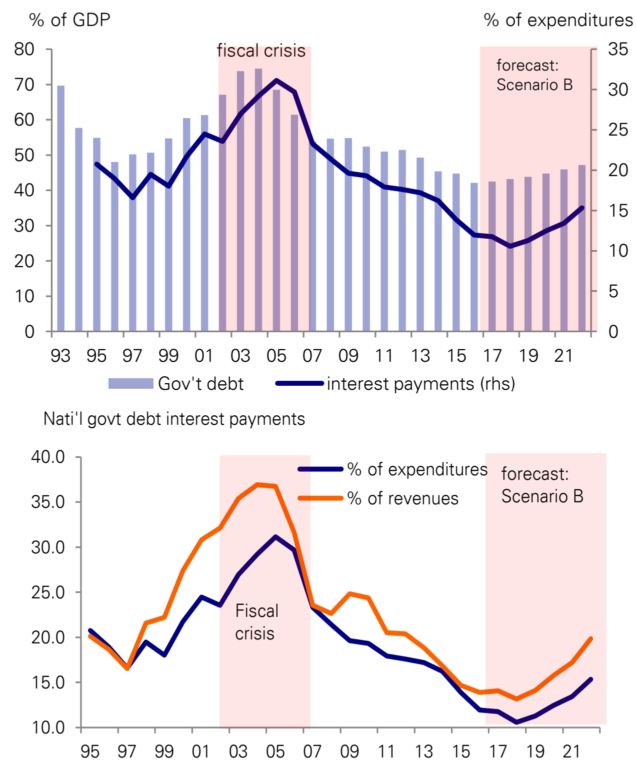
Scenario B is the more politically appealing option

	Scenario A		Scenario B	
	2018	2019	2018	2019
GDP growth (%yoy, real)	5.5	4.9	6.2	6.2
Inflation (%yoy)	2.8	2.6	3.3	3
Fiscal balance (% of GDP)	-3.0	-3.0	-4.0	-4.0
Gov't debt (% of GDP)	42.6	42.9	43.2	43.8
Interest payments				
% of revenues	13.3	14.2	13.2	14.1
% of expen.	11.2	11.9	10.6	11.3

Source: Deutsche Bank

Moreover, an IMF study has shown empirically what we fear for the country: that while the country's economic growth would initially get a boost from deficit-financed increases in public investments, consequent increases in borrowing costs do tend to constrain growth over time[8]. In fact, the latter scenario is nothing new to the Philippines; decades-long onerous debt repayments had long stunted the country's economic development. And while the risk of a repeat is currently remote, given ample fiscal and monetary buffers, policymakers ought to learn from history. Thus, against a loose fiscal stance, the importance of revenue mobilization cannot be more than emphasized. And for that, the CTRP must be seriously considered, without delay.

Although risk of a repeat is remote, lessons can be learned from the country's debt-ridden history



Source: CEIC and Deutsche Bank

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[8] Takuji Komatsuzaki, *Improving Public Infrastructure in the Philippines* (IMF Working Paper WP/16/39, February 2016).

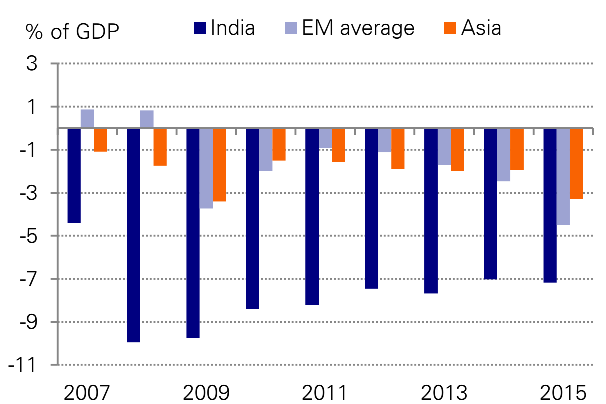
Analyzing India's debt sustainability

- We present the results of a debt sustainability analysis of the general government under various scenarios. Our analysis reveals that high economic growth rate and modest fiscal consolidation could lead to sustained improvement in India's debt/GDP ratio over the medium term.

Debt sustainability analysis

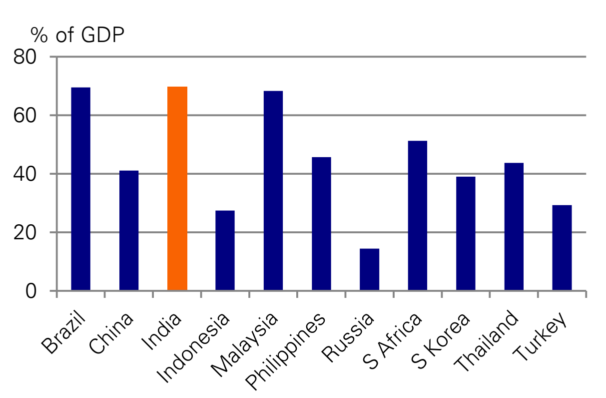
Despite running persistently large fiscal deficits in recent decades, India has seen its public sector debt/GDP ratio decline owing to high real and nominal growth rates and low real interest on public issuances. Indeed, the public sector debt/GDP ratio has gone down from 84% of GDP in FY06 to about 70% in FY17. Recent economic slowdown, particularly manifesting in a sharply lower nominal GDP growth, and a rise in real rates owing to RBI's inflation targeting, has however flattened the public sector debt/GDP ratio, which remains high compared to EM peers.

General government fiscal balance



Source: IMF, Deutsche Bank

General government gross debt for 2016



Source: CEIC, Deutsche Bank

The two tables below summarize the fiscal performance at the general government level. General government budget and primary deficits have been on a path of consolidation since FY10, while interest payments have remained broadly sticky at around 4.8% of GDP. State debt/GDP ratio has barely changed in the past 10 years, remaining sticky at about 20-21% of GDP, while the center's burden has fallen by 12.5% of GDP since FY05.

General Government fiscal snapshot

% of GDP	FY13	FY14	FY15	FY16	FY17F
Revenue	22.7	22.3	24.6	24.5	24.6
Expenditure	29.6	29.0	31.6	30.9	31.1
Interest payment	4.7	4.8	4.8	4.8	4.9
General govt. deficit	6.9	6.7	7.0	6.5	6.5
Primary deficit	-2.2	-1.8	-2.2	-1.6	-1.6

Source: RBI, Deutsche Bank

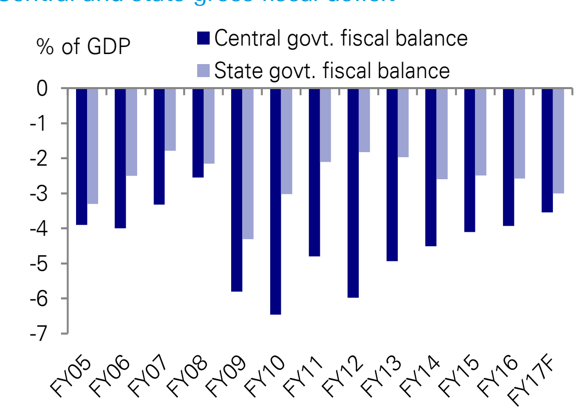
Liabilities position of the centre and the states

% of GDP	FY13	FY14	FY15RE	FY16BE
I. Central govt. debt	51.0	50.3	50.5	50.3
II. State govt. debt	20.8	20.6	21.1	21.4
III. Central loans to state	1.5	1.3	1.3	1.3
General govt. debt = I + II - III	70.3	69.6	70.4	70.5

Source: Ministry of Finance, Deutsche Bank

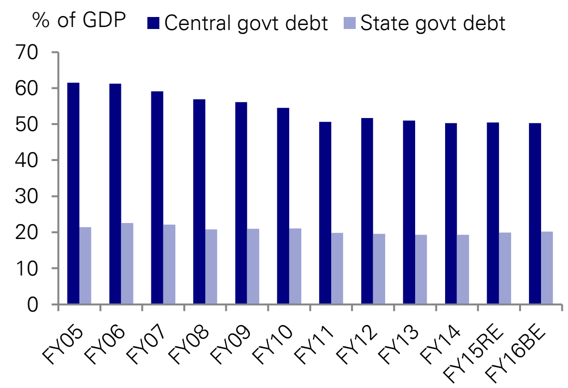
While the central government's fiscal deficit has reduced steadily in the last few years, the consolidated fiscal deficit of states has deteriorated by 1% of GDP (currently around 3% of GDP) over the past three years, thereby preventing meaningful improvement in the general government budget deficit. Along with the increase in fiscal deficit, market borrowing of the states has also increased significantly in the last few years, a cause of concern.

Central and state gross fiscal deficit



Source: CEIC, Deutsche Bank

Central and state government gross debt



Source: CEIC, Deutsche Bank

Against this backdrop, the central government formed an expert committee last year to recommend a desirable fiscal and debt consolidation path for India over the medium term. The Fiscal Responsibility and Budget Management Act (FRBM) review committee submitted its recommendations before the announcement of the Union Budget on 1st February 2017, with the detailed report being released subsequently in mid-April.

The FRBM committee recommended the central government to continue on the path of fiscal consolidation, with the medium term goal of bringing the centre's fiscal deficit down to 2.5% of GDP by FY23 (from 3.2% of GDP currently), which would result in the debt/GDP coming down to 40% of GDP (from about 49% currently). The committee also recommended a desirable fiscal path for the state governments, so that cumulatively the debt/GDP of states can remain constant at about the current level of 21% of GDP throughout the forecasting period. This would require state fiscal deficit to reduce by about 1% of GDP to 2.0% by FY23. If this is achieved, then India's overall public debt/GDP ratio would moderate to about 60% of GDP by FY23, a 10% drop from current levels.

FRBM committee recommended fiscal target

	FRBM committee recommended target			DB estimate
% of GDP	Central govt. fiscal deficit	Sate govt. fiscal deficit	General govt. fiscal deficit	General govt. fiscal deficit
FY17	3.5	3.0	6.5	6.5
FY18	3.0	2.8	5.8	6.2
FY19	3.0	2.7	5.7	6.0
FY20	3.0	2.5	5.5	6.0
FY21	2.8	2.3	5.1	6.0
FY22	2.6	2.2	4.8	6.0
FY23	2.5	2.0	4.5	6.0

Source: FRBM Review Committee Report, Deutsche Bank

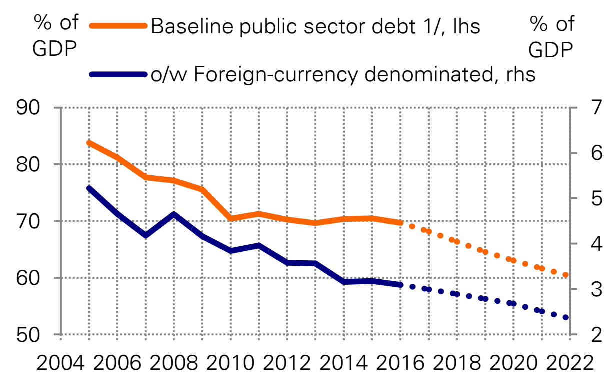
In the following pages of this report, we use our own economic forecasts to present a debt sustainability analysis of the general government, to ascertain how difficult it is to achieve the FRBM's medium-term debt/GDP target under various scenarios. The framework used here is the standard IMF debt sustainability exercise for emerging market economies. Debt dynamic is a function of previous period's debt stock, interest rate on debt, GDP deflator, real GDP growth rate, and exchange rate. We take the latest debt and GDP statistics at the general government level and then project them forward under a baseline scenario.

Baseline assumptions and projection

- Real GDP grows in the 7.75-8.0% range over the next six years (till FY23); nominal GDP growth averages close to 13% during the forecasting period;
- CPI inflation stabilizes in the 4.0-5.0% range as per RBI's medium-term inflation targeting framework; we have assumed GDP deflator to average 5% in the years ahead;
- Real interest rate on public debt works out to 3.5% on an average (derived from 8.5% nominal rate and 5.0% GDP deflator-based inflation);
- We assume general government deficit (centre + state) to stabilize at 6.0% of GDP through the forecasting period, versus the FRBM target of 4.5% of GDP by FY23, factoring in risk of slippages in some of the years;
- Primary deficit eases somewhat in the period ahead, averaging close to 1% of GDP; primary spending rises by 7.8% in real terms, in line with past trend while revenues rise 8.2% on an average, in line with GDP;
- The rupee remains broadly stable against the USD, with a slight depreciation bias in the medium term; given India's relatively small public external debt burden, the exchange rate assumption matters little in the debt sustainability exercise.

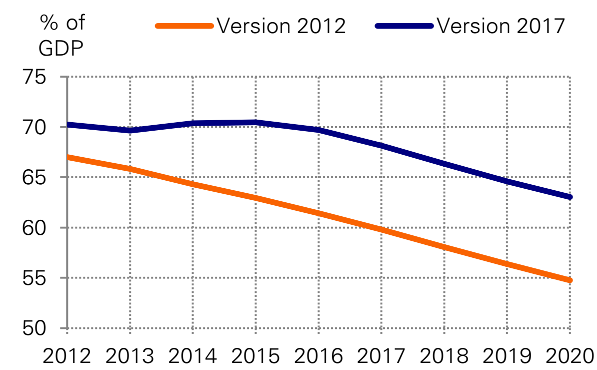
Under this scenario, public debt is projected to decline to about 60% of GDP by 2022 (FY23), as per the FRBM target. This outcome is primarily driven by the assumption that the real growth-real interest rate differential stabilizes at 4-4.5% during the forecasting period. India's debt burden does not look onerous under this scenario, but the interest cost of servicing the debt remains high during the forecasting period, accounting for 15-16% of total consolidated spending (or about 23-25% of central government discretionary spending). Given that India's total public spending on health and education barely reaches that level, the importance of reducing debt and interest cost is all too apparent.

Baseline Debt/GDP ratio



Source: Government of India, Deutsche Bank. 1/ Combined Central and State level debt

Baseline Debt/GDP ratio: projected in our 2012 exercise vs. latest projections



Source: Government of India, Deutsche Bank. 1/ Combined Central and State level debt

A word of caution - medium term forecasts are subject to various risks which are difficult to anticipate and therefore the actual outturn could be appreciably different from the projected path. Let us explain this by way of an example. In 2012 when we had undertaken the debt sustainability exercise based on the fiscal and growth data available at that time, our model had predicted debt/GDP to come down close to 60% by FY17, but as our current estimates show, the actual outturn will likely be close to 70%, almost 10% higher.

What went wrong despite serious focus on fiscal consolidation (albeit more on the central government front) in the last five years? A sharp slowdown in nominal GDP growth rate in FY15 and FY16, accompanied by an increase in real rates (measured in terms of GDP deflator) squeezed growth-interest differential and impacted the debt dynamic adversely. As a result of the shrinking growth-interest differential, the debt/GDP ratio in fact increased in FY15 (to 70.4%) from FY14 levels (69.6%) and further to 70.5% in FY16.

The good news is that the worst seems to be over for now. Our analysis suggests that the debt/GDP ratio has eased in FY17 to about 69.7%, primarily led by an improvement in the nominal GDP growth rate (to about 11.5%, from 10% in the previous two years). Indeed, if fiscal consolidation persists and growth continues to improve, then in such a scenario, it will not be difficult for India to achieve a 60% debt/GDP level by FY23, in our view.

The baseline debt/GDP projection does not incorporate any domestic or external shock. But as has been illustrated vividly through the last decade, India's fiscal regime is vulnerable to various shocks. It has also been seen that even after an extended high growth period, fiscal consolidation proves to be transitory when growth shocks materialize, or an external shock (global financial market volatility, for example) weakens the fiscal position indirectly by impacting growth and revenue adversely.

Keeping this in mind, in the rest of this note, we introduce some shocks to our baseline scenario and see how the projections change if indeed some of the key macro variables associated with debt dynamic were to take a turn for the worse in the coming years.

Stress Tests

Shock 1: No change in fiscal effort

If the primary deficit stays at around 1.7-2.0% of GDP (higher than our baseline assumption of about 1.0% of GDP), and the growth/interest rate nexus discussed above remains in place, India's debt path would still be on downward path, but the debt/GDP ratio will only fall to around 63.5% of GDP by 2022. A flatter path of debt adjustment should be a source of worry, as fragility to shocks would rise.

State fiscal finances pose the biggest risk to the overall fiscal consolidation target that has been set by the FRBM committee. Indeed, state fiscal finances have deteriorated in the last few years, with the overall state fiscal deficit having already risen to 3% of GDP currently, as per our estimate. 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.

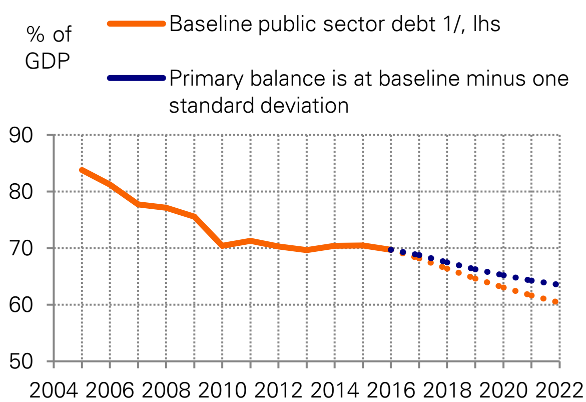
Then there are risks of escape clauses that can potentially get triggered which can adversely impact the fiscal and debt/GDP path. Most of the conditions (see below) which can provide a trigger for using the escape clause seem to be low probability event risks but the one related to agriculture output shock carries tangible risk, in our view. If monsoon rains disappoint, leading to poor harvest and prolonged farmer distress, there is a high likelihood of the escape clause to be triggered, which can potentially push up the fiscal deficit by 0.5% of GDP from the baseline estimate. While this need not derail the fiscal consolidation agenda altogether, it may delay the goal of achieving the 60% debt/GDP target by FY23, as set by the FRBM committee. The circumstances which can provide a trigger for using escape clauses could include:

i) Over-riding considerations of national security, acts of war, calamities of national proportion, and collapse of agriculture severely affecting farm output and incomes.

ii) Far-reaching structural reforms in the economy with unanticipated fiscal implications.

iii) Sharp decline in real output growth of at least 3% points below the average of the previous four quarters.

Debt dynamic favorable to achieve decline in debt path even with modest fiscal effort

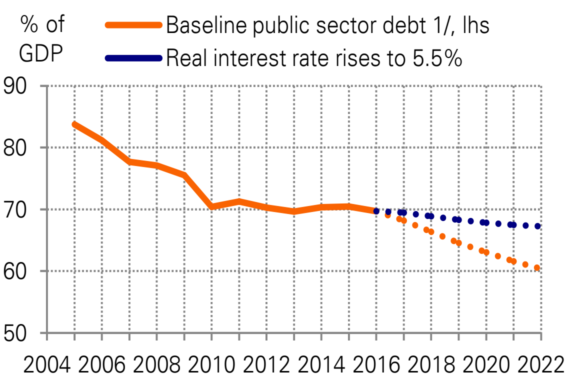


Source: Government of India, Deutsche Bank. 1/ Combined Central and State level debt

Shock 2: Real interest rate rises to about 5.5% on an average

If CPI inflation increases disproportionately in the years ahead, led by a spike in high food and services prices, RBI will be compelled to hike the policy rate, which may increase the real interest rate to mid single digit, when measured in terms of WPI and GDP deflator. Another possibility (though very unlikely) is that inflation remains stable but a sharp pressure on the exchange rate (as was experienced in 2013) forces RBI to hike the policy rate, thereby increasing the real interest rate. Under the interest rate shock scenario, real interest rate paid on public debt is raised by one standard deviation of the past average; under this scenario, the debt trajectory flattens considerably and debt/GDP comes down only modestly to 67.2% of GDP by FY23.

A rise in real interest rate could impact debt dynamic

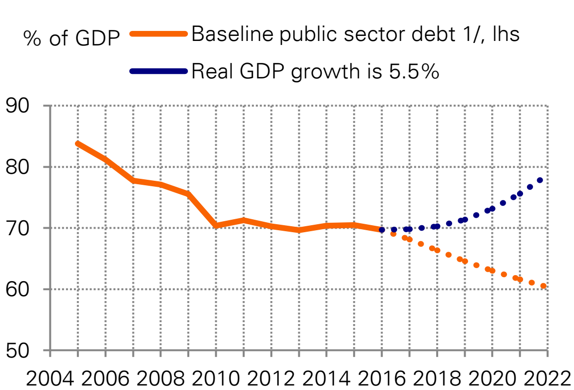


Source: Government of India, Deutsche Bank. 1/ Combined Central and State level debt

Shock 3: Real GDP growth moderates to 5.5%

Here we lower real GDP growth by 225-250bps (from our baseline forecast), which pegs economic growth to around 5.5%. The shock impacts the debt path severely, pushing up the debt ratio to 78.7% by 2022. In our 2012 debt sustainably exercise, a growth shock (under which real GDP growth was assumed at 4%, 200bps lower than the baseline forecast of 6%), resulted in pushing up the debt/GDP to 90% by 2020. The reason why debt/GDP trajectory is looking relatively benign in the recent growth-shock scenario is owing to the substantial revision in the GDP numbers in early 2014, which has raised India's real growth rate by 200bps from earlier levels.

Debt sustainability hinges critically on sustained, strong growth

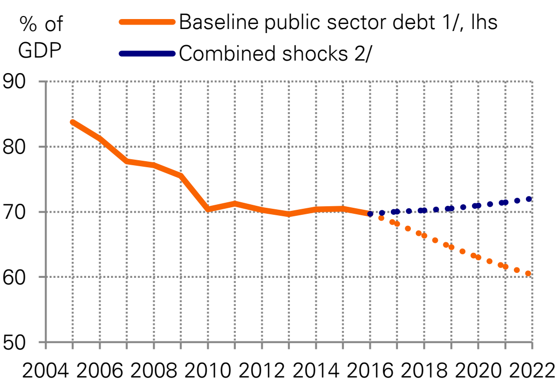


Source: Government of India, Deutsche Bank. 1/ Combined Central and State level debt

Shock 4: Combined shock

What if shocks were multiple in nature? There could be occasions when a growth shock eventually leads to a fiscal shock which then translates into an interest rate shock. What happens to the debt profile in case of such a combined shock scenario? With this in mind, we construct a scenario incorporating shocks half the size of the ones discussed above but in conjunction with one another. We find that the impact on debt is immediate and unambiguously adverse (the debt/GDP ratio rises to 72% by 2022). While the probability of such a manifestation is low, given the proliferation of extreme shocks to the global economy in recent years, it is important to be cognizant of such eventualities.

Debt path can turn higher if economy is hit with multiple shocks

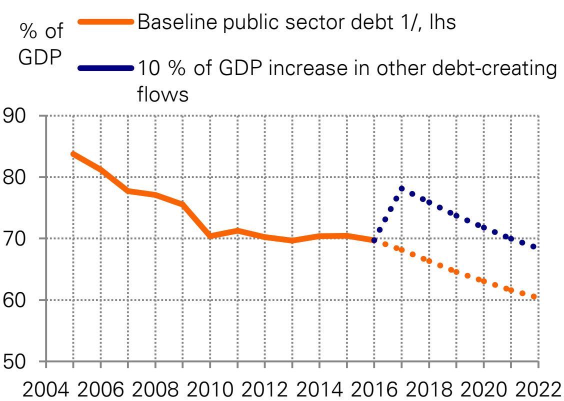


Source: Government of India, Deutsche Bank. 1/ Combined Central and State level debt. Combined shock scenario consists of slowing of real growth (to 6.0%yoy) coupled with a rise in real interest rate and a worsening of the primary balance by ½ standard deviation each

Shock 5: Contingent liability shock

Coinciding with the recent cyclical slowdown in growth, non-performing assets of state owned banks have increased appreciably. Loans related to power sector and aviation sectors have been or are in the process of getting restructured. In this scenario we assume that the government's contingent liabilities would rise suddenly. To account for such a risk, we raise the government's liabilities by 10% of GDP in 2017/18. This results in debt/GDP moderating to 68.4% by FY23 as against the FRBM target of 60% of GDP.

A one-off increase in liabilities would be a set-back for debt reduction



Source: Government of India, Deutsche Bank. 1/ Combined Central and State level debt

Conclusion

Our analysis reveals that high economic growth rate and modest fiscal consolidation could lead to sustained improvement in India's debt/GDP ratio over the medium term. In fact, we think it is possible for India to lower its debt/GDP to 60% of GDP by FY23, even with a consolidated general budget deficit amounting to 6.0% of GDP, provided nominal GDP growth averages about 13% during the forecasting period. In our view, barring some unforeseen shocks, a 13.0% nominal GDP growth assumption is realistic based on 7.5-8.0% real GDP growth and 5-5.5% inflation (in terms of GDP deflator) estimate on an average over the forecasting period. The FRBM committee has assumed 11.5% nominal GDP growth rate, with 4.5% of GDP terminal general budget deficit to arrive at a 60% debt/GDP ratio by FY23. We think nominal GDP growth would surprise to the upside, offsetting the adverse impact of any potential slippage on the fiscal front, thereby allowing the FRBM committee's medium term debt/GDP target to be met.

Results and assumptions

India: Public sector (centre plus state) debt sustainably framework (baseline)

% of GDP	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Baseline projection					
Public sector debt	**69.6**	**70.4**	**70.5**	**69.7**	**68.2**	**66.3**	**64.6**	**63.0**	**61.6**	**60.4**
o/w foreign-currency denominated	3.6	3.2	3.2	3.1	3.0	2.9	2.8	2.7	2.5	2.4
Change in public sector debt	-0.6	0.7	0.1	-0.8	-1.5	-1.8	-1.8	-1.5	-1.4	-1.2
Identified debt-creating flows	-1.6	0.3	0.0	-1.2	-1.8	-1.9	-2.0	-1.8	-1.6	-1.5
Primary deficit	1.8	2.2	1.6	1.6	1.3	1.1	1.2	1.2	1.1	1.1
Revenue and grants	22.3	24.6	24.5	24.6	24.7	24.8	25.0	25.5	25.5	25.5
Primary (noninterest) expenditure	24.2	26.8	26.1	26.2	26.0	25.9	26.2	26.6	26.6	26.6
Automatic debt dynamics	-3.3	-1.7	-1.5	-2.7	-2.9	-2.9	-3.0	-2.8	-2.6	-2.4
Contribution from interest rate/growth differential	-3.7	-1.9	-1.7	-2.6	-3.1	-2.9	-3.0	-2.8	-2.6	-2.4
o/w contribution from real interest rate	0.4	2.5	3.4	1.8	1.6	1.7	1.7	1.8	1.8	1.9
o/w contribution from real GDP growth	-4.1	-4.4	-5.1	-4.4	-4.6	-4.7	-4.7	-4.6	-4.4	-4.3
Contribution from exchange rate depreciation	0.3	0.1	0.2	-0.1	0.1	0.1	0.0	0.0	0.0	0.0
Other identified debt-creating flows	-0.1	-0.2	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1	-0.1
Privatization receipts (negative)	-0.2	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.2	-0.1	-0.1
Key Macroeconomic and Fiscal Assumptions										
Real GDP growth (in percent)	6.6	6.9	7.9	7.0	7.5	7.8	8.0	8.0	8.0	8.0
Average nominal interest rate on public debt (in percent)	7.8	7.6	7.6	7.7	7.9	8.0	8.3	8.5	8.7	8.9
Average nominal interest rate on forex debt (in percent)	5.6	4.9	5.5	5.4	5.4	5.4	5.4	5.4	5.3	5.3
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.1	4.2	5.5	3.2	2.9	3.3	3.3	3.5	3.7	3.9
Exchange rate (local currency per US dollar)	60.1	62.6	66.3	64.9	68.0	69.9	70.5	70.5	70.5	70.5
Nominal appreciation (increase in US dollar value of local currency, in percent)	-9.5	-4.0	-5.6	2.3	-4.6	-2.9	-0.8	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	6.6	3.4	2.1	4.5	5.0	4.8	5.0	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	2.9	18.6	4.8	7.1	6.2	7.1	8.8	9.4	7.4	7.6
Primary deficit	1.8	2.2	1.6	1.6	1.3	1.1	1.2	1.2	1.1	1.1

Source: IMF template, RBI, CEIC, Deutsche Bank

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Asia Strategy

- It's been mostly a good run for Asia macro this year, with tailwinds from a stronger than expected global macro momentum, and the worst of fears around protectionism, trade wars and tariffs having not materialized (particularly with the US-China bilateral relationship showing signs of stabilizing at the Xi-Trump summit). With a Fed hike in June completely priced in; vols across most asset classes near post GFC lows; EM dedicated funds still collecting AUM at a decent clip; and central banks in Asia having dialed down their interjections in the currency markets; it is tempting to argue that the carry drip narrative is the path of least resistance for Asia.
- But is this as good as it gets? Over the summer months, there are three dynamics which we will keep a keen eye on. One, whether data is able to clear what seems like a steeper hurdle on surprises, and particularly as the commodity price correction takes out some of the positive momentum from Asian exports. Two, after having been positive for Asia thus far (i.e., less central bank intervention), whether the trade narrative starts to turn more sour as we get headlines around the US Omnibus report on trade practices. And three, the market response as the narrative on balance sheet unwind by the Fed gets more airtime, including possibly as soon as when the minutes from this month's FOMC are published. A potential shift in the global central bank liquidity function is something emerging markets will find increasingly hard to ignore.
- We favor a portfolio approach to target a combination of these thematics. We remain long the carry theme selectively (via USD/INR puts and 3Y-6Y India bonds) and the broader flows/central bank narrative (short USD/THB). We are also still tactically long MYR exposure through front dated bonds. But we are rotating away from IDR longs (funded in SGD) to outright SGD shorts (RKO USD calls), and stay with steepening exposure to curves in China and Korea. We are also paid Singapore IRS.
- In external markets, fund inflows are at the steering wheel. We are perplexed with the lack of credit differentiation despite weakness in global commodities. With French and Korean presidential elections out of the way, markets will struggle to find material geopolitical risks that can derail the ongoing rally in the near term. All eyes are on the global rates, again. We remain committed to our preference for Mongolia vs. Sri Lanka in frontier markets, recommend a tactical 10/30Y curve flattening in Malaysia and continue advising clients to hedge via China 5Y CDS.

Local Markets

CHINA

- FX: Neutral
- Rates: 2Y/5Y NDIRS steepener, target +50bp

Retain underweight. Bond market sentiment has deteriorated since the start of April, against the backdrop of an improving economic growth outlook, tightening domestic liquidity, duration supply concerns and regulatory crackdown over financial over-leveraging. With G3 central banks maintaining their policy bias and uncertainties around US fiscal policy and geopolitical risks, we expect the PBoC should retain its current policy stance this month. Domestically – given 1) the ongoing tightening of regulatory requirements over financial leveraging, 2) the recent weakening in capital market investment sentiment, and 3) the May manufacturing PMI indicating somewhat softening domestic demand – we expect the PBoC to stabilize domestic liquidity conditions rather than impose additional tightening, in order to prevent disorderly deleveraging by financial institutions. As such, we expect the benchmark 7D repo rate to gravitate towards the 2.45-2.7% range but funding demand by non-bank financial institutions may keep the MM 7D repo fixing rate average at around 3-3.5% in May. Public and private financing activities should gather momentum during Q2-Q3, and we estimate at least RMB2tr worth of new issuance during the next two months. Considering the risk of domestic liquidity to tighten ahead of the MPA by the end of June, we believe it is important for financing activities to renormalize in the coming three to five weeks. We believe the 10Y CGB yield at 3.58% has more than priced in our growth outlook and duration supply outlook. The market fear of deleveraging by financial institutions has caused the yield curve risk premium to go up recently. We gauge the impact of regulatory tightening on the 10Y CGB yield by making reference to the 2013 financial deleveraging and conclude that financial deleveraging can cause bond yields to significantly overshoot and that we are approaching the peak of the latest round of market correction. Bond deleveraging poses an upside risk to bond yields in the next two months. We see the risk of the 10Y CGB yield overshooting towards 3.6%-3.7% before the end of H1, at which level we expect the demand for relatively safer bond assets (CGBs, policy bank bonds) to consolidate. For the IRS/NDIRS market, funding uncertainties, hedging demand for bonds and market conditions can cause 5Y IRS/NDIRS rates to drift further and we will watch out for tactical trading opportunities. The corporate credit market is most exposed to bond deleveraging and credit default events; we expect further widening in corporate credit spreads. We expect the pace of net interbank CD market issuance to slow as a result of unwinding bond market leverage by commercial banks. We retain our modest underweight on RMB bonds.

INDIA

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

Stay long INR assets. We see little reason to scale back our constructive view on INR assets, though as before, we are targeting more carry and currency gains, rather than compression in yields. We have been arguing for a structural break in the currency on the back of better flow support from FDI and equity allocations, and what we read as a shift in official management of the rupee. And while USDINR failed to break 64 on the downside towards end of last month – interrupted arguably by a broader risk off trend in markets - we think the risk reward still favors staying long the currency through USD puts. It seems to us that the authorities have reconsidered their view on valuation of the rupee, and are keener on using a stronger currency to help keep a lid on inflation. Liquidity management is likely a significant consideration as well. India's forward book, for example, rose by a startling $8bn in March, double the size of the increase in its spot book during the month, and the largest increase since May/June 2014. Interestingly, both periods featured foreign inflow rushes spurred by positive election surprises – in 2014, BJP performed strongly in General Elections, and this year in Uttar Pradesh State Elections. The fact that RBI sterilized a majority of its intervention (2/3rds) during the month via forwards is likely a reflection of its concern on the liquidity front about having already lent out more than half of its portfolio of bonds via reverse repos (hence also the debate on introducing a special deposit facility). Foreign inflows into bonds remain robust, though equities have disappointed. Lower commodity prices is positive for India macro. And INR should in general be low beta to risk aversion. To be sure, there isn't a particular catalyst for significant spread compression on rates, though a new 10Y benchmark bond should help with some adjustment on the curve. Liquidity remains ample, and sticky on the downside. We are not too keen on the technicals, so happy to stay with the belly of the curve, rather than extend on duration.

INDONESIA

- FX: Neutral

As good as it gets? The only thing that has dropped quicker than implied vol on IDR this year is its realized vol. The currency has effectively been in a 150-rupiah range for all but a handful of days this year. Exports are growing at their fastest quarterly pace in the last 12 quarters; inflation has bottomed out, but proving sticky around the 4-handle; $8bn+ has come into local equity and debt markets since end of last year; and reserves (including the forward book) are up $10bn+ year to date. On the face of it, there is little immediately to fault the story, except to wonder if the best is already in the price. Our trip to Jakarta earlier this week left us comfortable that the central bank stands guard against signs of economic and financial imbalances. The key challenge for authorities – and we found them again appreciative of the same – will be as/if capital flows are at risk of reversing when the Fed balance sheet normalization narrative is more on the radar for markets. In preserving value at the expense of lagging other regional peers, and in building reserve buffers, BI is effectively preparing itself for when there is more stress from global factors. That said, and given the risk that the current commodity driven risk off broadens out into a more sustained pressure on EMFX, and with the decision to convict the Jakarta Governor likely to make investors wary of political risks; we are for now rotating away from the SGD/IDR cross to outright shorts on SGD.

MALAYSIA

- FX: Tactically long MYR through front-end bonds (MGS Sept-18)
- Rates: Market weight on duration.

Cautious catch-up. After lagging Asian FX gains since the US election and regulatory changes, the MYR began to catch towards the end of last month. After a five month streak of outflows, in which $14bn left fixed-income markets, Malaysia received its first inflow in April with $1.6bn coming back into bonds. As we had argued earlier, the worst of the outflow pressure is likely behind us with speculative positioning much cleaner and large bond redemptions in the past us for now. The recent liberalization of dynamic hedging regulations was a step in the right direction which may have given confidence to offshore fund managers. From here on, 100% of AUMs can be dynamically hedged – up from 25% earlier - with any onshore forward hedges free to be cancelled, unwound and re-entered without showing documentation, after a one-time registration. There are also some welcome indications in the March data of an improvement in spot liquidity, although exporter conversion rules do not appear to have made a meaningful difference to *net* USD supply. The currency is still undervalued – and the cheapest in the region on an average of DB models. We think BNM may welcome a slightly stronger currency to encourage a reversion towards fair value, manage inflation and indicate confidence. The above suggests a case for being long the MYR; there are however a number of risks which caution us from being overly positive. The BNM has drawn down its reserves dramatically, particularly through widening out their short forward book to –$17.7bn. Net reserves coverage has thus weakened to just about 5.5x monthly imports. BNM is likely to want to rebuild reserves should there be a return in flows. The renewed weakness in commodities is a risk, with Malaysia the only oil exporter in the region. There are also signs that Malaysia may call early elections later this year, which could introduce fresh risk premium in the run-up to the event. We are keeping a tactical long exposure to the currency via front-end MGS bonds, with scope for USD/MYR to move to 4.20, but this is unlikely to be a de ja vu rally from last year when the currency gained down to 3.85.

PHILIPPINES

- FX: Moderately bearish
- Rates: Modest underweight

Curve to likely steepen further. Philippines remain one of the worst performing markets (on a total return basis) in the entire EM space this year. However, the progress on tax reform package, and the recent market friendly appointment of new BSP governor should help stabilise the sentiment in the near term. On the latter, the current BSP deputy governor Nestor Espenilla has been named as the successor to the outgoing Governor Tetangco, whose term is set to end this July. Appointment of Espenilla, a veteran with more than three decades at the BSP, should mean continuation of the policies and removes one of the uncertainties from markets perspective. Having said that, we see no reason to change our cautious bias, as domestic factors still continue to argue for higher term premium in the Phili rates market. For a start, inflationary pressures are most evident in the Philippines. After having settled below the 2.50% policy handle for two years in a row, Inflation has now moved past the 3% handle (latest headline CPI @ 3.4%, and core CPI @ 3%). And we expect inflation to stay elevated (around 3.5%+ levels) over the next couple of months, on account of the pass-through from recent peso weakness, coupled with the impact from upcoming tax reforms package. The fiscal deficit is set to rise under new administration after years of consolidation with rising focus on infrastructure spending. Funding needs, and to that extent the bond supply, should thus be somewhat higher than in the past. Supply technicals in the current quarter are not very supportive either, as bulk of the issuance is concentrated on the longer-dated bonds (7Y/10Y and 20Y RPGBs) as opposed to front-end papers in Q1-17 (3-5Y sector), adding more DVo1 supply to the street. Indeed, the recent auction turn-out has been weaker and most of the market interest is seen in the short-dated papers instead. Lastly, the ongoing current account balance erosion on back of a widening trade deficit is expected to remain a drag on the peso over the medium term. Against this backdrop, we stay cautious on duration and expect the curve to steepen further.

SINGAPORE

- FX: Buy USDSGD 1.42/1.4550 RKO calls
- Rates: Pay 5Y IRS, target: 2.30%

Buy USD/SGD topside options. SGD has been one of the poorest Asian FX performer in recent days . This has reflected both weakness in SGD NEER, and beta to USD strength, particularly against the JPY. We had anticipated SGD NEER weakness after the more dovish MAS meeting last month, in which they did not upgrade growth forecasts or signal scope for future tightening. With SGD NEER falling back below the midband now, the best of the policy leg of the move is likely done. However, SGD shorts continue to have appeal as a cheap proxy for a more a generalized bounce in the USD, and with seasonals suggesting we are less than halfway through an average USD/SGD May move. USD/SGD has had a very tight correlation to USD/JPY over the past year. This makes sense given a significant weight of the JPY in the SGD NEER basket (nearly 10% in the DB proxy), and similar risk characteristics (safe-haven status, correlation to US rates). With USD/JPY breaking to the topside - moving above 100dma and trend-line resistance in recent days – there could scope for a further move higher. USD/SGD will also act as a proxy to any short-term correction higher in USD/Asia after a significant run of weakness and inflows. The positive carry (roughly 50bps) to a long USD/SGD position makes it an attractive choice as a regional hedge. We like to express USD/SGD topside views in the option space. This also protects against the chance of a reversal lower in USD/JPY should risk sentiment sour as the USD gathers steam. The absolute vol base is very low with SGD vols the second cheapest in the region after CNY/CNH. 3M vol is on a 4 handle which is about half the vol base of USD/JPY, which has itself come off a lot. While low vol levels make vanillas attractive, we prefer to look at higher delta calls cheapened through selling lower delta strikes or barriers. The risk reversal in USD/SGD has bounced more than the ATMs in recent days, with the riskie/ATM ratio near one-year highs, which makes selling some topside attractive. A vanilla 1.42 USD/SGD call costs about 67bps (indicative). But combining this with an RKO at 1.4550 (above cycle highs) would cheapen it to 20bp for a potential 10x upside.

SOUTH KOREA

- FX: Long 3M 1x2 USD/KRW 1130/1100 put spread
- Rates: 2Y/10Y IRS steepener, target +60bp.

End to political uncertainty. The presidential election on 9 May, which resulted from the impeachment of former president Park Geun Hye, concluded with a complete turn of events in the politic landscape in Korea. Mr. Moon Jae In of the Democratic Party (a former opposition party) won the election with an approval rate of 41.1% vs. runner-up Hong Jun Pyo of the Liberty Korea Party with 24%. The progressive Democratic Party re-takes power within nine years after two conservative governments. This implies that Korean policies will likely be more biased towards the left from now on. In particular, acute scepticism over a trickle-down impact will likely translate into greater emphasis on income distribution and chaebol reform in economic policies. In this context, the new government will set the tone for general fiscal and FX policies as well, although such nuance is not available in the policy proposal yet. President Moon has taken office and should reshuffle the cabinet as soon as possible. We see no reason to change our view that the curves will steepen. We maintain 2Y/10Y steepeners with a target of +60bp. Despite President-elect Moon's decent approval rate of 41%, the sum of the second runner-up (Mr. Hong Jun Pyo) at 24% and the third runner-up (Mr. An Cheol Soo) at 21.4% is larger. This implies their cooperation is imperative for the President to promote his own policies, although Mr. Hong and Mr. An have been quite critical to his policies especially on issues of national security (THAAD) as well as funding method of his welfare and job boosting policies. Moving to economic policies, the highlights of his economic policy appear to be 1) creating 810K jobs (174K of public officers, 340K of public company workers, 300K of indirect employee in public sector) in his term; 2) limiting aggregate household debt with DSR (Debt to Service Ratio); and 3) economic democratization (i.e., Chaebol reform). Meanwhile, the new President has been known for his bias towards engagement with North Korea and also known to put more importance on the relationship with China. While he has reiterated the importance of Korea/the US alliance, his action on the already installed THAAD system will likely crystallize the foreign policy stance of the new government. This well expected event will likely reinforce risk on sentiment in the market, putting upward pressure with a steepening bias in the curves. The market will keep assessing the implications of the President Moon's economic policy, which looks more fiscal expenditure at this juncture.

TAIWAN

- FX: Moderately Bullish
- Rates: Neutral on duration

Slow but steady grind lower in USD/TWD. TWD continues to perform well - not just relative to its Asian peers, but also versus its EM peers. YTD, TWD has appreciated about 6.5% against the USD. And while the currency is looking expensive – and particularly viewed from the perspective of the REER band which we believe has historically informed the central bank's thought process on the same – there still remain arguments for this strength to persist. One, the central bank seems relatively tolerant of this strength in the currency, possibly due to sensitivity around the region to the mixed messages from the US administration on potentially labelling some of its trading partners as currency manipulators or penalise them for managing their currency too actively. Two, according to the 4Q financial reports of various Taiwanese Lifers, hedging activity has picked up again from 78% to 80% despite TWD deprecating in 4Q. With TWD likely to breach below 30 in the coming months, it is likely Lifers will increases their hedging ratio further especially given the recent depletion of their FX volatility reserves, and hence their cushion on absorbing further currency losses on their portfolios. With FX reserves declining, it is likely that we will see not only Lifers increasing their hedging to reduce any FX losses on their balance sheets, but also possibly a slowdown in their overseas investments to limit the losses. This would put further appreciation pressure on TWD, and depress the DF and NDF points. Third, equity inflows to Taiwan remain strong, particularly into the electronics sector given that the tech cycle continues to pick up steam, and has raised expectations of higher dividend payments given the strong earnings. With the S&P IT index continuing to rally, the TWSE still relatively cheap and electronics orders on the rise, this will also increase incentives for inflows to the Taiwan equity market, putting pressure on TWD to appreciate. Finally, the strong earnings growth in Taiwan has also resulted in a build-up of USD holdings by Taiwanese corporates. Given that TWD appreciation is likely to persist, companies are likely to sell USD/TWD on any rally, which will not only cap spot topside, but also possibly add to TWD appreciation pressures if combined with strong equity inflows.

THAILAND

- FX: Short USD/THB, target 33
- Rates: Long 10Y ThaiGB vs. 10Y IRS, target par

Swap spread wideners offer a god risk-reward. We see Thailand mostly as a good defensive long, given large underweights from the offshore community, and that the local bid remains fairly strong. We note that the swap spreads have tightened a lot. For instance, 10Y swap spread (10Y IRS vs 10y ThaiGB) is now hovering around -20bp – i.e. near the lower side of its multi-year range (-25 to +50bp). The tightening of the swap spreads has been largely driven by the underperformance of the cash bonds, especially as the local demand shifted away from govt. bonds towards corporate bonds for yield pick-up. For instance, the 10Y ThaiGB vs. UST spread widened to +40bp from -25bp a year ago. Whereas, the 10Y THB IRS vs. US IRS spread is hovering near multi-year lows. We understand the outperformance of THB IRS was also in part driven by some receiving flows from onshore corporates. Our meetings with local players last week left us with the impression that while most expect a gradual slippage in yields towards 3% (on 10Y ThaiGB), there will likely be much better support to the markets at those levels. Supply technicals are not particularly prohibitive here. With last week's 10Y auction behind us, next supply in this sector will hit the market only towards June-end, and there won't be any ThaiGB supply at all in the last two weeks of this month. Meanwhile, IRS market remains mostly a Beta play to the US, with BoT expected to remain on hold for the foreseeable future. With 10Y UST again finding a decent support at 2.30, and more importantly the speculative short positions having been largely unwound, the risk-reward favors playing from the short side here, we feel. Against this backdrop, we recommend scaling into swap spread wideners - paying 10Y IRS vs. 10Y ThaiGBs – targeting a move in the spread to flat.

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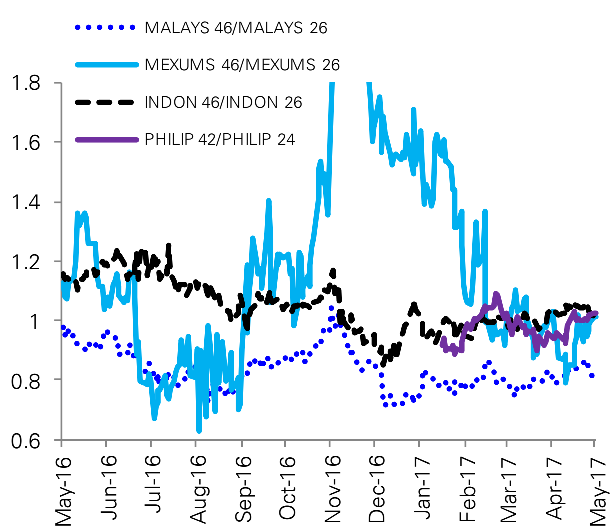
Credit

MALAYSIA: stay neutral, recommend a tactical curve steepener

Malaysia's CDS and bond spreads have been very resilient lately, despite continued weakness in commodity complex, especially oil. The spreads have also shrugged off 1MDB-related headlines that resurfaced in the past couple of weeks. 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.

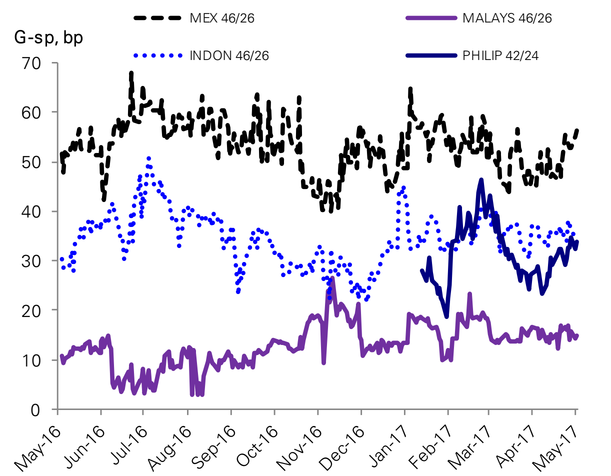
Malaysia 10/30Y yield curve flattened the most, %



Source: Deutsche Bank, Bloomberg Finance LP

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).

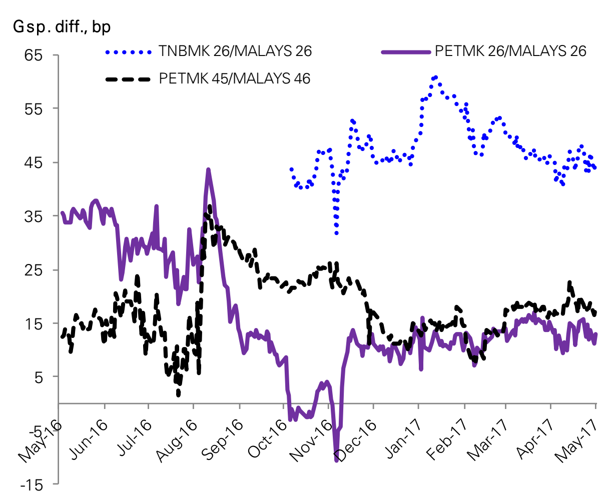
10/30Y spread differentials: MALAYS curve keeps flattening



Source: Deutsche Bank, Bloomberg Finance LP

We believe it makes sense to tactically sell MALAYS 46s (100/108bp bid price, Gspr) vs. buying MALAYS 26s (99.7/90bp 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 spread differential now being 20bp lesser vs. mid-Mar-17 (currently ~10bp and ~60bp respectively).

MALAYS long-end bonds outperformed quasis more than in the belly



Source: Deutsche Bank

Key risks: worse than expected economic growth, aggressive new bonds supply, plunge in oil prices, spike in currency volatility, political instability

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EMEA Strategy

EMEA FX: Over the past few weeks, US rates have moved higher while commodities prices (and thus inflation breakevens) have declined. This is a negative combination for EM FX, particularly as it means US real rates have drifted higher. Indeed, EM FX has depreciated over this period, given its sensitivity to real rates. However, it is not clear whether this negative dynamic will continue. Commodities prices have stabilized at the bottom of the range, rather than broken it convincingly, while real rates still remain well below the levels observed in March and December. Additionally, global growth remains robust and volatility is suppressed, both of which are positive for EM FX. Therefore, the asset class is facing significant crosswinds, with the near-term outlook not as clear as it was a few months ago. As a result of this, we turn more cautious and selective on EM FX, though not outright bearish. In EMEA, we rotate away from the commodity currencies we have liked in the past (RUB, ZAR) towards manufacturing currencies (TRY, ILS). We recommend: long TRYZAR, long 3m USDTRY digital puts, short USDILS and short EURCZK.

EMEA Fixed Income: In Hungary keep 2Y HUF payers vs PLN and position into 5Y payers vs long-end bonds. Following the recent rally in bonds, we are turning more cautious on any outright position and expect similar to Poland some retracement. Nevertheless, we still see 10Y bonds as outperforming Bunds as well as US-treasuries over the course of the year. In Turkey keep 1Y XCCY receivers but turn more cautions on long-end bonds. In Russia keep short-duration trades in OFZs and receive 1Y IRS (vs Mosprime). In South Africa expect 10Y South African bonds to range trade (8.65%-8.95%) over the next few weeks. ASW-spreads remain too wide, however, lack of trigger for tightening in the near-term. Enter short-end payers to position against interest rate cuts. In Israel remain positioned for a delayed monetary policy response and an only very gradual inflation turnaround by being long 2Y fwd 1y rates or 5Y5Y IRS vs USD. On the curve position into long-end bonds (best Oct-26) vs 2Y IRS. In Czech switch from 9x12 FRA – 1Y1Y steepeners into 6x9 FRA payers given not enough hikes priced. In Romania move from “underweight” to “tactically long” on valuation and favour Jun-21 or Feb-21.

EMEA Credit: We stay underweight on South Africa and position for further underperformance vs. Turkey, for which we stay neutral. We also retain marketweight on Russia – it will still likely return to investment grade on improving fundamentals even without sanction relief, but valuation is still very tight. We stay neutral on Ukraine, which has strongly recovered over the past month and its valuation cushion reduced against various risks. We retain a neutral position on Hungary. In relative value, we maintain Turkey 26s vs. South Africa 26Ns, long South Africa 24s vs. 5Y CDS, but take profit in short 10Y CDS vs. 43s in Russia.

EMEA FX: Turning more cautious

Trades: long TRYZAR, long 3m USDTRY digital puts, short USDILS and short EURCZK.

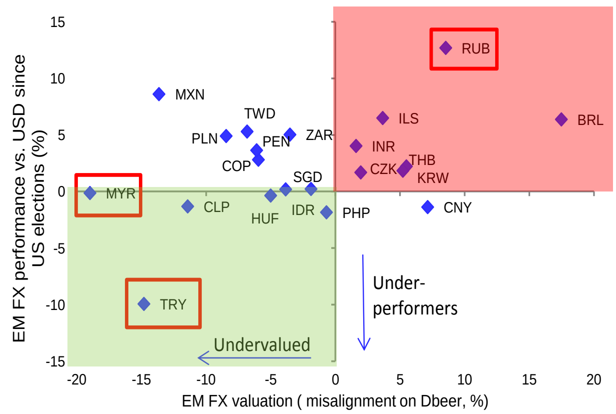
We identify the four dimensions of vulnerability that are most pressing currently, in our view: 1) Fundamental valuations; 2) scope for unwind of recent outperformance or ‘catch up’ of recent underperformance; 3) exposure to an increase in US real rates; 4) exposure to a decline in commodity prices. The first two are ‘internal’ sources of vulnerability and the last two are ‘external’ sources of vulnerability. We then overlay the exposure to these broad risk factors with idiosyncratic drivers to compile a list of EM currencies that are attractive and those that we are particularly concerned about. When the external environment is mixed and uncertain (yet not outright negative), relative value concepts and trades take on more importance – thus, differentiating ‘attractive’ and ‘vulnerable’ EM currencies is especially relevant at present, and the differentiation can be used to identify attractive RV trades, even as we wait for clarity on the direction of EM FX more broadly.

We capture the first two above-mentioned dimensions of vulnerability in the first chart below, which shows EM FX valuation on our preferred fundamental model (DBeer) and also the performance since the post-US election lows in EM FX. We find that TRY and MYR are relatively insulated on these metrics (undervalued and have underperformed the broader EM FX complex), while RUB is vulnerable (overvalued and have outperformed).

The last two dimensions of vulnerability – exposure to US real rates and commodity prices – are captured in the second chart below. BRL, ZAR, RUB and COP are the most exposed, as they have a high beta to US rates and to commodity prices. MXN and CLP meanwhile are moderately exposed. At the other end of the spectrum, most Asian currencies have limited exposure, while within EMEA ILS and CZK are insulated.

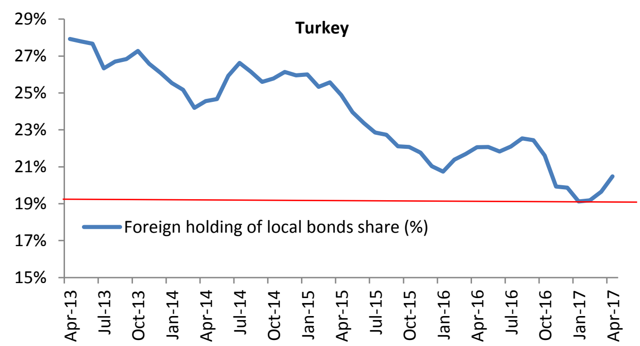
We use the vulnerability analysis above – along with idiosyncratic factors – to construct our ‘attractive’ and ‘vulnerable’ EM baskets, as detailed below.

EM currencies that have lagged the EM FX rally and are cheap are attractive longs (TRY, MYR); caution is warranted on the likes of RUB, which is expensive and has already rallied significantly



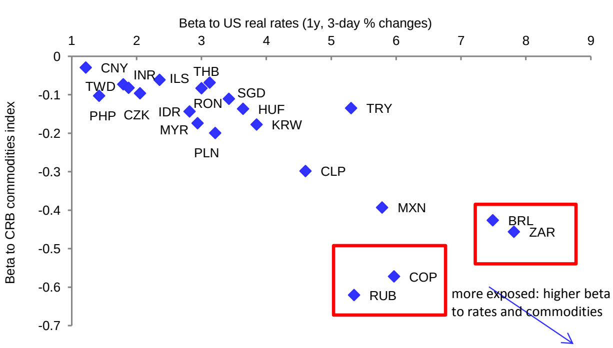
Source: Deutsche Bank, Bloomberg Finance LP

Despite recent bond inflows, foreign ownership share of local currency bonds remains near the recent lows, highlighting light positioning



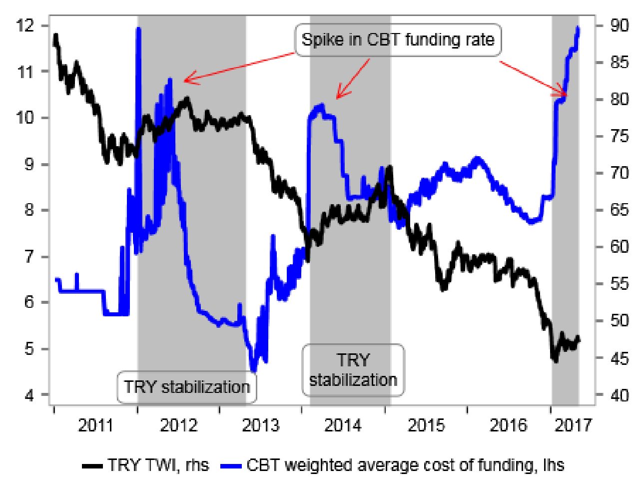
Source: Deutsche Bank, Bloomberg Finance LP

Exposure to the key external risks – rising US real rates and further commodity price declines; BRL, ZAR, RUB and COP are the most exposed



Source: Deutsche Bank, Bloomberg Finance LP

Monetary conditions are very tight, as highlighted by the spike in the CBT average funding rate

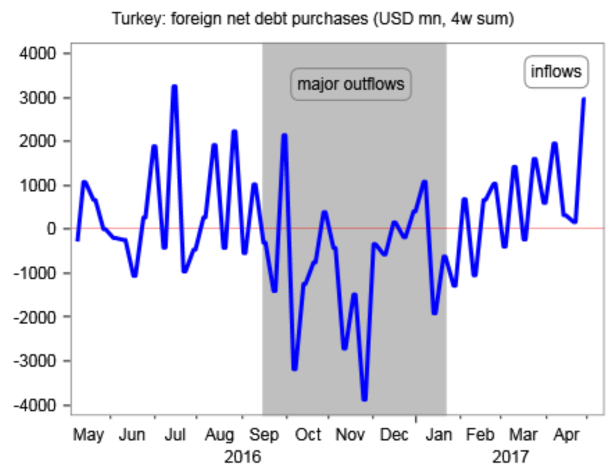


Source: Deutsche Bank, Macrobond

'Attractive' EM currencies

1) TRY is one of the least exposed currencies on the 'internal' risk metrics – valuation and recent performance. It is the second cheapest currency in EM versus fundamentals, and has also underperformed the rest of the EM FX complex since the US elections. In addition, positioning is still net short in FX and light in bonds. Meanwhile, monetary conditions are at all time tight levels, portfolio inflows have picked up and vol-adjusted carry is one of the highest in EM. TRY has little exposure to commodity prices, and while there is some exposure to US rates, it is much less so than for other high yielders like ZAR and BRL, and light positioning/cheap valuation could provide some insulation.

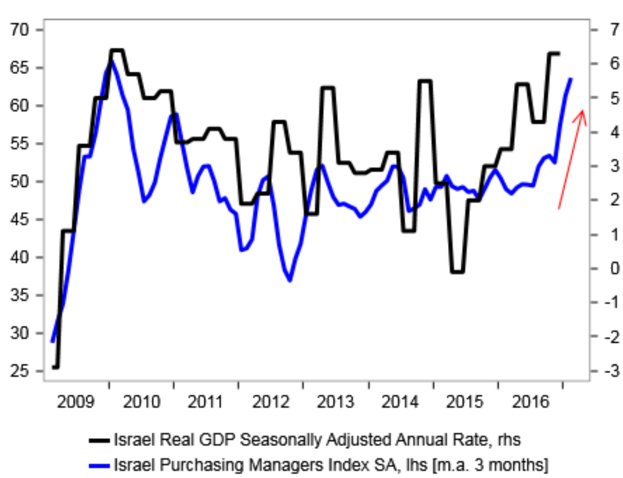
Weekly portfolio flow data for Turkey show that debt outflows have turned into inflows



Source: Deutsche Bank. Macrobond

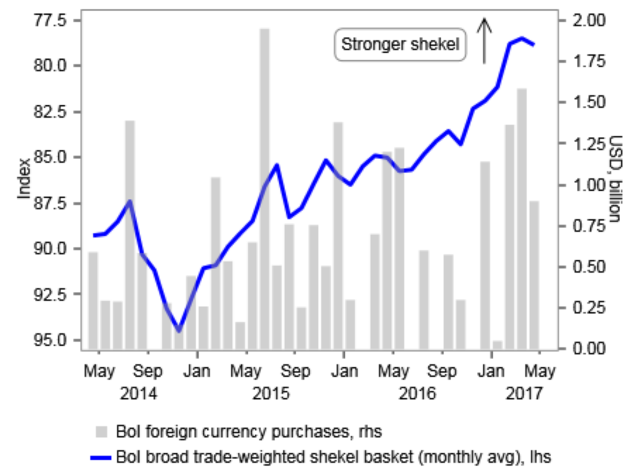
2) ILS is a relative safe haven in EM, as reflected in its low beta to both US rates and commodities prices. Additionally, activity data are robust, the BoI are likely to be less sensitive to FX strength due to the rebound in exports and inflation, the current account surplus is sizable at 4% of GDP, ILS is still not significantly overvalued, and positioning is relatively clean.

Israel - Real GDP growth and high frequency data (PMI) are both now robust



Source: Deutsche Bank, Macrobond

Recent BoI intervention has not been large enough to prevent shekel appreciation



Source: Deutsche Bank, Macrobond

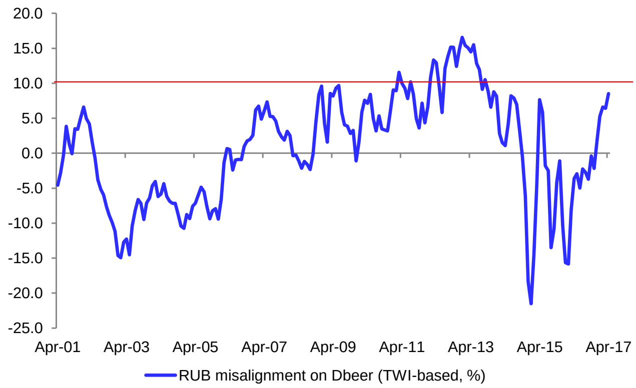
3) CZK: Like ILS, CZK is another quasi-safe haven in the region, and has very limited exposure to both US rates and commodities prices. The lack of a sustained CZK rally post floor removal is not surprising – long CZK positioning was always a concern, but we have seen that lighten up over the past few weeks (especially during the recent spikes in EURCZK towards 27). The fact that EURCZK did not spike after the floor removal (a real concern for many investors) was in itself a good sign. In our view, positioning is now lighter and selling interest in EURCZK emerges when it moves towards 27, thus limiting upside potential in the pair. Meanwhile, the macro story is very positive (strong growth and rising inflation), current account is in surplus, and the currency is undervalued on PPP.[9] We expect a grind lower in EURCZK over the coming months and expect the pair to settle in the 25.5-26 range (around PPP fair value).

'Vulnerable' EM currencies

1) RUB appears exposed on both the 'internal' and 'external' dimensions. RUB has been the best performer since the US elections, while it is nearing the 10% overvalued level which has been difficult to break in the past. RUB also has the highest beta to commodities and a relatively high beta to US rates. Further, positioning is still long and valuations vs. oil are unattractive (though it is worth noting that RUB has been overvalued vs. oil for the past 2 months without a significant correction).

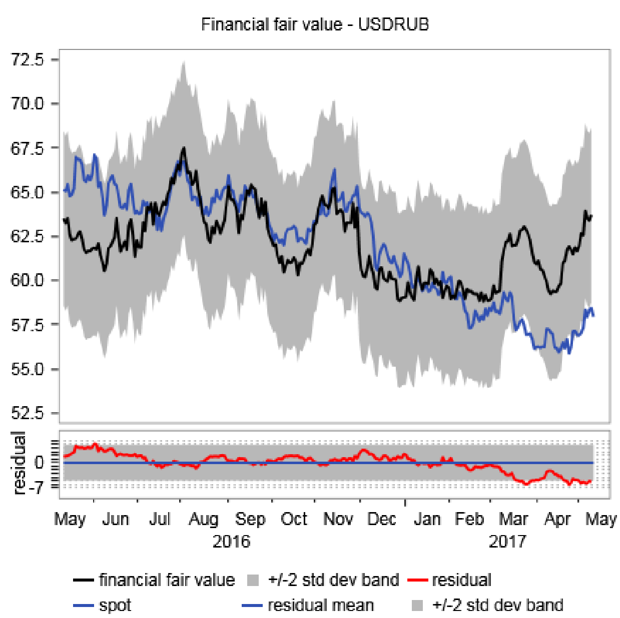
[9] While DBeer is normally our preferred valuation metric for EM currencies, it is more appropriate to analyze CZK valuation using PPP. This is because a regression-based approach like DBeer is less meaningful for analyzing pegged/floored currencies (as CZK was between 2013 and 2017).

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



Source: Deutsche Bank

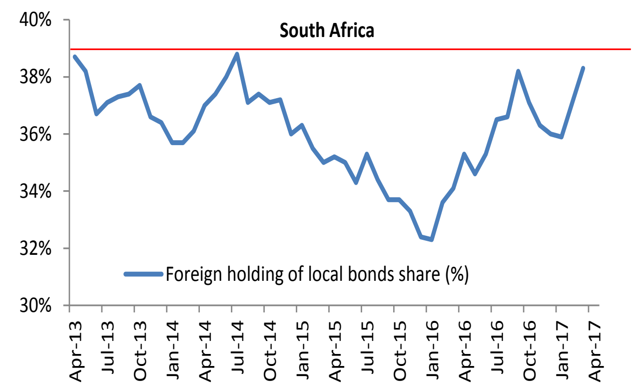
RUB is overvalued vs. oil on a simple regression of USDRUB on crude (12m, daily data); but caution is warranted on this result – RUB has been overvalued vs. oil for the past 2 months



Source: Deutsche Bank, Macrobond

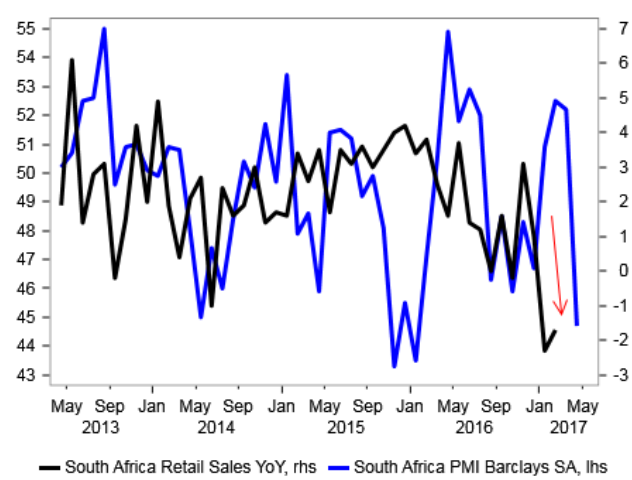
2) ZAR is also exposed, primarily on the external metrics. It has the highest beta in EM to US real rates, and has a high beta to commodities as well. Within the commodities, iron ore is an important export for South Africa, but is also one of the few commodities on which the outlook is bearish (according to DB Commodities); further, iron ore is also the commodity at most risk from any slowdown in China, given China's high share of global demand for iron ore. This adds another dimension of exposure. Lastly, near-term political risks have spiked post the cabinet reshuffle, which has also adversely affected business confidence and the investment climate, re-igniting recessionary risks. This is reflected by the latest PMI print, which recorded a sharp decline from 52 to 45 (thus back in contractionary territory for the first time this year); however, foreign holdings of South African bonds remains elevated despite the increased risks.

Foreign ownership of South African bonds is near 4y highs despite the recent spike in political risk



Source: Deutsche Bank, Bloomberg Finance LP

South Africa-PMIs have re-entered contractionary territory, while retail sales growth remains weak



Source: Deutsche Bank, Macrobond

The above buckets highlights a rotation away from commodity currencies we liked in the past (e.g. RUB, ZAR) towards manufacturing (non-commodity) currencies like TRY, INR and ILS. This is due to increased commodity price risks and also because the commodity currencies have already rallied significantly and therefore have less attractive valuations.

One RV trade that stands out is long TRYZAR – the move lower in the pair over the past few days also provides an attractive entry point. Go long TRYZAR, target 3.90, stop 3.69.

EMEA Fixed Income – consolidation but still selective value

Russia: In OFZs switch from Dec-19 into May-19 due to better valuation (current: 8.31%, target: 7.50%, stop: 8.55%). On the local curve keep 1Y IRS (vs Mosprime) receivers (entrance: 9.65%, current: 9.31%, target: 8.75%, stop: 9.80%). Dissuade from short-end receivers on the cross currency curve due to the high negative carry.

Rationale: Despite rich(er) valuation and more crowded positioning we continue to see value in Russian fixed income; inflation continues to come in on the lower end of the forecast range and is now close to target, domestic demand is not picking up quickly enough to create additional domestic price pressure, the currency remains well supported given low sensitivity to external market drivers (US treasuries and the Fed hiking cycle) and last but not least the CBR will continue to (gradually) ease over the next few months further supporting fixed income. The recent weakness in price action was mainly due to the sharp decline in oil, the profit taking post the more aggressive rate cuts and the overall somewhat more cautious view on EM fixed income following the strong rally YTD. However, we don't expect weak price action to continue and recommend adding rather than reducing risk at current valuation. On the curve we favour short-end bonds due to the low term-premia. On swaps we dissuade from outright short-end receivers in cross currency swaps given the high negative carry, however, we still like 1Y IRS (vs Mosprime) given noticeably less cuts priced than in XCCY. Please see for more details on our trades: (EMEA Rates – Russia: CBR to stay the course)

Turkey: Keep 1Y XCCY receivers (entrance: 11.80%, current: 11.60%, target: 11.25%, stop: 11.90%). Turn more cautious on bonds and only re-enter the long-end when trading above 10.70% (compound yield).

Rationale: We turn more cautious on Turkish fixed income given in our view rich valuation due to a) low term-premia, b) elevated near-term inflation pressure, c) low long-end B/Es – in particular compared to near-term inflation expectations, and d) limited near-term support by looser liquidity conditions. While we still like short-end cross currency receivers we see limited room for 1Y XCCY to go below 11.50% as long as average CBR funding is close to 11.95%. Given our view of inflation in double digits until at least the summer we expect tight liquidity to prevent a sharp rally in the near-term but see room for this trade to work over the summer. Please see here for more details: EMEA Rates – A cautious view on Turkish Fixed Income)

South Africa: Expect 10Y South African bonds to range trade (8.65%-8.95%) over the next few weeks. ASW-spreads remain too wide, however, lack of trigger for tightening in the near-term. Enter short-end payers to position against interest rate cuts best expressed via 12x15 FRAs (current: 7.10%, target: 7.30%, stop: 6.95%) or 1Y1Y IRS payers (current: 7.14%, target: 7.40%, stop: 6.90%). Rationale: Although the peak of the political turmoil is most likely behind us and the risk of a downgrade for local debt to junk by Moody's not our base case scenario we are more cautious on South African fixed income at current levels. We expect local assets to remain sensitive to domestic headline news and the currency highly exposed to external shocks such as a repricing in US real rates or a more aggressive Fed hiking cycle than currently priced. We see valuation in 10Y bonds as attractive when trading above 9.0% in particular in light of the supportive inflation outlook, the (as yet) still supportive supply/demand dynamics, a credible central bank and very high term premia priced into the curve. However, we are missing the trigger for bonds to move below 8.60% given the still increased political uncertainty. In addition recent macro data have disappointed to the downside which put the expected GDP improvements for 2017 at risk. The latter would weigh on revenues and increase the already stretched budget adding additional risk-premia onto the local bond curve. In the short-end we see valuation attractive to enter payers. The market is now pricing 30bp of cuts by year-end which we still find difficult to be realized given various domestic and external uncertainties.

Israel: Position for a delayed monetary policy response and only a very gradual inflation turnaround by being long 2Y fwd 1y rate outright with 10bp of 3m roll (current: 90bp, target: 75b, stop: 110bp) and by receiving 5Y5Y IRS vs USD (entrance: -50bp, current: -42bp, target: -25bp, new stop: -60bp). On the curve position into long-end bonds (best Oct-26) vs 2Y IRS (entrance: 190bp, current: 170bp, target: 140bp, new stop: 200bp) benefitting from further reduction in risk-premia and possible additional foreign inflows.

Rationale: Activity data remain strong and the growth outlook favourable. However, the exporters continue to feel the strong shekel despite some weakness over the last couple weeks. Overall, the strong shekel is further slowing the inflation turnaround which is already only very gradual and noticeably more subdued compared to CEE. Hence, we believe the BoI has no need to change its current monetary policy stance and it is (desperately) waiting for further rate normalization by the Fed to reduce the pressure on the shekel. Although the market is already pricing a very gradual hiking cycle with rates at 20bp by end-17 and 0.50% by end-18 the current inflation dynamics could in fact cause the BoI to remain on hold until well into 2018 before tightening gradually. Hence, given the attractive roll we still like short-end forward starting IRS receivers. In addition the curve remains next to Romania and Hungary the steepest in the world and we expect a further reduction in risk-premia in particular driven by possible further foreign inflows given that Israel remains one of the countries with the lowest share of foreign holdings across EM.

Hungary**:** Keep 2Y HUF payers vs PLN (entrance: 1.38%, current: 1.38%, target: 1.00%, new stop: 1.50%). On the curve keep flatteners best expressed by paying 5Y IRS against HGB 25Bs (current: 159bp, entrance: 179bp, new target, 115bp, new stop: 180bp). For 10Y bonds we now target 3.50% (before 3.60%) by year-end (constant maturity) which implies a selloff by 40bp compared to current levels, and a similar selloff than expected for Bunds and US-treasuries (DB forecast).

EMEA Fixed Income –"Out of the box" trades for May

Russia: Enter a 1Y-3Y-7Y butterflies in XCCY swaps being long the belly (current: -29bp, target: -40bp, stop: 0bp). This trade provides 27bp of positive 3m carry/roll and very low volatility.

Rationale:

1) Gradual easing cycle will only lead to gradual curve normalization. In April the CBR somewhat surprised markets by cutting rates by 50bp while 25bp were widely expected. This was not fully priced, nevertheless, the CBR response can easily be justified looking at the favorable inflation provide, the high real rates, the strong currency and the as late somewhat more dovish central bank comments. We have little doubt that the easing cycle is over or will be delayed, however, we expect the next phase of the easing cycle to be more gradual most likely with 25bp cuts at each meeting (base case scenario) or 50bp of cuts at every 2nd meeting reaching 8.00% by year-end (-125bp). While this will gradually lead to a re-inversion of the very short-end of the curve (1Y-3Y), the fact that the market is already well pricing this into the curve does not justify entering trades with heavy negative carry. Hence we see limited room for short-end steepeners to make up for the negative carry/roll of 70bp associated with trades in 1Y XCCY. In addition the fact that the next meeting is still five weeks away (DB expects 25bp cuts) further limits any near-term rally in short-end rates and favours bullish trades benefitting from high carry and low vol.

2) Low term-premia: Term-premia on Russian curves once again declined in recent weeks. In fact, it is next to Colombia and Chile the lowest in EM. More importantly for our trade recommendation is the fact that it is significantly lower in XCCY than it is in local bonds (lowest level in four years). Hence we expect a gradual increase in term-premia which should lead to a steepening of the curve.

3) Attractive steady-state return characteristics: Over the last few months we have many times highlighted the fact that everything is aligned for rate cuts which favours a bullish view on Russian fixed income, however, the high negative carry in short-end XCCY made positioning very tricky. Although we expect 1Y XCCY to reach 8.50% by end-Q2 and 8.00% by end-Q3, the contract has to move to at least 8.40% over the next 30d and even 7.95% over the next 3m to make up for the negative carry. We don't think this will be realized. Hence we butterfly trades in 1Y-3Y-7Y XCCY long the belly: This bullish trade provide high carry and low vol benefitting from a gradual easing cycle (1Y-3Y part) and protects against more aggressive easing (3Y-7Y). Looking into the steady-state return characteristics in the table below we see that this trade provides 27bp of 3m carry/roll with vol getting reduced significantly compared to outright or even flattener trades. In addition our carry/roll protection analysis (shown in the ratio) we see that the spread of the contract moved against us over 3 months by more than the 3m carry in only 6% of the time over the last 6 years (120 times out of 1925). This means that the current 3m carry/roll provides very good protection against the volatility in the contract.

Romania: Overweight Romanian bonds in particular as relative value trade to Hungary and Poland. Favour long-end bonds best Feb-25 (current: 3.60%, target: 3.25%, stop: 3.85%).

Rationale:

1) Delay in the hiking cycle due to more gradual inflation turnaround Going into the year we have been very bearish on Romanian fixed income in particular compared to Hungary and Poland given concerns on the expected sharp inflation turnaround, the therefore more hawkish BNR with at least 25bp of hikes later this year, concerns on the fiscal side and from February onwards the elevated political risk. And in fact, Romanian bonds underperformed noticeably with 10Y bonds just reaching the widest spread to Hungary and Romania since YTD. Despite some recent retracement we still see risk-reward in Romanian bonds as attractive. While the market has priced an aggressive hiking cycle over the next couple years, inflation did not spike as much as feared. In fact the CBRs new inflation forecast sees inflation at 1.7% by year-end (2.1% before) and we see additional room for further downward revision given the decline in energy prices. This will provide some additional room for markets to price out rate hikes and to support local assets.

2) Light positioning and high term-premia support long-end bonds Despite noticeable inflows into EM over the last few months, Romanian fixed income did not benefit. Although local bonds saw 0.5bn USD inflows by foreign investors to now ~5bn USD since Jan-13 this is only a small fraction of the 200bn USD inflows into EM local bonds since then (for more see here: EMEA Strategy Updated – Foreign holdings in local bonds). In fact, the share of foreign holdings declined to the lowest level in four years (17% vs 25% in mid-13). In addition the share is significantly lower than in Czech (47%), Poland (34%) or Hungary (29%). Although it is difficult to argue what could lead to inflows we can nevertheless argue that the market is not crowded at the moment and the risk of outflows in case of domestic or external shocks limited. Further we highlight that the term-premia increased sharply over the last few months also driven by additional concerns on the fiscal side. Although the latter is not yet off the table and in fact an ongoing risk we highlight that it now looks fairly priced. Although term-premia is still below levels seen in mid-15 it is in fact next to South Africa and Hungary the highest in EM at the moment.

3) Valuation attractive compared to Hungary and/or Poland: Last but not least we also highlight that valuation looks attractive compared to peers. The spread in long-end bonds compared to Hungary and Poland have reached the widest levels YTD and given the steepness of the curve Romanian long-end bonds should more so than Poland and similarly as Hungary in benefit from lower inflation expectations due to weakness in commodities. On the curve we see in particular Jun-21 and Feb-25 as attractive bonds.

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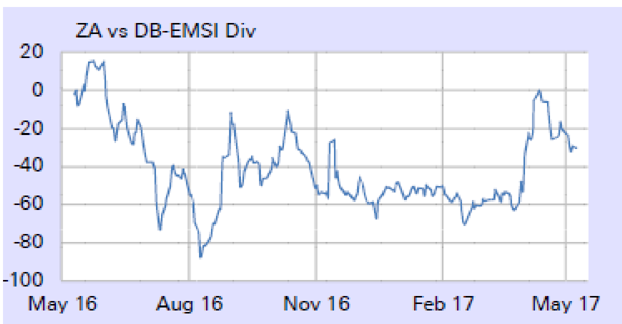
EMEA: Political risks recede, so do values in credits

South Africa – Stay underweight

To our surprise, South Africa credit was one of the better performers over the past month as it recovered nearly half of its underperformance incurred earlier as a result of cabinet reshuffle and loss of IG. Part of this was due to positioning, as many investors had lightened their exposure when political noises increased in March, and part of this was due to the newly-appointed finance minister Malusi Gigaba's seemingly friendly approach to investors' relations and fiscal stance.

Figure 1: South Africa credit has recovered nearly half of underperformance in March/April



Source: Deutsche Bank

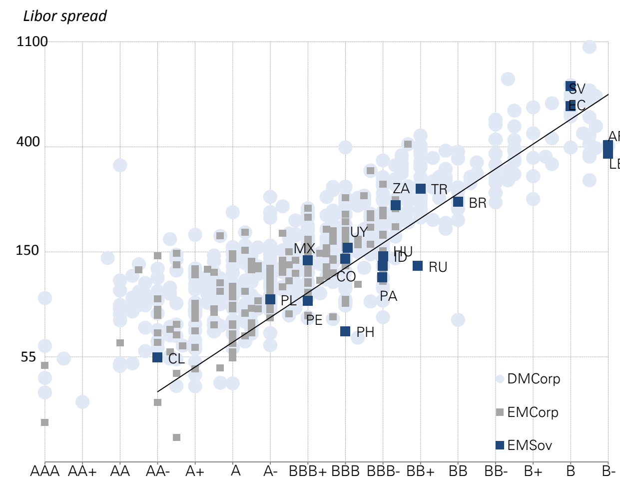
Political risk in South Africa could rise again. Despite the on-going attempts at a no confidence vote in parliament (pending a decision by the Constitutional Court on the secrecy of the vote) political pundits, such as the Eurasia group, believe Zuma will likely remain in power until the end of his term in 2019, and that Nkosazana Dlamini-Zuma is likely to win the ANC leadership contest, ensuring policy continuity.

This political dynamics in conjunction of slow GDP growth will likely lead to further credit rating downgrades – to that end, the current market pricing (at BB+/BB) does not represent a significant overshooting. Therefore, we continue to see downside risk and remain underweight. We hold our switch recommendation of Turkey 26s vs. South Africa 26Ns (entry: 42bp; current: 34bp; target: 0bp).

Focusing on relative value in South Africa, we recommended switching from 22s/25s to 24s and long 24s vs. 5Y CDS. While both positions have moved in our favor, we see more upside potential in the long 24s vs. 5Y CDS position (entry: 46bp; current: 29bp; target: 10bp; tightening stop to 40bp)

We continue to favor 10Y bonds (in comparison with the long end), to express a relatively cautious view. South Africa 10s30s, despite recent steepening, remains one of the flattest in EM.

Figure 2: Market is pricing BB+/BB for South Africa

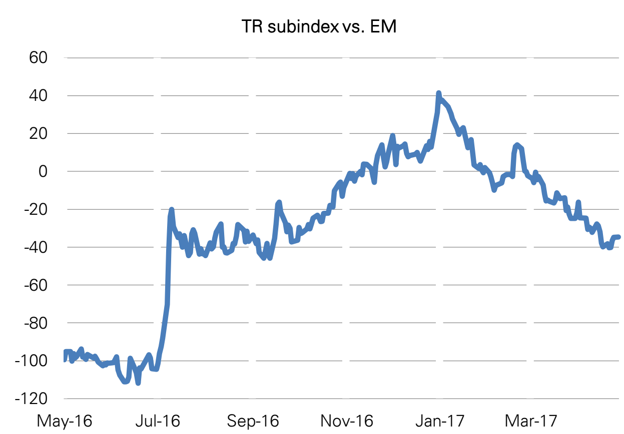


Source: Deutsche Bank

Turkey: A relative stability by Turkish standard

Turkish bonds have outperformed after the narrow YES vote on the constitutional referendum, and its outperformance was further entrenched by the tightening move by the CBT, which helped the bank recoup some credibility against the large slippage on the inflation front as well as political externality. However, after the recent rally, we believe the valuation cushion has significantly reduced.

Figure 3: A high level of premium is still in Turkish credit spread after recent outperformance.



Source: Deutsche Bank

While fiscal condition had been a strong point for Turkish credit historically, this anchor became eroded after last summer. This, combined with concerns related to institutional quality, weaker growth, and pressure on external accounts, has prompted Moody's to lower Turkey's outlook to negative from stable (while keeping its rating at Ba1), following a similar decision by S&P in January. However, S&P affirmed its rating on Turkey at BB(u) on 5 May, which is a sign that the agencies began to see some stabilization in the otherwise deteriorating credit quality as a result of growth recovery, strengthening of the currency, and supportive external backdrop for EM in general, and for Turkey in particular (constrained rise in US rate and recent correction to commodity prices are positive for Turkey).

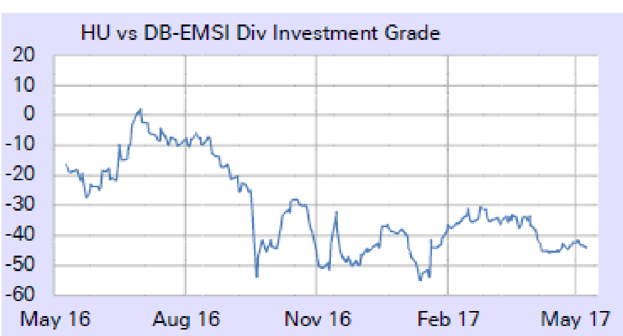
Overall, we see risk/reward as largely balanced given the current valuation. Therefore, we stay neutral for now, but remain in favor of Turkey vs. South Africa (for which we are underweight) and believe their 10Y bonds could converge to parity.

In relative value, we are neutral in terms of the 10s30s slope and note that CDS/bond basis has mostly recovered from tight levels and entered into a normal range.

CEE: stay marketweight on Hungary.

While the market friendly outcome in the French election should benefit CEE credits on the margin, Hungary does not look attractive for yield-hungry investors. In conjunction with a lack of a fundamentals catalyst, we retain neutral on Hungary.

Figure 4: Hungary has traded within a narrow range vs. EM IG average recently



Source: Deutsche Bank

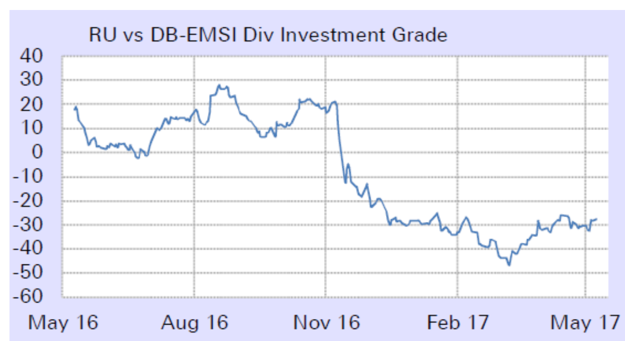
In Hungary, the 5.375% 23s are cheap – they are virtually flat to the 5.75% 23s and 24s, but trade +30bp wider than the 21s.

Russia: Return to IG likely, but more than priced in

Macroeconomic conditions continue to improve. Growth recovery is on track, but structural problems (lack of reforms) cap the trend growth at a low level. Inflation is decelerating faster than expected, enabling CBR to take a dovish stance. On the fiscal side, FinMin scored some good points with investors earlier this year by unveiling a solid medium term budget.

A key debate on Russia credit is whether the recovery in macroeconomic conditions and positive budget will likely lead to a return to investment grade this year – without any sanction reliefs. We believe there is a real possibility – 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. There have been positive actions by rating agencies recently as a result of improving macroeconomic fundamentals and fiscal plan. S&P is due to review Russia's rating again in September, while Moody's will likely review in August. While the sanctions by the US and EU had a negative impact on Russia's economy, a relief of sanctions (which we do not expect) would not actually add much to Russia's fundamentals, which are much more sensitive to oil prices. However, geopolitics, oil prices, and prospect of structural reforms (or lack thereof, especially considering 2018 elections) continue to pose main risks to Russia's return to IG.

Figure 5: Russia credit already trades significantly tighter than EM 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 Russia credit 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, making valuation more amenable. Given the technicals strength in the curve (there are scarcity of Russia sovereign bonds for offshore investors), we remain neutral this time.

How to position? Russia's cash curve has re-steepened recently, and now stands as the steepest curves in EMEA. The steepening, in conjunction with some tightening in the basis, enable us to take profit from the recommendation of selling 10Y CDs vs. 43s recently at target (entered at 12bp: target: -15bp). We are now neutral in terms of CDS/bond basis, but favor the long end of the curve after the recent steepening.

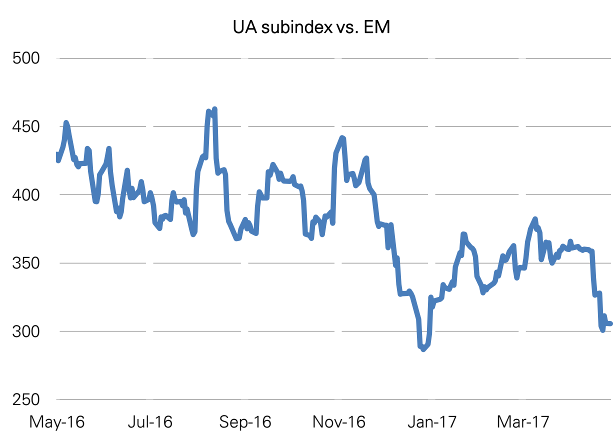
Ukraine: A strong recovery, but risks remain

The significant outperformance of Ukraine bonds vs. broad EM late-2016 as a result of strong growth acceleration was partially reversed earlier this year due to renewed conflicts in the east regions, as the blockades of the occupied territories have significantly dissipated growth momentum and delayed the implementation of the IMF program. In 2017, growth is set to be significantly lower than 2016 (which was 2.3%), while current account and fiscal account deficits are rising. The fundamentals, after a significant improvement in 2016, are deteriorating again. There are few signs that the country can stand on its own after the current IMF program expires in 2019.

After periods of underperformance, Ukraine bonds strongly recovered since late-April, as the conflict in the west regions eased, IMF (and EU support) tranche had been disbursed, and the high yields on offer was appreciated by investors. As a result of some relative stability, bond yields once again approached post-restructuring lows.

Will this sustain? We have our doubts as risks of early elections and debt repayments in 2019 become a major source of concern. Recent resignation of the National Bank of Ukraine Governor Valeria Gontareva was met with disappointment and concern regarding outlook for reforms. 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 program, especially with the major setback to economic growth due to the blockade. We remain marketweight on Ukraine credit because of these risks.

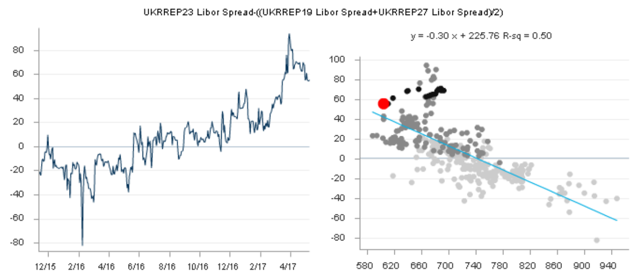
Figure 6: Ukraine credit outperformed again since late-April



Source: Deutsche Bank

Our recently recommended relative value position of long 23s vs. (19s + 27s) (see this *EM Sovereign Credit Weekly*) has moved in our favor (entry: 90bp; current: 55bp; target: 40bp). However, the cheapness of the 23s have not been entirely priced out. We hold this position for further gains.

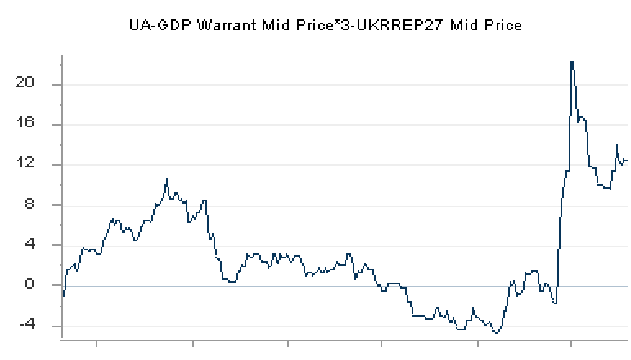
Figure 7: The cheapness of Ukraine 23s (vs. 19s + 27s) have not been completely corrected



Source: Deutsche Bank

Finally, we remain neutral on Ukraine's GDP Warrants. We turned neutral (from overweight) last month on the Warrants as a result of a quick run up in the prices. The Warrants have underperformed bonds over the past month, but from a historical perspective, it still looks quite expensive vs. bonds at the current level (see the graph below where we plot three times warrant price minus 2020s price). Another argument against the Warrants is that the holder-put option (whose theoretical value is about 8pts out of 65pts total for the warrants) should be ignored if one believes Ukraine will definitely not default before the end of the current IMF program, December 2018. We believe this argument is reasonable, as the bond curve embeds a much larger default probability in the near term than reality. Thus, with the fading out of the holder-put option value, any upside potential in the theoretical value of the warrants would need to come from better macro prospects than the previous forecast (a tall order) and lower credit spreads. Overall, we still see value in the instrument, but its attractiveness has significantly reduced after the recent run up in prices.

Figure 8: GDP Warrants still look quick expensive vs. bonds based on historical standards



Source: Deutsche Bank

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LatAm Strategy

- **LatAm FX**: Long BRL/MXN (entry: 6.0, target: 6.18), maintain long BRL/CLP (entry: 209, target: 214), sell 2m USDc/MXNp @18.50 vs buy 3m USDc/BRLp @3.167 with EKO @ 3 ref FX 19.02/3.167, buy 2m USDp/CLPc @ATMS with AKO @645 for 0.4%, buy 2m USDp/COPc @ATMS with EKO @2800 for 0.5%, maintain recommendation of buying 3M USD/BRL DNT (3.00,3.30) and sell 3M USD/BRL vol swap open as we expect a range-bound USD/BRL; maintain our recommendation of buying 3M USDp/MXNc 1x2x1 (buy/sell/sell); neutral PEN.
- **Rates**: Brazil: Receive Jan18|Jan19 (target: 8.50%) Chile: favor Jan22 vs 3M NDF (target 45 bp) Colombia: small overweight on IBR 6M3M (target: 4.60%), Mexico: receive TIIE10s vs US10s (target: 485 bp), receive TIIE 1Y2Y (target 6.80) Peru: buy Soberanos 26s (target:5.20%), receive PEN 2Y xccy swap (target 4.85%)
- **Credit**: We continue to favor higher yielding credits with a relatively positive story in the region – stay overweight on Argentina (favoring EUR bonds) and Brazil. We stay underweight on Colombia as market refocuses on its fiscal deterioration. We stay marketweight on Mexico (favoring Pemex vs. UMS), Peru, and Ecuador. In Venezuela, we move to be more defensive due to a higher likelihood of political transition and likely local supplies, favoring PDVSA 20s (we switch from 17Ns to 20s), PDVSA 35s and VENZ 28s. In relative value, we favor Pars vs. 5Y CDS, EUR 22s vs. USD 21s and YPF 25s vs. 24s in Argentina, 10s30s steepeners (27s vs. 47s) in Mexico, short 10Y CDS vs. 47s in Brazil, and PDVSA 20s vs. 17Ns and PDVSA 35s vs. 21s in Venezuela.

Local Markets

BRAZIL

- FX: Long BRL/MXN (e:6.0, t:6.18),), sell 2m USDc/MXNp @18.50 vs buy 3m USDc/BRLp @3.167 with EKO @ 3 ref FX 19.02/3.167, maintain existing recommendations: long BRL/CLP, buy 3M USD/BRL DNT (3.00,3.30) for.25, sell 3M USD/BRL vol Swap.
- Rates: Receive Jan18|Jan19 (target 8.50%).

FX: Over the last month, LatAm FX total returns were negative for the region's main currencies. Yet the BRL outperformed the rest of its regional peers and its carry returns were high enough to make up for the nominal depreciation of the real relative to the USD. Furthermore, considerable news on the political front in Brazil the USD/BRL continued to trade within the 3-3.30 range. Thus, despite the negative performance of FX over the past few weeks intra-LatAm crosses with long BRL legs delivered positive spot and carry returns as Brazil interest rates remain the region's highest despite the BCB's ongoing easing cycle. Our recommendation to fund a long BRL position with Chilean pesos reached its target a few days ago (see LatAm FX: Taking profits on CLP-funded recommendations) driven mainly by a strong correction of the USD/CLP. We have decided to keep the recommendation open and moved both the target and stop level to protect profits.

The main driver of our decision to keep our exposure to the BRL is that although over the course of the last month the risks of the social security reform derailing increased significantly, they seemed to have peaked. While there are still several challenges the pension reform needs to clear before it actually becomes legislation, since our previous EM monthly the reform cleared its first hurdle and was approved by the Lower House Special Committee (see Pension reform clears first hurdle) The vote in itself was a clear victory for the government given the aforementioned peak of derailment risks associated with a "national strike" against the reform and a significant government defeat in Congress over a vote on outsourcing legislation. The fact that the reform approved by the committee was not diluted beyond the 30% to 40% we had anticipated is further BRL-positive news.

The pension reform is likely to face its next obstacle towards the end of May, when the Lower House gets to vote on the bill. There are some risks however that the vote is delayed until early June as some Congressmen have become increasingly weary of voting ahead of the Senate vote on the labor reform to avoid bearing the political cost of a supporting an unpopular bill only to then see it rejected by the Senate. Our base case scenario though still expects a positive outcome on a vote on the Lower House by the end of May.

As we have stated before, the pension reform bill in its current form is far from "ideal" in terms of alleviating Brazil's fiscal issues. Yet we think that the ratification of the bill by the Legislative is enough to keep Brazil-risk contained and therefore keep the BRL trading within a range as markets seem to be more focused on the reform passing than on the details of what the reform actually entails. In addition to our optimistic view on the reform process, we expect the macro background to continue improving. Activity is showing some signs of recovery and imports have recovered. However, higher commodity prices have propped up exports resulting in trade surpluses this year. And while these are likely to dwindle as higher growth pushes imports to outperform exports, the current account deficit is still expected to end the year at 1.2% and FDI inflows are expected to be twice as large.

In addition to the cyclical arguments that lead us to favor the BRL, the monetary policy backdrop is also supportive of the currency. In particular, inflation prints are still falling (see Inflation drops below 4.5%) paving the road for even more aggressive easing by the BCB which has historically been BRL-positive.

In sum, our relatively optimistic outlook on political risks in Brazil coupled with a positive and improving macro backdrop lead us to favor being long BRL in intra-region crosses. And the recent retracement of currency towards 3.17 after reaching lows of 3.08 earlier this month leave significant room for the BRL to rally which translates into a still attractive long-BRL risk-reward ratio.

The BRL/CLP cross is mostly a carry trade as we now expect the CLP to remain relatively unchanged over the next month. While USD-funding is cheaper than CLP-funding, the intra-LatAm cross hedges our long BRL position from a negative shock to commodities that some market participants have started to fear due to China-related uncertainties.

We also recommend being long BRL/MXN. While both the BRL and MXN are high carry currencies, the cross also hedges commodity-related risks. However, unlike the CLP we believe the risks for the USD/MXN are skewed to the upside. The price of Mexico risk over the next month is likely to be driven by politics, just like Brazil risk. Furthermore, both currencies face event-related risk that could materialize in early June: in the case of the BRL, this is when the Lower House will vote on the pension reform and in the case of the MXN, the Edomex gubernatorial elections will take place on June 4th. Unlike our view on Brazil though, we expect political risks in Mexico to result in MXN-negative pressures as the PRI faces considerable risks of losing the governorship of the state of Mexico. We also recommend expressing this idea via options by selling 2m USDc/MXNp @18.50 and buying 2m USDc/BRLp @3.167 with EKO @3 (ref. FX 19.02/3.167)

In addition to recommending an outright long BRL exposure, we maintain the recommendations published on last month's EMM expressing our expectation of a range-bound USD/BRL via options open.

Rates Brazil rates market continues to trade in a very dichotomous ways. On one hand, the collapse of spot inflation, its effects on inflation expectations and the eerie activity numbers led to the faster cycle and continuing re-pricing of the terminal rates which in our view is still considerably above fair (we see rates ~8.25% by the end of 18 vs ~ 9.50+ priced by the market). Term-premium on the other hand is still significantly high due to the political noise regarding the social security reform going into an election year. The latter has disappointed yield seekers prospects of lower "neutral" rates and a much flatter real curve. Altogether in spite of the negative carry/roll, front end receivers continue to perform given the accommodative monetary stance while in comparison the long end struggles with the increase in fiscal risk (underperforming the front end). With some of the risk of the front end transmitted to the front, we continue to favor the 18s-19s sector of the curve where, in our view, yields should reflect a more accommodative monetary stance. Despite the steepening of the curve it is worth highlighting that in USD terms, Brazil's fixed income return tops its peers in EM. Our view is that a watered down version of the SSR will pass by mid-year which could lead the curve to flatten (we have been neutral in the Jan20-Jan25 spread), removing the fiscal spillage into the 18s19s sector and bring it closer to a pure representation of a monetary policy trade.

Given the delicate balance of risks we stick to a pure monetary policy play pushing the target in our Jan18|Jan19 (which rolls positively) to the 8.50% (currently at 9.03%) as we see the possibility of the BCB undershooting and bringing rates down to even 8.25%.

CHILE

- FX: Buy 2m USDp/CLPc @ATMS with AKO @645 for 0.4%, maintain our long BRL/CLP (e: 6, t: 6.18)
- Rates Neutral duration. Favor 5Y cash (Jan22) vs 3M NDF as an RV/carry play (level 78 bp target 45 bp)

FX: The CLP's price action during the last month brought what we think was a much needed correction to Chile's real exchange rate. The USD/CLP went from levels below 650 half-way through April to above-680 prints on May 9th. We had expected the CLP to weaken and the favorable price action pushed many of our previously published recommendations to hit their targets (see LatAm FX: Taking profits on CLP-funded recommendations).

Our strategic view on the CLP continues to point towards an even weaker nominal exchange rate. As we have previously noted, the pace of output growth is unlikely to recover before November's Presidential election. And in the absence of demand pressures, the current downwards trajectory of the inflation rate continues to skew the risks to our monetary policy forecasts to the downside. And as the carry costs for the Chilean peso drop even further, the balance of risks to our year-end forecast of 685 for the USD/CLP is tilted to the upside.

From a technical point of view, the recent price action is likely to result in somewhat of a retracement for the USD/CLP. So our short term expectations are for the Chilean peso to end the month trading close to its current level.

We express our view that while likely, a USD/CLP retracement is bound to be limited via options and recommend buying 2m USDp/CLPc @ATMS with AKO @645 for 0.4%.

Our strong views regarding political risks in Brazil lead are enough to make the risk-reward of a long BRL/CLP attractive. The CLP's contribution to this recommendation is mainly the provision of a low-volatility funding currency to a carry-positive cross. Also, the combination of the CLP's copper exposure and BRL's exposure to iron ore and agricultural commodity translates into the BRL/CLP being relatively neutral to the risk of widespread commodity selloff.

When we originally recommended the long BRL/CLP we argued that the carry-positive cross' attractiveness kwas contingent on our expectation that the BRL would remain relatively stable and that the CLP would weaken. Our expectations did materialize and our original long BRL/CLP reached its target. We now renew our recommendation to remain engaged on this particular cross because our updated expectations entail a rallying BRL and a stable CLP. Thus, we still like being long BRL/CLP but for different reasons than when we first published this recommendation. And in addition to moving the target to 214, we recommend adjusting the stop to 210 to protect the accumulated returns.

Rates: With a terminal rate priced at 2.5%, we believe that Chile's front end is priced to perfection. After reaching our target in our front end recommendations we have recently switched to neutral in rates, a stance we currently keep until the market turn its attention to the next election cycle. Regarding the latter we are on the camp that prospects of Pinera's election should 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. We do not see that happening in the near term and remain neutral duration and the curve. 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: Buy 2m USDp/COPc @ATMS with EKO @2800 for 0.5%. On the spot, we remain tactically neutral while our strategic view on the COP is still bearish.

– Rates: Small overweight on IBR 6M3M (level: 4.90%, target: 4.65%). In TES world favor TES 19s.

FX: The growth outlook in Colombia continues to deteriorate and the prospects of a more aggressive than previously expected easing cycle in Colombia continue to strengthen in the near term. The rising likelihood of COP carry costs falling in the near term strengthens the case to be short pesos in the near term. However, the recent bout of falling commodity prices in general and oil in particular has weakened the COP. In our view, these two developments roughly cancel each other out when it comes to the attractiveness of the risk-reward ratio of an outright long USD/COP position.

And our strategic view on the COP also continues to worsen. As we have previously noted, fiscal accounts in Colombia are not in a particularly healthy state despite the recent tax reform. The constant revisions of fiscal targets continue to erode the credibility of Colombian fiscal policy. Also, the opacity of fiscal expenditures associated with the Peace process makes any short term reductions of government outlays unlikely. While the risks of a downgrade are still contained, we think that in the near future, the probability of a downgrade far exceed those of an improvement of Colombia's sovereign rating.

As Colombia approaches an election year, we think the long-term case for a weaker COP continues to strengthen. When it comes to the spot USD/COP we remain neutral in the near term and will look for a stabilization of commodity and oil prices in the future in order to recommend short COP trades at more attractive levels.

However, the upside risks for the USD/COP are considerably higher than the downside risks. Also, the USD/COP tends to trade within a well-defined range. We thus recommend expressing this view by buying 2m USDp/COPc @ATMS with EKO @2800 for 0.5%.

Rates: Colombia's BanRep delivered a 50 bp cut, confirming the DB's (non-consensus) view of cycle acceleration that has been highlighted in our last publications(here and here for example). Going forward we expect BanRep *to* deliver another 50bp in May, before slowing back to 25bp cuts in June to August, as the favorable base effect of inflation dissipates. We also reduced our year-end rates to 5.25% in 2017 and 5.00% in 2018 from 5.75% - more or less in line with the pricing of IBR. Under DB's scenario value left in IBR is residual at best. Our favorite trade (the 6M3M receiver) has no value under our benchmark scenario but does profit if BanRep undershoots bringing rates to say 5% still this year (around 20 bp – see chart below). A better implementation would be the 3M3M (or the 6M point for those looking for outright positioning) which at horizon profits ~20 bp if DB's scenario materializes and 40 bp if the undershooting alternative materializes. The main caveat is obviously the very negative roll (-17 bp in a month) which makes waiting particularly painful. In terms of recommendation we extend the target on the 6M3M point to 4.66 bp (but tighten stops to 5.10) and recommend adding a small overweight to the 3M3M point (or 6M) targeting 4.80. In TES the 18s-20s sector of the curve have been stubbornly underperforming the swaps and presented an alternative of monetary policy play for RM/non-derivatives investors. Further down the curve cash is starting to look very expensive versus swaps, UVRs and globals. While real rates are still high (around 3% in the long end) we believe that exposure to rates might be better expressed using USD bonds swapped into COP or even through linkers as breakevens in the long end hover around 3%. Especially expensive are the 26s.

MEXICO

- FX: long BRL/MXN (e: 6, t: 6.18); maintain our recommendation of buying 3M USDp/MXNc 1x2x1 (buy/sell/sell) struck at (ATMS/19/21.70) for ~cash neutral open.
- Rates: Receive TIIE10s vs US10s (target: 485 bp), Receive TIIE 1Y2Y targeting 40 bp of rally (ref 7.20%)

FX: The MXN's price action over the last month continues show that as far as the market is concerned, the Peso is "just another" EM currency. In the months that followed the US election last November the Peso's price action seemed to recognize that when it came to uncertainties associated to the future direction of US policies, Mexico had more at risk than almost any other economy. But the MXN's brusque selloff and its rising volatility appears to have prompted Banxico to significantly hike rates and the Exchange Commission to announce a DNDF-based intervention. The peso's high carry cost relative to the rest of EM and the commitment of Mexican policy makers to prop up the peso via FX interventions lead to a sustained recovery of the MXN and a decline of its volatility during March and April.

Many investors interpreted the benign price action of the MXN as evidence that the likelihood of tail risks materializing on the trade policy front was close to negligible. However, despite the scarcity of Mexico and NAFTA-related headlines there has been no actual information regarding, for example, the goals of the US in a potential renegotiation of NAFTA. Therefore, in our view, the future of Mexico's economy is still highly uncertain despite the MXN's low realized volatility. And on April 26th when White House sources revealed to media that an executive order announcing the US' intent to withdraw from NAFTA had been drafted, markets seemed to remember that the Peso was not just another EM currency and in a matter of hours the USD/MXN increased 2.5% (see NAFTA? Not a credible threat). Our view is that while Mexico headlines are unlikely to go back to becoming as frequent as earlier this year, it is important to keep in mind that the future of the macro-drivers of the Mexican economy and the MXN still look uncertain and the risks are still skewed to the downside.

The peso's carry cost continues to increase in relative terms as the rest of LatAm's central banks are engaged in easing cycles. And despite our contention regarding the lack of fundamental reasons for a sustained appreciation of the MXN, it is important to recognize that Mexico's high interest rates and the intervention set up by the Exchange Commission are enough to expect MXN sell offs to be less abrupt than in the recent past.

Over the last couple of months relatively benign risk environment in financial markets globally and the very gradual deterioration of macro data in Mexico made it difficult to think of events likely to trigger a bout of MXN weakness. However, the gubernatorial elections in the State of Mexico (Edomex) next month are clear potential trigger for the MXN to depreciate. As we have highlighted in previous notes (see LatAm Strategy: Hedging Mexico Elections) domestic and more specifically political risks in Mexico are on the rise. The uncertainty surrounding the outcome of the 2018 Presidential election have not yet weighed significantly on the peso. But we think that both because the Edomex is the most populous state in Mexico and because polls suggest that there is a rising likelihood that the State will for the first time elect a non-PRI governor, regardless of the outcome on June 4th, markets are likely to re-price what we believe are currently underpriced risks associated with Mexican politics.

The balance of risks for the USD/MXN seems to us as skewed to the upside around June 4th. We choose to express our view by recommending a long BRL position funded with MXN (entry 6, target 6.18) in part because the carry costs associated with an outright long USD/MXN position are too high. Also, the timing of political risks in both Mexico and Brazil are conveniently lined up: the Brazilian Legislative power is likely to determine the fate of the social security reform at around the time Edomex voters will pick a new Governor. And while we are optimistic and expect the social security reform to be BRL-positive, we think the MXN is likely to weaken in the days around the election. Finally, the exposure of the BRL to iron ore and the MXN's exposure to oil allow us to express our MXN view while somewhat hedging commodity risks. The recommendations we published two monthlies ago (3M

USDp/MXNc struck at ATMS, RKO at 18.15 ~ 1% (break @ 19.47) as well as buying 3M USDp/MXNc 1x2x1 (buy/sell/sell) struck at (ATMS/19/21.70) for ~cash neutral-(break-evens @ ~between ATMS and 18.35, max profit of 3.5% @ 19, top breakeven @21.70) remain open and performing favorably but initiating them at current levels is no longer as attractive

Rates: Our views remain the same. We believe that the end of Banxico's tightening cycle is near. We also believe that as the latter approaches, cuts will start to eventually be priced in by TIIE – more precisely in the 2Y/3Y sectors of the curve – which should lead that sector to outperform the wings (1s/5s) as it normally does during easing cycles, shifting the curve dynamics from "parallel rallies" to "bull-flattening". While we expect the aforementioned sector to outperform, we favor outright positioning instead of RV since the yield-seeking across EM has the potential to continue to temporarily compress the term-premium in TIIE in spite of the upcoming cycle (like it did in Brazil and Colombia). In a nutshell while our view is that Mexico term-premium is structurally low, further compression could be seen in the near term. In terms of outstanding recommendations we have been highlighting different variations of over weights in the 10Y sector of TIIE:

1- A 5Y5Y receiver swaption initiated in January (see link) aiming to capture the high real rates

2- 10Y receivers vs the US (see link) as a proxy to MXN strength aiming at capturing the curve compression post implementation of the FX swaps program (implementation of hedges)

3- 1Y2Y forward starting receivers in TIIE targeting ~6.80%.

In cash MBONOs have cheapened a bit vs TIIE as hedging pressure (payers) on the latter wane off post introduction of the FX swaps program. That said cash still remains in the rich side especially in the long end of the curve

PERU

– Rates : Buy Sobranos 26s (target 5.20) Receive 2Y xccy swaps (target 4.85).

We have been recommending exposure to Soberanos for a while but with Soberanos 26s hovering around 5.50 we favor switching some of the exposure to the front end. Note that term premium in Peru is still high and the bond curve still steep leading us to marginally extend the target of the Sob26s.

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, like swapping into Soles for the heavily USD invested PF community and the constant intervention of the CB in FX which altogether tends to flatten the forward curve leading the xccy swaps to rally. Receive 2Y sector targeting 4.85%

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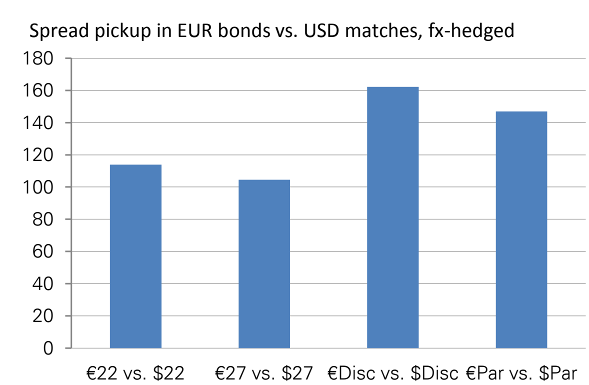
Credit

Argentina: Outperformance likely to continue, for now

We remain overweight on Argentina credit and position for continued outperformance of Argentina bonds given the higher yield on offer, credible policy direction (with challenges), and problems with EM high yielders elsewhere. The main risk stems from the proximity of the mid-term elections, as some investors may decide to position more conservatively ahead of the elections, but we are among the ones that would give the Macri administration the benefit of the doubt.

Our preferred assets within the Argentina complex continue to be in the EUR-denominated bonds. While some correction to their excessive cheapness has taken place, the cheapness vs. USD counterparts (fx hedged) are still ranging from a little over 100bp (the 22s) to close to 200bp (the Discounts), see chart below. While our recommendation of long EUR 27s reached its target, we retain long the EUR 22s, as well as the RV position of EUR 22s vs. USD 21s (current fx-hedged spread differential: 135bp; target: 100bp), for further gain. Meanwhile, we believe the technical conditions on the EUR Discounts and Pars are due to improve, and we point out that they remain exceptionally cheap to the bullet bonds and should be the favorite assets for real money investors with a relatively long horizon.

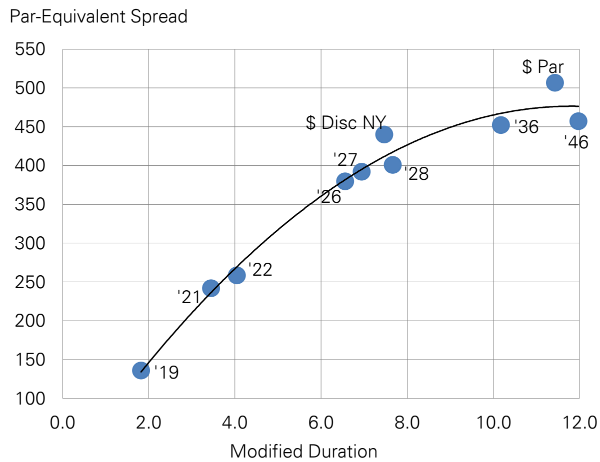
Figure 1: Argentina EUR denominated bonds remain significantly cheap to their USD counterparts



Source: Deutsche Bank

On the USD bond curve, the Pars and Discounts are obviously cheap to the bullet bonds, but among the latter group, the 28s are the most expensive at the 10Y sector while the 22s are expensive compared to the 21s at the shorter end of the curve.

Figure 2: Argentina USD curve – rich/cheap analysis



Source: Deutsche Bank

We also retain long on Argentina Pars vs. 5Y CDS (at par-equivalent spread dv01-neutral ratio of one bond x 1.25 CDS) – see our *Trade Recommendation note* from 2 April. Meanwhile, investors should also consider long EUR Pars vs. 5Y CDS to capitalize on (or benefit from) potential corrections because: 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 are changing our view on GDP Warrants. While we continue to believe the instrument has good value over the long term, we do not see a catalyst for it to perform within the next year (while offering no carry). GDP growth this year will most likely be below trigger, likely the next year as well. There could be a few more years of drought in terms of cash flows. In addition, the potential legal issues will unlikely be resolved when there is no coupons payment to force government's hand. Therefore, we unwind our recommendation of long EUR warrants at the current price of 9.7 (we entered at about the same level last year).

Brazil: A diluted reform is good enough for now

The social security reform cleared its first hurdle – the Lower House Special Committee approval, in early May. However, the committee significantly watered down the government's original proposal (by some 40% according to our economist Jose Carlos Faria's estimate), and the risk of further dilution remains. We expect the Lower House floor to vote on the pension reform by (at the earliest) the end of May, and final approval by the Senate to likely take place in September.

Our economist, Jose Carlos Faria, believes the reforms will likely be passed as his base case scenario, but the reforms, after dilution, will likely not be enough to stabilize Brazil's debt dynamics and another reform will be needed under the new government after 2018. Nevertheless, this is a crucial step for long-term fiscal consolidation and, perhaps, the best the Temer government could do under the circumstances; this outcome will likely be well accepted by the markets. Under this scenario, Brazil's credit rating is expected to stabilize this year at BBB (with negative outlook removed, which Moody's has already done in March). With its higher yield on offer in comparison with most other EM names and the carry seeking environment, we continue to see scope for Brazil to outperform average EM at this point. Therefore, we maintain overweight.

Other supporting factors for our overweight recommendation include: growth recovery seems on track, although more lackluster than previously expected; a sharp decline in inflation has allowed the BCB to accelerate the pace of monetary easing, helping to ensure growth recovery; trade surplus continues to surprise on the upside, and external balance looks benign.

The Brazil 10s30s curve still looks flat in comparison with peers. CDS/bond basis has tightened, but the 10Y CDS vs. 47s remains close to the high end of the historical range. We retain selling 10Y CDS vs. 47s (current: -29bp; target: -50bp).

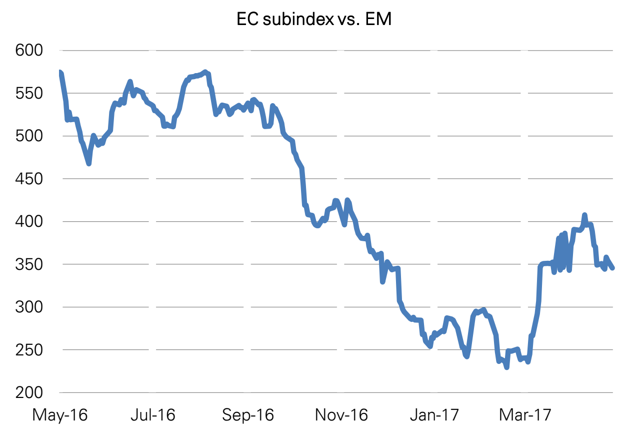
Finally, we remain constructive on Petrobras despite a prolonged period of outperformance. We continue to see good relative value in Petrobras 5Y sector even at its historical tight vs. the sovereign.

Ecuador: awaiting policy signal

Having covered underweight last month following the underperformance of the Ecuador curve due to the incumbent victory of the presidential election, we retain neutral despite cheap valuations. Spreads have recovered from post-election peak, but only marginally. We do not yet see a catalyst for the spread to materially tighten in the near term, as President Moreno's cabinets remain up in the air and Correa's influence is expected to remain strong during his presidency. Market will likely react positively if some pragmatic figures are confirmed into important cabinet positions, especially the finance minister. Thus far, there is no clarity. In addition, the recent downturn in the oil markets makes us more cautious. We prefer to wait for any clarity in terms of policy signal to decide on the next move. We remain neutral for now, despite what we see as quite attractive yield levels.

Where to position? The bond curve (from 22s to 26s) has significantly steepened over the past month as the spread differential has moved from -20bp in late-March to +60, close to the steepest historically on the curve. Having previously favored the 22s, we now shift our preference to the 26s.

Figure 3: Ecuador bonds have recovered marginally from post-election wides.



Source: Deutsche Bank

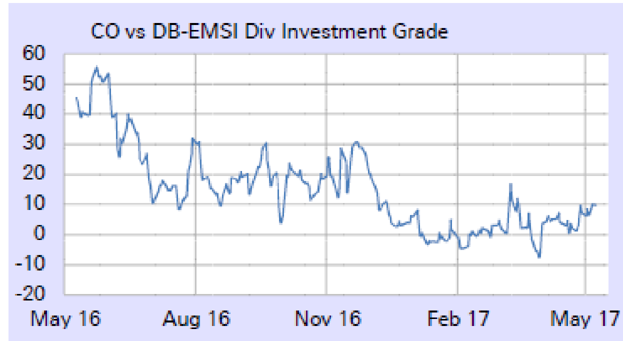
Colombia: Stay underweight on tight valuation and budget underperformance

Ongoing deceleration in economic activity, challenges to consolidate fiscal accounts after the approval of tax reform, and still tight valuation (even after recent correction) should make investors re-focus on the deteriorating debt dynamics and turn to a more cautious view on its credit performance, in our view.

In terms of fiscals, the ministry of finance lifted the deficit ceiling to 3.6% of GDP last month from 3.3% for 2017. Even though it was consistent with our forecast, our economist, Cesar Arias, sees this new target as a floor, not a ceiling, for the budget deficit this year. Risk remains to the downside, and in reality, we assume the deficit will likely be around 4%. The glow of the tax reform has faded and it is now clearer that the reform will not be enough to arrest the negative debt trajectory. 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.

Even though Colombia underperformed EM IG average during the past month, valuation remains tight. In our view, risk/reward remains biased to the downside at the current valuation. We remain underweight.

Figure 4: A correction has taken place in Colombia’s credit spreads over the past month



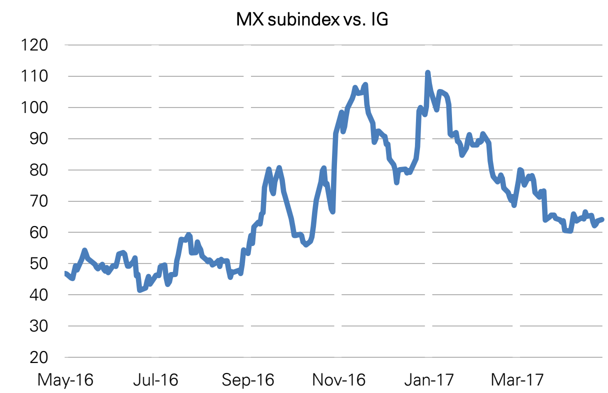
Source: Deutsche Bank

10s30s curve has recently steepened further and Colombia is one of the steepest curves in EM. However, we do not see a strong reason for long duration on the curve, so we stay neutral in terms of the slope. We maintained short 10Y basis (10Y CDS vs. 26s), which has tightened by 20bp recently. We hold this position for residual gains (keeping our target at 60bp vs. current level of 70bp).

Mexico: Stay marketweight

Lack of developments on the US trade policy front, domestic policy responses (rate hikes and fx intervention), and light positioning triggered a significant recovery of Mexican assets over the past few months, as its cash sub-index retraced most of the underperformance vs. EM IG post-US election. However, more recently, recovery seemed to have run its course and Mexico’s spread over EM IG average has stayed within a narrow range of 60-65bp, a level of premium that is justified by the uncertainty regarding the future of NAFTA, weakening fundamentals (weak growth, high inflation, a deteriorating external account, structural fiscal issues, and contingent liabilities related to Pemex), and political noise that will likely surround the gubernatorial election in EDOMEX, in our view. We stay marketweight at the current levels.

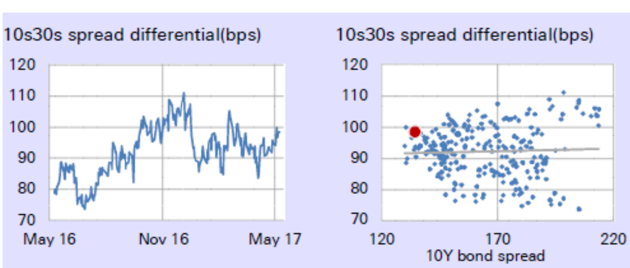
Figure 5: The recovery of Mexico credit has run its course; sizeable risk premium to likely remain



Source: Deutsche Bank

In terms of asset allocation, we note that Mexico 10s30s has re-steepened by about 15bp from the flattest levels in recent months, and the curve slope is at comparable levels to the other regional low-beta curves (Peru, Colombia, etc). However, we retain dv01-neutral curve steepeners in 27s vs. 47s (entry: 70bp; current: 78bp; target: 90bp; stop: 60bp).

Figure 6: Mexico 10s30s has re-steepened



Source: Deutsche Bank

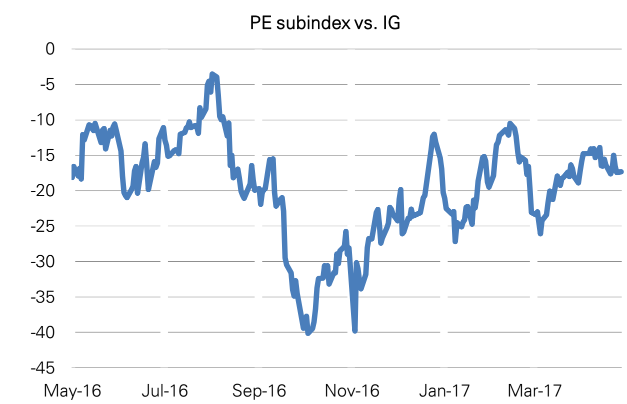
Finally, we are constructive in the relative value of Pemex bonds vs. sovereign in general at the current valuation. While other main regional large O&G names (e.g., Petrobras, Ecopetrol, YPF, etc.) have their bonds trading at historical tights vs. their respective sovereign curves, Pemex has lagged in this sense. At +150bp over sovereign curve in the 10Y sector, the spread differential is still much wider than pre-commodity correction levels (2014 or before). The scarcity of IG names among LatAm corporate, completion of market financing this year, and our integral view on Pemex/Mexico support our positive view on Pemex vs. Mexico.

Peru: Neutral; unwind short Peru 27s

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. However, favorable initial conditions – low debt, moderate budget deficits, and single digit inflation – provide room to adopt countercyclical policies. Despite recent setbacks, Peru continues to feature one of the best credit fundamentals among EM peers.

Peru credit valuation has improved over the past month. At 15-20bp tighter than the EM investment grade average, Peru's premium is at the average level of the past year. The correction was especially notable in the 10Y sector, as our recommendation of short Peru 27s reached its target on 18 April (entered at 74bp; target: 100bp). We retain neutral on Peru credit and continue to favor the long end of the curve (favoring the 50s), where valuation looks much more attractive.

Figure 7: Peru's valuation has improved recently



Source: Deutsche Bank

Venezuela: Higher likelihood of political transition and higher risk of bond supplies

There are two pertinent themes in Venezuela that are very relevant for asset allocation considerations within the Venezuela complex: the higher likelihood of political transition and potential fire-sale of bonds held within Venezuela.

The recent mass protests organized by the opposition, the hard-line stance taken by the government, increasing isolation of the Maduro government, and heightening international pressure signal not only deeper political/social crisis, but also an increasing likelihood of a political transition in the next 18 months. While we leave it for the political pundits (and economists) to opine on whether/when/how this will happen, we observe that such a scenario has not been materially reflected in the bond prices. Market so far has mostly been focused on refinancing risk and oil prices.

What would the implications of a higher likelihood of political transition be on bond prices? It will likely depend on how the political transition takes place and what the end game will be. In most conceivable scenarios, we believe it is likely to lead to a higher probability of restructuring (bad for front-end and high-priced bonds) and higher recovery value (good for low-priced bonds). In other words, it will likely lead to an equalization of bond prices. Thus far, we have seen little evidence of it.

On the other hand, we have highlighted the increasing difficulty for the authorities to engage in creative re-financing schemes to raise fresh money, such as debt swap, gold swap, repo transactions, etc., after the National Assembly announced about two weeks ago that it that would nullify any new government debt issuance, some derivative transactions and the formation of joint ventures not explicitly approved by congress. This measure will likely make any counterparty – potentially engaged in a transaction to help Venezuela or PDVSA raise money – to be more cautious about the legality of the transaction and their reputational risk (if they do engage).

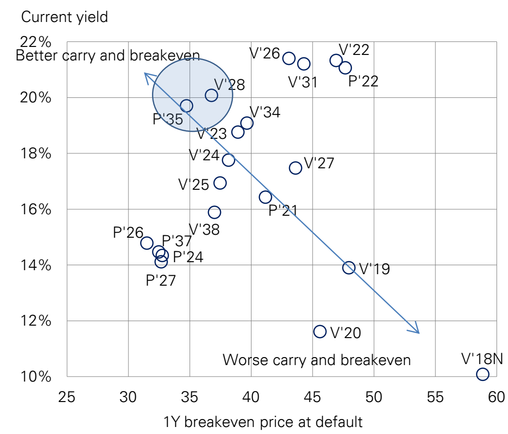
However, the authorities have two remaining channels to resort to without legal constraints: sell the gold reserve that the Central Bank holds and sell the bonds locally within government's control (in the Central Bank, government controlled public banks and PDVSA entities, etc), including PDVSA 6% 22s, Venezuela 36s, and some of the PDVSA 26s and 31s.

We are more concerned about the latter, which will highly likely take place in the coming months before PDVSA faces its maturity hump in October and November. When it happens, there will likely be a technical selloff across both curves, but price actions would be marginally in favor of the front end, as completion of these transitions will likely be positive for the near term repayment capability.

Combining these factors, which have somewhat different effects on the curves, and the recent dip in oil prices, 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. Specially, we have the following recommendations:

- At the front end, we favor PDVSA 20s vs. PDVSA 17Ns (more on this below), and we dislike Venezuela 18s, 19s, and 20s.
- At the longer end of curve, PDVSA 35s and Venezuela 28s offer the best combination of (high) carry and low loss at default – see graph below.

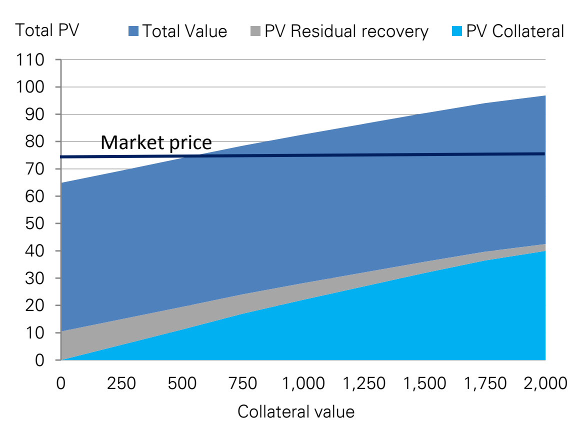
Figure 8: Besides PDV 20s (not shown), PDV 35s and VEN 28s offer the best combo of carry and safety



Source: Deutsche Bank

We have always been constructive on the (partially) collateralized PDVSA 2020s and believed that the market has under-priced the collateral value in this bond. In a Trade Recommendation report published on Thursday (see *PDVSA: Optimal allocation via the 20s*), we re-iterate this argument while presenting more details on our pricing model on the 2020s bonds. We find that, assuming a total collateral value of USD1.1bn (a rather conservative assumption, in our view), the model fair value for the bonds is around 84, 6.5pts higher than current market prices (77.5 mid). The loss at default of the bonds is limited by the collateral (the coverage will likely increase as the bonds amortize) and recovery on the un-collateralized notional. We recommend switching from 17Ns to 20s, a position that significantly increases defensiveness and also capitalizes on potential upside from the under-pricing of the 20s.

Figure 9: Fair value (with components) of PDV 2020s under varying assumption of total collateral value



Source: Deutsche Bank

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China

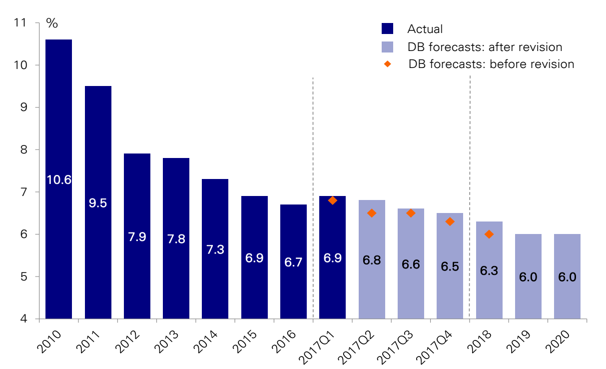
Aa3/AA-/A+
Moody's/S&P/Fitch

- Economic outlook: We revise up our GDP growth forecast to 6.7% in 2017 and 6.3% in 2018 (6.5% and 6.0% before revision). Q1 growth edged up to 6.9%yoy from 6.8% in Q4, as the property cycle remained strong.
- Main risks: Growth likely peaked in Q1. Credit supply will likely tighten in the next few quarters and drive growth to 6.5% by Q4.

Growth may have peaked in Q1

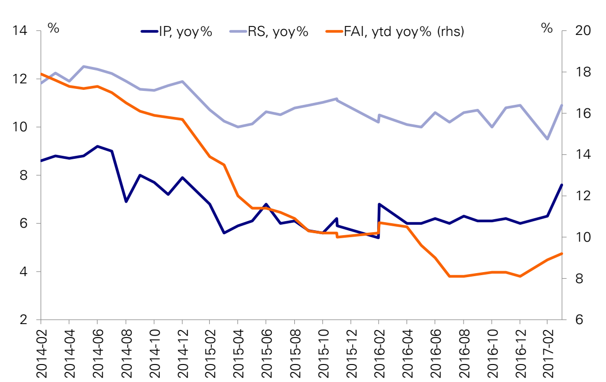
Real GDP grew 6.9%yoy in Q1 (6.7% and 6.8% in 2016Q3 and Q4 respectively), slightly stronger than our forecast of 6.8%. The first sector grew 3.0% (4.0% and 2.9% in Q3 and Q4 respectively), the second sector grew 6.4% (6.1% in both Q3 and Q4), while the tertiary sector grew 7.7% (7.6% in Q3 and 8.3% in Q4).

Real GDP growth, actual and DB forecasts



Source: Deutsche Bank, WIND

Growth of IP, FAI and retail sales

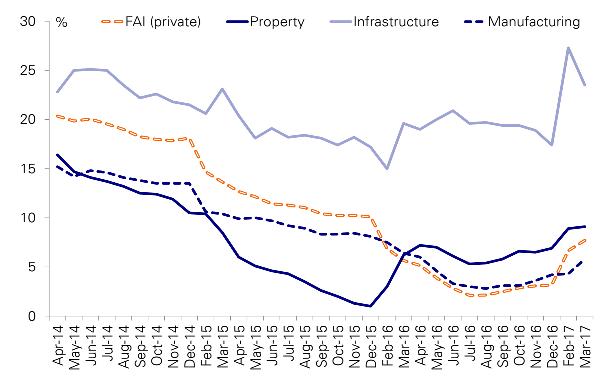


Source: Deutsche Bank, WIND

All headline activity indicators strengthened in March. Growth of industrial production picked up from 6.3%yoy in Jan-Feb to 7.6%, fastest pace since Feb 2015. The YTD growth of fixed asset investment (FAI) accelerated to 9.2%, compared with 8.9% in Jan-Feb. Growth of retail sales, which slowed to 9.5%yoy in Jan-Feb, rebounded to the Dec 2016 level of 10.9%.

On FAI, growth of infrastructure investment moderated from 27.3%ytd in Jan-Feb to 23.5%ytd in March, while property investment growth further strengthened from 8.9%ytd in Jan-Feb to 9.1%ytd, both consistent with our expectation. Manufacturing FAI grew 5.8% in Jan-March, faster than the 4.3% in Jan-Feb. Partly because of this, the improvement in private FAI continued, with the ytd growth rising from 6.7% in Jan-Feb to 7.7%.

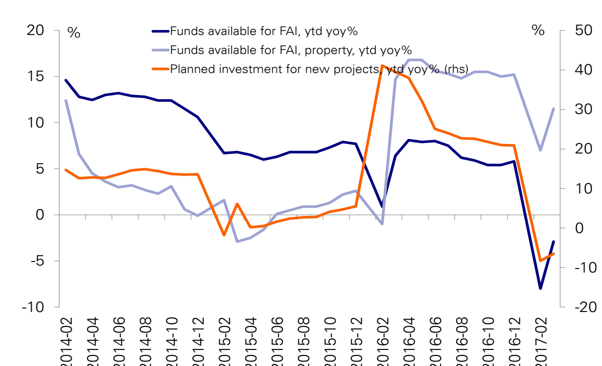
YTD growth of fixed asset investment



Source: Deutsche Bank, WIND

Despite the strong investment, the picture depicted by leading indicators seems less rosy. The ytd growth of funds available for FAI is still negative in March (-2.9%), although it improved compared with the -8.0% in Jan-Feb. Planned investment for new projects also declined 6.5% compared with Q1 2016. These indicators suggest that growth of total FAI will likely be on a gradual declining path for the rest of the year.

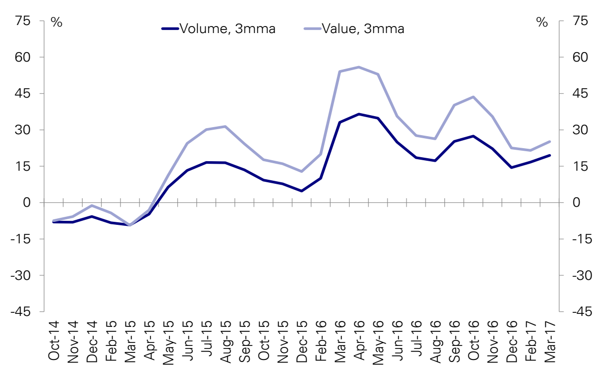
Growth of funds available for FAI and planned investment for new projects



Source: Deutsche Bank

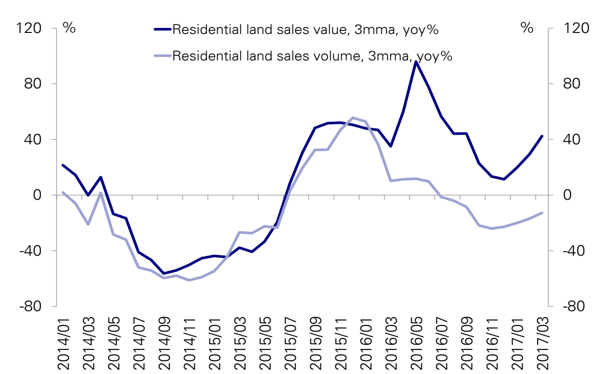
The property cycle remains strong which will help to avoid sharp economic slowdown in 2017. Property sales growth moderated slightly in March on a monthly basis, but was still picking up if we look at the 3-month moving averages, from 16.7% in Feb to 19.5% in volume terms and from 21.5% in Feb to 25.1% in value terms. More importantly, leading indicators such as land sales and housing new starts did not show any signs of moderation. Growth of land sales continued to improve in both value (3mma 42.4% vs. 29.3% in Feb) and volume terms (3mma -12.7% vs. -17.0% in Feb), and housing new starts grew 11.6%ytd in Jan-March vs. 10.4%ytd in Jan-Feb and 8.1% in 2016.

Growth of property sales



Source: Deutsche Bank, WIND

Growth of land sales



Source: Deutsche Bank, CREIS

Taking all factors into consideration, we revise up our annual GDP growth forecast for 2017 from 6.5%yoy to 6.7%, but maintain the view that growth will likely drop on quarterly basis, with growth for Q2, Q3 and Q4 at 6.8%, 6.6% and 6.5% respectively (6.5%, 6.5% and 6.3% before revision). We also revise up growth forecast for 2018 to 6.3% from 6.0%. On policy outlook, we do not see any urgency for the government to roll out additional fiscal stimulus. As our baseline case we expect no benchmark interest rate in 2017 and 2018, but believe the chance for such a hike in 2018 is on the rise.

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China: Deutsche Bank forecasts

	2015	2016F	2017F	2018F
National income				
Nominal GDP (USD bn)	11,065	11,207	11,510	11,407
Population (m)	1,376	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 (USDbn)				
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**	**17Q2F**	**17Q3F**	**17Q4F**
1-year deposit rate	1.50	1.50	1.50	1.50
10-year yield (%)	3.62	3.70	3.70	3.70
USD/CNY	6.90	7.02	7.21	7.40

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

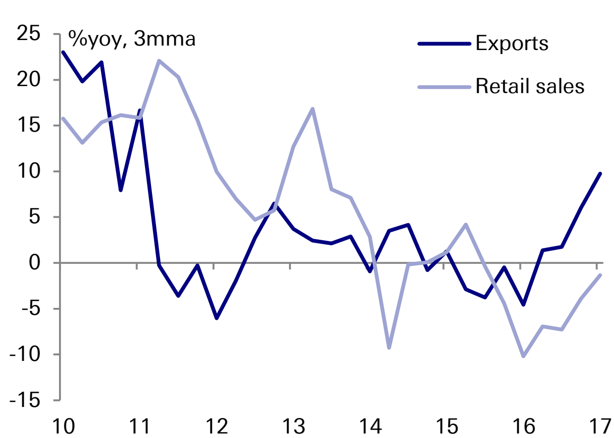
Aa1/AAA/AA+
Moody's/S&P/Fitch

- Economic outlook: The downgrade to our US growth forecast takes some shine off the outlook for Hong Kong after what appears to have been a stronger-than-anticipated start to the year. Upgrades to the Chinese forecast and a return to growth in tourist arrivals at least three months earlier than expected are important positive developments.
- Main Risks: The US review of China's trade and investment (and currency) policies casts a shadow over the outlook, as this could lead to penalties that restrict the flow of trade through Hong Kong at a time when rising US interest rates begin to crimp demand.

Which way will the forecast change?

With first quarter GDP growth due to be released the day after this report is published, we're refraining from making any change to our forecasts here. This is despite the fact that our US colleagues have just revised down 2018 GDP growth by a full percentage point, which would ordinarily lead to a significant cut to our forecast for Hong Kong's GDP growth. But the first quarter looks like it might have yielded higher GDP growth than we had been expecting at the beginning of the year, possibly enough to offset the downgrade to US GDP. So even with a more muted US outlook, we might find ourselves revising up growth forecasts for Hong Kong, at least in the near term.

Merchandise export and retail sales volumes, 2010-17



Sources: CEIC and Deutsche Bank Research

The importance of external demand is readily apparent. Even after a few years of disappointing growth, exports of goods and services exceeded 200% of GDP last year. Usually, important moves up or down in trade volume growth are mirrored in GDP. As the above chart shows, merchandise exports have grown at their fastest pace in six years so far this year. We had been expecting this surge in exports to happen: GDP growth in Hong Kong's export markets has been rising and commodity price increases restored purchasing power in emerging markets that had accounted disproportionately for the decline in exports in 2015-16. But still, exports have grown faster than we'd expected, providing an important boost to growth relative to our forecasts. Note that according to our models, export growth has probably peaked in volume terms. We expect growth to be a little less impressive in the rest of the year. Still, average growth in exports this year is likely to be the strongest since 2011.

Services exports to some extent mirror merchandise trade, which drives demand for logistics and transportation services. But tourism has become an important component of demand in recent years – non-residents account for nearly 15% of consumption in Hong Kong – and this has rebounded more strongly than we'd expected. Already, the fact that tourist arrivals had risen 0.4%yoy in Q4 last year was a pleasant surprise. We'd not expected growth to return until the second half of this year. But Q1's 3.7%yoy growth in visitors was much higher than we'd expected – the fastest growth in two years. While average visitor spending has declined in recent years, this bump up in arrivals will help support the hospitality and catering sectors. Already, we think, it is reflected in the retail sales figures. After a few very disappointing years, retail sales posted two consecutive months of 4.4%mom(sa) volume growth in Feb/March. These were the best two months in four years. Sales volumes were still down on the quarter but the YoY growth rate improved to -1.3%yoy, the slowest rate of decline in six quarters.

Retail sales are only about one quarter of total consumption, but they tend to be indicative of the trend in the broader measure of consumption growth. So with both consumption growth and export growth looking likely to have risen in Q1, we think growth this past quarter might have been stronger than our original forecast. That presents some upside risk to our 2017 growth forecast even with the small reduction in our US growth forecast.

Realistically, a 100bps decline in the US growth forecast for 2018 would lead us to revise down our forecast for Hong Kong's growth rate next year. But because this week's GDP report might change our baseline for 2018, we don't know what the new forecast will be. But we would still most likely be expecting growth to be at least a little stronger next year than this year.

Another surprising feature of the first quarter was the drop in inflation. Headline inflation, which had been in a narrow range of 1.2% to 1.3% over October to January, dropped to -0.1% (yoy) in February and edged up to 0.5% in March. We knew there was a base effect in February that would take inflation temporarily lower. The surprise was the failure to rebound in March. The culprit is food prices. Fresh food prices, which had been rising at about a 3% rate in late 2016, have fallen at an average 2.7% pace in Feb/March. Similarly sharp declines have been seen in China and Taiwan and in some Latin American countries too. Better weather may play a role, but it's hard to know whether this is a temporary factor or something that will keep inflation low for the rest of the year. We lean towards the former interpretation.

Fresh food prices in Hong

Sources: CEIC and Deutsche Bank Research

The drop in inflation is also a consequence of the way housing is measured in the CPI. According to the CPI, housing costs were up 0.2%yoy versus 3.9% housing inflation a year ago. This is because the CPI includes private rents with a very long lag (which we estimate at about 16 months). But as residents of Hong Kong know, housing inflation really has been rising over the past year. Private rents were up 8.3%yoy in March, whereas they were falling 3.7% in March last year. Contrary to what the statisticians say, consumers in Hong Kong feel like inflation has been accelerating over the past six months, even with the drop in food prices.

That's important, because invariably when the Fed starts raising rates, some people will say it is not appropriate for Hong Kong's rates to follow US rates and the very low reported inflation rate will encourage people in that belief. But with GDP growth running ahead of potential and underlying inflation actually rising, we think it is appropriate for monetary policy to be tightening in Hong Kong.

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Hong Kong: Deutsche Bank Forecasts

	2015	2016F	2017F	2018F
National Income				
Nominal GDP (USD bn)	309.4	320.7	343.2	371.0
Population (mn)	7.3	7.4	7.4	7.5
GDP per capita (USD)	42325	43483	46255	49714
Real GDP (YoY%)	2.4	1.9	2.7	3.5
Private consumption	4.8	1.6	3.2	3.0
Government consumption	3.5	3.3	2.5	2.0
Gross fixed investment	-3.2	-0.5	5.2	7.8
Exports	-1.4	0.9	3.6	4.8
Imports	-1.8	1.2	3.7	4.9
Prices, Money and Banking				
CPI (YoY%) eop	2.3	1.2	0.0	3.8
CPI (YoY%) ann avg	3.0	2.4	0.0	3.0
Broad money (M3, eop)	5.5	7.7	8.3	10.0
HKD Bank credit (YoY%, eop)	3.8	7.9	9.0	12.5
Fiscal Accounts (% of GDP)[1]				
Fiscal balance	0.6	3.7	1.6	2.1
Government revenue	18.6	22.1	19.7	20.3
Government expenditure	18.0	18.4	18.2	18.1
Primary surplus	0.6	3.7	1.6	2.1
External Accounts (USD bn)				
Merchandise exports	501.7	502.6	520.8	554.9
Merchandise imports	524.6	519.8	536.7	569.9
Trade balance	-22.9	-17.2	-16.0	-15.0
% of GDP	-7.4	-5.4	-4.7	-4.2
Current account balance	10.3	14.4	18.6	23.8
% of GDP	3.1	4.5	5.4	6.4
FDI (net)	-78.5	22.4	-6.0	-25.0
FX reserves (USD bn)	358.8	386.2	406.8	428.7
FX rate (eop) HKD/USD	7.75	7.76	7.80	7.80
Debt Indicators (% of GDP)				
Government debt[1]	6.5	7.0	7.3	7.5
Domestic	5.8	6.3	6.6	6.9
External	0.8	0.7	0.6	0.6
Total external debt	420.3	450.0	430.0	410.0
in USD bn	1300.3	1443.1	1475.6	1521.3
Short-term (% of total)	69.3	70.0	70.0	70.0
General				
Unemployment (ann. avg, %)	3.3	3.3	3.3	3.3

Financial Markets	**Current**	**17Q2F**	**17Q3F**	**17Q4F**
Discount base rate	1.25	1.50	1.75	1.75
3-month interbank rate	0.94	1.50	1.75	1.75
10-year yield (%)	1.40	**1.50**	**1.60**	**1.70**
HKD/USD	7.79	**7.80**	**7.88**	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: While there are several moving parts which cloud the medium-term inflation outlook at this stage, we think risks are biased to the upside and RBI will not hesitate to hike rates, even in 2017, if some of the risks were to manifest.
- Main risks Equity market valuations remain stretched, while there is uncertainty regarding how the summer monsoon will pan out this year. There could be short-term disruptions once the GST becomes operational and the favorable flow dynamic may ease in the coming months due to negative seasonality.

Hawkish RBI to focus on medium-term inflation outlook

The minutes of the April MPC meeting (released on 20 April) were unambiguously hawkish, with one member even suggesting that a 25bps pre-emptive repo rate hike at this juncture probably would have made it easier for the central bank to achieve its medium term CPI target of 4%. The MPC members highlighted potential upside risks to inflation from the following ten factors: i) narrowing output gap; ii) implementation of HRA allowances; iii) GST; iv) ongoing increase in administered prices of various items; v) rising rural wages; vi) risk of sub-normal monsoon; vii) return of pricing power; viii) imported inflation on account of higher global commodity prices; ix) exchange rate volatility; and x) geo-political risks.

The risks are diverse and difficult to quantify accurately, which adds to greater uncertainty regarding the future inflation outlook. Against this backdrop, it is unsurprising that the RBI has adopted a cautious and conservative monetary stance, thereby showing willing to err on the side of caution. The risks to inflation will become apparent from the second half of FY18 when the base effect turns negative and pushes CPI slightly above the 5% mark; consequently the central bank will look though the base effect-led benign inflation outcome likely in the April-June quarter, in our view.

Our inflation forecasts suggest that under a base case scenario CPI will average about 3.2% in the April-June quarter (assuming no adjustment in HRA allowance in this quarter), lower than the 3.9% median estimate of professional forecasters. We see CPI inflation picking up thereafter to 4.5% average during the July-Sep quarter, a tad higher than the consensus estimate (4.2% average). Barring any shocks, CPI inflation should average close to 4.0% in the first half of FY18, which will be in the lower range of the MPC's forecast.

Throughout 2H of FY18, CPI inflation will likely stay above the 5% mark, due to an unfavorable base effect. We forecast CPI inflation to average 5.3% in the second half of FY18, under our base case scenario (consensus estimate is at 5.0%). This should result in 4.5% average CPI inflation for FY18 as a whole.

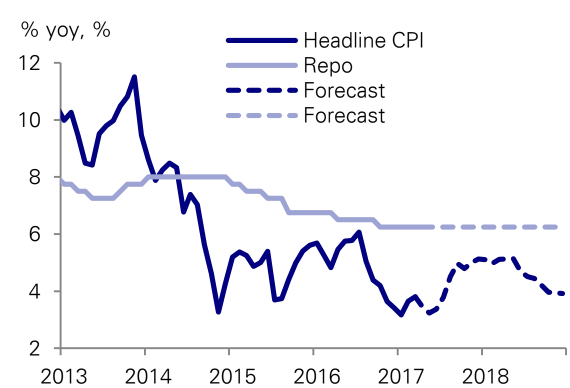
While there are several moving parts which cloud the medium-term inflation outlook at this stage, we think risks are biased to the upside (relative to RBI's 4% medium term CPI target) and RBI in our view will not hesitate to hike rates, even in 2017, if some of the risks were to manifest.

Quarterly inflation forecast (%, average)

FY18	CPI inflation, consensus forecast	CPI inflation, DB forecast
Q1	3.9	3.2
Q2	4.2	4.5
Q3	4.8	5.2
Q4	5.3	5.3
FY18 Average	**4.6**	**4.5**
FY18	Core CPI, consensus forecast	Core CPI inflation, DB forecast
Q1	4.9	4.8
Q2	4.9	5
Q3	4.9	4.8
Q4	4.9	4.9
FY18 Average	**4.9**	**4.9**

Source: RBI, Deutsche Bank. Note: Core CPI inflation = CPI excluding food and fuel

Risks to inflation are to the upside in 2HFY18, leading RBI to turn hawkish from earlier this year



Source: CEIC, Deutsche Bank

Focus on Indian monsoon

IMD forecasts a normal monsoon, but risks remain

The Indian Meteorological Department released its provisional forecast for summer monsoon (June-Sep'17) last month. According to the IMD, the monsoon seasonal rainfall is likely to be normal in 2017, with precipitation seen at 96% of the long period average (LPA) with a model error of +/-5%. The probability of near normal monsoon occurring in 2017 is 38%, as per the IMD's estimate. Skymet Weather Services, a private agency, has however forecasted a below-normal monsoon for India in 2017 (with precipitation expected at 95% of the long period average with an error margin of +/-5%). According to Skymet, there is 0% chance of excess rainfall but 15% chance of a drought in 2017 (defined as cumulative rainfall falling more than 10% of LPA through June-September period). The Australian Bureau of Meteorology has also warned about a possible formation of El Nino in 2017, which is associated with below average rainfall outcome.

IMD's forecast for the southwest monsoon (June-Sep): 2017 vs. 2016 & 2015

Category	Rainfall Range (% of long period average)	Forecast Probability (%) for 2015	Forecast Probability (%) for 2016	Forecast Probability (%) for 2017
Deficient	< 90	33	1	
Below Normal	90 - 96	35	5	
Normal	96 -104	28	30	38
Above Normal	104 -110	3	34	
Excess	> 110	1	30	

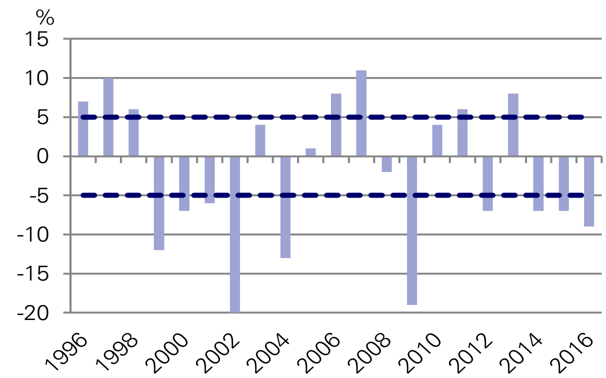
Source: IMD, Deutsche Bank. Note: 1) The long period average of the season rainfall over the whole country for the period 1951-2000 is 89 cm. 2) India Meteorological Department will issue updated forecasts in June 2016 as a part of the second stage forecast.

The adjacent chart shows the variance between the IMD's provisional forecast (released in April each year) and the actual rainfall outcome during June-Sep. While IMD's forecast record has improved since 2010, it becomes clear from the chart, that the big misses have been more when actual rainfall has been deficient, rather than being excess. The forecast misses for the years 2002, 2004 and 2009 – which were characterized by severe drought – are particularly striking.

While it is too early to predict how south-west monsoon will actually pan out in 2017 (IMD will come out with an updated forecast in June), we think it is instructive to consider the following facts related to India's monsoon and it's likely impact on key macro variables.

* Historically, El Nino conditions have generally led to poor monsoon outcome in India, though not necessarily resulting in outright droughts. In fact, as the IMD has pointed out, during 34% of El Nino years, monsoon season rainfall in India was normal or above normal.

Difference between IMD's provisional forecast and actual rainfall outcome



Source: IMD, Deutsche Bank

El Nino years, Indian monsoon, agriculture GDP growth

	EL Nino years	Intensity of El Nino	Indian rainfall deviation from LPA	Agriculture GDP growth, %yoy
1	**1951**	**moderate**	**-18.7**	**1.9**
2	1952	weak	-8.2	3.1
3	1953	weak	9.8	7.5
4	1957	strong	-2.4	-4.1
5	1958	weak	9.8	9.8
6	1963	moderate	-2.1	2.4
7	1965	strong	-18.2	-9.9
8	**1968**	**moderate**	**-10.3**	**0.0**
9	1969	weak	0.2	6.3
10	1972	strong	-23.9	-4.4
11	1976	weak	2.5	-5.2
12	1977	weak	4.0	9.6
13	1982	strong	-14.5	0.6
14	**1986**	**moderate**	**-12.7**	**0.6**
15	**1987**	**moderate**	**-19.4**	**-1.1**
16	1991	moderate	-9.3	-1.4
17	1994	moderate	-0.9	5.2
18	1997	strong	2.2	-1.3
19	**2002**	**moderate**	**-19.2**	**-4.9**
20	**2004**	**weak**	**-13.8**	**1.1**
21	2006	weak	-0.4	4.6
22	**2009**	**moderate**	**-21.8**	**1.0**
23	**2014**	**weak**	**-12.0**	**1.0**
24	2015	strong	-14.0	0.8

Source: Deutsche Bank. Note: A drought in India is defined as cumulative rainfall during June-September being 10% lower than the long period average (LPA). The long period average of the season rainfall over the whole country for the period 1951-2000 is 89 cm

* Also, there are many years when monsoon rains have been late to arrive but have picked up subsequently to offset the negative impact. There is a limit to the catch-up, however. Typically, if the initial rainfall is 25% or more below LPA in June, there is a high likelihood of a poor monsoon.

Cumulative monsoon rainfall (% deviation from normal)

Years	June	July	Aug	Sep	June-Sep
1965	-33.3	-4.8	-22.7	-20.8	-18.2
1969	**-23.5**	**6.6**	**5.8**	**2.8**	**0.2**
1972	-26.7	-31.2	-14.1	-23.6	-23.9
1974	-25.6	-4.4	-5.3	-21.8	-12.0
1979	-15.5	-16.0	-18.5	-27.6	-19.0
1982	-16.8	-23.1	8.9	-32.2	-14.5
1987	-21.6	-28.8	-3.7	-25.1	-19.4
1992	**-22.0**	**-19.1**	**14.7**	**-2.6**	**-6.7**
1995	**-23.6**	**3.5**	**-0.4**	**6.4**	**-1.9**
2009	-47.2	-4.3	-26.5	-20.2	-21.8
2012	**-23.0**	**-19.0**	**-12.0**	**-8.0**	**-8.0**
2014	-43.0	-23.0	-17.0	-12.0	-12.0

Source: IMD, Deutsche Bank. Note: The years highlighted in bold represent periods when monsoon rains recovered sharply after recording a significant shortfall in June

* Normal cumulative rainfall is a necessary but not sufficient condition for ensuring healthy harvest. The temporal and spatial distribution of rainfall is equally important. Too much rain at the end of the monsoon period including unseasonal rainfall could lead to flooding, while too little rainfall at crop-critical areas could be equally damaging for agricultural production.

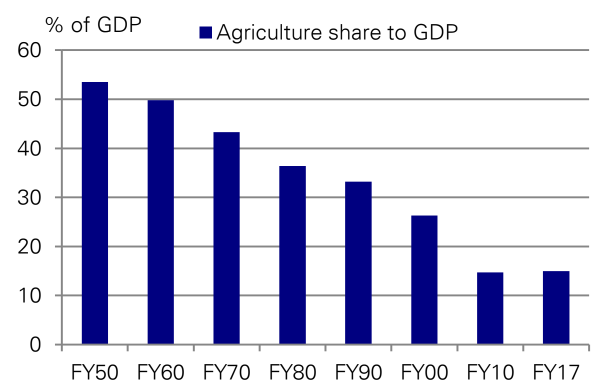
Spatial distribution of rainfall is equally critical

	States	Region	State wise key crops grown & their share in total production
1	Gujarat	Central	Oilseeds (21%), cotton (30%), onion
2	Madhya Pradesh	Central	Pulses (26%), oilseeds (20%), wheat (15%)
3	Maharashtra	Central	Pulses (16%), sugarcane (22%), coarse cereals (15%), cotton (23%), oilseeds(16%), onion
4	Rajasthan	North West	Oilseeds (19%), wheat (9%), coarse cereals (15%), pulses (13%)
5	Haryana	North West	Wheat (12 %), rice (4%), cotton (7%)
6	Punjab	North West	Wheat (18%), rice (11%), cotton (6%)
7	Uttar Pradesh	North West	Wheat (32%), rice (14%), pulses (10%), sugarcane (39%), potato
8	Bihar	East/North East	Raw jute (17%), wheat (5%), potato
9	Andhra Pradesh	South	Rice (12%), cotton (20%), coarse cereals (13%)
10	West Bengal	East/North East	Rice (14%), raw jute (75%), potato

Source: Ministry of Agriculture, RBI, Deutsche Bank.

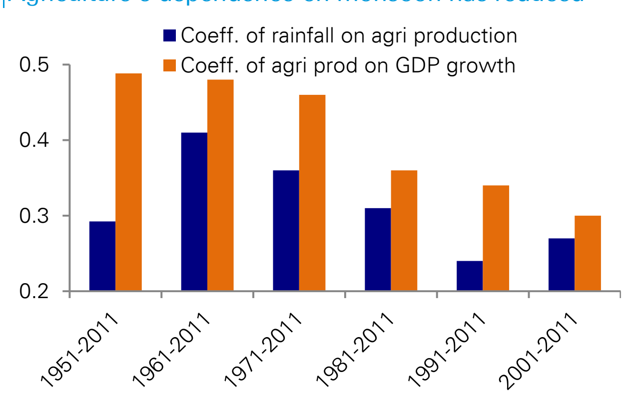
* Agriculture's dependence on summer monsoon has reduced considerably over the years, due to structural changes in the economy. Apart from improved irrigation facilities (though remaining below the desired levels), the other big shift that has happened over the years is the reduction in monsoon dependent Kharif (summer) crop's contribution to total food production, with a concomitant rise in the Rabi (winter crop) production (Kharif's share in total agri production has fallen from 66% in the 1950s to 50% currently, with share of Rabi rising concomitantly). This structural shift has helped to moderate the impact of a bad monsoon on agricultural production, as a good Rabi production has often provided the necessary support in offsetting the adverse impact of a monsoon-deficient poor Kharif production. The rise in ancillary jobs within the farm sector, which now contribute materially to "agricultural sector" growth, has also reduced the dependency of rural households on core farming activities. This is particularly important, as without this, the rural sector would have been much more vulnerable to the vagaries of monsoon rains than currently.

Agriculture share to GDP has fallen steadily



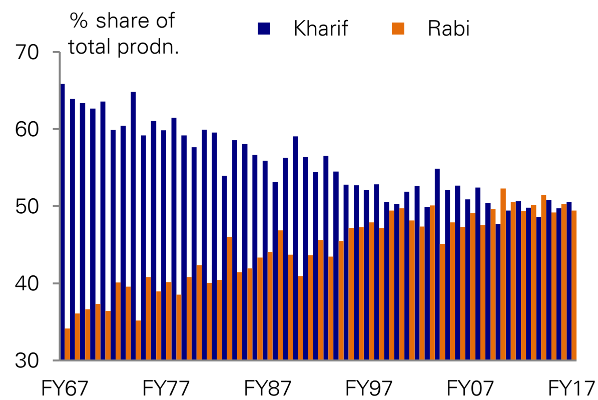
Source: CEIC, Deutsche Bank

Agriculture's dependence on monsoon has reduced



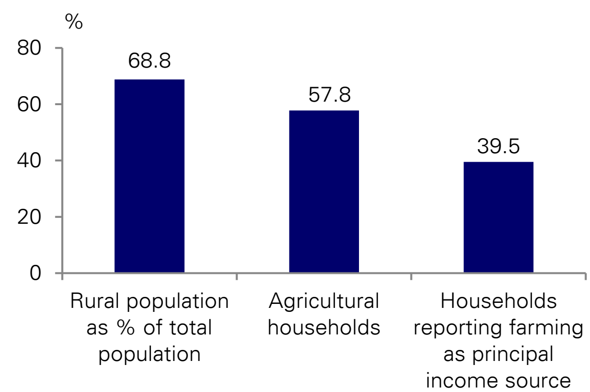
Source: IMD, CEIC, Deutsche Bank. Coefficient estimates of two regressions. First regresses agriculture production growth on rainfall deviation from long period average (LPA) during the periods specified. Second regresses overall real GDP growth on agriculture production growth.

Monsoon dependent Kharif crop's share in total production has fallen sharply over the decades, with a concomitant rise in the share of Rabi crop



Source: CEIC, Deutsche Bank

Out of 69% rural population and 58% of households engaged in agricultural activities, only 40% depend on farming as their principal source of income



Source: Census 2011, Situational Assessment Survey 2013, NCAER Report: Transformation in Indian agriculture, allied sectors and rural India, Dr. Anil K. Sharma, Deutsche Bank

* The importance of summer monsoon should not be under-estimated however, in our view, as the south-west monsoon remains critical for filling up the 91 key water reservoirs in the country. Reservoir water is used for drinking, irrigation (Rabi crop), hydroelectric power generation, and industrial use and therefore it is critical that the storage level remains healthy for economic activities to progress normally. The two back to back severe droughts in 2014 and 2015 resulted in pushing the water storage level to as low as 15% of the capacity by end-June 2016, which thankfully improved to a healthy level by October 2016 (76% of the storage capacity), post last year's normal monsoon.

Data from the Central Water Commission show that water levels in the 91 major reservoirs in the country is currently (as on 4 May'2017) at 26% of their storage capacity. Reservoirs of the southern (9%) and northern (25%) regions have relatively lesser water compared to the other three regions (east: 40%; central: 38%; west: 31%). If monsoon rains disappoint in July-September meaningfully, the water storage levels of the reservoirs may become an issue for the winter Rabi crop, which now contributes 50% to overall agricultural production.

Storage status of 91 major water reservoirs

Region (States) (Monitoring No. of Reservoirs)	% of live storage capacity				
	13-Apr-16 (last year)	30-Jun-16 (trough)	30-Sep-16 (end of monsoon)	13-Oct-16 (peak)	04-May-17 (latest)
NORTH (Himachal Pradesh, Punjab & Rajasthan), (6 Reservoirs)	23%	24%	76%	74%	**25%**
EAST (Jharkhand, Odisha, Tripura & W. Bengal), (15 Reservoirs)	34%	17%	86%	85%	**40%**
WEST (Gujarat & Maharashtra), (27 Reservoirs)	18%	9%	80%	87%	**31%**
CENTRAL (Madhya Pradesh, Uttar Pradesh, Uttarakhand & Chhattisgarh.), (12 Reservoirs)	31%	20%	91%	92%	**38%**
SOUTH (Karnataka, Tamil Nadu, Andhra Pradesh & Telengana, & Kerala), (31Reservoirs)	15%	10%	52%	53%	**9%**
Total (91 reservoirs)	**23%**	**15%**	**74%**	**76%**	**26%**

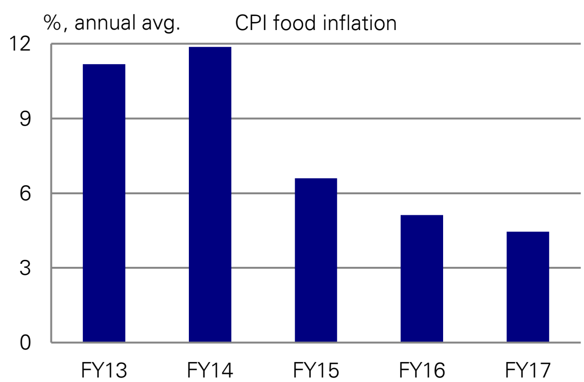
Source: Central Water Commission, Deutsche Bank

* In the event of a poor monsoon outturn this year, agricultural sector growth will likely suffer, but not as much as in the previous decades, when bad monsoon evidently resulted in sharp decline in agricultural production. Moreover, a poor agricultural sector growth outturn is unlikely to have any material impact on overall GDP growth, given that the agricultural sector now contributes lower than 15% to total GDP. We estimate about 25bps downside risk to growth from the baseline (we are forecasting 7.5% real GDP growth for FY18) if monsoon rains were to disappoint this year, ceteris paribus.

* Over the past decade, poor monsoons have not necessarily caused high food price inflation. For example in 2002 and 2004, cumulative rainfall was down 19% and 14% respectively, but thanks to an effective undertaking by the government that saw large scale disbursement from the government's food stocks, inflation remained under control. Similar dynamic was witnessed in FY15 and FY16, when due to effective administrative measures taken by the government, CPI food inflation remained on an easing path despite faced with two successive droughts in 2014 and 2015.

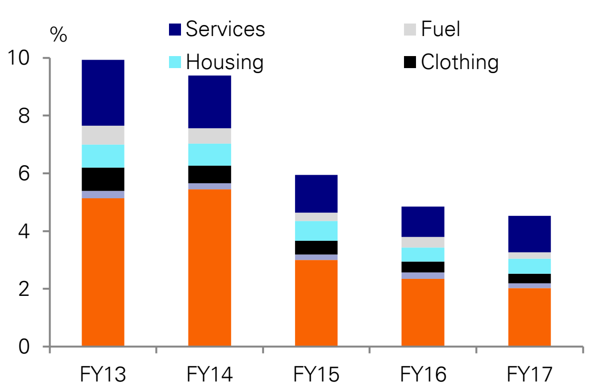
* However, with food price inflation already having come down to 4.5% (average in FY17), it may be difficult to sustain these levels and hence there could be some potential upside risk to food and consequently headline CPI inflation from the baseline, in the event of a poor monsoon. As per our estimate, a poor monsoon can potentially push up headline CPI inflation by an additional 30-40bps from our baseline forecast of 4.5% average for FY18, ceteris paribus.

CPI food inflation eased through FY15 and FY16 despite two back to back droughts



Source: CEIC, Deutsche Bank

Contribution of food inflation to CPI inflation has been reducing steadily



Source: CEIC, Deutsche Bank

Steps that were taken by the Government in 2014/2015 to improve the availability & to contain prices of essential food items:

- States were advised to allow free movement of fruits and vegetables by delisting them from the APMC Act.
- A Price Stabilization Fund (PSF) with a corpus of INR5bn was approved for implementation aimed at regulating price volatility of agricultural and horticultural commodities both when there is price rise or vice-versa through procurement of farm produce, maintenance of buffer stocks and regulated release into the market.
- States were advised to exempt levy of market fee on fruits and vegetables and to allow establishment of "Kisan Mandis"/ Farmers markets where producers and Farmer Producer Organizations (FPOs) can directly market their produce to wholesalers, organized retailers and ordinary consumers. Such alternative marketing channels promoted to reduce intermediaries and to contain marketing costs, are intended to benefit both farmers and consumers.
- Government also encouraged production of horticultural crops through a centrally sponsored scheme, namely Mission for integrated Development of Horticulture starting in FY14/15.
- Authorized States/UTs imposed stock limits in respect of onion and potato for a period of one year under the Essential Commodities Act.
- Government approved the release of additional five million tonnes of Rice to BPL & APL families in states pending implementation of National Food Security Act (NFSA).
- Advisory to State Governments was issued to take action against hoarding & black marketing and effectively enforce the Essential Commodities Act, 1955 & the Prevention of Black-marketing and Maintenance of Supplies of Essential Commodities Act, 1980.
- Authorized States/UTs to impose stock limits from time to time in the case of select essential commodities such as pulses, edible oil, and edible oilseeds.
- Based on interaction with the State Governments/UTs on 4th July, 2014, a decision was taken to amend the Essential Commodities Act to make hoarding and black marketing a grave offence and increase the period of detention to one year from six months.
- The Government approved Open Market Sale of 10mn tons of wheat in the domestic market in 2014-15.

Rupee and reserves adequacy

Currently India has sufficient FX reserves to cover 11 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 USD15-20bn per year), assuming imports will increase from FY18 onward on account of higher global oil prices and an incremental recovery in growth.

Given the excess amount of liquidity in the money market, RBI has shown greater comfort with rupee strength in the current phase, compared to past periods. There is probably another reason why RBI has tolerated more FX strength in the current period. Our understanding is that RBI is comfortable with the current bout of rupee appreciation, because it helps reduce pressure on imported inflation, which is a key source of inflation risk for the Indian economy, as per the central bank's view. Apart from FX pass-through risks to inflation, there are various other risks which RBI does not have control over and hence the central bank is probably happy with the recent bout of FX appreciation as it helps reduce at least once source of inflation risk, however small the positive impact may be (as per RBI's estimate, a 5% appreciation of INR/USD could soften inflation by 10-15 bps in FY18).

Going forward, the central bank will have to balance its priorities of achieving an ambitious inflation target (4% CPI inflation on a durable basis) while ensuring that reserves adequacy strength remains intact or improves further through steady reserves accumulation and prudent demand management strategies. We think the central bank will continue with a balanced approach of FX intervention, which further strengthens the reserves adequacy position, but opportunistically also allow the rupee to appreciate a bit more at times (like in the current episode) to help contain imported inflation risks.

Finally, a word of caution for Indian corporates. India's short-term external debt on a residual maturity basis (up to 1 year) was USD189bn at the end of December 2016. While non-resident Indian deposits (USD75bn), which are sticky in nature, account for the bulk of this short-term external debt, the external commercial borrowings of corporate entities, at USD25bn, are also not trivial. Many Indian companies continue to carry unhedged foreign exchange exposure, which is a risky strategy. While the RBI will continue to manage volatility in the FX market, this should not be taken for granted, and in our view it would be prudent for companies to continue hedging in a disciplined manner to avoid disappointment in the future.

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India: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	2068	2195	2520	2770
Population (mn)	1271	1289	1307	1325
GDP per capita (USD)	1628	1703	1929	2091
Real GDP (YoY %)	7.4	7.5	7.3	7.8
Private consumption	6.7	8.3	8.0	8.6
Government consumption	0.8	14.1	9.1	10.0
Gross fixed investment	7.1	-1.1	3.8	3.8
Exports	-6.3	0.5	6.5	7.3
Imports	-6.2	-2.6	7.5	7.3
Real GDP (FY YoY %) [1]	7.9	7.0	7.5	7.8
Prices, Money and Banking				
CPI (YoY%) eop	5.6	3.4	5.3	3.8
CPI (YoY%) avg	4.9	5.0	4.1	4.7
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	380.0	400.0
FX rate (eop) INR/USD	66.3	67.9	67.5	69.5
Debt Indicators (% of GDP)				
Government debt	70.4	69.9	68.5	66.8
Domestic	67.3	66.8	65.5	63.9
External	3.2	3.1	3.0	2.9
Total external debt	23.2	20.8	18.6	17.3
in USD bn	479.2	456.1	465.2	479.1
Short-term (% of total)	17.0	18.4	18.6	18.6
General				
Industrial prodn (YoY%, avg.)	3.2	0.3	2.7	3.9
Financial Markets	*Current*	*17Q2F*	*17Q3F*	*17Q4F*
Repo rate	6.25	6.25	6.25	6.25
3-month treasury bill	6.25	6.30	6.30	6.30
10-year yield (%)	6.93	6.80	7.00	7.10
INR/USD	64.6	65.0	66.0	67.5

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

Indonesia

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

- Economic outlook: Inflation appears to have bottomed out and a combination of stronger GDP growth and a moderately weaker currency should take inflation high enough in H2 that Bank Indonesia will begin to raise rates before year-end.
- Main risks: Inflation is very volatile, but we think it is more likely to surprise to the upside than to the downside. The timing of interest rate increases could also be brought forward if expectations for US monetary policy become significantly more hawkish.

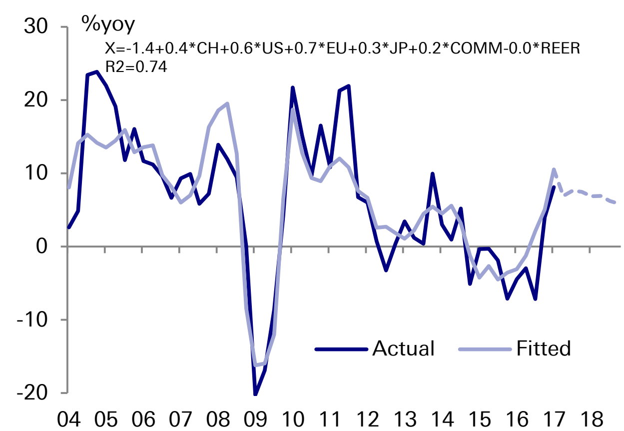
A weaker start to the year

We have trimmed our GDP growth forecasts in response to a slightly weaker than expected first quarter GDP report – particularly the softness in domestic demand – and a reduction in our US GDP growth forecasts. The revisions are unlikely materially to affect the outlook for inflation other than perhaps to take out some of the upside risk. Our base case remains that inflation will be above 4% by Q4 and that BI will respond by raising interest rates before year-end (October to be precise) and cumulatively 100bps over the following year.

GDP growth of 5.0%yoy in Q1 was hardly disappointing, representing essentially the mid-point of the 4.7% - 5.2% range within which growth has fluctuated over the past three years and a tiny pickup from 4.9% the previous quarter. But this continuity masked that growth slowed to 1.1%QoQ(sa) from 1.4% in Q4. We don't read too much into this except that it would take a heroic effort to make up the lost growth in Q1 to meet our previous 5.5% annual average growth forecast. That's why we've trimmed it to 5.3%.

The most impressive part of the Q1 report was the 8.0%yoy growth in exports of goods and services. This was in fact very slightly weaker than we'd expected (8.5%). But it was by no means an outlier, as the chart below shows. But it was mainly driven by the surge in commodity price inflation, which reinvigorated demand in commodity exporting emerging markets. Given the importance of these terms of trade effect, we think this past quarter represented the high water mark for export growth this cycle. As the chart shows, we expect that export growth will be moderately weaker in the rest of the year. This will still likely be the best year for export growth since 2011, though. The downgrade to our 2018 US growth forecast has caused us to revise export growth down a little.

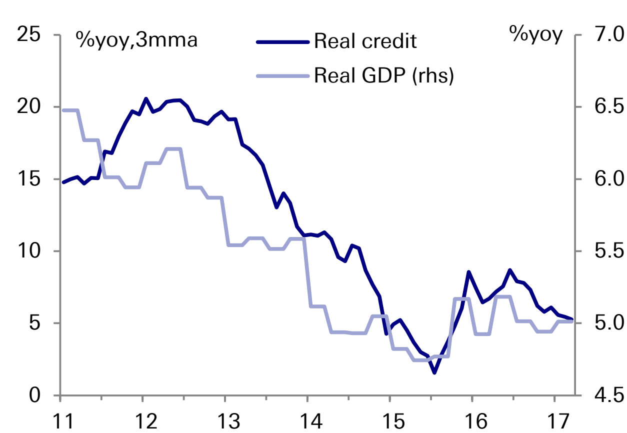
A simple model for real exports of goods and services



Sources: CEIC and Deutsche Bank Research

We're more interested, therefore, in the domestic demand indicators than in the recovery in exports. Indonesia is a much less export sensitive economy than most other Asian economies, so growth prospects mainly come down to the outlook for consumption and investment. For example, relative to our forecast machinery investment was disappointingly weak. We model it – not tremendously successfully – as a function of exports and consumption growth and we assume the shortfall will be made up in the next couple of quarters.

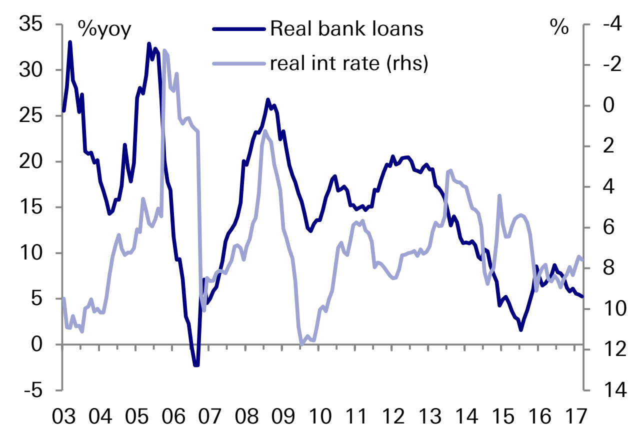
Real GDP and credit growth



Sources: CEIC and Deutsche Bank Research

We confess to not having a good model for consumption growth given the lack of reliable employment or income data. But we note that slowing population growth exerts a statistically identifiable, if not hugely significant, drag on consumption over time. The other determinant of consumption demand that we can identify is real credit growth. Indeed, as the chart above shows there's a close enough link between credit growth and GDP that we can explore this area for a view on growth prospects.

Real credit and interest rates



Sources: CEIC and Deutsche Bank Research

From this perspective, the slightly disappointing first quarter – at least to us – reflected the fact that while real interest rates fell real credit growth did too. Our expectation for a pickup in growth rests on the decline in real interest rates – as BI responds to inflation only with a lag – stimulating a pickup in borrowing and therefore in consumption and investment activity.

Headline inflation has risen from 3.0% in December to 4.2% in April mainly due to rising electricity charges. Core inflation has risen only from 3.1% to 3.3%. We expect both measures of inflation to rise to or above 4.0% over the next six months, but we expect BI to wait until Q4 to raise rates, which means real rates will be falling for most of the year, stimulating credit demand.

An obvious risk to this baseline case, therefore, is that with nonperforming loans rising – albeit to only just above 3% in recent months – banks might not pass on these lower interest rates to all borrowers. Indeed, while interest rates on corporate loans have fallen with the BI rate (or reverse repo since last August) over the past two years, rates on consumer credit have not. Even if banks don't cut nominal interest rates, rising inflation will make borrowing seem more attractive. But banks need to be willing to lend for this to translate into faster growth. We'll watch this closely.

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Indonesia: Deutsche Bank forecasts

	2015	2016F	2017F	2018F
National Income				
Nominal GDP (USDbn)	861.2	932.7	**981.6**	**1,032.0**
Population (mn)	255.5	258.7	**261.9**	**265.0**
GDP per capita (USD)	3,624	3,925	**4,131**	**4,342**
Real GDP (YoY%)	4.9	5.0	**5.3**	**5.1**
Private Consumption	5.0	5.0	**5.0**	**5.3**
Government consumption	5.3	-0.1	**3.4**	**2.0**
Gross fixed investment	5.0	4.5	**4.8**	**3.6**
Exports	-2.1	-1.7	**6.2**	**5.1**
Imports	-6.4	-2.3	**3.6**	**2.7**
Prices, Money and Banking				
CPI (YoY%) eop	3.4	3.0	**4.3**	3.6
CPI (YoY%) ann avg	6.4	3.5	4.1	3.8
Core CPI (YoY%)	4.9	3.4	**3.4**	**3.8**
Broad money (M2)	12.8	7.9	**9.2**	**5.2**
Bank credit (YoY%)	10.8	8.3	**9.9**	**5.1**
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	15.1	15.3
Primary surplus	-1.2	-1.0	-0.3	-0.1
External Accounts (USD bn)				
Merchandise exports	149.1	144.4	**168.0**	**181.9**
Merchandise imports	135.1	129.1	**149.7**	**162.0**
Trade Balance	14.0	15.4	**18.3**	**19.9**
% of GDP	1.6	1.7	**1.9**	**1.9**
Current Account Balance	-17.5	-16.3	**-13.5**	**-7.1**
% of GDP	-2.0	-1.8	-1.4	-0.7
FDI (net)	10.7	15.1	8.0	16.0
FX Reserves (eop)	1.1	-12.1	**110.1**	**108.0**
FX rate (eop) USD/IDR	13,855	13,417	14,325	13,622
Debt Indicators (% of GDP)				
Government Debt	27.4	27.5	**28.9**	**27.3**
Domestic	12.2	11.0	**10.7**	**9.4**
External	15.2	16.6	**18.2**	**17.8**
Total external debt	36.1	34.0	**32.6**	**29.5**
in USD bn	310.7	317.0	**320.0**	**304.3**
Short-term (% of total)	12.5	13.3	14.0	12.0
General				
Industrial Production (YoY%)	4.3	4.3	**4.6**	**4.3**
Unemployment (%)	6.0	5.9	5.8	5.7
Financial Markets (eop)	**Current**	**17Q2F**	**17Q3F**	**17Q4F**
BI 7d reverse repo	4.75	4.75	4.75	5.00
10-year yield (%)	7.05	7.20	7.25	7.50
USD/IDR	13,367	**13,500**	**14,100**	14,325

Source: CEIC, DB Global Markets Research, National Sources

Malaysia

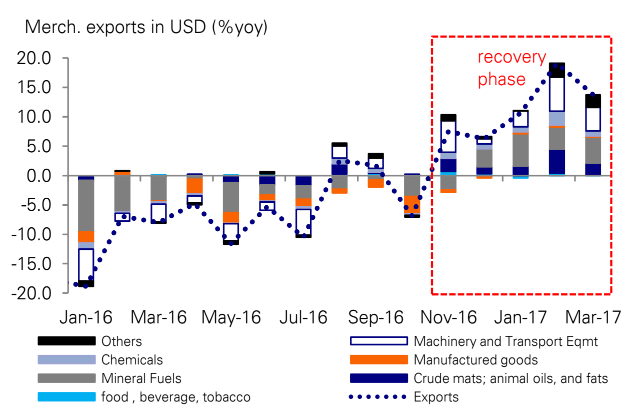
A3/A-/A-(Neg)
Moody's/S&P/Fitch

- Economic outlook: The Malaysian economy continued to gain momentum in the first quarter. However, as softer spending counters the acceleration in exports, the economy likely retained the 4.5%yoy growth in Q1, as recorded in the preceding quarter.
- Main risks: The spike in headline inflation, largely due to a low base on fuel, could spur further price acceleration and weigh on growth recovery.

Sustaining the momentum

Nearly halfway into the year, the Malaysian economy is still gaining momentum, at least per the latest data. Merchandise exports sustained the double-digit expansion in the first three months of 2017, posting average growth of 14.5%yoy. The expansion is evident across the board, stemming from better export earnings of mineral fuels (16% of total exports), but also of machinery and transport equipment (41%) and chemicals (8%), among others. More importantly, the expansion is not just underpinned by higher export prices, but of a marked increase in shipments of Malaysia's key products.

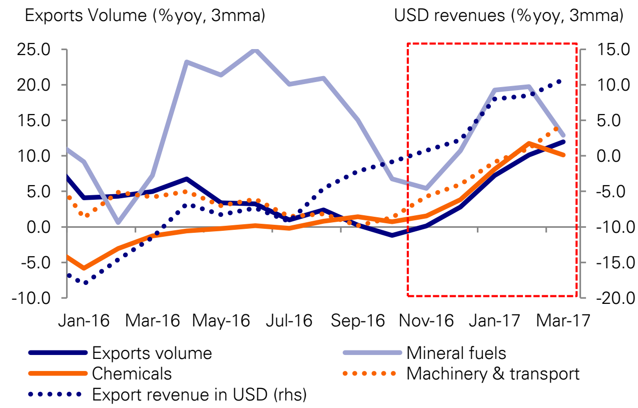
Continued rebound in export earnings...



Source: CEIC and Deutsche Bank

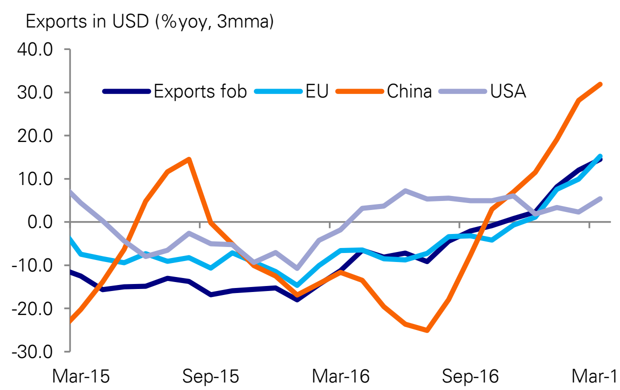
By destination, China remains the key driver behind the rebound; earnings from the Chinese market surged 31.9%yoy in the first quarter. Europe's demand for Malaysia's shipments has been gaining pace as well while that of the US has been expanding at a more subdued pace of about 5%. PMI readings in April continue to suggest strong growth momentum in the US, Eurozone, and China, in turn pointing to a sustained strength in Malaysia's (and Asia's) exports.

...as well as in export volumes



Source: CEIC and Deutsche Bank

Rebound in demand still led by China, then Europe

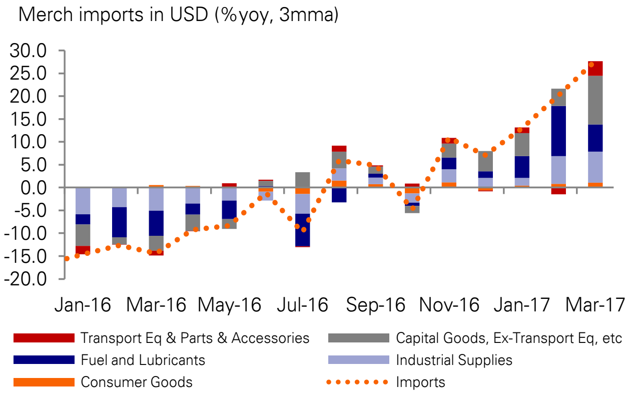


Source: CEIC and Deutsche Bank

Has this rebound in external demand also lifted domestic demand?

Indeed in line with the acceleration in factory output and export orders, business sentiment has firmed, exceeding the optimism threshold in Q1 and now pointing to a stronger pace of business activity in the current quarter. As one indicator, imports of capital goods, transport equipment, and industrial supplies expanded by 15-17%yoy in the first quarter, up from single-digit rates in 2016Q4. So clearly, it is not just fuel that caused imports to accelerate from 4.4%yoy in Q4 to 20.3%yoy last quarter. Likewise, import volumes for manufactured goods and machinery & transport, aside from mineral fuels and chemicals, exhibited double-digit rates of expansion last quarter.

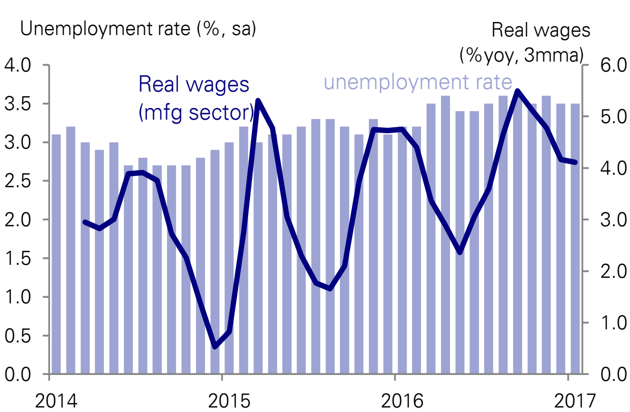
Imports are gaining pace across the board, suggesting a modest turnaround in domestic demand



Source: CEIC and Deutsche Bank

However, consumer sentiment, while inching a tad higher in Q1, remained depressed, although spending remained buoyant, as it grew at least 6%yoy (real) in 2016. We see private consumption growing by at least 5%yoy in 2017, underpinned by a sustained increase in real wages and low unemployment rates as well as fiscal transfers to low-income households, although weak sentiment is still likely to weigh on spending. We have concerns that the spike in headline inflation could spur second-round effects and cause further acceleration in consumer prices, thereby further dampening sentiment. This does not appear to be the case at the moment. Consumer goods imports, for instance, gained pace last quarter to grow 5.5%yoy (nominal), a reversal from the 1.7%yoy drop in Q4.

Buoyant spending supported by wage increases



Source: CEIC and Deutsche Bank

Overall, we see Malaysia on track with a modest lift to growth in 2017. Q1 GDP growth is likely to settle at 4.5%, in line with the previous quarter. The softer pace of spending will likely keep the BNM on hold in 2017.

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Malaysia: Deutsche Bank forecasts

	2015	2016F	2017F	2018F
National Income				
Nominal GDP (USD bn)	296.4	296.9	293.6	310.2
Population (mn)	31.2	31.7	32.1	32.6
GDP per capita (USD)	9,504	9,377	9,136	9,506
Real GDP (YoY%)	5.0	4.2	4.5	4.7
Private consumption	6.0	6.1	5.3	4.9
Government consumption	4.4	1.0	-0.7	4.5
Gross fixed investment	3.7	2.7	5.7	5.2
Exports	0.6	0.1	1.6	0.8
Imports	1.2	0.4	1.4	0.7
Prices, Money and Banking (YoY%)				
CPI (eop)	2.7	1.8	**3.7**	**3.0**
CPI (ann avg)	2.1	2.1	**4.2**	2.7
Broad money (eop)	2.6	3.0	**6.0**	**6.5**
Private credit (eop)	8.4	5.7	**5.7**	**6.5**
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	175.6	165.7	173.8	177.4
Goods imports	147.5	141.2	148.1	152.8
Trade balance	28.1	24.4	25.7	24.6
% of GDP	9.5	8.2	8.7	7.9
Current account balance	8.9	6.1	8.4	7.6
% of GDP	3.0	2.0	2.9	2.4
FDI (net)	1.2	4.3	1.6	2.5
FX reserves (eop)	95.3	94.5	95.4	98.4
MYR/USD (eop)	4.3	4.5	4.6	4.7
Debt Indicators (% of GDP)				
Government debt[1]	69.9	68.3	71.8	71.4
Domestic	52.8	51.0	54.2	53.7
External	17.1	17.3	17.6	17.7
Total external debt	65.5	68.2	72.1	74.7
in USD bn	194.3	202.6	211.6	231.7
Short-term (% of total)	42.2	42.1	42.7	41.3
General (ann. avg)				
Industrial production (YoY%)	4.7	3.8	4.5	4.5
Unemployment (%)	3.2	3.5	3.6	3.7
Financial Markets (%, eop)	*Current*	*17Q2F*	*17Q3F*	*17Q4F*
Overnight call rate	3.00	3.00	3.00	3.00
3-month interbank rate	3.39	3.43	3.43	3.43
10-year yield	3.94	4.10	4.20	4.30
MYR/USD	4.33	4.53	4.64	4.60

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

Philippines

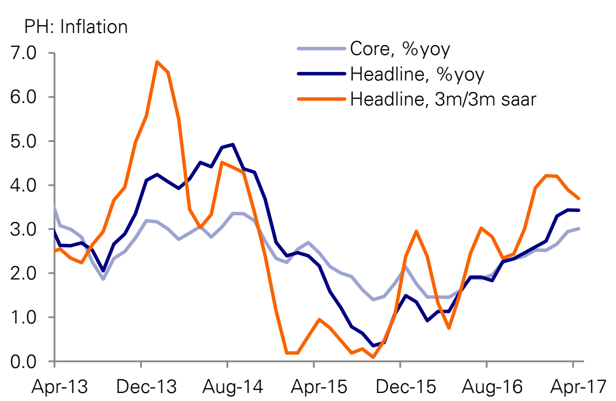
Baa3(Pos)/BBB-/BBB-
Moody's/S&P/Fitch

- Economic outlook: Numerous inflationary pressures, robust economic growth, and rapid credit expansion will likely guide the BSP to hike the policy rate by 25bps in August and November.
- Main risks: Upside inflationary surprises could prompt a much-earlier-than-expected rate hike.

Inflation cools, but rate hikes loom

Inflation was steady at 3.4%yoy in April, as sequential increases in consumer prices slowed down to 0.1%mom(sa) from 0.4%mom(sa) in the previous month. Last month's inflation should keep the BSP on hold in May. However, despite the easing in inflation momentum of late, upside pressures still abound. We see inflation inching a tad higher to 3.5% in May and hovering between 3.4-3.6% through October before moderating towards 3.0-3.3% through the first half of 2018. We now see the BSP hiking policy rates twice this year, by 25bps each in August and November, to guard against the upside risks to inflation. We cite three factors that could influence the BSP's decision to tighten the policy valve earlier than we had expected.

Price pressures are building



Source: CEIC and Deutsche Bank

1. Momentum is still high, making inflation highly exposed to numerous upside risks. Food inflation continued to rise in April, due to sharper increases in meat and fish prices as rice prices remained steady from the previous month. Likewise, the transport price index sustained the acceleration on the back of higher crude oil prices relative to a year ago. Indeed, even as the momentum softened 20bps from March to print 3.7%qoq(saar), it still exceeded the 3.4%yoy inflation print in April, suggesting that upward price pressures will likely remain firm in the coming months. Dissipating base effects though could dampen inflationary pressures.

The BSP cited some tightness in domestic food supply, which has in part caused the pick-up in food and overall headline inflation. From this standpoint, weather disturbances that may disrupt agricultural production could easily led to a spike in inflation. Food plays an important role in Philippine inflation dynamics, given its 36.2% weight in the CPI basket. Perhaps what could temper this particular upside risk to inflation is the likelihood of El Niño forming in the latter half of the year during the rainy season, which reduces the onset of typhoons. However, El Niño persisting through the dry season next year could also adversely affect agricultural output and push prices higher.

The BSP is forecasting inflation to average 3.4% in 2017 (DB: 3.3%) and 3.0% in 2018 (DB: 3.3%), with the balance of risks tilted to the upside, owing to possible adjustments in electricity rates and transportation fares, and the inflationary impact of the new administration's fiscal program. In relation to that program, the first package of the tax reform faces hurdles in Congress but it remains on track for implementation in the first half of 2018. The inflationary impact of the tax reform now stands higher than the BSP's earlier estimates (+50-70bps upside) with a tax on sweetened beverages having been recently added in the first package. In addition, the peso's weakness stands to be another source of inflationary pressure.

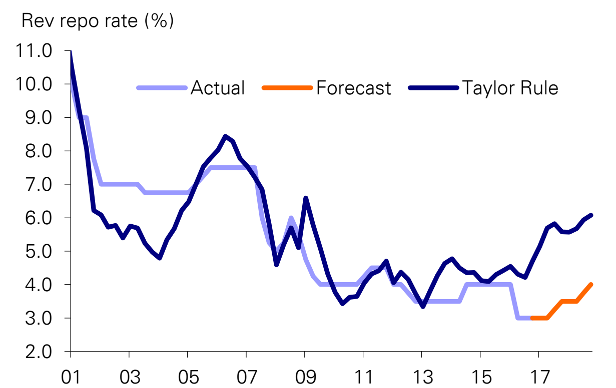
Stripping out volatile components of the CPI, such as selected food and energy items, core inflation has likewise steadily inched higher from 2.5%yoy in December (2016: 1.9%) to 3.0%yoy in April (2017ytd: 2.8%). This suggests the presence of demand-induced price pressures, and/or second-round effects from faster commodity price increases.

2. Robust domestic demand adds to potent price pressures. Strong domestic demand, alongside a recovery in exports, is likely to facilitate GDP growth of 6.2% in 2017 and 6.5% in 2018, in our view. Overseas Filipinos' remittances and credit sustained double-digit average growth (in PHP) in the first two months of 2017, supporting private consumption. Imports, on the other hand, slowed in January and February, but nevertheless sustained double-digit expansion rates. In particular, imports of raw materials and intermediate goods recorded a material pick-up (5.8%yoy in Jan-Feb vs. 1.6%yoy in Q4). We believe this is in line with the acceleration in exports in the first two months of 2017 (+15.4 vs. 3.9%yoy in Q4). As such, the trade balance would have likely become less of a drag to Q1 GDP growth. The weak link is government spending, which, as per fiscal accounts, has recorded a sharp decline in growth to 4.0%yoy in Q1, from 15.1%yoy in Q4. Overall, we estimate that the economy expanded by 6.4% yoy

in Q1, just a tad slower than the 6.6%yoy rate in the preceding quarter.

Against this backdrop of strong growth and rising inflation, our Taylor rule model suggests a BSP going through a rate hike cycle this year through 2018.

Strong growth, rising inflation indicate policy rate hikes



Our Taylor rule model expresses the policy rate as a function of the output gap, inflation, & FF rate.
Source: CEIC and Deutsche Bank

3. Rapid credit growth and negative real rates pose risks to financial stability. Credit has accelerated alongside robust economic activity. This is ideally a welcome development, given the country's low leverage, with bank lending accounting for just 44% of GDP by end-2016. However, bank lending has been expanding at a pace considerably faster than the underlying pace of economic activity, warning about a deterioration in credit quality. According to the latest data, lending may already be growing (19.7%yoy in March, net of RRA) at more than twice the pace of nominal GDP growth, suggesting the need for some policy intervention by the monetary authorities.

Negative real interest rates arising from higher inflation could also only add fuel to the fire, potentially driving credit growth even stronger. Car loans, for instance, after peaking at 34%yoy in mid-2016 to a still-rapid pace of 28%yoy in December, could again accelerate as consumers guard against expectations of higher inflation (and higher automobile excise taxes).

Moreover, the appointment of Deputy Governor Nestor Espenilla, Jr., who currently heads banking supervision at the BSP, as the next BSP Governor come July may mean a more active role for the BSP in ensuring financial stability while advancing financial inclusion.

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Philippines: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USD bn)	292.8	304.9	306.8	326.8
Population (mn)	101.0	102.6	104.1	105.4
GDP per capita (USD)	2,899	2,971	2,949	3,100
Real GDP (YoY%)	6.1	6.9	6.2	6.5
Private consumption	6.3	7.0	5.4	5.9
Government consumption	7.6	8.4	1.2	5.0
Gross fixed investment	16.9	25.2	12.1	14.9
Exports	8.5	10.7	12.9	10.3
Imports	14.6	18.5	13.0	12.8
Prices, Money and Banking (YoY%)				
CPI (eop)	1.5	2.6	3.0	3.4
CPI (ann avg)	1.4	1.8	3.3	3.3
Broad money (M3, eop)	9.4	12.8	12.4	11.4
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	52.0	52.7
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	25.6	24.3
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	14.3	11.0	6.9
Unemployment (%)	6.3	5.7	6.0	5.8
Financial Markets (%, eop)	*Current*	*17Q2F*	*17Q3F*	*17Q4F*
Policy rate (BSP o/n repo)	3.50	3.50	3.75	4.00
Policy rate (BSP o/n rev repo)	3.00	3.00	3.25	3.50
3-month T-bill rate	2.35	2.45	2.75	3.00
10-year yield (%)	4.65	4.65	4.75	4.90
PHP/USD	49.9	50.5	51.3	52.0

(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

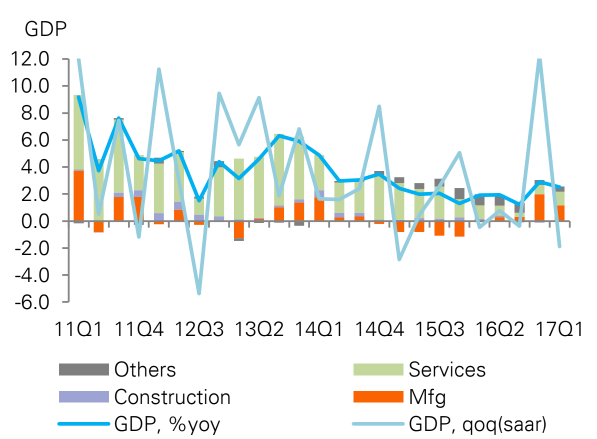
- Economic outlook: Trade, factory output, PMI, and credit data point to Q1 growth of 2.8%yoy, per our estimates. A sustained growth recovery may pave for policy tightening by the MAS in October.
- Main risks: A growth slowdown in China could disrupt the exports recovery and hurt the city-state's improving economic prospects.

MAS lets policy easing run its course

The MAS kept monetary policy unchanged at its April meeting as it transitioned to a cautiously upbeat tone in line with modest improvements in the global and Singapore economies.

In the statement released after the meeting, the MAS recognizes the slight improvement in the global economy since the October policy review. While the Singapore economy contracted by 1.9%qoq(saar) in Q1, according to advance estimates and following the strong 12.3% expansion in 2016Q4, the MAS believes underlying economic momentum is intact, given still elevated electronics output. On an annual basis, advance estimates show Singapore's GDP expanded by 2.5% in Q1, from 2.9%yoy in the preceding quarter.

Growth eases in Q1 (advance estimate) although underlying momentum, albeit uneven, remains intact.

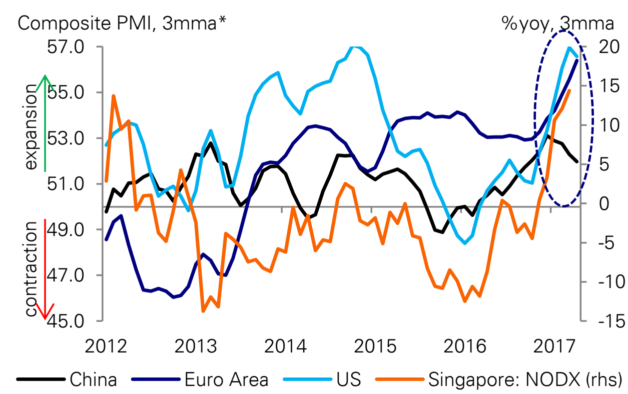


Source: CEIC and Deutsche Bank

The construction sector pulled down growth, as output contracted by 1.1%yoy after expanding by 0.2%yoy in Q4. But manufacturing output accelerated to 6.6%yoy from 3.6%yoy previously, and the services sector gained pace by 50bps to grow 1.5%yoy in Q1.

The monetary authority cited healthy levels persisting in electronics production and related services segments. The MAS further mentioned that stronger business sentiment has lifted global capital expenditure, while improving labor market conditions in the developed economies should continue to support the turn in external demand. Accordingly, the pick-up in Singapore's trade-related sectors should be sustained; the 'turnaround in the global IT cycle will continue to benefit the domestic semiconductor and precision engineering industries'. China's stable outlook, on the other hand, is seen to continue to anchor relatively buoyant global demand.

Rebound in Singapore's non-oil exports is being supported by firming activities in key markets



*US refers to ISM manufacturing PMI
Source: Bloomberg Finance LP, CEIC, Haver Analytics, and Deutsche Bank

To be fair, the MAS is cautious of the downside risks surrounding its slightly brighter global economic outlook. It sees domestic economic activity to be uneven, with the rest of Singapore's manufacturing sector likely to remain patchy, and discretionary spending to be weighed down by weak consumer sentiment and the slack in the labor market. Against this cautious stance, the MAS continues to expect the Singapore economy to grow within 1-3% in 2017, fairly in line with the 2% growth in 2016.

Meanwhile, there has largely been no change in the MAS' inflation outlook. In line with the last assessment in October, the MAS continues to expect core inflation to average 1-2% in 2017 and to trend slightly towards sub-2% over the medium term. Increases in both core and headline inflation are largely expected to stem from higher prices of oil-related items and administrative price adjustments this year, with demand pressures likely to remain muted. This uneven pace of domestic expansion and lack of demand-driven price pressures, in our view, kept away the urgency to tweak policy at this month's review.

Indeed, the MAS intends to let monetary easing run its course, as what we heard from the MAS briefing on 27 April, two weeks after the policy review. MAS Chief Economist Edward Robinson stressed that the April monetary decision is a continuation of the easing cycle since January 2015, when the slope of the FX policy band was first reduced in an off-schedule move, and hence the reference to 'an extended period' in the latest policy statement. While the MAS officially expects growth to settle within 1-3% this year, Robinson believes it will likely be within a tighter 2-2.5% range, with the output gap seen to close through 2018. He noted a satisfactory pick-up in labor productivity, which rose to 2.4%yoy in 2016Q4 (1.0% in 2016) from -0.2% in 2015, and that the new few years could see productivity expand by around 1.5%. But he finds the strength of wage growth (above 3%yoy since 2015) unsettling, and that the more acceptable rate could be about 1%, as suggested by Singapore's Phillips curve. Skill mismatches, in line with the ongoing economic transition, could continue to put upward pressure on the unemployment rate for an extended period before labor conditions improve.

And so, with the pick-up in growth momentum a fairly recent phenomenon and the challenging domestic labor market likely to put a lid on price pressures and the growth recovery, MAS delivered an *unhurried* decision in April, according to the Chief Economist. He further shared the MAS' NEER neighborhood exercise, wherein results show that modestly loosening policy could raise medium-term inflation much more than GDP growth. A modest tightening, on the other hand, could open the output gap and reduce inflation. Given that Singapore's monetary policy decision is guided by price stability, there is clearly no need then to hurriedly tweak monetary policy. But he also noted that the MAS has an internal endpoint for the neutral slope of the policy band. To him, an economy with a sizeable trade surplus should maintain a gradual pace of currency appreciation over time.

Thus, we advise investors to be on guard. Alongside a modest improvement in Singapore's growth outlook, core inflation inching slightly closer towards 2% by year-end—which is our baseline view—could prompt some fine-tuning by the MAS, we reckon. The MAS should be in a position to modestly tighten policy, such as by increasing the slope of the S$NEER to 0.5%, even as the pick-up in core inflation would be largely driven by the turnaround in commodity prices and administrative price increases. Recall that expectations of a slower pace of economic expansion, when the 2016 growth outlook was revised from ~2-2.5% to 1-3% was what prompted a policy turn to neutral in April 2016. The MAS may just reverse that move in October.

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Singapore: Deutsche Bank Forecasts

	2015	2016F	2017F	2018F
National Income				
Nominal GDP (USD bn)	296.8	297.0	**300.0**	**316.6**
Population (mn)	**5.5**	5.6	5.7	5.8
GDP per capita (USD)	53,629	52,961	**52,653**	**54,637**
Real GDP (YoY%)	1.9	2.0	2.5	3.0
Private consumption	4.6	0.6	1.1	2.2
Government consumption	8.0	6.3	8.1	4.8
Gross fixed investment	1.1	-2.5	2.8	5.3
Exports	2.6	1.6	2.8	3.3
Imports	2.9	0.3	2.7	3.2
Prices, Money and Banking				
CPI (YoY%) eop	-0.6	0.2	2.2	**2.5**
CPI (YoY%) ann avg	-0.5	-0.5	1.6	**2.5**
Broad money (M2, eop)	1.5	8.0	**5.4**	**5.0**
Bank credit (eop)	2.5	5.5	**6.4**	**8.0**
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	1.43	1.40
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	7.1	7.2
Unemployment (%) (eop)	1.9	2.1	2.2	2.2
Financial Markets	*Current*	*17Q2F*	*17Q3F*	*17Q4F*
3-month interbank rate	1.00	1.03	1.08	1.12
10-year yield (%)	2.15	2.30	2.40	2.60
SGD/USD	1.40	1.41	1.42	1.43

(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: After impressing the market with a GDP growth of 2.7%yoy in Q1, Korea faces further upside risks to growth, as fiscal policy may turn more supportive, while exports remain strong.
- Main risks: Adverse (geo)political and trade policy risks to growth continue to hover over Korea.

A time for reconciliation

GDP growth momentum strengthens despite political headwinds, as expected... Korea's 1Q'17 GDP growth accelerated to 2.7%yoy (0.9%qoq sa), from 2.4% (0.5%) in Q4'16, above the market forecast of 2.6% but below our estimate of 2.8%. The 0.1ppts downside against our forecast may be attributable to weak services exports, in the areas of travel and shipping services in particular. Travel credit fell 13.8% in Q1, vs. a 9.9% rise in Q4, while shipping services credit continued to post a double-digit fall of 17.6% in Q1, marking its eighth consecutive quarterly decline.

Divergence in goods and services exports

Sources: CEIC, Deutsche Bank

Reflecting China's retaliation against South Korea over THAAD, the number of Chinese visitors to South Korea fell 7.9% in Q1, vs. 7.2% growth in Q4, dragging down total growth to 4.4% from 16.3% in Q4. To counter the impact, the Korean government has eased visa rules to attract tourists from elsewhere in Asia, although North Korea security concerns have muted the potential positive impact of its diversification efforts. For example, the Japanese government issued a travel warning against its citizens visiting South Korea as the US and North Korea escalated their threatening rhetoric.

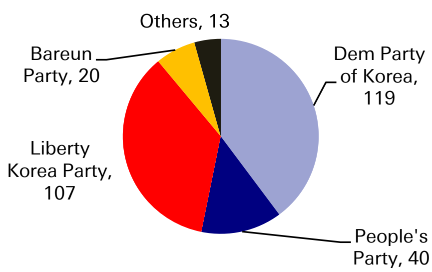
In other areas, details of the GDP report were largely in line with our expectations, with the rebound in growth led by goods exports and facility investment. Goods exports rose 6.4% in Q1, up from 2.1% in Q4, while facility investment surged 14.4%, vs. 1.9% in Q4, contributing 1.3ppts and 3ppts to overall growth in Q1, vs. 0.2ppts and 1ppts in Q4. In the same period, however, a sharp acceleration in import growth to 9.4%, from 3.3%, brought the net trade contribution to growth down sharply to -2.9ppts, from -1ppts. Meanwhile, private consumption growth rebounded to 2% in Q1, from 1.5% in Q4, contributing 1ppts in Q1 vs. 0.7ppts in Q4, while sustained robust growth in construction investment, at 9.6%, contributed 1.2ppts during the quarter, after posting double-digit growth over a year.

Growth rebound led by exports and investment

Sources: CEIC, Deutsche Bank

...with fiscal policy posing further upside risks to growth... Even better, exports surged 24.2%yoy in April, up from 15% in Q1 and well above the market's and our forecast of 17% and 18%, respectively. While this upside surprise may be attributable to ship and vessel deliveries, the general strength in goods exports more than made up for weakness in services exports, posing further upside to our forecast of 2.5% GDP growth for this year. We hold off on revisions, however, in case of positive policy surprises from the new administration and negative trade policy surprises from the US and/or China. President Moon Jae-In championed greater fiscal spending and corporate reform during his campaign, which requires the National Assembly's support. Barring a significant change in the composition of South Korea's political parties, however, the ruling Democratic Party of Korea does not have enough votes (180 required) to push through President Moon's economic agenda without support from other parties. While we expect little, if any, resistance to increasing welfare spending for the poor and elderly, Korea's history of fiscal discipline suggests that a 5% increase in the 2018 budget (the preliminary plan has government expenditure rising 3.5% next year in line with the medium-term target) is more likely than the 7% boost promised during his campaign. As far as the supplementary budget is concerned, we see little problem in pushing through a KRW10tn extra budget for the remainder of 2017 if much is spent on welfare, given upside surprises in tax revenue collection this year. However, if a significant portion of the extra budget is unexpectedly marked for the four river project then we could see significant resistance and increasing political tension. Meanwhile, his more ambitious economic reform agenda, including the removal of a financial company's voting rights in its stake in non-financial affiliates and tax rate hikes, for example, will remain highly contentious.

National Assembly's composition



Sources: NA, Deutsche Bank

...as the Bank of Korea likely to mull over the timing of monetary tightening. According to our Taylor rule model, the Bank of Korea (BoK) policy rate is at least 125bps too low. Real rates have turned negative since September last year, with a rise in inflation, now hovering around the BoK target of 2%. Although inflation surprised to the downside in April, falling to 1.9%yoy in April from 2.1% in Q1, this was mainly driven by a decline in volatile food price inflation to 2.9% from 4.2% in the same period. As it seeks to confirm the durability of the economic recovery, we continue to see the BoK erring on the side of caution and forgoing rate hikes this year. We expect the BoK to deliver rate hikes in 2018, however, with risks tilted to the upside, due to a rebound in growth and rate hikes by the Fed. Moreover, should the new administration seek to support highly vulnerable households via debt restructuring, this would ease the constraints on the BoK hiking rates. As far as its vulnerability is concerned, Korea stands in the middle of our rankings when compared with its peers. For details please refer to the Asia Vulnerability Monitor on 25 April.

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South Korea: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USDbn)	1384	1412	1467	1487
Population (m)	50.6	50.8	51.0	51.1
GDP per capita (USD)	27332	27786	28782	29081
Real GDP (yoy %)	2.8	2.8	2.5	2.6
Private consumption	2.2	2.5	1.8	2.2
Government consumption	3.0	4.3	3.2	4.0
Gross fixed investment	5.1	5.2	4.2	0.9
Exports	-0.1	2.1	5.0	5.2
Imports	2.1	4.5	4.9	4.9
Prices, money and banking				
CPI (yoy %) eop	1.1	1.3	1.9	2.3
CPI (yoy %) ann. Avg.	0.7	1.0	2.1	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	0.1	0.0	-0.2
Government revenue	21.7	22.3	21.6	21.4
Government expenditure	21.7	22.2	21.6	21.6
Primary surplus	1.2	1.4	1.4	1.7
External accounts (USDbn)				
Merchandise exports	542.9	511.8	596.6	642.3
Merchandise imports	420.6	391.3	481.5	530.3
Trade balance	122.3	120.4	115.1	111.9
% of GDP	8.8	8.5	7.8	7.5
Current account balance	105.9	98.7	90.4	83.5
% of GDP	7.7	7.0	6.2	5.6
FDI (net)	-19.7	-16.4	-17.0	-17.0
FX reserves (USDbn) [1]	368.0	371.1	371.0	379.3
FX rate (eop) KRW/USD	1172	1209	1220	1200
Debt indicators (% of GDP)				
Government debt[2]	38.1	39.0	39.4	40.5
Domestic	37.6	38.6	39.0	40.1
External	0.5	0.4	0.4	0.4
Total external debt	28.6	26.6	24.9	24.8
in USDbn	395.4	375.0	365.0	350.0
Short-term (% of total)	27.1	26.7	27.4	28.6
General				
Industrial production (yoy %)	-0.6	1.1	2.0	2.5
Unemployment (%)	3.6	3.7	3.9	3.9
Financial markets	*Current*	*17Q2F*	*17Q3F*	*17Q4F*
BoK base rate	1.25	1.25	1.25	1.25
91-day CD	1.45	1.45	1.48	1.50
10-year yield (%)	2.24	2.40	2.60	2.70
KRW/USD	1136	1160	1200	1220

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

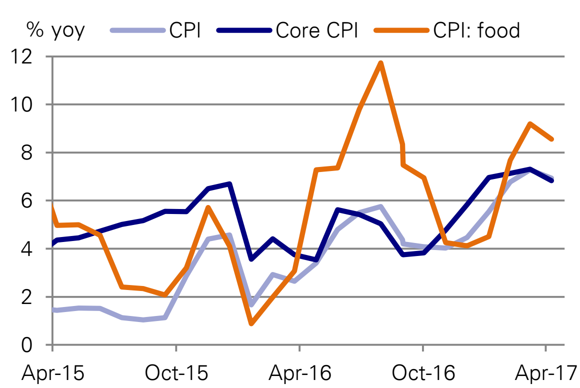
- Economic outlook: Inflation has likely peaked, gross official FX reserves have bottomed, fiscal consolidation is underway while growth continues to be below potential.
- Main risks: While the latest issuance of USD1.5bn international sovereign bond will increase FX reserves, the reserves adequacy position is still uncomfortably weak, which continue to expose the Sri Lankan economy to potential external shocks.

Sri Lanka trip notes

We met up with senior officials of Central Bank of Sri Lanka and Ministry of Finance last month to discuss the near and medium-term outlook of the Sri Lankan economy. Key takeaways:

*CBSL hiked rates in March to contain inflation expectations. With output gap remaining negative, private sector credit growth continuing to moderate (eased to 20.4%yoy in March'17, down from 21.9%yoy in Dec'16) and headline inflation mainly reflecting the adverse impact of drought, recent hike in VAT rate and FX depreciation, the authorities did not see any real risk of overheating and hence were comfortable to hike the policy rate by just 25bps, with the main objective of containing inflation expectations.

CPI inflation has peaked



Source: CEIC, Deutsche Bank

The authorities mentioned that they are monitoring the trend of private sector credit to construction and SME sectors closely to ascertain whether there are risks to credit quality issues and potential building up of a property bubble. The authorities also expressed their discomfort about broad money supply (M2b) growing at 18-20%, when nominal GDP growth is just 8-10%. Having delivered a 25bps rate hike in late March, we think the CBSL will be on the sidelines for the next few months, evaluating how credit and M2b growth responds in the period ahead. Our forecasts of inflation and other monetary indicators suggest that the CBSL will likely raise rates once again in the September meeting by 25bps, pushing up the policy rate to 9.0%.

* CBSL expects 5% growth in 2017. We took comfort from the fact that the authorities remained realistic about growth expectations (DB estimate: 5% growth for 2017) and indeed considered restoring macro stability and fiscal consolidation as bigger priorities in the short-term. With economic mismanagement in the past, Sri Lanka's potential growth rate has fallen to 5.5-6.0% currently, from about 6.3-6.5% earlier, as per CBSL's estimate. The authorities seemed determined not to repeat the past mistakes and instead focus on prudent macro policies which will help support a balanced, sustained good quality growth in the future.

* Fiscal consolidation to continue. We saw a sense of urgency among the Sri Lankan authorities to reduce fiscal deficit and debt, which have been responsible for creating macro-economic imbalances in the past. The authorities informed us that the 2016 fiscal target has been met and fiscal consolidation remains on track as per the latest data available for 2017. The new Inland Revenue Act should help further to continue with the fiscal consolidation agenda, as also the various other SOE reforms that have been agreed with the IMF. The authorities seemed confident of achieving the 4.7% of GDP fiscal deficit target for 2017, based on improving tax/GDP supported by tax hikes and reduced exemptions. We remain slightly skeptical about the ambitious revenue targets, given the weakness in growth. In our view, any potential shortfall in revenue will be offset by reduced capital expenditure to meet the fiscal deficit target.

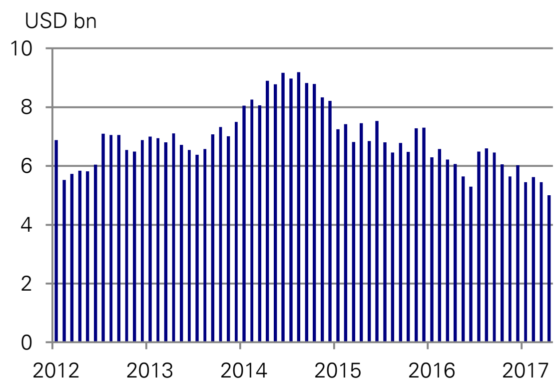
IMF fiscal targets for Sri Lanka

Items, % of GDP	2017F	2018F	2019F	2020F
Revenue and grants	**14.0**	**15.3**	**15.5**	**15.8**
Tax revenue	12.9	14.1	14.3	14.6
Non-tax revenue +grants	1.2	1.2	1.2	1.2
Expenditure	**18.8**	**19.3**	**19.2**	**19.3**
Current non-interest	9.2	9.2	9.2	9.2
Interest	4.7	4.7	4.6	4.5
Capital	4.9	5.4	5.5	5.6
Overall balance	**-4.7**	**-4.0**	**-3.7**	**-3.5**
Primary balance	0.0	0.7	0.8	1.0
Public debt	75.5	73.1	70.7	68.2

Source: IMF, Deutsche Bank

* FX reserves – the worst is behind us. As at end April, gross official reserves were down to just USD5.0bn (down from USD6.0bn in end-Dec 2016) but thankfully the worst seems to be over. The government's latest (11th tranche) issuance of USD1.5bn international sovereign bond (at 6.2%) along with other expected financial inflows to the government and the likely disbursement of the 3rd tranche under the IMF Extended Fund Facility (EFF), would improve the FX reserves position in the month ahead. We estimate gross official reserves to rise to USD7.0-7.5bn by the end of this year. But this will still be significantly lower than the target that the IMF had set for 2016 and 2017 respectively (USD7.8bn and USD9.4bn). Clearly, a lot has to be achieved on the external front if the IMF's FX reserves target for the subsequent years are to be met (2018: USD11.9bn; 2019: USD13.0bn; 2020: USD13.8bn).

Gross official reserves have bottomed



Source: CBSL, Deutsche Bank

* Rupee to continue depreciating to strengthen reserves adequacy and export competiveness. The authorities felt that the appreciation in real effective exchange rate should be contained, which would entail about 3% depreciation of the rupee against the USD per year in nominal terms. As per the CBSL's estimate, 1% depreciation in rupee results in 0.2-0.3% increase in inflation, but at this juncture rupee depreciation is critical to improve the export dynamic and the overall BOP and reserves adequacy level. Furthermore, depreciation of the currency will be net positive for the fiscal position and neutral for the external debt dynamic. We would expect the CBSL to continue being net buyers of USD in the FX market, which should see the rupee depreciating to 155 against the USD by the end of this year and further to 159 by end-2018.

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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	4.6	4.5
CPI (YoY%) avg	2.2	4.0	5.7	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*	*17Q2F*	*17Q3F*	*17Q4F*
Reverse Repo rate	8.75	8.75	9.00	9.00
LKR/USD	152.6	153.0	154.0	155.0

Source: CEIC, DB Global Markets Research, National Sources

Taiwan

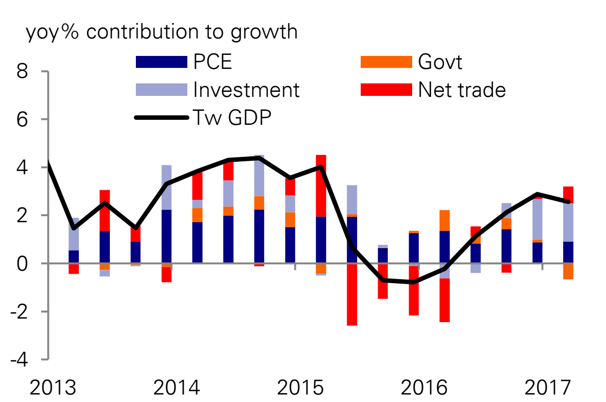
Aa3/AA-/A+
Moody's/S&P/Fitch

- Economic outlook: Although export growth peaked, we see Taiwan's GDP growth hovering around the mid-2% level in 2Q17, as domestic demand improves.
- Main risks: Taiwan would see a precipitous fall in growth if the US and/or China turn to broad-based punitive trade measures.

Better growth despite policy challenges

Taiwan's GDP growth impresses the market in 1Q, as expected… Taiwan's growth momentum strengthened in 1Q17 to 0.7%qoq sa, from 0.5% in 4Q16. On a yoy basis, high base effects guided Taiwan's GDP growth slightly lower, to 2.6% in 1Q17 from 2.9% in 4Q16. This was, however, stronger than the market forecast of 2.4%yoy. Against our own forecast of 2.7%, this 1ppt downside surprise was due largely to weak government expenditure. The latter fell 4.7%yoy in 1Q, dragging GDP growth by 0.7ppts, down from the positive 0.1ppt contribution to GDP growth during the previous quarter. This weakness was countered by the improvement in net trade and private consumption's contributions to GDP growth in 1Q2017, which rose to 0.7ppts and 0.9ppts, respectively, from 0.4ppts and 0.7ppts in 4Q16. Meanwhile, the capital investment contribution to GDP growth stood high at 1.6ppts in 1Q17, albeit down from 1.7ppts in 4Q16. With 1Q growth coming in better than the government's forecast, we expect the DGBAS to revise up its 2017 growth forecast of 1.9% when it releases the final 1Q GDP report late this month.

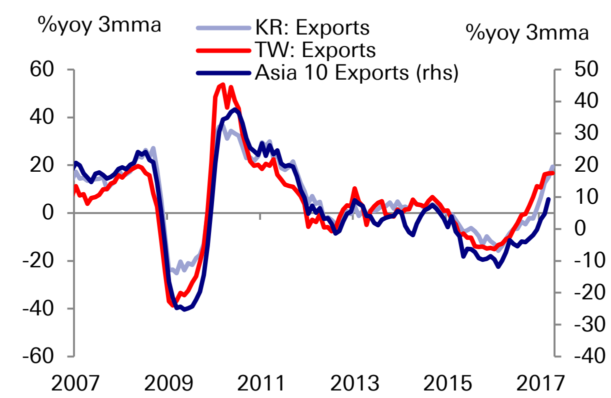
Growth led by investment as net trade improves…



Sources: CEIC, Deutsche Bank

…with exports continuing to support growth in 2Q… Although export growth peaked, we see Taiwan's GDP growth hovering around the mid-2% level in 2Q17, as domestic demand improves. Moreover, we see a limited slowdown in export growth, to average around 10% in Q2, vs. 15.9% growth in Q1. Indeed, in April, exports rose 9.4%yoy. Further ahead, the government's Infrastructure Development Plan (please see our previous monthly for details) provides upside risks to our growth outlook. If the infrastructure development plan is implemented in late 2017, it could add another 0.2ppts to overall growth. We hold off any revision for now, however, given the uncertainties with investment funding and US and China trade policies.

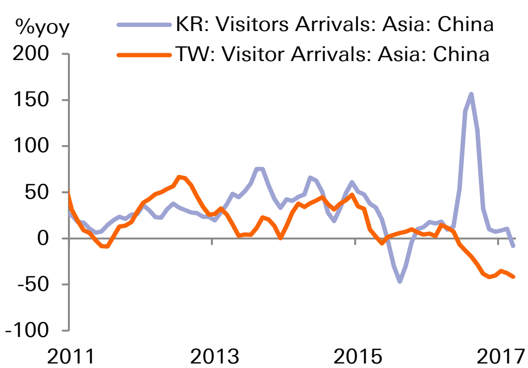
….as exports remain robust



Sources: CEIC, Deutsche Bank

…supported by exports, as punitive trade measures remain limited to a few goods… As highlighted in our previous monthly report, steel products stood out as a source contention in global trade. In fact, steel goods dominated anti-dumping discussions at the WTO last year and the US continued to impose punitive measures on selected steel products last year, including those from Taiwan, together with India, Brazil, the UK, South Korea, Japan and China. Following the executive order by President Trump to carry out a special investigation on steel imports under the 1962 Trade Expansion Act, which allows emergency trade sanctions on national security grounds, the International Trade Commission on 5 May also applied duties to carbon and alloy steel cut-to-length (CTL) plate from Taiwan, Austria, Belgium France Germany Italy Japan and South Korea. Dumping margins ranged from 2.62% to 6.95% for Taiwan, while for others the range varied from 5.4% to 53.7%. While further measures against base metals could have a meaningful impact on Taiwan's trade with the US – they represent about 15% of total exports to the US and are among the top two contributors to the trade surplus with the US – they account for less than 2% of Taiwan's total exports to the world, suggesting a limited impact on Taiwan's overall export outlook. Unless the US and/or China opt(s) for broad-based punitive trade measures ahead, we expect only a limited slowdown in Taiwan's export growth ahead.

Chinese visitors drag on tourism



Sources: CEIC, Deutsche Bank

Like its Korean counterpart, Taiwan also faced pressure on its tourism sector as China restricted its outbound tourism. The number of visitors to Taiwan fell more quickly at 9.9%yoy in 1Q 2017, vs. 4.2% in 4Q 2016, as the pace of decline in Chinese visitors accelerated to 41.6% from 40.1% in the same period. This fall in services exports takes on an even greater significance when compared to South Korea's 7.9% decline in the number of Chinese visitors in 1Q 2017, after the Chinese government imposed punitive measures against it for THAAD deployment. To support the sector, the Taiwanese government further simplified visa regulations and expanded related subsidies to attract tourists from elsewhere in Asia last month.

…as the CBC keeps its monetary policy supportive. Although our Taylor rule model suggests that the Central Bank of China (CBC) policy rate should be about 50bps higher, we see it delaying normalization of its monetary policy until next year to ensure durability of its economic recovery, amid low headline inflation and the TW dollar's strength. Taiwan is benefiting from a strong rebound in tech demand supporting its tech-heavy stock market and guiding the TW dollar closer to its fair value. Moreover, Taiwan's underlying risk of disorderly adjustment remains relatively low compared to its peers in EM Asia. For details, please refer to the Asia Vulnerability Monitor on 25 April. Although CPI inflation surprised to the downside in April, falling to 0.1%yoy from 0.2 % in March, we take caution, 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.

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Taiwan: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National income				
Nominal GDP (USDbn)	528.3	530.6	554.6	555.4
Population (m)	23.5	23.5	23.6	23.6
GDP per capita (USD)	22486	22536	23508	23498
Real GDP (yoy %)	0.7	1.5	2.3	2.4
Private consumption	2.7	2.1	2.0	2.2
Government consumption	-0.3	3.0	0.2	0.5
Gross fixed investment	1.6	2.7	2.2	2.6
Exports	-0.3	2.1	3.6	4.1
Imports	1.2	3.4	3.3	3.9
Prices, money and banking				
CPI (yoy %) eop	0.1	1.7	1.3	1.5
CPI (yoy %) annual average	-0.3	1.4	1.3	1.5
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	-0.3
Government revenue	15.9	15.8	15.7	15.7
Government expenditure	15.8	16.0	15.9	16.0
Primary surplus	1.0	0.7	0.6	0.5
External accounts (USDbn)				
Merchandise exports	335.5	314.8	329.4	344.0
Merchandise imports	262.9	244.1	264.4	284.3
Trade balance	72.6	70.6	65.0	59.6
% of GDP	13.7	13.3	11.7	10.7
Current account balance	75.5	74.0	63.7	54.9
% of GDP	14.3	13.9	11.5	9.9
FDI (net)	-12.4	-13.0	-13.0	-12.0
FX reserves (USDbn)	426.0	434.2	437.9	438.6
FX rate (eop) TWD/USD	33.1	32.3	32.5	32.4
Debt indicators (% of GDP)				
Government debt[2]	37.3	37.3	37.3	37.6
Domestic	37.3	37.3	37.3	37.6
External	0.0	0.0	0.0	0.0
Total external debt	34.7	35.6	35.1	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	2.0	2.5
Unemployment (%)	3.8	3.9	3.9	3.9
Financial markets	*Current*	*17Q2F*	*17Q3F*	*17Q4F*
Discount rate	1.38	1.38	1.38	1.38
90-day CP	0.48	0.51	0.56	0.58
10-year yield (%)	1.15	1.20	1.35	1.45
TWD/USD	30.3	31.2	32.0	32.5

Source: CEIC, Deutsche Bank Global Markets Research estimates, National Sources
Note: (1) Credit to private sector. (2) Including guarantees on SOE debt

Thailand

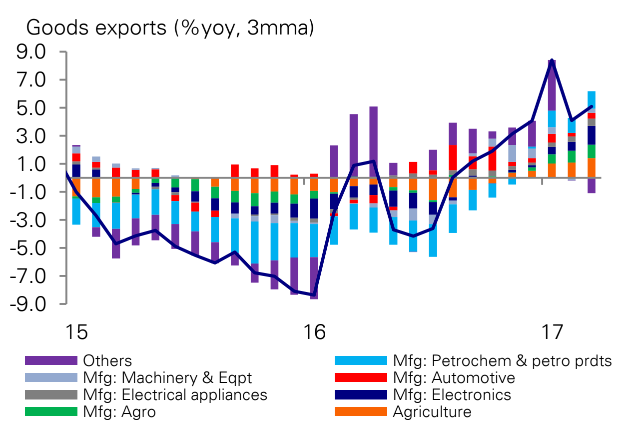
Baa1/BBB+/BBB+
Moody's/S&P/Fitch

- Economic outlook: The economy is poised to grow by at least 3.5% in 2017 owing to a sustained exports rebound, better commodity prices, and continued fiscal support. We see no rush to lift rates given lack of demand-induced price pressures.
- Main risks: Potential trade protectionist policies as the US addresses its trade deficit pose a material headwind to Thailand's export-oriented economy.

Trip notes: Cautiously upbeat

We were in Bangkok last week to meet representatives from the government (the Bank of Thailand, the Ministry of Finance, and the National Economic and Social Development Board), corporates, and institutional investors. The Thai authorities share our view that Thailand is facing a cyclical upturn. We left the BOT with a sense that it was in no rush to lift rates, a view also shared by institutional investors we met. The corporates we met, on the other hand, raised concerns over the impact of US President Trump's evolving trade policy on Thailand.

A broad-based rebound in Thailand's exports

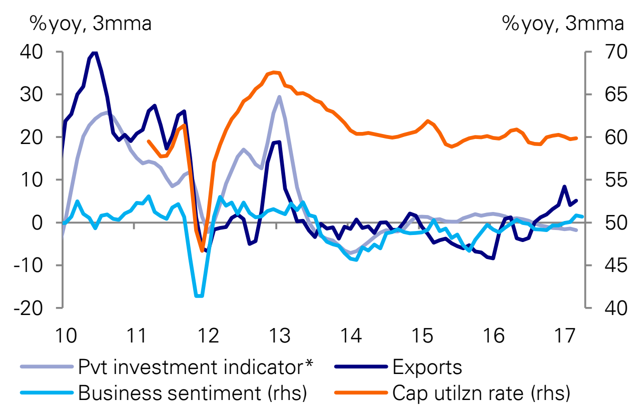


Agriculture refers to rice, rubber, tapioca, and fruits. Others refer to Fishery, Forestry, and Mining and other manufacturing products (metal and steel, chemicals, jewelry, apparels & textile mats, etc). Source: CEIC and Deutsche Bank.

Government representatives we met were cautiously upbeat with regard to Thailand's economic outlook. The forces that used to hold back economic expansion now appear to be receding. External demand, which is believed to be the primary drag to growth 2-4 years back, rebounded in the first three months of 2017. Thailand's exports earnings have lagged behind the rest of the region's double-digit expansion, in part attributed by authorities to the baht's appreciation. Nonetheless, earnings grew 5%yoy in the first quarter, a marked improvement from the four-year exports slump through mid-2016.

The Thai authorities now expect a more pronounced exports expansion this year (relative to 2016), due to improving global economic conditions. This development should in turn facilitate a modest turnaround in private sector investment, as also suggested by the improvement in business sentiment. But authorities cited still-subdued capacity utilization rates restraining a material investment pick-up.

Private sector investments could modestly turn around following the exports rebound, recovering sentiment



*Source: CEIC and Deutsche Bank (*indicator released by the BOT)*

Consumer spending could also see a modest lift as the distortionary effect of the first-time car buyer scheme dissipates and farm incomes improve. After the scheme was introduced in 2011 to revive the auto manufacturing industry following severe flooding in the same year, motor vehicle sales surged 1.7x to about 1.3mn units in 2012 and 2013. Sales have since eased towards 750-800th units per annum in 2015-16 and appear to be on a path of recovery, with 2017Q1 growth of 16%yoy (3mma) the fastest since May 2013. This is in part due to the expiry of the 5-year vehicle ownership period mandated by the scheme, which may also urge financial institutions to ease credit standards.

Farm incomes have also been gaining pace since bottoming out in mid-2016, posting 21%yoy growth in Q1 on the back of better crop yields and higher prices. The agricultural sector is an important factor in assessing the pace of overall consumption as it absorbs 30% of total employment.

Indeed, the BOT noted a slightly faster pace of increase in private consumption, particularly on passenger cars, in Q1 (3.0%yoy vs. 2.8%yoy in Q4). And the sharp pick-up in consumer confidence since the start of 2017, which reached a 2-year high in April, bodes well for a sustained improvement in consumer demand.

Thailand's elevated household debt at 80% of GDP though stands to weigh on consumer demand. The authorities, however, pointed out that Thai households have already undergone deleveraging with household loans steadily decelerating from a peak of 18.5%yoy growth in end-2012 to 3.4%yoy by end-2016. Moreover, about 18% of HH debt is said to be for unincorporated businesses, and not for personal consumption.

As Thailand's headwinds recede, including that of tourism following the crackdown on illegal tours since Q4 and perhaps on the country's political situation, the economy can continue to count on fiscal support. This year could see the delivery of major projects, which are part of the THB895.8bn (~6% of GDP) infrastructure plan for 2017, and THB190bn supplementary budget that was passed in January. The government recognizes that it has to take an active role to help Thailand break from the middle-income trap, especially given structural bottlenecks such as rapid population aging and overdue structural transformation. It, however, recognizes the need to improve its disbursement rate on capital expenditures, which is currently at about 75%.

Overall, the authorities expect 2017 GDP growth to settle at around 3.5%. While they place low odds for a 4% outturn, we believe this is still attainable given the cyclical tailwinds surrounding the economy. The BOT expects the output gap to close by late 2018. The authorities estimate Thailand's potential growth rate at 3.3-4.5%, slightly higher than the IMF's 3% estimate.

Given the lack of demand-induced price pressures, the authorities expect increases in inflation to be fairly subdued and to be driven by higher crude oil prices. The BOT forecasts inflation at 1.2% in 2017 and 1.9% in 2018, within its 1-4% target and with risks tilted to the downside due to the labor market slack. We got the sense from the BOT that it is in no rush to lift rates, given its comment on the order of priority, namely: inflation, output gap, and then financial stability.

On US-Thailand trade relations, while corporates we met raised concerns over the impact of US President Trump's evolving trade policy on Thailand, the authorities were not as worried, as they believe Thailand's large current account surplus is temporary, a result of an imports slump from the growth slowdown rather than strong exports. As a note, the April meeting between the US and Thai delegations discussed barriers to US exports to Thailand, particularly related to customs, agriculture, intellectual property, labor, financial services, and other issues.

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Thailand: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	399.3	407.1	431.2	452.8
Population (m)	65.7	65.9	66.2	66.4
GDP per capita (USD)	6,075	6,175	6,510	6,818
Real GDP (yoy %)	2.9	3.2	4.0	4.0
Private consumption	2.2	3.1	2.5	3.9
Government consumption	3.0	1.6	8.0	8.5
Gross fixed investment	4.4	2.8	7.8	5.5
Exports	0.7	2.1	7.7	6.6
Imports	0.0	-1.4	9.5	8.6
Prices, Money and Banking				
CPI (yoy %) eop	-0.9	1.1	**1.0**	**1.8**
CPI (yoy %) ann avg	-0.9	0.2	**0.9**	**2.1**
Core CPI (yoy %) ann avg	1.1	0.7	**0.8**	1.5
Broad money	4.4	4.2	**5.4**	**7.1**
Bank credit (yoy %)	2.7	3.1	**8.5**	**7.7**
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	239.0	260.3
Merchandise imports	187.2	178.4	211.1	232.7
Trade balance	26.8	35.8	27.9	27.6
% of GDP	6.7	8.8	6.5	6.1
Current account balance	32.1	46.8	39.7	42.2
% of GDP	8.1	11.5	9.2	9.3
FDI (net)	4.0	-10.5	-2.1	3.4
FX reserves (USDbn)	156.5	171.9	182.5	199.5
FX rate (eop) THB/USD	36.0	35.8	36.4	37.4
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	**5.7**	**5.4**
Unemployment (%)	0.9	1.0	1.2	1.3
Financial Markets	*Current*	*17Q2F*	*17Q3F*	*17Q4F*
BoT o/n repo rate	1.50	1.50	1.50	1.50
3-month Bibor	1.59	1.60	1.62	1.61
10-year yield (%)	2.73	2.85	3.00	3.15
THB/USD (onshore)	34.7	35.5	35.8	36.4

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

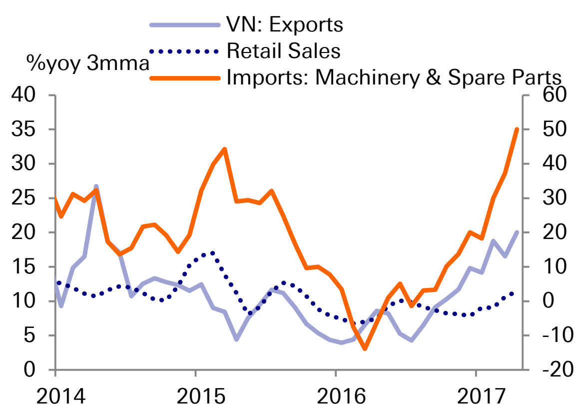
B2/BB-/B+
Moody's/S&P/Fitch

- Economic outlook. High frequency data point to improved growth momentum in Q2, led by private demand as public investment drags.
- Main risks. Without a strong rebound in public investment, Vietnam is likely to miss the government's 2017 growth target of 6.7%.

Better start to Q2, but still off target

Private domestic demand improves… High-frequency data showed that Q2 has started on a strong note. There was a meaningful improvement in private consumption and facility investment. Retail sales growth accelerated to 13.5% yoy in April from 10.7% yoy in Q1, but when adjusting for inflation, the improvement was more notable – rising to 9.2% from 5.7%. Meanwhile, imports of machinery and spare parts continued to print impressive growth of 44.5% in April, increasing from 37.3% in Q1.

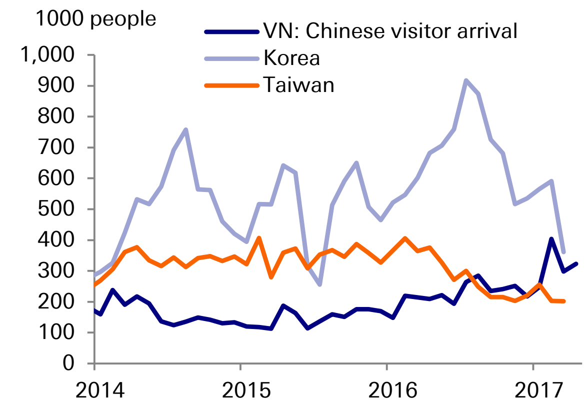
Pick-up in domestic demand



Sources: CEIC, Deutsche Bank

On the external front, like elsewhere in Asia, Vietnam saw continued strength in export growth, but a slowdown from the peak in Q1. Exports rose 16% yoy in April, down modestly from 16.5% in Q1. Computer/electronics, and telephone/spare parts surged 22.5% in April vs. 10.2% in Q1, guiding the contribution to overall export growth sharply higher to 6.8ppts for the month vs. 3.3ppts for Q1, while textile/footwear export growth decelerated sharply to 5.3% in April from 12.9% in Q1, contributing far less to overall growth at 1ppts in April vs. 2.4ppts in Q1. Meanwhile, imports growth continued to outpace that of exports, at 23.8% in April, albeit down from 26% in Q1, leaving Vietnam with a trade deficit of USD0.8bn in April vs. USD0.6bn (monthly average) reported in Q1.

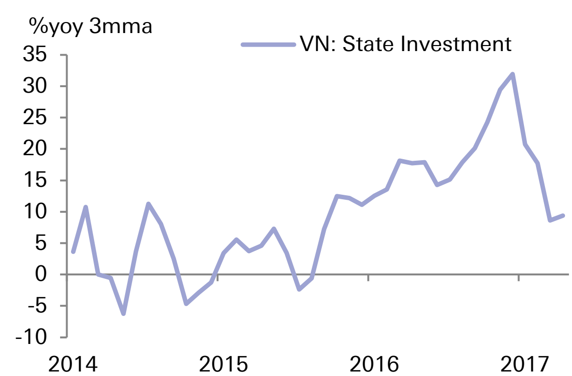
Rebound in electronics/telephone exports



Sources: CEIC, Deutsche Bank

On the tourism front, Vietnam continued to enjoy robust growth. In particular, the number of tourist arrivals surged to 35.8% yoy in April, up from 30.5% in Q1. With Chinese tourists shying away from Taiwan and South Korea due to political reasons, their arrival to Vietnam surged 54.3% in April, albeit down from 63.8% in Q1. Tourism retail sales growth accelerated to 17.1% in April, from 11.1% in Q1.

Weak public investment

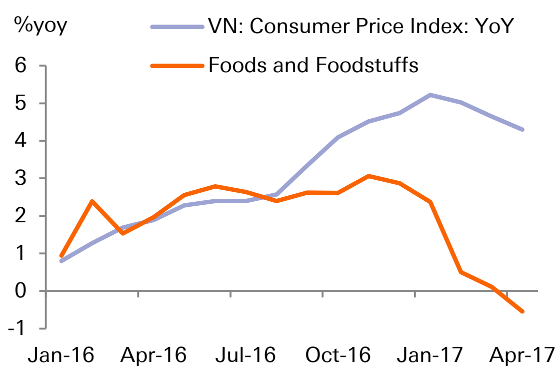


Sources: CEIC, Deutsche Bank

…while public investment lags, albeit keeping the lid on fiscal deficits… However, data on public domestic demand remained weak. In contrast to our expectations, the government is yet to complete the investment plans, limiting public investment. In fact, the latter contracted 2% yoy in April, after reporting a slower growth of 8.6% in Q1 this year vs. 18.1% in Q1 2016. On the other hand, this relative weakness in investment expenditure kept the lid on fiscal deficit, which stood at 0.4% of GDP in Q1 this year vs. 3.8% in Q1 2016.

…prompting policy calls to boost growth… In response to the weakness in public investment, the central government has called on local authorities and public bodies to review and resolve any issues that may prevent a timely implementation of state disbursement. Putting the implementation risk aside, the fact remains that Vietnam's debt is rapidly reaching the public debt ceiling of 65%. Reflecting the government's commitment to fiscal discipline, it has kept the debt ceilings unchanged and plans to limit state guarantees as well, which, in turn, will limit the government's ability to carry out large investment projects and provide fiscal support to overall growth. Underpinning the importance of foreign capital in this regard, the government called on the Ministry of Planning and Investment to find means to support ODA and FDI, among others. Implemented FDI rose 2.6% in April vs. 3.3% growth reported in Q1.

Inflation eases, as food prices fall



Sources: CEIC, Deutsche Bank

Meanwhile, the State Bank of Vietnam (SBV) kept monetary conditions supportive of growth. Credit growth accelerated to its six-year high of 4.9% yoy ytd in April, up from 3% in the same period last year. At the same time, the finance ministry sought to boost social housing loans with subsidies. Although this growth was led by manufacturing, a further acceleration in credit growth warrants caution, especially as Vietnam struggles with bad debt resolution and restructuring of weak credit institutions, amid a lack of fresh capital. Given Vietnam's macroeconomic challenges, we see the SBV holding off on rate hikes until next year.

…as inflation remains contained around the government target of 4%. CPI inflation unexpectedly eased to 4.3% in April, from 5% in Q1, amid unusually low food price inflation. The latter fell further to -0.5% in April from 1% 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.

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Vietnam: Deutsche Bank forecasts

	2015	2016F	2017F	2018F
National income				
Nominal GDP (USD bn)	193	205	213	231
Population (m)	91.6	92.5	93.4	94.2
GDP per capita (USD)	2111	2219	2282	2452
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	4.7	7.6
CPI (yoy %) ann avg	0.6	2.7	4.9	6.0
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	41.0	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*	*17Q2F*	*17Q3F*	*17Q4F*
Refinancing rate	6.50	6.50	6.50	6.50
VND/USD	22730	23200	23500	23800

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: With inflation already above target, the CNB removed its FX floor in April. We expect inflation to stabilize at target in 2018 and the EURCZK to move lower this year. 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.

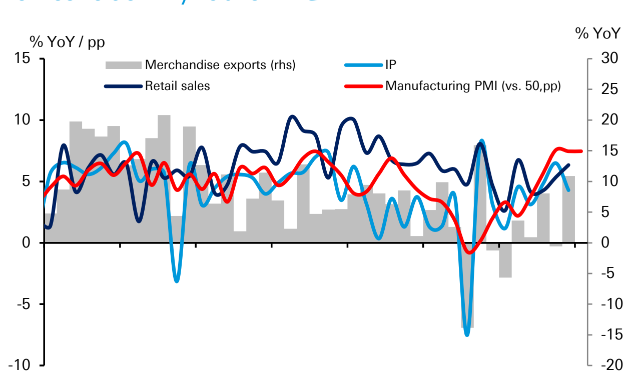
The CNB exits from FX floor

Growth to gain speed this year

Revised GDP numbers indicate that annual real GDP growth has accelerated slightly in Q4 to 1.9% YoY, which along with the 1.8% YoY in Q3 are the lowest readings since Q1-14. In line with the quarterly data, full year growth recorded a sharp slowdown to 2.3% in 2016 from 4.6% in the previous year. Subdued capital formation as a result of lower EU funds absorption is the main reason for the deceleration from last year.

We expect growth to gain speed into 2017 thanks to increased absorption of EU funds as additional funds from the 2014-2020 programme period become available 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.

Domestic activity robust in Q1



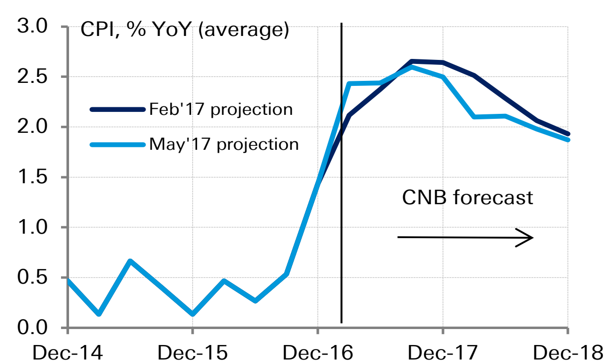
Source: CSO, Markit, Haver Analytics, Deutsche Bank

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.

The CNB released new macroeconomic forecasts in May, whereby it has revised the inflation outlook path slightly lower than its previous forecast. This is due to a slightly higher anti-inflationary impact of import prices than previously assumed, due to the sooner-than-expected exit from the FX floor. Nonetheless, the central bank continues to expect inflation to remain in the upper band of the target this year and return to a sustainable 2% in the beginning of 2018.

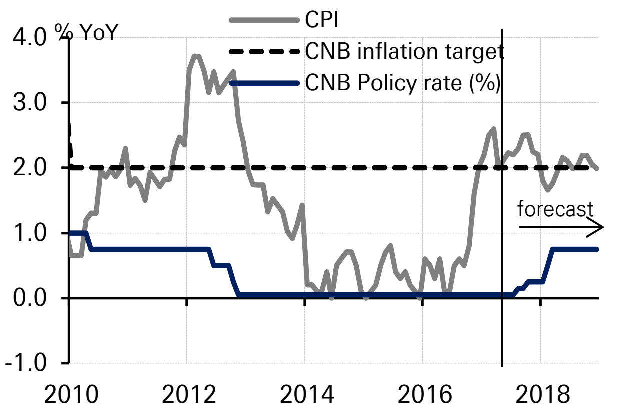
CNB revises inflation path slightly downward



Source: CSO, CNB, Haver Analytics, Deutsche Bank

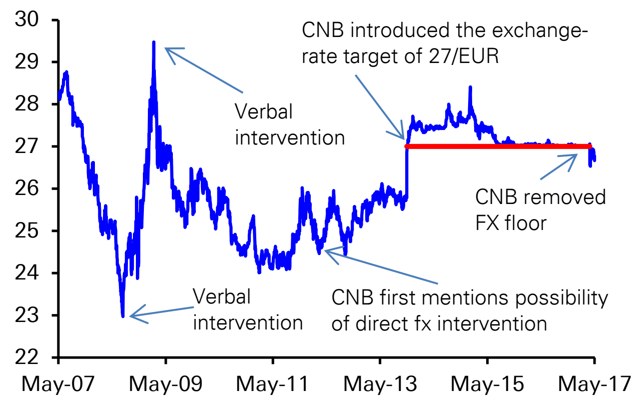
We continue to expect headline inflation to remain mostly above target through the year and to stabilize at 2% only in the beginning of 2018. Inflation is likely to be driven higher by a slight inflationary impact of import prices in the first half the year along with growth of the domestic economy and 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

CZK "overboughtness" preventing sharp appreciation



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 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. 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.

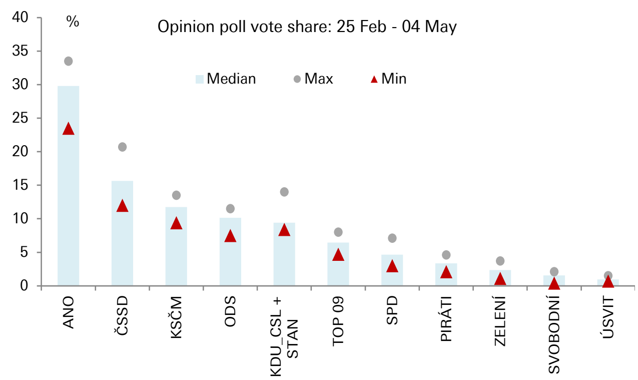
Politics in uneasy balance as President Zeman has announced legislative elections to be held on 20th/21st October. However, the government is quite unstable less than six months before the scheduled elections. The stand-off between the PM Sobotka (head of CSSD party) on one side and the Finance Minister Babis (head of ANO party), who appears to be supported by the President on the other continues. The PM has called for FinMin Babis' resignation or removal by the President as FinMin Babis, a billionaire businessman, faces criticism for conflicts of interests over his business conglomerate, tax savings through bond issues, and inappropriate communication with the press.

The PM Sobotka had offered to resign, if that would lead to removal of the entire cabinet. However, the Prime Minister backtracked from his offer to resign after the President insisted that, this move would not dissolve the government, but that the PM was free to resign alone. The President has now further added that for firing the finance minister, PM Sobotka has to terminate the agreement, which formed the current coalition government and nominate a replacement. In the meantime, Finance Minister Babis has said he will not stand down, however should he be forced out, Babis suggested that his party ANO might still remain in government if the party were allowed to nominate his successor. PM Sobotka agreed that there should be no issues with ANO retaining the post but the new minister should not have any links to Finance Minister Babis' business conglomerate, with which several members of the ANO party are associated.

Some political analysts have suggested that the government reshuffle may be part of a campaign strategy of the PM Sobotka (who heads the CSSD party) before the legislative elections, where the opinion polls predict an easy victory for the ANO party which Finance Minister Babis heads. Currently, we do not expect elections to be brought forward as all the three parties in the current government are against any early election[10]. Finance Miniser Babis' willingness to let ANO continue in government even if he is forced to step down also shows his reluctance for early elections.

President Zeman's office stated that he will decide on the resignation of the current cabinet upon his return from China trip on May 18. Market implications, in our view, will be limited, as cabinet reshuffles are not uncommon in Czech, while macro-policy institutions remain strong.

Babis' ANO party comfortably in lead as per latest opinion polls



Source: Médea Research, Focus, Median, Phoenix Research, Sanep, CVVM, Kantar TNS, STEM/MARK, Deutsche Bank

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Czech Republic: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	185	193	186	200
Population (mn)	10.5	10.5	10.6	10.6
GDP per capita (USD)	17 594	18 290	17 580	18 962
Real GDP (YoY%)	4.6	2.3	2.1	2.8
Private Consumption	3.1	2.8	2.8	2.3
Government	2.0	1.2	2.1	2.0
Gross Fixed Investment	10.2	- 1.0	0.5	4.1
Exports	7.9	4.0	4.2	4.3
Imports	8.4	3.0	4.2	4.4
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	140.8
Goods Imports	120.8	120.8	113.6	131.4
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	25.00	27.05
EUR/CZK (eop)	27.0	27.5	25.5	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	72.1	64.7
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	3.3	4.2
Unemployment (%)	6.5	5.5	5.3	5.2
	Spot	**17Q2F**	**17Q3F**	**17Q4F**
Financial Markets				
Key official interest rate	0.05	0.05	0.15	0.25
USD/CZK (eop)	24.50	23.64	24.81	25.00
EUR/CZK (eop)	26.7	26.0	26.3	25.5

Source: Haver Analytics, CEIC, DB Global Markets Research, NBP

[10] http://www.reuters.com/article/us-czech-government-idUSKBN17Z17N?il=0

Hungary

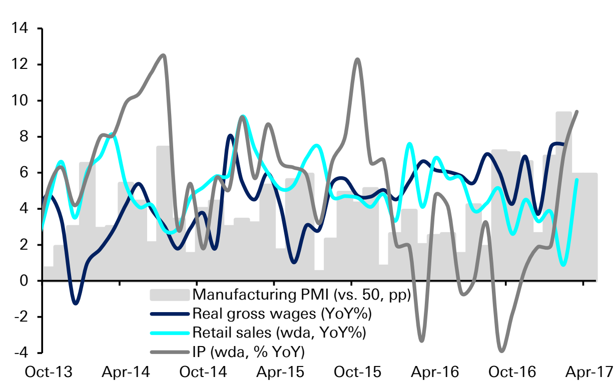
Baa3(stable)/BBB-(stable)/BBB-(stable)
Moodys/S&P/Fitch

- 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 in late H1 2018. NBH retains bias for additional unconventional easing though room for further 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 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.

Improved outlook

Year-to-date high frequency indicators continue to point to tight conditions in the labor market, as manifested in almost all-time low unemployment rate (4.5%) in March and an over 7% annual rise in real wages (also following the strong minimum wage hike). Higher disposable income for households has finally been reflected in retail sales growth, which accelerated markedly (to 5.6%YoY) in March on the back of higher non-food purchases. Manufacturing PMI remained unchanged in April; yet at 55.9, it was still well entrenched in the expansionary territory. Industrial production gained further momentum in March (9.4%YoY, in working-day adjusted terms), reflecting improving Euro-zone demand as well as better confidence levels.

Economic activity gains further momentum



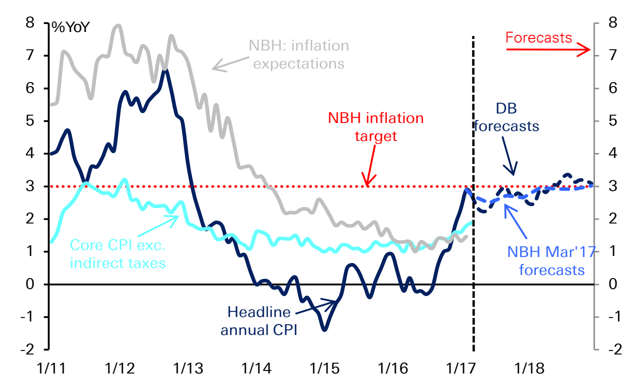
Source: Haver Analytics, CSO and Deutsche Bank

Household consumption is set to stay as the main driver of growth in 2017, buttressed further 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 slightly better at 3.3%YoY. This compares to NBH's and the government's projections at 3.6% and 4.1%, respectively.

CPI: softer

Annual CPI has decelerated by 0.7pp since February, and receded to 2.2%YoY in April. 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 all played a role beyond falling consumer prices. At 1.8%YoY, core inflation, excluding indirect taxes, remained close to its highest levels since early 2013, yet was still well below the 3% target.

Headline CPI has softened following the sharp rise



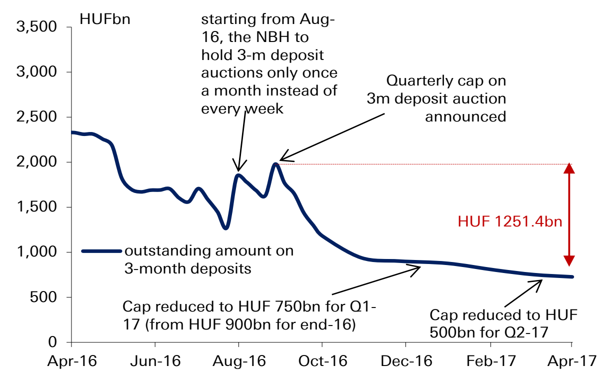
Source: Haver Analytics, NBH, CSO and Deutsche Bank

NBH's updated estimates in the March forecasting round still envisages sustainable fulfillment of the target only in the first half of 2018. The Bank slightly revised up its 2017 estimate to 2.6%YoY (from 2.4%, DB: 2.6%) while keeping the 2018 forecast unchanged at 3% (DB: 3.0%). 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.

NBH: business as usual

NBH kept its base rate unchanged at its all-time low of 0.9% in April for the eleventh consecutive month. Forward-looking bits of the statement were mostly unchanged with the NBH still remaining committed to maintain the current base rate and loose monetary conditions for an extended period. The MPC also reiterated its readiness to ease monetary conditions further, via unconventional, targeted instruments, if inflation remains persistently below the 3% target. Hence, it is business as usual on monetary policy front.

NBH reduced cap on 3m deposits in March



Source: NBH and Deutsche Bank

Next decision on the limit for three-month deposits will be in June and until then NBH will remain on auto-pilot with a well-known bias for easing. The Bank looks set to limit the cap further in June given its expectations for a 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 16bps, and the limit for end-Q2 2017 on stock of deposits is now much lower at HUF500bn, compared to HUF1,976bn parked back in September when NBH had first introduced the cap (for end-2016).

Fiscal policy to remain accommodative in 2018

The draft 2018 budget was submitted to the Parliament in early May with the final vote expected to take place around mid-June following a general debate this month. Main priorities of the Budget comprise increasing employment, improving security, and supporting growth. ESA-defined budget deficit is foreseen at 2.4% of GDP, i.e. unchanged from the 2017 target. Around 7%YoY rise in expenditures due to higher social and defense spending and enhanced housing and infrastructure projects are planned to be financed by improved revenues (7.4%YoY) thanks to better economic activity (GDP growth: 4.3%YoY), and hence higher VAT receipts. The recently submitted update to the EU on the Convergence Programme also confirms that the government has formally postponed the fiscal consolidation until after the 2018 elections as a more nuanced decline in public debt is projected only from 2019 onwards.

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Hungary: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	122	124	127	124
Population (mn)	9.9	9.8	9.8	9.8
GDP per capita (USD)	12 348	12 639	12 954	12 617
Real GDP (YoY%)	3.1	2.0	3.3	3.1
Private Consumption	3.0	4.1	4.8	3.7
Government	0.9	0.1	1.5	1.2
Gross Fixed Investment	1.9	- 15.5	9.7	7.5
Exports	6.1	5.7	6.3	6.7
Imports	7.7	5.8	6.8	6.7
Prices, Money and Banking (YoY%)				
CPI (eop)	0.9	1.8	2.6	3.1
CPI (period avg)	- 0.1	0.4	2.6	3.0
Broad money (eop)	6.3	5.2	6.1	6.1
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	94.1	92.4
Goods Imports	83.5	85.8	89.5	88.3
Trade Balance	4.9	5.8	4.6	4.1
% of GDP	4.0	4.7	3.6	3.3
Current Account Balance	4.1	6.1	4.3	3.9
% of GDP	3.4	4.9	3.4	3.1
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	73.1	71.9
Domestic	48.4	52.8	52.8	52.1
External	26.4	21.3	20.3	19.8
External debt	108.0	96.1	94.8	93.5
in USD bn	131	119	121	116
Short-term (% of total)	12.2	11.9	11.5	11.0
General (ann. avg)				
Industrial Production	7.4	1.2	4.4	4.6
Unemployment (%)	6.9	5.3	4.3	4.2
	Spot	**17Q2F**	**17Q3F**	**17Q4F**
Financial Markets				
Key official interest rate	0.90	0.90	0.90	0.90
USD/HUF (eop)	285	283	294	306
EUR/HUF (eop)	311	312	312	312

Source: Haver Analytics, CEIC, DB Global Markets Research, NBP

Poland

A2(negative)/BBB+(stable)/A-(stable)

Moodys/S&P/Fitch

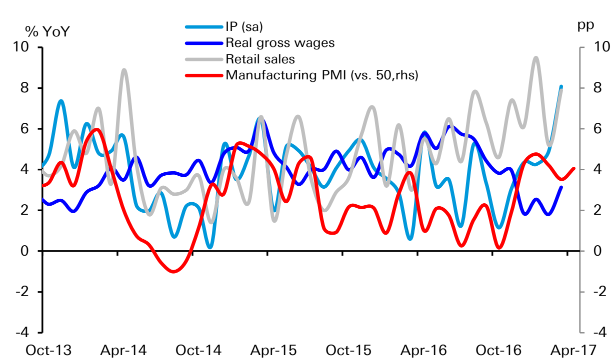
- Economic outlook: Growth outlook appears to be gradually improving. Headline CPI has picked up recently on commodity price stabilization, but core is still low. The NBP retains its cautious wait-and-see approach and has a neutral bias.
- Main risks: Worries over relations with EU and fiscal dynamics will persist, but it seems a lot is already in the price.

Macro resiliency versus political volatility

Growth is likely to accelerate this year, primarily due to improving domestic demand. Labor market remains tight and wage growth is forecast to accelerate in an environment of all-time low unemployment rates. Fiscal transfers to households also are expected to support disposable income this year, while the low interest environment aids consumption through borrowing. Investments meanwhile are likely to recover in 2017 as more projects financed by EU funds under the new 2014-2020 programming.

Real GDP growth slowed in 2016 to a three-year low of 2.8% (prev. 3.9%), led mainly by the slowdown in investments as a result of lower EU funds absorption. Latest high-frequency indicators point to a strong pick-up in activity in Q1. Retail sales (in CPI-adjusted terms) has posted a growth of 7.5% YoY on average in the first quarter (vs. 4.1% on average in Q1-16), on the back of strong growth in real wages. Growth in industrial production has also been robust, increasing by 5.8% YoY on average in Q1 (vs. 2.4% YoY in Q1-16).

Activity indicators strong in Q1

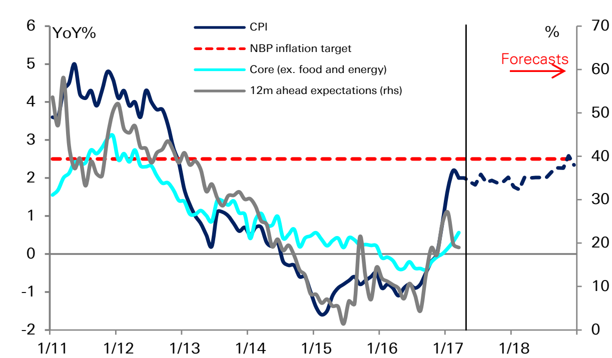


Source: Haver Analytics, CSO, and Deutsche Bank

Inflation risks are still low. CPI inflation remained constant at 2.0% YoY in April accompanied by a 0.3% MoM monthly rise in prices. The details of components, to be released with the final print, are likely to show that the prices of food and transport have declined in YoY terms mainly due to the fading out of the effect of the past surge in global commodity prices. 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 0.6% YoY in March and unlikely to accelerate markedly 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 expected exchange rate appreciation, keeping import price growth at moderate levels.

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 accelerating wage growth against the backdrop of all-time low unemployment rates. We thereby expect headline inflation to stabilise around 2% (NBP target 2.5%) for the rest of 2017.

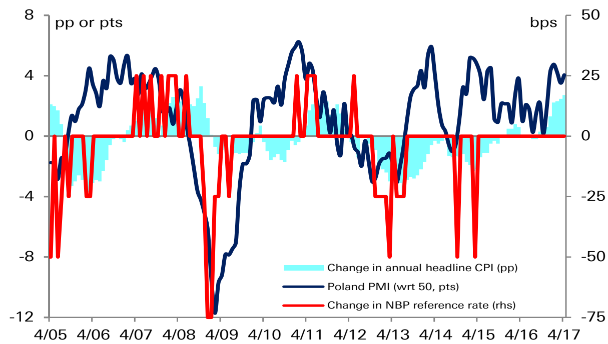
Inflation likely to stabilise around 2%



Source: Haver Analytics, CSO, and Deutsche Bank

The NBP retains neutral bias despite upward revision to inflation forecasts. Poland's MPC left rates on hold at 1.50% at its April meeting. Governor Glapinski reiterated that he sees no possibility of a rate change this year and would "personally" like to keep them stable in 2018 as well. 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.

NBP maintains neutral stance



Source: Haver Analytics, CSO, and Deutsche Bank

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 slightly ambitious 3.6% real GDP growth and overreliance on recovery in tax revenues. 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. Fiscal deficit for 2016 was reported at 2.5% of GDP, roughly unchanged from the previous year as higher social spending due to the Family 500+ programme was offset by lower co-financing obligations on EU funded projects, the new bank tax and the one-off revenue receipts from the LTE auctions and transfer from the 2015 NBP profit.

Apart from fiscal sustainability, relations with EU is a main risk. Relations with the European Union soured further at the European Council's meeting, where Poland authorities tried to block the reappointment of former Polish PM Donald Tusk as the President of the EC, despite Tusk enjoying widespread support from other EU governments. Moreover, two days after his reappointment, Tusk was subpoenaed by Polish authorities in a case related to the 2010 plane crash that had killed former Polish President Kaczynski.

Concerns have re-emerged that Poland's relationship with the EU is likely to strain further and that Poland will have to cope with a smaller inflow of EU funds in the new EU budget cycle that will start in 2021. 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. If the EC remain unsatisfied with the response, 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.

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Poland: Deutsche Bank Forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	477	469	482	455
Population (mn)	38.0	38.0	38.0	38.0
GDP per capita (USD)	12 557	12 350	12 695	11 975
Real GDP (YoY%)	3.8	2.7	2.7	3.4
Private Consumption	3.0	3.8	3.8	3.3
Government	2.4	2.8	3.5	3.9
Gross Fixed Investment	6.1	- 7.9	5.8	5.4
Exports	7.7	9.0	6.2	6.7
Imports	6.6	8.9	7.1	6.8
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	8.7	9.8
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	201.2	198.4
Goods Imports	188.6	193.4	202.2	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	- 5.5	- 5.8
% of GDP	- 0.6	- 0.3	- 1.1	- 1.3
FDI (net)	9.8	5.0	4.8	7.8
FX Reserves (eop)	89.4	109.5	108.6	105.9
USD/PLN (eop)	3.90	4.18	4.31	4.68
EUR/PLN (eop)	4.25	4.41	4.40	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	71.7	71.3
in USD bn	330	336	346	324
Short-term (% of total)	11.1	15.4	12.1	12.3
General (ann. avg)				
Industrial Production	4.8	2.9	3.3	4.5
Unemployment (%)	10.5	9.0	8.4	8.1
	Spot	**17Q2F**	**17Q3F**	**17Q4F**
Financial Markets				
Key official interest rate	1.50	1.50	1.50	1.50
USD/PLN (eop)	3.87	3.87	4.10	4.31
EUR/PLN (eop)	4.22	4.26	4.35	4.40

Source: Haver Analytics, DB Global Markets Research, NBP

Russia

Ba1 (stable)/BB+ (positive)/BBB- (stable)

Moody's / S&P / Fitch

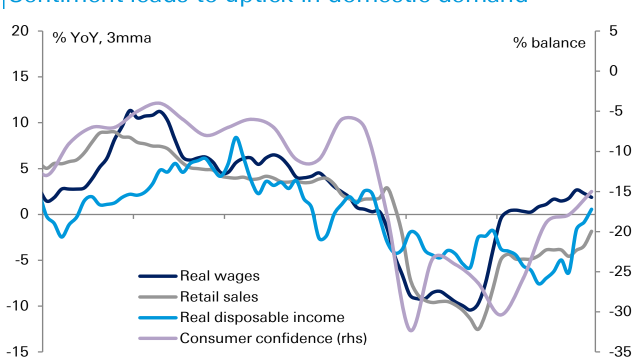
- Economic outlook: We expect growth of 1.6% in 2017 and 2% in 2018. We continue to expect another 125bps in cuts this year (200bps cumulative in 2017). We have revised our forecast for Ruble to have it drift weaker towards 59.5 by end-2017.
- Main risks: stem from commodity price jitters. Russia-US/EU relationship may have its up and downs, but an outright stand-off is unlikely.

Strong macro in focus

Russia's gradual growth recovery remains on track. Russia's real economy posted a marked recovery in 2016 with full year growth improving to -0.2% from an upward revised -2.8% in 2015. GDP growth has finally entered positive territory in Q4-16, with a reading of +0.3% YoY. Positive contribution from net exports combined with a slower decline in final consumption expenditure and a strong inventory accumulation has contributed to the positive reading in Q4.

Growth indicators post timid recovery in March after the disappointing data in February. The most important indicator of domestic demand pressure -- retail sales -0.4% YoY (-2.8% Feb) remains low, explained by the low growth in real disposable income and high savings ratio. Real disposable income is still in negative territory due to ongoing fiscal consolidation but has improved slightly from the previous month (-2.5% YoY in March vs. -3.8% prev.). Real wages have also improved by 0.5pps to 1.5% YoY in March. Improvement in disposable income accompanied by a broad-based increase in consumer sentiment in March has helped the slight recovery in domestic demand. Industrial production is also back in positive territory (+0.8% YoY) after a large drop (-2.7% YoY) in February.

Sentiment leads to uptick in domestic demand

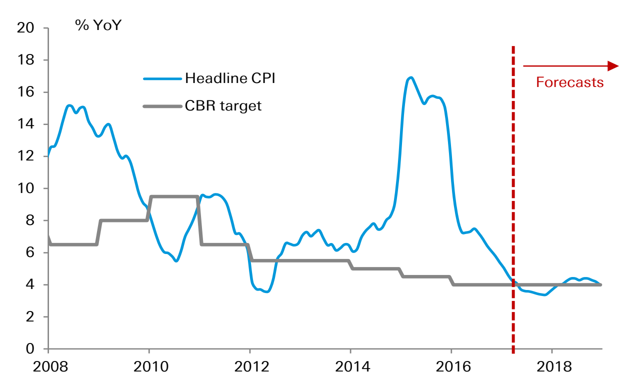


Source: Rosstat, Haver Analytics, Deutsche Bank

Inflation continues to head south. Prices increased by 0.3% MoM in April, the fastest in three months. However, base effects continued to push YoY inflation lower. Headline inflation declined to 4.1% in April, just 0.1 pps short of the CBR's 4% target. The decline in headline was supported by a decline in non-food goods inflation. Food price inflation in YoY terms has posted an increase from March, 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 by next month (May) driven lower by base effects as well as the disinflationary impact of the appreciating ruble in YoY terms. Risk of a continuous undershoot on the target has emerged. Inflation expectations remain volatile but have declined to 11.0% in April (lowest since beginning of data series). Global commodity price increases have also stalled in March even as we see limited risk of pass-through of commodity prices increase to inflation in Russia anyway. 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).

Inflation decelerating faster than expected, target within reach



Source: Rosstat, Haver Analytics, Deutsche Bank

CBR over-delivers in April. The CBR cut its key rate by 50bps in April, more aggressive easing than market expectations. This is the second rate cut this year and follows the 25bps cut at the previous meeting in March. Moreover, the CBR announced that going forward the MPC will also take into account the deviation of oil prices from their baseline assumption (drop to USD 40/barrel) along with developments on inflation and economic activity in making their decision on the key rate. The CBR stated that their *"assessment of the overall potential of the key rate reduction before the end of 2017 is unchanged."* Recall that in the previous statement the CBR had admitted the possibility of cutting the key rate gradually in Q2 and Q3 in light of the development of inflation and activity developments.

We believe there is risk that inflation may undershoot the CBR's 4% target over the summer. We also 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. We expect the CBR to maintain its dovish stance and continue to ease the policy rate depending on how data on inflation vs. inflation expectations pan out. We thereby retain our call for a cumulative 200bps in rate cuts this year to take the key rate to 8.00% by end-2017, most likely via another 5x25bps cuts. Additionally, the CBR will probably start discussing putting in place a band around the 4% target (possibly +/-1pp), as inflation undershoots, which is a usual practice for many inflation-targeting central banks. The CBR may also start calibrating communication on outlook beyond end-2017 target to anchor inflation expectations.

Ruble strength likely reached its peak; expect moderate depreciation into 2H2017. The ruble has continued on an appreciation trend since the beginning of the year, reaching a low of 55.8 earlier in late-April, driven mainly by an increase in oil prices, but also strong positive real rates. Current account surplus improved sharply in Q1 by USD 12.7bn to USD 22.8bn. The largest boost to C/A surplus has come from an improvement in the goods balance driven by the increase in oil exports in value terms in line with higher crude prices in the beginning of the year. Dollarisation in terms of share of FX in deposits with the banking sector has continued to decline as high real rates encourage conversion of USD deposits into RUB. Concerns about a stronger RUB has picked up with a number of government officials talking about the RUB being too strong. We expect the RUB to depreciate slightly by year-end to reach 59.5, as a more dovish central bank and stable inflation is likely to lower real rates. C/A inflows are also likely to be lower for the rest of the year, with Q1 usually being the strongest quarter historically. The planned FX purchases by MinFin should also weigh on the ruble as they cumulate through the year. Oil prices remain the main risk to our forecast. The ruble could receive a boost if oil prices rebound back to around USD 55/barrel.

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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)	9 323	8 741	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	3.6	4.0
CPI (period avg)	15.5	7.1	3.8	4.2
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)	72.88	60.27	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**	**17Q2F**	**17Q3F**	**17Q4F**
Policy rate (repo)	9.25	9.00	8.50	8.00
10-year bond yield (eop)	7.72	7.80	7.70	7.60
RUB/USD (eop)	58.08	57.29	58.62	59.50

Source: Deutsche Bank, National Sources.

South Africa

Baa2 (negative)/BB+ (negative)/BBB- (negative)
Moody's/S&P/Fitch

- Economic outlook: Recent economic momentum surprised to the downside, while preliminary data shows a worrying deterioration in Q2.
- Main risks: Confidence levels have suffered a significant blow, which could lead to significant cutbacks in jobs, investment intentions and capacity. For now we see no further downgrades this year, bar the review from Moody's. But risks of further downgrades aren't negligible.

When confidence gives way

Economic growth momentum disappoints

Economic momentum has weakened significantly. Our preliminary GDP growth forecast for Q1 is 0.6% qoq saar – about 0.5% below our original forecast – from -0.3% in 4Q16. Weakness seems broad based with both consumer and supply sectors, bar agriculture, coming under pressure. Evidently, this slowdown continued in early data readings for Q2, however April is known for extended long holiday breaks that seasonal adjustment can rarely remove. Even in the event that GDP reverses Q1 gains this quarter (i.e. -0.6% qoq), GDP will still expand 0.4% yoy in Q2 supported by the low base last year. However, that will leave the economy 0.5% up in the first half of the year, with very little buffer from further risks down the line. It's no surprise that after the tumultuous month of April, post the cabinet reshuffle and sub investment grade outcomes, business and consumer confidence would have taken a large setback. The question is whether there is scope to cut jobs and capex from an already low base, sufficient to propel the economy into recession in 2H17. For now, we revised growth down annual growth for a second time since March, yielding 0.6% for the year, recovering to 1.7% next year (previously 2%).

Inventory restocking cycle unlikely to kick start revival

Without recent events unfolding, however we would have begun to see momentum behind the inventory restocking cycle gather traction. However amid the uncertain economic and political landscape, a strong sequential rebound is highly unlikely. Usually inventory changes amplify the business cycle. Part of our thesis on growth this year was that inventories would make a significant contribution to the recovery this year. Our forecast accounted for 1% of GDP to arise from the restocking cycle. While the extent of the recent destocking cycle was fairly large, in comparison to previous cycles, bar 2008, it's possible that demand weakness could add to renewed destocking. Moreover, the decidedly negative outlook on growth is likely to keep stock building fairly muted. As uncertainty fades, conditions should be more amenable to a revival in inventory restocking and its contribution to growth. This is more likely to play out next year, but we can still foresee a lingering risk culture, if political uncertainty does not lift.

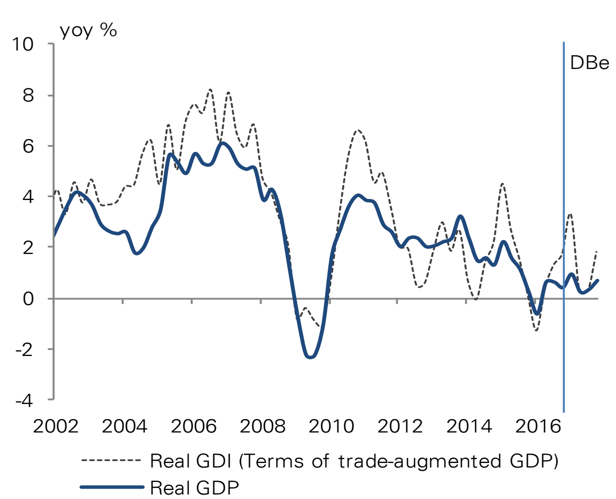
How much further will corporates cut back?

Importantly, the low base generated in this downturn - the second largest on record - may help in buoying activity. At this juncture we fail to see corporates cutting jobs as significantly as the past several years. On capex and streamlining business processes, further cutbacks are likely. We will be keeping a close eye on investment intentions, planned capacity reductions and corporate liquidations.

…could also depend on terms of trade developments.

While confidence will determine a great deal how growth may pan out this year, commodity prices may also lend a hand. Based on our estimates, positive terms of trade developments in 2H16 have had a significant impact on overall income levels. We estimate the impact of terms of trade gains on income of around 1% of GDP in 2H16. As commodity prices, especially coal and iron ore were still well supported in 1Q17, income gains could have been as large as 2% of GDP. This should provide a significant buffer to the miners in the short-term, preventing deeper cost cutting, but this will depend what happens next.

Terms of trade a welcome boost to income



Source: Deutsche Bank, SARB

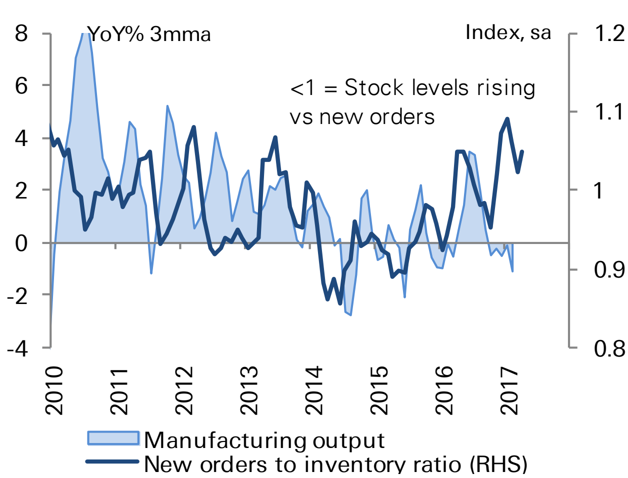
Slowdown in production in Q1 caught us by surprise

Electricity consumption contracted by 0.9% qoq sa in Q1, offsetting the 0.7% growth recorded in Q4. This reflects very weak supply conditions. Attached to this trend, the capacity utilization rate of large manufacturers also moderated unexpectedly in Q1 to 80.8, after rising all of last year to peak at 82.8%. Deteriorating demand was the main reason for this decline. At the time of writing, mining and manufacturing production figures for March were still due – mining showed some improvement from a low base in 4Q16, though manufacturing continued to fall.

Recent decline in PMI seem sentiment driven.

April's purchasing managers' index, while more sentiment driven, was indicative of worsening conditions in the sector. The PMI declined to 44.7 (from 52.2 in March), the lowest since Nenegate. Since Nenegate, the PMI has served as a good barometer for political confidence, as the second half of last year sentiment was very low when the State Capture report, threats to the Fin Min etc were high. That said, the sector also had an overhang of stock levels. Since November last year, stock levels have begun to normalize, while new orders were rising. Even though the latest decline in business activity reflects very poorly on the prospects for the sector, the leading indicator (new orders to inventory ratio) is still above one and rising – i.e. inventories are lower than new sales orders. This ought to translate in better momentum for manufacturing output in months ahead. Hence, we would err on the side of caution for now in extrapolating the latest PMI to the sector.

Manufacturing production declines, but new orders to inventories have been rising

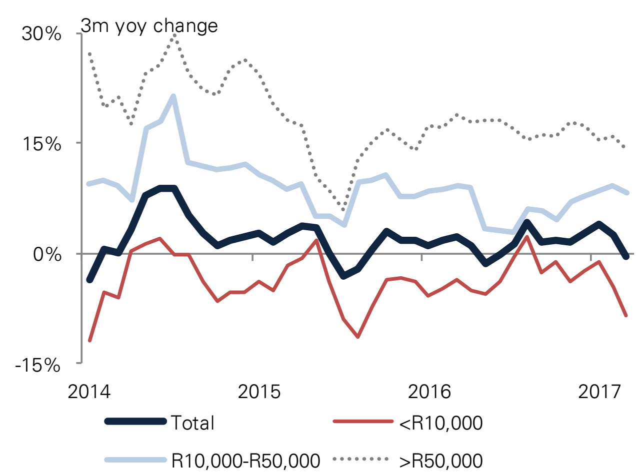


Source: Deutsche Bank, Absa/BER

Salary increases are offset by job cuts

Income data for March has improved for working individuals, looking at the BankservAfrica's disposable salary index (BDSI). This data series is a mere proxy for national statistics, capturing only salaried individuals that are paid through the banking system. The BDSI rose by 7.8% yoy in March (from 5.7% in February) – the first real increase since May last year. However, when the average salary is combined with the number of payments made, (i.e. the number of jobs), there appears to be a decline in compensation growth to 3.9% yoy in March – reflecting significant cuts in the number of salary payments to low income earners (earning below R10k per month). Middle income earners have been showing steady increase in job growth, while high income earners have seen a moderate slowdown in the number of salary payments.

Job growth per salary category (monthly)



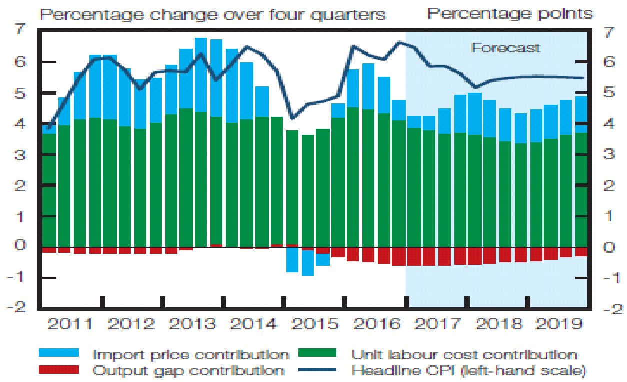
Source: Deutsche Bank, BankServAfrica

The take away is that the lower income class is still under severe financial pressure. Clearly, if economic conditions deteriorate as it now appears to be, job growth in the middle and higher income bands are at risk. For now, we think that corporates will be reluctant to cut jobs significantly further, but could exercise greater control on wage settlements.

Wage settlements in bargaining agreements are losing momentum

For individuals where salaries are determined in bargaining council agreements (c 30% of the market), the average wage settlement for Q1 moderated to 7.6% in Q1 (vs 7.8% in 1Q16). The average wage increase for 2016 was 7.5% and 8.1% the year before. We continue to expect a further reduction in wage increases towards 6.5%-7% over the next two years. Given these trends, we find it difficult to see how the SARB's forecast of 8% salary growth over the next two years will materialize. Wage agreements have important ramifications for inflation. As illustrated in the SARB's research below, unit labour cost (productivity adjusted wage increases) contributes on average 70% to consumer inflation.

SARB decompose inflation drivers: ULC



Source: SARB

Rate cuts reinstated this year as inflation surprises.

Inflation surprised positively in March falling to 6.1% while core dropped to 4.9% - the lowest in four years. The moderation was a combination of technical factors relating to the reweighting and rebasing of the basket, but disinflation in fx-sensitive components also gathered traction. This outcome was of equal surprise to the SARB, whom we now believe could cut rates in Q3 (50bps). Though political uncertainty and exogenous risks skew risks to the exchange rate to the upside, the balance of risks in our view could still lead to earlier rate action if the rand remains generally well behaved. We continue to see downside momentum on inflation, expecting headline inflation of 5.4% and 4.9% in 2017 and 2018 respectively. This is starkly lower than the SARB trajectory of 5.9% and 5.4%. Core inflation could settle at 4.8% and 4.7%, respectively (vs SARBe of 5.4% and 5.2%). Both food and core goods prices are in sharp descent and services inflation should track this lower. Food disinflation should accelerate, reaching around 3% by end of the year. Secondly, while the exchange rate has weakened vs. the low point reached earlier this year, the rand is still some 7% stronger than a year ago. In other words, fx pass through resulting from the near 10% deprecation since last month's low should not be extrapolated to future inflation just yet. The threshold whereby the rand may become more inflationary vs last year is around R14.14/USD. Finally, as discussed above we maintain that there are more downside risks to wage settlements this year, given the weakness in economic activity, but also heightened levels of political uncertainty. This should broadly play out in services inflation, which tends to be skewed towards labour income. As it stands, services inflation receded to 5.4% yoy in March - the lowest level in six years. The pass through from lower wage increases has not yet begun to feed through to these prices in our view. Hence we continue to hold the view that CPI should recede towards the midpoint of the target band by year-end.

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South Africa: Deutsche Bank Forecasts

	2015	2016F	2017F	2018F
National Income				
Nominal GDP (USD bn)	236	299	355	391
Population (mn)	55.0	55.9	56.8	57.7
GDP per capita (USD)	4327	5 354	6 247	6 775
Real GDP (%)	1.3	0.3	0.6	1.7
Priv. consumption	1.7	0.8	1.0	1.8
Gov't consumption	0.5	2.0	0.5	0.4
Gross capital formation	2.3	- 3.9	0.5	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	4.6	5.4
CPI (YoY %, pavg)	4.6	6.4	5.4	4.9
Fiscal Accounts (% of GDP) [1, 2]				
Overall balance	- 3.9	- 3.6	-3.0	-2.8
Revenue	29.8	29.4	30.0	30.3
Expenditure	33.6	33.0	33.0	33.1
Primary balance	- 0.8	-0.2	0.5	1.0
External Accounts (USDbn)				
Goods exports	80.5	76.2	85.8	92.5
Goods imports	83.1	75.2	83.2	90.6
Trade balance	-2.7	1.0	2.6	1.8
% of GDP	-0.9	0.3	0.7	0.5
Current account balance	-13.5	-9.8	-9.4	-11.3
% of GDP	-4.4	-3.3	-2.6	-2.9
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	13.60	13.0	12.75	12.40
ZAR/EUR	14.65	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 remains on a recovery path. CPI looks set to remain volatile and elevated. CBT's exotic tightening cycle has reached its peak. Pro-growth fiscal stance will be maintained.
- Main risks: Political uncertainty slightly receded in the aftermath of the April referendum; yet geopolitical and security risks have yet to dissipate decisively. 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.

A new (or old) playing field?

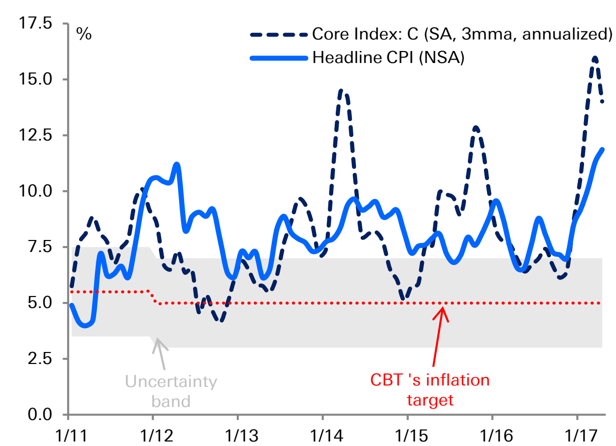
The 'Yes' vote for constitutional amendments held a narrow lead (51.4%) in the April referendum. The bulk of the changes, including a formal shift to an executive presidency, will kick in with the next dual elections (Parliamentary and Presidential) scheduled to be held in November 2019. The Parliament has six months to make subsequent amendments in the related laws, including the electoral law, as well as Parliamentary bylaws. The immediate changes post referendum are removal of the current constitutional ban on the President's formal association with a political party, restructuring of the Supreme Council of Judges and Prosecutors, and abolishment of military courts. As such, immediately following the formal publication of referendum in the Official Gazette, President Erdogan formally re-linked himself with the ruling AKP, and he is expected to reclaim party chairmanship in the forthcoming Grand Extraordinary Congress (on May 21). It remains to be seen whether such a change would also entail a cabinet reshuffle, which seems likely according to local dailies, such as Hurriyet and Haberturk (on April 25). The possibility of reinstating capital punishment (important for Turkey's EY accession bid) and trajectory for foreign relations (with Russia and the US) post referendum will be closely followed. Notwithstanding recent assurances by key AKP officials to hold dual elections on time, markets also could still seek robust clarity regarding possibility of early elections.

President Erdogan's and AKP government's approach to reforms will be key for potential growth prospects in the aftermath of the constitutional referendum. Markets would seek signals for the authorities' willingness post referendum first to defend structural gains from the first-generation reforms (i.e. price stability, fiscal order and healthy banking system) and then deliver on much-coveted second-generation reforms (on the labor market, low savings issue as well as the tax system). We still think nominal GDP growth will remain relatively resilient in 2017. Real growth looks set to transpire above 3%YoY (DB: 3.4%), fully thanks to countercyclical policies, i.e. credit and fiscal impulse. FX-adjusted credit growth exceeded 30% (WoW, 13wma, annualized) in April on the back of a rapid rise in commercial credit thanks to the Credit Guarantee Fund.

Inflation: headline peaked in April?

Headline annual CPI came in at 11.9%YoY in April after 11.3% previously. Main upside driver were again food. FX pass-through impact, while still evident, was partially softer in absence of further TRY weakening also thanks to extended tax cuts in white goods, furniture and some other household utensils. Core inflation, C index, was however slightly lower this time in annual terms.

Headline up, core slightly down in April



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

Base effects look set to turn slightly supportive from May onwards, albeit until July, which hints that April could be the peak in the current cycle. Despite a welcome deceleration in April, it is, however, too early to claim the same for core CPI as the lagged impact of ongoing FX pass-through is still expected to exert some further pressure in the coming months. Barring a major downward correction in food (USD/TRY and Brent), headline annual CPI looks set to remain in double-digit levels for most of 2017 (10.6% on average) due to higher trend inflation and consistent FX pass-through throughout the year.

The Central Bank of Turkey (CBT) has not changed its inflation outlook much in the April forecasting round (end-2017: 8.5%), notwithstanding the major upside surprise in year-to-date outturn. We are worried about the ongoing deterioration in trend inflation, and, while base effects will provide some mechanical downward pressure on headline next year, we do not think levels below 8% on a sustainable basis will be likely in 2018 due to the weaker form of policy tightening, sticky services as well as worsening trend inflation. Our end-year estimates for 2017 and 2018 are 1.3pp and 2.1pp above the CBT's latest forecasts respectively, and risks are tilted to the upside.

Rising inflation differential vis-à-vis trading partners fundamentally argues for a weaker lira during the rest of the year. Ongoing challenges in external financing, for instance banks' long-term external debt roll-over rate in February reached its lowest level since November 2012, and the ongoing decline in FX reserves also point to a likely renewed downward adjustment in the lira. We still expect levels around 3.90 against the USD by year-end.

CBT is done with exotic tightening

We are still of the view that despite ebbs and flows, global backdrop is turning secularly unsupportive for Turkey. Hence, we think CBT will continue to keep monetary conditions tight, in a la Turca terms, at least during the summer, and average funding rate could remain close to 12% in the current framework, (i.e. with the late liquidity window at 12.25%) in response to external shocks, such as a change in re-pricing for Fed rate normalization. However, despite the official rhetoric for possible additional tightening if need be, the CBT's latest instrument choice, slightly tamer core CPI in April, lack of a major upward revision in the April Inflation Report, and MPC's pro-growth bias all suggest we have reached the peak of current tightening cycle in April. Hence, barring a major change in the external backdrop, we expect steady policy rates ahead though MPC will probably tinker with liquidity conditions (and hence the effective rate).

Meanwhile, we still believe CBT still aims to return to a single benchmark rate at some point, again along the lines of the Bank's former rhetoric on the issue. Given the starting point, 'Simplification 2.0' - if and when delivered – will probably entail looser liquidity conditions and a subsequent convergence first the from late liquidity window to O/N lending for the effective upper bound, which mechanically means 'easing' if what CBT has delivered so far is technically defined as 'tightening'. While we think any kind of simplification is unlikely any time soon (or until at least July CPI is out) given that the CBT is still committed to keep current tight conditions until inflation outlook improves, markets could start pricing in some simplification expectations in the coming period.

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Turkey: Deutsche Bank Forecasts

	2015	2016F	2017F	2018F
National Income				
Nominal GDP (USD bn)	857	856	796	807
Population (mn)	77.7	78.6	79.4	80.2
GDP per capita (USD)	11 023	10 901	10 025	10 063
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	8.5
CPI (period avg)	7.7	7.8	10.6	8.5
Broad money (eop)	17.1	18.3	14.3	15.1
Bank credit (eop)	19.3	15.3	15.6	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	164.0	171.6
Goods Imports	200.1	191.0	207.4	220.3
Trade balance	- 48.1	- 40.8	- 43.4	- 48.7
% of GDP	- 5.6	- 4.8	- 5.5	- 6.0
Current account balance	- 32.1	- 32.6	- 34.4	- 38.0
% of GDP	- 3.7	- 3.8	- 4.3	- 4.7
FDI (net)	12.5	9.1	6.4	9.0
FX reserves (eop)	92.9	92.1	80.1	77.0
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	53.2
in USD bn	396	404	415	430
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**	**17Q2F**	**17Q3F**	**17Q4F**
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	10.57	10.30	10.10	9.90
TRY/USD (eop)	3.59	3.67	3.73	3.90

(1) Central government
Source: Deutsche Bank, National Sources.

Argentina

B3(positive)/B(stable)/WD(stable)
Moodys /S&P /Fitch

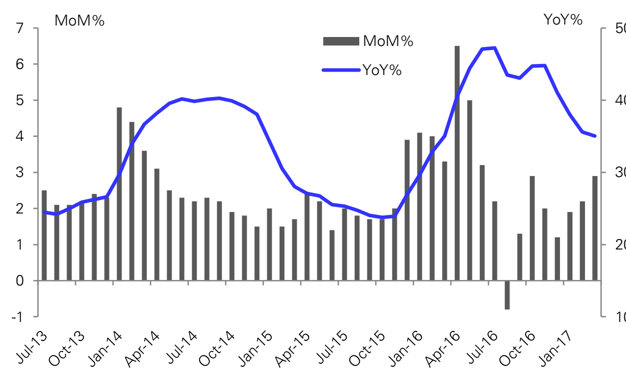
- Economic outlook: Inflation has decelerated more slowly than the authorities expected, prompting the central bank to raise interest rates. High rates support the FX, undermining the competitiveness of local producers and delaying the recovery, which has led the central bank to announce a target for reserve accumulation. 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.

Policy dilemmas

The central bank was forced to hike interest rates

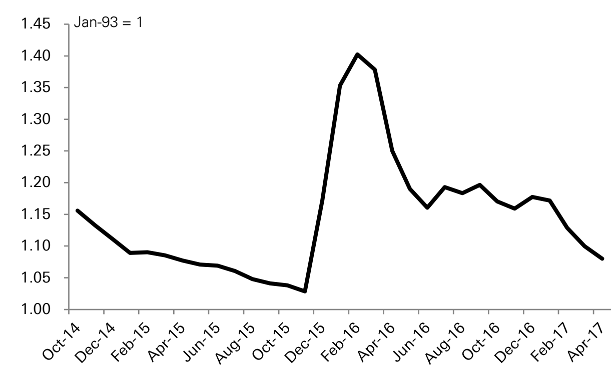
After rising a higher-than-expected 2.4% MoM in March, the GBA (Gran Buenos Aires) CPI surprised on the upside again and climbed 2.6% MoM in April, more than the consensus forecast of 2.0%, as utility prices rose a hefty 3.7% MoM. In 12 months, the CPI climbed 27.5%, led by a 35.6% surge in regulated 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 had hinted at a tighter monetary stance by allowing higher interest rates in the secondary market, we expected the BCRA to remain on hold before resuming cutting rates at the end of 2Q17. BCRA President Federico Sturzenegger mentioned higher-than-expected inflation in February and March to justify the decision, even though the inflation uptick was mainly caused by increases in regulated prices. The BCRA also mentioned the deterioration in inflation expectations, as its own survey of market participants in March pointed to a consensus inflation forecast of 21.2% for 2017, in contrast with the official target of 12% to 17% (the consensus forecast dropped slightly to 21.0% in the April survey). 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. Moreover, as economic activity remains subdued, we expect the central bank to resume cutting interest rates in June following the transitory inflation surge observed in February, March and April. However, in light of the latest developments, we have raised our year-end 7-day repo rate forecast to 22.0% from 21.0%.

Argentina: Consumer price index (Buenos Aires)



Source: City of Buenos Aires

Argentina: Real exchange rate



Source: BCRA, DB

The central bank announced a target for reserves

After hiking interest rates to fight inflation, the BCRA announced a plan to raise the stock of international reserves to 15% of GDP up from the current level of 10% of GDP – which would require the purchase of USD25bn. The authorities highlighted the macro-prudential role of international reserves, which provide liquidity to the FX market in moments of volatility and a cushion for external financing during episodes of sudden capital stops. The central bank has purchased approximately USD20bn since 2016. However, we believe the accumulation of reserves mainly aims to weaken the peso. The nominal ARS exchange rate has been quite stable this year, not only due to high domestic interest rates, but also because of the dollar inflows triggered by the tax amnesty program and the rating upgrade announced by Standard & Poor's, which raised Argentina's long-term sovereign rating to B from B- in April. The combination of a relatively stable nominal exchange rate and high inflation has led to a significant appreciation of the peso in real terms, which has offset a large part of the FX devaluation that took place in December 2015, hurting the competitiveness of local companies and leading to deterioration in the trade balance and to an increase in the current account deficit. The trade deficit, for example, climbed to USD1.1bn in 1Q17 from USD0.3bn in 1Q16, as exports rose 1.7% YoY but imports surged 7.5% YoY. The BCRA announcement on international reserves and the adverse effects of the real appreciation on economic growth and external accounts reinforce our view that the nominal exchange rate will eventually weaken. It is also worth noting that the central bank has decided that banks will no longer have to limit their FX positions to 30% of their net equity, which could raise the demand for dollars. Therefore, although the risk seems tilted towards a stronger peso, we are keeping our year-end FX forecast unchanged at ARS17.5/USD.

We have cut our 2017 GDP growth forecast to 2.4%

The INDEC index of economic activity fell 1.9% MoM in February, posting its second consecutive decline. The index fell 2.2% YoY, well below the market consensus forecast of -0.9% YoY. The decline in economic activity was led by manufacturing (-7.1% YoY), mining (-6.7% YoY) and retail (-4.9% YoY). The car sector is a good example of how the manufacturing sector has been hurt by the exchange rate appreciation: although vehicle sales rose 12.6% YoY in April, domestic production plummeted 15.1% YoY and exports fell 10.3% YoY. On the other hand, the agricultural sector is performing very well and there are signs of a consistent recovery in construction activity as well (the INDEC synthetic indicator of construction activity surged 10.8% YoY in March, perhaps reflecting an increase in public investment). All in all, we still believe that the economy will benefit from lower interest rates, better access to international capital markets, increased government transfers due to the "reparación historica" social security settlement program (which will peak in 1H17), a strong agricultural harvest, and a gradual recovery of the Brazilian economy. However, in light of the latest data and delay in the monetary easing cycle, we have cut our 2017 GDP forecast to 2.4% from 2.7%. For 2018, we are keeping our forecast unchanged at 2.8%.

Government on track to meet its fiscal target this year

The government obtained ARS40.5bn (0.4% of GDP) in revenues related to the tax amnesty program ("blanqueo de capitales") this year, which led to a total windfall gain of 1.8% of GDP in 2016 and 2017 combined. Thus, despite the slow economic recovery, increase in social security benefits and usual pressure to boost fiscal spending during an election year (mid-term elections will take place in October), we believe the most likely scenario is that the government will meet this year's primary deficit target of 4.2% of GDP.

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Argentina: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	633.3	545.5	620.7	624.8
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	2.5	3.2
Gov't consumption	6.8	0.3	2.3	1.0
Gross capital formation	3.8	-5.5	3.0	4.0
Exports	-0.6	3.7	3.6	2.0
Imports	5.7	5.4	1.5	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	15.3
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	-15.0	-18.6	-20.6
% 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
	633.3	545.5	620.7	624.8
General	43.1	43.6	44.1	44.6
Industrial production (YoY%)	14.7	12.5	14.1	14.0
Unemployment (%)				
Financial Markets (eop)	**Current**	**17Q2**	**17Q3**	**17Q4**
7-day repo rate (% p.a.)	26.3	25.3	23.5	22.0
1 month BADLAR	19.0	18.5	18.5	18.0
ARS/USD	15.5	15.9	16.7	17.5

Source: DB Global Markets Research forecasts, National Sources

Brazil

Ba2(stable)/BB(negative)/BB(negative)

Moody's/S&P/Fitch

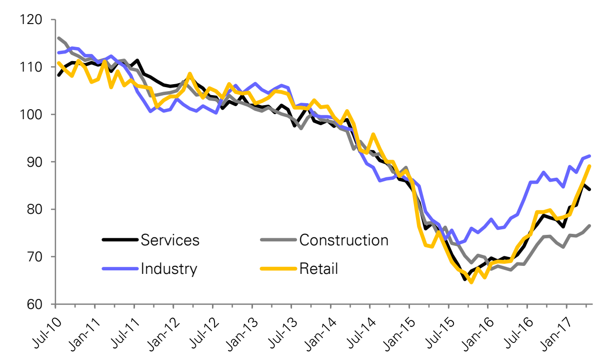
- Economic outlook: Although the economy is struggling to recover, a sharp decline in inflation has allowed the BCB to accelerate the pace of monetary easing, which will ultimately drive the recovery. However, the fiscal imbalance remains a serious risk as the public debt will not stabilize in the absence of structural reforms.
- Main risks: The main risk is a possible rejection of the social security reform by Congress, as it is a crucial step for long-term fiscal consolidation. Our scenario assumes that Congress will pass a diluted reform, enough for the country to buy time to postpone additional fiscal measures until after the 2018 election. The *Lavajato* investigation remains a source of political risk.

Diluted reform in a diluted economy

Data revisions point to positive growth in 1Q17

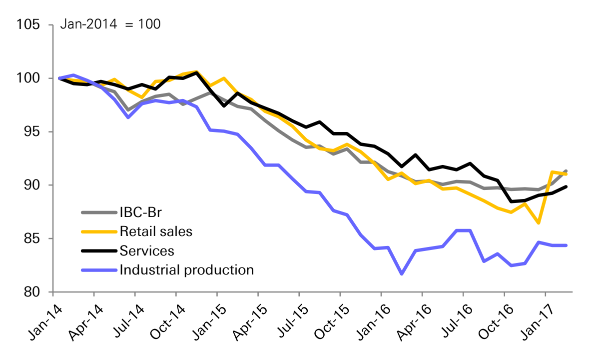
In our previous Monthly, we stressed that the economic indicators then available pointed to a significant recovery in business and consumer confidence that was not matched by a similar improvement in the "hard data" on economic activity such as retail sales, activity in the services sector and industrial production. Nevertheless, the official statistics agency IBGE has recently unveiled some methodological changes to its surveys that have altered this picture. Although IBGE reported that retail sales fell 0.2% MoM in February, it informed that, due to the adoption of a larger sample and revision to the survey's weighting structure, January sales were revised to +5.5% MoM from -0.7% MoM. Supermarket sales (the survey's main component), for example, were revised to +8.1% MoM from +0.2% MoM. IBGE also revised activity in the services sector for January to +0.2% MoM from -2.2% MoM and reported a 0.7% MoM increase for February. Probably mostly due to the IBGE changes, the BCB revised its monthly GDP proxy IBC-Br for January to +0.62% MoM from -0.26% MoM. Moreover, the IBC-Br jumped 1.31% MoM in February and should the index remain unchanged on a MoM basis in March, it would climb a hefty 1.5% QoQ in 1Q17 (although we expect a slight decline in March as payback for the sharp increase in February). Therefore, we have revised our 1Q17 forecast to 1.2% QoQ from 0.4% QoQ. Nevertheless, we will have to take the 1Q17 numbers with a grain of salt, as they could overestimate the pace of recovery due to the said methodological changes (especially in the case of the services survey) and GDP might decelerate again in 2Q17 after posting a strong first quarter. It is important to mention that unemployment remains very high (13.7% in March) and credit conditions remain tight, which do not bode well for a speedy recovery in household consumption. Furthermore, the combination of low capacity utilization and high political uncertainty (not only because of the reforms, but also due to the 2018 elections) does not offer a strong incentive for corporates to resume investing. On the other hand, the agricultural sector is having a record harvest this year, net exports are doing quite well and the decline in interest rates will eventually provide a strong stimulus to aggregate demand. All in all, given our revised 1Q17 estimate, we have raised our 2017 GDP forecast to 0.7% from 0.3%.

Brazil: Business confidence



Source: FGV

Brazil: Selected economic indicators



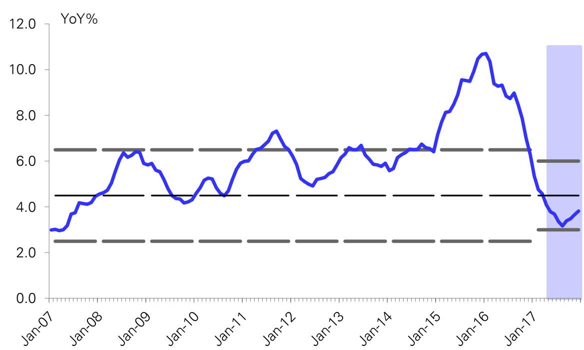
Source: IBGE, BCB

The disinflation process continues

Inflation continues to surprise on the downside, reflecting not only weak economic activity (i.e. a negative output gap), but also a sharp correction in agricultural prices. The IPCA consumer price index rose 0.14% in April, down from 0.25% in March. In 12 months the IPCA decelerated to 4.08% from 4.57% in March, reaching the lowest level since July 2007. While headline inflation in April was influenced by a transitory reduction in electricity prices that will be reversed in May, core inflation decelerated to 5.3% YoY in April (down from 8.7% a year earlier). Also, service prices – which in theory are the most sensitive to economic activity and monetary policy – decelerated to 5.9% YoY, the lowest increase since July 2008.

Wholesale agricultural prices have declined by approximately 11% since June 2016, reversing a negative shock caused by supply constraints last year. Given Brazil's record harvest and current international trends, we expect domestic food prices to remain subdued, thereby contributing to further disinflation. We have cut our 2017 IPCA forecast further to 3.8% from 4.0% and, given lower inertia, we have also lowered our 2018 forecast to 4.4% from 4.6%.

Brazil: IPCA and inflation targets



Source: IBGE, DB forecasts

Slow growth + low inflation = lower rates

As we expected, the BCB accelerated the pace of monetary easing and cut the SELIC overnight interest rate by 100bps to 11.25% in April – its fifth consecutive rate cut. As it announced the decision, the COPOM claimed that it "considered the pace of easing appropriate", suggesting another 100bp rate cut at the next meeting in May. However, the COPOM minutes published a few days later had a more dovish tone, explaining that the committee members argued that the economic outlook could justify "an intensification of the pace of monetary easing larger than the one decided at the meeting". While the authorities also claimed that the current pace of 100bps would be more adequate due to the "exploratory" conduction of monetary policy and uncertainty surrounding the risk factors (mainly the external environment, domestic reforms, food price decline and the speed of economic recovery), the comment clearly opened the door for a further acceleration in the pace of easing (to, say, 125bps) depending on upcoming data. We continue to forecast another 100bp rate cut for the next COPOM meeting as the authorities have opened the door for a larger cut, but have not explicitly endorsed it yet. Moreover, as real rates decline, the risk of a rebound in inflation in 2018 tends to increase, especially if factors exogenous to monetary policy (such as a failure to pass the social security reform) worsen. Nevertheless, given the slow economic recovery (notwithstanding the 1Q17 GDP numbers) and benign short-term inflation outlook, the risk is currently tilted towards a larger rate cut. Also, we believe that rates are poised to "undershoot" the neutral real interest rate, so we have lowered our year-end SELIC rate forecast to 8.25% from 9.0% (we now expect another 100bp cut, followed by one 75bp cut, two 50bp cuts and one final 25bp cut in December).

Social security reform will be watered down

The social security reform cleared its first hurdle, the Lower House Special Committee approval, in early May. However, the committee watered down the government's original proposal significantly, and the risk of further dilution remains. The committee changed practically all the reform's main points:

- The government's plan was to introduce a minimum retirement age of 65 years for men and women. The approved version maintained this age for men, but set a lower minimum retirement age of 62 for women even though women on average live longer than men.
- According to the government's proposal, workers would have to contribute to the social security system for at least 49 years in order to earn full benefits. According to the revised version, this period falls to 40 years.
- According to the original proposal, the transition rule would apply to 50-year-old or older men, and to 45-year-old or older women, who would have their retirement postponed by a number of years equal to 50% of the number of years they would have to wait to retire under the existing rules (younger men and women would be subject to the minimum retirement age of 65). The revised proposal applies the transition rule to all workers and reduces the time penalty to 30%. Minimum retirement ages would begin at 53 for women and 55 for men, and gradually increase to 65 starting in 2020.
- The new proposal reinstates the special retirement plans for teachers and police officers that the government indented to axe.
- The revised bill maintains the indexation of the BPC ("Benefício de Prestação Continuada") welfare program to the minimum wage. The minimum age for people to qualify for the BPC program gradually rises from 65 to 68 beginning in 2020, instead of immediately climbing to 70 as the government had proposed.
- The revised bill maintains the indexation of pensions to the minimum wage. It also allows workers to accumulate retirement benefits and survivor pensions up to the equivalent of two minimum wages, nixing the government's plan to prevent people from receiving two benefits at the same time.
- The revised bill sets a minimum retirement age of 60 for rural workers instead of the government's proposed minimum retirement age of 65.

While the government claimed that its original proposal would save BRL678bn over the next 10 years, we estimate that these modifications could reduce the savings by roughly 40%. Even so, the government has not yet secured the minimum 308 votes needed to pass the constitutional amendment on the Lower House (LH) floor. Consequently, additional concessions cannot be ruled out. The government scored an important victory by passing its labor reform (which essentially introduces more flexibility in the labor market, giving workers and employers more leeway to negotiate contracts) in the LH in April. However, the labor reform is certainly much less controversial than the pension reform and requires fewer votes than a constitutional amendment (it obtained 296 votes in the LH). Moreover, according to local media, there is a growing movement among LH members to wait for the Senate to vote on the labor reform before voting on the pension reform. Apparently, LH representatives fear bearing the political cost of approving unpopular reforms only to see them later rejected by the Senate. We do not expect the Senate to pass the labor reform before June, as it will have to clear three committees before reaching the floor. Thus, although we expect the LH floor to vote on the pension reform by the end of May, there is a risk that it could be postponed until June. In that case, final approval by the Senate could take place in September instead of August.

The trade surplus continues to surprise on the upside

The trade surplus totaled USD21.4bn in 4M17, compared to USD13.3bn in 4M16, as exports surged 21.8% (mainly due to higher commodity prices) and imports rose 9.5%. Exports of raw materials grew 32.1% YoY and total exports to China jumped 46.8% (China purchased 26.0% of Brazilian exports in 4M17, up from 21.6% in 4M16). 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 USD60bn from USD55bn (compared with USD47.7bn in 2016, according to SECEX data). The large trade surplus will contain the current account deficit (an estimated USD22bn or 1.0% of GDP this year), which we expect to be easily financed by approximately USD60bn in foreign direct investment. Therefore, we have revised our year-end FX forecast slightly to BRL3.10/USD from BRL3.15/USD. We are assuming that the government will manage to pass the social security reform this year, as a failure to do so would likely lead to a much weaker FX.

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Brazil: Deutsche Bank forecasts

	2015	2016	2017F	2018F
National Income				
Nominal GDP (USDbn)	1,798	1,799	2,109	2,173
Population (m)	204	206	207	209
GDP per capita (USD)	8,792	8,735	10,165	10,402
Real GDP (YoY%)	-3.8	-3.6	0.7	2.8
Private consumption	-3.9	-4.2	0.2	2.3
Government consumption	-1.1	-0.6	-0.2	1.3
Gross capital formation	-13.9	-10.2	0.5	8.5
Exports	6.3	1.9	0.0	3.0
Imports	-14.1	-10.3	3.0	6.0
Prices, Money and Banking				
CPI (YoY%, eop)	10.7	6.3	3.8	4.4
CPI (YoY%, avg)	9.0	8.7	3.9	4.1
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	-8.1	-7.7
Interest payments	-8.4	-6.5	-6.0	-5.9
Primary balance	-1.9	-2.5	-2.2	-1.8
External Accounts (USDbn)				
Merchandise exports	190.1	184.5	205.0	210.0
Merchandise imports	172.4	139.4	145.0	160.0
Trade balance	17.7	45.0	60.0	50.0
% of GDP	1.0	2.5	2.8	2.3
Current account balance	-58.9	-23.5	-22.0	-40.0
% of GDP	-3.3	-1.3	-1.0	-1.8
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	3.10	3.30
Debt Indicators (% of GDP)				
Government debt (gross)*	65.5	69.9	75.5	78.5
Domestic	61.1	66.2	72.2	75.2
External	4.4	3.6	3.3	3.3
Total external debt	30.1	30.7	26.2	25.6
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 (%)	11.25	10.25	9.00	8.25
10-year Pré-CDI rate (%)	10.3	9.8	9.5	9.3
BRL/USD	3.16	3.00	3.05	3.10

(*) 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

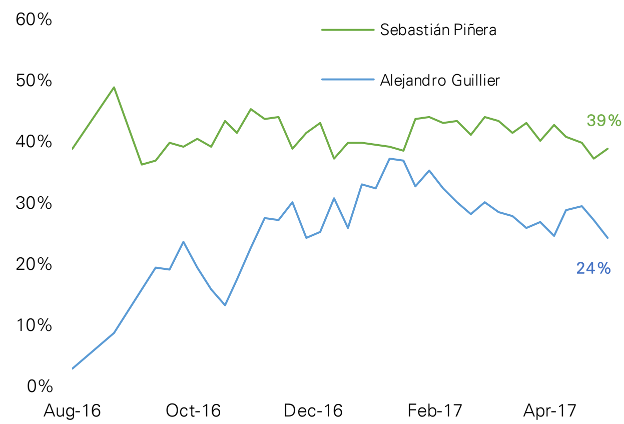
- Economic outlook: Risks to activity remain unchanged since last month and there is still a dearth of potential catalysts for higher growth despite the positive surprise of March's activity data. However, the stabilization of the non-mining Imacec hints at marginally higher monthly activity prints. On the inflation front, pressure on prices continues to decline across inflation measures but the stabilization of activity and depreciation of the CLP somewhat cap the downside risks to inflation. Despite the BCCh's sooner-than-expected reduction of the TPM in April, we continue to expect only one more 25bp reduction to the TPM this month. The risks to our forecast are still on the downside but as the BCCh has forcefully communicated they are not more dovish. The economy averted a technical recession and going forward, political developments are likely to be the most important forces shaping Chile's economic outlook for next year.
- Main risks: The main risk in the near term is that the inflation rate accelerates its decline. On the activity front, the main risk is the potential of the new labor legislation that came into effect on April 1st to result in longer than average strikes. As we get closer to November's election, the risks of politically-driven strikes also increases.

Predictable economy, less predictable politics

The BCCh reduced the monetary policy rates by 25bp in its April meeting. And while we did expect a rate reduction we had expected the easing to materialize in May. Inflation data in Chile continues to exhibit weakness although it is no longer surprising analysts on the downside. Activity is likely to normalize a little bit faster than expected as March's monthly GDP proxy surprised on the upside as non-mining activity mitigated the drag on growth driven by the Escondida strike. Going forward we expect activity to return to its pre-strike levels. Overall, growth will be back on its unimpressive path leading to a 1.5% y/y expansion of GDP this year.

As we have previously noted, much of the sluggishness of activity is driven by uncertainty and lack of confidence that are unlikely to change ahead of November's Presidential election. Thus we expect that going forward macro data will be relatively stable. On the other hand, political developments over the last month especially on the pro-Government coalition have been significant and have resulted in a fracture of the traditionally cohesive center-left coalition currently in power.

Piñera is still ahead of the polls



Source: Cadem, Deutsche Bank

The 2017 Presidential election

Recent polls continue to show that Sebastián Piñera continues ahead of the pack on the way to the 2017 Presidential elections. Piñera, a former President and candidate of a coalition of center-right parties will not face any primary challengers even if the opposition decides to actually hold primary elections. While it is evidently clear that Piñera will prevail in any primary election, minor candidates from within his coalition have argued that holding primaries would be useful as a way of publicly discussing the platform and future government program of Piñera and also because primary elections would legally allow Piñera to campaign early. Over the past few weeks Piñera has unveiled some of the priorities his potential Presidency would have on the policy front. Unsurprisingly, Piñera is committed to focusing on growth and to achieve that he proposes a partial modification of some of the tax and labor reforms of the current administration. Our view is still that a Piñera victory would trigger a significant increase of investments which would not depend on his legislative agenda. In particular, the cash-rich corporate sector is eager to resume investing as long as the reform agenda of the current administration is not pushed any further.

On the other hand, the government coalition has weakened politically due to internal power struggles. After 3 of the 5 parties of the governing coalition decided to back former news anchor and current Senator Alejandro Guillier as their candidate, the Christian Democrats decided to participate directly on the general election's first round rather than to take part on primaries within the coalition. The situation is still very much in flux so it is hard to draw strong consequences regarding the future of the coalition.

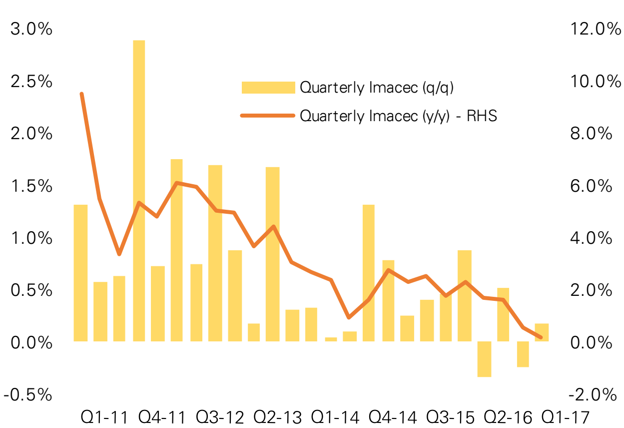
However, in the near term the internal struggle seems to have reduced the appeal of Guillier on the polls which strengthens Piñera's chances of becoming President again.

It is still too early to make any forecasts ahead of the November election but relative to a month ago, Piñera seems to have a clearer way to the election. On the other hand, the internal struggles that plague the government coalition are likely to erode the popularity of Guillier over the next few weeks which could result in a dissipation of the uncertainty regarding the election result earlier than expected.

The post-Escondida economy

March's IMACEC print was released last week. The consensus expectation was for the economy to contract 0.4% y/y mainly because the Escondida strike extended well into the second half of the month. The 0.2% y/y expansion of the IMACEC during the month was a positive surprise. The composition of March's Imacec made the unexpected data print even more significant. Because while the mining Imacec contracted by 22.7% y/y, the non-mining activity index managed to post a 2.2% y/y expansion that partially offset the expected weakness of the mining sector. Furthermore, March's data suggests that GDP during Q1 '17 expanded by 0.2% y/y and 0.2% q/q. If the quarterly national accounts do not deviate from the Imacec, the Chilean economy will have narrowly avoided a technical recession for the second time over the past 12 months.

Growth surprise, recession avoided



Source: BCCh, Deutsche Bank

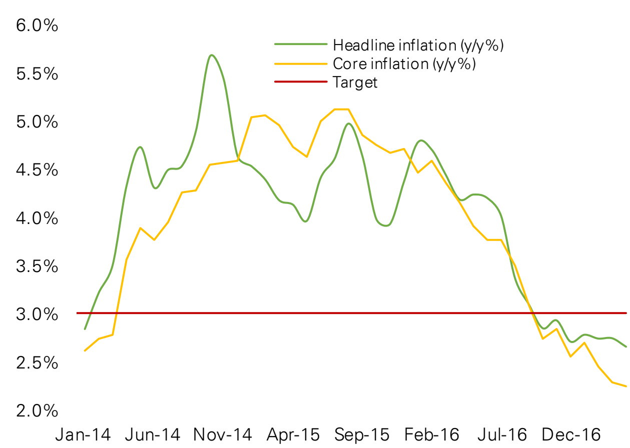
During March retail sales registered a 4.9% y/y expansion which was also above expectations (4.2% y/y) The robust print is a positive development as it suggests that February's very weak print (-1.4% m/m) was an outlier rather than a signal of a weakening trend. Retail sales of durable goods still exhibit relatively weak growth. However, March's retail sales suggest that despite the shift in the composition of employment towards self-employment, consumption is likely to be relatively resilient over the next few months which caps the downside risks to activity.

Going forward we expect stability on the activity front at least until November's election. Once there is clarity regarding who will be Chile's next President there will be room for shifts of sentiment that could result in a more meaningful recovery of activity and especially of investments.

Inflation and the BCCh

The minutes of the BCCh's April monetary policy meeting were in line with our monetary policy forecasts. The BCCh's decision was somewhat surprising as we expected a 25bp reduction to the TPM to be implemented in May rather than in April. However, the minutes suggest that the BCCh's decision should not be interpreted as a change of the central bank's policy stance. In fact, it seems that the members of the board continue to view the current macro juncture as compatible with the base case scenario published in March's Quarterly Inflation Report.

Inflation is still relatively low

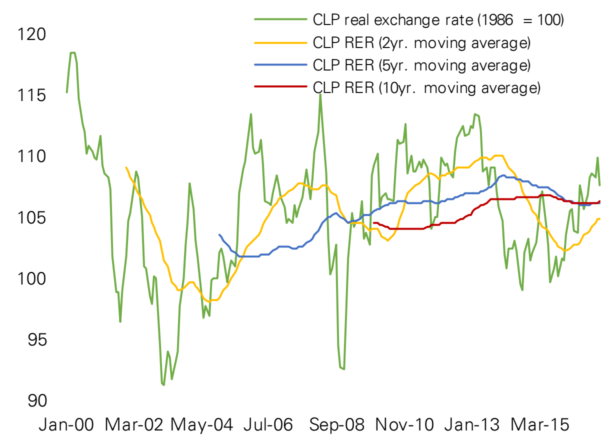


Source: INE, Deutsche Bank

The BCCh used the minutes not only to communicate that their base case scenario remained valid. They also registered a discussion in which the BCCh's research team argued that the current base case scenario could still be considered as valid even if the TPM was reduced by a further 25bp. In our view, the tone of the minutes suggests that the BCCh is poised to reduce the policy rate by another 25bps. While the next cut might come even before a new quarterly inflation report is published, the minutes suggest that the market should not interpret an earlier than expected cut as evidence of the BCCh's view of the economy becoming more pessimistic. We thus continue think that a reduction of the policy rate below 2.5% at this stage is fairly unlikely.

Inflation data released after the BCCh's April meeting was consistent with the idea that there has not been a significant further deterioration of the balance of risks either for activity or inflation. The headline index increased by 2.7% y/y during April which was in line with expectations and was also the same inflation rate registered in March. While inflation numbers were pretty low across the index' components we do not see much room for inflation rates to continue to fall in the near term. In particular, the signs of stabilization on the activity front and the CLP's depreciation over the past few weeks should both contribute to somewhat capping the downside risks on future inflation prints.

Recent FX depreciation caps downside risks to inflation



Source: BCCh, Deutsche Bank

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Chile: Deutsche Bank forecasts

	2015	2016F	2017F	2018F
National income				
Nominal GDP (USD bn)	243	247	266	275
Population (mn)	18	18	18	19
GDP per capita (USD)	13	14	14	15
Real GDP (YoY%)	2.3	1.6	1.5	2.5
Private Consumption	2.0	2.4	2.4	2.0
Government consumption	4.5	5.1	3.5	4.0
Gross Investment	-0.8	-0.8	0.3	3.0
Exports	-1.8	-0.1	1.6	0.3
Imports	-2.7	-1.6	4.0	1.6
Prices, Money and Banking				
CPI (eop)	4.4	2.7	2.9	3.0
CPI (annual avg)	4.3	3.8	2.8	3.0
Broad money (avg)	11.3	9.7	8.6	10.1
Credit Growth (avg)	10.0	8.5	8.4	10.1
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-0.4	-2.1	-3.1	-3.0
Revenue	19.9	20.1	20.6	21.4
Expenditure	20.3	22.3	23.7	24.4
External Accounts (USD bn)				
Goods Exports	62.2	60.6	67.5	70.7
Goods Imports	58.7	55.3	59.0	59.7
Trade balance	3.5	5.3	8.4	11.0
% of GDP	1.4	2.1	3.2	4.1
Current Account Balance	-4.7	-3.6	-3.3	-2.7
% of GDP	-1.9	-1.4	-1.3	-1.0
FDI (gross)	20.5	12.2	12.9	13.4
FX Reserves (eop)	38.6	40.5	39.7	39.5
USD/CLP (eop)	707.3	667.3	685.0	675.0
Debt Indicators (% of GDP)				
Government Debt	17.4	22.2	24.3	26.3
Domestic	14.2	18.2	20.0	21.7
External	3.2	3.9	4.4	4.5
External debt	68.4	81.1	91.8	95.1
in USD bn	153	195	224	241
Short-term (% of total)	13.7	13.7	13.7	13.7
General (ann. avg)				
Industrial Production (YoY%)	0.6	-1.5	-3.0	0.2
Unemployment (%)	6.3	6.5	6.7	6.7
Financial Markets (eop)	*Spot*	*17Q2F*	*17Q3F*	*17Q4F*
Overnight rate (%)	2.75	2.50	2.50	2.50
3-month rate (%)	2.85	2.92	3.09	3.22
USD/CLP	679.05	672.00	680.00	685.00

Source: Deutsche Bank Forecasts and National Statistics

Colombia

Baa2 (stable)/BBB (negative)/BBB (stable)

Moody's / S&P / Fitch

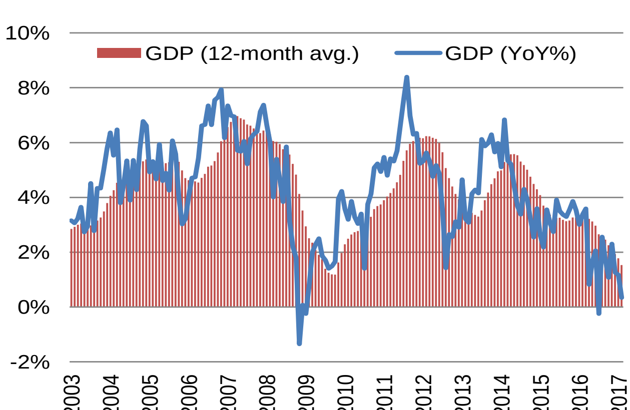
- Economic outlook: Policymakers seem willing to take on additional fiscal and inflation risks to stimulate a rapidly decelerating economy. The ministry of finance relaxed the budget deficit targets under the fiscal rule again and BanRep accelerated its easing cycle despite evidence of inflation persistence and risks of exceeding its inflation target for a third consecutive year in 2017.
- Main risks: Firm oil prices and foreigners appetite for local currency government bonds continue to support local markets. However, rates and foreign exchange remain vulnerable to commodity shocks and shifts in market sentiment. Credit valuation looks expensive relative to peers given the country's deteriorating growth outlook and challenges to stabilize the public debt burden even after the approval of a long-awaited tax reform.

The growth and inflation dilemma

Gradual but broad-based economic deceleration

The economy could decelerate for the fourth consecutive year in 2017. The monthly GDP proxy expanded a mere 0.3% in February, bringing 12-month average growth to 1.7%, lower than the 2.0% in 2016 and 3.1% in 2015 (Figure 1). Trade and industrial sectors, which together account for 23% of GDP, reported very negative results in February. Retail sales fell 7.2% in real terms, the sharpest contraction since 2009. The one-off hike in the VAT tax rate to 19% from 16% and the effect of one less calendar day heavily influenced the monthly results. However, the fact that 13 of the 15 activities measured in the retail survey showed annual contractions is symptomatic of more structural weaknesses in private consumption.

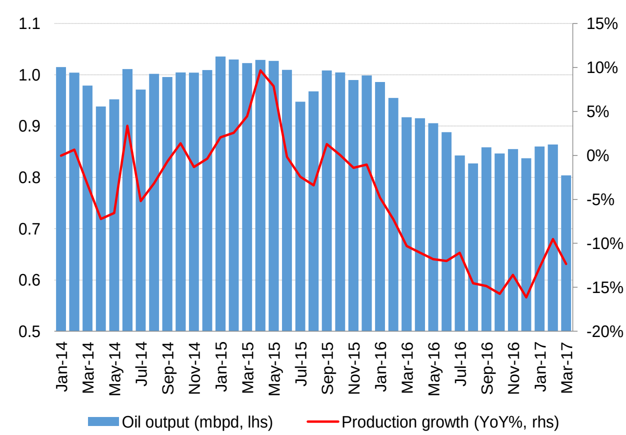
Figure 1: Economic deceleration intensifies



Source: National Statistical Department (DANE), Deutsche Bank

The outlook for the oil industry remains challenging despite the recovery in international prices and the recent introduction of tax incentives for private investment. The state-owned Ecopetrol turned profitable again in 2016 thanks to a disciplined cost rationalization strategy and would be able to increase investment in production ($2.2 million) and exploration ($650m) in 2017. However, export prices near breakeven levels ($44 per barrel), recurrent guerrilla attacks to the main pipeline infrastructure and the prolonged restructuring of Pacific Rubiales, the largest private contractor, continue to put pressure on crude output (Figure 2). In our view, low proven oil reserves (only 6.3 years) and subdued exploration activity (just 15 wells drilled in 2016) raise concerns about the country's capacity to remain a net oil exporter.

Figure 2: Declining oil production despite recovery in international prices



Source: National Hydrocarbons Agency (ANH)

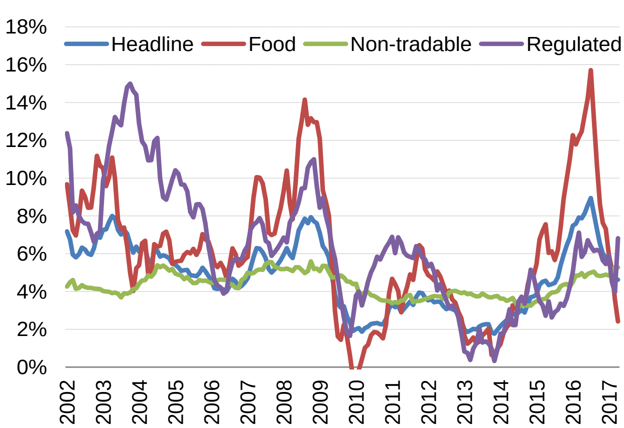
We are maintaining our growth forecasts of 2.0% in 2017 and 3.0% in 2018 for now. However, the materialization of this baseline scenario will hinge on the capacity of different agencies to accelerate the execution of large infrastructure projects and public works at the local level. The government successfully raised $4.2 billion from local banks and international capital markets to fund the first 8 concessions of the 32 included in the 4G program. Disbursements were limited in 2016 ($650 million), but they are expected to treble in 2017 ($1.9 billion), as the authorities resolve contractual disputes and advance mandatory consultations with local communities. Moreover, the central government is urging sub-national authorities to deploy up to $2 billion in unspent oil and mining royalties for local development and the construction of tertiary roads agreed with the FARC in the context of the peace agreements signed in December 2016.

BanRep accelerates easing despite inflation persistence

We maintain our long-held view that disinflation driven by base effects, falling inflation expectations, and disappointing economic activity data provide a narrow window for BanRep to accelerate its easing cycle in 2Q17. Our baseline projections have inflation temporarily hovering around 4% in June-August before it rekindles outside the target band in 4Q17. Signs of a more dovish bias at BanRep support our rationale. April's decision to lower the policy rate by 50bp to 6.5% was favored by 4 of the 6 board members. In May, Jose Antonio Ocampo will join as a new voting co-director. In a recent interview, Ocampo welcomed the 50bp move in April and advocated that BanRep could contribute to reignite growth through additional rate cuts and a more competitive exchange rate.

Inflation persistence could slow the pace of inflation convergence to target and limit room for monetary accommodation after favorable base effects fade off. Consumer prices have fell uninterruptedly to 4.7% in April from a peak of 9.0% last July, mainly driven by a rapid correction in food prices after weather conditions and transport strikes normalized (Figure 3). Nonetheless, measures of core inflation deteriorated for the second consecutive month in April, affected by selective increases in consumption taxes and high levels of backward-looking indexation in the costs of essential services and public utility tariffs. Housing, healthcare, education and communications together weight 42% in the consumer basket and have grown well above headline inflation in 4M17.

Figure 3: Food inflation drops, regulated prices surge



Source: Central Bank of Colombia (BanRep)k

Overall, we expect BanRep to deliver another cut of 50bp in the May meeting and return to a more gradual pace of 25bp reductions in June-August. Based on the present level of real interest rates (2.8%), we estimate that there is space to take the current policy rate of 6.5% to 5.25% by end 2017 and 5.00% by end 2018.

Cesar Arias, New York, 212-250-0664

Colombia: Deutsche Bank forecasts

	2015	2016F	2017F	2018F
National income				
Nominal GDP (USD bn)	292	282	306	329
Population (m)	48	49	49	50
GDP per capita (USD)	6,048	5,791	6,208	6,592
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	4.4	3.7
CPI (annual avg)	5.0	7.5	4.5	3.7
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	-3.7	-3.5
Revenue	16.2	14.9	15.1	15.4
Expenditure	19.2	18.9	18.8	18.8
Primary Balance	-0.4	-1.1	-0.7	-0.5
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	-3.4
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	3,009.7	3,039.8
Debt Indicators (% of GDP)				
Government Debt	42.7	43.7	44.7	45.3
Domestic	26.5	28.2	28.9	29.3
External	16.2	15.5	15.8	16.1
External debt	37.9	42.5	40.9	39.2
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 (%)	6.50	5.75	5.25	5.25
3-month Interbank rate (%)	5.75	5.44	4.99	5.04
USD/COP (eop)	2,967	2,975	3,007	3,010

Source: Deutsche Bank estimates, and National Sources

Mexico

A3 (negative)/BBB+ (stable)/BBB+ (stable)

Moody's/S&P/Fitch

- Economic outlook: Over the next month, politics in Mexico will steal the spotlight from economic developments. The Edomex gubernatorial election scheduled for June 4th is crucial for the PRI's political future. Also, the election is likely to increase the visibility of domestic political risks in Mexico to foreign investors which would result in domestic factors becoming more relevant drivers of Mexican asset prices. We expect the current trends of most macro aggregates to continue during next month: inflation is likely to continue to increase, activity will weaken, retail sales and consumption will remain relatively resilient, and the MXN will trade within a range. We expect Banxico to follow the Fed and hike the policy rate by 25bp in both June and September.
- Main risks: The main risks to the Mexican economy are now equally divided between domestic and foreign sources. The uncertainty regarding US trade policy is still present and the threats of the US of walking away from NAFTA last month were a reminder of their existence. On the other hand, an unexpected result in the Edomex election in the form of a stark defeat for the PRI could lead to a spike in risk aversion due to its implications for the 2018 Presidential race.

Time to focus on politics

On the economic front, April was a relatively uneventful March. The most relevant macro aggregates maintained their prior trends: inflation surprised on the upside, industrial activity fell again, retail sales continues to expand, and gross fixed investments are still on a downwards trajectory. For the first time in a while, a news headline surprised analysts positively when towards the end of April when Moody's decided to uphold Mexico's sovereign rating. Given that Moody's rating is one notch above S&P's and Fitch's and that there has been no significant improvement in Mexico's fiscal accounts, most analysts had expected a downgrade. Headlines also were the source of a negative surprise late in the month when US media reported the US was about to announce its decision to quit NAFTA. President Trump later decided against leaving NAFTA but it only took a few hours for USD/MXN to rally 2.5%.

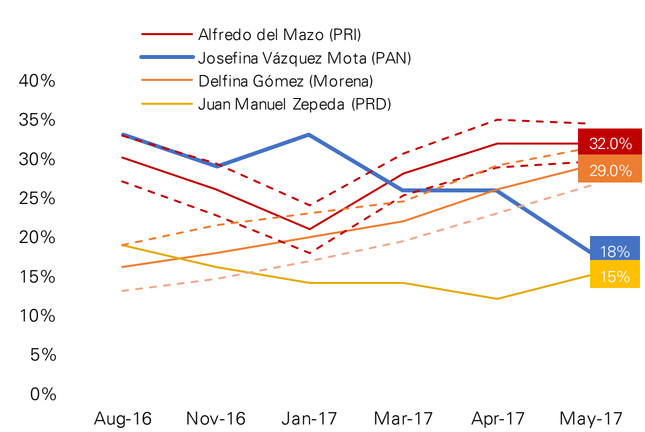
Next month, Mexicans will most likely be paying close attention to local elections scheduled for June 4th. Four of Mexico's States will hold elections that day the Edomex' Gubernatorial race will be followed particularly closely as it is perceived to be an important bellwether ahead of the 2018 Presidential race.

The upcoming elections in Edomex, Coahuila, Nayarit, and Veracruz

On June 4th, three out of Mexico's thrirty-one States are scheduled to hold gubernatorial elections. While citizens of the State of Mexico (Edomex) will only vote to elect a new governor, voters in Coahuila and Nayarit will also choose new State legislatures and municipal governments. The state of Veracruz will also hold an election to renew its municipal governments. The three States that will choose new governors are currently governed by PRI incumbents. And with only a month left, the latest polls (see https://goo.gl/mdpp81, https://goo.gl/4vUxC1, and https://goo.gl/us9SvV) suggest that the Edomex and Coahuila races will be heavily contested while Nayarit's current Governor seems very likely to be re-elected.

Roughly 25% of Mexico's voters will vote in these contests. Given that the 2018 Presidential election is only a year away, we think the outcome of these elections will be an indication of the electoral strength of Mexico's main parties. And while we do not consider the outcome of the June races will materially alter the expected results of the Presidential race, we do think that the relevance of these elections for the PRI could result in considerable media coverage. The potentially large number of headlines these elections are likely to trigger in both local and foreign media could become a trigger of political noise in Mexico suddenly becoming a more important driver of Mexican asset prices. Thus, June 4th could have important market-moving consequences.

Figure 1: A close race in Edomex

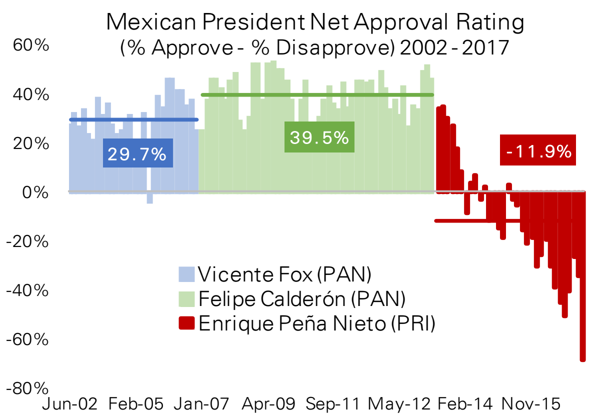


Source: El Financiero,Deutsche Bank

Edomex: No upside for the PRI

The most relevant of the June 4th elections is the gubernatorial contest in Edomex. The State of Mexico is the country's most populous federal entity with more than 15.2m inhabitants. Around 11.3m registered voters live in Edomex and they amount to 13.3% of Mexico's total eligible voters. Historically, the Edomex has been an electoral stronghold of the PRI and it has been governed by PRI-affiliated Governors since the 1920s.

Figure 2: EPN's low approval a burden for the PRI



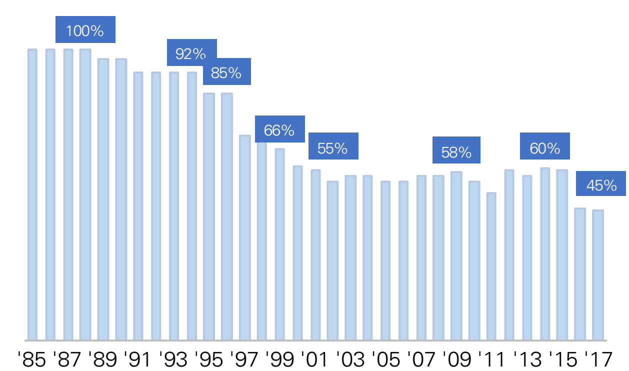
Source: Parametric, Deutsche Bank

Six years ago, the PRI's candidate Eruviel Ávila was elected governor with over 62% of the vote. However, this year polls suggest that the Edomex voters could be about to elect a non-PRI governor for the first time. The latest poll numbers (see https://goo.gl/SLUF8S) show that after two televised debates and a widely-publicized corruption scandal involving Morena and AMLO, Alfredo del Mazo (PRI) and Delfina Gómez (Morena) are tied although Gómez has momentum on her side. Former Presidential candidate Josefina Vázquez Mota (PAN) continues to lose likely voters. If she remains on her current path she risks obtaining fewer votes than Juan Zepeda Hernández (PRD) on June 4th.

Losing the Edomex Governorship would be a huge blow for the PRI and President Peña Nieto (EPN) in particular. The PRI's candidate is the son and grandson of former Governors of the Edomex and a cousin of EPN. The unusually large number of recent visits to Edomex by President Peña Nieto, his wife, and several members of his cabinet are a further indication of just how important the Edomex race is for the PRI. A defeat in Edomex would all but guarantee that Mexico's next President would not be a member of the PRI. The share of Mexicans living under PRI governors would drop to an all-time low of around 30% and Peña Nieto's influence within the party would drop significantly.

Over the next month the campaigning in Edomex will only become more intense. Optimistic PRI adherents would probably argue that Josefina Vázquez Mota's (PAN) recent statements linking Delfina Gómez to a possible case of corruption during her term as mayor of Texcoco could halt her momentum and revitalize del Mazo's campaign. While that scenario is feasible, del Mazo's support is unlikely to increase both given his cousin's record-low net approval ratings and the high share of voters of Edomex stating that they would never vote for the PRI.

Figure 3: Record low % of voters under PRI governors

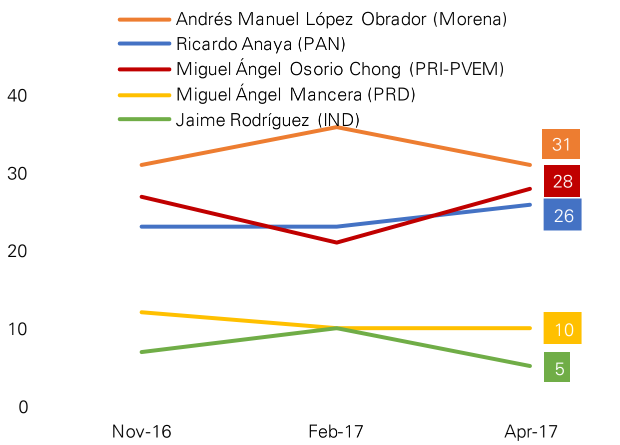


Source: INEGI, Deutsche Bank

Edomex: Only upside for Morena and a potential silver lining for the PAN

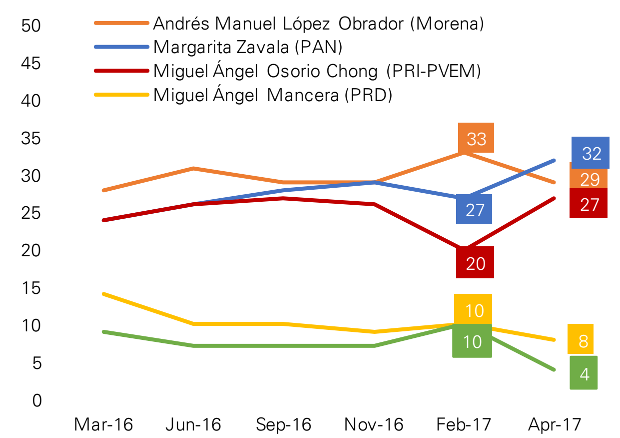
A defeat of the PRI would most likely also entail that Delfina Gómez (Morena) would become the Edomex next Governor. In that scenario, we expect Andrés Manuel López Obrador (AMLO) to argue that Morena's victory in the Edomex is proof that he will become Mexico's next President. AMLO is an experienced politician who is running for President for the third time. He is particularly skilled at employing the media and social networks to further his agenda. We therefore think that the if Morena were to win the Edomex election, the headlines would tend to overstate the impact this would have on AMLO's likelihood of becoming Mexico's next President. The media exposure he would get as a result of a Morena victory would probably heighten his visibility and markets would most likely over-react leading to a temporary sell-off of Mexico risk. Even if Delfina Gómez obtains a close second place in June's election we expect AMLO to spin the outcome as a victory for Morena by noting that his 3 year old party almost managed to defeat a party that has dominated Mexican politics for almost a century. In that case, the market reaction would likely be less pronounced yet still lead to a selloff of Mexican assets. In sum, while we think the strength of AMLO's candidacy does not depend on Morena's results in the Edomex election, we do recognize that June 4th could solidify the perception of AMLO as a front runner.

Figure 4: Anaya is not a strong candidate for '18



Source: El Financiero, Deutsche Bank

Figure 5: Zavala could threaten AMLO



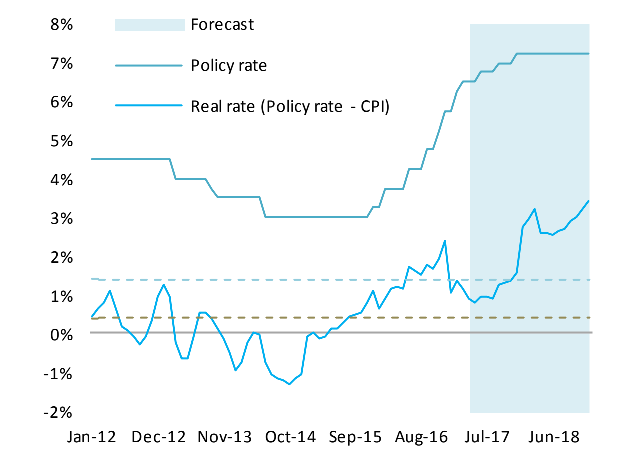
Source: El Financiero, Deutsche Bank

Finally, a PAN defeat in the Edomex could prove to be helpful for the party's chances of winning the Presidency next year. The PAN is currently divided and both former first lady Margarita Zavala and Ricardo Anaya (the party's current President) are competing to become the PAN's Presidential candidate. If Vázquez Mota electoral results are as weak as her current poll numbers, Ricardo Anaya would probably pay the political costs. Also, a defeat could coalesce different factions within the party around Zavala as she is the only candidate who appears to have as much support as AMLO on Presidential polls. In sum, the Edomex election could end up being negative for AMLO even if the PRI loses.

A brief comment on inflation and Banxico

Inflation prints in Mexico continue to surprise on the upside. During April, headline inflation reached 5.82% y/y which was well above March's 5.35% y/y print. Core inflation is also on the rise and rose from 4.48% y/y on March to 4.72% y/y in April. Yet while inflation data has consistently been above expectations, medium term inflation expectations remain stable according to Banxico's survey despite the continued upwards adjustment of the median forecast of year-end inflation.

Figure 6: Rising real rate? Not likely



Source: Banxixo, Deutsche Bank

Despite the stability of medium-term inflation expectations we still expect Banxico to raise the policy rate by 25bp when the Board meets in June. The Mexican central bank will most likely follow the Fed both next month and in September which will bring the policy rate to 7% and allow Banxico to end its hiking cycle. Yet while the consensus view also expects the hiking cycle to come to an end when the policy rate reaches 7%, our expectations regarding the path of interest rates during 2018 is not shared by the majority of analysts who expect the nominal rate to stay at 7% until early 2019.

When we combine the consensus view on the path of nominal rates and the path of inflation we find that these imply an increasing path for short-term real rates in Mexico. Furthermore, the implied path of real rates is well above the upper bound neutral rate estimates for Mexico. Given that we share the consensus' view on the path of inflation, we believe that sooner rather than later analysts will have to correct their monetary policy forecasts.

Because despite the currently high inflation data maintaining the policy rate on hold through 2018 will be excessively contractionary for Mexico's economy. There are no demand-side pressures on prices and both Banxico and analysts expect the output gap to remain negative until 2019. Also, the DNDF intervention program is likely to limit the depreciation potential of the MXN which translates into capped inflation risks. Therefore, we expect Banxico to quickly bring the policy rate closer to and even below its neutral level as soon as the dissipation of base effects of January's gasoline price hikes reduce the risk of medium term inflation expectations dislocating from the 3% target. We therefore reiterate our forecast of two more hikes of 25bp each this year and the beginning of an easing cycle in Q3 2018.

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Mexico: Deutsche Bank Forecasts

	2015	2016F	2017F	2018F
National income				
Nominal GDP (USD bn)	1,152	1,046	1,272	1,269
Population (mn)	121	122	124	125
GDP per capita (USD)	10	9	10	10
Real GDP (YoY%)	2.6	2.3	1.5	2.4
Private Consumption	2.3	2.8	2.1	2.2
Government consumption	2.3	1.1	1.1	1.2
Gross Investment	4.2	0.4	-0.3	2.0
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	5.8	3.5
CPI (annual avg)	2.7	2.8	5.5	3.8
Broad money (period avg)	20.1	15.9	12.0	7.5
Credit Growth (period avg)	11.7	15.6	14.4	16.4
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-3.5	-3.0	-2.6	-2.4
Revenue	23.4	21.3	19.6	19.7
Expenditure	26.8	24.2	22.2	22.1
Primary balance	-1.2	-0.6	-0.5	-0.3
External Accounts (USD bn)				
Goods Exports	380.5	374.0	403.3	437.8
Goods Imports	395.2	387.1	419.2	458.5
Trade balance	-14.7	-13.1	-15.9	-20.7
% of GDP	-1.3	-1.2	-1.2	-1.6
Current Account Balance	-33.3	-22.5	-34.3	-33.0
% of GDP	-2.9	-2.1	-2.7	-2.6
FDI (net)	33.2	18.7	21.0	26.0
FX Reserves (eop)	187.5	176.4	161.6	160.0
USD/MXN (eop)	17.2	20.7	19.5	20.0
Debt Indicators (% of GDP)				
Government Debt	43.9	47.7	47.4	46.4
Domestic	29.5	30.1	30.3	29.7
External	14.4	17.6	16.0	15.0
External debt	25.6	30.4	26.0	24.6
in USD bn	294.3	317.9	309.9	330.2
Short-term (% of total)	15.8	15.5	15.6	15.6
General (ann. avg)				
Industrial Production (YoY%)	1.0	0.0	0.3	2.7
Unemployment (%)	4.4	3.9	3.9	4.0
Financial Markets (eop)	*Spot*	*17Q2F*	*17Q3F*	*17Q4F*
Overnight rate (%)	6.50	6.75	7.00	7.00
3-month rate	6.96	7.01	7.54	7.82
USD/MXN	18.95	19.10	19.50	19.50

**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

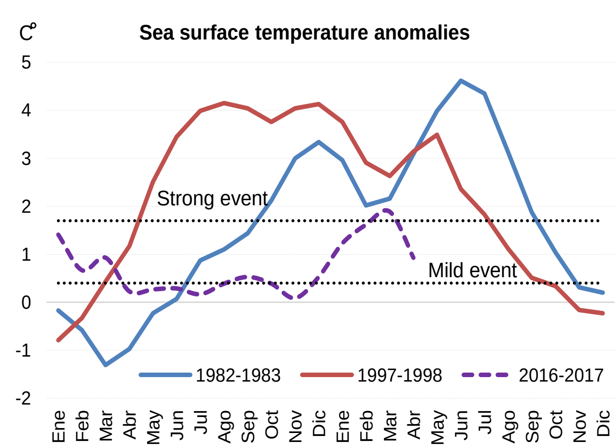
- Economic outlook: Negative growth shocks from Odebrecht and the Coastal Niño prompted the government to launch a fiscal stimulus and the central bank (BCRP) to ease monetary policy. Favorable initial conditions – low debt, ample fiscal savings and low inflation – provide room for countercyclical policies without compromising fiscal sustainability or monetary policy credibility.
- Main risks: A prolonged Coastal Niño could amplify economic losses and slow reconstruction efforts. Capacity constraints or fiscal slippage could limit the impact of the stimulus and deteriorate public finances. Our interest rates and foreign exchange forecasts are sensitive to monetary policy changes in the U.S. and a correction in metals prices.

The challenge of reconstruction

Strong but temporary shock on growth and inflation

The government revised down its 2017 growth estimates 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 infrastructure projects. Latest forecasts suggest that the weather shock is shorter and more geographically confined than previous El Niño episodes (Figure 1). While the most affected Northern provinces account for only 12% of the country's GDP, their share of production is particularly relevant for fishing (40%), agriculture (22%), trade (14%) and transport (14%). The restructuring of 6 infrastructure concessions, representing nearly 5% of GDP, would have knock-on effects on private investment, formal job creation and household consumption.

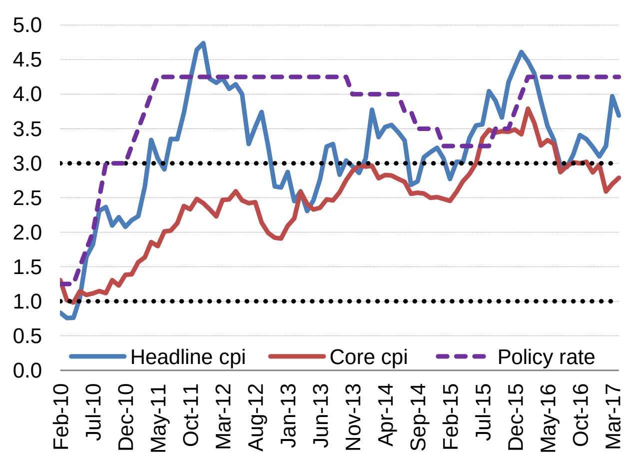
Figure 1: The Coastal Niño seems shorter and more geographically confined than previous episodes



Source: U.S. National Oceanic and Atmospheric Administration, Deutsche Bank

The inflationary impact of the Coastal Niño was strong but short-lived. Consumer prices surged to 4.0% in March from 3.3% in February, fueled by crop losses and food supply disruptions in Northern Peru. Inflation partially reverted to 3.7% in April (Figure 2) thanks to improved weather conditions and the swift re-establishment of critical transportation networks. Inflation expectations remained relatively contained despite the severity of the temporary shock. Year-end inflation projections inched up to 3.2% in April from 2.9% in February. However, core measure of consumer prices (2.8%), as well as 1-year (2.8%) and 2-year (2.7%) inflation expectations are still anchored within the BCRP's official target band of 1% to 3%.

Figure 2: Inflationary impact of the Coastal Niño was strong but short-lived, contained effect on expectations



Source: National Statistical Institute (INEI), Deutsche Bank

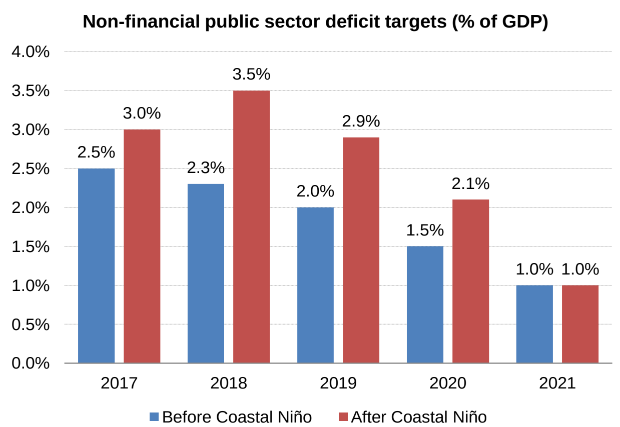
In our view, the negative monthly inflation print and relative stability of expectations in April were the two catalysts that the BCRP was waiting for to start an easing cycle. We expect the BCRP to deliver 2 to 3 reference rate cuts of 25bp starting this month. While current real rates deflated by inflation expectations (1.5%) are below the long-term neutral rate estimated by the BCRP (2%), we think that a widening negative output gap warrants a more accommodative policy stance. Domestic demand growth was muted (0.1%) in 4Q17 and negative (-2.4%) excluding inventories.

Borrowing costs are falling in response to cuts in reserves requirements to bank deposits. Lending rates for prime corporates dropped by 22bp to 4.97% in March. Credit has been less reactive, signaling demand-side constraints. Bank loans grew by a modest 5.6% in March after having decelerated by an average 6.5% in 2016, the slowest pace since 2014.

Ample fiscal absorption capacity, implementation risks

The government estimates that restoring infrastructure losses would require additional spending of $6.2 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 3).

Figure 3: 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 0.3% 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 had access to $3.7 billion in contingency lines for natural disasters from multilaterals.

The fiscal expansion is not risk-free and congressional oversight by the opposition controlled legislature is likely to be strong. Fiscal revenue assumptions could prove optimistic if economic growth remains sluggish, commodity prices correct and one-off windfalls from capital repatriation, tax disputes and formalization efforts disappoint. On the other hand, institutional capacity constraints, fiscal slippage and implementation delays could limit the impact of the program and deteriorate public finances.

Cesar Arias, New York, 212-250-0664

Peru: Deutsche Bank forecasts

	2015	2016F	2017F	2018F
National income				
Nominal GDP (USD bn)	192	195	212	228
Population (mn)	31	31	32	32
GDP per capita (USD)	6,175	6,198	6,668	7,097
Real GDP (YoY%)	3.3	3.9	2.8	4.0
Private Consumption	3.4	3.4	3.1	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	3.3	2.5
CPI (annual avg)	3.5	3.6	3.6	2.7
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	19.1	19.1
Expenditure	22.3	21.0	22.0	22.5
Primary balance	-1.1	-1.5	-1.8	-2.2
External Accounts (USD bn)				
Goods Exports	34.2	36.8	41.6	43.8
Goods Imports	37.4	35.1	37.7	39.8
Trade balance	-3.1	1.7	3.9	4.1
% of GDP	-1.6	0.9	1.8	1.8
Current Account Balance	-9.4	-5.5	-5.1	-5.7
% of GDP	-4.9	-2.8	-2.4	-2.5
FDI (net)	8.1	6.6	5.7	6.0
FX Reserves (eop)	61.5	61.7	63.4	64.8
USD/PEN (eop)	3.4	3.4	3.3	3.3
Debt Indicators (% of GDP)				
Government Debt	23.3	23.8	25.5	27.4
Domestic	12.2	13.5	14.8	16.2
External	11.1	10.3	10.7	11.3
External debt	38.1	38.2	36.0	34.3
in USD bn	73.3	74.7	76.4	78.2
Short-term (% of total)	9.3	9.6	9.9	10.1
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	3.75	3.75
3-month rate	5.18	5.03	5.05	5.06
USD/PEN (eop)	3.29	3.31	3.28	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 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.

Radicalization averts negotiated solution

Political confrontation reaches new highs

Once PDVSA overcame a $2 billion bond maturity in April, credit concerns quickly shifted to the escalation of social tensions and the prospects of a disorderly political transition. As we go to press, opposition supporters would have completed 5 weeks of daily demonstrations. The local pollster Meganalisis calculated that 2.5 million people marched in Caracas and 6 million nationwide during the largest opposition protests on April 19th. This was double the turnout reported by the firm after electoral authorities blocked the recall referendum last September. The government also demonstrated strong mobilization capacity among its core constituencies, with 3 million people rallying for the regime in Caracas, according to official sources.

Repression is on the rise. The National Guard and National Police have used tear gas, water cannons and rubber bullets to disperse protestors and block their access to government offices in downtown Caracas. Additionally, President Nicolas Maduro deployed 500,000 armed militia members to counter potential violent disruptions by the opposition. The Attorney General warned against the use of excess force and arbitrary detentions. The first month of protests have left a tragic balance of 39 casualties, 750 injured and 1150 arrested, including 250 civilians being tried in military courts. At this pace, the number of victims could soon exceed the 43 violent casualties recorded during the anti-government protests of February 2014.

Constitutional assembly unlikely to ease tensions

On May 1st, President Maduro invoked article 347 to reform the constitution enshrined by Hugo Chavez since 1999. The law is short on procedural details, adding uncertainty to the rules and the timeline of this proposal. In 1999, the reform involved 3 national elections: a referendum to start the process; elections to select the members of the constituent assembly; and a final referendum to approve the new text. This time, President Maduro indicated that half of the 500 delegates to the assembly would be appointed by workers and communal organizations and the other half would be elected in local jurisdictions. The political parties currently represented in the legislature would not be invited to participate in the process.

The terms of the constitutional assembly were rapidly rejected by the opposition and the international community. Abstaining from the reform process is a risky decision. Boycotting the congressional elections in 2015 isolated the opposition and allowed the government to extend its control to the legislative, judicial and electoral powers. Participating could also be politically costly and wane momentum in the streets. Last year's failed dialogue attempt with the government deepened divisions among opposition factions and disenfranchised the population. The U.S. Deputy Secretary for Western Hemisphere Affairs, Michael Fitzpatrick, alerted that discretional constitutional changes could lead the administration to consider additional individualized sanctions against Venezuelan officials.

Humanitarian aid, an opportunity for compromise

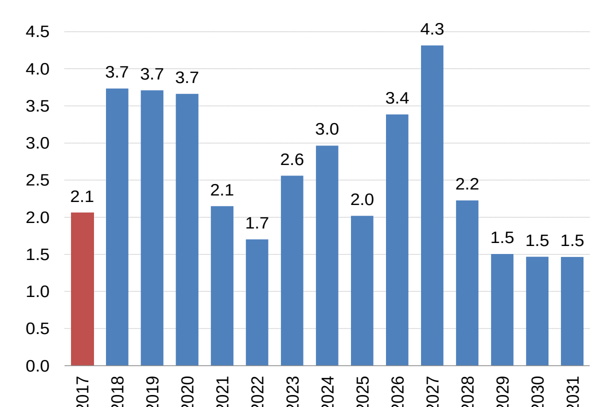
In our view, while the two parties are far apart and it would be difficult to find new credible mediators, there is still room for a negotiated solution. The starting point could involve the opening of a humanitarian channel for food and medicine in exchange for the release of political prisoners. The non-governmental organization Penal Forum reported that 68 people have been arrested in Venezuela for political reasons last month, taking the number of these prisoners to 185. Agreement on a calendar for regional, local and presidential elections could be the second step. The opposition could capitalize on the 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 9 legislators represents an opportunity for compromise even if a third party have 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 drug trade, a prelude for tougher targeted sanctions. The likelihood of this legislation being passed is uncertain, but it could serve as reference for other multilaterals institutions such as the United Nations, to whom Venezuela approached for assistance earlier this year.

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 a 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 (Figure 1). Since Venezuela does not have global bond repayments until August 2018, we assume that these are bilateral and multilateral obligations. Together these creditors account for 20% of total government external debt.

Figure 1: Sovereign external debt amortizations ($ bn)



Source: Office of the U.S. Press Secretary, The White House

Cesar Arias, New York, 212-250-0664

Venezuela: Deutsche Bank forecasts

	2015	2016F	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	-9.5	-4.2	-4.9
Government consumption	4.5	6.5	4.6	7.0
Gross fixed investment	-7.0	-10.3	-2.4	-6.7
Exports	-5.0	-12.0	9.5	4.5
Imports	-5.5	-20.0	1.5	-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%)	n.a.	n.a.	n.a.	n.a.
Unemployment (%)	6.8	7.4	8.0	8.5
Financial Markets (eop)	*Spot*	*17Q1F*	*17Q2F*	*17Q4F*
Lending Rate	22.82	30.00	30.00	30.00
USD/VEF (eop)	6.29	9.98	15.00	30.00

(*) 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	1.75	2.00
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	1.75	2.25
Vietnam	6.50	6.50	6.50	6.50	6.75	7.50
Latin America						
Brazil	11.25 ↓	10.25	9.00	8.25 ↓	8.25 ↓	8.25 ↓
Chile	2.75 ↓	2.50 ↓	2.50	2.50	2.50 ↓	3.00
Colombia	6.50 ↓	5.75	5.25	5.25	5.25	5.00
Mexico	6.50	6.75	7.00	7.00	7.00	6.50
Peru	4.25	3.75	3.75	3.75	3.75	3.75

↑/↓ 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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*Other information available upon request

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CreditHold ("C-H"): The credit spread of the Reference Credit Instrument (bond or CDS) is expected to perform in line with the credit spread of bonds / CDS of other issuers operating in similar sectors or rating categories over the next six months.

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Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor who is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates – these are common in emerging markets. It is important to note that the index fixings may -- by construction -- lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which coupons are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.

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