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Emerging Markets

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Idiosyncratic Hurdles

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Key Economic Forecasts

	Real GDP (%)			Consumer prices (% pavg)			Current account (% GDP)			Fiscal balance (% GDP)		
	2018	2019F	2020F	2018	2019F	2020F	2018F	2019F	2020F	2018F	2019F	2020F
Global	**3.8**	**3.4**	**3.5**	**3.3**	**3.1**	**3.1**	**0.4**	**0.0** ↑	**-0.2** ↑			
US	**2.9**	**2.5**	**2.1**	**2.4**	**1.9**	**2.3**	**-2.5**	**-3.5**	**-3.5**	**-3.8**	**-4.2**	**-4.0**
Japan	**0.8**	**0.3**	**0.2**	**1.0**	**0.5**	**0.7**	**3.4**	**3.7**	**4.1**	**-2.2**	**-2.0**	**-1.9**
Euroland	**1.8**	**0.9**	**1.3**	**1.8**	**1.2** ↓	**1.5**	**2.9**	**2.3**	**2.0**	**-0.8**	**-1.0**	**-1.0**
Germany	1.4	0.5	1.4	1.9	1.6	1.6	7.4	6.4	6.0	1.7	0.8	0.5 ↓
France	1.6	1.3	1.3	2.1	1.5	1.7	-0.3	-0.3	-0.2	-2.5	-3.2	-2.0
Italy	0.9	0.3	0.7	1.2	1.2	1.4	2.5	2.2	2.2	-2.1	-2.4	-2.2
Spain	2.6	2.1	2.0	1.7	1.3	2.0	0.9	1.2	1.0	-2.7	-2.2	-1.8
Netherlands	2.7	1.9	1.8	1.6	2.3	2.0	10.8	9.9	9.7	0.8	0.6	0.4
Belgium	1.4	1.4	1.4	2.3	1.8	1.6	-1.3	0.4	0.5	-1.1	-1.3	-1.4
Austria	2.8	1.9	1.8	2.1	1.6	1.8	2.3	2.3	2.5	-0.2	0.1	0.3
Finland	2.3	1.9	1.8	1.2	1.3	1.5	-1.9	0.0	0.5	-0.7	-0.7	-0.6
Greece	1.9	1.9	1.8	0.8	1.0	2.7	-1.0	-0.6	-0.3	0.6	1.1	1.3
Portugal	2.1	1.7	1.5	1.2	0.7	1.6	-0.4	0.0	0.0	-0.8	-0.7	-0.6
Ireland	6.8	3.4	3.3	0.7	1.0	1.1	9.1	10.0	9.0	0.0	0.0	0.3
Other Industrial Countries	**1.9**	**2.0** ↓	**1.9**	**2.2**	**2.0**	**2.1**	**-0.9**	**-0.7** ↑	**-0.5** ↑			
United Kingdom	1.4	1.5	1.3	2.5	1.9	2.2	-3.9	-3.3	-3.0	-1.1	-1.9 ↓	-1.5 ↓
Sweden	2.4	2.0	1.9	2.0	1.9	1.9	2.0	3.1	3.1	1.7	0.9	0.6
Denmark	1.4	1.9	1.7	0.7	1.5	1.8	5.9	6.2	6.1	-0.3	-0.2	0.2
Norway	1.7	2.1	2.0	2.8	2.1	2.0	8.1	6.0	6.1	7.2	5.3	5.2
Switzerland	2.5	1.4	1.6	0.9	0.8	1.1	10.2	10.3	10.7	0.4	0.5	0.4
Canada	1.8	2.4	2.1	2.4	2.2	2.1	-2.1	-2.1	-2.1	-0.8	-0.8	-0.7
Australia	2.8	2.4 ↓	2.7 ↓	1.9	2.3 ↓	2.5	-2.2	-2.0 ↑	-1.5 ↑	-1.2	-0.6	0.2
New Zealand	2.8	3.4	3.5	1.6	2.2	2.2	-3.3	-3.0	-3.0			
Emerging Europe, Middle East & Africa	**2.8**	**2.2**	**2.8** ↓	**6.9**	**6.8** ↓	**5.8** ↓	**2.5**	**1.9** ↑	**1.5** ↑	**-1.6**	**-2.6** ↓	**-2.4** ↓
Bahrain	3.1	2.9	2.6	2.7	3.7	3.0	-1.9	-5.7	-6.5	-6.4	-6.9	-6.5
Czech Republic	2.9	2.8 ↑	3.0 ↑	2.1	2.5 ↑	2.0	0.3	0.5 ↑	0.7 ↑	1.4	1.0	0.9
Egypt	5.3	5.6	6.1	21.6	13.2 ↓	9.3 ↓	-2.4	-1.7	-1.0	-9.8	-8.6	-7.8
Hungary	4.9	3.5 ↑	3.1 ↑	2.9	3.3 ↑	3.0	0.5	0.3 ↓	0.9 ↓	-2.1	-1.9 ↑	-1.8
Israel	3.3	3.2	3.2	0.8	1.2 ↑	1.4	3.0	2.0	2.2	-2.9	-3.5	-3.0
Kuwait	2.6	4.0	1.9	0.6	2.0	2.5	16.0	10.8	9.9	13.5	9.0	9.2
Oman	3.1	3.0	3.5 ↑	0.9	3.2 ↓	3.4 ↓	-12.3	-18.0 ↓	-18.5 ↓	-11.9	-15.0 ↓	-12.8 ↓
Poland	5.1	3.8	3.4	1.7	1.8	2.6 ↓	-0.7	-1.2	-1.1	-0.6	-1.8	-2.1
Qatar	1.4	3.1	3.2 ↓	0.3	2.5 ↑	2.9 ↑	9.9	21.1 ↑	16.3 ↑	3.5	4.1 ↑	2.9 ↑
Russia	2.3	1.4	1.8	2.9	4.9 ↓	3.9	6.9	5.7 ↑	5.4 ↑	2.6	1.7	1.1
Saudi Arabia	2.2	1.8	2.2	2.5	3.1	2.4	8.7	4.5	4.5	-5.1	-9.0	-6.9
South Africa	0.8	1.4 ↓	1.5 ↓	4.6	4.7 ↑	5.2 ↓	-3.5	-2.8	-3.2	-4.5	-4.5 ↓	-4.5 ↓
Turkey	2.6	-0.2	3.5	16.2	16.2 ↑	13.5	-3.6	-1.6 ↑	-2.6 ↑	-2.0	-3.0	-2.6 ↑
United Arab Emirates	2.0	1.9	2.1	3.1	2.0	2.8	8.1	4.0	2.0	0.1	-2.8	-2.6
Asia (ex-Japan)	**6.2**	**5.7**	**5.8**	**2.6**	**2.5**	**2.9**	**0.5**	**0.0**	**-0.3** ↑	**-2.9**	**-3.6**	**-3.3**
China	6.6	6.1	6.0	2.1	2.4	2.6	0.4	-0.2	-0.4	-3.5	-4.5	-4.0
Hong Kong	3.0	1.5	1.2	2.4	2.0	2.0	4.2	5.8	6.4	2.0	-0.5	-0.4
India	7.4	7.0	7.6	4.0	3.1	3.9	-2.4	-2.0 ↑	-2.0 ↑	-3.5	-3.6	-3.5
Indonesia	5.2	4.8	4.5	3.2	3.1	3.2	-3.0	-3.5 ↓	-4.3 ↓	-1.8	-1.7 ↑	-1.5
Korea	2.7	2.3	2.2	1.5	1.1	1.9	4.6	4.1	3.5	1.5	0.1	-0.6
Malaysia	4.7	4.4	4.0	1.0	1.1	2.4 ↓	2.4	1.7 ↑	0.4 ↑	-3.8	-3.5	-3.3
Philippines	6.2	5.7	5.5	5.2	3.1 ↓	2.8 ↓	-2.4	-2.0 ↑	-1.7 ↑	-3.2	-3.0 ↓	-2.8 ↓
Singapore	3.2	2.4	2.5	0.4	0.6 ↑	0.8 ↓	17.7	17.7	17.5	0.4	-0.7	-0.4
Sri Lanka	3.2	3.5	3.8 ↑	4.3	4.5 ↑	5.0 ↑	-3.2	-2.9 ↑	-2.9 ↑	-5.0	-5.0	-5.0
Taiwan	2.6	2.1	2.0	1.3	0.9	1.0	11.6	10.2	8.7	-0.3	-0.4	-0.7
Thailand	4.1	3.8	3.5	1.1	1.2	1.7	7.5	4.5	3.1	-0.5	-1.0	-1.4
Vietnam	7.1	6.6	6.3	3.5	3.5	4.4	3.3	2.7	1.1	-4.3	-4.4	-4.8
Latin America (ex Venezuela)	**1.4**	**1.7** ↓	**2.6** ↓	**7.0**	**8.4** ↑	**6.2** ↑	**-2.0**	**-1.9** ↓	**-1.9**	**-4.2**	**-3.9** ↑	**-3.0** ↑
Argentina	-2.5	-1.2 ↓	1.8	33.8	49.1 ↑	27.9 ↑	-5.2	-2.0 ↓	-2.4	-5.2	-2.9 ↑	-1.5 ↑
Brazil	1.1	1.6 ↓	3.0 ↓	3.7	3.7	4.1	-0.8	-1.9 ↓	-1.6	-6.4	-6.5	-5.2
Chile	4.0	3.3	3.4	2.3	2.1	2.7	-3.1	-2.9 ↓	-2.7 ↓	-1.7	-1.5	-1.3
Colombia	2.7	3.2	3.3	3.2	3.4	3.4	-3.8	-2.6	-2.5	-2.7	-1.9	-0.9
Mexico	2.0	1.5 ↓	1.7	4.9	4.2 ↑	3.9 ↓	-1.8	-1.7	-1.8	-2.0	-2.0	-1.9
Peru	4.0	4.3	3.9	1.3	2.5	2.3	-0.7	-1.1	-1.5	-3.3	-2.8	-1.8
Memorandum Lines: 1/												
G7	**2.1**	**1.7**	**1.6**	**2.1**	**1.6**	**1.9**	**-0.3**	**-0.8**	**-0.8**	**-2.5**	**-2.9** ↓	**-2.7** ↓
Advance Economies	**2.1**	**1.7**	**1.6**	**2.0**	**1.5** ↓	**1.8**	**0.1**	**-0.4** ↑	**-0.4** ↑			
Emerging Markets	**4.9**	**4.5**	**4.8**	**4.1**	**4.1**	**3.9**	**0.7**	**0.2**	**-0.1**	**-2.7**	**-3.4**	**-3.1**
BRICs	**5.8**	**5.5** ↓	**5.7** ↓	**2.8**	**2.9**	**3.2**	**0.2**	**-0.3**	**-0.4** ↑	**-3.2**	**-3.9**	**-3.5**

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

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

Egypt forecasts are fiscal year forecasts

Venezuela has been excluded from all aggregate averages

2/Forecasts for Kazakhstan, Nigeria, Romania and Ukraine are taken from IMF and are also used in aggregation groups

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Extended accommodation has again tamed the tail risks of recession. Although DB's growth "momentum" gauges continue to point to deceleration, the pace has slowed and "green shoots" seem poised to appear in coming months. However, the spillover from policy stimulus to EM will be less, because of size and – in the case of China – its more inward nature. These more hopeful signs – if accompanied by a US-China trade deal with unwinding of tariffs – would likely lift Asia first. Elsewhere, however, absent a strong external push, EM idiosyncratic risks will weigh on several large EM such as Brazil, Mexico, Argentina, Turkey and South Africa.

This Month's Special Report

China's fiscal policy stance is not as expansionary as it seems. Utilizing provincial level budget reports, we estimate the total government deficit to be 5.5% of GDP in 2019, lower than the consensus view of 6.0-6.5%. Revenue from land sales is critically important for financing the deficit.

Recent business cycle indicators have taken another turn for the worst in January. Our business cycle model suggests that the downturn has indeed intensified since 2018, after briefly shifting into a recovery between 1Q16 and 1Q18. This means that since the start of 2018 the economy may have entered a second downturn, commonly referred to as a double-dip, or back-to-back downturn. The timing of the global slowdown and domestic headwinds imply that a trough is unlikely to be reached any time soon. In this note, we also look at some of the silver lining messages from current business cycle trends and review our growth and policy forecasts for the next two years. We also consider some of the main data points the SARB has to consider post elections to corroborate an unchanged policy stance that we now foresee.

When it comes to trading and investing in an asset class, it is crucial to assess both the current valuation and the expected return over the investment horizon. The former measures the dislocation between the market level and the fair value, thus helping investors decide the timing of entry, while the latter estimates the expected gains investors could earn by holding the asset for some period. EM local fixed income is no exception. In this report, we intend to provide a quantitative toolkit for analyzing the valuation of EM local bonds in a systematical and comprehensive manner.

Emerging Markets and the Global Economy in the Month Ahead

- Extended accommodation has again tamed the tail risks of recession. Although DB's growth "momentum" gauges continue to point to deceleration, the pace has slowed and "green shoots" seem poised to appear in coming months. However, the spillover from policy stimulus to EM will be less, because of size and – in the case of China – its more inward nature.
- These more hopeful signs – if accompanied by a US-China trade deal with unwinding of tariffs – would likely lift Asia first. Elsewhere, however, absent a strong external push, EM idiosyncratic risks will weigh on several large EM such as Brazil, Mexico, Argentina, Turkey and South Africa.
- EM assets have moderately overpriced the improvement in external financial conditions. Local fixed income valuations – with few exceptions – seems most unappealing. Hard currency debt seems fair, but it faces increased idiosyncratic risks. Fundamental valuation remains most appealing for EM FX, but as investor shift focus from carry to growth, domestic bottlenecks will become binding across many large EM.
- We have been most skeptical on EM FX in recent months, but growth headwinds are easing. We position for early signs of the end of this downturn and a possible trade deal in Asia via short USD/CNH and long TWD vs. THB (while hedging with risk-reversals in USD/SGD and USD/KRW). These positive shocks should also spillover to CLP, COP and PEN.
- On EM idiosyncratic risks, politics benefit INR but weigh on BRL, MXN, ARS, TRY and ZAR. Stay long RUB (vs. USD and MXN), and open tactical short EUR/HUF while favoring ILS vs. CZK.
- In local fixed income, the case for duration has weakened on advanced re-pricing of extended accommodation and rising idiosyncratic risks. However, valuation still points to positive returns in select markets. To reflect changes in valuation and risks, we reduce Poland and South Africa to neutral, Hungary to underweight. We hold overweights in Brazil (reduced on higher volatility), Russia, Colombia (reduced), Peru and underweights in Chile and Israel.
- Stay neutral Mexico while favoring duration. Tactically overweight Turkey on better short-term valuation and falling price pressure, and stay overweight Egyptian 6m T-bills. Pricing vs. our forecasts bode for payers in CLP, CZK, PLN, and ZAR, steepeners in HUF and bear-flatteners in MXN.
- We move to market-weight sovereign credit as idiosyncratic risks loom near-term. Overweight KSA and Indonesia (through Pertamina), underweight South Africa, Peru, Philippines, and Mongolia. We favor Petbras 27s vs. Brazil 5Y CDS and Pemex 48s vs. Mexico 45s.
- We like curve flatteners in Pemex (35s vs. 24s), S. Africa (30s vs. 25s), Romania (48s vs. 24s), Egypt (48s vs. 27s), Brazil (48s vs. 28s/10Y CDS), and Colombia (45s vs. 24s). Long basis in South Africa (27s vs. 5Y), Mexico (27s vs. 5Y), and Indonesia (28s vs. 5Y). Switch from 24s to 5.25% 25s in Bahrain sukuks. Switch from 28Ns to Discounts and from 48s to Pars in Argentina. We are also outright long Ukraine warrants .

EM specifics resurface

Extended accommodation is again taming recession risks. As it has been the norm post- GFC, low inflation has allowed central banks to delay normalization to abate fears of recession. There are early signs that this response is working again, although DB's growth "momentum" gauges continue to point to deceleration. We expect to see "greener shoots" early in H2 given the usual lags in transmission - but conditional on stabilization in China and progress in trade relations between China and the US. Recessions tend to follow deep imbalances that we do not currently see looming in the horizon.

However, the EM spillover from policy stimulus will be dampened this time. China's response to growth slowdown is a fraction of that seen in 2008 and directed more at domestic consumption than investment given idle capacity. This mitigates the pass-through to commodities and global / EM exports. Encouragingly, even if China's land market is still weak, it is already showing signs of stabilization. Further policy easing should pave the way for a rebound in H2.

Absent a strong external push, EM idiosyncratic risks will play a larger role in coming months – and mostly negative outside Asia. We expect reduced recession fears and some growth recovery across the US, EU and China to benefit EM – especially the still (fundamentally) undervalued FX in H2. However, as the push forces from DM and China will be weaker this time, EM domestic developments should matter more. Politics and constrained policies are critically delaying recoveries across large EM such as Brazil, Argentina, and Turkey, and they are likely to remain a persistent drag also in Mexico, South Africa and Russia. This and less appealing valuation across fixed income will limit upside in the month ahead, in our view.

The External Backdrop

US: Resilient growth with subdued inflationary pressures benefits EM. The rebound in hiring pushed nonfarm payroll quarter and annual average gains to a sound 180k-210k range, which should allay both FOMC and market recession fears. This is over twice the pace required to meet labor force growth. With nominal income in Q1 4.9% up, the latest data suggests upside risk to DB's 1.5% Q1 forecast (DB forecast 2.3% growth for the year). This backdrop should discourage parallels with 1998 and thus mute risks of preemptive easing – unless China fails to stabilize (chart).

The room for further repricing seems limited. Our US strategists see some signs of overshooting in US rates, term-premium has compressed further and positioning has moved close to neutral. Still, tame average hourly earnings (two-tenths lower to 3.2%), robust foreign and domestic demand, full SOMA reinvestments late this year and well-anchored inflation poses little upside risk to yields. In all, we see **EUR/USD** range bound and our US strategists expect **UST 10Y** yields near current levels and at 2.40% by year-end.

EU: Recession averted. Baring negative shocks from Brexit or trade, recent data show signs of bottoming. Domestic data have been resilient with services PMIs back to long-term averages and recovery across the bigger countries. Retail sales have confirmed domestic resilience, in contrast with manufacturing and other trade-related activities – the main drags on growth. Altogether, Q1 data surprises were much less negative than in Q4 pointing to a reduced risk of recession and Q1 GDP growth at 0.2% (vs. DB's 0.1% qoq). Accordingly, DB's model shows a significant drop in recession risk.

We expect the underlying monetary conditions to remain supportive EM fixed income – and less so EM FX. The chart below shows that DB's estimate of the (shadow) monetary policy rate has dipped below what would be consistent with both ECB's and DB's (more bearish) growth and inflation paths – thus suggesting undershooting. However, the need to prevent clogging in the banking transmission channel may require further assurances – possibly via tiering, stronger forward-guidance and TRTRO3 incentives in June. This and that growth momentum and surprises have yet to turn should anchor EU rates but also prevent **EUR** strength for now.

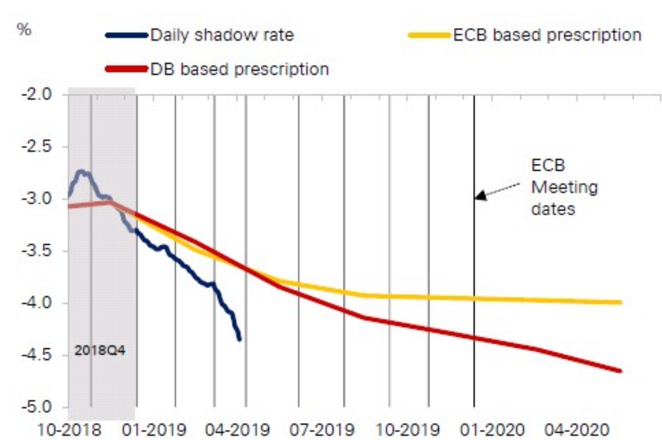
Figure 1: US: Weaker case for preemptive cuts

	Sep-98	Current
ISM manufacturing	49.3	55.3
ISM nonmanufacturing	53.5	56.1
Jobless claims (1,000s)	294	202
Unemployment rate	4.5	3.8
3m moving average of payrolls	232	180
Core PCE inflation %yoy	1.4	1.8
Core CPI inflation %yoy	2.5	2.1
6m % change in S&P 500	-5.5	0.4
DB FCI	-2.1	1.1
Chicago FCI	0.0	0.8
Global mfg PMI	49.3	50.6

Note: Chicago FCI was multiplied by -1 as per the note below Note: Chicago Fed FCI is multiplied by -1 so that higher values correspond with easier financial conditions.

Source : ISM, DOL, BLS, BEA, S&P, FRB Chicago, JPM, IHSM, Haver Analytics, Deutsche Bank.

Figure 2: EU: (Over) pricing accommodation

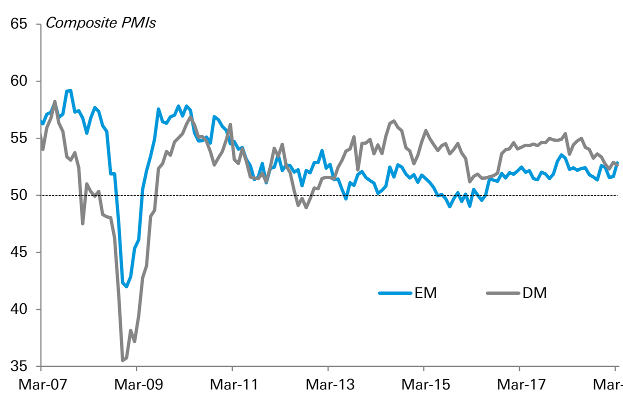


Source : DB Research, Bloomberg Finance LP, Haver Analytics

EM: Country specifics return to the forefront

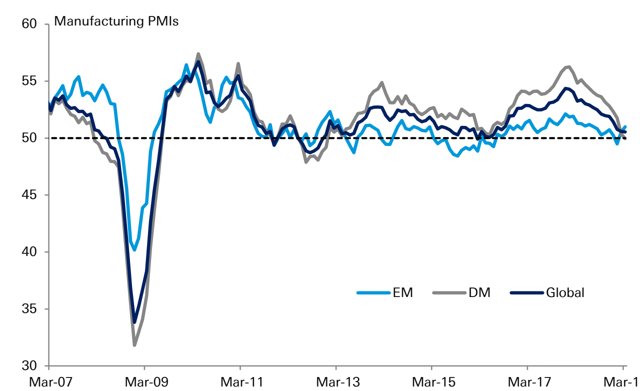
EM idiosyncratic risks are on the rise. Developments in the US and EU – and China – have overshadowed EM specifics, but these idiosyncratic risks have been brewing across several important EM – especially in Turkey, Brazil and Argentina – for months. If the boost from extended accommodation and a potential trade deal between the US and China is indeed limited as we expect, domestic bottlenecks would be first order determinants of growth across several large economies in LatAm and CEEMEA. We still see higher likelihood of these risks being resolved favorably, starting with Asia, However, a lot is at stake and uncertainty has to fall fast for investment and activity to rebound. On the brighter side, inflation remains favorable - with notable exceptions. However, the edge EM surveys had over DM has vanished (charts)

Figure 3: EM catches down



Source : DB Research, Bloomberg Finance LP, Haver Analytics

Figure 4: Trade drags manufacturing

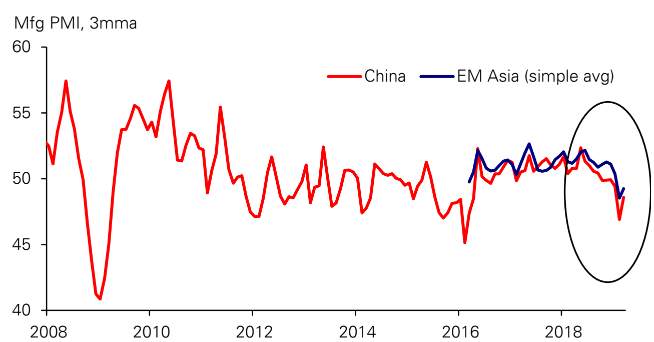


Source : DB Research, Bloomberg Finance LP, Haver Analytics

We see signs of EM Asia's growth slowdown bottoming. The region's PMIs have rebounded and China's recent data of stabilizing land and property prices suggest its slowdown has at least halted. The balance of risks for risk in the near term looks skewed to the upside as the economy's assets could enjoy strong tail–winds if a US–China trade deal was to materialize. We therefore continue to expect EM Asia to reach a trough in terms of production and trade in Q2 due in part to stimulus policies providing further support. China's policy easing seems to have in part contributed to a pickup of land sales growth and our expectation of further policy stimulus to the land and property markets this quarter might render lending rate cuts unnecessary. So despite its relatively weak momentum, China's MMI point to an improvement in its growth trajectory after the relatively weak batch of Q1 data reflected in the poor performance of high-frequency indicators such as industrial production, credit growth, imports, and auto sales.

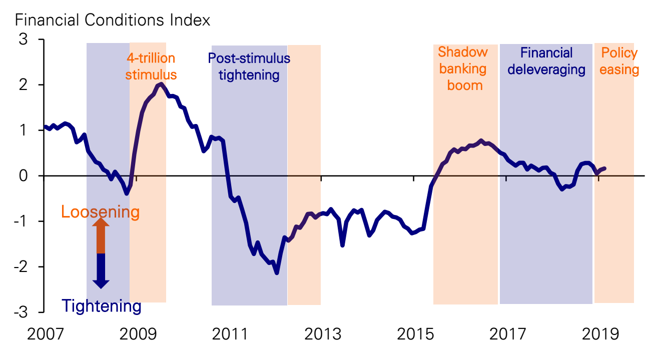
The rest of EM Asia also looks, for the most part, poised to recover on the back of monetary stimulus. As expected, the RBI delivered a further rate cut. The BNM has, in our view, already signaled an earlier than expected rate reduction as a "pre–emptive" attempt to steady growth and ensure price stability. Malaysia's negative output gap, low inflation and limited fiscal space hint at the need of easier monetary policy. The BNM has been prudent thus far as it has sought to build reserves but with these having reached a comfortable enough level we think the bank is more comfortable cutting in May rather than waiting until September. We continue to expect BSP and BI to deliver 150bp and 100bp rate cuts through late 2020, which would bring about their soft landing. Only South Korea stands out in EM Asia in terms of its weak growth and deteriorating growth prospects. Its weakness is broad-based as it goes beyond a sharp contraction of exports and bleeds into retail sales and investments. Yet the BoK has yet to shift in its policy bias despite the sharp decline of inflation and the BoK governor considers its current rate "accommodative". While we do not expect a recession, we remain concerned over the Korean economy's structural challenges. In the near term, neither monetary policy nor fiscal policy will provide a strong enough backdrop for activity to recover.

Figure 5: PMIs rebounded



Source s: Deutsche Bank Research, Haver Analytics

Figure 6: China's monetary easing



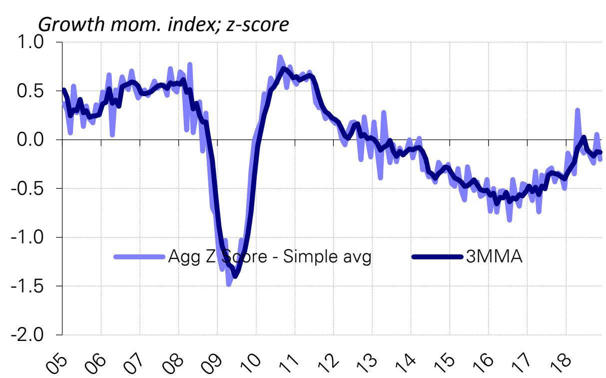
Source s: Deutsche Bank Research

The outlook for LatAm's economies varies by size. On one hand, the fate of Argentina, Brazil, and Mexico seems increasingly dependent on political events and the prevailing electoral, political, and policy uncertainty is already weighing on growth prospects. On the other hand, the smaller Andean economies (Chile, Colombia, and Peru) seem to be on more solid footing as far as their growth cycle goes.

We have reduced our growth forecast for Brazil to 1.6%, Mexico's to 1.5%, and expect Argentina's output to shrink 1.2% this year. A less favorable external backdrop means that growth is almost exclusively determined by internal demand which tends to suffer in periods of high uncertainty. Argentina's high inflation inertia despite real rates increasing to the current 36% illustrates how difficult it has been for policymakers to build credibility under these circumstances. In Brazil, the Government seems to now have somewhat of a working coalition in Congress but governability is still in question. And in Mexico, institutions seem poised to deteriorate as the government's agenda has concentrated power in the Presidency and curtailed the independence of important regulatory entities. Despite a rebound in January (1.6% y/y), the 6.8% contraction of gross fixed capital formation in 2018 was the main drag on growth and is likely to continue to weigh on activity. Because of policy uncertainty the slowing economy has failed to tame inflation inertia thus delaying a much needed easing cycle.

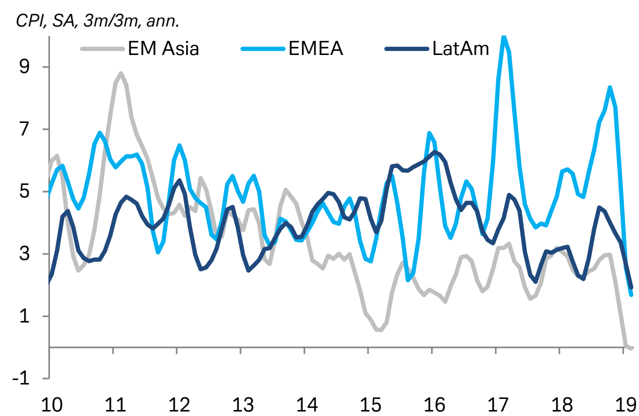
Growth prospects remain brighter for the Andean economies and could further improve if the US and China were to strike a trade deal soon. In Chile, despite the recent slowdown of activity (1.4% y/y in February) we remain relatively optimistic and expect the investment-driven growth cycle to endure. The drop of inflation seems a bit more contained after the 2% y/y print during March yet we expect the BCCh to remain on hold until at least Q4. In Colombia we expect foreign investment into the mining sector pushing growth above 3% this year. Banrep is unlikely to hike beyond 4.5% (a lower bound of their estimate of the neutral rate). A possible sovereign credit downgrade to BBB- and the chronic current account deficit will limit foreign financing and thus likely trigger a fiscal contraction into 2020 suggesting growth will peak this year. Finally, in Peru the economic recovery is broadening helped by lower funding costs for corporates, higher prices of metals, private investment in the mining sector, and non–mining GDP growth of roughly 4% that will reach low- and middle-income households and thus strengthen consumption. While public investment remains slow due to red tape and the turnover of local administrators overall growth prospects remain positive.

Figure 7: LatAm struggling to launch



Source : Bloomberg Finance LP, Haver Analytics

Figure 8: Inflation remains supportive

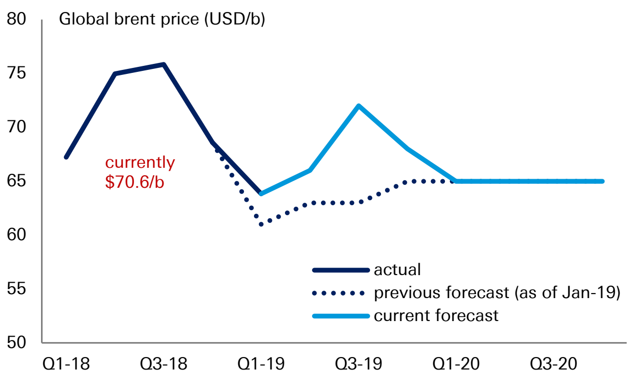


Source : Bloomberg Finance LP, Haver Analytics

The new external backdrop characterized by an erosion of growth prospects and more dovish central banks in developed markets matters for CEEMEA. The clear slowdown of activity and trade across the globe has lead policymakers in CEEMEA's "low-yield" economies to switch towards a more dovish monetary policy stance or at the very least show less appetite to tighten monetary conditions until the uncertainty regarding the outlook on global growth and trade dissipates. The relaxation of global monetary condition on the back of the dovish turn of the world's main central banks has been especially relevant for CEEMEA's "high-yielders". The decreasing costs of external funding usually leads to an appreciation of EM's higher yielding currencies and to prevent their exports to lose competitiveness central banks such as South Africa and Russia have also leaned towards a more dovish stance. We no longer expect the SARB to deliver 50bp worth of hikes next year and see the policy rate steady at its current level until the end of 2020. In our view the CBR has also veered away from its previously hawkish bias as it lowered its inflation projections on the back of a lower-than-expected VAT pass-through. We now expect the CBR to cut its policy rate in September. The only outlier in the region has been the Central Bank of Turkey which unexpectedly returned to managing liquidity on the back of the volatility of financial markets and pushed its rate up to 25.5%. We have scaled back our rate cut expectations this year by roughly 400bp to 20% and expect the first cut in July.

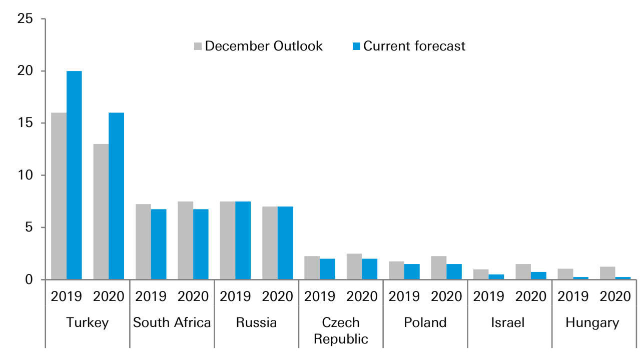
The region's recent electoral results were for the most part unsurprising. In Ukraine, Zelensky obtained more votes than Poroshenko and Tymoshenko combined and will now face Poroshenko on a runoff scheduled for April 21st. In Israel, early results suggest PM Netanyahu's coalition will remain in power despite the performance of the newly formed Blue and White center–left coalition. Both of these results lead us to expect a post–election decline of political and policy uncertainty. In Turkey, local election results were less straightforward. The ruling alliance obtained a majority of the votes yet the opposition seems to have scored important victories in Ankara and Istanbul. Some of the results have been contested and according to AKP and MHP representatives as well as some political commentators (such as from daily Haberturk), repeat elections in Istanbul cannot be ruled out.

Figure 9: Oil forecasts have been revised higher following recent recovery (DB forecasts in chart)



Source : Deutsche Bank

Figure 10: CEEMEA central banks have also turned more dovish (except in Turkey) (DB forecasts in chart)



Source : Deutsche Bank

Strategy: The risks within

We expect investors shift focus away from carry back to growth, as the worst of the synchronized deceleration we highlighted in our previous Monthly seems past. However, reduced pass-through from China stimulus and the soft-landing that lies ahead seem weak push forces to overshadow increasing idiosyncratic risks across many large economies outside Asia.

We see the trend of the recent months giving way to more idiosyncratic performance in the coming month. EM assets have already moderately overpriced the improvement in external financial conditions. Local fixed income valuations – with few exceptions – seems most unappealing. We find hard currency debt fairly valued, but while low core rates for longer better anchor credit markets, increased idiosyncratic risks weigh on the higher yielding curves. Fundamental valuation remains most appealing for EM FX, but these also face domestic bottlenecks – especially in Argentina, Brazil, Mexico, Turkey and South Africa.

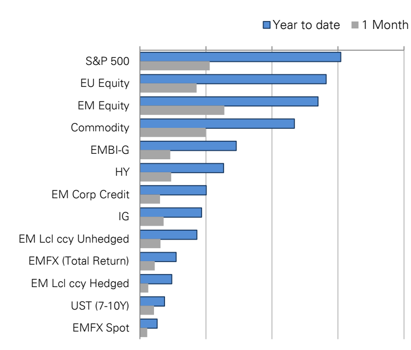
We have been most skeptical on EM FX in recent months, but growth headwinds are easing. Still, rising idiosyncratic risks in many large EM outside Asia hinder upside despite broadly favorable valuations. We position for early signs of the end of this downturn and a possible trade deal in Asia via short USD/CNH and long TWD vs. THB (while hedging with risk-reversals in USD/SGD and USD/KRW). These positive shocks should also spillover to CLP, COP and PEN. On EM specifics, politics benefit INR but weigh on BRL, MXN, ARS, TRY and ZAR. Stay long RUB, and open tactical short EUR/HUF while favoring ILS vs. CZK.

In local fixed income, the case for duration has weakened on weaker external push and idiosyncratic risks, but valuation still points to positive returns in select markets. To reflect changes in valuation and risks, we reduce Poland and South Africa to neutral, Hungary to underweight. We hold overweights in Brazil (reduced on higher volatility), Russia, Colombia (reduced), Peru and underweights in Chile and Israel. Stay neutral Mexico while favoring duration. Tactically overweigh on better short-term valuation and falling price pressure, and stay overweight Egyptian 6m T-bills. Pricing vs. our forecasts bode for payers in CLP, CZK, PLN, and ZAR, steepeners in HUF and bear-flatteners in MXN.

We move to tactical neutral on sovereign credit. The total return of the EM credit benchmark in Q1 (7%) – and year to date (7.6%) – is the strongest on record. However, despite supportive valuation and technicals, it looks difficult for the benchmark spread to break out of recent range in the coming month due to the multitude of EM idiosyncratic uncertainties. We therefore take a more cautious stance and continue to focus on country specific risks and relative value opportunities.

Overweight Saudi Arabia complex *(new)* and Indonesia*(new)*(through Pertamina), underweight South Africa *(new)*, Peru, Philippines, and Mongolia *(new)*. We prefer a number of quasi-sovereign names to their sovereign counterparts, including Pemex/Mexico (long end), Petrobras/Brazil (belly) and Pertamina/Indonesia (long end). Convexity remains cheap and as such we favor curve flatteners (sometimes combined with CDS/bond basis wideners) on a number of curves, including Pemex, Brazil, Colombia, Romania, South Africa, and Egypt. Switch from 24s to 5.25% 25s in Bahrain sukuks, and switch from 28Ns to Discounts and from 48s to Pars in Argentina. We are also outright long Ukraine warrants.

Figure 11: EM local markets underperformed



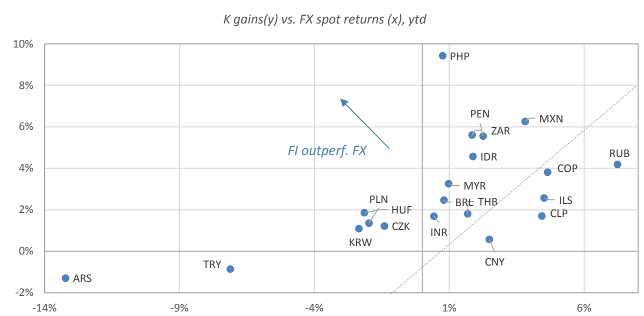
Source : DB Research, Bloomberg Finance LP

EM FX: Pick your spot

We have turned skeptical EM FX as the global economy slowed. Performance has been lackluster since. Although EM FX has regained the 7pp lost since last September, total returns vs. the USD since May of 2018 are close to zero. EM FX spot is only 1pp up year-to-date – led by LatAm and Asia, with CEEMEA flat in the year – and near zero over the past month. Carry has accounted for most of the 3% gains this year (4% in LatAm), but carry currencies – as a basket – are roughly unchanged since February. We have favored fixed income over FX and – as the chart below shows – local bonds have largely outperformed spot as markets repriced lower growth.

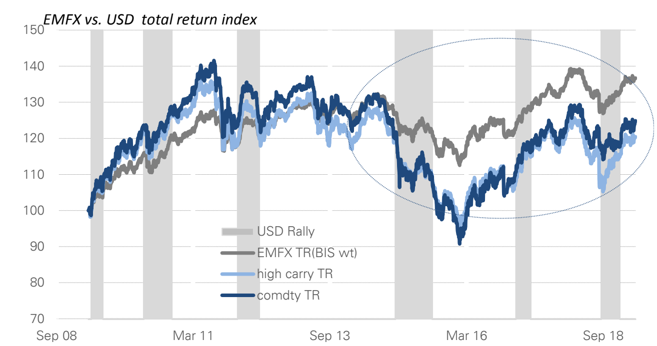
More structurally, however, lackluster growth and EM idiosyncratic developments have persistently hindered EM FX performance. As the chart below shows, the more growth- and risk-sensitive commodities and high-carry baskets have underperformance the broader EM FX basket since 2013, when EM-DM growth differentials collapsed and the taper tantrum marked the end of years of easy credit and the beginning of difficult macro adjustments in the more exposed EM.

Figure 12: EM FX underperforms local fixed income



Source : DB Research, Bloomberg Finance LP

Figure 13: Growth and idiosyncratic risks – a persistent drag on EM FX



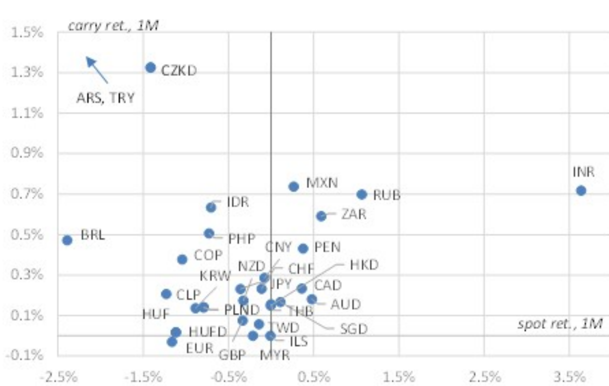
Source : DB Research, Bloomberg Finance LP

The external headwinds are easing, but idiosyncratic risks have risen. Growth seems close to trough, and a US-China deal could compound "greener shoots" that are likely to show in coming months. This should be felt earlier in **Asia** via a recovery in both sentiment and hard data, the confirmation of a bounce in China's credit impulse; and resolution of election-related idiosyncratic risks in India and Indonesia. More positively, we could see a repricing of the RMB complex depending on the trade deal – particularly if accompanied by unwinding of tariffs and a more balanced approach. We estimate that a rollback in tariffs to 10% on $200bn means a return to 6.50 for USD/CNH. However, outside Asia, political risks are now more binding – especially in Argentina, Brazil, Mexico, Turkey and – less so – South Africa. These should weigh on otherwise broadly supportive fundamental valuation (chart).

We see investors gradually shifting focus away from carry into growth while avoiding the more sensitive political risks (chart). A bounce in growth and sentiment should benefit a basket of North Asian FX (CNY, TWD, KRW) as PMIs recover, but we favor TWD vs. THB in particular, which has lagged on valuation and led on PMIs. As a hedge for possible trade setbacks, we prefer risk-reversals in USD/SGD and USD/KRW. Although INR valuations are less compelling and CAD wider than in previous elections, we still see elections-related upside. Potential positive developments in Asia would also spillover to CLP and COP (and less so PEN), where valuations are still supportive and growth dynamics much stronger than in the larger LatAm economies.

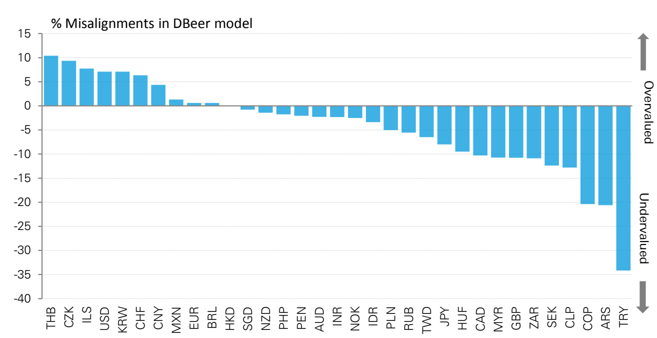
We expect political and policy risk to continue to limit recovery upside in Brazil, Mexico, Turkey and – with weak growth – South Africa. We find that the rally in ZAR overestimates the benefits of upcoming elections given constraints imposed by multi-faction party politics, growth that is likely to hover near 1% and Eskom restructuring bottlenecks. While recent measures buy time, Eskom losses are mounting over the coming years and load shedding is already binding. We maintain a constructive view on RUB on BoP fundamentals and valuation (even if sanctions risk dampen appreciation) and continue to expect outperformance vs. MXN, where positioning has increased and valuation is less appealing. We expect a higher range for USD/BRL (3.80-3.95) as we enter the more difficult months for social security reform and favor tactical long as protection for receivers. We stay neutral the very high carry ARS and TRY on higher risk of flight to USD. On the more idiosyncratic low-yielders, we favor ILS vs. CZK (on tech sector inflows) and – tactically – open short EUR/HUF as rising inflation puts a floor on further dovish NBH re-pricing.

Figure 14: EM FX: Investors shifting away from carry trades



Source : DB Research, Bloomberg Finance LP

Figure 15: Fundamental valuation awaits for growth



Source : DB Research, Bloomberg Finance LP, Haver Analytics

Asia: Long USDTHB (target: 33); Long 3M USDKRW risk reversal; Long 3M USDSGD risk reversal; Long 3M 6.65 USDCNH put; Short 3M USDTWD NDF (target 29.5 spot); Long 3M USDINR 1x2 68.5/67 leveraged put spread.

CEEMEA: Long USD/ZAR (target: 15.0); Short EUR/HUF (315.0); Long ILS/CZK (6.50).

LatAm: Buy USD/BRL(target:3.93);Sell USD/COP(target:3050);Sell USD/CLP (target: 650); Sell MXN/RUB (target: 3.3); Sell USD/PEN (target: 3.25).

EM Local Rates: Little left

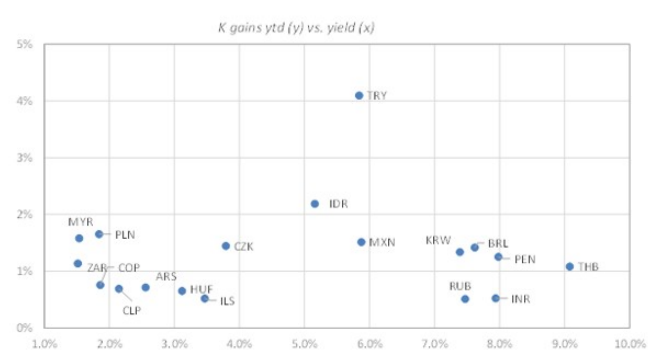
EM local fixed income (LFI) is returning to its more idiosyncratic norm. External drivers tend to account for at most half to two-thirds of LFI returns, in our estimation, but this explanatory power rose to three-fourths of total return variation during the latest repricing of core rates. In recent weeks, however, as valuation turned less appealing and core rates settled at a lower level, LFI returns started to track more closely domestic developments again. As the chart below shows, returns are quite disperse and not aligned with yield levels as they were in the first couple of months of 2019 – when the "carry trade resurfaced".

EM LFI is 2.4% and 4.3% up in the year – FX-hedged and unhedged, respectively – with better performance tilted towards high-yielders. However, as premium compressed and the external push waned, returns have stalled since the third week of March amid some pullback in high-yielders.

The case for duration has weakened, but it remains valid for select curves. Local bonds benefitted from the repricing in core rates that seems to have reached its limit, and – absent a stronger external push – local developments have taken the forefront. Accordingly, we weigh more heavily domestic drivers and valuation in picking our favorite overweights and underweights. Our bond model (see special report for a tutorial) highlights tight valuation across low-yielders such as Chile, Korea, Thailand and CE3 – especially Poland and Czech Republic, and in the higher-yielding South Africa. In contrast, valuation – with the help of leftover premium and carry – points to positive returns for the remainder of the year in Brazil (belly), Colombia, Peru, Mexico (longer-end), Russia (belly), India (8y) and Indonesia 15Y). Although supply risk in the latter two is a headwind, recent steepening favor continued exposure to policy easing.

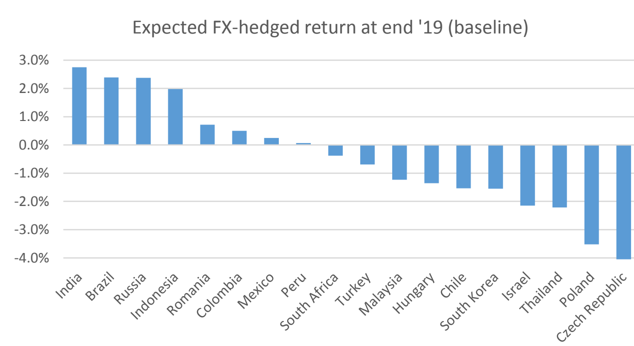
To reflect changes in valuation and risks, we reduced Poland and South Africa to neutral, Hungary to underweight while holding overweights in Brazil (reduced on higher volatility), Russia, Colombia (reduced), Peru and underweights in Chile and Israel. Stay neutral Mexico while favoring duration and overweight Egyptian 6m T-bills. Another change to highlight is our tactical Turkey overweigh on better short-term valuation, higher B/Es and term-premium, even lighter bond positioning and our view of falling price pressure over the upcoming months.

Figure 16: Local fixed income back to idiosyncratic mode



Source : DB Research, Bloomberg Finance LP, Haver Analytics

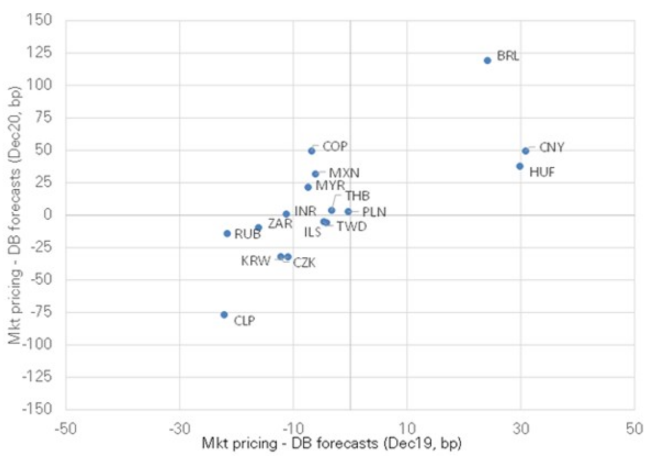
Figure 17: Assessing value vs. fundamental drivers



Source : DB Research, Bloomberg Finance LP, Haver Analytics

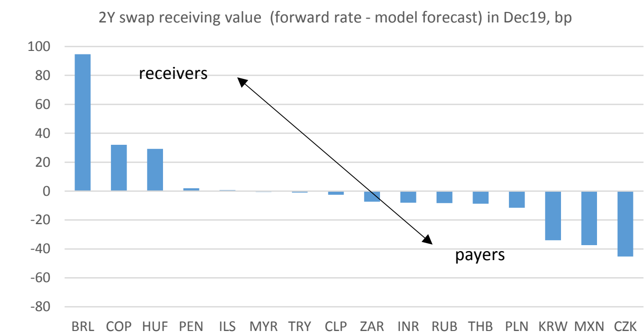
Different monetary policy prospects should also gain importance. We expect short-end pricing and overall returns to follow more closely the outlook for policy rates and thus inflation, inflation expectations, FX and credit risks. Narrowing the focus to market pricing and our baseline forecasts, we see some premium left in Brazil, Colombia, Hungary, China, Malaysia and Mexico (chart). Once we factor in premium (stemming mostly from FX and inflation forecasts), however, value stands out only in Brazil (and less so in Colombia and Hungary – see chart on the right). Pricing vs. our forecasts bode for paying especially in Chile, Czech Republic, Poland (especially in longer tenors) and Korea. We keep receivers in Brazil and in Colombia (vs. US) and favor steepeners instead in Hungary. Reduced premium support short-end steepeners in Poland and ZAR payers (particularly in the belly). Valuation and positioning favors tactical bear-flatteners in Mexico.

Figure 18: Market vs. forecasts: The outliers



Source : DB Research, Bloomberg Finance LP, Haver Analytics

Figure 19: Monetary premium: Brazil stands out



Source : DB Research, Bloomberg Finance LP

Asia: Pay CNH 3x12 (target 400); Long 8Y India GBs (target 7.2%); Long 15Y IndoGBs (target 7.5%).

CEEMEA: Pay 10Y PLN IRS (target: 3.0%); Pay 2Y2Y CZK IRS (target: 2.40%); Pay 5Y ZAR IRS (target: 7.80%); Enter 2s10s HUF IRS steepeners (target: 190bp).

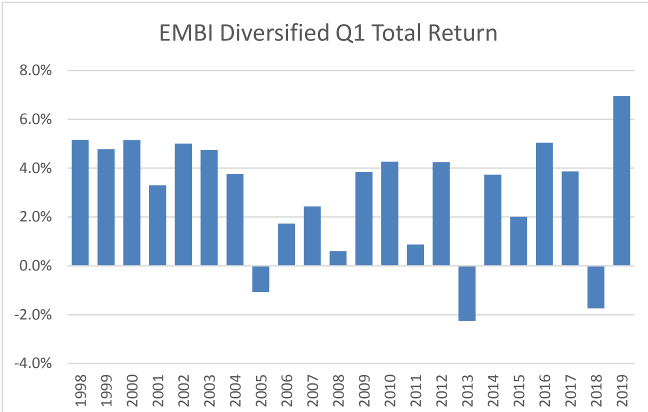
LatAm: Receive BRL Jan 23s (target: 7.75%); Receive COP IBR 3Y vs. US (target: 200bp); Pay CLP/CAM 2Y (target: 3.6%); Long COLTES 28s (with extended target of 6.25%); Long Soberano 28s (with extended target of 5.0%); Switch from COLTES 24s to 28s (target: 55bp); Switch from CLP BTP 43s to 35s (target: -25bp); Switch from Bonos 31s to 38s (target: 15bp); Long Mexico MBONOS 38s vs. paying 20Y TIIE (target: -30bp).

Credit: Minding idiosyncratic risks

The total return of the EM credit benchmark in Q1 (7%) – and year to date (7.6%) – is the strongest on record. The strong performance is mainly attributed to spread tightening (65 and 76bp), although the compression of UST yields (28bp and 19bp in the 10s) and carry also contributed.

But spread valuation does not yet look stretched. The spread tightening year-to-date has merely retraced the widening in Q4, during which time the benchmark lost just 1.3% in total return terms thanks to the 38bp compression in UST yields. Current benchmark spreads are at the 5 year average and also right in the middle of 2018 tights and the January wides. Under the supportive backdrop of extended accommodation and continued inflows into USD assets, there seems to be scope for spreads to tighten further.

Figure 20: Q1 total return performance of EM credit benchmark



Source : Bloomberg Finance LP

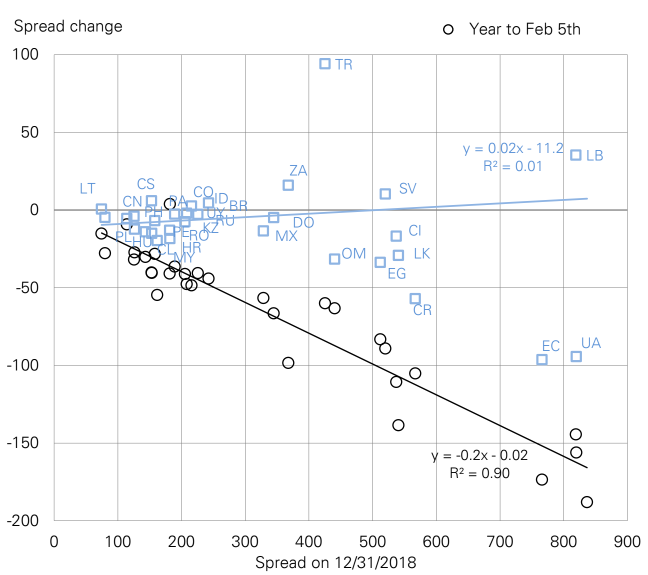
Figure 21: Current spread is at past 5Y average

Source : Bloomberg Finance LP

However, idiosyncratic hurdles will likely constrain performance in the near term. As we pointed out last week (see [EM Sovereign Credit Weekly: In the absence of beta...]), the market has been mostly range-bound and traded in accordance with idiosyncratic risks over the past two months. While in January the market traded with a very strong beta component, that pattern has completely broken since February 5th. In fact, with rising uncertainty in Argentina, Turkey and Brazil, EM idiosyncratic risks are playing an even larger role in April.

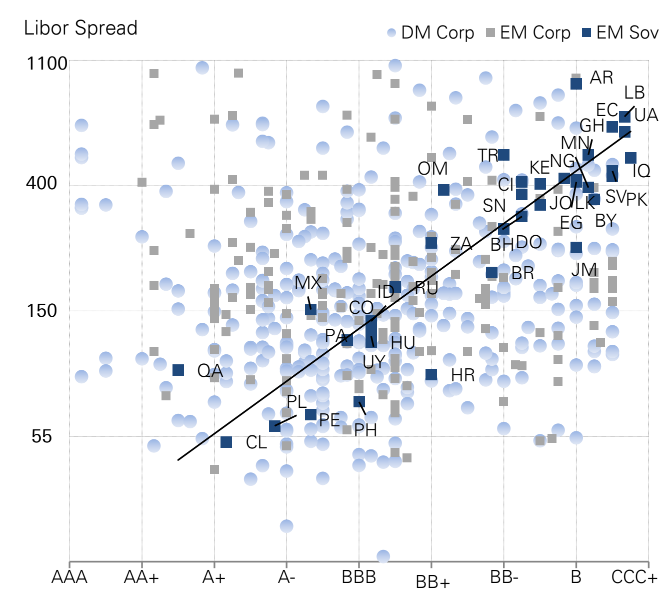
We therefore take a more cautious stance and reduce overall exposure to neutral (from overweight) in the month ahead. At the same time, we continue to focus on country specific risks and relative value opportunities.

Figure 22: Country subindex spread change (year to Feb 5th and since Feb 5th) vs. beginning of year spreads



Source : Deutsche Bank

Figure 23: EM Sovereigns 10Y bonds spread vs. rating (in context of global credit)



Source : Deutsche Bank, Bloomberg Finance LP, Fitch, Moody's, S&P

Idiosyncratic uncertainties make us take a neutral stance on all three largest curves in LatAm, namely Argentina, Brazil, and Mexico. We remain neutral on **Argentina**, where a negative feedback loop between macro and political risks has further worsened incumbent's electoral outlook. Credit spreads are back to the highest levels in the Macri era. The situation remains fluid, but so are the risks of a sharp squeeze if the electoral outlook improves. The latter seems unlikely, however, since voters are giving higher weight to inflation and the economy. The recently increased risk-premium on **Brazil** reflects difficulty in approving pension reforms, and it is likely to stay in the coming month as the approval process enters its critical stage. We prefer Petrobras to Brazil, especially at the belly of the curve, as we believe the benefit of ToR settlement - from both fundamental and technical perspectives - could effect a further reduction in Petbra's beta and its spread differential vs. Brazil (we favor PETBRA 27s vs. Brazil 5y CDS).

Tactically, we move **Mexico** to marketweight (from underweight). While we remain strategically bearish on the name, we acknowledge that the deterioration in macro conditions and institutional quality is likely a slow-burning process. The risk for a significant negative shock over the near term seems contained. We see scope for **Pemex** - with its steep curve - to converge somewhat vs. Mexico over the near term as recent and expected additional government support - albeit not offering a sustainable solution - should help alleviate near term downgrade pressure on the oil company.

The Andean low-yielders are unlikely to be a source of outperformance. We highlighted the fiscal risks in **Colombia** last week, but saw downgrade risk as relatively contained this year. We prefer its Asian comparable Indonesia both in terms of credit fundamentals and bonds valuation, but strong oil prices help keep the name at marketweight. Meanwhile, relative valuation supports a continued underweight position on **Peru** but marketweight on **Chile**.

Strong oil prices make us tweak country weights in GCC names. DB changed it's 2019 average Brent forecast to 67.4 from 63 earlier this week, and we reflect this through a shift in our preferences within the GCC. We move to OW the **Saudi Arabia** complex and don't expect major Saudi issuers to be in the market before H2 (when KSA are expected to issue sukuks). We move **Qatar** to MW due to high cash prices after our recommended long hit target this week. Our tactical OW **Oman** has also largely played out and with upcoming supply risk, we move this name to MW.

Idiosyncratic uncertainties also plague the "big three" in CEEMEA, namely Russia, South Africa and Turkey. After limited market reaction to recent negative sanctions news and considering our outlook for oil, we cover the underweight in **Russia**. Instead, we move **South Africa** to UW after the Moody's induced 30bp rally across cash and CDS. A confluence of factors, from Eskom's likely need for more government support, supply and election risks, and outperformance of credit vs. other asset classes lend themselves to this view. We retain the MW on **Turkey**, with a cautious bias. Implementation will be key in judging the structural reform and economic measures announced by Albayrak on Wednesday.

Elsewhere, we maintain a constructive outlook on **Ukraine**, expressed through GDP warrants, because bonds are not attractive. Stay MW overall as political uncertainty remains around Presidential front-runner Zelensky's economic program and how he would approach the conflict in the East, if elected. While **Egypt** has underperformed Ukraine in recent months despite strong growth and a benign budget proposal, we remain MW ahead of the executive presidency/extension of term limits vote in Parliament 16th April.

In Asia, we prefer the Indonesian complex among the large curves, especially the long end of Pertamina. We remain constructive on Indonesia's credit fundamentals, and we position for an incumbent victory in next week's elections - and hence continued reforms. Recent (moderate) underperformance on the back of narrowing lead in the polls by President Jokowi helps provide a better entry level, although we acknowledge Indonesia is already a very crowded long. The sovereign curve is quite tight and flat (although it is still wider than like rated Colombia), but long-end Pertamina bonds continue to offer sizeable spread pick-up (about 75bp). We remain underweight the **Philippines** on valuation. Among the high-yielders, we prefer **Sri Lanka** (marketweight) to **Mongolia** (underweight) on valuation and near term risks.

Convexity remains cheap. With the notable exceptions of Argentina and Turkey (given their yield levels and idiosyncratic concerns), curves across EM remain unusually steep in many cases. We have initiated curve flatteners (often via long 30Y bonds vs. CDS) on a number of curves - namely Brazil, Colombia, Egypt, and Romania - over the past couple of weeks, and we keep these positions. In addition, we initiate curve flatteners in Pemex and South Africa.

Key country positioning and trade recommendations

- Key Overweights: KSA , Indonesia.
- Key Underweights: South Africa, Peru, Philippines, Mongolia.
- Outright: Long Ukraine Warrants; Buy South Africa 5Y CDS.
- Inter-credit: Petbra 27s vs. Brazil 5Y CDS (*new*), Pemex 48s vs. Mexico 45s; Panama 26s vs. Peru 27s .
- Cash curves: Pemex 35s vs. 24s (*new*), South Africa 30 vs. 25s *(new)*;Brazil 47s vs. 28s; Colombia 45s vs. 24s;Romania 48s vs. 24s; Egypt 48s vs. 27s.
- Cash switches: Bahrain 5.25% 25s vs. 24s *(new)*; Argentina Discounts vs. 28Ns, Argentina Pars vs. 48s, Argentina EUR Pars vs. USD Pars (fx-hedged).
- CDS/bond basis: South Africa 27s vs. 5Y CDS *(new)*; Brazil 47s vs. 10Y, Mexico 27s vs. 5Y CDS, Indonesia 4.1% 28s vs. 5Y CDS, Russia 23s vs. 5Y CDS.

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ChinaFiscal Series: What is the true fiscal stance?

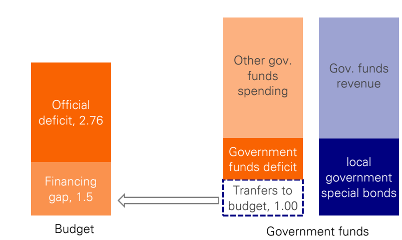
China's fiscal policy stance is not as expansionary as it seems. We utilize provincial level budget reports to reveal the true policy stance. We estimate the total government deficit to be 5.5% of GDP in 2019, lower than the consensus view of 6.0-6.5%. Revenue from land sales is critically important for financing the deficit. We reiterate our view that the property sector policy will be loosened and PBoC will cut the benchmark lending rate in Q2.

- The government's 2019 budget announced at the NPC appeared very expansionary. It promised substantial tax cuts, stable spending growth, and the issuing of more special bonds. The puzzling part of the budget, though, is that the official deficit target was increased only marginally. The implicit financing gap is as much as RMB1.5tr. How could the government finance a major tax cut without either cutting spending or raising deficit?
- We analyzed the government's budget financing gap in 2019 as well as in previous years. Digging into budget reports of provincial local governments, we found that local governments transferred large sums of revenues from government funds (which comprises mainly land sales and special bonds) to the budget.
- Transfers from government funds helped finance 60% of the financing gaps in previous years, according to our estimates. Another RMB1tr transfer is needed to help close the budget financing gap in 2019, in turn reducing government funds spending. The remaining RMB0.5tr could come from budget stabilization funds, SOE profit contributions, etc.
- We estimate total government deficit (including budget and government funds) to be 5.5% of GDP in 2019, a 0.9ppt increase from 2018. This is comparable to the deficit increase in 2018 (1ppt), and much smaller than the stimulus in 2015 (2.1ppt increase).
- Whether the actual fiscal stance can reach this target will depend crucially on local government land sales revenue. If land sales fall short, the government might not have sufficient revenue to transfer into the budget. Land auctions have declined to -19% yoy in Jan-Feb. A loosening of policy in the property sector seems inevitable.

1. The fiscal puzzle for 2019

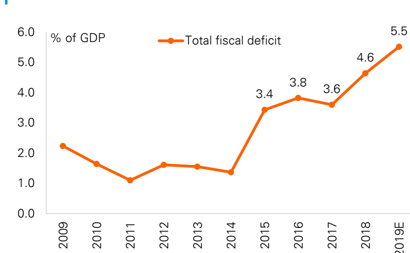
The National People's Congress concluded on 15 March, leaving us with what appears to be a very expansionary fiscal stance. The government promised to cut taxes substantially, keep on-budget spending growing, and significantly increase new local government special bonds for off-budget investment. Taking these measures together, the market seems to believe that the total fiscal deficit is on track to exceed 6% of GDP.[1] Indeed, if we take the difference between the budgeted revenue (RMB19.25tr) and spending (RMB23.52tr), and add special bond issuance of

Figure 24: The gap in the budget will largely be financed by transfers from government funds



Source : Deutsche Bank estimates

Figure 25: We forecast total fiscal deficit will be 5.5% in 2019



Source : Deutsche Bank estimates
Note: total fiscal deficit is the actual deficit of general budget and government funds combined.

1 See for example, Bloomberg report on March 15, "China Reveals the Fiscal Tricks Needed to Deliver Record Tax Cut" https://www.bloomberg.com/news/articles/2019-03-15/china-reveals-the-fiscal-tricks-needed-to-deliver-record-tax-cut .

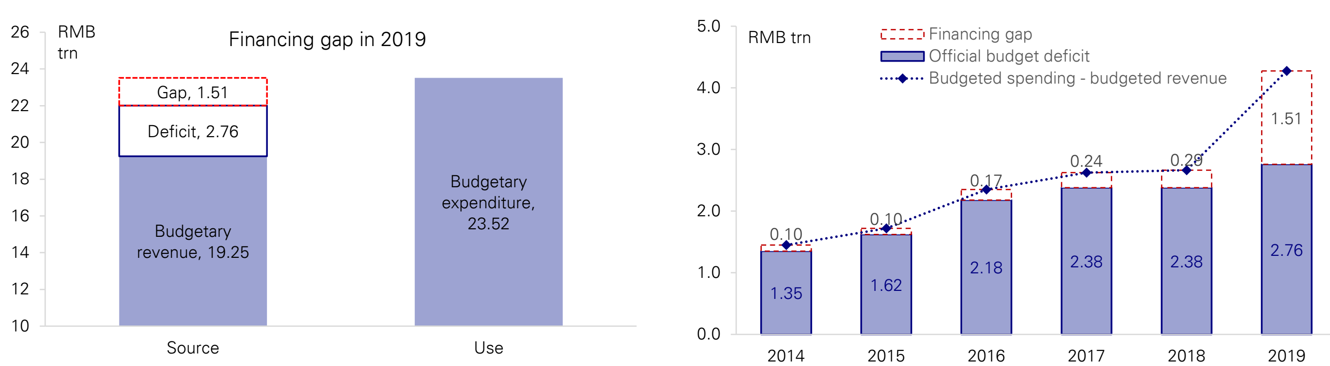
RMB2.15tr, the sum would be 6.6% of GDP.

What makes the fiscal picture less clear, however, is an implicit financing gap in the government's 2019 budget:

- On the revenue side, the government will: (1) significantly cut value added tax (VAT) by as much as 3ppts, which could cost RMB800bn; (2) cut personal income tax by c.RMB500bn; and (3) cut various taxes and fees for small enterprises by another RMB200bn annually. It will also cut social security contributions. This amounts to a total package of RMB2tr.
- On the spending side, the government still wants it to grow by 6.5% to RMB23.52tr in 2019. This includes a RMB280bn increase in social security spending, in part to offset the planned cut in social security contributions.
- Despite all these revenue and spending measures, the government proposed only a small fiscal deficit increase of RMB380bn (0.2% of GDP). This suggests that the government will have a large financing gap, c.RMB1.5tr (Figure 26). This is the first time we have seen such a big gap in the government's annual budget.

Here *financing gap = budget spending - (budget revenue + deficit)*. If the money that the government spends does not come from its revenue, nor from running a deficit (which will be financed by government bonds), where will it come from?

Figure 26: China's 2019 government general budget implies an unprecedented financing gap of RMB1.5tr



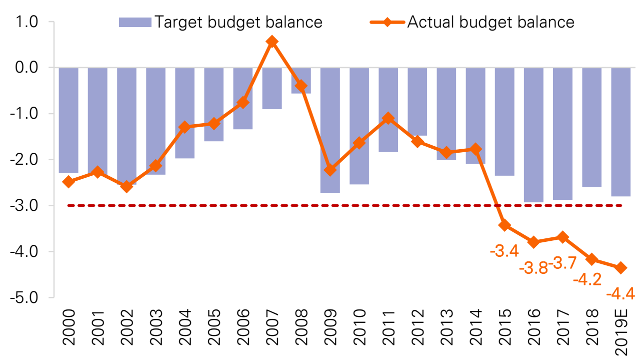
Source : Deutsche Bank estimates, Government Budget

2. The financing gap is likely a result of past spending overruns

It may appear strange as to why the government prepared a budget with a financing gap. To understand, it is important to recognize that China's *actual* budget deficit, which is the actual difference between government on-budget revenue and spending, has already deviated from the announced *official* budget deficit since 2015 (Figure 27).

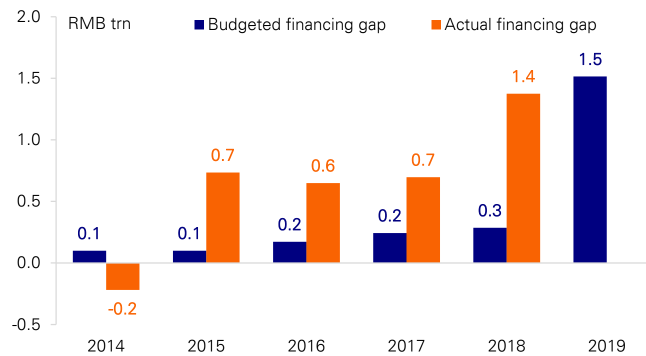
Actual deficits were historically in line with official deficits; in 2000-14, actual deficits were smaller than budgeted in 13 out of the 15 years. However, in 2015, the gap between official and actual deficits suddenly widened. In 2018, the official deficit was 2.6% of GDP, but actual deficit was 4.2% of GDP. This implies an actual financing gap of RMB1.4tr in 2018 (Figure 28). In this regard, the RMB1.5tr financing gap in the 2019 budget is not new, but a continuation of what happened in previous years.

Figure 27: Actual budget deficit has been much higher than official deficit since 2015, creating a financing gap



Source : Deutsche Bank estimates, MoF, WIND

Figure 28: Budgeted financing gap in 2019 is comparable to the actual financing gap in 2018



Source : Deutsche Bank estimates, MoF, WIND
Note: budgeted financing gap = budgeted spending - budgeted revenue - bond financing. Actual financing gap = actual spending - actual revenue - bond financing.

What changed in 2015? We think this happened because:

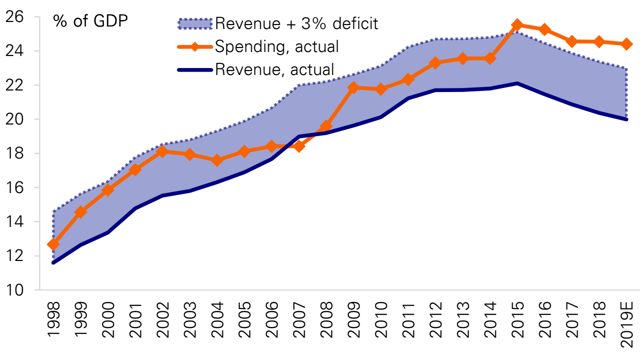
1. A series of tax cuts and reforms were implemented starting from 2015, leading to a big drop in total fiscal revenue from 22% of GDP 2014 to 20% in 2018.
2. Meanwhile, 2015 was also a difficult year for the economy. The government had to increase spending to support the economy, despite lower revenue growth.
3. Lastly, the official deficit is effectively capped at 3% of GDP. The 3% ceiling, though not formally written in law, is believed by the government to be "international best practice" (such as in the EU's Stability and Growth Pact), and has always been followed until today.

These goals, however, are not compatible (Figure 29): when the government cut revenue and raised spending at the same time, the gap between the two widened. However, the official deficit was still constrained by the 3% ceiling. A financing gap thus emerged.

The financing gap coincided with a new budget law that came into effect in 2015. Prior to the new law, local governments were required to run a balanced budget each year; spending could not exceed revenues. This restriction was removed by the new law. Local governments significantly increased their deficits from 2015 onwards (Figure 30).

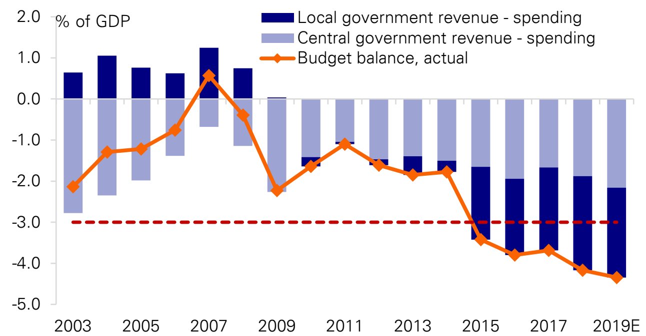
These deficits were financed largely out of local governments' own resources. Back in 2015, local governments were encouraged to spend more by utilizing available resources and savings from previous years. The government also initiated a campaign to find and utilize "sunk funds", i.e. money that was allocated but not yet spent, sitting idly in various government accounts. All these measures may have helped finance the gap in 2015. But then, the gap persisted and continued to widen in the subsequent years. We don't think it is plausible to assume that local governments have had sufficient savings to continue financing the gap until today. Where, then, did the financing come from?

Figure 29: Financing gap emerged because revenue fell as % of GDP while spending was sustained



Source : Deutsche Bank estimates, MoF, WIND

Figure 30: Financing gap was largely borne by local governments



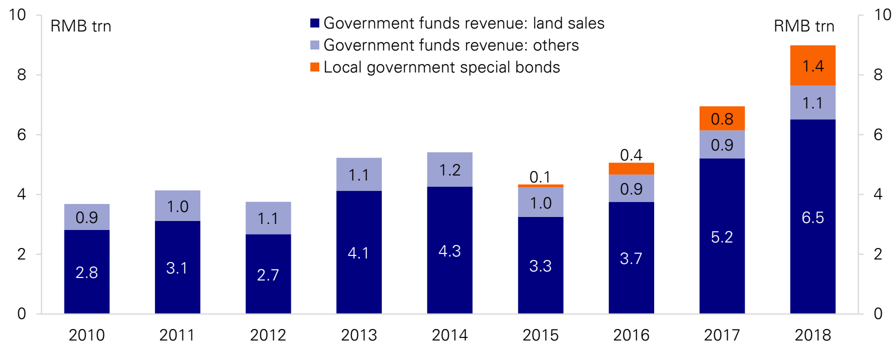
Source : Deutsche Bank estimates, MoF, WIND
Note: Tax rebate and transfer from the central government is included in local government's revenue.

3. Government funds may have provided most of the additional funding to the budget

While the national budget did not give sufficient details about the financing gap, we thought local governments might have answers. After all, it is local governments who overspent their budgets. With this in mind, we carefully reviewed available local government budget reports. Our main finding is that local governments financed a large part of the gap through transferring revenue from government funds.

For those who are not familiar with China's fiscal system, the government funds are a set of fiscal accounts run separately from the budget. The biggest revenue source under government funds is land sales. Total government fund revenues reached RMB7.5tr in 2018, almost comparable to local government's budgetary revenue (RMB9.8tr in 2018), of which RMB6.5tr was from land sales. In addition, local governments started to issue special bonds in recent years; the proceeds of special bonds are also managed under the government funds. As such, government funds are of crucial importance to local governments (Figure 31).

Figure 31: Government funds are important sources of local government revenue



Source : Deutsche Bank Research, MoF, WIND

Local governments are allowed by law to transfer funding from the government funds to the budget under certain conditions. For example, if revenue is substantially larger than expected in a year, the additional revenue exceeding 30% of expected revenue can be transferred to the budget. Another example is if fund balances have not been spent and thus rolled over for two consecutive years. In practice, local governments may have even greater flexibility[2] .

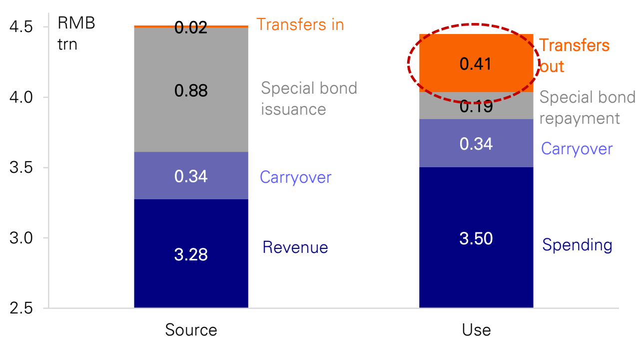
National level budget and fiscal data do not provide any details about these local government transfers. Fortunately, fiscal transparency has greatly improved in recent years at the local government level. Local governments are required by law to present their budget reports to subnational people's congresses and seek their approval. These reports are increasingly more informative and made available to the public. We reviewed all provincial government budget reports in the past two years. Here are our main findings:

- We were able to obtain detailed information on the source and use of government funds for 15 out of the 31 provinces in 2018. These 15 provinces in total received RMB3.28tr of government funds revenue. They also issued RMB0.88tr of local government special bonds. On the use of funds side, they recorded RMB3.5tr of spending and RMB0.19tr of bond repayments. In other words, our sample represents 45% of total local government funds revenue, 45% of spending, and 51% of new special bond issuance.
- We found these 15 provinces in total transferred RMB0.41tr of funds out of the government funds budget (Figure 32). This is about 10% of their revenue (including special bonds) under government funds.
- Did these transfers go into the budget? Only a few provinces explicitly said that these funds went into the general budget. The others did not specify. To find out, we compared the amount of government fund transfers in each province with their financing gap in their budget (i.e., total budget spending in excess of budget revenue, central government transfers, and net bond issuances). We found a good correlation: provinces which took more money away from the government funds were also likely to have larger financing gaps in their budget (Figure 33). If a province spent 1 yuan more than its revenues in 2018, it likely transferred 0.6 yuan out of its government funds. This correlation also holds in 2017.

2 For example, one city government stated in its budget document (link here in Chinese) that it transferred all the additional land sales revenue into the general budget, rather than only the above 30% part.

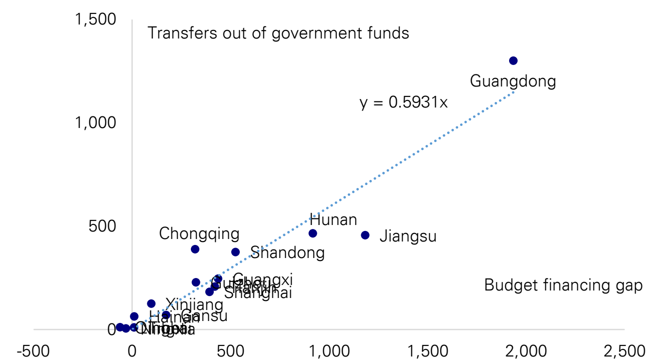
Our analysis above suggests it is very likely that local government funds helped close their budget financing gap. In fact, based on our sample, c.60% of the gap at local government level may have been financed by transfers from government funds.

Figure 32: Local governments transferred revenue out of the government funds account...



Source : Deutsche Bank estimates, 15 provincial government budget reports in 2018

Figure 33: ...and these transfers likely helped finance budget spending



Source : Deutsche Bank Research, 15 provincial government budget reports in 2018

4. Where else can the government find more budget funding?

In addition to the government funds, the government has a number of other accounts outside the budget, including the SOE funds and the social security funds. The budget also mentioned a list of other additional funding sources, such as spending carry overs, stabilization funds, and chasing "sunk funds".

Let's go through these possible sources of budget financing one by one:

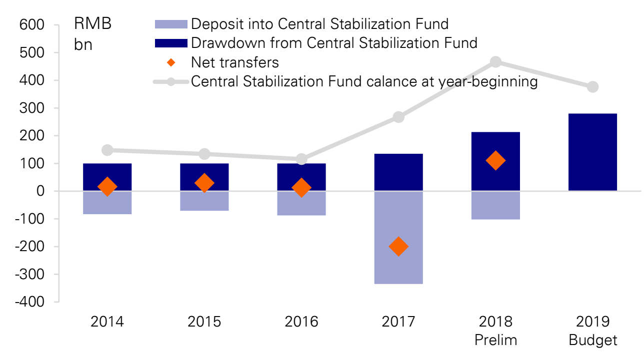
Carry over spending - negligible. "Carry over spending" is spending that has been budgeted but not fully spent in the previous year, and subsequently carried over into the next year. While there is a small amount of carry overs funds available from 2018 — we calculated RMB0.3tr from 15 provincial budgets — the government will also have to carry over some of the 2019 spending into 2020. On a net basis, we don't think the government can get much financing from carry overs.

Stabilization funds - **RMB0.4tr at most**. Central and local governments may accumulate stabilization funds when they spend less than budgeted, and may draw from it later. The central government still has RMB376bn left in its stabilization fund and pledged to draw RMB280bn from it this year. At year end, it will likely deposit about RMB100bn back, judging from historical experience. Net withdrawal would be RMB180bn (Figure 34). For local governments, we don't know how much is left in their stabilization funds, but given that local governments have had budget overruns for several years now, it is not likely they still have much left in the funds. In fact, we looked into this year's local government budgets and found that 12 provinces withdrew RMB330bn from their stabilization funds during 2018 and deposited back RMB300bn by year-end. So net financing was minimal at RMB30bn only. Even if we assume local governments significantly increase net withdrawal from stabilization funds to RMB200bn in 2019, and adding the RMB180bn from the central government, we get a total of c.RMB400bn financing from stabilization funds.

"Sunk funds" - uncertain but likely small. "Sunk funds" are fiscal resources that have been earmarked for specific spending but have not actually been spent, sitting idly in certain government accounts. In the last fiscal downturn in 2015, the state council required all levels of governments to find sunk funds and reallocate them for new spending. By July 2015, the government was able to "revitalize" c.RMB250bn of sunk funds for new spending, according to a state council press release. Therefore, we are skeptical how much more sunk funds the government will be able to reallocate this time, given the last campaign was run not long ago. Implementation of the new budget law has also enhanced the government's fiscal management and eliminated many sunk fund accounts.

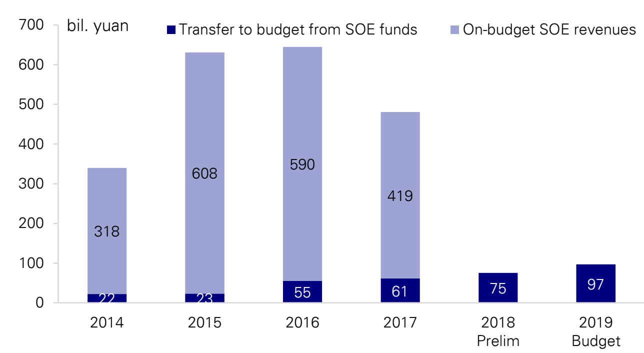
SOE contributions - RMB0.1tr at most. The government said that it will further increase profit contributions from central SOEs and state-owned financial institutions. SOE contributions are largely managed under the SOE funds. For 2019, the government's total surplus under the SOE funds is RMB97bn, including both central and local SOEs. This is the maximum amount it could transfer into the budget. Meanwhile, profits from state-owned financial institutions are already part of the central government's budget revenue. Increases should have already been included in the budget would not contribute toward the financing gap (Figure 35).

Figure 34: Stabilization funds net contribution to budget is likely small



Source : Deutsche Bank estimates, MoF

Figure 35: SOEs' contributions to fiscal revenue



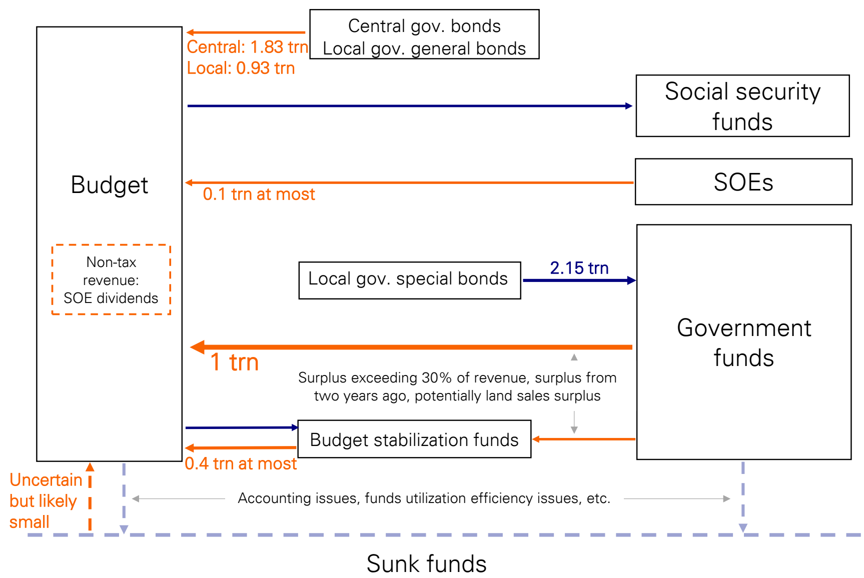
Source : Deutsche Bank estimates, MoF

Social security funds - zero. The social security funds are strictly set aside for current and future social security spendings. Using them to finance other government spending is unthinkable and has no precedent.

Quasi-fiscal entities - unlikely. Firstly, there is no clear channel how money in these entities can be transferred back to the budget. Secondly, there is no incentive for local governments to do so either. Quasi-fiscal entities are often leveraged and can get much more out of 1 yuan of fiscal resources compared with on-budget spending.

All in all, sources other than the government funds may add up to another RMB0.5-0.6tr of possible financing for the budget. This is not sufficient to finance the RMB1.5tr gap. In order to finance the remainder of the gap, we think the government will have to again rely on transfers from the government funds. The needed amount is about RMB1tr, which is 11% of government funds revenue, in line with the share in 2017-18. Figure 24 sums up all the budget financing channels.

Figure 36: Channels to finance budget deficit



Source : Deutsche Bank estimates

5. How expansionary can fiscal policy be this year?

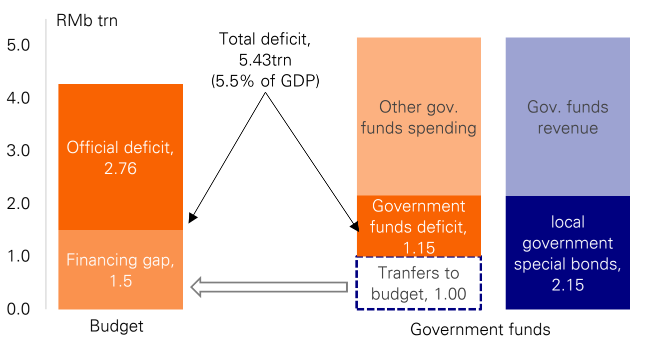
In the previous sections, we identified a RMB1.5tr financing gap in the government's 2019 budget and discussed how it came to be. We found that most of it — about RMB1tr — will likely have to be financed by transfers from the government funds. The rest will come from stabilization funds and various other sources. What does it tell us about the government's fiscal stance in 2019?

1. The first conclusion is that we cannot simply take a RMB4.3tr difference between revenue and spending in the budget and add RMB2.15tr of special bonds to get a total fiscal deficit at RMB5.4tr (6.6% of GDP). To avoid double counting, the RMB1tr transfer from the government funds to the budget should be deducted from the calculation, as is illustrated Figure 37 .

The government's total fiscal deficit should be 5.5% of GDP in 2019, of which 4.4% is from budget and 1.1% from government funds. The marginal increase in fiscal deficit in 2019 is 0.9ppts. This is comparable to the increase in 2018 (1ppt), but is much smaller than the increase in 2015 (2.1ppts) (Figure 38).

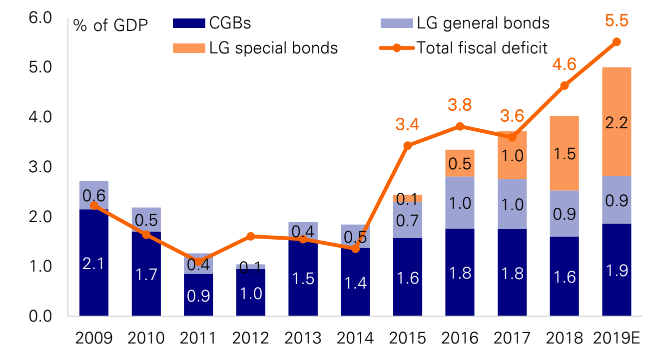
To verify this result, we may also approach the government's fiscal stance from "below the line", e.g. how much the government borrows. The government's net debt increase, combining all central and local government bonds, is no more than 5% of GDP. Non-debt financing, as we discussed above, could be another RMB0.5-0.6tr, or 0.5% of GDP, at most. This again tells us that the government's total fiscal deficit should be c.5.5% of GDP.

Figure 37: Total fiscal deficit should be 5.5% of GDP in 2019



Source : Deutsche Bank estimates, MoF

Figure 38: The amount of total fiscal deficit increase in 2019 is comparable to 2018

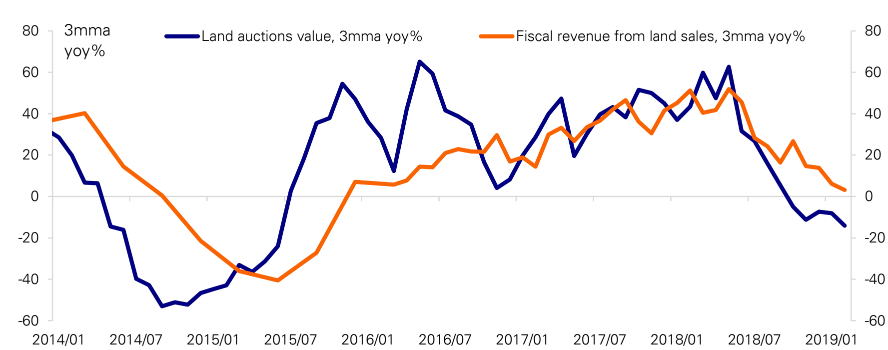


Source : Deutsche Bank estimates, MoF

2. Our study also highlights the importance of land sales revenue for local governments. After local governments gained flexibility on budget spending since 2015, they have been effectively using government funds revenue, which is mostly from land sales, to support the budget. The higher the land sales revenue, the more local governments will be able to transfer them out and support budget spending. Conversely, if land sale revenues fall, not only will local governments have to cut government funds spending, they may also need to reduce transfers, and therefore tighten on-budget spending. This suggests local governments have great incentives to secure land sales revenue.

The government expects a 3% increase in land sales revenue this year to RMB6.7tr. We are less optimistic and think land sales could fall short of the government's expectations by RMB0.8tr, if current downward trend continues in the land and property markets. We continue to observe negative growth in government land auctions, which is a leading indicator for land sales revenue (Figure 39). In Jan-Feb, land sales revenue was -5% yoy. We think the government may have to relax property policy restrictions later this year to help stabilize the land market. Vice Premier & member of the Politburo Standing Committee Han Zheng visited the Ministry of Housing right after the NPC. He emphasized that housing policy should stick to the goals of "stable land prices, stable property prices, and stable expectations".

Figure 39: Falling government revenue from land sales



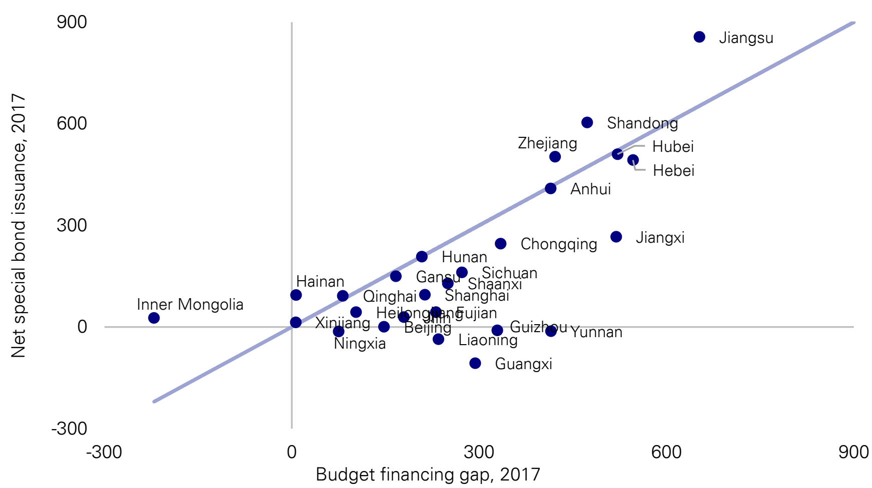
Source : Deutsche Bank estimates, CREIS, MoF, WIND

3. A last interesting observation is on local government special bonds. The government's actual budget financing gap each year, as we illustrated in Figure 26 , is not far from the amount of local government special bonds issued in the same year. This

correlation appears to hold at provincial level too (Figure 40). Is it just a coincidence? Or does it mean that local government special bonds are just budget financing disguised as off-budget spending?

To be sure, we find no evidence of any local government directly transferring special bond revenue into the budget. Nevertheless, we note that a large share (about 2/3) of special bonds are for land development and urban resettlement projects. Practically, this spending is not very different from how local governments would spend their land sales revenue. If special bonds proceeds are spent on land development, wouldn't that free up local government's land sales revenue, which in turn could be transferred to the budget through various channels? In this regard, special bonds should not be treated as completely separate from the budget. The government may have separate pockets, but money is fungible after all.

Figure 40: Local government special bond issuance is correlated with budget financing gap



Source : Deutsche Bank estimates, MoF, WIND

Previous reports in China Fiscal Series

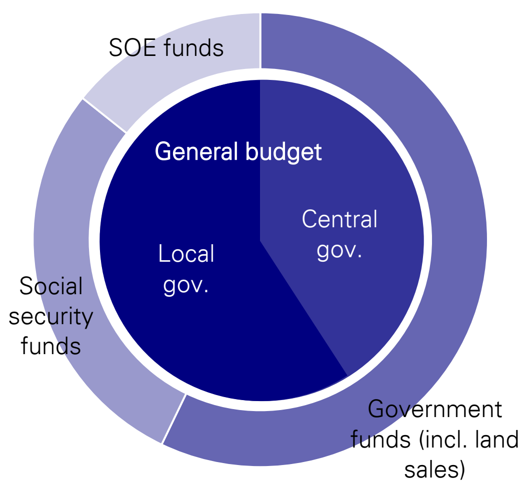
1. China Fiscal Series: Revisiting the LGFV debt issue, Nov 5, 2017.
2. China Fiscal Series: LGFVs debt growth slowed, asset quality still poor , Oct 19, 2018

Appendix

An overview of China's government accounts

China's public finance system went through a major change after the implementation of the new budget law in 2015. It is by law that all levels of governments should set up four different accounts and take all the revenue and expenditure into the full scope of public finance (Figure 41). The four accounts, as required by law, should also be complete and independent. We go through the four accounts one by one.

Figure 41: An overview of China's government accounts



Source : Deutsche Bank estimates, MoF

1. **General budget** is the most important account of the public finance. Taxes contribute most to the revenue side, along with fees and contributions from SOEs. The expenditure includes general operations of the government, social welfare along with others. Before the new budget law, only central government was allowed to run a budget deficit. After 2015, local governments are also allowed to issue local government general bonds to finance budget deficit with the approval from People's Congresses.

2. **Government funds** are the second most crucial account, and the most volatile one given its close relationship with land and property market. It is also the only account that is mainly managed by the local governments. All the government funds are set up for specific public utilities and therefore related with specified functions and even programs. Local government special bonds are also managed under government funds. The expenditure of the government funds should be based on the revenue and, in principal, deficit is not allowed. Land sales contribute most to the revenue of government funds (86% in 2018).

3. **SOE funds** are government accounts to manage profit contributions from central and local SOEs. The government increased SOE profit payout ratio in recent years; the goal is to reach 30% payout ratio in 2020. Only a small portion of SOE fund revenues are transferred to the general budget. The rest

are largely spent back on SOEs. It is worth noting that state-owned financial institutions do not contribute to the SOE funds; their profits are directly paid into the general budget.

4. **Social security funds** are independent accounts for social benefits, including pension contributions, national health insurance, unemployment and disability benefits, etc. Social security funds also receive large transfers from the general budget for its current and future spending.

Governments are also allowed to set up **stabilization funds for general budget**. Governments can deposit into this satellite account when running a budgetary surplus and withdraw from it if necessary, achieving inter-annual budget balance.

How are those accounts related between layers of government and with each other?

A transfer mechanism is applicable to all of four accounts between the central and local governments. Local governments rely most on transfers from central government in the general budget (42% of local government general budget revenue in 2017).

The coordination between the four accounts and the overall efficiency of public finance was further emphasized by the state council in June 2015, following a fiscal downturn. Specifically, the government funds and the general budget are instructed to be further consolidated. The government funds that share a similar function as expenditure under the general budget are required to be consolidated with the general budget and no longer managed under government funds. Revenue from government funds can be transferred into the budgetary stabilization funds if: (1) the surplus exceeds 30% of current year revenue; or (2) if the surplus has been rolled over in the account for more than two years. 11 government funds were reclassified into the general budget account in 2015.

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South Africa: A back-to-back downturn?

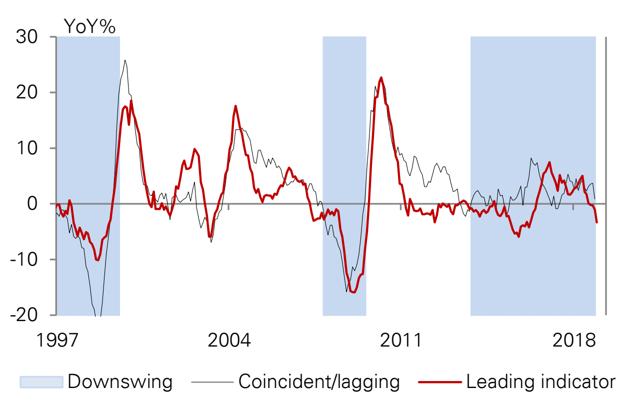
- Recent business cycle indicators have taken another turn for the worst. The leading index has been contracting sequentially for the last nine months, and in 4Q18 contracted YoY for the first time since 1Q16. This is negative for the six- to twelve-month outlook. Combined with the coincident and the lagging indicator, there is confirmation that there is a renewed slowdown underway.
- Our business cycle model suggests that the downturn has indeed intensified, but due to previous data revisions, the business cycle downturn since 2014 may have been briefly interrupted between 1Q16 and 4Q17. This means that since the start of 2018 the economy entered a second downturn, commonly referred to as a double-dip, or back-to-back downturn.
- Indicatively, some indicators point to further deterioration in the cycle up to 3Q19 this year, but we can't be sure given the slowdown in the global business cycle. The leading indicator of key trade partner countries, excluding the US, has recently contracted for the first time since 2012. In turn, while domestic electricity constraints will remain a binding constraint on growth, the Minister of Public Enterprises, Mr Pravin Gordhan, recently confirmed that the extent of electricity load-shedding will be curtailed.
- Why the double-dip? Firstly, wages have to adjust to "clear the market", or from a business cycle perspective, the unit price of labour needs to collapse. This was not evident in the first dip. Clearly the ramifications of the first dip of the cycle where the profit recession coincided with still high wage costs, could have triggered the cause for the second dip. Secondly, renewed policy/political uncertainty came at an unfortunate time in 2018, as in its absence, the upturn that may have started in 2016 could have resulted in the productivity baton being passed from labour to capital. 2018 is now characterised as an income recession with both profit and wages contracted in real terms - last experienced in the early 1990s and the back-to-back recession in the 1980s. Finally, with the real policy rate rising from 1.2% in the "recovery" phase to 2.5% in 2018, and 2.7% currently, we argue that monetary policy has become restrictive.
- The silver lining within current business cycle indicators is the convergence between manufacturing wage growth and productivity. Simplistically this means that unit labour costs have compressed, making the tradeable sector more competitive. Typically this is rand supportive, as lower relative unit labour costs are positive indicators for capital inflows. A second observation is that usually a contraction in real wage and profit tends to lead to a convergence in labour and capital shares of income, which is further confirmation that the business cycle downturn may be maturing.
- In light of our findings and revisions to global growth, we have reduced domestic growth to 1.4% (from 1.6%) in 2019, and to 1.5% in 2020 (from 1.9%). Inflation was revised slightly up to 4.7% in 2019 (due to recent oil price revisions), but down to 5.2% (from 5.5%) in 2020 on lower food inflation pressures, reduced electricity tariff assumptions and lower unit labour costs.
- As a consequence, we now see the SARB keeping policy rates on hold at 6.75% (40% probability), with the probability of a rate cut vs rate hike scenario evenly balanced at 30%. Fiscal metrics may yet again disappoint.

We now expect deficits near 4.5% over the medium term, but will unpack these in a follow-up note. What matters though is that weaker growth and deteriorating fiscal metrics seem to be the consensus view. We have not changed our view on the currency, which we still see at R13.5/USD and R12.20/USD end 2019 and 2020, respectively.

Business cycle blues

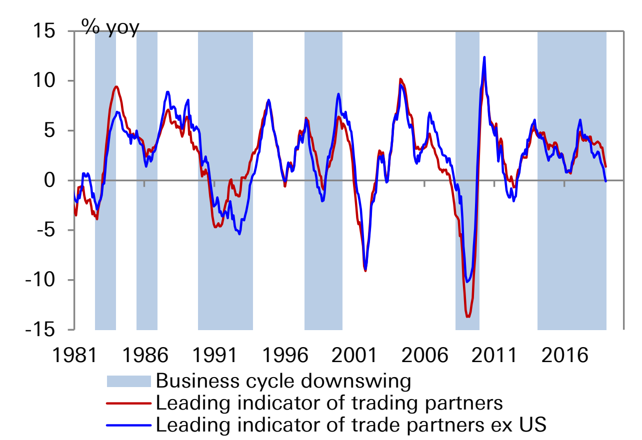
Recent business cycle indicators have taken another turn for the worst. The SARB leading index has been contracting sequentially for the last nine months (QoQ s.a.), and contracted YoY in 4Q18 for the first time since 1Q16. In January the YoY slide deepened to 3.3%, which suggests a deteriorating outlook over the next six to twelve months. Combined with the coincident and the lagging indicator, there is confirmation that there is a renewed slowdown underway. A ratio of these two indicators - the "present-to-past" ratio - seems to be partly lagging the leading indicator, thus corroborating deteriorating conditions. In turn, leading indicators of key trade partner countries are slowing, and excluding the US, contracted in December last year (-0.1% YoY).

Figure 42: Domestic leading indicator contracting anew



Source : SARB, Deutsche Bank

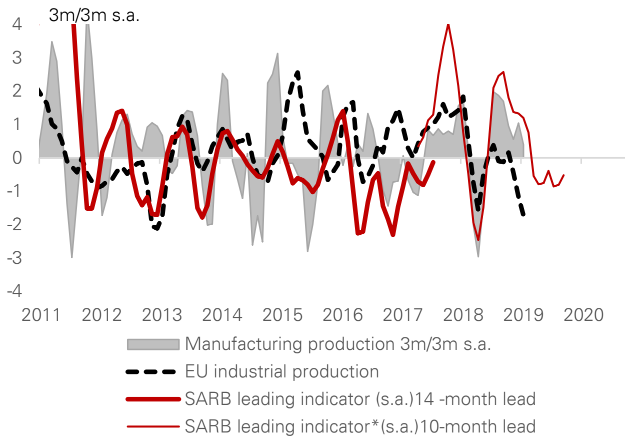
Figure 43: Trade partners leading index ex US decline



Source : SARB, Deutsche Bank

The combination of leading indicators (SARB leading index and the PMI) and apparent high inventories to sales ratios across sectors, now point to a strong likelihood of recession in the manufacturing sector in 2019. New passenger car sales, one of the high frequency leading indicators, contracted by 6% yoy in Q1 (weakest since 2016). And the external outlook for auto exports remain weak given the sharp slowdown in EU demand (a large export market). Recent Q1 business confidence indicators suggests that the manufacturing sector reduced working hours (also a component of the SARB leading indicator), back to comparable lows in 2017, while domestic and export orders contracted anew. Export orders are now at the worst level since 2010.

Figure 44: Manufacturing could contract in 2019, based on EU cycle and leading index



*SARB leading indicator was updated in 2015, since then the lead time shortened from 14 months to 10 months. Source : SARB, Factset, Deutsche Bank

Figure 45: High inventory ratios could weigh on new orders for manufactured goods (and imports)

		Inventories to turnover ratio		
	LT	2016	2017	2018
Mining	43.8	46.2	47.3	49.8
Manufacturing	47.5	54.5	55.3	56.0
Electricity	32.8	35.5	38.7	39.9
Construction	17.8	22.1	16.9	20.8
Trade	36.5	40.9	41.1	41.6
Transport & comms	8.5	7.5	7.4	5.9
Business services	10.5	9.8	11.7	10.6
Personal services	6.5	5.0	4.3	4.2
All industries	33.1	**36.6**	**37.0**	**37.8**

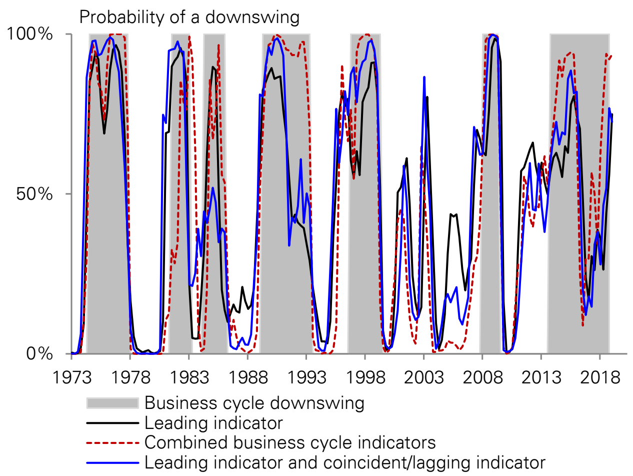
* LT = Long-term average Source : Stats SA, Deutsche Bank

A back-to-back downturn?

Our business cycle model suggests that the downturn has indeed intensified, but due to previous data revisions, the business cycle downturn that started end 2013 may have been briefly interrupted between 1Q16 and 1Q18. The probabilities of three models we track, all collapsed from 2Q16 to levels consistent with an upswing (15-20%), but spiked again above 70% in 1Q18, which is consistent with another downswing phase. This could mean that the first downturn lasted about nine quarters, and the second one is underway for five quarters now. The average business cycle downturns lasted around seven quarters.

This means that since the start of 2018 the economy entered a second downturn, commonly referred to as a double-dip, or back-to-back downturn. This is not yet officially confirmed by the SARB. Indeed, the SARB previously dismissed the potential for an upturn in business cycle in 2Q16 (see here), saying it was not broad-based, and led mainly by the global cycle indicators in the index (including export commodity prices). Recent data revisions could possibly challenge this view—e.g., private sector investment and real disposable income for example were higher than previously reported.

Figure 46: Probability model[3] suggests possibility of back-to-back downturn



Source : SARB, Deutsche Bank

Figure 47: Economic performance much worse in second dip, with some indicators hitting fresh lows*

Indicator average over period	Dec'13 - 2Q16	3Q16 - 4Q17	1Q18 to 1Q19	Current
Manufacturing orders: domestic (% net balance)	-10.4	-20.1	-25.6	-28
Manufacturing orders: exports (% net balance)	-8.3	-8.0	-16.8	-27
(% net balance)	6.2	12.3	4.4	2
demand (% net balance)	9.9	9.9	8.0	5
Retailers: stocks vs expected demand (% net balance)	13.4	14.4	14.6	17
Avg. hours worked per factory worker in manufacturing (% net balance)	-14.3	-15.0	-13.0	-19
Manufacturing capacity utilisation (%)	81.0	81.6	81.3	81.4
Industrial production (mining, elec, manuf) (YoY%)	-0.2	0.8	0.0	-0.2
Manufacturing ULC (YoY%)	4.2	4.3	2.6	2.1
Export price index (YoY%)	3.5	6.6	2.9	2.4
Business confidence: total (% satisfactory)	40.7	34.3	35.4	28
satisfactory)	29.6	28.6	29.8	25
Business confidence: retail (% satisfactory)	45.2	33.3	32.2	24
SACCI business confidence index	100.4	94.0	95.5	93.4
Real GVA ex. Agri (YoY%)	1.3	1.0	0.9	0.9
Retail sales (YoY%)	2.6	2.3	2.4	1.2
New passenger vehicle sales (YoY%)	-3.9	-4.1	-2.0	-5.7
Real M1 growth (YoY%)	5.3	3.9	0.2	-0.1
Non-farm payrolls (YoY%)	0.2	0.0	0.3	0.2
Gross operating surplus (nominal YoY%)	5.1	7.0	3.8	4.9
Real policy rate	0.5	1.2	2.5	2.7
Ratio of investment in machinery and equipment to demand	9.0	8.6	8.1	7.6
Building plans passed (units) >80	1.3	-5.3	-1.4	1.1
Leading indicator: all trade partners (YoY%)	3.2	3.6	3.2	1.4
Leading indicator: trade partners ex US (YoY%)	2.8	4.0	1.9	-0.1

**Red text indicates components of leading indicator. Shaded areas highlight the lows. Underlined figures in last column shows new lows in recent data prints Source : SARB, StatsSA, BER, Factset*

Possible triggers of the second dip?

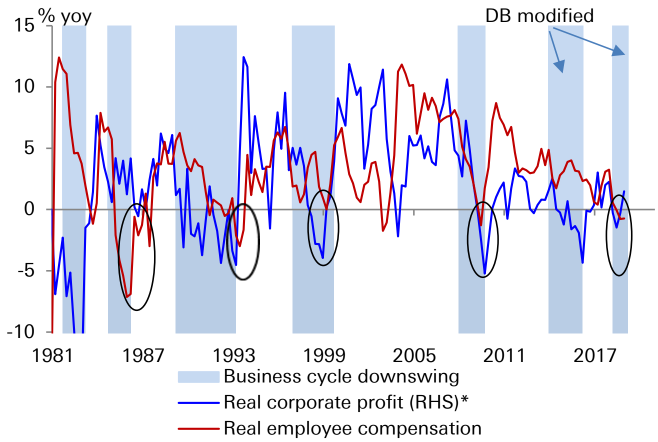
Contrary to initial expectations that 2018 would be a positive year, it turns out that nearly 60%, or 14, of a set of 25 macro indicators we monitor reached new lows last year (Figure 47). This compares to only eight (or 32%) that may have bottomed between 2016 and 2017, and 10% in the first dip. We think the ramifications of the first dip of the cycle where the profit recession coincided with still high wage costs (Figure 48), could have triggered the cause for the second dip in 2018.

Renewed policy/political uncertainty came at an unfortunate time in 2018, as in its absence, the upturn that may have started in 2016 could have resulted in the productivity baton being passed from labour to capital. 2018 is now characterised as an income recession as both profit and wages contracted in real terms - last experienced in the early 1990s and the back-to-back recession in the 1980s. As seen in the last column of Figure 47 , it seems from the BER survey data, that new lows are being hit in 1Q19 for manufacturing and retail components. Higher stock of finished goods for retailers have cascading effects to manufacturing and imports (as discussed above).

In addition, what is striking is that over these three periods, the real policy rate rose from 0.5%, to 1.2% and 2.5%. At the current level of 2.7%, real rates are more restrictive given the phase of the business cycle: real GDP ex agriculture is growing at 0.9%; the SARB's potential growth estimate is at 1.3% and its estimate of neutral real rates between 2.1% and 2.3%.

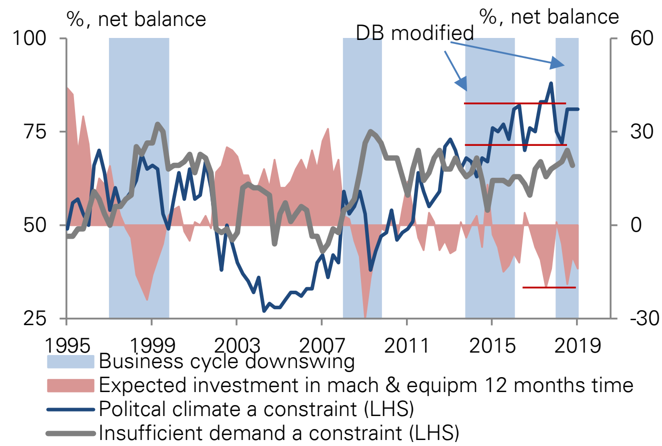
3 * Logit model specification with downswing a function of YoY% in leading indicator, ratio of coincident to lagging indicator, lagging indicator and the inverse of lagging indicator at various lag/lead lengths.

Figure 48: Real wage contraction confirms income recession in 2018



** Real corporate profit is gross operating surplus less GDP deflator. Source : SARB, Deutsche Bank, Stats SA*

Figure 49: Political constraints, insufficient demand and expected investment precipitate double dip?



Source : BER, SARB, Deutsche Bank

Where is the bottom?

It may be too early to conclude that the recent spike in bad data prints marks the bottom. However, we can compare the second dip with historical turning points, to compare how many quarters of weakness lie ahead before a trough is reached.

- Dip 1: Interestingly, this methodology broadly corroborates the probability estimates. Based on an extensive list of business cycle indicators, it would appear that Dip 1 may have troughed in 4Q15 (rather than our estimate of 1Q16). However, the latter is corroborated by the fact that coincident business cycle indicators actually reached their worst point in February 2016 and some predicting the worst point in 2Q16. In this instance, lagging indicators (of the preceding upturn) peaked 3Q15, two quarters before we believe the trough was reached in 1Q16. This is somewhat later than historical cycles, which suggests business cycle stresses peaked six quarters before the trough.
- Dip 2: So far, this dating methodology also suggests that most indicators reached their low in 4Q18, but as stated, we're unsure whether indicators, like manufacturing could reach new lows. Indicatively, some indicators suggest that the lower turning point in the cycle may be in 2Q19 or as late as 3Q19. If the lagging indicator is anything to go by, the estimated trough, using a two-quarter lead, would suggest a lower turning point in 2Q19 and 2Q20 if we rely on the historical average.

Figure 50: Business cycle chronology: comparing double-dip troughs with historical turning points of previous cycles, where 1Q16 and 1Q19 mark the respective bottoms of each cycle

		Quarter indicator troughed/peaked*	Dip 1		Dip 2	
Indicator		Historical average: (where 0= quarter that trough/bottom in business cycle)	Cycle Trough (1Q16 = 0)	Estimated trough based on current cycle vs average	Potential trough (1Q19= 0)	Estimated trough based on current cycle vs average
Value of non-residential buildings completed	StatsSA	-7	-10	Mar-15	-10	Dec-18
Instalment credit % hhould cred	SARB	-7	-9	Jun-15	-9	Dec-18
Yield spread	Bloomberg Finance/LP	-7	-4	Jun-16	-11	Jun-18
Interest Rates: Predominant Overdraft Rate	SARB	-6	-6	Dec-15	-8	Dec-18
Ratio of investment in machinery and equipment to demand	SARB	-6	-9	Mar-15	-9	Dec-18
New Vehicles Sold (SA, % yoy)	Haver	-6	-7	Sep-15	-10	Jun-18
Manufact Srvy: Finished Goods Stock Rel to Demand Expect	BER	-6	-7	Jun-15	-11	Dec-17
Manufacturing: Unit Labor Cost: Nominal (SA,% yoy)	SARB	-5	-5	Mar-16	-9	Jun-18
Retail Srvy: All Retailers: Stock Rel to Expected Demand	BER	-5	0	Dec-16	-7	Sep-18
Labour productivity	SARB	-4	-4	Dec-15	-8	Jun-18
Non-Agricultural Employment [Break-Adjusted](SA,% yoy)	Haver	-4	-4	Dec-15	-7	Sep-18
Retail Sales Volume Index (SA, % yoy)	StatsSA	-4	-7	Mar-15	-7	Mar-18
Manufacturing: Capacity Utilization Rate (SA, %)	StatsSA	-4	-2	Mar-16	-8	Mar-18
Real M1 % yoy	SARB/StatsSA	-4	-7	Dec-14	-3	Jun-19
Manufacturing Survey: Average Hours per Factory Worker	BER	-4	-8	Dec-14	-5	Sep-18
Manufact Survey: Raw Material Stocks Rel to Planned Prod	BER	-3	1	Dec-16	-7	Jun-18
Real GVA ex. agriculture, forestry & fishing (% yoy)	StatsSA	-3	0	Jun-16	-7	Mar-19
Industrial Production (SA,% yoy)	StatsSA/DB	-3	0	Dec-15	-10	Sep-17
Manufacturing Survey: Domestic Orders Received	BER	-3	-7	Dec-14	-2	Sep-19
Exports & Nonfactor Service Price incl Gold (% yoy)	SARB	-3	-3	Dec-15	-4	Mar-19
Business Confidence: Retail Trade	BER	-3	-2	Sep-15	-2	Jun-19
Gross Operating Surplus	SARB	-2	3	Mar-17	-3	Jun-19
Business Confidence: Manufacturing	BER	-1	1	Jun-16	0	Mar-19
Manufacturing Survey: Export Orders Received	BER	-1	0	Jun-15	-2	Mar-19
Business Confidence Index	BER	-1	-3	Jun-16	0	Jun-19
SACCI Business Confidence Index	Haver	-1	1	Mar-16	0	Mar-19
Median date based on all indicators				Dec-15		Dec-18
Median date where turning point is yet to happen				Jun-16		Jun-19
Median date of leading indicators		-3.7		Dec-15		Mar-19
Median date of coincident indicators (where actual data was at worst)		-3.3		Feb-16		Jun-18
Median date of lagging indicators (where pressures peaked)		-5.6		Sep-15		Nov-18

Source : Deutsche Bank

This analysis is highly depended on new data and how the domestic cycle will be influenced by the slowdown in the global business cycle. It makes it more important now than before that the China stimulus begin to bear fruit. Not only could this bear positively on the EU cycle, but it may well continue to prop up commodity prices. Terms of trade could be a supportive factor (especially for the income outlook), but if offset by export volume declines, the benefit shrinks.

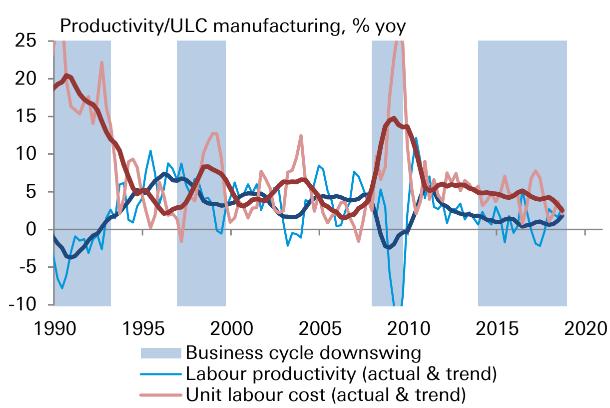
In turn, there are headwinds locally given electricity constraints that will remain a binding constraint on growth for the time being. Admittedly, the Minister of Public Enterprises, Mr Pravin Gordhan, recently confirmed that the extent of electricity load-shedding will be curtailed to no more than Stage 1 load-shedding (5% reduction in demand). We think this may be absorbed fairly easily by the economy, as it could shave around 0.1% of growth if limited to a week in total. In Q1, however, when there was in total 13 days of load-shedding (of which six days were Stage 4, 20% reduction in demand), we estimate the cost to the economy near R28bn (0.6% of GDP).

Every dark cloud has a silver lining

We note a few silver linings given current business cycle indicators:

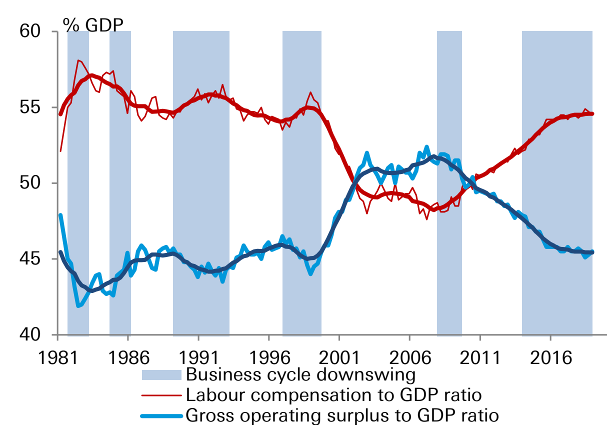
- The convergence between manufacturing wage growth and productivity has given rise to a significant drop in unit labour costs. This could spread to other sectors where labour costs are comparatively high. Given the poor outlook for employment, labour market slack will continue to weigh on the inflation outlook for the time being. This gives us some comfort that the risk of rate hikes has reduced. We have revised our expectations of the SARB policy rate to flat for the time being, with a 30% probability of a cut within the next year (see our recent note "QPM signals first cut" here).
- Both profit and wage growth contracted in real terms last year. The last time this occurred was in the early nineties and back-to-back downturns in the eighties. Typically, contraction in real incomes occur late in the cycle. As shown in Figure 48 , the "first dip" showed a sharp contraction in corporate profit in real terms, but not in wage growth. **Usually, wages have to adjust to "clear the market", or from a business cycle perspective, the unit price of labour needs to collapse.** Only then it has historically been shown that a coinciding collapse in income marks the end in the downturn, which now seems to appear evident (Figure 52). Clearly the ramifications of the first dip of the cycle where the profit recession coincided with still high wage costs, could have triggered the cause for the second dip.

Figure 51: Manufacturing ULC at lowest in more than ten years



Source : SARB, Deutsche Bank

Figure 52: Converging income shares usually a sign of tipping points



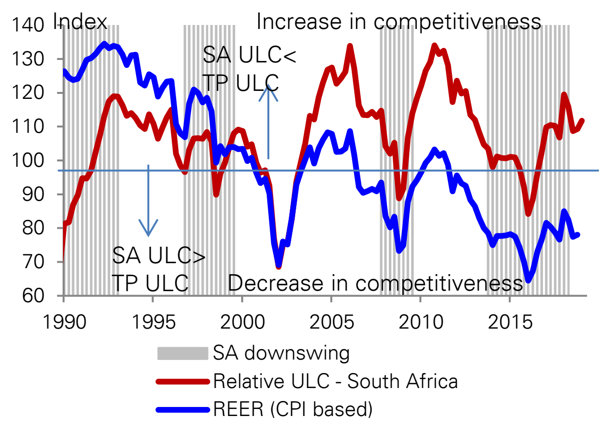
Source : SARB, Deutsche Bank

What is important around the real contraction in income growth, is that this usually marks the start of converging wage and capital shares (economic upturn), which we have written about before. Simplistically, this implies that the gap between wage growth and labour productivity is narrowing, i.e., a drop in unit labour costs.

As this is already evident in the tradeable sector, there should be a recovery in competitiveness, supporting the outlook for export activity and eventually the investment drive. This trend is already underway in the manufacturing sector as highlighted in last month's note (see p85 here). As illustrated in Figure 53 below, it's important to judge this progress versus SA's main trade partner countries. To date, these developments are still supportive of an appreciating bias in the rand, but it remains to be seen wether the best is past us.

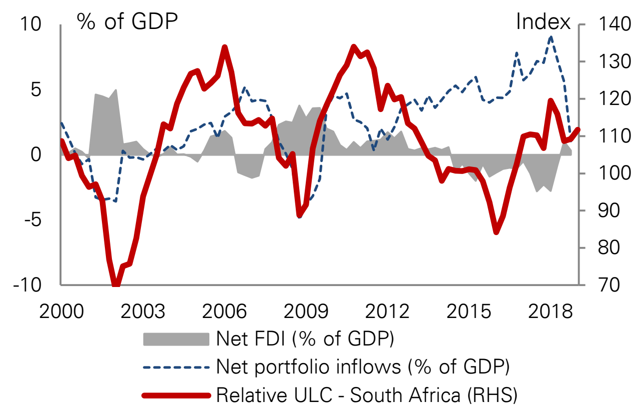
Typically improving unit labour costs in the tradeable sector have several financial market spin-offs—promoting capital inflows (Figure 54), lowering yields/cost of borrowing, supporting local asset prices—and macro economic spin-offs—lower inflation, improved export competitiveness, restoring purchasing power, etc. **Interestingly is the positive mix in capital flows that came about in 2H18, with the first net FDI inflows recorded since 2014.**

Figure 53: Relative trade-weighted ULC regaining momentum?



Source : Factset, Deutsche Bank, SARB

Figure 54: Typically supportive of capital inflows



Source : Factset, Deutsche Bank, SARB

Growth revisions still reflect uncertainty and pre/post election "drift"

In light of our findings and our team's revisions to global growth, we have reduced domestic growth to 1.4% (from 1.6%) in 2019, and to 1.5% in 2020 (from 1.9%). We now see household demand weaker than last year, slowing to 1.4% from 1.8%, given ongoing labour market pressure but also a deterioration in net wealth (led by negative property price and equity price trends). We remain of the opinion that capital investment would be negative this year, as corporate profits are unlikely to recover meaningfully until next year. There is also uncertainty on the progress in government capital investment stemming from concerns that the ANC could potentially lose election support in some regions where it still controls the purse strings (e.g., Gauteng).

Finally, inflation was revised slightly up to 4.7% in 2019 (due to recent oil price revisions), but down to 5.2% (from 5.5%) in 2020 on lower food inflation pressures, reduced electricity tariff assumptions and lower unit labour costs. As a **consequence, we now see the SARB keeping policy rates on hold at 6.75% (40% probability), with the probability of a rate cut vs rate hike scenario evenly balanced at 30%.**

One of the risks to any policy cuts is the destruction a double dip creates, especially if more cost cutting ensues and capacity is destroyed. Inflation risks could then typically surface faster as cost push factors offset the drag from labour market slack. As such, the SARB will be more sensitive to post-election data, making it less likely that a rate cut ensues this year. **For cost push inflation risks to be averted, we believe it's important that the productivity baton is passed from labour to capital (raising potential growth).** Indicators that are critical to monitor in this regard would include the BER's business confidence assessment on constraints to investments—e.g., demand and political uncertainty; expected business conditions and intentions to invest. An improvement in these indicators could also be indicative that last year's "Ramaphoria" will not be repeated.

However, fiscal metrics may yet again disappoint. We now expect deficits near 4.5% over the medium term, with particular concerns around the tax multiplier assumptions given our expectations of lower nominal GDP growth. This deserves a follow-up note. What matters though is that weaker growth and deteriorating fiscal metrics seem to be the consensus view. **Relative to peers, this deterioration is not necessarily out of kilter, which implies unchanged credit ratings scores for now.** As such, we have not changed our view on the currency, which we still see at R13.5/USD and R12.20/USD end 2019 and 2020, respectively, underpinned by our house view for euro-dollar.

Danelee Masia, Johannesburg, 27(11)775-7267

A quantitative toolkit for analyzing EM local bonds

Introduction - Where and how do we find value in EM local fixed income

When it comes to trading and investing in an asset class, it is crucial to assess both the current valuation and the expected return over the investment horizon. The former measures the dislocation between the market level and the fair value, thus helping investors decide the timing of entry, while the latter estimates the expected gains investors could earn by holding the asset for a certain period of time. EM local fixed income is no exception.

In this report, we provide a quantitative toolkit for analyzing the valuation of EM local bonds in a consistent and comprehensive manner. **In the first section**, we identify value across countries based on **fundamental valuation models**[4] . The model provides two value metrics - current valuation and expected returns, which serve as guidance for country allocations. **In the second section**, we look into choice of duration based on **term premium models** - level and distribution. **In the third section**, we focus on bond selection based on **calibrated curves** and the associated technical parameters. **In the fourth section**, we summarize all the model results on EM local bonds, based on the three models above. **In the last section,** we assess the risks to EM local bonds and conduct scenario analysis w.r.t. core rates.

Fundamental valuation model - Identifying value in EM local fixed income

- Our fundamental valuation model provides a useful guidance in our country positioning recommendations.
- The model generates two value metrics - current valuation and expected returns. The former measures the cheapness / richness of bonds implied by underlying drivers, while the latter estimates expected returns going forward.
- Based on both current valuation and expected returns at the year-end, the model implies to **overweight** Russia, Romania, Brazil, Peru, India and Indonesia, while **underweight** Czech Republic, Hungary, Israel, Chile, South Korea and Thailand.

Background

EM yields tend to move in tandem with macro variables such as policy rates and inflation (expectation), as well as financial variables such as CDS, FX and core rates. Unlike EM FX, EM yields are more idiosyncratic and capture more country-specifics on top of core rates. In this regard, it is necessary to identify what drives yields for each country. To this end, we first decompose yields into two components – risk neutral rates (RN) and term-premium (TP) (See Appendix A for the methodology). Then we pinpoint the underlying drivers for each component. RN is defined by

4 In this report, the fundamental valuation model and the bond valuation model are interchangeable

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the average of the current and future expected short-term rates. As such it depends on the trade-off between growth and inflation. Under an expectations hypothesis, RN is exactly the long-term rate observed in a risk-neutral world. In the real world where investors tend to be risk-averse, investors will require more than what RN provides. That's where TP comes in. TP, the residual after excluding RN from market yields, captures all the risk factors derived from policy/inflation/fiscal uncertainties, market volatility and appetite for risk. It therefore reflects the premium required to compensate risk-averse investors.

Decomposing the yield

By definition, variables related to monetary policy are the most relevant to RN. In its reduced form, RN simply follows the Taylor rule, as a function of inflation (expectation), output gap and FX (where it matters, such as Mexico, for example). In most cases, policy rate (with lags) explicitly serves as a (predominant) driver for RN, to capture the persistence and smoothing of policy rates. In contrast, **TP captures all risk factors beyond expectations.** Accordingly, its specification is more country-specific, since vulnerabilities vary across countries. Among others, policy rates and core rates play a crucial role in shaping TP, simply because central banks can deploy monetary policy to contain inflation risks, while risks in core rates tend to spill over to EM yields through liquidity and portfolio rebalancing channels. In addition to these variables, we find credit[5] , inflation and/or FX to be potential drivers for TP in some countries[6] . **In this sense, policy rates anchor the level of the curve, while all other relevant macro and financial variables determine the shape of the curve (both slope and curvature).**

To sum up, the valuation model for yields can be viewed as an extended Taylor rule augmented with various risk factors.

Combining the drivers for RN and TP

We show an example using Mexican 10Y bonds to illustrate how we derive the valuation models for bonds yields from the initial models for RN and TP[7] .

Figure 55: What drives Mexico's RN and TP

	RN					TP				
	Driver		Current level, %	Model implied, %	spread, bp	Driver		Current level, %	Model implied, %	spread, bp
Mexico	policy rate (+)	FX (+)	7.66	8.08	-42	policy rate (-)	UST (+)	0.27	-0.38	65

Source : Deutsche Bank, Bloomberg Finance LP

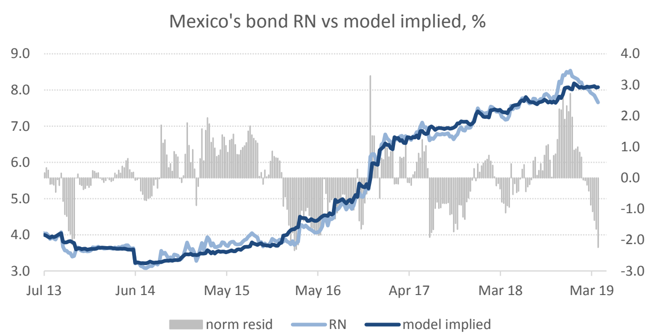
For Mexico, RN is positively driven by policy rate and FX (see the table above). The current level of RN is 7.7%, lower than what is implied (8.1%) by the current level of policy rate (8.25%) and FX (19.0). Interestingly, RN, the neutral rate from market perspectives, has been declining since the end of last year, which is in line with the market pricing implied by short-term forward rates.

5 CDS serves as a driver for some countries, where fiscal condition is a major issue (e.g. Brazil and Colombia), or where CDS tends to capture the geopolitical risk (e.g.Russia and Turkey).
6 We show TP's drivers for each country in the second section.
7 Bond yields used in our model are ones for constant maturity bonds for all bond yields

Mexico's TP, on the other hand, is driven by policy rate and UST 10Y. The former compresses TP, while the latter does the opposite. Currently its TP (0.3%) is too high compared to the model level (-0.4%) implied by its drivers.

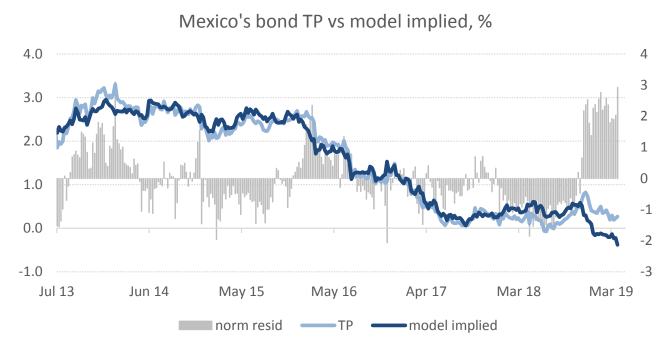
What does this imply for the 10Y local bond yields in Mexico? Since the yield is simply the sum of RN and TP**,** we conclude Mexico's 10Y yield is significantly higher than what the drivers imply, with the dislocation in TP (~3.0 std.dev) outweighing that in RN (~-2.0 std.dev).

Figure 56: Mexico - the market is pricing cuts more aggressively than implied by the underlying drivers...



Source : Deutsche Bank, Bloomberg Finance LP

Figure 57: ... while its TP is too high compared to its drivers



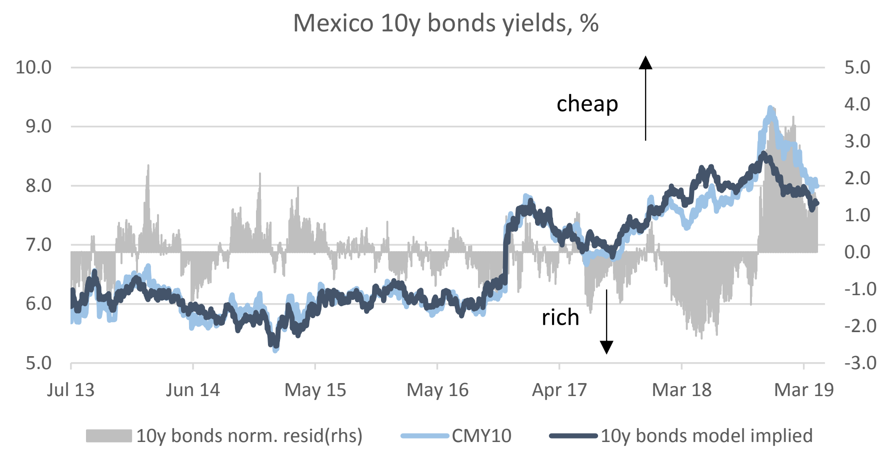
Source : Deutsche Bank, Bloomberg Finance LP

Formulating the Fundamental Valuation Model

Now we are in a position to assess the effect on bond yields of the underlying drivers in a more direct manner, based on the "extended Taylor rule" and the drivers for RN/TP respectively. To this end, we regress the level of yields on the level of relevant drivers. We use daily data of constant maturity yields at 2Y, 5Y and 10Y for the post taper-tantrum period.[8] As implied by RN and TP, Mexico's yields are too high compared to their underlying drivers as the charts below show. The table below summarizes the model specification for each country.

8 The rationales behind the choice of time periods include: a). The post taper-tantrum period is a new cycle for EM in terms of liquidity environment; 2). The duration for an EM country's economic cycle tends to be 4~6 years on average.

Figure 58: Mexico's 10Y bonds look cheap compared to model implied levels



Source : Deutsche Bank, Bloomberg Finance LP

Figure 59: Drivers for bond yields

	Yield drivers					
country	**short-end rates**	**inflation**	**FX**	**CDS**	**UST 10y**	**EUR swap 10y**
Czech Republic	x	x				x
Hungary	x	x				x
Israel	x					x
Poland	x	x				x
Romania	x	x				x
Russia	x	x		x		
South Africa	x	x	x		x	
Turkey	x	x	x	x		
Brazil	x	x		x		
Chile	x		x	x	x	
Colombia	x	x		x	x	
Mexico	x		x		x	
Peru		x	x	x	x	
India	x	x			x	
Indonesia	x			x	x	
Malaysia	x	x	x	x	x	
South Korea	x	x			x	
Thailand	x	x			x	

Source : Deutsche Bank, Bloomberg Finance LP

Current Valuation vs. Expected Return

Before we present the full model results, we introduce two value metrics: current (bond) valuation and expected return (at the end of the investment horizon). Both are derived from the same model. While bond valuation evaluates the current richness/cheapness of (10Y) local bonds implied by underlying drivers, expected return incorporates macro forecasts to calculate a holding-period return for a pre-defined period.

Current valuation - This metric quantifies the current dislocation. Based on the valuation model, we can obtain the model implied yields (or the “fair” yields). **We measure the current dislocation in yields by the normalized residuals between the market level and the model implied level.** So a positive normalized residual implies that the market level of yields is higher than the "fair" level, and thus the bonds look cheap compared to what is implied by underlying drivers.

Expected return - We forecast yields at the end of holding period, based on the model structure and the forecasted values of underlying drivers made by our economists and the European/US Strategy team (forecasts for core rates). Currently, for this exercise, we focus on forecasts at the end of this year (2019). Note that any other time period is possible.

Calculation of Bond Valuation and Expected Return:

First, we calculate the year-end yield (**C**) by adding to the current market level (**A**) the delta(beta times the change in underlying drivers between the year-end and the current).

Second, we calculate the year-end yield (**D**) by adding the same delta to the current model implied level (**B**).

Yield C indicates where the yields are likely going in a short period of time given the current dislocation, while yield D is the "fair value" of yields at the year end.

Next, we take the simple average of these two numbers (C and D) to obtain the model forecast at the year-end (**E**). For this, we assume the market yield level at year-end will converge to the model implied level at the year end.

Last, we calculate the expected return on bonds held until the end of the holding period (the end of year in this example), using the current market level of yields, the forecasted yields at the end of the period, and the bonds' coupon income.

Note: For now we use the simple average of C and D to obtain the year-end yield forecasts E. Generally speaking, the further away we are from the year-end, the more likely the year-end yields will be closer to number D, which is based on the current model implied level. By contrast, the closer we are approaching the year-end, the more likely the year-end yields will be closer to number C, which is based on the current market level. More rigorously, the weights on C and D should vary with the horizon till the year-end, and should be country-specific, depending on the half-life of mean-reverting statistics.

We take Mexico again as an example. For Mexico, we expect the policy rate to be lowered to 8.0% with one cut and FX to hit 19.8 at the year-end. DB official forecasts for UST 10Y at the year-end is 2.4%. These inputs imply the delta to be -1bp. Given the current market yield (7.99%) and the model implied (7.70%), the model suggests the year-end yield be 7.83%.

Figure 60: Deriving year-end forecasts for 10Y yields

Country	Current		End '19		
	market level (A)	model implied (B)	C (based on A)	D (based on B)	model forecast E
Czech Republic	1.90	1.91	2.46	2.47	2.46
Hungary	2.90	2.99	2.95	3.32	3.13
Israel	1.98	2.05	2.45	2.52	2.48
Poland	2.80	3.13	3.07	3.40	3.24
Romania	4.91	4.82	5.06	4.97	5.02
Russia	8.29	7.58	8.29	7.58	7.93
South Africa	8.92	8.95	8.90	8.93	8.91
Turkey	17.49	18.82	16.10	17.43	16.76
Brazil	8.98	9.77	8.68	9.47	9.08
Chile	4.05	4.40	4.08	4.44	4.26
Colombia	6.47	6.55	6.62	6.70	6.66
Mexico	7.99	7.70	7.98	7.69	7.83
Peru	5.20	5.33	5.25	5.38	5.31
India	7.40	6.97	7.33	6.89	7.11
Indonesia	7.61	7.43	7.44	7.26	7.35
Malaysia	3.78	3.83	3.82	3.87	3.85
South Korea	1.88	2.47	2.07	2.66	2.36
Thailand	2.43	3.14	2.43	3.14	2.78

Source : Deutsche Bank, Bloomberg Finance LP

The Bond Valuation Model results - how to read the table

The (10Y) bond table consists of three panels: 1) The current valuation (ranking based on the dislocation vs the fair value), 2) Year-end forecast rankings based on the FX-hedged returns and 3) a combined ranking (average of the two sub-rankings).

<u>The "Current" panel</u>

- **Market level:** The current market yield of the 10Y local bonds (constant maturity)

- **Model implied:** The fair yield of the 10Y local bonds yields implied by the underlying drivers
- **Spread (bp):** The difference between market yield vs model implied yield
- **Normalized resid:** Normalized residuals to measure the current dislocation. The larger the number, the "cheaper" the bonds.
- **R^2:** Assessing the fit of valuation models.
- **Valuation ranking:** Ranking for current valuation based on the current dislocation (normalized residuals)

The "End-19" panel

- **Yield forecast – model:** model yield forecasts (E) obtained by the simple average of yield C and D discussed in the previous section.
- **Yield forecast – DB:** DB 10Y bond yield forecasts based on model forecasts, with adjustments due to technical and subjective factors.
- **Local ccy (duration) return based on DB year-end forecast:** the expected return on bonds in local currency based on DB yield forecasts. The return consists of two components: capital gain and yield income. The former comes from the yield change between the year-end forecast and the current level (both duration and convexity), while the latter comes from coupon income or carry and roll[9] .
- **FX implied yields:** holding period FX implied yield until year-end (vs USD).
- **FX-hedged return:** "excess return" defined by the difference between local currency (duration) return and the holding period FX implied yield.[10] .
- **FX-hedged return ranking:** ranking the FX-hedged return from the highest to the lowest.

9 Here we use the yield to maturity (prorated according to the holding period) to approximate the coupon income.

10 Foreign investors earn the FX-hedged return by borrowing USD funds, investing in local bonds while buying FX forwards. Denote FX-hedged return by r_hedged, local ccy (duration return) by r_lcy, US funding cost by libor, and FX spot by S and FX forward by F. Then we have 1+r_hedged = S*(1+r_lcy)/(F*(1+libor)), and then r_hedged = r_lcy – FX implied yields by Covered Interest Parity. Here we don not take into account over- or under-hedging. So the number is approximated FX-hedged return. Note: Foreign investors bear the US funding cost either directly through leverage (for hedge funds) or indirectly through opportunity cost (for real money). To compare with the returns on hard currency, usually we add the US libor rate to the returns shown in the table. But this does not change the ranking

Figure 61: 10Y bond valuation table

EM 10Y bonds valuation model

		Current						End '19					
Country	Combined ranking based on current valuation and expected return	market level	model implied	spread (bp)	normalized resid	R^2	valuation ranking	yield forecast: model	yield forecast: DB	local ccy (duration) return; DB fcst	FX implied yields	FX-hedged return (duration return - FX implied yields)	FX-hedged return ranking
Czech Republic	11	1.90	1.91	-1	-0.1	93%	6	2.46	2.40	-3.0%	1.1%	-4.0%	18
Hungary	10	2.90	2.99	-9	-0.3	89%	9	3.13	3.25	-1.3%	0.1%	-1.4%	12
Israel	13	1.98	2.05	-7	-0.4	93%	10	2.48	2.40	-2.1%	0.0%	-2.1%	15
Poland	15	2.80	3.13	-33	-1.1	73%	12	3.24	3.25	-2.4%	1.1%	-3.5%	17
Romania	4	4.91	4.82	9	0.5	91%	5	5.02	4.90	3.6%	2.9%	0.7%	5
Russia	2	8.29	7.58	71	1.3	88%	2	7.93	8.00	7.9%	5.5%	2.4%	3
South Africa	8	8.92	8.95	-3	-0.2	86%	8	8.91	9.20	4.8%	5.2%	-0.4%	9
Turkey	13	17.49	18.82	-133	-1.4	91%	15	16.76	16.00	18.9%	19.6%	-0.7%	10
Brazil	7	8.98	9.77	-79	-1.2	87%	14	9.08	9.00	6.5%	4.1%	2.4%	2
Chile	15	4.05	4.40	-35	-2.1	69%	16	4.26	4.30	0.6%	2.1%	-1.5%	13
Colombia	8	6.47	6.55	-9	-0.4	90%	11	6.66	6.60	3.7%	3.2%	0.5%	6
Mexico	4	7.99	7.70	29	1.2	93%	3	7.83	7.90	6.4%	6.1%	0.2%	7
Peru	6	5.20	5.33	-13	-0.1	81%	7	5.31	5.30	3.0%	3.0%	0.1%	8
India	1	7.40	6.97	44	1.5	84%	1	7.11	7.00	8.1%	5.3%	2.8%	1
Indonesia	3	7.61	7.43	18	0.9	89%	4	7.35	7.25	7.8%	5.8%	2.0%	4
Malaysia	11	3.78	3.83	-5	-1.2	63%	13	3.85	4.00	1.1%	2.3%	-1.2%	11
South Korea	17	1.88	2.47	-59	-2.4	83%	17	2.36	2.10	-0.6%	1.0%	-1.6%	14
Thailand	18	2.43	3.14	-71	-2.5	79%	18	2.78	2.70	-0.5%	1.7%	-2.2%	16
EM	-	**5.83**	**5.99**	**-16**	**-0.4**	-	-	**5.92**	**5.86**	**3.5%**	**3.9%**	**-0.4%**	-
CEEMEA		6.15	6.28	-13	-0.2			6.24	6.18	3.3%	4.4%	-1.1%	
LatAm		6.54	6.75	-21	-0.5			6.63	6.62	4.0%	3.7%	0.3%	
Asia		4.62	4.77	-15	-0.7			4.69	4.61	3.2%	3.2%	-0.1%	

Source : Deutsche Bank, Bloomberg Finance LP

Last, **in the "Combined ranking" panel,** we rank the 10Y bonds based on both the average of 1) The current valuation ranking and 2) The expected return rankings.

Assigning weights to "Current valuation" and "Expected return"

The weight on the current valuation and on the expected return actually depends on the investment horizons and on whether there is any structural change in the country. The current valuation indicates the timing of an entry point and implies the potential gain in the near future: the larger the positive dislocation is, the cheaper the bonds are currently trading and the more likely the yields will mean-revert back to the model fair value. Given that the current valuation (model dislocation) is based purely on historical patterns, it has trading implications mostly likely for a short horizon.

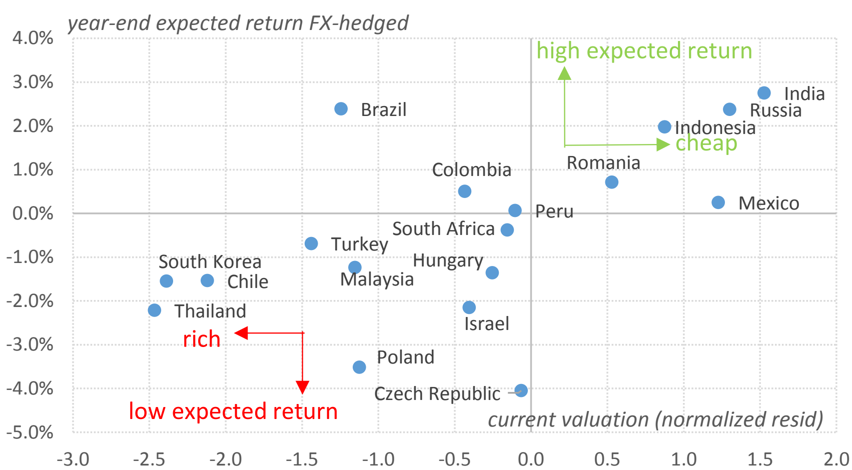
For a longer time horizon - in our case until end-19 - investors should assign more weight on expected returns. By doing so, the forward-looking dynamics of the underlying drivers - which reflect the investors' subjective views on fixed income relevant developments - are considered in the valuation process.

In addition, **for countries undergoing structural changes,** the model structure may not hold as well as in the past, and thus the model implications based purely on historical patterns are less indicative even for the near future. In this sense, **investors should also put more weight on expected returns**, which embody forward-looking views.

Current valuation vs Expected return

As the bond table above shows, 10Y bonds in India, Russia and Mexico currently look cheap, while Thailand, South Korea and Chile are rich. On the other hand, India, Brazil, Russia and Indonesia provide the highest FX-hedged returns at the year-end, while CEE3, Israel, Thailand and South Korea do the opposite. Overall, India, Russia and Indonesia are top ranked based on both metrics, while Thailand, South Korea and Poland are at the bottom of the scale. The scatter plot below summarizes the relationship between these two metrics. For most of the countries, the two metrics are roughly in line with each other, with the notable exception of Brazil, which is undergoing structural changes.

Figure 62: Current valuation vs expected returns



Source : Deutsche Bank, Bloomberg Finance LP.

Term Premium Model - Extend or shorten duration

- Our Term Premium Model serves as a reference in guiding our duration view for each curve.
- Term Premium (TP) is typically the main source of dislocation in bond valuation. Higher levels / percentiles of TP tend to imply higher expected returns on bonds held until the end of horizon.
- Our TP model suggests extending duration in Brazil, South Africa and Romania, while shortening duration in South Korea, Thailand and Mexico.
- Analyzing the cycles of TP and RN also helps in identifying value in EM fixed income.

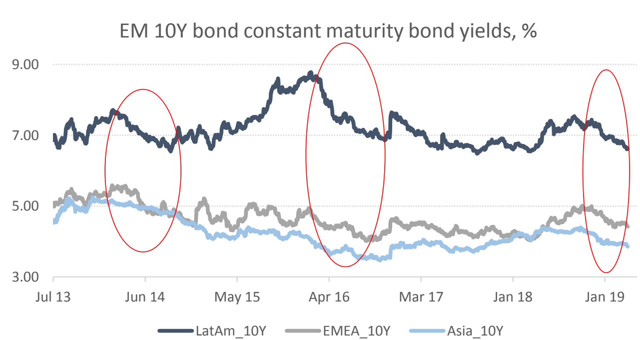
How does term premium help investors position on duration?

In the previous section, we introduced **current valuation** and **expected return** from the fundamental valuation model, which helps identify the overall value in local fixed income markets across EM. In this section we turn to **term premium** to address the question on how to position on duration.

The importance of term premium. Intuitively, high term premium implies value in extending duration, while low term premium implies the opposite. In this regard, TP serves as a solid metric to select duration exposure and provides an useful took for selecting EM local bonds. For investors who don't have a full set of bond valuation models across the EM, they can rely on TP (together with RN in some cases) to identity the sweet spots of local bonds.

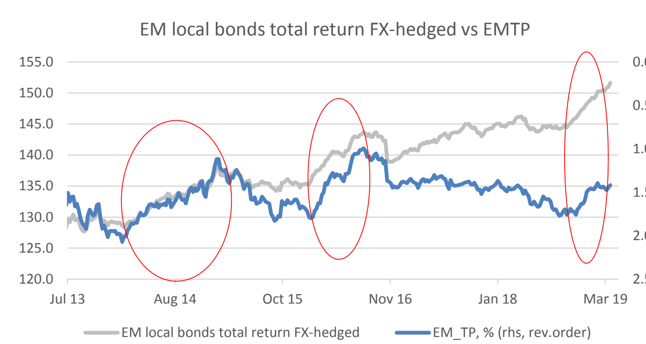
From an empirical perspective, as discussed in our previous report (please see here), **TP has been a crucial component of value and cushion for EM duration over the years.** As the chart below shows, over the past 6 years, the rally in EM fixed income is driven largely by the compression in TP.

Figure 63: EM local bonds have rallied since last November...



Source : Deutsche Bank, Bloomberg Finance LP

Figure 64: ... Similar to previous episodes, the recent rally has been driven largely by the compression of TP



Source : Deutsche Bank, Bloomberg Finance LP

In our model, we examine term premium both in the context of cross-country comparison and in the context of historical distribution (measured by the **percentile of term premium**). Through the latter, we attain a fairer comparison across EM in terms of TP, especially for those countries that tend to have high or low levels of TP over 6 years.

Term premium across countries - to extent or shorten duration? The table below ranks TP based on the current level and the percentile of TP (over the past 6 years). It also shows the drivers and the model implied level of TP.

Our model results show that TP is particularly high in Brazil, Romania and Hungary, and low in Turkey, South Korea and Mexico. Historically, the percentile of TP is high in India, South Africa and Brazil, and low in South Korea, Turkey and Israel.

Overall, extending duration looks most attractive in Brazil, South Africa and Romania, while it looks least attractive in Turkey, South Korea and Thailand. Based on the model, we suggest a neutral stance on Russia and the Czech Republic.

Figure 65: Term premium table

	combined ranking	TP, %	ranking	percentile of TP	ranking	TP drivers	model implied, %	norm. resid
Czech Republic	10	0.99	11	37%	7	infl, EU10	1.03	-0.3
Hungary	7	2.43	3	33%	11	policy, infl, EU10	2.52	-0.3
Israel	13	1.26	9	14%	16	policy, EU10	1.37	-0.7
Poland	8	1.62	7	35%	9	policy, infl, EU10	1.71	-0.7
Romania	3	2.51	2	38%	6	policy, infl, EU10	2.23	1.7
Russia	10	0.81	13	48%	5	policy, infl, CDS	0.48	1.0
South Africa	2	2.05	5	92%	2	policy, FX, UST	1.72	1.4
Turkey	17	-3.78	18	6%	17	TRLIB3m, FX, CDS	-4.31	0.9
Brazil	1	2.87	1	77%	3	policy, CDS	3.75	-1.5
Chile	12	1.23	10	33%	10	policy, UST	1.37	-1.6
Colombia	5	1.98	6	37%	7	policy, CDS, UST	2.14	-0.7
Mexico	15	0.27	16	17%	14	policy, UST	-0.38	2.9
Peru	8	2.12	4	28%	12	FX, CDS, INFL, UST	2.16	0.4
India	5	0.88	12	97%	1	infl, UST	0.40	1.9
Indonesia	4	1.49	8	65%	4	policy, CDS, UST	1.17	2.1
Malaysia	14	0.78	14	19%	13	policy, CDS, UST	0.89	-0.8
South Korea	17	0.23	17	5%	18	policy, UST	0.66	-2.7
Thailand	15	0.45	15	15%	15	policy, UST	0.90	-1.6

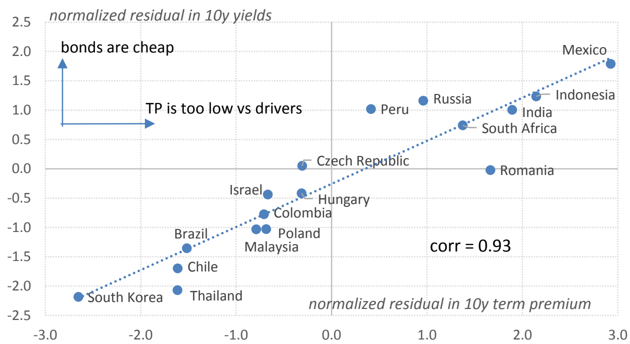
Source : Deutsche Bank, Bloomberg Finance LP

What does term premium tell us about overall bond valuation?

Since both the term premium model and the bond valuation models share almost the same structures, term premium has strong implications for bond valuation - both in terms of current valuation and expected returns. The chart below (left) shows that the dislocation in TP is tightly correlated to that in bond valuations. **In fact, TP tends to be the main source of dislocation in bond valuations**. In terms of the expected returns, the connection also holds: **a better rank in TP (based on both the level and the percentile shown in the TP table) tends to be associated with higher expected returns on 10Y bonds**, as the chart below (right) shows[11] . Bear in mind, however, that monetary policy cycles have been particularly long and slow-moving after the global financial crisis, so that risk (and thus TP) has been the dominant dynamic. This could change if policy normalization unfolds.

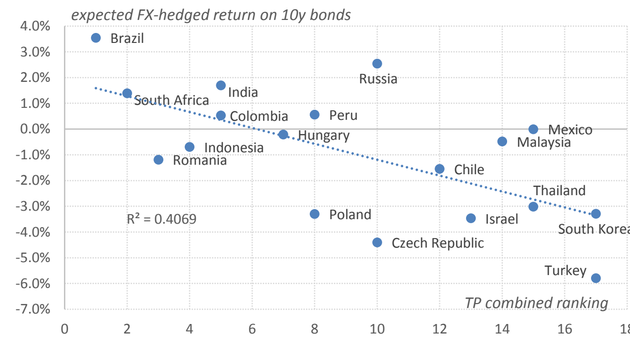
11 Rare exceptions to this could occur if there are large swings in monetary policy and thus in RN.

Figure 66: Dislocation in bonds valuation comes largely from that in TP



Source : Deutsche Bank, Bloomberg Finance LP

Figure 67: Higher levels / percentiles of TP imply higher expected returns for the holding period

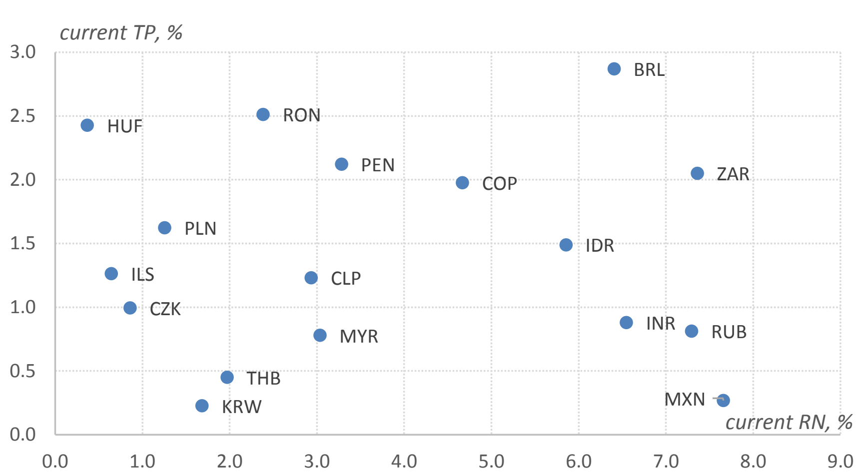


Source : Deutsche Bank, Bloomberg Finance LP. Note: The returns are based on model forecasts without any adjustments by technical factors that model doesn't capture for the sake of having a fair comparison between TP and bond valuation.

The value from RN/TP - looking into the future

Figure 68 shows the current RN vs current TP and indicates where the value would come from. **Brazil** and **South Africa** have both a high TP and a high RN. With BCB on hold this year, the value in Brazil will come largely from the further compression in TP, if the fiscal reforms make material progress. In South Africa, uncertainties in the fiscal prospects and the forthcoming rating update in November, combined with still elevated inflation pressure are major risks to the decline in both TP and RN, regardless of their currently high levels. **India**, **Mexico, Russia** and **Turkey** have substantial RN, which is expected to provide value across the curve on the back of dovish CBs, Turkey particularly. In addition, **Turkey**'s still low but rising RN provides Turkish local bonds more cushion than previously. **Colombia** and **Indonesia** have high RNs and sufficient levels of TP. The value in the former if any will come from the compression in TP, barring worsening fiscal prospects, while the value in the latter will come largely from the decline in RN. **Romania** and **Peru** have high TP and moderate RN, the value will result mainly from the compression of TP. By contrast, **South Korea**, **Thailand** and **Czech Republic** have both very low TP and RN and thus we don't see value left or duration extension. Please see Appendix B for detailed discussion on the cycles of RN/TP.

Figure 68: Current TP vs current RN: where is value left?



Source : Deutsche Bank, Bloomberg Finance LP

Bond calibrated curve model - How to pick the bond on the curve?

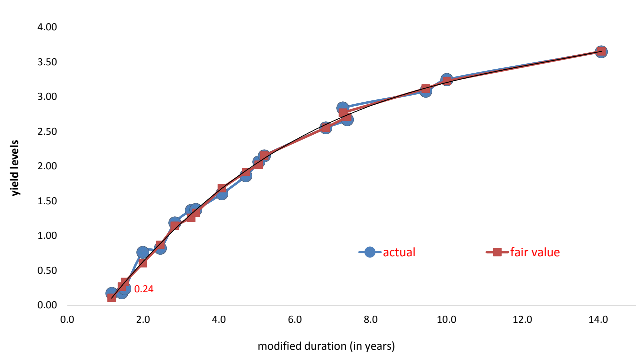
After we have identified whether a specific country provides value in fixed income and whether we see more value in being long/short duration, the question remains which bond to buy.

For this, we use an adjusted term-structure model based on Nelson-Siegel-Svensson. The spline curve fitted model (based on zero-coupon curves) is a bond fair value model to identify the dislocation (richness/cheapness) of a bond to the cash curve. By deriving a price for each bond, the model indicates where the price of a bond "should" trade based on bonds with similar characteristics.

The curve construction is only based on liquid bonds, however, we model a zero yield curve on a daily basis and from there derive the "fair value" for each bond - even if not included in the construction process. Nevertheless, we leave bonds out of the process with less than 3m of modified duration.

Historical richness/cheapness vs fair value Some bonds will always show up as rich/cheap given low/high liquidity (on-the-run/off-the run) or other factors (date of coupon payments, PD bonds). Hence comparing the cheapness/richness to the "actual fair value" can be misleading with a limited chance of near-term mean-reverting characteristics. Therefore, we don't just compare a bond's current value to the actual fair value, but also incorporate how the bond has been trading vs the mode price on a daily basis over the past three months.[12] [13] The latter feature is reflected in "pickup" in our bond valuation tables for each country.

Figure 69: The fitted yield curve - fair value vs market yields



Source : Deutsche Bank

Figure 70: Comparing current richness/cheapness to fair value and historical richness/cheapness - in bps

Source : Deutsche Bank

Although the bond calibrated curve model is important in evaluating richness/cheapness for specific bonds, when picking the most attractive bond on the curve, additional factors should be considered as well - particularly ASW-spreads, Carry/Roll and Volatility. **Below we show the bond valuation table for Hungary (as of**

12
13 For the historical richness/cheapness longer/shorter periods could be considered. This said, we back-tested the time-period and found that a longer period (six months) is not quick enough in incorporating price sensitive events such as switch-auctions/buy-backs or new benchmark bonds being issued into the average historical richness/cheapness. Further, longer period would exclude new issued bonds for a too long time from our "bond valuation rankings".

10-Apr-19) and explain the table input variables.

Terminology:

- **Model spread -** is the calibrated fair spread using our term structure model
- **Rich/Cheap -** reflects the difference between market spread and model spread.
- **Pickup -** richness/cheapness relative to the long-term richness/ cheapness (3m)
- **In the range bar chart,** the light blue area shows the 10% to 90% range of the past one year (6m for rich/cheap range bar); the dark blue shows the 25% to 75% range; the dot indicates the current level.
- **Carry** is the accrued premium over the next 3 months. Roll is the gain of holding such a position over the next three months due to curve decay. Total is the sum of carry and roll, representing the steady-state return.
- **Break-Even (B/E) sum of carry and roll** is also the amount of spread change over the next 3 months which would offset the steady-state returns (carry/ and rolldown) of a dv01-neutral long position.
- **Vol** - Volatility is measured as the annualized standard deviation of the 3m change in the underlying bond over the past 252 trading days.
- **Ratio** is defined as vol adjusted carry/roll and it is not calculated for negative carry/roll.

Figure 71: Bond valuation table for Hungary

Hungary

Bond	Maturity	Amount outstanding (USD bn)	Amount issued in auctions YTD (USD bn)	Amount issued in switches YTD (USD bn)	Liq	Rank	Dur	Yield in %	YTM change (bp) 1d	YTM change (bp) 1w	YTM change (bp) 1m	Carry/Roll (3m) B/E	Carry/Roll (3m) Vol	Carry/Roll (3m) Ratio	Rich (-) / Cheap (+) current (bp)	Rich (-) / Cheap (+) avg (bp)	Rich (-) / Cheap (+) pickup (bp)	Rich (-) / Cheap (+) pickup z-score (3m)	Rich/Cheap (3m) -20 30	ASW: bond - swap Level	ASW: bond - swap Z-Score (1Y)	Change 1d	Change 1w	Change 1m	Range 12m -40 100
20/B	Jun-20	2.2	-	-	L1	1	1.17	0.17	3	6	-10	17.0	47.3	0.4	7	-1	8	2.5		-28	-1.3	6	7	6	
20/C	Sep-20	1.1	-	-	B	13	1.44	0.18	0	1	-26	16.4	46.6	0.4	-9	-8	-2	-0.4		-37	-1.4	4	1	-9	
20/A	Nov-20	2.0	-	-	L1	18	1.52	0.24	-2	1	-28	16.9	50.1	0.3	-10	-7	-3	-0.7		-35	-1.3	2	1	-10	
21/C	Apr-21	2.6	0.3	-	L2	10	1.99	0.76	-3	7	-22	22.8	51.2	0.4	16	18	-2	-0.7		4	-1.7	1	5	-3	
21/B	Oct-21	2.3	-	-	L1	9	2.45	0.82	-1	10	-16	20.3	49.7	0.4	-5	-6	1	0.3		-4	-1.0	3	7	5	
22/A	Jun-22	3.4	-	-	L1	12	2.83	1.18	0	7	-22	20.4	51.8	0.4	4	9	-5	-1.2		16	-1.0	5	2	1	
22/C	Aug-22	0.3	0.3	-	B	3	3.27	1.37	0	7	-13	21.1	49.4	0.4	11	12	-1	-0.7		31	-0.1	4	2	11	
22/B	Oct-22	3.8	-	-	L1	2	3.39	1.38	-2	6	-17	20.3	46.9	0.4	5	3	2	0.4		27	0.1	3	0	7	
23/A	Nov-23	3.5	-	-	L1	5	4.07	1.60	-1	10	-14	17.9	51.9	0.3	-8	-14	5	1.6		27	0.4	4	4	9	
24/B	Jun-24	3.1	-	-	L1	14	4.71	1.86	-2	9	-18	17.2	57.5	0.3	-5	-3	-3	-1.0		42	-0.4	4	2	4	
24/C	Oct-24	2.1	0.8	-	L1	11	5.04	2.07	-2	9	-16	17.3	52.2	0.3	4	7	-2	-1.0		56	0.2	4	3	5	
25/B	Jun-25	4.2	-	-	L1	17	5.19	2.15	-2	4	-17	16.2	55.1	0.3	0	5	-5	-2.7		53	0.5	4	-2	3	
26/D	Dec-26	2.1	-	0.5	L1	15	6.82	2.55	-5	7	-11	14.3	58.1	0.2	0	3	-3	-1.5		70	0.5	1	1	6	
27/A	Oct-27	4.2	0.2	-	B	6	7.38	2.67	-2	11	-1	13.2	58.4	0.2	-4	-7	3	2.2		70	0.9	4	6	15	
28/A	Oct-28	1.4	-	0.5	L2	4	7.27	2.84	-4	7	-4	13.0	56.5	0.2	7	0	6	1.3		75	1.9	4	4	11	
30/A	Aug-30	0.5	0.4	-	B	16	9.45	3.08	-4	8	-12	10.8	52.4	0.2	-4	0	-4	-1.4		80	1.3	4	5	2.42	
31/A	Oct-31	0.7	-	-	B	8	10.01	3.25	-3	8	0	10.2	48.3	0.2	2	3	-1	-0.2		85	1.3	5.22	6	13.3	
38/A	Oct-38	0.2	0.1	-	L2	7	14.09	3.65	-5	15	-2	7.1	31.1	0.2	0	-1	0	0.4		80	0.6	3.69	12.7	14.2	

Source : Deutsche Bank

How to select bonds? The best bonds in each country have the lowest rank. The selection process is based on a) recent price action (10%), b) steady-state return characteristics (carry/roll) (25%), c) rich/cheap analysis (50%) and d) basis analysis (15%). The bond selection can change on a daily basis. Note, in the final ranking, we don't include bonds with less than three months of data available. It is also worth keeping in mind, that the attractiveness of the bonds can change on a daily/weekly basis and is therefore more volatile than our country views (based on the fundamental model) and our term premium model.

Figure 72: Weightings for bond valuation across countries

Price action				Carry/Roll			Rich/Cheap Analysis				Basis analysis				
1d	1w	1m	Total	3m B/E	Vol	Total	current	pickup	z-score	Total	z-score	absolute	1m	Total	Total
			10%			25%				50%				15%	100%
20%	30%	50%	100%	70%	30%	100%	30%	60%	10%	100%	34%	33%	33%	100%	

Source : Deutsche Bank

Results for Hungary: Our term premium model implies high absolute term premium (compared to EM peers), however, historically, TP rather back at the long-term average. Hence Hungary is now ranked in the top thrid (7th). Nevertheless, given our ongoing concern on elevated inflation pressure, and our underweight on Hungary - based on the Fundamental Valuation Model and the Expected Return Model, we suggest to express a neutral view on duration in Hungary. We would therefore recommend to buy the best ranked bonds in the belly of the curve. At the moment, these are 22/C, 22/B and 23/A.

The local bond valuation tables are published on a weekly basis for CEEMEA/LatAm in our EM Local Rates Monitor and for CEEMEA on the website on our daily CEEMEA Local Rates Update .

A model-implied portfolio - What the metrics imply for the portfolio construction process

All three metrics - **bond valuation, expected return** and **term premium** - are important factors to identify value in local fixed income markets. When creating a final EM local bond portfolio, despite the strong predicting power of the three metrics, adjustments have to be made in regards to 1) supply/demand dynamics, 2) positioning, 3) flows, 4) credit risks, 5) political developments and 6) the external backdrop. To that end, our EMFI Scorecard is a more comprehensive metric. The EMFI Scorecard evaluates local fixed income markets on a basis of a number of fundamental and technical factors that are generally considered to be important drivers of EM Fixed Income. The EMFI Scorecard consists of 9 variables - with the three discussed in this piece being included. Please see here for the latest publication.

Nevertheless, also the EMFI Scorecard cannot exhaust all the potential drivers of EM Fixed Income. At the end of the day, a subjective strategy view on each country (fixed income market) remains a key input in any successful portfolio selection.

Below, we provide a model-implied portfolio purely based on the three metrics introduced in this report. **Please note that the portfolio selection may and in fact does differ from our current outstanding strategy views due to the additional considerations mentioned above when finalizing an EM Fixed Income Portfolio.**

For a detailed overview on our current views in CEEMEA, please see here: CEEMEA Strategy – Where is the value in Fixed Income

Figure 73: Model-implied EM local bond portfolio

Model-Implied EM Local Bond Portfolio			
Country	**Country view**	**Duration**	**Model-Suggested Bonds**
Czech Republic	neutral	neutral	Sep-22, May-24
Hungary	neutral	neutral	22/B, 23/A
Israel	modest underweight	short	Jan-21, Mar-23
Poland	underweight	neutral	Jan-23, Apr-24
Romania	overweight	long	Feb-25, Apr-26, Sep-31
Russia	overweight	neutral	Jul-22, Sep-26
South Africa	neutral	long	R2037, R2040
Turkey	underweight	short	Mar-22, Jan-23
Brazil	overweight	long	NTNF 27s
Chile	underweight	short	BTP 22s
Colombia	modest overweight	long	COLTES 28s
Mexico	overweight	short	Mbonos 38s vs 20Y TIIE
Peru	overweight	long	PERUGB 28s
India	overweight	long	-
Indonesia	overweight	long	-
Malaysia	neutral	short	-
South Korea	underweight	short	-
Thailand	underweight	short	-

Source : Deutsche Bank

Assessing risks

As we already show in Figure 59 , core rates and CDS are two key financial drivers for TP andthus the duration for bonds. Here we show the beta to these two drivers at tenors of 2Y, 5Y and 10Y for both bonds and swaps in Figure 75 .

Beta to core rates: Across tenors, the long(er)-end is more sensitive than the short(er)-end. This pattern of incremental beta is more salient in Mexico and CEE countries, while is less so in most LatAm and Asian countries. Across countries, Czech Republic, Mexico and Hungary are the most sensitive, while Brazil, Russia and Turkey are hardly affected.

Beta to CDS: Across tenors, 5Y and 10Y have the largest sensitivity in countries that are exposed to CDS. Across countries, Brazil, Russia, Indonesia and Colombia re the most susceptible to either fiscal prospects or geopolitics. Other countries have subdued or little sensitivity to CDS.

The beta analysis provides us a guidance on how EM local yields will behave given shocks to key financial/external drivers. When we have bullish views on core rates, high (core rate) beta countries could potentially benefit from the re-pricing in core rates more than peers. Otherwise, those high beta countries could suffer larger loss in tandem with core rates sell-off. Regarding CDS, if we expect countries to embrace bright fiscal prospects, or to face subdued geopolitics, then high beta countries would benefit thought the compression in TP.

Note: Betas in the table are the coefficients of core rates and CDS in the valuation model. The EM yields, core rates and CDS are in pp unit, so a reading of "1.2" means a 100bp shock to core rates / CDS leads to 120bp rise in yields. Readings of "0" means either the coefficients are insignificant, or that adding the variable doesn't raise adjusted R^2.

The table on the right summarizes risks to duration. We find core rates are the crucial risk to duration. To quantify how core rates will affect 10Y yields forecasts and thus the expected returns at the year end, we conduct a full range of scenario analysis. Assume at the year end, the range of UST 10Y is from 2.0% to 3.4%, and that of EUR swap 10Y is from 0.1 to 1.5. DB official forecasts for the two rates at the year end are 2.4% and 0.9% respectively. Based on the valuation model, there is a model forecasted yield associated with a number of core rates. Then we form a range of forecasted yields at the year end for each country and accordingly a range of expected FX-hedged returns at the year end. Because of the linear model structure, expected returns are most sensitive to core rates in Czech Republic, Mexico and Hungary, while are insensitive in Brazil, Russia and Turkey.

Figure 74: Risks to duration

Country	Risk to duration extension
Czech Republic	higher core rates, higher inflation
Hungary	higher core rates, higher inflation
Israel	higher core rates
Poland	higher core rates
Romania	higher core rates
Russia	geopolitics
South Africa	worsening fiscals, higher inflation
Turkey	geopolitics/fiscals, weaker FX
Brazil	underdelivery of fiscal reforms
Chile	higher core rates
Colombia	worsening fiscals, higher core rates
Mexico	weaker FX, higher core rates
Peru	higher core rates
India	higher core rates
Indonesia	higher core rates
Malaysia	higher core rates
South Korea	higher core rates
Thailand	higher core rates

Source : Deutsche Bank, Bloomberg Finance LP.

Figure 75: Beta to core rates and CDS

	Bonds					
	beta to core rates			beta to CDS		
	2Y	5Y	10Y	2Y	5Y	10Y
Czech Republic*	0.3	0.8	1.2	0.0	0.0	0.0
Hungary*	0.0	0.5	0.8	0.0	0.0	0.0
Israel*	0.0	0.2	0.6	0.0	0.0	0.0
Poland*	0.2	0.4	0.4	0.0	0.0	0.0
Romania*	0.5	0.4	0.6	0.0	0.0	0.0
Russia	0.0	0.0	0.0	1.1	1.3	1.2
South Africa	0.1	0.4	0.6	0.0	0.0	0.0
Turkey	0.0	0.0	0.0	0.7	0.8	0.7
Brazil	0.0	0.0	0.0	0.7	1.1	1.2
Chile	0.4	0.4	0.4	0.3	0.4	0.3
Colombia	0.4	0.5	0.3	0.6	0.9	1.1
Mexico	0.3	0.7	1.0	0.0	0.0	0.0
Peru	0.0	0.4	0.6	0.1	1.0	1.1
India	0.5	0.6	0.5	0.0	0.0	0.0
Indonesia	0.5	0.7	0.7	1.3	1.3	1.2
Malaysia	0.3	0.3	0.4	0.0	0.0	0.2
South Korea	0.3	0.5	0.5	0.0	0.0	0.0
Thailand	0.2	0.5	0.6	0.0	0.0	0.0

Source : Deutsche Bank, Bloomberg Finance LP. Note: countries with '' mean core rates are 10Y EUR swap rates. Otherwise, core rates are UST 10Y.*

Figure 76: Scenario analysis for expected returns on 10Y bonds held until the year end

	expected FX hedged return on 10y bonds (until end '19) with different core rates															benchmark
UST 10y	2.00	2.10	2.20	2.30	2.40	2.50	2.60	2.70	2.80	2.90	3.00	3.10	3.20	3.30	3.40	2.40
EUR swap 10y	0.10	0.20	0.30	0.40	0.50	0.60	0.70	0.80	0.90	1.00	1.10	1.20	1.30	1.40	1.50	0.90
Czech Republic*	3.8%	2.8%	1.8%	0.8%	-0.1%	-1.1%	-2.1%	-3.1%	-4.0%	-5.0%	-6.0%	-7.0%	-8.0%	-8.9%	-9.9%	-4.0%
Hungary*	3.1%	2.6%	2.0%	1.5%	0.9%	0.3%	-0.2%	-0.8%	-1.4%	-1.9%	-2.5%	-3.0%	-3.6%	-4.2%	-4.7%	-1.4%
Israel*	2.0%	1.4%	0.9%	0.4%	-0.1%	-0.6%	-1.1%	-1.6%	-2.1%	-2.7%	-3.2%	-3.7%	-4.2%	-4.7%	-5.2%	-2.1%
Poland*	-1.0%	-1.3%	-1.6%	-1.9%	-2.2%	-2.6%	-2.9%	-3.2%	-3.5%	-3.8%	-4.2%	-4.5%	-4.8%	-5.1%	-5.4%	-3.5%
Romania*	4.7%	4.2%	3.7%	3.2%	2.7%	2.2%	1.7%	1.2%	0.7%	0.2%	-0.3%	-0.8%	-1.3%	-1.8%	-2.3%	0.7%
Russia	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%
South Africa	1.3%	0.8%	0.4%	0.0%	-0.4%	-0.8%	-1.2%	-1.6%	-2.0%	-2.4%	-2.8%	-3.2%	-3.6%	-4.1%	-4.5%	-0.4%
Turkey	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%
Brazil	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%
Chile	-0.2%	-0.5%	-0.8%	-1.2%	-1.5%	-1.9%	-2.2%	-2.6%	-2.9%	-3.3%	-3.6%	-3.9%	-4.3%	-4.6%	-5.0%	-1.5%
Colombia	1.4%	1.2%	1.0%	0.7%	0.5%	0.3%	0.0%	-0.2%	-0.4%	-0.7%	-0.9%	-1.1%	-1.4%	-1.6%	-1.8%	0.5%
Mexico	2.7%	2.1%	1.5%	0.9%	0.2%	-0.4%	-1.0%	-1.6%	-2.2%	-2.8%	-3.4%	-4.0%	-4.7%	-5.3%	-5.9%	0.2%
Peru	1.7%	1.3%	0.9%	0.5%	0.1%	-0.3%	-0.8%	-1.2%	-1.6%	-2.0%	-2.4%	-2.8%	-3.2%	-3.6%	-4.0%	0.1%
India	4.1%	3.8%	3.4%	3.1%	2.8%	2.4%	2.1%	1.7%	1.4%	1.0%	0.7%	0.3%	0.0%	-0.4%	-0.7%	2.8%
Indonesia	3.8%	3.4%	2.9%	2.4%	2.0%	1.5%	1.0%	0.6%	0.1%	-0.4%	-0.8%	-1.3%	-1.8%	-2.2%	-2.7%	2.0%
Malaysia	-0.1%	-0.4%	-0.7%	-0.9%	-1.2%	-1.5%	-1.8%	-2.1%	-2.4%	-2.7%	-2.9%	-3.2%	-3.5%	-3.8%	-4.1%	-1.2%
South Korea	-0.1%	-0.5%	-0.8%	-1.2%	-1.6%	-1.9%	-2.3%	-2.6%	-3.0%	-3.4%	-3.7%	-4.1%	-4.5%	-4.8%	-5.2%	-1.6%
Thailand	-0.3%	-0.7%	-1.2%	-1.7%	-2.2%	-2.7%	-3.2%	-3.7%	-4.2%	-4.7%	-5.1%	-5.6%	-6.1%	-6.6%	-7.1%	-2.2%

Source : Deutsche Bank, Bloomberg Finance LP.

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Appendix A: The decomposition of yields into TP and RN

We employ a regression-based method to estimate dynamic arbitrage-free term structure (DAFTS) models by following Antonio Diez de los Rios 2016 (ADR henceforth). Arbitrage-free conditions guarantee bonds with same risks (cross time and cross tenors) are exactly priced, which is the key to price term premium consistently. Log bond prices and yields are therefore linear in pricing factors that are extracted from observed yields.

The efficiency of the estimation is asymptotically equivalent to maximum likelihood estimation (MLE) widely used to estimate DAFTS models, which thus generates minimum information loss. Compared to MLE, the regression-based method is robust and easy to compute, and thus can be applied to a variety of term structures cross time and cross countries. In terms of model implemention and results, ADR is model is largely similar to NY Fed ACM term premium model. We replicated / applied both models to EM term structures and have maintained / updated EM term premium on a weekly basis based on ADR model.

Algorithm:

Step 1: Extract the first 3 principal components from zero yields as state variables (pricing factors).

Step 2: Run cross-section regressions of yields on pricing factors (obtained in Step 1) to get expected short rates.

Step 3: Estimate state transition equations (vector auto-regression on the pricing factors) to get relevant coefficients for use in Step 4.

Step 4: Derive risk-neutral rates (RN) on tenor n, which are defined by the average of current and expected future short rates.

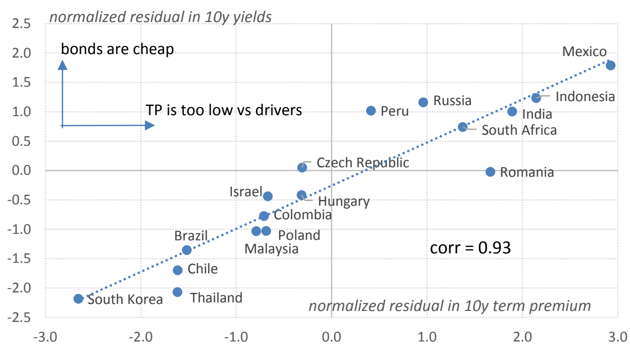
Step 5: Calculate TP as the difference between yields and RN, on each tenor.

Appendix B: The cycles of RN/TP

Since both the term premium model and the bond valuation models share almost the same structures, term premium has strong implications for bond valuation - both in terms of current valuation and expected returns. The chart below (left) show that the dislocation in TP is tightly correlated to that in bond valuations. **In fact, TP tends to be the main source of dislocation in bond valuations**. In terms of the expected returns, the connection also holds: **a better rank in TP (based on both the level and the percentile shown in the TP table) tends to be associated with higher expected returns on 10Y bonds**, as the chart below (right) shows[14] .

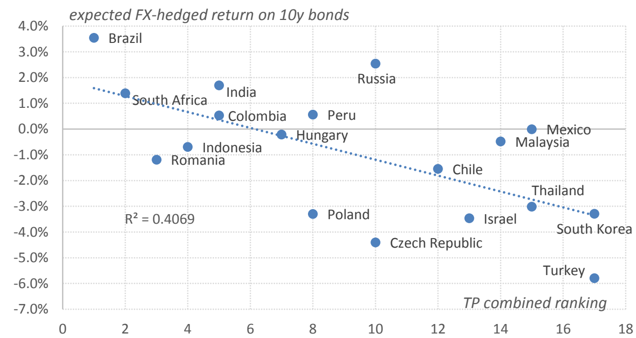
14 Rare exceptions to this could occur if there are large swings in monetary policy and thus in RN.

Figure 77: Dislocation in bonds valuation comes largely from that in TP



Source : Deutsche Bank, Bloomberg Finance LP

Figure 78: Higher levels / percentiles of TP imply higher expected returns for the holding period



Source : Deutsche Bank, Bloomberg Finance LP. Note: The returns are based on model forecasts without any adjustments by technical factors that model doesn't capture for the sake of having a fair comparison between TP and bond valuation.

Where do we stand in the TP/RN cycles?

So far we have discussed how to identify value across countries based on the fundamental valuation model, and how to form a duration view based on the term premium model. In this subsection, we analyze on the recent developments of TP/RN, from both historical and cross-sectional perspectives, and discuss where value would come from, given the current level of TP/RN and their potential dynamics going forward.

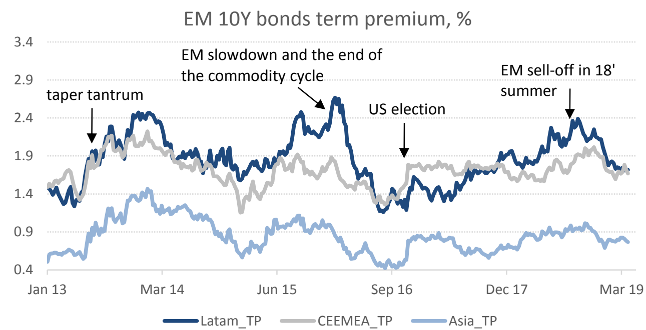
In an earlier report (please see here) published in early November '18, we highlighted the hefty cushion built between late '16 and late '18 due to rising TP across a large set of EM curves, and argued that those extreme levels (in last November) of TP could lead to a correction in the following months. Since early November in 2018, EM local fixed income has seen a broad-based strong performance, returning about 6.0% (FX-hedged). As a result, TP has compressed significantly to reflect the re-pricing of the core rates, as well as reduced inflationary risks associated with lower growth prospects. Meanwhile, risk-neutral rates (RN) have declined only moderately, reflecting the more dovish tones across EM central banks.

Since early November, TP has significantly declined from historical highs to below the average levels post-tantrum across all three regions. This accounted for the most of the recent rally in EM fixed income (FX-hedged). Given the ongoing global deceleration, our DM strategists see room for further flattening, which would provide (limited) scope for TP to compress further.

The cycles of RN/TP - looking into the past

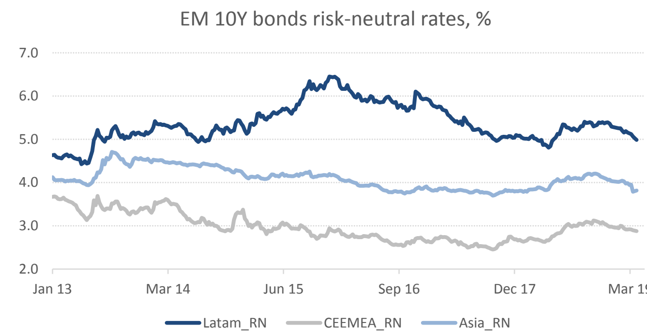
Past RN cycles - EM central banks entered easing cycles in early 2016 as global liquidity was tightened and the commodity cycle ended. From early 2018, CBs turned hawkish, as external liquidity conditions eased and inflationary pressure heightened. Since early this year, CBs have turned dovish again, on the back of the more dovish Fed, slower growth and subdued commodity prices. Accordingly, RN declined significantly in 2016-17 and bottomed out around early 2018. RN has been trending down this year and this has contributed to the outperformance of EM fixed income FX-hedged of late.

Figure 79: EM term premium has declined from historical highs since last November



Source : Deutsche Bank, Bloomberg Finance LP

Figure 80: EM central banks have turned more dovish since early this year

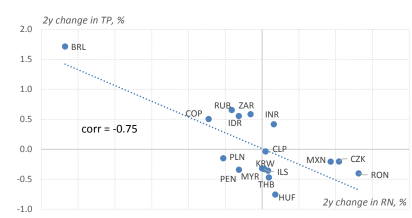


Source : Deutsche Bank, Bloomberg Finance LP

On the back of a dovish Fed, sluggish recovery and contained inflationary risks, we expect further re-pricing of RN in some countries. We see a decline in RN is likely happen in India, Indonesia, Malaysia, Russia, Turkey and Mexico through the course of this year. By contrast, RNs in Czech Republic, Israel and Chile are expected to rise. On aggregate, EM RN is running near historical lows (less so in Asia), so the further decline in RN is limited, barring recession in the US and the EU.

Past TP cycles - As the chart above shows, the substantial TP accumulation between late'16 and late '18 has only been partially retraced. Initially, TP rose from historical lows in early 2016 on the back of policy easing and economic recover. The US elections in November 2016 boosted TP significantly in a short time period, as a by-product of core rate re-pricing. EM sell-off in last May and August / September further raised TP to almost historical highs. Since early November, TP has declined significantly, largely driven by the collapse of core rates and subdued inflationary risks. TP has stabilized somewhat of late. As the side chart shows, **TP and RN tend to be negatively correlated: higher RN – policy rate – tend to compress TP by suppressing inflationary pressure.**

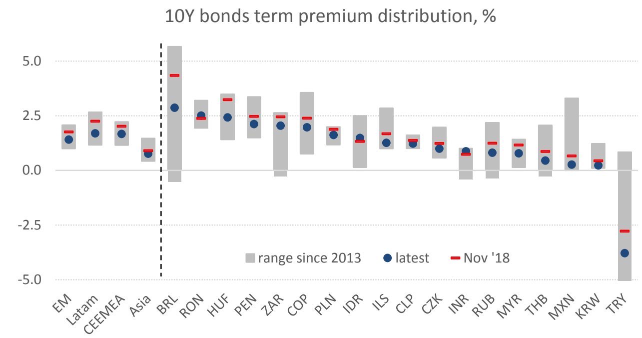
Figure 81: Term premium shrinks as risk-neutral rate rises



Source : Deutsche Bank, Bloomberg Finance LP

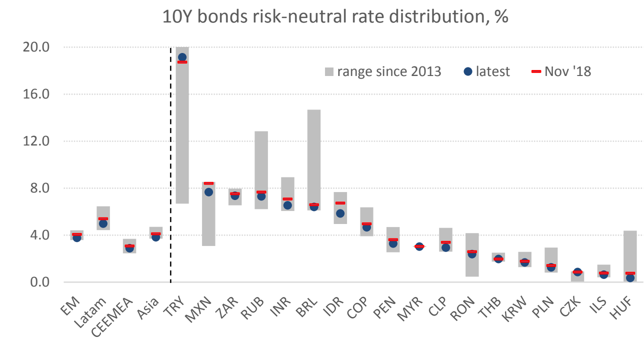
TP/RN distribution across countries: As the charts below show, TP and - to a lesser extent RN - have declined across the board since last November. On the country level, only in South Africa and India TPs hover around the higher-end of the distribution, while TPs in Peru, Israel, Chile, Czech Republic, Thailand, Mexico, South Korea and Turkey are at the lower-end of historic range. For RN, Turkey, Mexico and Czech Republic have hit historical highs, while Russia, India, Brazil, Colombia, Chile, Thailand, South Korea, Poland, Israel and Hungary are at the bottom of the distribution.

Figure 82: Since last November, EM TP has compressed noticeably to the mid-sector or lower-end of the distribution cross the board...



Source : Deutsche Bank, Bloomberg Finance LP

Figure 83: … while only a slight decline happens to RN



Source : Deutsche Bank, Bloomberg Finance LP

Asia Economics

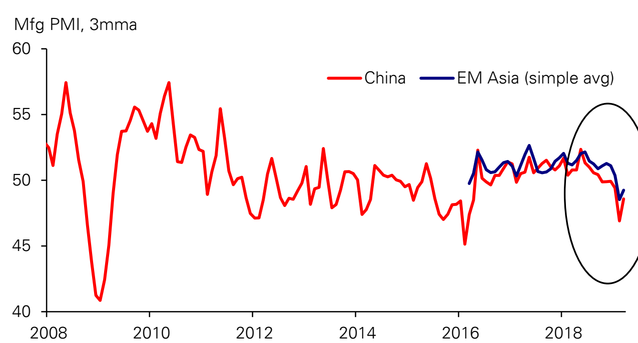
Structural constraints on Korea's policy

There are signs of stabilization in EM Asia's growth, which is consistent with our expectation. Not only have the region's PMIs rebounded, pointing to a bottoming out of exports, data for China point to stabilization in its land and property markets, suggesting a halt to the slowdown. Moreover, the region could enjoy strong tail-winds from a US-China trade deal in a month's time, although the EU remains a point of concern, as Brexit risks hover over the region. Assuming that such a tail risk is contained, we continue to expect EM Asia to establish a trough on production and trade in Q2, with stimulus policies providing additional support. In this regard, Korea continues to stand out in its policy conservatism due to concerns over the economy's structural challenges, reserving aggressive policy responses for a crisis. In this report, we also discuss in detail the state of the Korean economy and its policy responses in the face of structural constraints.

Signs of EM Asia's growth bottoming

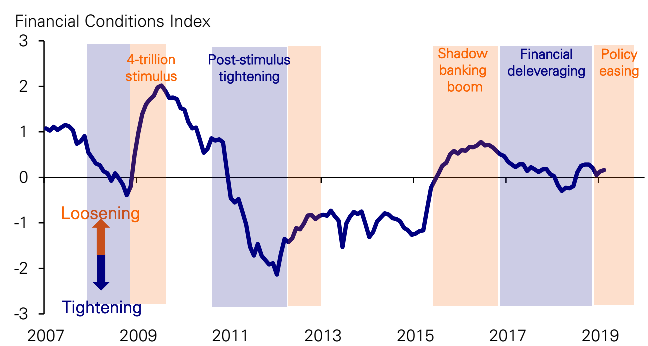
There are signs of stabilization in EM Asia's growth, which is consistent with our expectation. Not only have the region's PMIs rebounded, pointing to the bottoming of exports, China's data point to stabilization in its land and property markets, suggesting a halt in its slowdown. Moreover, the region may enjoy strong tailwinds from a US-China trade deal in a month's time, although the EU remains a point of concern, as Brexit risks hover over the region. Assuming that such a tail risk is contained, we continue to expect EM Asia to establish a trough on production and trade in Q2, with stimulus policies providing further support.

Figure 84: PMIs rebounded



Sources: Deutsche Bank Research, Haver Analytics

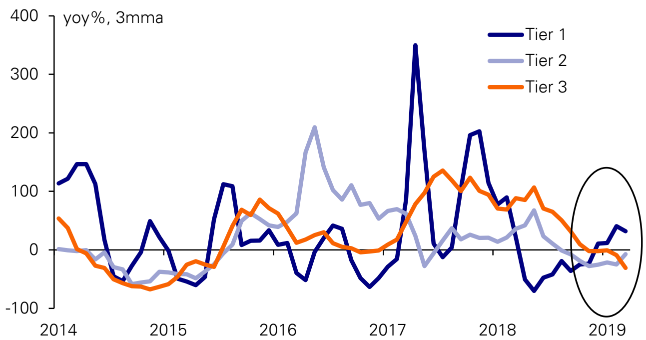
Figure 85: China's monetary easing



Sources: Deutsche Bank Research

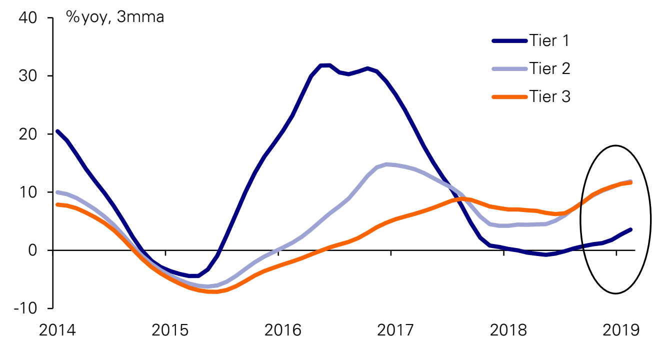
RBI delivered another rate cut, as widely expected, while BNM signaled an earlier rate cut to "pre-emptively" promote steady growth and ensure price stability. Although a negative output gap, low inflation and limited fiscal room suggest a need for monetary easing, BNM has practiced prudence thus far, to ensure the ringgit's stability as it sought to improve the FX buffer (FX reserves). With improvement in the latter, we think BNM may feel comfortable enough to deliver a rate cut in early May now, instead of waiting until September (see report). We continue to expect BSP and BI to deliver 150bps and 100bps rate cuts through late 2020, which would bring about their soft landing. Meanwhile, thanks to its policy easing, China is showing signs of stabilization in the land and property markets. Not only has land sales growth recovered in Tier 1 and 2 cities and the number of failed land auctions fell, the residential land auction premium in Tier 2 and 3 cities has risen, while housing prices continued to head higher, thanks to easing regulatory policies as well. We continue to expect more policy easing in the land and property markets in this quarter (see report), which may render lending rate cuts unnecessary.

Figure 86: Tier 1& 2 city residential land sales rebound



Sources: CREIS, Deutsche Bank Research

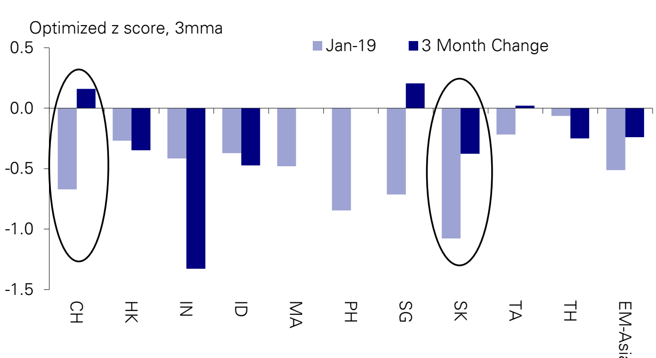
Figure 87: China's housing prices continue to rise



Sources: Deutsche Bank Research, NBS

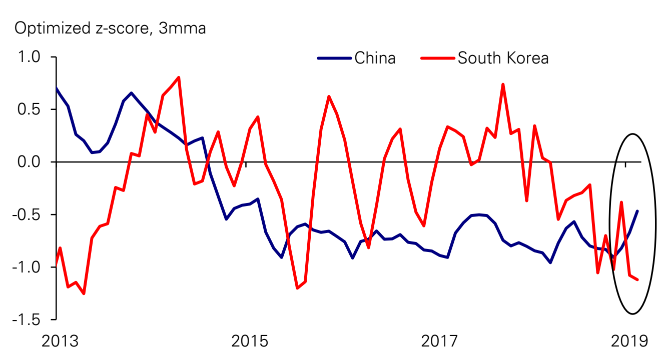
These developments are indeed a welcome change, against the backdrop of very weak growth momentum in Q1, as suggested by the weighted z-scores of a range of high-frequency critical indicators (industrial production, credit growth, imports, retail sales, auto sales, etc). While China's MMI point to an improvement in its growth trajectory, although its momentum remains relatively weak against its own history, South Korea stands out on both the weakness and deterioration in its growth trajectory.

Figure 88: Korea's MMI weakest and worsening still



Sources: CEIC, Deutsche Bank Research

Figure 89: China's MMI bounds

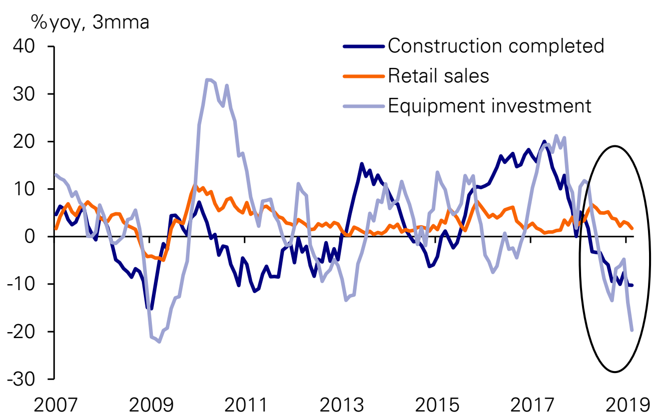


Sources: CEIC, Deutsche Bank Research

South Korea's growth and policy challenges

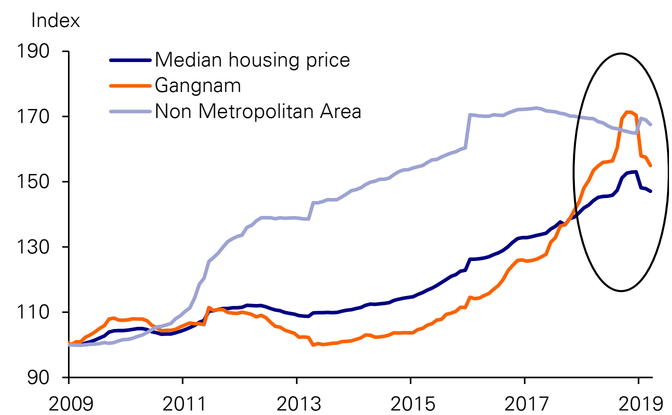
South Korea's weakness is broad-based, and not limited to a sharp contraction in exports. Retail sales growth slowed to 1.1%yoy in Jan/Feb from 3.1% in Q4, while facility and construction investment contracted 22% and 10.8%, respectively in Jan/Feb, vs. a 4.8% and 7.6% fall in Q4. While the latter is not surprising, given the strength of construction investment over the last few years, our concerns rose amid a negative turn in housing prices. Even the affluent Gangnam median housing prices have fallen 9% since end-2018. There are no signs of easing of the prudential measures, which the IMF noted as "working so well in Korea that it is used as an example for other countries." The government's hardline stance is not surprising given the disconcerting level of Korea's household loans (86.1% of GDP) and its policy priority in reducing income/wealth gap.

Figure 90: Broad-based slowdown



Sources: CEIC, Deutsche Bank Research

Figure 91: Housing prices are falling



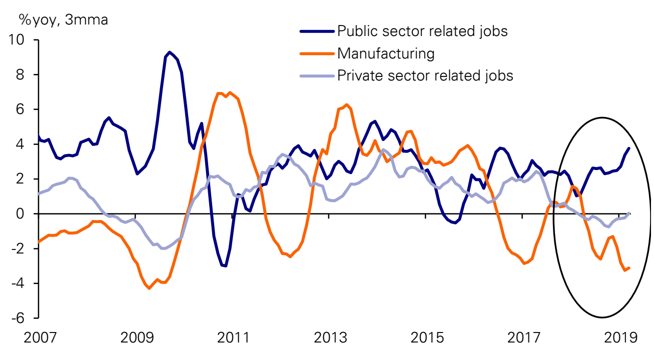
Sources: CEIC, Deutsche Bank Research

In its recent review, the IMF recommended that while "the BoK (Bank of Korea) should have a clearly accommodative monetary policy stance…the authorities should maintain appropriately tight macroprudential policies to preserve financial sector resilience." However, studies have shown that tighter macroprudential policies aimed at containing credit growth had a significant negative impact on inflation (see report). Looking ahead, we expect heated debate over monetary policy and prudential regulations given such a trade-off, along with increased efforts to find alternative policy tools, to achieve the BoK's dual mandate of ensuring price and financial stability. While any change in Korea's monetary policy framework is unlikely in absence of a crisis, clearly it needs to prepare for the next crisis, especially with the BoK policy rate not too far from its zero bound.

The BoK has yet to shift its policy bias, despite the sharp fall in inflation. The latter fell well below its target of 2%, to 0.5% in Q1 from 1.8% in Q4 last year, leaving the real policy rate at 1.25%, vs. -0.04% in Q4 2018. Despite this, the BoK governor reiterated recently that the policy rate remains "accommodative", supportive of growth. Indeed, in the context of longer time horizon, a rebound in inflation ahead points to a real policy rate of 0.6% this year – not too far from our estimate of its neutral rate. Although we expect the BoK's policy bias to turn dovish ahead, for an actual rate cut, it may require GDP growth below 2% and/or an outright contraction in payrolls. The latest data, although weak, do not suggest GDP growth below 2%, nor a sharp deterioration in the unemployment rate. Payrolls rose 0.7%yoy in Q1 2019, up from meager 0.3% growth in Q4 2018.

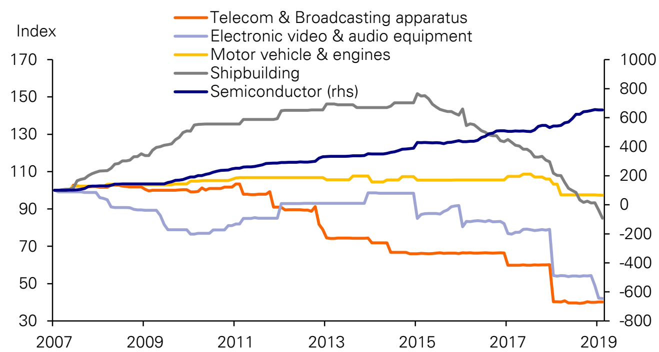
While we do not expect a recession, we remain concerned over the Korean economy's structural challenges. Among its challenges, Korea continues to suffer from very restrictive labor market regulations, hindering the economy's competitiveness. In fact, the IMF went further to note that, while there is a need for more fiscal stimulus, "flexicurity should be adopted as a basis for labor market policies by making employment protection legislation more flexible, while further enhancing social safety nets and Active Labor Market Policies…while rigidities in product market regulations should be addressed." (see link) The emergence of an export trough should not detract from the point that the long-term outlook for global trade remains highly challenging, especially in light of a reversal in trade liberalization, with non-tariff barriers remaining a significant policy tool.

Figure 92: Manufacturing jobs are contracting



Sources: CEIC, Deutsche bank Research

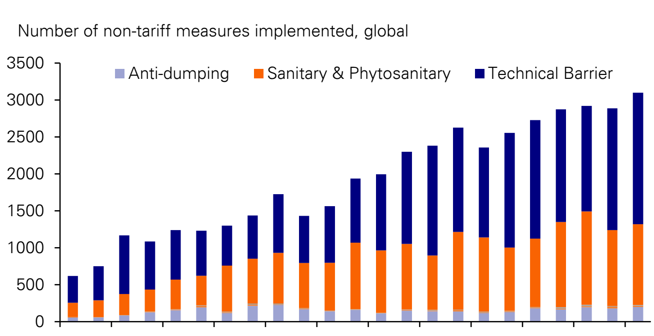
Figure 93: Mfg production capacity is stalling



Sources: CEIC, Deutsche bank Research

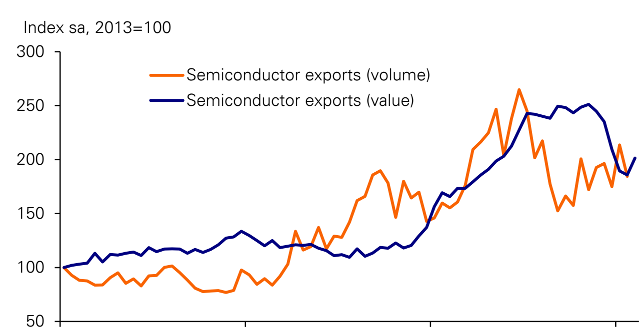
This, in turn, suggests that an export economy like Korea needs economic recalibration, providing the private sector more room to seek alternative engines of growth. Clearly, the government needs to remove the shackles of outdated regulations, including allowing for greater flexibility in the labor market to improve labor productivity, especially if it aims to continue to raise income. Meanwhile, the manufacturing sector continues to hollow out, with its payrolls declining at a faster pace of 3.1% in Q1, vs. a 1.9% fall in Q4 2018, while its production capacity continued to contract. This is a structural challenge, which cyclical monetary and fiscal responses may not address. Although the bright spot of the manufacturing sector, the semiconductor industry, has also come under pressure, amid sharp decline in its exports. The sharp decline in semi exports reflect falling prices, rather than volume, however. In fact, low base effects suggest its rebound in growth on a volume basis ahead.

Figure 94: Rising non-tariff measures



Sources: Deutsche Bank Research, WTO

Figure 95: Korea's semi exports stabilized

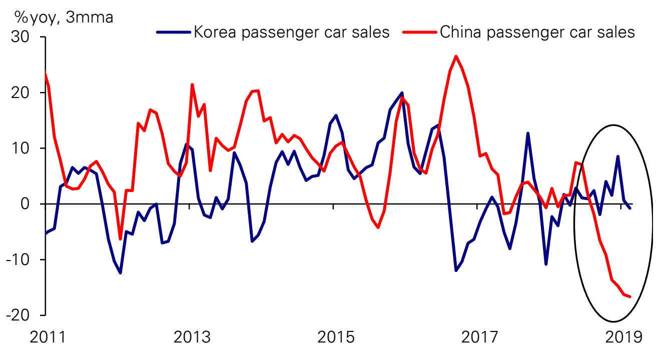


Sources: CEIC, Deutsche Bank Research

This year, the government is likely to see another year of a balanced budget, despite the supplementary budget (<KRW7tn). With the supplementary budget, the gov-

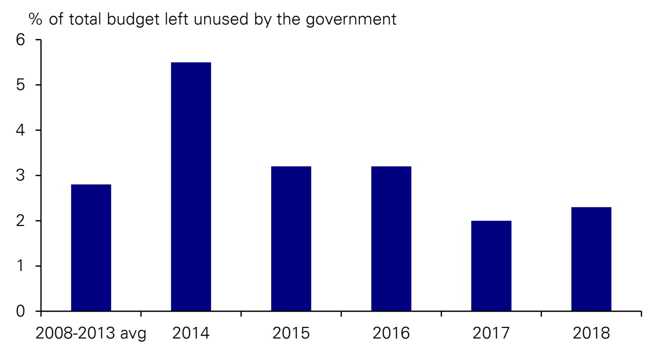
ernment seeks to address the country's pollution crisis. Its fight against micro-dust is likely to remain the policy priority, given the public's outcry over the poor air quality[15], ahead of the National Assembly election next April. While the Korean government is unlikely to be as aggressive as its German counterpart's in imposing a very restrictive emission standards, given the latter's subsequent economic difficulties (see report), we could see it raising tax incentives in auto consumption to shift Korean consumer behavior in favour of low-emission vehicles. While Korea's auto sales have not plunged as much as China's, they nevertheless fell 2.6% in Jan/Feb, after a 8.6% surge in Q4.

Figure 96: Auto sales: China vs. Korea



Sources: CEIC, Deutsche bank Research

Figure 97: Govt continues to underspend



Sources: Deutsche Bank Research, MoSF

Despite its efforts, the government's fiscal stimulus remained restrictive, as it sought increases in revenue, via tax hikes, among other things, to finance its larger welfare spending. In fact, the government continued to run fiscal surpluses since 2015. Last year, KRW8.6tn, 2.3% of the total budget, was left unused, an increase of KRW1.5tn from the previous year. With the government debt below 40% of GDP, the Korean government has the means to boost growth. In the face of Korea's rapidly ageing population and its huge public burden ahead, the government is unlikely to shift away from its fiscal conservatism unless facing a crisis. While we see its fiscal balance turning into a deficit next year, this is likely largely due to revenue misses rather than aggressive spending plans.

15 Korea's average exposure to PM2.5 levels was double the OECD average of 12.5, far higher than the WHO's recommended limit of 10 micro grams. According to Seoul University, toxic dust storms were linked to nearly 12K deaths in 2015 (see report)

Figure 98: China

	2017	2018	2019F	2020F
National income				
Nominal GDP (USD bn)	12,151	13,617	14,103	14,731
Population (m)	1,390	1,395	1,420	1,425
GDP per capita (USD)	8,621	9,623	9,931	10,341
Real GDP (YoY%)[1]	6.9	6.6	6.1	6.0
Private consumption	7.8	7.6	7.5	7.2
Government consumption	8.2	7.6	7.0	7.2
Gross capital formation	4.5	4.0	3.5	4.0
Export of goods & services	7.4	11.8	5.2	7.0
Import of goods & services	13.2	16.7	8.0	8.0
Prices, Money and Banking				
CPI (YoY%) eop	1.8	1.9	2.5	2.6
CPI (YoY%) ann avg	1.6	2.1	2.4	2.6
Broad money (M2) eop	8.1	8.5	8.8	8.5
Bank credit (YoY%) eop	10.5	9.0	9.8	9.5
Fiscal Accounts (% of GDP)				
Budget surplus	-3.7	-3.5	-4.5	-4.0
Government revenue	21.0	20.4	19.3	19.5
Government expenditure	24.8	24.5	23.8	23.5
Primary surplus	-3.2	-3.0	-4.0	-3.5
External Accounts (USD bn)				
Merchandise exports	2,263	2,487	2,612	2,795
Merchandise imports	1,844	2,136	2,306	2,491
Trade balance	420	352	305	304
% of GDP	3.5	2.6	2.2	2.1
Current account balance	164.9	54.5	-28.2	-58.9
% of GDP	1.4	0.4	-0.2	-0.4
FDI (net)	66.3	20.0	40.0	50.0
FX reserves (eop)	3,140	3,000	2,800	2,600
FX rate (eop) USD/CNY	6.5	6.9	7.0	7.4
Debt Indicators (% of GDP)				
Government Debt[2]	37.2	37.6	39.3	40.4
Domestic	37.0	37.4	39.1	40.2
External	0.2	0.2	0.2	0.2
Total external debt	13.0	13.2	13.5	14.0
in USD bn	1,580	1,797	1,904	2,062
Short-term (% of total)	60.0	60.0	60.0	60.0
General (YoY%)				
Fixed asset inv't (nominal)	7.2	6.0	5.6	5.8
Retail sales (nominal)	10.2	9.5	9.4	9.0
Industrial production (real)	6.6	6.2	5.5	5.3
Merch exports (USD nominal)	7.9	9.9	5.0	7.0
Merch imports (USD nominal)	16.1	15.8	8.0	8.0
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
1-year deposit rate	1.50	1.50	1.50	1.50
10-year yield (%)	3.29	3.40	3.45	3.40
USD/CNY	6.72	6.93	6.97	7.00

Sources: CEIC, Deutsche Bank 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 issued.

Figure 99: Hong Kong

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	341.7	363.1	377.3	388.1
Population (mn)	7.41	7.48	7.53	7.57
GDP per capita (USD)	46,088	48,522	50,126	51,248
Real GDP (YoY%)	3.8	3.0	1.5	1.2
Private Consumption	5.5	5.6	0.8	1.3
Government consumption	2.8	4.2	7.2	5.8
Gross fixed Investment	2.9	2.2	0.8	2.9
Exports	5.9	3.8	2.1	1.2
Imports	6.6	4.5	1.5	1.2
Prices, Money and Banking				
CPI (YoY%) eop	1.7	2.6	2.1	1.5
CPI (YoY%) avg	1.5	2.4	2.0	2.0
Broad money (M3) eop	10.0	4.3	5.0	7.7
HKD Bank credit (YoY%) eop	19.7	8.9	6.7	6.0
Fiscal Accounts (% of GDP)[1]				
Fiscal balance	5.5	2.0	-0.5	-0.4
Government revenue	22.8	20.8	19.6	20.0
Government expenditure	17.3	18.8	20.1	20.3
Primary surplus	5.5	2.0	-0.5	-0.4
External Accounts (USD bn)				
Merchandise exports	540.5	570.1	591.9	604.5
Merchandise imports	563.5	602.5	623.6	635.5
Trade Balance	-22.9	-32.5	-31.7	-31.0
% of GDP	-6.7	-7.0	-8.4	-8.0
Current Account Balance	15.9	15.1	21.8	24.9
% of GDP	4.7	4.2	5.8	6.4
FDI (net)	24.0	25.0	50.0	75.0
FX Reserves (eop)	431.4	424.7	441.4	458.4
FX rate (eop) USD/HKD	7.81	7.83	7.81	7.80
Debt Indicators (% of GDP)				
Government debt[1]	5.5	4.9	4.4	3.7
Domestic	4.5	4.0	3.5	2.9
External	1.0	0.9	0.9	0.9
Total external debt	461.1	478.3	498.1	495.0
in USD bn	1,575.3	1,736.7	1,879.3	1,920.8
Short-term (% of total)	66.8	68.0	70.0	70.0
General (ann. avg)				
Unemployment (ann. avg, %)	3.1	2.8	2.9	3.0
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
Discount base rate	2.75	2.75	2.75	2.75
3-month interbank rate	1.77	2.17	2.80	3.00
10-year yield (%)	1.61	1.70	1.80	1.80
USD/HKD	7.84	7.84	7.83	7.81

Source s: CEIC, Deutsche Bank Research, National Sources
Note: (1) Fiscal year ending March of the following year. Debt includes government loans, government bond funds, retail inflation-linked bonds, and debt guarantees.

Figure 100: India

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	2,559	2,712	2,931	3,257
Population (mn)	1,299	1,316	1,333	1,351
GDP per capita (USD)	1,970	2,061	2,199	2,411
Real GDP (YoY%)	6.8	7.4	7.0	7.6
Private consumption	6.5	8.5	6.6	7.1
Government consumption	14.0	10.7	8.3	7.3
Gross fixed investment	7.6	11.1	8.5	9.6
Exports	5.7	10.6	4.0	3.3
Imports	15.5	15.7	5.2	5.3
Real GDP (FY YoY %) [1]	7.2	7.0	7.4	7.6
Prices, Money and Banking				
CPI (YoY%) eop	5.2	2.1	3.8	3.8
CPI (YoY%) avg	3.3	4.0	3.1	3.9
Broad money (M3) eop	10.0	10.2	13.5	14.5
Bank credit (YoY%) eop	9.9	14.3	15.0	16.0
Fiscal Accounts (% of GDP)				
Central government balance	-3.5	-3.5	-3.6	-3.5
Government revenue	9.2	9.5	9.8	9.8
Government expenditure	12.8	13.0	13.4	13.3
Central primary balance	-0.4	-0.4	-0.5	-0.4
Consolidated deficit	-6.5	-6.5	-6.6	-6.5
External Accounts (USD bn)				
Merchandise exports	304.1	332.1	346.6	368.3
Merchandise imports	452.2	519.0	537.0	575.8
Trade Balance	-148.1	-186.9	-190.3	-207.5
% of GDP	-5.6	-6.9	-6.5	-6.4
Current Account Balance	-38.2	-64.9	-59.8	-66.7
% of GDP	-1.4	-2.4	-2.0	-2.0
FDI (net)	28.9	31.5	32.0	35.0
FX Reserves (eop)	409.3	396.1	423.2	437.0
FX rate (eop) USD/INR	63.9	69.8	72.0	70.0
Debt Indicators (% of GDP)				
Government Debt	68.6	68.5	68.1	68.0
Domestic	66.2	66.2	65.9	65.8
External	2.5	2.2	2.2	2.2
Total external debt	20.1	19.2	18.7	17.8
in USD bn	513.4	521.2	547.3	580.1
Short-term (% of total)	19.0	19.9	20.1	20.1
General				
Industrial Production (YoY%)	3.5	5.2	4.1	5.5
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
Repo Rate	6.00	6.00	5.75	5.75
3-month treasury bill	6.21	6.20	5.90	5.90
10-year yield (%)	7.37	7.25	7.15	7.10
USD/INR	69.3	70.0	71.5	72.0

Source s: CEIC, Deutsche Bank Research, National Sources
Note: (1) Fiscal year ending March of the following year.

Figure 101: Indonesia

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	1,015.4	1,042.2	1,109.1	1,194.3
Population (mn)	261.4	264.2	267.3	270.3
GDP per capita (USD)	3,885	3,945	4,149	4,419
Real GDP (YoY%)	5.1	5.2	4.8	4.5
Private Consumption	4.9	5.0	4.9	4.7
Government consumption	2.1	4.8	5.0	3.0
Gross fixed investment	6.2	6.7	5.5	4.6
Exports	8.9	6.5	2.9	1.3
Imports	8.1	12.0	4.4	1.1
Prices, Money and Banking				
CPI (YoY%) eop	3.6	3.1	3.6	2.9
CPI (YoY%) ann avg	3.8	3.2	3.1	3.2
Core CPI (YoY%)	3.1	2.8	3.1	3.1
Broad money (M2)	8.3	6.3	16.0	8.5
Bank credit (YoY%)	8.1	10.2	13.1	7.9
Fiscal Accounts (% of GDP)				
Budget surplus	-2.5	-1.8	-1.7	-1.5
Government revenue	12.3	13.1	13.4	13.6
Government expenditure	14.8	14.8	15.1	15.0
Primary surplus	-0.9	0.0	-0.2	0.1
External Accounts (USD bn)				
Merchandise exports	169	181	182	187
Merchandise imports	150	181	195	216
Trade Balance	18.8	-0.4	-12.9	-28.7
% of GDP	1.9	0.0	-1.2	-2.4
Current Account Balance	-16.2	-31.1	-39.1	-51.9
% of GDP	-1.6	-3.0	-3.5	-4.3
FDI (net)	18.5	13.8	15.0	10.0
FX Reserves (eop)	130.2	120.7	120.7	123.7
FX rate (eop) USD/IDR	13,548	14,481	14,700	14,100
Debt Indicators (% of GDP)				
Government Debt	29.0	28.4	28.6	27.0
Domestic	17.1	16.6	17.5	18.0
External	11.6	11.3	10.5	9.7
Total external debt	34.7	32.6	29.8	28.6
in USD bn	352.5	339.7	330.0	342.0
Short-term (% of total)	15.6	15.0	14.5	14.0
General				
Industrial Production (YoY%)	4.2	4.3	4.2	4.0
Unemployment (%)	5.5	5.3	5.6	6.3
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
Reverse repo rate	6.00	6.00	6.00	5.75
10-year yield (%)	7.65	7.40	7.25	7.00
USD/IDR	14,155	14,369	14,544	14,700

Sources: CEIC, Deutsche Bank Research, National Sources

Figure 102: Malaysia

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	315.3	354.5	**365.0**	**376.2**
Population (mn)	32.0	32.4	32.8	33.3
GDP per capita (USD)	9,847	10,946	**11,120**	**11,313**
Real GDP (YoY%)	5.9	4.7	4.4	4.0
Private consumption	7.0	8.1	**6.0**	**5.9**
Government consumption	5.4	3.3	5.7	4.0
Gross fixed investment	6.2	1.4	**1.7**	**3.6**
Exports	9.4	1.5	**-0.8**	**1.2**
Imports	10.9	0.1	**1.0**	**2.2**
Prices, Money and Banking (YoY%)				
CPI (eop)	3.5	0.2	**2.0**	**1.9**
CPI (annual avg)	3.8	1.0	1.1	**2.4**
Broad money (eop)	4.9	8.0	**6.8**	**6.6**
Private credit (eop)	5.8	6.4	**6.8**	6.2
Fiscal Accounts (% of GDP)				
Central government surplus	-3.1	-3.8	-3.5	-3.3
Government revenue	16.3	16.3	17.4	**15.2**
Government expenditure	19.4	20.1	20.9	**18.5**
Primary Balance	-1.1	-1.6	-1.3	-1.1
External Accounts (USD bn)				
Goods Exports	188.0	207.3	**201.9**	**199.0**
Goods Imports	160.8	177.2	**172.9**	**172.8**
Trade Balance	27.3	30.1	**29.0**	**26.2**
% of GDP	8.6	8.5	**7.9**	**7.0**
Current Account Balance	9.5	8.3	**6.1**	**1.7**
% of GDP	3.0	2.4	**1.7**	**0.4**
FDI (net)	3.8	2.9	4.4	3.4
FX reserves (eop)[1]	102.4	101.4	**105.5**	**107.9**
FX rate (eop) USD/MYR	4.1	4.1	4.2	4.3
Debt Indicators (% of GDP)				
Government debt[2]	65.5	66.5	67.5	**67.7**
Domestic	61.9	63.1	64.2	**65.0**
External	3.5	3.4	3.3	2.7
Total external debt[3]	**67.5**	**62.6**	**60.7**	**61.4**
in USD bn	**212.9**	**221.8**	**221.5**	**231.0**
Short-term (% of total)	**39.7**	43.8	**45.6**	**45.6**
General (ann. avg)				
Industrial Production (YoY%)	**4.5**	**3.0**	**2.8**	**2.7**
Unemployment (%)	3.4	3.4	3.4	**3.5**
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
Overnight call rate	3.25	3.00	3.00	3.00
3-month interbank rate	3.69	3.44	3.46	3.48
10-year yield (%)	3.78	3.75	3.75	3.70
USD/MYR	4.09	4.14	4.15	4.20

Sources: CEIC, Deutsche Bank Research, National Sources
Note: (1) Not adjusted for forwards. (2) Contingent liability estimates for 2015-2016. PPP liabilities excluded to maintain cross-country comparability. (3) Includes non-resident holdings of MYR debt.

Figure 103: Philippines

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	313.5	**330.7**	**358.0**	**373.2**
Population (mn)	104.9	106.6	108.3	110.0
GDP per capita (USD)	**2,988**	3,103	**3,306**	**3,391**
Real GDP (YoY%)	6.7	6.2	5.7	5.5
Private consumption	5.9	**5.6**	5.5	5.7
Government consumption	**6.2**	**13.0**	6.5	6.0
Gross fixed investment	9.4	12.9	8.7	6.0
Exports	**19.7**	**13.4**	9.3	7.2
Imports	18.1	**16.0**	10.1	8.3
Prices, Money and Banking (YoY%)				
CPI (eop)	2.9	5.1	**3.2**	**2.4**
CPI (ann avg)	2.9	5.2	**3.1**	**2.8**
Broad money (M3, eop)	11.3	**8.9**	10.8	10.9
Private credit (eop)	13.9	**14.7**	10.8	10.9
Fiscal Accounts (% of GDP)[1]				
Fiscal balance	-2.2	**-3.2**	**-3.0**	**-2.8**
Government revenue	**15.6**	**16.4**	**17.3**	**18.3**
Government expenditure	17.9	**19.6**	**20.3**	**21.1**
Primary surplus	-0.3	**-1.2**	**-1.0**	**-0.8**
External Accounts (USD bn)				
Goods Exports	**51.8**	**51.7**	**52.2**	**55.9**
Goods Imports	**92.0**	**100.7**	**104.3**	**112.5**
Trade Balance	-40.2	-42.0	-46.3	**-56.6**
% of GDP	**-12.8**	**-14.8**	**-14.7**	**-15.2**
Current Account Balance	**-2.1**	**-7.9**	**-7.1**	**-6.4**
% of GDP	-0.7	**-2.4**	**-2.0**	**-1.7**
FDI (net)	**7.0**	**5.9**	2.0	1.5
FX Reserves (eop)	81.6	**79.2**	**74.6**	**70.7**
FX rate (eop) USD/PHP	49.9	52.7	**55.5**	**56.7**
Debt Indicators (% of GDP)				
General government debt[2]	45.1	**44.6**	**43.7**	43.0
Domestic	**29.3**	**28.5**	**28.2**	**28.2**
External	15.8	**16.1**	**15.5**	**14.7**
External debt	23.3	**23.9**	**19.3**	**18.2**
in USD bn	73.1	**79.0**	69.0	68.0
Short-term (% of total)	19.5	**20.3**	17.4	17.6
General (ann. avg)				
Industrial Production (YoY%)	**7.5**	**4.9**	**5.5**	5.4
Unemployment (%)	5.7	5.3	**5.2**	**5.3**
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
Policy rate (BSP o/n repo)	5.25	5.00	4.75	4.75
Policy rate (BSP o/n rev repo)	4.75	4.50	4.25	4.25
3-month Tbill rate	5.73	5.19	4.94	4.94
10-year yield (%)	5.92	5.60	5.40	5.20
USD/PHP	52.1	54.0	54.8	55.5

Sources: CEIC, Deutsche Bank Research, National Sources
Note: (1) Refers to general government. (2) Includes guarantees on SOE debt.

Figure 104: Singapore

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	337.0	361.1	367.1	369.5
Population (mn)	5.6	5.6	5.7	5.7
GDP per capita (USD)	60,051	64,043	64,785	64,930
Real GDP (YoY%)	3.9	3.2	2.4	2.5
Private consumption	3.2	2.4	2.2	2.8
Government consumption	4.2	3.6	4.4	3.9
Gross fixed investment	5.3	-3.4	0.7	2.3
Exports	5.4	5.2	1.7	2.1
Imports	7.0	4.5	0.8	1.7
Prices, Money and Banking				
CPI (YoY%) eop	0.4	0.5	0.9	0.2
CPI (YoY%) ann avg	0.6	0.4	0.6	0.8
Broad money (M2)	3.2	3.9	3.4	2.7
Bank credit (YoY%)	3.6	4.9	6.7	3.3
Fiscal Accounts (% of GDP)[1]				
Fiscal balance	2.0	0.4	-0.7	-0.4
Government revenue	19.3	18.3	18.3	18.3
Government expenditure	17.0	17.9	19.0	18.7
External Accounts (USD bn)				
Merchandise exports	400.4	450.6	434.0	424.7
Merchandise imports	309.3	353.1	334.1	324.4
Trade Balance	91.2	97.6	99.9	100.2
% of GDP	27.1	27.0	27.2	27.1
Current Account Balance	53.9	63.9	64.9	64.5
% of GDP	16.0	17.7	17.7	17.5
FDI (net)	51.1	44.8	44.1	44.3
FX Reserves (eop)	279.9	287.7	305.1	322.0
FX rate (eop) USD/SGP	1.34	1.37	1.38	1.40
Debt Indicators (% of GDP)				
Government debt[2]	108.0	106.6	107.2	112.2
Domestic	108.0	106.6	107.2	112.2
External	0.0	0.0	0.0	0.0
Total external debt	424	418	412	406
in USD bn	1,428	1,509	1,513	1,501
Short-term (% of total)	76.0	75.9	75.6	75.4
General				
Industrial Production (YoY%)	10.5	7.3	2.0	2.7
Unemployment (%) (eop)	2.2	2.1	2.2	2.3
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
3-month interbank rate	1.94	1.92	1.86	1.84
10-year yield (%)	2.07	2.10	2.08	2.08
USD/SGD	1.35	1.36	1.36	1.38

Source s: CEIC, Deutsche Bank Research, National Sources
Note: (1) Fiscal year starts in April. (2) Public debt issuance is done to ensure the availability of sovereign curve.

Figure 105: South Korea

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	1,531	1,619	1,634	1,695
Population (mn)	51.4	51.6	51.8	52.0
GDP per capita (USD)	29,787	31,350	31,541	32,605
Real GDP (YoY%)	3.1	2.7	2.3	2.2
Private consumption	2.6	2.8	2.3	2.0
Government consumption	3.4	5.6	4.7	4.7
Gross fixed investment	8.6	-2.3	-0.7	1.9
Exports	1.9	4.0	2.8	2.4
Imports	7.0	1.5	1.7	2.0
Prices, Money and Banking				
CPI (yoy %) eop	1.4	1.3	2.2	1.5
CPI (yoy %) ann avg	1.9	1.5	1.1	1.9
Broad money (Lf)	6.8	6.5	5.9	6.2
Bank credit (yoy %)	7.4	6.8	6.2	5.8
Fiscal Accounts (% of GDP)				
Central government surplus	1.4	1.5	0.1	-0.6
Government revenue	23.3	24.7	24.7	24.8
Government expenditure	21.9	23.3	24.6	25.4
Primary surplus	2.2	2.4	1.1	0.6
External Accounts (USD bn)				
Merchandise exports	577.4	630.3	657.2	673.4
Merchandise imports	457.5	510.5	544.5	570.2
Trade balance	119.9	119.8	112.8	103.2
% of GDP	7.8	7.4	6.9	6.1
Current account balance	75.2	76.4	67.3	58.8
% of GDP	5.1	4.6	4.1	3.5
FDI (net)	-14.6	-20.0	-18.0	-16.0
FX Reserves	389.3	404.4	404.7	408.5
FX rate (eop) USD/KRW	1,071	1,118	1,140	1,120
Debt Indicators (% of GDP)				
Government debt[1]	37.5	37.8	38.5	40.0
Domestic	37.1	37.4	38.1	39.6
External	0.4	0.4	0.4	0.4
Total external debt	28.5	27.9	27.5	26.8
in USD bn	412.0	440.6	450.0	455.0
Short-term (% of total)	27.7	28.8	29.6	29.5
General				
Industrial Production (YoY%)	1.9	0.6	1.0	0.8
Unemployment (%)	3.7	3.9	4.0	4.1
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
BoK base rate	1.75	1.75	1.75	1.75
91-day CD	1.97	1.90	1.90	1.90
10-year yield (%)	1.87	1.85	1.80	1.80
USD/KRW	1145	1,145	1,150	1,140

Sources: CEIC, Deutsche Bank Research, National Sources
Note: (1) Central government debt and guarantees.

Figure 106: Sri Lanka

	2017	2018F	2019F	2020F
National Income				
Nominal GDP (USDbn)	88.0	88.2	88.4	92.7
Population (mn)	21.4	21.7	21.9	22.2
GDP per capita (USD)	4,104	4,067	4,032	4,181
Real GDP (YoY%)	3.4	3.2	3.5	3.8
Total consumption	1.8	1.6	2.7	3.8
Total investment	8.2	6.6	6.6	7.0
Exports	7.6	0.5	3.0	4.0
Imports	7.1	1.8	5.0	7.8
Prices, Money and Banking				
CPI (YoY%) eop	7.1	2.8	5.8	4.4
CPI (YoY%) avg	6.6	4.3	4.5	5.0
Broad money (M2b) eop	16.7	13.0	13.0	14.0
Bank credit (YoY%) eop	14.1	15.9	13.5	16.0
Fiscal Accounts (% of GDP)				
Central government balance	-5.5	-5.0	-5.0	-5.0
Government revenue	13.8	14.5	14.3	14.1
Government expenditure	19.4	19.5	19.3	19.1
Primary balance	0.3	0.8	0.0	-0.4
External Accounts (USD bn)				
Merchandise exports	11.4	11.9	12.5	13.2
Merchandise imports	21.0	22.2	22.9	24.0
Trade balance	-9.6	-10.3	-10.4	-10.8
% of GDP	-10.9	-11.7	-11.8	-11.7
Current account balance	-2.3	-2.8	-2.6	-2.7
% of GDP	-2.6	-3.2	-2.9	-2.9
FDI (net)	1.6	1.0	0.7	0.8
FX reserves (eop)	8.0	7.8	8.0	8.5
FX rate (eop) USD/LKR	152.9	182.3	183.0	185.0
Debt Indicators (% of GDP)				
Government debt	76.9	80.2	80.1	79.8
Domestic	41.7	43.3	43.3	43.1
External	35.2	36.9	36.9	36.7
Total external debt	58.9	61.1	64.0	64.1
in USD bn	51.8	53.9	56.6	59.4
Short-term (% of total)	14.8	14.8	14.7	14.6
General				
Unemployment (%)	4.2	4.2	4.2	4.2
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
Reverse Repo rate	9.00	8.50	8.50	8.50
USD/LKR	174.8	175.0	176.5	183.0

Sources: CEIC, Deutsche Bank Research, National Sources

Figure 107: Taiwan

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	574.9	589.4	583.0	596.0
Population (mn)	23.6	23.6	23.6	23.6
GDP per capita (USD)	24,438	25,016	24,708	25,231
Real GDP (YoY%)	3.1	2.6	2.1	2.0
Private consumption	2.5	2.0	2.0	1.9
Government consumption	-0.6	3.5	1.1	3.2
Gross fixed investment	-0.1	2.1	2.9	0.1
Exports	7.4	3.7	2.3	2.0
Imports	5.3	4.9	2.4	1.4
Prices, Money and Banking				
CPI (eop)	1.2	-0.1	1.6	1.3
CPI (annual avg)	0.6	1.3	0.9	1.0
Broad money (M2)	3.6	3.4	3.2	3.5
Bank Credit[1] (yoy %)	4.6	4.9	4.3	3.8
Fiscal Accounts (% of GDP)				
Budget surplus	-0.1	-0.3	-0.4	-0.7
Government revenue	15.8	15.8	15.7	15.7
Government expenditure	15.9	16.0	16.1	16.4
Primary surplus	0.6	0.4	0.3	-0.1
External Accounts (USD bn)				
Merchandise exports	349.8	353.4	362.7	376.8
Merchandise imports	269.0	285.7	301.5	321.4
Trade balance	80.9	67.7	61.3	55.3
% of GDP	14.1	11.5	10.5	9.3
Current account balance	82.8	68.3	59.2	52.1
% of GDP	14.4	11.6	10.2	8.7
FDI (net)	-8.3	-11.0	-8.0	-10.0
FX Reserves (eop)	451.5	461.8	467.1	473.2
FX rate (eop) USD/TWD	29.8	30.7	31.4	31.0
Debt Indicators (% of GDP)				
Government debt[1]	30.6	30.7	30.8	31.2
Domestic	30.6	30.7	30.8	31.2
External	0.0	0.0	0.0	0.0
Total external debt	31.6	34.7	34.3	33.9
in USDbn	181.9	204.6	200.0	202.0
Short-term (% of total)	93.0	94.3	94.5	94.6
General				
Industrial production (YoY%)	5.0	3.6	2.8	3.2
Unemployment (%)	3.8	3.7	3.9	4.0
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
Discount rate	1.38	1.38	1.38	1.38
3-month Taibor	0.66	0.67	0.67	0.67
10-year yield (%)	0.76	0.90	1.00	1.00
USD/TWD	30.8	31.3	31.5	31.4

Sources: CEIC, Deutsche Bank Research, National Sources
Note: (1) Central government debt and guarantees.

Figure 108: Thailand

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	455.6	505.1	531.1	560.3
Population (mn)	66.2	66.4	66.5	66.6
GDP per capita (USD)	6,881	7,425	7,944	8,340
Real GDP (YoY%)	4.0	4.1	3.8	3.5
Private consumption	3.0	4.6	4.2	3.6
Government consumption	0.1	1.8	2.9	2.6
Gross fixed investment	1.8	3.8	4.3	5.7
Exports	5.4	4.2	3.4	3.0
Imports	6.2	8.6	2.8	2.4
Prices, Money and Banking				
CPI (yoy %) eop	0.8	0.4	1.8	1.4
CPI (yoy %) ann avg	0.7	1.1	1.2	1.7
Core CPI (yoy %) ann avg	0.6	0.7	0.8	1.1
Broad money	4.3	5.1	4.7	5.1
Bank credit[1] (yoy %)	4.3	5.9	3.7	5.0
Fiscal Accounts (% of GDP)[1]				
Central government surplus	-1.1	-0.5	-1.0	-1.4
Government revenue	17.3	17.5	17.0	16.4
Government expenditure	18.4	18.0	17.9	17.9
Primary surplus	0.2	0.8	0.1	-0.2
External Accounts (USD bn)				
Merchandise exports	235.3	253.4	267.4	281.4
Merchandise imports	201.1	229.8	252.3	271.2
Trade balance	34.2	23.6	15.1	10.1
% of GDP	7.5	4.7	2.8	1.8
Current account balance	50.2	37.7	23.8	17.2
% of GDP	11.0	7.5	4.5	3.1
FDI (net)	-10.6	-5.7	-8.1	-6.9
FX reserves (eop)	202.6	205.6	207.1	210.0
FX rate (eop) USD/THB	32.6	32.6	32.3	32.0
Debt Indicators (% of GDP)				
Government debt[1]	35.3	35.9	36.6	37.8
Domestic	34.7	35.4	36.2	37.4
External	2.9	3.1	3.3	3.3
Total external debt	34.1	30.4	28.6	27.7
in USDbn	155.2	153.7	152.1	155.2
Short-term (% of total)	59.5	59.4	59.2	59.4
General				
Industrial production (YoY%)	1.8	3.7	3.0	2.5
Unemployment (%)	1.2	1.1	1.1	1.1
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
BoT o/n repo rate	1.75	1.75	1.75	1.75
3-month Bibor	1.88	1.84	1.84	1.84
10-year yield (%)	2.42	2.40	2.40	2.35
USD/THB	31.9	32.2	32.5	32.3

Sources: CEIC, Deutsche Bank Research, National Sources
Note: (1) Central government debt and guarantees.

Figure 109: Vietnam

	2017	2018F	2019F	2020F
National Income				
Nominal GDP (USDbn)	223.8	244.7	260.8	285.1
Population (mn)	95.5	94.7	95.7	96.7
GDP per capita (USD)	2,390	2,584	2,725	2,948
Real GDP (YoY%)	6.8	7.1	6.6	6.3
Private consumption	7.4	8.0	7.4	7.1
Government consumption	7.0	6.6	6.5	6.8
Gross fixed investment	8.2	7.5	7.2	6.7
Exports	18.4	13.0	10.0	7.8
Imports	19.3	13.1	10.4	8.2
Prices, Money and Banking				
CPI (yoy %) eop	2.6	3.0	5.0	4.2
CPI (yoy %) ann avg	3.5	3.5	3.5	4.4
Broad money (yoy %)	15.0	16.6	18.5	17.5
Bank credit (yoy %)	17.5	16.8	15.8	15.0
Fiscal Accounts (% of GDP)[1]				
Federal government surplus	-4.5	-4.3	-4.4	-4.8
Government revenue	23.6	23.5	23.4	23.2
Government expenditure	28.1	27.8	27.8	28.0
Primary fed. govt. surplus	-2.5	-2.4	-2.2	-2.5
External Accounts (USD bn)				
Merchandise exports	214.3	244.0	269.0	290.0
Merchandise imports	202.6	231.0	257.0	282.0
Trade balance	11.7	13.0	12.0	8.0
% of GDP	5.2	5.3	4.6	2.8
Current account balance	6.4	8.0	7.0	3.0
% of GDP	2.9	3.3	2.7	1.1
FDI (net)	13.6	13.0	11.0	9.0
FX reserves (eop)	48.7	60.0	67.0	73.0
FX rate (eop) USD/VND	22,654	23,145	23,800	24,100
Debt Indicators (% of GDP)				
Government debt[2]	58.5	58.0	57.7	57.5
Domestic	28.5	30.6	30.2	30.3
External	30.0	27.4	27.5	27.2
Total external debt	48.4	49.0	49.1	48.4
in USD bn	108.2	120.0	128.0	138.0
Short-term (% of total)	17.6	21.7	23.4	23.2
General				
Industrial production (YoY%)	9.3	11.4	9.3	8.0
Unemployment (%)	2.2	2.2	2.2	2.2
Financial Markets (eop)	*Current*	*19Q2F*	*19Q3F*	*19Q4F*
Refinancing rate	6.25	6.25	6.25	6.25
USD/VND	23,200	23,700	23,750	23,800

Sources: CEIC, Deutsche Bank Research, National Sources
Note: (1) Includes off-budget expenditure. (2) Central government debt and guarantees.

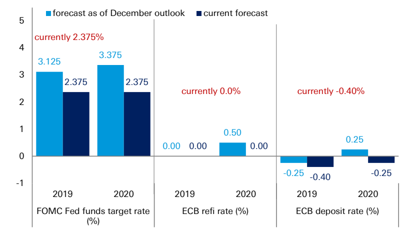
CEEMEA Economics

'No trend is the new trend'. This was our approach to 2019. The first three months of the year have seen many shifting parts with parallel as well as opposite implications for global growth, trade, and markets. While headlines pertaining to 'trade wars' (and undue friction they insert on global growth/trade/inflation) has calmed down in Q1 2019, fault lines in the Developed Markets (DM), in the form of Brexit, and fault lines between DM and Emerging Markets (EM) (due to sanctions cycle) continued to remain in place. Scars from last year's electrified environment on trade relations already took its toll on global growth, particularly in Europe and China, while the economic activity remained robust in the US. Market sell-off late last year and continued softening in major economies, despite recent rebound seen in the US and China, led major central banks (CBs) to deliver a dovish tilt in their policy stance. Lagged impact from softer oil prices through end-2018 also played a role in this more accommodative stance by major CBs. The Fed is now expected to remain on hold this year and next, with inflation showing signs of softening. No policy tightening is expected from the ECB, either, at least until end-2020, while possibility of credit easing on the back of weaker growth sentiment in Euro area is likely dominate ECB policy-making in the coming months.

Such change in external backdrop matters for CEEMEA. Low-yielders in the region, such as Israel, Hungary, Poland and the Czech Republic, have either delivered a dovish tilt or appeared less enthusiastic to tighten monetary conditions without more clarity on global economic/trade outlook. A more accommodative stance by major CBs was also an important factor, as the regional policy-makers had to take into account a decreasing opportunity cost of external funding, which may put undue appreciation pressure on their currencies. High-yielders in the region, such as South Africa and Russia, also shifted their monetary stance, too. The SARB delivered a more dovish statement than expected in the March meeting, citing downward revisions to domestic (and global) growth forecasts and lower unit labor costs. We now expect steady rates in South Africa until end-2020, versus 50bps hike next year we pencilled in previously. The CBR also ended its near-term hawkishness last month, while lowering the inflation projections on the back of lower-than-expected VAT pass-through. While the CBR retains its long-held caution, still seeing medium-term risks as pro-inflationary, we now expect the first cut in September as the Bank also moved forward its expected timing of the return to easing to 'later in 2019'. The outlier was the Central Bank of Turkey, which delivered an unexpected return to the liquidity management due to heightened market oscillation ahead of the local elections, and jacked up its effective policy rate to 25.5%. While the Bank quickly reversed back to single-policy rate framework post elections, we scaled back our rate cut expectations this year to 400bps to 20% (due to recent market volatility and its impact on TRY outlook) and now expect the first formal cut to take place in July.

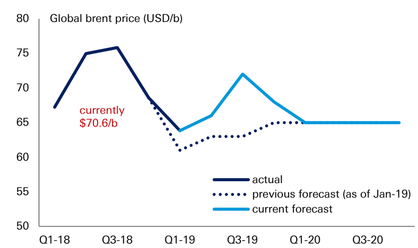
Meanwhile, election cycles in Ukraine and Israel did not provide surprising results. With 30% of the vote (and coming first in 20 of 25 regions) Zelensky won more votes than his rivals Poroshenko and Tymoshenko put together. A Zelensky/Poroshenko runoff is now scheduled on 21 April. Based on unofficial results, PM Netanyahu and his rightist bloc is also expected to run Israel for another term, despite a neck-to-neck race between Netanyahu's Likud and newly formed Blue and White (centre-left). Such outcome points to general political and policy stability post-elections. Results from Turkey's local elections were less straightforward, however. While the

Figure 110: DM central banks have turned more dovish (DB forecasts in chart)



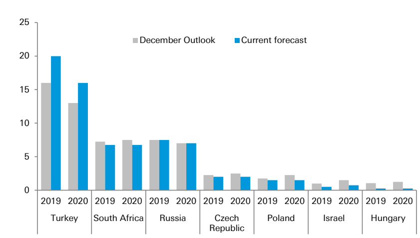
Source : Deutsche Bank

Figure 111: Oil forecasts have been revised higher following recent recovery (DB forecasts in chart)



Source : Deutsche Bank

Figure 112: CEEMEA central banks have also turned more dovish (except in Turkey) (DB forecasts in chart)



Source : Deutsche Bank

ruling Republic Alliance managed to stay above the 50% threshold, the opposition managed to win in important cities, such as Ankara and Istanbul, based on unofficial results. The objection process is still underway as the AKP contested results in Istanbul. The entire process is expected to be finalized by April 13th, according to the electoral calendar. However, based on comments from AKP and MHP representatives as well as from political commentators (such as from daily Haberturk), a repeat elections in Istanbul (or in some of her districts) cannot be ruled out.

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CEEMEA low yielders

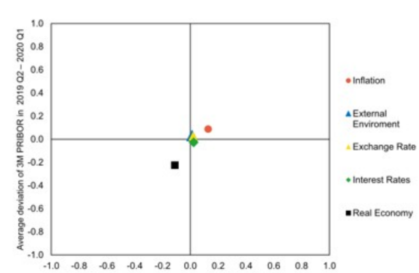
- **Economic outlook:** Economic activity looks set to slow and converge further to respective potential growth rates in 2019 across CEEMEA low yielders. Core CPI, meanwhile, looks set to rise in general due to domestic cost-push pressure and the lagged impact of lingering resilient domestic absorption conditions. Regional Central Banks (CBs) look set to follow the footsteps of major CBs and shift to a more accommodative stance in general.
- **Main risks:** A marked softening in Euro area growth (due to global trade tensions or idiosyncratic EU-related issues such as Brexit) would complicate the inflation, rates and growth outlooks across Emerging Europe. Domestic political risk premium may rise in Poland and Israel ahead of general elections during the year. Geopolitical risks remain ever present in Israel, while further escalation in US-Iran tensions or any mis-step in US-EU trade negotiations may lead to a cyclical uptick in the general risk premium attached to regional assets.

External factors are too overwhelming to ignore

First, global activity disappointed earlier in the year. Later on, inflation outturns were slightly lower than expected, particularly core CPI dynamics in the Euro area. Market sell-off late last year in the developed world also added another layer of pessimism on the growth outlook via the wealth channel. As usual, the major central banks, both the Fed and the ECB shifted to a more accommodative stance based on the aftermath of this faltering in the macro background.

Small open economies in the Central and Eastern Europe (CEE) found it too difficult to ignore the latest shifts in the global backdrop, particularly in Europe. The Czech National Bank, for instance, kept its policy rates unchanged in the March Board meeting, citing a softer growth, inflation and rate outlook in the Euro area. Motion for a hike (by 2 members against 5 votes for on hold) as well as Governor Rusnok's comments in the press conference suggest the Board has not formally dropped a tightening bias but it is not as strong as it used be, following a series of hikes last year. The Board appears concerned about global growth, citing it as an anti-inflationary risk, while acknowledging the possibility of faster unwinding of domestic inflation pressures (due to weaker HH consumption in Q4 and weaker growth in wages of late). CZK is still the main inflationary risk factor. The Bank also mentions a list of external factors as a source of uncertainty mostly with downside risk to domestic inflation and interest rates, such as (i) the unfinished negotiations on Brexit; (ii) persisting protectionist tendencies in global trade; and (iii) a potential stronger cyclical slowdown of the global economy.

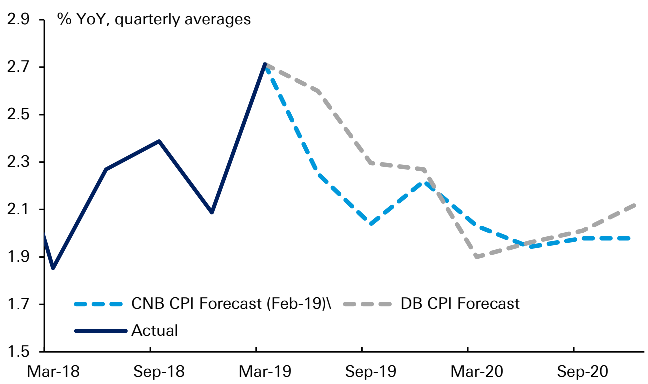
Figure 113: CNB's latest assessments of risks on CPI and rates



Source : CNB

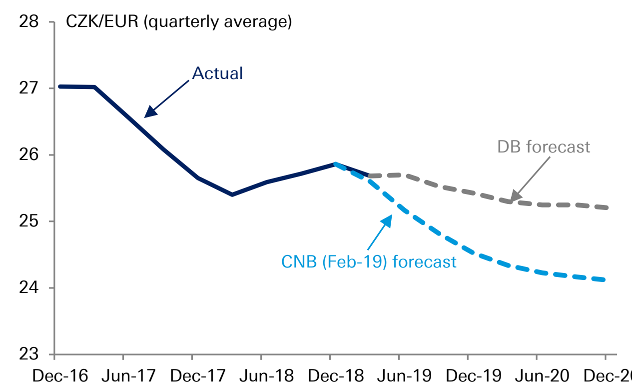
Overall, CNB appears in no rush to deliver any more tightening from here, and wants to have better visibility, particularly on the external front. Governor Rusnok's comments about a preference for stability in rates (rather than fluctuation) also suggest the Board do not want to make a mistake by hiking now and then cutting later due to a domestic slowdown or slower growth abroad. Updated forecasts in May will be key to understanding whether we have one more 25bps in this cycle or not. We retain our call for policy rates to reach 2%, based on the Board's prevailing – albeit softer than before – tightening bias as well as our expectations that headline inflation remaining close to the upper band in early Q2, yet risks are admittedly tilted toward termination of the tightening cycle.

Figure 114: DB expects higher inflation compared to CNB over the next few quarters



Source : CNB, Deutsche Bank

Figure 115: CNB expects a stronger CZK

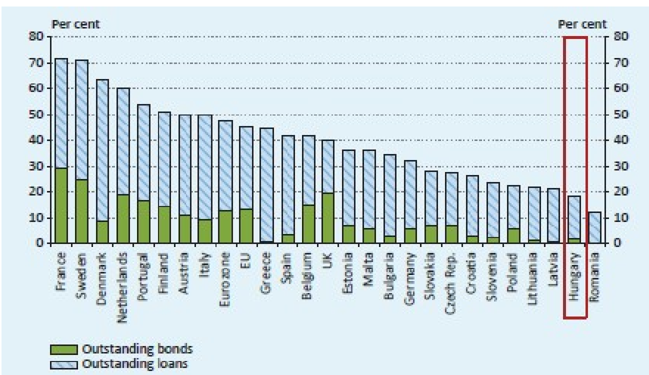


Source : CNB, Deutsche Bank

The National Bank of Hungary (NBH) also shifted away from its recent hawkish tilt in the March MPC meeting. The Council's inherent easing bias also made a comeback in the form of an unexpected corporate bond buying program which mainly aims to improve monetary policy transmission mechanism by deepening liquidity in corporate bond market. The Bank, meanwhile, hiked the lower end of their corridor by 10bps to -0.05bps while keeping the rest of the rates (including base rate) unchanged. This means the width of corridor now stands at 95bps. This was in line with market expectations. The MPC delivered a moderate quantitative tightening by cutting down on amount of average liquidity to be crowded-out by HUF100bn (to HUF300-500bn) to be delivered via changes to stock of swap instruments. More importantly, the Bank has changed its forward guidance, and there is no reference to normalization of the policy framework anymore, which may signal the policy move was a one-off.

To dive into the details of the new corporate bond purchase programme, the NBH note that the main aim of the programme is to ensure the development of the corporate bond market in Hungary. Also, the NBH note that while the bank's various measures to induce lending in markets (Funding for Growth scheme, Funding for Growth scheme Fix) have been successful, the share of bonds in total non-financial corporations' credit at 1.5% at the end of 2018 is low and below the average for EU as well as other CEE countries. The NBH then cite three major advantages of having a well-developed and liquid corporate bond market, namely: (i) decline in corporates' funding costs as a result of increased competition, (ii) increasing efficiency of monetary policy transmission, and (iii) increased financial stability and mitigate effects from any potential economic crisis. In order to pursue these aims, the NBH will launch its "Bond Funding for Growth Scheme" from July 1st, 2019, whereby the Bank plans to purchase bonds with good ratings issued by non-financial corporates as well as securities backed by corporate loans worth a total of HUF 300bn (which the NBH estimate to be 0.7% of GDP). However, the NBH have committed to keep this monetary policy neutral and sterilise the excess liquidity via the preferential deposit facility.

Figure 116: The corporate bond market is still underdeveloped compared to the region



Source : NBH, Deutsche Bank

Figure 117: The NBH's new BGS programme

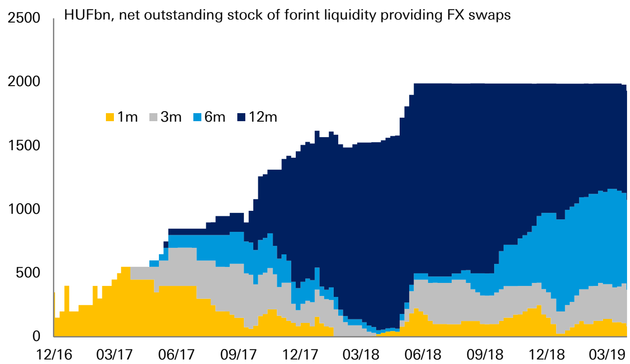
Key conditions of the Bond Funding for Growth Scheme of the Magyar Nemzeti Bank	
Total amount	HUF 300 bn (0.7 percent of GDP)
Start of the purchases	1 July 2019
Issuers of the bonds to be purchased	domestic non-financial corporations
Denomination of the bonds to be purchased	HUF
Original maturity of the bonds to be purchased	minimum 3 years, maximum 10 years
Credit rating of the bonds to be purchased	at least B+
Proportion of MNB's purchase per bond series	max. 70 per cent
Maximum exposure of the MNB per corporate group	HUF 20 bn
Minimum volume per issuance	HUF 1 bn
Sterilisation of the excess liquidity arising from the purchases	by the preferential deposit facility

Source : NBH, Deutsche Bank

On the quantitative tightening, NBH Deputy Governor Nagy revealed that it could result in a reduction in the stock of outstanding FX swaps by about HUF 130bn to take the total stock to about HUF 1.87 tn. This could lead to an increase in the 3m BUBOR rate by c.10bps to about 0.23%. After the monetary policy announcement, the 3m BUBOR rate jumped by 6bps to 0.19%, before returning to 0.16% in early April.

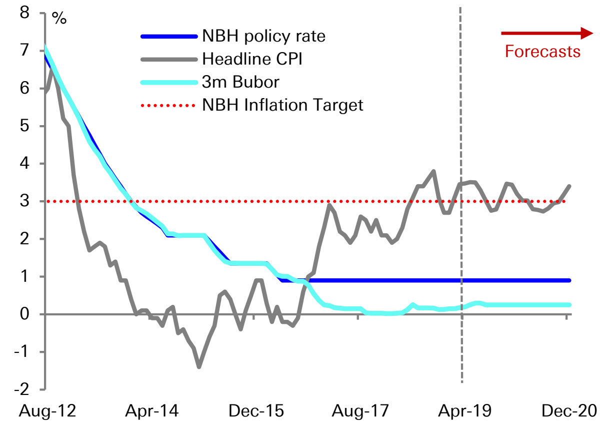
The NBH have also made small upward revisions in both CPI and growth for this year and next, as part the Bank's quarterly Inflation Report. The Bank revised the inflation forecast upward for this year and next by 0.2pps to 0.1pps respectively. They now expect inflation to average 3.1% in both years. The Bank expects headline to hover around the 3% target in the coming years and core inflation to slow down from late 2019 onwards. The NBH have also revised up their growth forecasts by 0.3pps to 3.8% for 2019 and by 0.2pps to 3.2% for 2020. The statement itself pointed to rising uncertainty on inflation due to external factors, and many references to a more accommodative stance by the ECB and others. The Bank also said that the MPC will now be cautious but the Governor confirmed that the stance remains loose and that this is not a start of a tightening cycle.

Figure 118: The stock of NBH swap stock has declined from HUF 2tn slightly



Source : NBH, Deutsche Bank

Figure 119:Base rate to remain unchanged, while 3m BUBOR to rise slightly

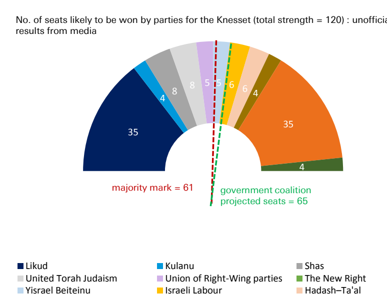


Source : NBH, Haver Analytics, Deutsche Bank

Overall, despite both core and headline inflation hovering above the 3% target, the NBH retains its dovish bias, and simply cannot ignore a more accommodative stance by ECB and others. The Bank also sees no reason to deliver further tightening from here, despite a more aggressive cycle priced in by markets year-to-date. So, the hike itself may not have a tightening impact either with only a mild tightening coming from the quantitative side. We retain our call for 3M Bubor rate to rise only slightly to 0.25% in end-2019.

In Israel,the April 9th election results were mostly in line with our expectations. The Likud party, led by incumbent PM Benjamin Netanyahu and the Blue & White alliance (led by Benny Gantz and Yair Lapid) emerged neck-to-neck in terms of vote shares (both roughly at 26%), according to the official results released after counting of all "regular votes"[16]. The absentee votes cast by soldiers, disabled persons, foreign envoys, hospitalised persons, prisoners, etc. are yet to be counted. After the final count, the Central Elections Committee will allocate seats depending on the number of parties/alliances which crossed the electoral threshold and the votes received by those parties/alliances. According to media reports[17] both Likud and the Blue and White party are likely to emerge as the joint largest parties with 35 seats each in the new Knesset. However, the Blue & White alliance is unlikely to able to garner the numbers to be able to stake claim to form the government, as Yisrael Beiteinu (Netanyahu's former coalition partner which fell out with Likud and withdrew from ruling coalition last November) has ruled out supporting them. As a result, Netanyahu is likely to be able to form a coalition government with the help of the smaller right-wing parties and the likely support of Yisrael Beiteinu. It remains to be seen whether the formal indictment against Netanyahu in bribery and fraud related cases will complicate the outlook for any new Likud- led government, which is expected to be formed by Netanyahu in the coming weeks. Please see our report here for potential economic and market impact from the election outcome.

Figure 120: Netanyahu likely to form next government with a right-wing coalition



Source : Kan News, Deutsche Bank

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Twisha Roy, Bangalore

16 https://votes21.bechirot.gov.il/nationalresults
17 https://www.kan.org.il/Radio/item.aspx?pid=82709

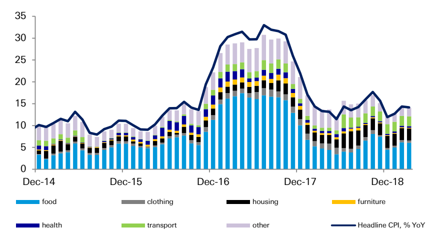
Egypt

- Economic outlook: Growth is expected to increase to 5.6% in FY2018/19 and 6.1% in FY2019/20 on the back of higher investment and export of goods and services and the gradual recovery in private consumption. Headline inflation is expected to remain elevated until mid-2019 on the back of unfavorable base effects and volatile food prices while core inflation is expected to remain at single-digit levels.
- **Main risks:** A deterioration of domestic security conditions that could lead to a capital flight and to a disruption in FX inflows. This could widen the current account deficit (via less tourist inflows) as well as shrink the sources of external financing (by disrupting FDI inflows). A drawdown in FX reserves that may ensue, coupled with a rise in risk premiums of Egyptian assets, could pose a risk to financial stability.

Monetary conditions to remain tight for now

The government recently revised up its growth forecast for FY-2020 to 6.1%, in line with our projections. The growth is expected to receive extra support from private consumption going forward while enjoying continued public investments and FDI inflows into the oil and gas sectors. Recent PMI data for the month of March also point to improvements in non-oil private activity on the back of domestic demand while exports orders continue to fall. The recent 100bps cut in policy rates by the CBE and the further cuts that we expect since Q4-2019 should be supportive of private growth.

Figure 121:Percentage points contribution to headline inflation



Source : Haver Analytics, Deutsche Bank

Headline inflation for the month of March in Egypt decelerated for the first time in three months on an annual basis, edging down to 14.2% from 14.4% in the preceding month (v.s DB forecast of 14.3% YoY). As we had expected, the Pound's appreciation since more than a couple of months ago coupled with the dissipation of food supply shocks seem to have eased inflationary pressures during March. Food continues to be the main driver of inflation (+6.1pps) rising by 1.5% on a monthly basis in March. The shortage of some items (such as fruits and vegetables) was met with government intervention in the food market; this led to high price volatility since last October but seems to be stabilizing according to the latest CPI data. Furthermore, transport costs inched up 0.2% on a monthly basis, increasing by 39.6% YoY (due to base effects) amid government plans to introduce automatic fuel price indexation mechanisms (starting in April) that would link local fuel prices to global prices.

We think risks are tilted to the upside due to inflationary expectations ahead of fuel price increases (due to price adjustments) as well due to the approach of the month of Ramadan. The main source of inflationary pressure for the rest of the year would be the introduction of automatic fuel pricing mechanisms. The mechanism for 95-octane gasoline would start from April but according to officials, the price for the fuel would remain on hold during Q2-2019 due to stronger EGP and higher oil prices. The decision should come at a fiscal cost to the government. However the extension of the mechanism to other fuel grades including 8-octane and 92-octane later in the year, would translate to further inflationary pressures which we see mostly likely towards the end of Q2-2019 and during Q3-2019. Overall, our forecasts point to inflation hovering between 13.5% to 14% during most of H1-19 before falling to 12% in June due to favourable base effects. We expect some upward pressure on inflation in H2-2019 given more regulated price adjustments but expect inflation to fall back to 12% by year-end. Given the inflation background, we expect the easing cycle to remain on hold until the end of Q4-2019 when a 100bps is certainly possible.

As we have previously noted in our research, money supply dynamics have also turned supportive of inflation dynamics, M2 growth has declined since mid-2018 due to fiscal consolidation, and CBE tight monetary conditions continue. Despite the reversal of portfolio outflows (since January-2019) which also contributed to the cooling down of M2 growth during last year, the latest data as of end-February continue to show a fall in M2 growth on an annual basis to 11.6% from 12% in the previous month.

The appreciation in the Egyptian pound since January (to around EGP/USD 17.35 from around 17.2) has happened on the back of renewed portfolio investments into the local debt market. However, prudent financial policy has been crucial, whereby state banks drew down on their foreign assets to support the local currency in the FX market. In our view, the FX stability has been crucial for ensuring investor confidence and renewed hot money inflows, which in turn has alleviated pressures on the country's foreign assets. In fact, Egypt's net foreign assets have recovered according to the latest data driven by both commercial banks' and central bank's net foreign positions. This should be supportive of FX stability going forward. We are expecting a further narrowing down of the current account deficit which would be supportive of local currency at least in the near term; the increase in domestic gas production as well as higher oil exports is expected to contribute. According to the latest data, oil exports surged by 60% YoY in H2-2018. Also, further tourism into the country as well as higher revenues from the Suez Canal are also expected to increase FX inflows. That said, we cannot discount down side risks (current account deficit widening) in light of higher imports driven by higher domestic economic activity and public investments (as well as a slowdown in remittance inflows), as most of it comes from Egyptians working in GCC countries that are facing tougher laws unfavourable to foreign labour presence in those countries.On the fiscal side, the IMF is also projecting an overall fiscal deficit of 8.6% of GDP in fiscal year 2019, similar to our forecast and our call since last year predicting a slight fiscal slippage. As previously mentioned, higher than budget projected yields on both local debt and oil prices is responsible for the expected fiscal target miss. We expect an improvement in the primary surplus for FY 2019 to 1.9% of GDP from 0.2% in the previous FY. The cabinet also recently approved a draft 2019/20 budget with a primary surplus of 2% of GDP, a figure also in line with our expectation for FY2020. The draft budget assumes a budget deficit of 7.2% of GDP while we continue to project a deficit of 7.8% of GDP driven by higher public expenditure. The official FX projections see a slight depreciation of local currency to USD/EGP 18.0 for the next FY as well as oil prices at USD 68/barrel (Brent).

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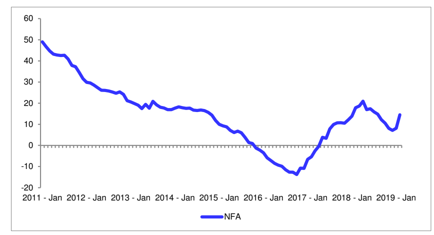
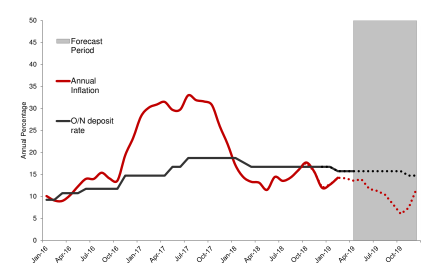
Figure 122: NFA (USD Bn) fell due to portfolio outflows in 2018 but has recovered since the start of the year



Source : Haver Analytics, Deutsche Bank

Figure 123: High real rates to persist while another 100bps cut by the CBE in Q4-2019 is possible



Source : Haver Analytics, Deutsche Bank

GCC

- Economic outlook: Lower oil prices compared to 2018 are expected to put pressure on the fiscal balance, especially in Saudi Arabia, Oman and Bahrain. The decline in oil exports, which may lead to tighter liquidity conditions as well as higher government borrowing, poses downside risk to private sector growth. The reduction in oil production following the recent OPEC+ agreement and the possibility of further extension of the cuts until year-end will likely lead to fragile growth, especially in Saudi Arabia, in our view. Nevertheless, non-oil growth should continue to rely on expansionary fiscal policies, public investment projects and private sector stimulus programs. Enjoying larger excess capacities and production flexibility, Saudi Arabia, the UAE and Kuwait should drive most of the changes in oil production potentially to support oil prices. Given the large financial buffers of these countries the exchange rate pegs should continue to act as an important anchor for financial and price stability.

- **Main risks:** Geopolitical tensions pose a risk to growth. They are weighing on economic activity by increasing domestic uncertainty. The state of regional affairs is susceptible to escalation of interstate tensions that could disrupt FX inflows and oil outflows. Saudi Arabia already looks to be struggling to attract foreign capital needed to diversify its economy. Political fatigue with pursuing diversification programs, structural and fiscal reforms may lead to higher debt, downward pressure on credit ratings and could adversely affect long-run growth. This is most evident in Bahrain, where we think more radical reform programs need to be implemented to ease market concerns.

Higher capital expenditures (especially in Saudi Arabia), the promotion of Public Private Partnership projects, the expo 2020 in UAE, the five-year development plan in Kuwait, 2022 World Cup matches in Qatar and the "GCC Development Fund" in Bahrain should remain key drivers of non-oil activity in the next couple of years. On the other hand, we expect geopolitical tensions, tighter liquidity conditions and labour market reforms to continue to weigh in on growth via higher uncertainty, higher funding costs and the departure of expatriate employees, respectively.

We expect fiscal expansion to be led by Saudi Arabia, as the Kingdom needs to stimulate the economy which suffers from high unemployment rates and economic uncertainty. Nevertheless, the large financial buffers of Saudi Arabia, UAE, Kuwait and Qatar in terms of the size of their foreign asset holdings on one hand and the geostrategic importance of the other states (such as Bahrain) or the necessity to contain contagious financial pressures on the other, should keep the GCC economies and their pegged exchange rates relatively stable against external shocks even if fiscal reforms slow down (further).

That said, risks remain skewed to the downside, emanating from the escalation of intra-regional tensions. Other risks include a slowdown in global growth that would hamper demand for oil and gas, especially by Asian countries, and the faster-than-expected tightening in global financial conditions that would require further tightening by GCC central banks to mitigate financial pressures on the peg. These factors may pose severe risk to real growth dynamics of GCC economies.

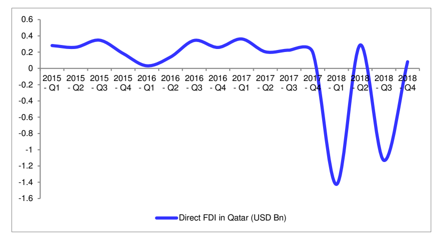
Qatar- global slowdown marginally weighing on growth

Overall growth in 2018 encountered a setback emanating from a negative shock to the mining and quarrying sector, which includes oil and natural gas, contracting by an annual rate of 2% in Q4. We think that the negative shock originated externally with the slowdown in Asian and European economic activity and hence softer demand for gas. The sector which accounts for 46% of the overall economy, brought overall annual growth down to 1.4%, much lower than market expectations which were projecting overall growth of above 2% in 2018. On a quarterly basis GDP decreased by 1.2% in the final quarter of last year. Therefore, the non-hydrocarbon economy similar to last year, did most of the heavy lifting, supporting overall growth whereby the non-mining and quarrying sector grew 2.4% YoY last year, with the construction sector posting a high growth rate of 7.2% YoY.

Growth in Qatar continues to be driven by the government's USD200bn infrastructure investment program under the Qatar National Vision 2030. Latest data however points to a recovery in the hydrocarbon sector, with the Industrial production index showing the mining and quarrying category growing by 0.9% YoY and 1.8% MoM in January while the overall index growing by 0.6% YoY. We think recent infrastructure project tenders have helped spur hydrocarbon activity. Industrial production however was dragged by the manufacturing sector which slowed down 1.2% YoY and increased 0.5% MoM. Together with latest data points on manufacturing activity from last year, risks are tilted to the downside in our view, with the possibility of further slowdown in the manufacturing sector.

The country continues to suffer from low levels of FDI which is apparent in the fragility of its growth dynamics. Notwithstanding, the importance of the oil and gas sector as the main driver of growth, the government is continuing with institutional reforms, aimed at improving the regulatory system that is more favourable to foreign investors. We believe that the introduction of measures such as allowing complete foreign ownership across all sectors, facilitating the issuances of commercial and industrial licenses and offering long-term expatriates permanent residencies would support growth in the medium term. The government is currently looking into identifying new areas where foreigners can own real estate, as part of the campaign to draw more investment to the country's real estate sector. The real estate index fell 2.5% YoY in December partly owing to the embargo. The government is particularly keen to attract more demand in the real estate sector, to prevent the possibility of over supply especially after the world cup event.

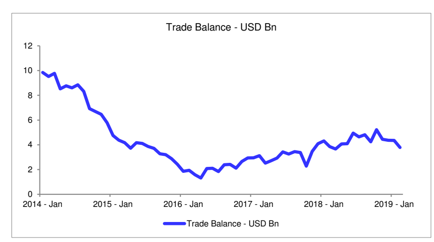
Figure 124: The country is still struggling with attracting FDI



Source : Deutsche Bank, Haver Analytics

We are pencilling in an acceleration in overall growth during 2019 and 2020 on the back of more buoyant activity in the gas sector. On the one hand, Qatar Petroleum has awarded several contracts related to its LNG expansion project aimed at increasing LNG production capacity from 77mn tonnes a year to 110mn tonnes a year by 2024. We are expecting announcements regarding major related tenders this month (April). On the other, we expect external demand for Qatari natural gas, especially from Europe after several years of subdued demand as well as continued demand from China and India to boost the energy sector. Qatar has supplied 22% of China's imports of LNG over the past ten years.

Figure 125: Trade balance has deteriorated recently



Source : Deutsche Bank, Haver Analytics

Global economic conditions were also somewhat reflected on Qatar's trade balance with the surplus decreasing 2% YoY to USD 3.8bn in February, with exports falling 0.5% YoY. However, imports increasing by 2% YoY was the main driver of the fall in the surplus, perhaps a sign of the rise in domestic investment/economic activity and another sign of the failure of the embargo in insulating the country. The fall in oil and natural gas exports by 0.1% YoY is not alarming or indicative of further slowing down especially as we expect higher growth and demand from the euro area in the coming quarters.

We expect a budget surplus of slightly above 4% of GDP for 2019 on the back of high hydrocarbon revenues. The issuance of a total of USD 12bn sovereign bonds in March which received orders of USD 50bn should increase financial buffers of the country, granting it a comfortable position to weather external shocks. More importantly, the government is thought to be taking advantage of improved financial conditions as well as looking to provide a benchmark to government-related companies that plan to issue bonds.

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Russia

- **Economic outlook:** Growth has had a subdued start to 2019, with softer consumer and construction activity. Things should pick up later in 2019, helped by spending on national projects, but we expect the growth potential of Russia's economy to remain subdued.
- **Inflation and monetary policy** Lower-than-expected VAT hike pass-through has led to a less elevated inflation path. We expect that YoY inflation has now peaked and see the CBR returning to policy easing later this year. News on sanction risks re-emerged over the past month.

Turning point in inflation and rates cycle

Economy cooling in H1-19; household spending shows signs of recovery

Growth momentum has been slowing in Q1 so far, as had been anticipated, according to the latest high-frequency data. The monthly GDP series now points to growth of 1.3% YoY for Q1, the lowest in a year and down from 2.7% in Q4. All five major sectors of the economy look likely to experience a slowdown compared to Q4, with the construction sector emerging as the worst performer.

However, on a positive note, growth in 4 out of the 5 major sectors (except Transportation) improved in February from their January lows. Manufacturing PMI also improved further in March to reach 52.8, the highest since January 2017. Household spending has also begun to show signs of recovery as both retail sales growth and consumer confidence improved slightly in February. With the peak impact of the VAT hike behind us, we expect household spending to start recovering from Q2, as inflation starts decelerating and confidence recovers. We retain our cautious GDP growth view for 2019 (1.4%), but see downside risks as more limited.

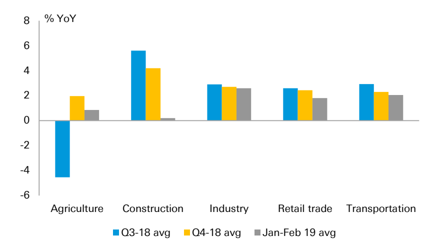
Net exports are expected to contribute negatively in Q1, as lower oil prices on a year-on-year basis lead to a decline in exports growth. However, exports are expected to recover in Q2, in line with rising oil prices. Fiscal spending will be a key determinant for the growth outlook later this year and in 2020. The first signs of the purse strings loosening have started to appear, such as an increase in payments for low-income pensioners announced in the past month, but the major spending on national projects is expected to appear only in late 2018.

Inflationary risks moderating

March headline inflation was reported at 5.3% YoY (0.3% MoM) slightly below our expectations. Food price inflation decelerated in YoY terms, for the first time since June last year, as the base effects began to fade. Inflation in non-food goods and services also stabilised post the January VAT-hike led jump. VAT pass-through has been lower than expected, remaining of limited magnitude outside of automatically indexed services prices. As a result, household and business inflation expectations, though still elevated, eased in March. In fact, consumer inflation expectations have now declined to their lowest since May 2018.

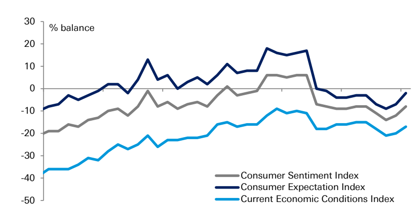
We now expect that the peak in the YoY inflation path has been reached, and is set to start declining from May onwards. We expect headline YoY inflation to decline to about 4.3% at the year-end, below the CBR's estimate of 4.7-5.2%. That said, with some temporary factors helping to keep inflation under control, there are upside risks - for instance, the agreement between the government and oil producers

Figure 126: Slowdown evident in all major sectors in first two months of 2019



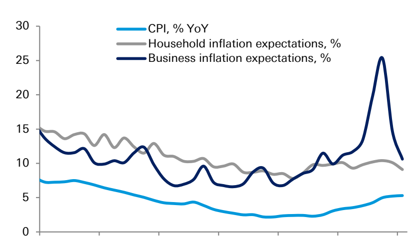
Source : Rosstat, Haver Analytics, Deutsche Bank

Figure 127: Consumer confidence has improved in Feb-Mar



Source : Haver Analytics, Deutsche Bank

Figure 128: Inflation expectations starting to moderate from recent highs



Source : CBR, Haver Analytics, Deutsche Bank which has kept petrol prices stable is expected to end in June.

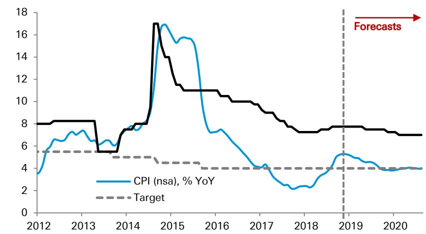
CBR turning mildly dovish as inflation outturns undershoot expectations

As widely expected, the CBR kept rates on hold (7.75%) at the March meeting. With the lower than expected VAT impact and a better external environment, the bank removed the near-term hawkish bias that it had held since last summer.

The CBR lowered their inflation projections to 4.7-5.2% at end-2019 (vs 5.0-5.5% in December), while the statement noted that "short-term inflationary risks have abated," although inflation expectations "remain elevated" and "deferred effects" of the VAT hike may manifest themselves in the coming months. However, there were clear dovish changes in the language. First and foremost, the CBR removed its near-term hawkish bias, with Governor Nabiullina noting that the CBR expects the H2 2018 hikes to now be enough to keep inflation under control. The CBR retained its long-held caution – still seeing medium-term risks as pro-inflationary – but it moved forward its expected timing of the return to easing. It now expects this later in 2019, although the Governor avoided being drawn on exact timing (versus end-2019/early-2020 expectation as of the December 2018 meeting).

The CBR's dovish tilt, along with the continued decline in inflation expectations in March has re-affirmed our view that the first rate cut is now likely to come as early as September. Rates remain a few 25bps increments above neutral, which the CBR sees in the 6-7% range, and we expect a return to the upper end of this range in 2020. However, the easing cycle will be gradual given the CBR's inherent caution, still elevated external risks, unanchored inflation expectations, high consumer credit growth and expected fiscal spending.

Figure 129: We now expect three rate cuts beginning Q3-2019 to take key rate to 7.00% in 2020



Source : Rosstat, CBR, Deutsche Bank

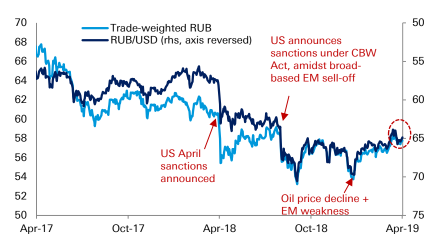
Ruble under moderate pressure as sanctions headlines hit the wires

The ruble came under some renewed pressure at the end of March, weakening by c. 2%, as fresh headlines related to sanctions hit the news wires, although it has since retraced the move, helped by higher oil prices.

First, reports suggest that the US State Department has prepared a draft of new sanctions under the second-round of the CBW Act sanctions, which await White House approval. The US administration is to choose at least three out of possible six areas (see table). While we expect some of the softer options to be chosen, uncertainty regarding the final measures implemented remains. Second, both the DASKA and DETER bills have been re-introduced in Congress. The former seeks to discourage cyber threats and proposes further sanctions on Russian individuals, cyber operations and gas export facilities. The latter could impose sanctions in case of interference in US elections. However, the momentum of progress on these bills has been slow so far.

The news from the conclusion of Robert Mueller's investigation has also helped remove one of the tail risks that could trigger Congressional pressure for severe sanctions. The summary of the report to Congress by the Attorney General found that the investigation did not establish that members of the Trump Campaign conspired or coordinated with the Russian government in its 2016 presidential election interference activities. However, the opposition has demanded that the full report be produced, and pressure to implement further sanctions could pick up in case of any adverse revelations or a spike in geopolitical tensions.

Figure 130: Ruble under moderate pressure over sanctions news



Source : Bloomberg Finance LP, Haver Analytics, Deutsche Bank

Figure 131: Options under second-round of CBW Act

Options before US government for second round of sanctions under CBW Act	
1	Opposing assistance by international financial institutions
2	Prohibiting US banks from lending to the Russian government
3	Further restrictions on exports to Russia
4	Restrictions on Russian imports into the US
5	Downgrading or suspension of diplomatic relations
6	Termination of US landing rights for state-controlled air carriers

Source : Deutsche Bank

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South Africa

- Economic outlook: With less than a month to go we look at some of the main election discussion points. We think a "goldilocks" outcome for the ANC could be around 57%-58%, based on the mid-point of the two main polls available to the market. That said, based on the ANC's own research unit , that shows Ramaphosa's approval rating of 73% among voters is higher that of the ANC's 60%, we expect a strong enough outcome that should cement the President's position as leader of the ANC for well up to two terms. This is important for policy stability in our view.
- Main risks: A weakening business cycle could make it more difficult for any post-election market rally to be sustained. From an election perspective, the market sees a weak showing for the ANC (sub 55% scenario) as a risk to Ramaphosa's term in office. However, the earliest he could be voted out by the party is at the next ANC elective conference in 2022.

Elections: what's the hype all about?

The South African general elections will take place on May 8th. From numerous interactions with our client base, the general consensus view out there is that a victory for the ANC greater than 60% will be beneficial to South Africa and allow President Ramaphosa to fast-track structural reforms. The market response to this scenario outcome is likely to be favourable. There is a lot of debate however around the various outcomes of scenarios. In our view a strong victory, should not be construed with all things positive given the challenging business cycle setting right now (see our Thematic note). That said, based on the ANC's own research unit , that shows Ramaphosa's approval rating of 73% among voters is higher that of the ANC's 60%, we expect a strong enough outcome that should cement the President's position as leader of the ANC for well up to two terms. This is important for policy stability in our view. The ANC, aware of challenges, has set it's target of at least 60% of votes on the 8^{th} .

ANC support has diminished

The ANC's support has been reduced over the years. As seen at the local elections in 2016, albeit not strictly comparable due to even lower voter turnout, the ANC won by the smallest margin since the turn of democracy. Local elections put ANC in first place at 53.9%, but this represented a substantial decline from 62.2% in the 2014 national elections. In the past, the only times that the ANC registered below 60% were indeed at local government elections (1996: 58%; 2000: 59.4% and in 2016: 53.9%). Coincidently, these years coincided with either business cycle downswings or recessions. But voter turnout has also been weaker in local elections. At the national level, the ANC's best support year was in 2004 when it received 69.7% (Thabo Mbeki's era) followed by 65.9% in 2009 when Zuma's first term started. Some observers attribute voter turnout due to increasing apathy as one of the main reasons for weakness in the ANC support over the years. A moderation in voter turnout is a global phenomenon and as highlighted further below could make or break the ANC's support in key regions, like Gauteng.

Opposition parties are gaining

The two main opposition parties, namely the DA and EFF received 22.2% and 6.4% in the national elections in 2014. In the local elections (2016) support firmed to 26.9% and 8.2% respectively, which had major ramifications for coalition governments being formed in key regions, particularly Johannesburg and Tshwane. For this reason, there is huge interest on whether these parties will increase support at the provincial level. Gauteng with the largest share in the economy, but also highest unemployment rate, is the most contested province. Gauteng is also home to the largest tax base; has the highest urbanised population density and as a consequence may have ramifications for Ramaphosa implementation of regional reform/ investment, in the scenario the ANC slips below 50%.

Which polls to follow?

There are only two polls that are published, both fraught with measurement issues, but they are the only guide points for the market. The Ipsos poll states that the ANC, DA and EFF would receive 61%, 14% and 9% respectively, while the Institute for Race Relations (IRR) survey conducted in February, puts the ANC at 53.7%. Both institutions are likely to release another poll soon.

It's often asked why South Africa does not have as many polls as in other countries. This could be due to the structural dominance of the ANC, but also the structure of society and the economy makes it difficult and expensive. There is also an unavoidable margin of error due to the assumptions that polls are forced to make in order to account for aspects of social structure, such as the urban/rural divide, first and second economies, etc. Historically, modeling has been a far more effective predictor of SA election results as an effective specification can take important factors such as parties' ability to transport voters to election sites, voter turnout, trends from by-elections, etc. into account.

The potential challenges of a strong outcome scenario for the ANC.

We are generally wary of what the implications of a strong (above 60%) victory scenario for the ANC may have on confidence and the outlook. In our view, **a strong victory for a fragmented institution like the ANC simply leads to a continuation of the status quo.** We think it may embolden the various factions within the ANC, leading to a continuation of confusing messages, and possibly unwinding a great deal of goodwill that's been built up since last year since the launch of Ramaphosa's New Dawn campaign. Business confidence could struggle to recover in such an environment. Conflicting messages from the ANC in its election manifesto adoptions which included aspects like prescribed assets and a broadening of the SARB's mandate, may also have played a part in the weaker business confidence outcome in Q1. A strong victory thus may provide very little incentive to change.

- The "Party List" Dilemma

A stronger ANC showing also leads to more seats in parliament. These seats are a direct function of the hierarchy in which individuals appear on the ANC list (see here). A cursory look at the ANC's election list suggests that the number of discredited officials from the Zuma era while still high in the top 20, is far greater as one moves down the list. This would clearly not be beneficial when it comes to enacting reforms (see here). The Zondo State Capture Inquiry has implicated many ANC officials in dealings with the corrupt Gupta family, and linked them to several patronage networks. These very members' names still appear reasonably high on the party list of eligible members considered for parliament (see here and here), which could detract from Ramaphosa's clean governance agenda. Moreover, there are questions as to left leaning elements in the ANC's manifesto (see here and here) that some of these members propose.

- More difficult to separate the party from the state

As a result, one of the biggest challenges since Ramaphosa's election is that policy messaging has been mixed vs. the market expectation that it would all be business friendly. However, media and some analysts often misconstrue ANC rhetoric for government's position on a matter. Perhaps this is because of the Zuma era. But there is a clear fundamental difference between the party's views and interests, and that of government; and that of the state. Government is only an agent of the state (its people), and the ANC as a ruling party is in temporary control of government. Land reform, for example, is less of a policy priority it seems for voters than it is for some members in the party, and government for that matter (see poll). As Ramaphosa is also president of the ANC, he has the obligation to support the vision of the party, but also have to act in the interest of the state (see here and here). He has done so several times, but more recently when he was reportedly immovable on the functional separation of Eskom, despite resistance from the party and his cabinet.

Ramaphosa's election of his cabinet

While the elections list provides the order of members elected for Parliament (400 in total), Ramaphosa can select his cabinet ministers from any position on that list. Thus even though the list creates a potential dilemma for the President, he is likely to bypass this by cutting the size of ministers in cabinet from 72. Based on media reports (see here and here) this reduction could be 30 to 50 fewer ministers with their deputies. The likelihood thus is for a fairly market friendly cabinet, especially considering talks that several ministries where there has been duplication and cadre deployment could be amalgamated and that economic and policy monitoring ministries streamlined (see here).

The timing and legalities of election announcement, new Parliament and cabinet selection

- The Electoral Act states that the election result must be announced by the Electoral Commission within seven days of the election date, 8th May 2019, but may not be sooner than 21:00 on the second day after the poll or all objections, other than appeals to Electoral Court, have been dealt with.
- The Constitution states that the first sitting of the new Parliament must take place at a date and time determined by the Chief Justice, but cannot be later than 14 days after the election results have been announced.
- The Constitution states that the President is to be elected at the first sitting of Parliament and must assume the position, by swearing or affirming faithfulness to the Constitution, within 5 days.
- The Constitution states that the President can appoint as many ministers as she/he wants, but only two can be from outside the National Assembly. It does not state a time constraint for the composition or announcement of cabinet.

Will reform take off after the elections, as commonly perceived?

In our view, reform is already underway (mining charter, energy, labour, SOEs, clean governance etc.). However, a second wave of planned reforms that are yet to take shape, will be far more focused and business orientated. This includes the President's aim to increase South Africa's position to top- 50 in the World Bank's Ease of Doing Business Index within the next three years. It would amongst others include an extensive review on administered prices and logistic costs, which will cement the SARB's focus on anchoring inflation expectations closer to the mid-point of the target band.

The concern that investors would be looking for justification of post-election reform momentum gaining traction, may be left disappointed. As explained in the thematic note above, growth dynamics in the short term (19H2), especially base effects, could well turn negative post elections. It may also lead to a repeat of the post ANC election "Ramaphoria" which faded, disappointing equity investors positioned for a stronger upturn.

In turn, if the ANC was to achieve a "goldilocks" scenario of not too hot, nor too cold, there could possibly be more traction in reform (as explained by the dilemma posed by the ANC's tainted party list). This scenario would probably put the ANC in the middle of the two main polls in the region of 57% to 58%. A moderately weaker outcome could, counterintuitively, help Ramaphosa to consolidate government by reducing the size of cabinet with less pressure to make political appointments. It also sends the message to the ANC that change is afoot; pressuring the party toward greater introspection. But importantly, this scenario could set the foundation for a more focused ANC-led government.

Coalitions in the scenario of a weaker ANC victory?

Evidently, if the ANC suffers a significant share of the electoral vote there are risks of coalitions being formed, especially with the EFF. We do not see the ANC and EFF amalgamating or embarking on a coalition due to the ideological differences between the parties. The ANC is more likely to align with smaller parties if it needs to consolidate to achieve absolute majority.

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Turkey

- **Economic outlook:** Turkey entered a technical recession in Q4 2018. A full-year contraction during 2019 is expected. Notwithstanding a slight deterioration in the underlying momentum in February and March, inflation looks set to decelerate in 2019, in the absence of further shocks. Subdued domestic demand with lower inflation should open the door for rate cuts by the CBT.
- **Main risks:** Geopolitical risks have risen slightly of late due to lack of full agreement with the US regarding Turkey's engagement in Syria as well as Turkey’s planned purchase of S-400 missiles from Russia. A prolonged dispute process due to contested results in the Istanbul mayoral election may exert upside pressure on political risk premium attached to the Turkish assets. Another bout of a major TRY depreciation could propagate a negative feedback loop between the real and nominal economies. The macro policy mix post elections will determine the duration of Turkey’s ongoing hard landing.

Turkey: What kind of normalization?

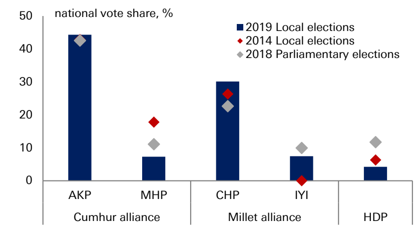
Turkish voters paid a visit to the ballot box for municipalities' elections in late March. While the full unofficial results are still not out due to the contested race in Istanbul, the unofficial results based on the total votes from Anadolu Agency, suggest the Republic Alliance, formed by AKP and MHP, garnered 51.6% of the total votes, followed by CHP-led opposition bloc (the Nation Alliance) at 37.6%. Pro-Kurdish HDP stood at 4.2%, followed by the Felicity Party at 2.7%. Results so far point to maintenance of status quo on the political front, given that the Republic Alliance managed to stay above the 50% threshold, and not too far away from their performance in June 2018 Parliamentary elections (53.7%), notwithstanding the ongoing recession and high inflationary environment.

That said, results also reveal a fledgling shift in underlying momentum behind the opposition, who managed to win in Ankara, for the first time in more than two decades. At the time of writing, the opposition candidate in Istanbul also appears to have won with a razor-thin margin, based on the unofficial results after recounting invalid votes. Meanwhile, the objection process is still underway as the AKP has continued to contest results in Istanbul. The entire process is expected to be finalized by April 13th, according to the electoral calendar. However, based on comments from AKP and MHP representatives as well as from political commentators (such as from daily Haberturk), the AKP is expected to request repeat elections in Istanbul (or in some of her districts), based on organized irregularities and other mass mistakes made during the voting process.

A prolonged dispute process, involving repeat elections in Istanbul (full or only in one or more districts), may exert upside pressure on political risk premium attached to the Turkish assets, which may later on rise ambiguity over the economic outlook. For now, we retain our call for a mild recession during 2019 (-0.2%YoY) as rising downside risks from recent market volatility and elevated political risk premium have been partially compensated by recent state banks-led surge in credit growth. The government's forthcoming reform package, (expected to entail tax reforms, capital support to state banks, steps to deploy in fight against inflation, main pillars of new financial architecture which aims to make Istanbul an international financial hub as well as measures to ease real sector firms' access to financing) will also be important to understand the forthcoming macro policy mix (and the authorities' macroeconomic priorities).

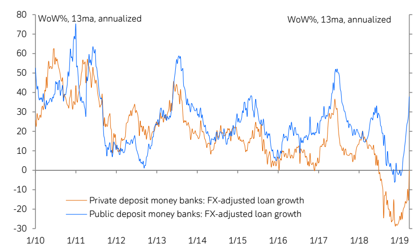
Annual headline inflation remained mostly unchanged at 19.7% in March, against market expectations for a marginal decline. Breakdown confirms unprocessed food (4.5%MoM) is the main item which exerted upside pressure, followed by energy (pump prices), health (due to an administered price hike in medicine prices) and restaurants. Services CPI also remained sticky at 0.6%MoM, mostly on the back of rents. Other items, such as processed food, clothing, durable goods, all undershot their respective historical trends, on the back of ongoing recession, extended duration for tax reductions (VAT or special consumption tax) on selected items (house, vehicles, furniture, white goods) and stable TRY (until final week of March). Both core B and C indicators continued to retreat during the month and reached 17.7%YoY and 17.5%, respectively. Momentum-wise (measured as annualized rate for 3-month average change in seasonally adjusted series), however, core C CPI, closely followed by the CBT, accelerated slightly to 6.3%, after 6% and -1.2% in February and January, respectively.

Figure 132: Cumhur alliance won the highest share of votes overall



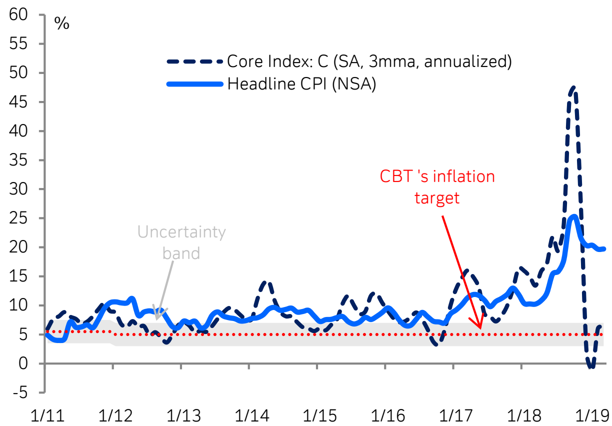
Source : Anadolu Agency, Deutsche Bank

Figure 133: A state-bank led recovery in credit growth



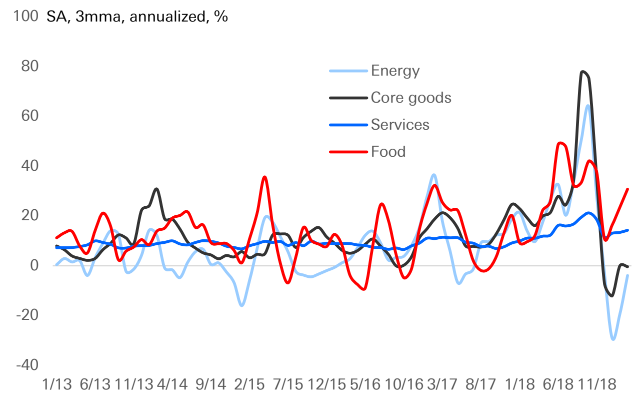
Source : CBT, Haver Analytics, and Deutsche Bank

Figure 134: Momentum in core worsens, while recent TRY performance ...



Source : TurkStat, CBT, Deutsche Bank

Figure 135: Renewed rise every where but core goods



Source : TurkStat, Deutsche Bank

Notwithstanding subsidized sales on selected unprocessed food items, roll-over in tax-cuts in selected core durable items and dampened demand pull pressure, headline inflation is not declining as much as expected. Rising global energy prices is probably one factor here while stickiness seen in services due to squeezed mark-up rates and elevated cost-push pressure (such as from wages) is also contributing. Unanchored CPI expectations, despite some improvement of late, is another factor too. Assuming (i) there will be no return to former tax rates on selected durable goods; (ii) a mild full-year recession this year; (iii) an ongoing commitment to macro rebalancing strategy mentioned in the New Economic Program (NEP); (iv) oil prices hovering around USD65/bbl during 2019; and (v) absence of a renewed bout of major TRY sell-off due to domestic political and geopolitical headlines ahead, we retain our call for headline CPI to decelerate from May onwards and before accelerating through year-end. We now expect it to end 2019 closer to 13.5%YoY, which is 0.5pp higher than our previous estimate on the back of announced tobacco price hike by major retail sellers effective as of April.

Recall that the Turkish markets sold off sharply a week before the elections. While one could attach the usual rise seen in political risk premium ahead of any ballot as a possible culprit, another catalyst was probably heightened market scrutiny over recent decline in CBT's reserves, particularly in light of recent media reports, such as in the Financial Times. The response by the authorities to undue market oscillation was relatively strong. The CBT scrapped its one-week repo auctions in late March, citing rising financial stability risks. The Bank also stopped its daily auctions for FX deposits against TRY deposits while increasing banks' limit on outstanding FX swaps with the CBT to 40% (step-by-step) from 10%. The end-result was a rise in CBT's effective rate (or weighted average rate) to 25.5% ahead of elections, as all funding from CBT funding to banks passed through the upper-end of rate corridor. More importantly, with the BRSA regulation from last year (capping local banks' swap transactions (where they lend TRY on spot in return for FX) with offshore counterpart at 25% of their latest regulatory capital) still in place, TRY rates, particularly at short end, spiked in an explosive manner, probably due to lack of sufficient TRY liquidity available to offshore entities. The wedge between onshore and offshore O/N rates reached triple-digits ahead of the ballot before returning to their normal levels post elections.

Figure 136: CBT's reserves have been recently under spotlight

Source : CBT, Haver Analytics, and Deutsche Bank

Following their unexpected return to liquidity management just one week before elections, the CBT embarked on a normalization process in the second week of April, and much sooner than our expectations. The Bank re-introduced one-week repo auctions on April 8th, hinting that effective rate will again converge back to the current one-week repo rate at 24% before long. The Bank's move signals that single-policy framework is MPC's main preference when it comes to policy conducting. We recently scaled back our rate cut expectations this year to 400bps to 20% (due to recent market oscillation and its impact on TRY outlook) and expect the first formal cut to take place in July. However, rising bias for discretionary in policy-making, such as moving back to active liquidity management despite earlier commitment for a simplified monetary framework, suggests an earlier-than-expected monetary policy easing cannot be ruled out, assuming the authorities' commitment to fiscal prudence remains unchanged (despite ongoing hard landing conditions).

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Figure 137: Czech Republic: Deutsche Bank Forecasts

	2017	2018F	2019F	2020F
National Income				
Nominal GDP (USDbn)	216	244	254	291
Population (mn)	10.6	10.6	10.6	10.6
GDP per capita (USD)	20483	23127	24003	27522
Real GDP (YoY%)	4.5	2.9	2.8	3.0
Private Consumption	4.4	3.2	3.4	3.1
Government consumption	1.3	3.7	2.7	2.2
Gross Fixed Investment	4.1	5.4	5.3	3.5
Exports	7.1	4.5	3.9	4.3
Imports	6.3	6.0	5.1	4.4
Prices, Money and Banking (YoY%)				
CPI (eop)	2.4	2.0	2.3	2.2
CPI (annual avg)	2.5	2.1	2.5	2.0
Broad money (eop)	8.6	5.6	5.3	5.2
Fiscal Accounts (% of GDP)				
Fiscal balance	1.5	1.4	1.0	0.9
Revenue	40.5	40.3	39.9	39.9
Expenditure	39.0	38.9	38.9	39.0
Primary Balance	2.2	2.3	1.9	1.8
External Accounts (USD bn)				
Goods Exports	146.7	161.4	165.3	185.9
Goods Imports	135.6	151.4	155.4	173.7
Trade Balance	11.1	10.0	9.9	12.2
% of GDP	5.1	4.1	3.9	4.2
Current Account Balance	3.4	0.7	1.4	2.1
% of GDP	1.6	0.3	0.5	0.7
FDI (net)	1.9	5.4	3.3	3.6
FX Reserves (eop)	145.0	138.7	141.7	150.9
USD/CZK (eop)	21.3	22.5	21.2	19.4
EUR/CZK (eop)	25.5	25.7	25.4	25.2
Debt Indicators (% of GDP)				
Government Debt	34.6	32.5	30.7	29.2
Domestic	18.2	19.3	16.3	15.0
External	16.4	13.2	14.4	14.2
External debt	94.9	79.3	75.2	64.1
in USD bn	205.3	193.9	190.8	186.9
Short-term (% of total)	57.1	59.5	55.2	53.3
General (ann. avg)				
Industrial Production (YoY%)	6.5	3.3	2.8	2.7
Unemployment (%)	4.2	3.2	3.2	3.2
	Current	**19Q2F**	**19Q3F**	**19Q4F**
Financial Markets				
Key official interest rate (eop)	1.75	2.00	2.00	2.00
USD/CZK (eop)	22.8	22.1	21.6	21.2
EUR/CZK (eop)	25.6	25.6	25.5	25.4

Source : DB Global Markets Research, National Sources

Figure 138: Egypt: Deutsche Bank Forecasts

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	234	250	254	257
Population (mn)	97.6	99.5	101.5	103.5
GDP per capita (USD)	2 448	2 530	3 097	3 743
Real GDP (YoY%)	4.1	5.3	5.6	6.1
Private Consumption	1.8	1.7	2.0	2.6
Government consumption	- 6.1	1.5	1.5	1.5
Gross Investment	11.3	15.0	16.0	15.0
Exports	13.5	14.3	11.0	8.0
Imports	- 0.5	2.4	3.0	1.0
Prices, Money and Banking (YoY%)				
CPI (eop)	22.3	14.4	11.7	9.0
CPI (annual avg)	23.3	21.6	13.2	9.3
Fiscal Accounts (% of GDP)				
Fiscal balance	- 10.9	- 9.8	- 8.6	- 7.8
Revenue	19.0	19.4	17.9	23.0
Expenditure	29.7	29.2	26.5	30.8
Primary Balance	- 1.8	0.2	1.9	2.0
External Accounts (USD bn)				
Goods Exports	21.7	25.8	29.5	32.0
Goods Imports	57.1	63.1	69.0	67.5
Trade Balance	- 35.4	- 35.0	- 39.5	- 35.5
% of GDP	- 14.2	- 14.0	- 12.8	- 9.3
Current Account Balance	- 15.6	- 6.0	- 5.1	- 4.0
% of GDP	- 6.3	- 2.4	- 1.7	- 1.0
FDI (net)	7.9	7.7	9.0	11.0
FX Reserves (eop)	30.6	43.5	48.0	51.0
USD/EGP (eop)	17.65	17.91	17.20	16.50
EUR/EGP (eop)	20.84	20.73	20.24	21.15
Debt Indicators (% of GDP)				
Government Debt	105.9	102.3	98.0	95.0
Domestic	91.1	83.3	75.0	68.0
External	14.8	19.0	23.0	27.0
External debt	33.7	37.0	38.6	39.2
in USD bn	79	93	98	101
Short-term (% of total)	15.5	14.0	12.0	11.0
General (ann. avg)				
Industrial Production (YoY%)	8.8	17.9	14.5	17.0
Unemployment (%)	12.5	11.1	9.7	8.8
	Current	**19Q2F**	**19Q3F**	**19Q4F**
Financial Markets				
CBE deposit rate	15.75	15.75	15.75	14.75
CBE lending rate	16.75	16.75	16.75	15.75
USD/EGP (eop)	17.32	17.30	17.20	17.10
EUR/EGP (eop)	19.48	20.12	20.24	20.60

Source :Deutsche Bank, Haver Analytics, and National Sources

Figure 139: Hungary: Deutsche Bank Forecasts

	2017	2018F	2019F	2020F
National Income				
Nominal GDP (USDbn)	140	156	163	187
Population (mn)	9.8	9.8	9.8	9.8
GDP per capita (USD)	14 233	15 891	16 682	19 178
Real GDP (YoY%)	4.1	4.9	3.5	3.1
Private Consumption	4.1	4.6	3.9	2.9
Government consumption	1.3	- 0.5	1.0	0.9
Gross Fixed Investment	18.2	16.5	8.5	2.6
Exports	4.7	4.7	5.1	5.2
Imports	7.7	7.1	6.4	4.5
Prices, Money and Banking (YoY%)				
CPI (eop)	2.1	2.7	3.6	3.4
CPI (annual avg)	2.3	2.9	3.3	3.0
Broad money (eop)	7.8	11.8	7.4	6.8
Fiscal Accounts (% of GDP)				
Fiscal balance	- 2.2	- 2.1	- 1.9	- 1.8
Revenue	44.7	44.7	44.3	44.1
Expenditure	46.9	46.8	46.2	45.9
Primary Balance	0.6	0.7	0.9	1.1
External Accounts (USD bn)				
Goods Exports	96.6	105.3	109.4	125.2
Goods Imports	94.5	107.0	111.8	126.0
Trade Balance	2.2	- 1.7	- 2.4	- 0.9
% of GDP	1.5	- 1.1	- 1.4	- 0.5
Current Account Balance	3.9	0.8	0.6	1.7
% of GDP	2.8	0.5	0.3	0.9
FDI (net)	2.1	4.4	3.1	3.4
FX Reserves (eop)	27.1	29.6	29.8	31.0
USD/HUF (eop)	259	281	268	250
EUR/HUF (eop)	310	322	322	325
Debt Indicators (% of GDP)				
Government Debt	71.5	70.5	69.5	68.6
Domestic	54.5	56.2	56.0	56.1
External	17.0	14.3	13.5	12.5
External debt	85.2	80.6	80.5	80.0
in USD bn	119	125	131	150
Short-term (% of total)	11.3	11.9	11.7	11.5
General (ann. avg)				
Industrial Production (YoY%)	4.6	3.8	3.4	3.2
Unemployment (%)	4.2	3.7	3.6	3.8
	Current	**19Q2F**	**19Q3F**	**19Q4F**
Financial Markets				
3M Bubor	0.16	0.30	0.25	0.25
Base rate (eop)	0.90	0.90	0.90	0.90
USD/HUF (eop)	286	274	271	268
EUR/HUF (eop)	322	318	320	322

Source : DB Global Markets Research, National Sources

Figure 140: Qatar

	2017	2018F	2019F	2020F
National Income				
Nominal GDP (USDbn)	167	191	190	202
Population (mn)	2.6	2.8	2.8	2.8
GDP per capita (USD)	63 249	68 630	67 575	71 781
Real GDP (YoY%)	1.6	1.4	3.1	3.2
Prices, Money and Banking (YoY%)				
CPI (annual avg)	0.4	0.3	2.5	2.9
Broad money (eop)	21.3	- 6.5	8.0	6.5
Fiscal Accounts (% of GDP)				
Fiscal balance	-1.6	3.5	4.1	2.9
Revenue	31.0	33.8	32.8	32.6
Expenditure	33.3	30.3	31.6	30.8
External Accounts (USD bn)				
Goods Exports	67.5	85.3	102.9	97.8
Goods Imports	- 30.8	- 33.3	32.4	33.8
Trade Balance	37.6	52.0	70.5	64.0
% of GDP	22.0	26.8	37.1	31.6
Current Account Balance	6.4	17.8	40.1	32.9
% of GDP	3.8	9.9	21.1	16.3
FDI (net)	- 0.7	- 0.7	- 0.7	- 0.7
FX Reserves (eop)	37.6	49.3	68.3	80.1
USD/QAR (eop)	3.6	3.6	3.6	3.6
Debt Indicators (% of GDP)				
Government Debt	47.1	44.1	47.8	47.3
Domestic	31.0	21.5	29.0	31.0
External	18.8	22.6	18.8	16.3
External debt	88.0	89.7	96.4	96.8
in USD bn	147.0	170.9	183.2	195.9
Financial Markets	**Current**	**19Q2F**	**19Q3F**	**19Q4F**
Policy rate 1 (eop)	5	5	5	5
Policy rate 2 (eop)	2.5	2.5	2.5	2.5
USD/QAR (eop)	3.64	3.64	3.64	3.64

Source : DB Global Markets Research, National Sources

Figure 141: Russia: Deutsche Bank Forecasts

	2017	2018F	2019F	2020F
National Income				
Nominal GDP (USDbn)	1 584	1 648	1 732	1 855
Population (mn)	146.8	146.8	146.7	146.6
GDP per capita (USD)	10 791	11 229	11 803	12 653
Real GDP (YoY%)	1.6	2.3	1.4	1.8
Private Consumption	3.3	2.3	1.9	2.1
Government consumption	2.5	0.3	1.0	1.0
Gross Investment	6.0	0.8	1.9	1.8
Exports	5.0	5.5	2.4	2.7
Imports	17.4	2.7	3.9	2.9
Prices, Money and Banking (YoY%)				
CPI (eop)	2.5	4.3	4.3	4.0
CPI (annual avg)	3.7	2.9	4.9	3.9
Broad money (eop)	10.5	13.0	11.4	10.8
Credit Growth (eop)	7.5	11.6	10.2	9.6
Fiscal Accounts (% of GDP)				
Fiscal balance	- 1.4	2.6	1.7	1.1
Revenue	16.4	18.7	18.1	17.3
Expenditure	17.8	16.1	16.3	16.2
Primary Balance	- 0.7	3.4	1.0	0.3
External Accounts (USD bn)				
Goods Exports	353.5	443.1	420.4	439.7
Goods Imports	238.1	248.6	244.9	259.3
Trade Balance	115.4	194.5	175.5	180.5
% of GDP	7.3	11.8	10.1	9.7
Current Account Balance	33.1	113.7	99.2	100.9
% of GDP	2.1	6.9	5.7	5.4
FDI (net)	- 8.2	- 23.1	- 6.9	- 7.4
FX Reserves (eop)	432.7	468.5	482.5	497.0
USD/RUB (eop)	57.60	69.47	62.00	63.50
Debt Indicators (% of GDP)				
Government Debt	12.6	12.1	14.2	15.1
Domestic	9.4	8.8	10.5	11.6
External	3.1	3.3	3.7	3.5
External debt	32.7	27.5	30.0	30.0
in USD bn	518	454	520	557
Short-term (% of total)	10.8	11.9	11.9	11.9
General (ann. avg)				
Industrial Production (YoY%)	2.1	2.9	2.6	2.9
Unemployment (%)	5.2	4.8	4.9	4.7
	Current	**19Q2F**	**19Q3F**	**19Q4F**
Financial Markets				
Policy rate (Key rate)	7.75	7.75	7.50	7.50
10Y yield (eop)	8.29	8.25	8.15	8.00
USD/RUB (eop)	65.35	64.00	63.00	62.00

Source : DB Global Markets Research, National Sources

Figure 142: South Africa Macro Forecasts

	2017	2018F	2019F	2020F
National Income				
Nominal GDP (USDbn)	355	364	370	429
Population (mn)	56.7	57.4	58.2	59.1
GDP per capita (USD)	6 255	6 303	6 316	7 205
Real GDP (YoY%)	1.4	0.8	1.4	1.5
Private Consumption	2.0	1.8	1.4	2.1
Government consumption	0.2	1.9	0.6	0.1
Gross Investment	1.0	- 1.4	0.1	2.3
Gross Fixed Investment	1.0	- 1.4	0.1	2.3
Exports	- 0.7	2.6	2.3	0.0
Imports	1.0	3.3	1.9	1.9
Prices, Money and Banking (YoY%)				
CPI (eop)	4.7	4.5	5.1	5.0
CPI (annual avg)	5.3	4.6	4.7	5.2
Fiscal Accounts (% of GDP)				
Fiscal balance	- 4.3	- 4.5	- 4.5	- 4.5
Revenue	28.7	29.2	29.2	29.2
Expenditure	33.0	33.7	33.7	33.7
Primary Balance	- 1.1	- 0.4	- 0.3	- 0.3
External Accounts (USD bn)				
Goods Exports	89.7	93.1	104.2	121.4
Goods Imports	84.1	91.3	99.2	115.8
Trade Balance	5.5	1.8	5.0	5.7
% of GDP	1.6	0.5	1.4	1.3
Current Account Balance	- 8.9	- 13.4	- 10.2	- 13.9
% of GDP	- 2.4	- 3.5	- 2.8	- 3.2
FDI (net)	- 6.1	- 2.3	- 1.5	- 3.4
FX Reserves (eop)	50.7	50.2	50.8	51.0
USD/ZAR (eop)	12.34	14.39	13.50	12.20
EUR/ZAR (eop)	14.72	16.48	16.27	15.84
Debt Indicators (% of GDP)				
Government Debt	52.7	54.0	54.2	54.3
Domestic	48.1	47.7	49.0	48.9
External	4.6	6.2	5.2	5.4
Financial Markets	**Current**	**19Q2F**	**19Q3F**	**19Q4F**
Policy rate	6.75	6.75	6.75	6.75
10Y yield (eop)	8.92	9.00	9.10	9.20
USD/ZAR (eop)	14.03	13.75	13.60	13.50
EUR/ZAR (eop)	15.85	15.99	16.00	16.27

Source : SARB, National Treasury, Haver Analytics

Figure 143: Turkey: Deutsche Bank Forecasts

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	851	765	735	752
Population (mn)	80.3	81.4	82.5	83.6
GDP per capita (USD)	10 597	9 395	8 905	8 989
Real GDP (YoY%)	7.4	2.6	- 0.2	3.5
Private Consumption	6.1	1.1	- 4.0	3.5
Government consumption	5.0	3.6	6.4	4.3
Gross Fixed Investment	7.8	- 1.7	- 11.5	5.1
Exports	11.9	7.5	6.0	2.3
Imports	10.3	- 7.9	- 7.8	4.3
Prices, Money and Banking (YoY%)				
CPI (eop)	11.9	20.3	13.5	12.1
CPI (annual avg)	11.1	16.2	16.2	13.5
Broad money (eop)	15.7	19.1	14.8	16.5
Credit Growth (eop)	19.8	9.3	7.1	12.2
Fiscal Accounts (% of GDP)				
Fiscal balance	- 1.5	- 2.0	- 3.0	- 2.6
Revenue	20.3	20.5	19.4	19.5
Expenditure	21.8	22.4	22.3	22.1
Primary Balance	0.3	0.0	- 0.1	0.4
External Accounts (USD bn)				
Goods Exports	166.2	174.6	176.2	179.5
Goods Imports	225.1	216.3	204.1	217.2
Trade Balance	- 59.0	- 41.7	- 27.8	- 37.7
% of GDP	- 6.9	- 5.5	- 3.8	- 5.0
Current Account Balance	- 47.3	- 27.8	- 11.6	- 19.9
% of GDP	- 5.6	- 3.6	- 1.6	- 2.6
FDI (net)	8.8	9.5	7.5	7.9
FX Reserves (eop)	84.2	72.9	67.9	66.5
USD/TRY (eop)	3.78	5.29	6.44	6.87
Debt Indicators (% of GDP)				
Government Debt	28.2	28.8	31.6	31.2
Domestic	17.2	15.8	17.2	17.6
External	11.0	13.0	14.5	13.6
External debt	53.4	58.9	61.2	60.5
in USD bn	455	450	449	455
Short-term (% of total)	26.3	26.2	28.0	26.5
General (ann. avg)				
Industrial Production (YoY%)	9.0	1.3	- 0.2	2.7
Unemployment (%)	10.9	11.0	13.1	12.4
	Current	**19Q2F**	**19Q3F**	**19Q4F**
Financial Markets				
Policy rate = effective funding rate	25.18	24.00	21.00	20.00
Overnight lending rate	25.50	25.50	22.50	21.50
1 Week repo rate	24.00	24.00	21.00	20.00
10Y yield (eop)	17.49	17.00	16.50	16.00
USD/TRY (eop)	5.67	5.77	6.00	6.44

Source : Deutsche Bank Global Markets Research, National Sources

LatAm Economics

The deterioration of prospects for global growth weigh on the outlook of all of the region's economies. However, the more dovish monetary policy stance recently adopted by the world's largest central bank has lead to price fluctuations in financial market that suggest very clearly that there is a divide between LatAm's largest and smallest economies. And when looking at macroeconomic fundamentals, we also find that the outlook for the region's economies varies by size, On one hand, the fate of Argentina, Brazil, and Mexico seems increasingly dependent on political events, and the prevailing electoral, political, and policy uncertainty is already weighing on growth prospects. On the other hand, the smaller Andean economies (Chile, Colombia, and Peru) seem to be on more solid footing as far as their growth cycle goes.

In Brazil we have reduced our growth forecast for 2019 to 1.6%. Recent activity data has been poorer than expected and growth expectations for this year have dropped from roughly 2.6% at the beginning of the year to the current 1.9% in the span of just a few months. Inflation remains contained although the recent rebound of headline inflation suggests that while the BCB does have room to maneuver if necessary, it should be careful in its use of its limited "monetary gunpowder". Overall, we continue to think that the future of the economy continues to still hinge on the future of the social security reform. While the Government finally seems to now have the support of a working coalition in Congress, the uncertainty now becomes the date in which the reform will finally pass (so that less politically contentious yet still important microeconomic reforms can be evaluated by Congress) and the amount of savings the reform will entail over the next few years. Overall, governability is still in question as the coordination between the Executive and Legislation has only stopped worsening and not yet improved.

We have also revised our growth forecast for Mexico down to 1.5% from 1.6%. In a nutshell, the economy continues to show signs of deceleration without any potential trigger that could turn the situation around, in our view. In particular, investments continue to be scarce and despite a rebound of gross fixed capital formation during January (1.6% y/y), we continue to expect investments to be the main drag on growth (just as they were during 2018 when they dropped 6.8% y/y). As Banxico has recognized, political and policy uncertainty continue to pose significant inflationary risks via a weakening of the MXN. And with headline inflation soon–to–return to above 4% territory and core inflation at still elevated levels and showing signs of greater persistence than in the past, the central bank is unlikely to feel comfortable enough to kick-start a cycle of monetary easing which could provide some much needed relief to faltering growth.

An improvement of Argentina's macro backdrop still requires policymakers' credibility to grow rapidly. Exchange rate volatility and high inflation persist. The BCRA has contracted monetary conditions and announced further measures aimed at boosting the demand for local currency. Yet data still does not clearly indicate whether the cycle has reached its trough. and as we get closer to the election, the government is likely to be tempted to adopt less austere fiscal measures to attempt to shore up its political support as the stagnation of real wages seems to have hurt the popularity of the governing coalition Cambiemos.

Growth prospects remain brighter for the Andean economies and could further improve if the US and China were to strike a trade deal soon. **In Chile, despite the recent slowdown of activity (1.4% y/y in February) we remain optimistic** and expect the investment-driven growth cycle to endure. The drop of inflation seems a bit more contained after the 2% y/y print during March yet we expect the BCCh to remain on hold until at least Q4. Overall, the economy should expand by roughly 3.3% in 2019.

In Colombia we expect foreign investment into the mining sector pushing growth above 3% this year. Banrep is unlikely to hike beyond 4.5% (a lower bound of their estimate of the neutral rate). A possible sovereign credit downgrade to BBB- and the chronic current account deficit will likely limit foreign financing and thus likely trigger a fiscal contraction into 2020 suggesting growth will peak this year.

Finally, **in Peru economic recovery is broadening** helped by lower funding costs for corporates, higher prices of metals, private investment in the mining sector, and non–mining GDP growth of roughly 4% that will reach low- and middle-income households and thus strengthen consumption. While public investment remains slow due to red tape and the turnover of local administrators, overall growth prospects remain positive.

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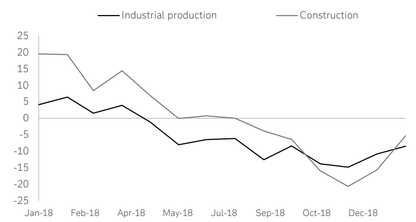
Argentina

In Argentina, FX volatility and high inflation persist. The BCRA announced further measures aimed at boosting the demand for pesos by increasing the rate offered for fixed-term deposits. On April 5, the IMF Executive Board completed third review under Argentina's Stand-By-Arrangement and approved USD 10.8bn disbursement. While praising the implementation of the monetary plan and the correction of both fiscal and external imbalances, the IMF expressed concerns for this year's fiscal target and inflation stabilization. On the political front, the economic downturn and increasing nominal instability have hurt the popularity of the Cambiemos coalition. The materialization of the economic recovery and the peso stability will play a critical role in President Macri's chances to win the elections in October.

Activity: the elusive trough of the cycle

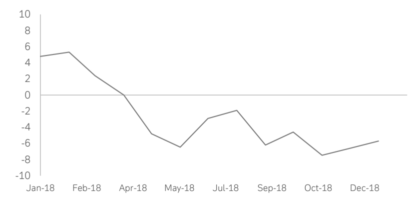
Aggregate demand remains depressed despite encouraging numbers in February, especially from industrial production and construction that grew -8.5% y/y (2.4% m/m sa) and -5.3% y/y (8.3% m/m sa). For two months in a row both indicators improved (month-on-month) which might suggest that economic activity could start improving in the next months. Nevertheless, we believe that additional information (especially regarding other sectors of the economy) will play a critical role in determining with more accuracy whether or not the Argentine economy has reach the trough of the cycle.

Figure 144: Industrial production and Construction y/y



Source : INDEC

Figure 145: Economic activity y/y



Source : INDEC

While in January the Economic Activity Index (EMAE) grew -5.7% y/y (above market expectation -6.0% y/y) and 0.6% m/m (seasonally adjusted), most sectors are still depressed. Only three sectors experienced year-on-year growth: agriculture (8.9% y/y), fishery (10.2% y/y), and education (1.3% y/y). Key sectors, directly related to aggregate demand, are still depressed and experienced large declines. For example commerce and manufacture industry grew -12.3% y/y and -10.1% y/y. Moreover, private consumption indicators do not lend support to the idea that Argentina may have already bottomed out. In fact, supermarket and shopping center sales grew -15.1% y/y and -10.5% y/y in January, suggesting that demand conditions are still depressed. Besides, March indicators are not entirely promising as automobile production grew –10.5% m/m. Therefore, next economic numbers will provide us with key information to determine the evolution of economic activity.

The peso (again) under pressure

FX volatility and high inflation persist in Argentina. Along with rising political uncertainty, the peso has depreciated nearly 8.9% from 39.8 on March 1 to 43.4 on April 9. Since January's inflation surprise (2.9% m/m) released on February 14, the peso entered into a faster depreciation path that has accelerated after February's inflation print (3.8% m/m) and more disappointing inflation prospects. The Leliq rate increased nearly 22.8 pp from 43.9% on February 14 to 66.8% on April 10, however the rate offered by local banks for fixed-term deposits (Badlar) has only increased 12.8 pp from 36% on February 14 to 48.8% on April 9.

The BCRA has announced over the last weeks a set of policies aimed at increasing the extent of interest rate pass-through from the Leliq rate to the rate offered by local banks for fixed-term deposits. The main objective of these policies is to increase the rate offered by local banks and thereby increase the demand for pesos.

BCRA's policy actions

Only 90 minutes after INDEC released February's inflation on March 14, Governor Sandleris in a press conference announced the extension of the monetary plan—zero monetary base growth without seasonal adjustment—until the end of 2019 (not until June as it was previously scheduled). In addition, Governor Sandleris noted that the government will send a bill to Congress aimed at making price stability the main mandate of the BCRA.

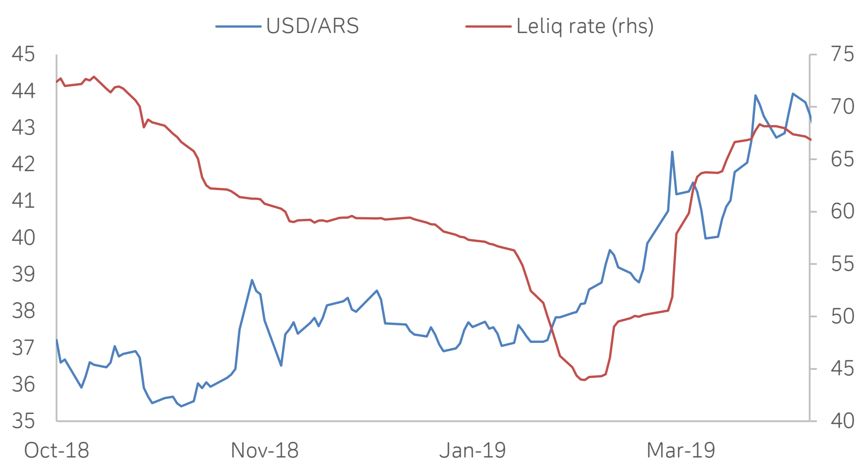
On March 28, in response to risks of additional nominal instability, the BCRA announced further measures aimed at increasing the rate offered by local banks for fixed-term deposits by allowing banks to increase their demand for Leliq. The BCRA increased the limit of Leliq holdings in local banks' portfolio (reverting a previously adopted policy) from 65% to 100% of banks previous month's capital.

In a press communiqué on April 1st, the BCRA announced that the Leliq rate will be kept above 62.5% during April. As the Leliq rate has experienced certain degree of volatility over the last months, through this action the objective of the BCRA was to decrease bank's spread uncertainty and thereby provide them with incentives to increase the rate offered for fixed-term deposits.

On April 5, the BCRA announced additional measures aimed at increasing the transmission from monetary policy to fixed-term deposit rates. According to the new policy, which will start in April 30, individuals will be allowed to hold fixed-terms deposits in any banks without being a direct client. This measure introduces capital mobility, more competitions, and will thereby help to transmit monetary policy actions to the rates offered by local banks.

The main objective of this set of policies is to avoid currency substitution that will depreciate the peso further. With higher inflation expectations (nearly 4% m/m for March and above 3.5% m/m for April) and FX volatility, the BCRA is increasingly concerned about (ARS) deposits in local banks.

Figure 146: Nominal exchange rate and policy rate



Source : Bloomberg Finance LP

Inflation expectations

Overall, there has been a substantial upward adjustment in inflation expectations since the rebound of inflation in January.

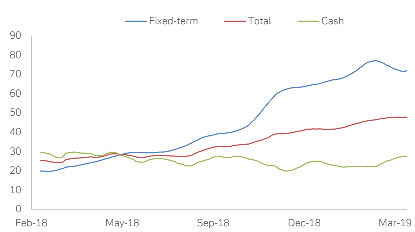
According to the BCRA survey of market expectations (REM), analysts expect March inflation at 3.8% m/m, 0.8 pp higher compared to the previous survey. For December 2019, analysts expect headline inflation at 36% y/y and core inflation at 35.1% y/y, nearly 4.1 pp and 5pp above February's survey. For 2020, analysts expect 23% y/y for headline inflation and 22% y/y for core inflation, 2.7 pp and 2.9 pp higher than the previous survey. Private consultants predict a higher inflation for March, near 4% m/m (above REM's 3.8% m/m). For instance, the Statistical Institute of Workers (ITE) predicts March inflation near 4% m/m (see Ambito). According to ITE higher inflation was driven by education (16.6%), transportation and communication (5.4%), food (5.2%). The increase was spread out as 61% of the 327 categories experienced increases above 1.5% in March. We expect March inflation near 4.1% m/m.

Why does the BCRA need to increase the rate offered for fixed-term deposits?

As we have previously argued, in its pursuit of lower inflation the BCRA needs to mitigate the risks of a USD/ARS spike as inflation pass-through is large and quick in Argentina. Recent data suggest the risks of a depositor-driven spike of USD/ARS demand appear to be on the rise if the real rate offered for fixed-term deposit does not increase, especially in a scenario with FX volatility and rising inflation.

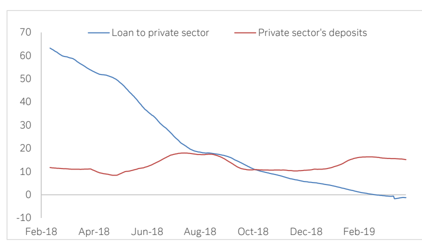
The chart below shows that the rate of growth of CDs (fixed-term deposits) and other longer term instruments has declined as depositors seem to be less willing to lock their money for longer time periods and are instead reallocating towards cash. Besides, the growth rate of USD-deposits has picked up since February and remains elevated and close to those observed back in the high-stress period of July-September last year.

Figure 147: Private sector deposits (30-day avg. y/y growth)



Source : BCRA

Figure 148: Private sector non-ARS deposits and loans (30-day avg. y/y growth)

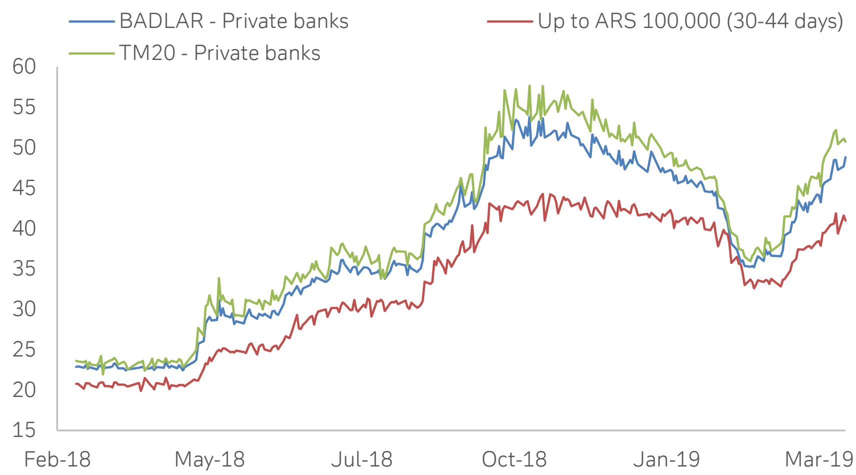


Source : BCRA

Together, both of these charts suggest that depositors might be switching to USD-deposits in local Argentine banks. The good news is that they still trust their money in local banks which is a big deal given Argentina's relatively recent history of forced "pesification" of USD deposits.

The bad news is that this data also suggest a less enthusiastic demand for pesos despite the increase in the Leliq rate. Given that, interest rates for ARS deposits have somewhat recovered over the last month, it is possible that the appetite for ARS deposits returns and that the rise in the Leliq rate will continue to be passed-through into deposits and result in faster growth of CDs. However, given the highly volatile political environment and the recent behavior of deposits in USD and ARS one could hardly argue that the probability of a depositor-driven spike in the demand for USD/ARS is negligible. The political risks are compounded by inflation remaining high despite the contraction of output and recent BCRA announcements. We remain cautious regarding the prospects for the ARS despite the upcoming USD sales by the Treasury and a very good harvest season (see The ARS' future: harvest season, IMF dollars, and the electoral cycle).

Figure 149: Interest rates in ARS deposits



Source : BCRA.

How much ARS denominated assets are under risk of dollarization?

With the Badlar rate currently at 48.8% (nearly 4.1% m/m), inflation expectation close to 4% m/m, and high FX volatility one may ask how much peso-denominated assets are subject to dollarization risk.

The table below indicates that total monetary assets subject to dollarization sum up to nearly USD 64.3bn (USD/ARS=43). However, monetary assets are not always subject to be dollarized. For instance, cash in circulation is required for transaction purposes, therefore cash balances held by privates are unlikely to be fully dollarized. Considering partial dollarization propensities and under a conservative scenario, we infer that nearly USD 20.7bn (ARS assets measured in USD) are at risk of dollarization. In case a dollarization scenario is triggered, it is likely that the ARS/USD could rapidly cross the upper bound of the non-intervention zone.

Figure 150: Assets at risk of dollarization (in ARS million, otherwise specified)

Assets	Stock	% subject to dollarization	Total subject to dollarization
Money (held by indivuduals):			
Cash in circulation	711,756	10%	71,176
Checking accounts	401,282	20%	80,256
Savings accounts	556,519	30%	166,956
Fixed-term deposits (nominal)	1,124,723	50%	562,361
Fixed-term deposits (inflation adjusted CER/UVA)	29,811	30%	8,943
Total money	**2,824,090**		**889,692**
Total money (in USD bn)	**64.3**		**20.7**
Others:			
Lecap	385,034	30%	115,510
Bonds (in USD bn)	**8.8**		**2.7**

Source : BCRA.

On the political front, the economic downturn and the increasing nominal instability have hurt the popularity of the Cambiemos coalition and the gap between former President Cristina Fernandez and President Macri has narrowed.

A recent survey by Proyeccion MyC Consulting (in Grupo La Provincia) indicates that economic matters account for more than 72% of Argentines' problems. Main issues are inflation (27.7%) and unemployment (17.6%). In accordance with more deteriorated economic conditions, the analysis indicates that more than 62.3% disapprove President Macri's administration and only 28.6% approve his performance. A survey by Reyes-Filadoro and Numeral 8 performed during March 10-13 indicates that the negative opinion towards President Macri has probably increased 10 pp between December and March. Furthermore, the survey indicates that half of those who voted for him in 2015 feel disappointed. An additional survey by Management and Fit Consulting (also in Grupo La Provincia) corroborates the decline in President Macri's approval which is currently near 25%. According to the survey, Governor Maria Eugenia Vidal is among the higher rated politician in Cambiemos with an approval rate above 39% and a rate of rejection only slightly above 48%.

Disappointing economic performance during recent months have hurt the chances of Cambiemos to win the elections in October. The economic recovery and the peso stability (achieved through the supply of USD from the Treasury and agricultural exports) will play a critical role in President Macri's chances to win the elections in October.

Figure 151: Key electoral dates

Dates	Event
12-Jun	Registration deadline for national alliances
22-Jun	Candidate registration deadline for primaries
12-Jul	PASO campaigns begin
9-Aug	PASO campaigns end
11-Aug	PASO General Elections, PASO CABA, PASO Buenos Aires, Salta, Catamarca
22-Sep	General election campaigns begin
13-Oct	First mandatory debate in Buenos Aires
20-Oct	Second mandatory debate
25-Oct	General election campaigns end
27-Oct	Election day
17-Nov	Presidential debate
3-22 Nov	Runoff campaigns
24-Nov	Presidential election runoff

Source : Local press.

Provincial elections

In Rio Negro Arabela Carreras for the provincial party Juntos Somos Rio Negro (JSRN) won the gubernatorial elections with 52.49%. In second place was the Peronist Martin Soria (Frente para la Victoria) with 35.08% and third was Lorena Matzen (UCR- Cambiemos) with 5.7%. Similar to Neuquen's results of last month, the provincial party retains the gubernatorial government in Rio Negro. Despite the fact that provincial results should not be extrapolated at the national level, it stands out that neither the Peronist Party nor Cambiemos were able to impose their candidates in the provinces. In Chubut (PASO primaries), Governor Arcioni will run for re-election as he obtained 31.8% of the votes, second place were Peronists (Gustavo Mac Karty 12..1%, the Kirchnerist Carlos Linares 16.6%, and Omar Burgoa 3.6%). In the third force was Gustavo Menna (Cambiemos) 14%. Next PASO will be held this Sunday April 14 in Entre Rios.
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Brazil

Brazil: Recovery postponed

The first 100 days of this administration are reinforcing the view that there is no effective government without a representative coalition. We have repeatedly highlighted that the outlook for reforms hinged critically on both the executive forming a coalition representative of the governing base and the President himself leading the process. Neither of these strong pre-conditions materialized in the first months of this administration, which led to turmoil in congress with scathing exchanges between the President and the Lower House President. It has been a troubled learning process for this new administration. There are signs that – slowly – the communication between executive and legislative is improving, that a working coalition is in progress and that the President will take a more active role in defending reforms. However, the clear lesson from these missteps is that the whole process of establishing proper governability will take longer than expected. Consequently, rather than having the first social security vote in the Lower House by the end of H1, we now expect it to happen in August.

Hesitation and changes in direction have taken a toll on the President's popularity. According to Datafolha, his approval rate is the lowest for a first mandate in about 30 years. The pressure is building for him to show results. The ideological battles and inaction have been most evident in the ministry of education, which culminated in the replacement of the minister. More broadly, emphasis on ideology rather than priorities and results seems to be the main drag for this administration, according to the local press.

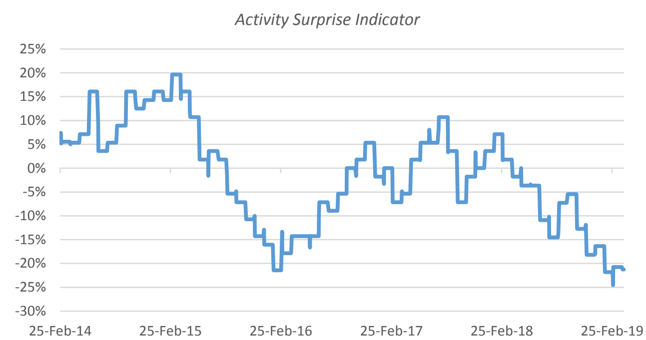
Resources and additional meetings aimed at forming a working coalition for the social security reform are underway. This should secure approval in the CCJ (without change but by a small margin) and quick transition to the special committee, where the most important discussions and watering down will happen. On the brighter side, a survey conducted by newspaper O Estado indicates that only 10% of the House see no need for reform, while only 20% reject the current proposal (vs. a 60% majority required). The same source reports that 198 out of the 308 needed are now in favor of reform (129 conditioning support on adjustments in the current text). This is 10% higher than two weeks ago – a surprise given the frictions between executive and legislative of the past month.

The main casualty of political noise has been growth. We now project 1.6% for the year, while forecasting 2020 growth at 3.0%. Late last year we believed that Brazil growth could reach 3.0% - before the downgrading in global growth that took place in the following months and recent escalation in political noise. Uncertainty was falling significantly post-elections, but it has stalled halfway between recent peak and 2013 trough as those fears mounted. As investment is the main potential driver of acceleration and uncertainty is likely to linger for at least another quarter, we are back-loading our forecasts. Still, we see broad consensus for reforms, fiscal adjustment and supportive initial conditions for growth to accelerate later in the year.

Consumption has been the main anchor for activity, while industrial activity remains lackluster – as elsewhere in the world. In contrast with other economies, however, Brazil's industry has failed to recover, and it is still hovering near 2009 levels still. A combination of weak exports (dragged by Argentina and the slowdown in global trade) and weak capital goods demand suggests this is unlikely to change anytime soon. The accident in Brumadinho took a toll on mining (to the tune of 15%), contributing to the roughly flat IP reading year-to-date (-70bp in January and

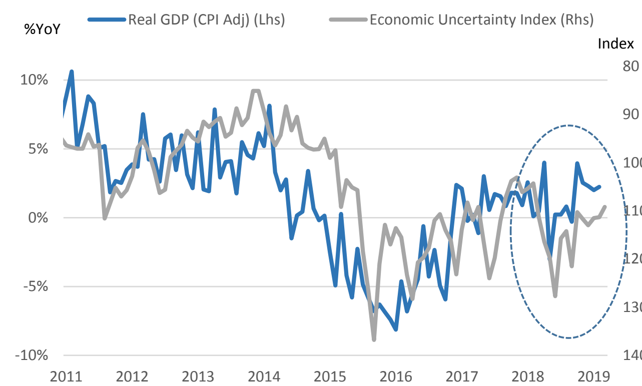
70bp in February). Capital goods sales will pick up slowly, since the output gap remains large (possibly in excess of 4pp), external demand weak, and while uncertainty weighs on domestic investment. Growth – which is hovering just above 1% - has benefitted from domestic demand, and this should remain the case for most of the year given the marked improvement in households' balance sheets. Encouragingly, real incomes are growing (even if moderately so) with the help of rising employment and low inflation, while monetary stimulus is helping – judging by the 10+% growth in non-earmarked new credit (chart below).

Figure 152: Activity still surprising on the downside



Source :DB Research, Bloomberg Finance LP, Haver Analytics

Figure 153: Uncertainty remains elevated – weighing on growth



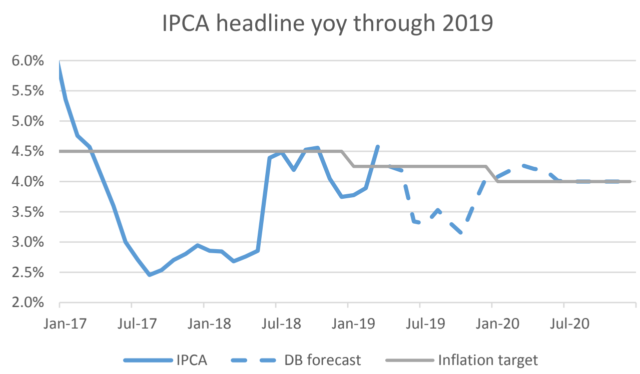
Source :FGV, BCB, IBGE

The central bank is reassessing growth and the outlook for monetary policy. The message from the last communique is that the monetary authorities need more time to understand what is driving growth disappointments before deciding on whether there is space for cuts. Accordingly, they have signaled low-for-longer, as we expected. However, there may be a narrow window for easing as inflation recedes in Q2/Q3 – especially if reforms falter and growth slows further.

We believe – and it seems the central bank agrees – that temporary shocks such as the truckers' strike, Argentina, elections, tighter USD financial conditions in Q4 and global deceleration explain Brazil's failure to launch. As the central bank has highlighted in recent reports, uncertainty correlates negatively with capacity utilization, and both the strike and Argentina account for a significant share of the weak performance in the industrial sector. However, there is more to explain, and we expect the central bank to signal whether they see room for easing as reforms unfold and the data come in over the coming couple of months.

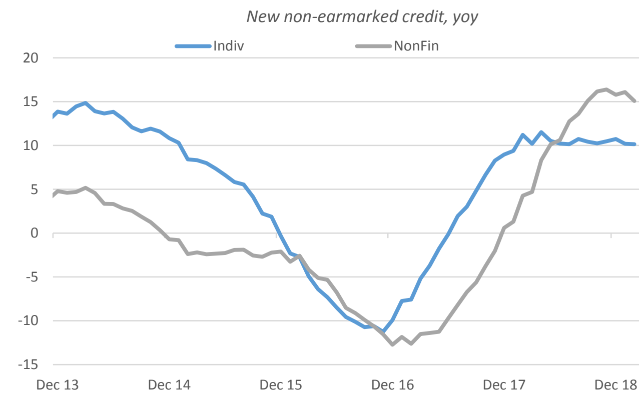
Inflation is rising, but temporarily so. Our model estimates inflation on target in 2020 and below target in 2019. With 2020 inflation expectations anchored at target and Selic forecasts stable at 6.50% this year, we would need a large change in central bank model forecasts to drive market participants more hopeful of a cut. **The central bank survey also shows 2020 Selic at 7.50% - in line with our view. Our Selic model, however, continues to point to downward risks to these estimates (25-50bp).**

Figure 154: Inflation: Up and down – below target



Source : DB Research, Haver Analytics

Figure 155: Credit recovers on stimulus



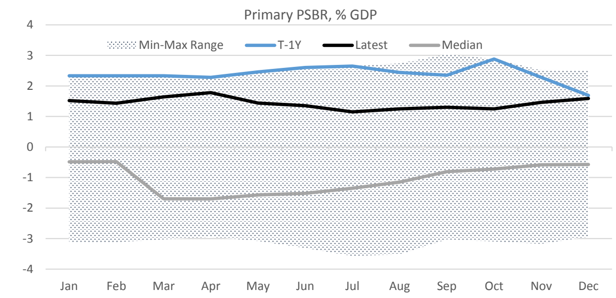
Source : DB Research, Haver Analytics

Fiscal accounts continue to show some improvement despite activity. As the chart below shows, the primary balance has improved vs. last year, but it remains well below the median. In addition, it remains about 4pp of GDP below the surpluses required to reverse the debt trajectory. The -R$139bn target is too lax and easy to beat – especially with one-offs. However, the government will need to be much more aggressive on cutting subsidies to sustain its debt.

It is crucial, however, that social security reform progresses so that growth picks up and the second part of the adjustment – spending cuts – can follow. Dealing with the calamitous fiscal situation of many local governments is essential to restore sustainability. The government will send to congress its fiscal balance plan for states (PEF) over the next couple of weeks. With 12 states that cannot borrow with federal guarantees, cutting expenditures and raising revenues (with the help of privatization) will likely be important ingredients to qualify for support – most likely in the form of tranches as states show results.

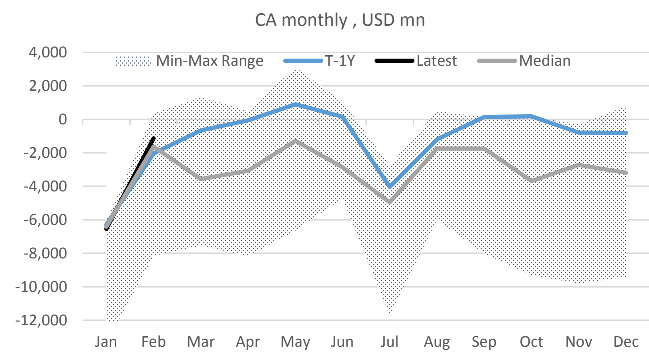
The BoP numbers remain supportive – but thanks to subdued demand. Disappointments in exports and exports have been offsetting, as low domestic growth has compensated for low external demand. As the chart below shows, the CAD remains close to historical lows as it follows its typical seasonal pattern. FDI is enough to fund such deficit 3-4 times so that overall funding risks remain muted – a resilient spot in the Brazilian economy.

Figure 156: Fiscal figures improve gradually



Source : DB Research, Haver Analytics

Figure 157: CA: In line with 2018



Source : Haver, Brazil Central Bank

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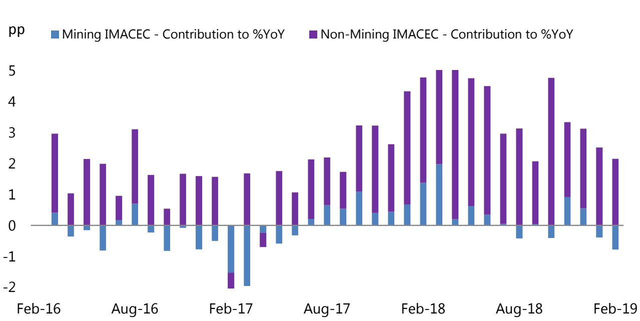
Chile

The BCCh blinked: on hold until at least Q4 19

On March 29, the board of the BCCh decided to maintain the TPM on hold, at 3%, until the next scheduled monetary policy meeting on May 9. The unanimous decision was broadly expected and while, ahead of the meeting, there was still some uncertainty regarding whether the BCCh would stick to its previously-stated goal of reaching a neutral interest rate by H1 20, the post–meeting statement dissipated most of that.

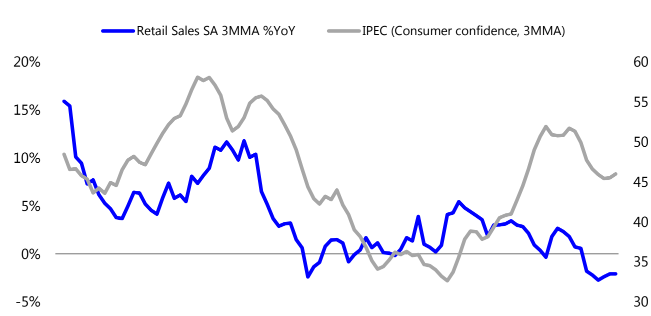
The board acknowledged that recent inflation data had fallen short of the path for the CPI that the central bank had anticipated in its base-case scenario. As we have noted in previous research, some of that "negative surprise" could be explained away by the changes to the reference CPI basket and methodological improvements to inflation measurement recently implemented by the National Statistics Institute (INE). However, the BCCh's latest statement also acknowledged that the influx of immigrants might have been significant enough not only to have an impact on labor market outcomes, but possibly on the economy's potential output as well. This is, in our view, a significant change in the bank's assessment of the current macro situation.

Figure 158: A slowdown in mining is weighing growth down



Source : BCCh, Deutsche Bank

Figure 159: And on the demand side, consumption continues to disappoint

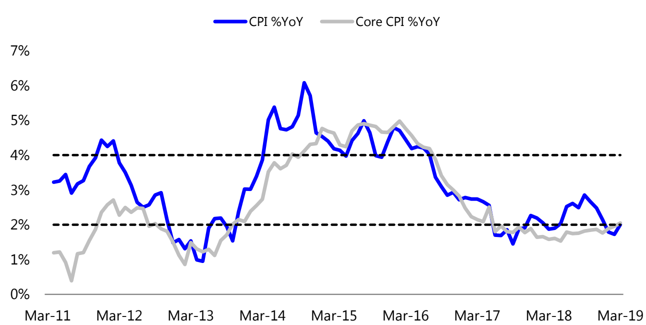


Source : Instituto Nacional de Estadísticas (INE), Deutsche Bank

A reassessment of potential output is needed

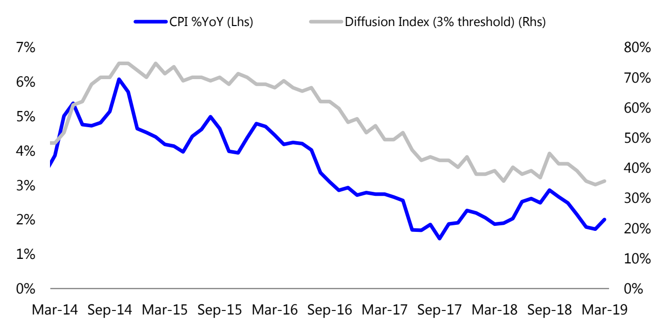
In previous statements, the BCCh confidently argued that normalizing rates and pushing the TPM to at least 4% by H1 20 was the appropriate course of action, despite the relatively feeble inflation data. In its view, the Chilean economy was slowing down but growth remained well above potential. The BCCh argued that inflationary pressures (not being immediately observable) did not mean that those risks were fully absent (after all, an economy growing above potential should eventually produce inflation). And therefore, a normalization of monetary conditions was in order.

Figure 160: Inflation is back within the tolerance range



Source : Instituto Nacional de Estadísticas (INE), Deutsche Bank

Figure 161: Diffusion indexes also suggest smaller downside risks to inflation



Source : Instituto Nacional de Estadísticas (INE), Deutsche Bank

But the BCCh's statement regarding the impact of the expansion of the labor force on potential output means that the central bank is no longer as confident in its estimate of said potential output. And until that estimate is revised (on June 10, when the next quarterly inflation report is published) the BCCh is a lot less likely to rely on the unobservable output gap in favor of, for example, inflation expectation measures both from surveys and financial markets.

Normalization is not over: The BCCh's new base-case scenario

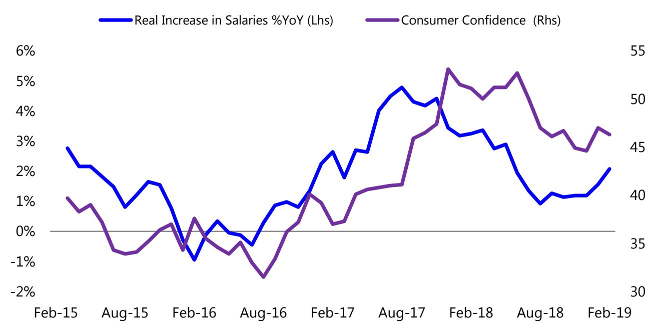
The week after the BCCh strongly signaled a pause in the normalization of policy rates, the Q1 19 quarterly inflation report (IPoM) was published. The IPoM offered a more detailed account of the changes to the BCCh’s future monetary policy actions that the post-meeting statement had already hinted at. In particular, the BCCh explicitly indicated that the TPM would remain at its current level for at least two quarters, as more clarity was needed regarding the economy's capacity utilization. Does this mean that the BCCh has abandoned its goal of normalizing monetary conditions? Not quite.

In fact, the BCCh was fairly straightforward in expressing its optimistic outlook for growth. The BCCh still sees investment as the driver of the cycle on the demand side, while consumption is expected to expand (though not as strongly as in previous cycles). And despite the uncertainty that now envelops the BCCh's view of Chile's output gap estimate, the bank clearly noted that its expectation of growth between 3% and 4% for 2019 and 2020 required the withdrawal of the existing monetary stimulus. In the new scenario, the BCCh suggested it would follow a path similar to that expected by economists: a single 25bp hike before year-end and then a gradual increase of the TPM aimed at reaching a neutral nominal rate of between 4%-4.5% by H1 21.

A more dovish BCCh could boost growth

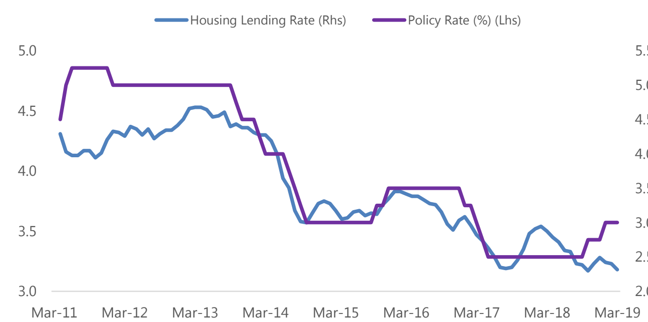
The headwinds that the global economy is facing have not yet had a significant impact in Chile's economy. The recent batch of activity data, however, has been at the weaker end of market expectations, and the adoption of a more patient approach to the normalization of interest rates by the BCCh could help smooth the recent volatility we observed in growth-related indicators.

Figure 162: Recovery of real salaries should lead to stronger consumption in Q2



Source : Instituto Nacional de Estadísticas (INE), Adimark GFK, Deutsche Bank

Figure 163: Easy credit conditions despite tightening should also bolster consumption



Source : BCCh, Deutsche Bank

In February, industrial production declined 3.6% y/y, a contraction far larger than the 2.1% y/y expected by consensus. The culprit for such a disappointing performance was the weather, as a rainier-than-usual summer in the North of Chile forced many mines to interrupt their production, explaining the large 9.4% y/y decline in mining activity. But the lower-than-expected IP print was not all about the weather and mining. In fact, manufacturing activity expanded only 0.8% y/y, while the consensus expected 1.1% y/y growth. The seasonal and one-off factors driving the weak IP print lead us to believe activity numbers are poised to improve later in the year.

Retail sales during February also disappointed, because while the consensus expectation was for the index to have grown 1.5% y/y, commercial activity during the second month of the year only expanded 0.7% y/y. Sales of durable goods continued to decline (1.8% y/y in February) and while sales of non-durable goods are still growing (0.5% y/y), the rate of expansion is declining (compare January's -0.6% 3m/3m saar with February's -1.2% 3m/3m saar). Yet just as with IP, there are reasons to be optimistic: labor market conditions have not deteriorated, consumer credit growth has picked up speed, and banks seem to have become increasingly less strict when it comes to offering consumers credit, which together lead us to expect a recovery in retail sales between Q2 '10 and Q4 '19.

Overall, the economy only grew 1.4% y/y during February, according to the IMACEC - also falling short of the 2% y/y consensus expectation. Early data for March, such as electricity generation, exports, imports of goods, and capital goods imports, all suggest that while March is likely to be a month of slightly stronger growth than February, the pace of activity will not recover until later in the year, mainly on the back of a rebound in consumption and assuming a relatively benign external scenario.

Bottom line: the BCCh is now a more patient hawk

In the midst of February's activity data, the higher-than-expected March CPI print came as both a surprise and a reminder that the absence of evidence of inflation over the last few months should not be interpreted as evidence of inflationary risks not being present. During March, inflation reached 2% y/y, which was marginally above the 1.9% y/y consensus expectation. In m/m terms, the March print stood at 0.5%, which was above both the 0.4% m/m consensus expectation and the 0.35% m/m inflation implied by the UF market. Headline inflation returned to the BCCh's tolerance range, after having fallen to 1.7% y/y in February, while core inflation stood at 2% y/y. And while the upside surprise was driven mostly by food items, the stability of price growth at a rate that is within the BCCh's tolerance range lends credence to the central bank's base-case scenario of a delayed-but-not-abandoned interest rate normalization.

In our view, the main risks to the Chilean economy continue to be external in nature, as leading indicators of investment continue to look promising and the weakest demand-side contributor to growth so far (private consumption) should rebound over the next few months. In this context, we expect that after the BCCh's announced two–quarter hiking hiatus, the TPM will rise to 3.25% by year-end followed by three 25bp hikes in 2020. The risks to our scenario beyond a further deterioration in the global economy are mostly related to the BCCh announcing a significant revision of their potential output and neutral rate estimates when the next IPoM is published in June.

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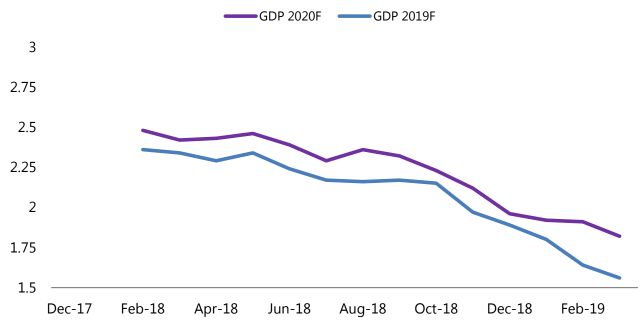
Mexico

Monetary policy constrained by inflationary risks and policy uncertainty

Over the last month, Mexico's macro outlook has changed little. As expected, Banxico decided to keep the overnight rate on hold at 8.25% until the board meets again on May 16, 2019. The Minister of Finance published the "Pre–Criteria for Economic Policy" (CGPE), a step in the 2020 budget cycle, which reduced the government's growth forecasts for 2019 and 2020. Yet, it reiterated the government's commitment to deliver a primary surplus of 1% of GDP. In addition, the Ministry of Finance stated its intentions of using part of the Fund for the Stabilization of Budget Revenues (FEIP) to prepay part of Pemex' debt. The announcement is positive for Pemex, but the implications for Mexico's fiscal accounts are less clear.

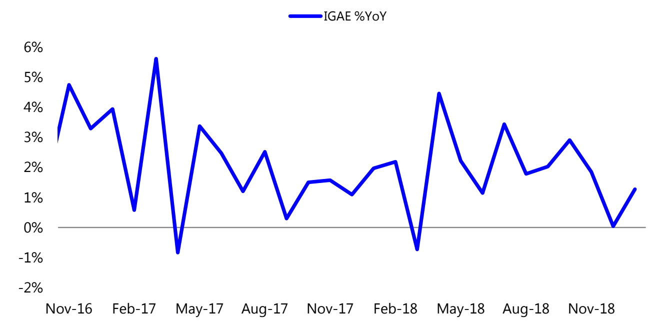
On the activity front, there was somewhat of an improvement in the latest batch of data. January's industrial production, retail sales, and gross fixed capital formation were all stronger than expected, which naturally resulted in January's IGAE printing an above–consensus print of 1.3% y/y (vs. the expected 1.1% y/y). February's trade balance totaled USD 1.2bn, which was above the median expectation of a USD 304m surplus (albeit only as a result of a moderation of imports). The banking credit growth rate also inched up in February. While consumer confidence and the IMEF PMI declined in March, the former remains near record-high levels, and the latter remains in 'expansionary' territory.

Figure 164: Although growth expectations continue to fall...



Source : Banxico, Deutsche Bank

Figure 165: ...data has improved at the margin



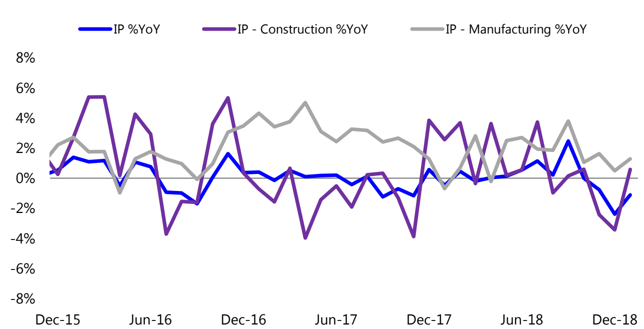
Source : INEGI, Deutsche Bank

After dipping below 4% y/y in February, headline inflation rebounded to 4% y/y in March, driven by higher energy prices and some core goods. Core inflation also reverted its declining trend of three months and reached 3.71%. The persistence of core inflation at the current level and the stickiness of inflation expectations are likely to continue to stand in the way of a more dovish Banxico – especially as long as the government does not furnish a more detailed plan for the transfer of fiscal funds to Pemex that addresses some of the issues that keep Pemex' profitability from improving.

Dovish turn? A proposal that is still unattractive to Banxico

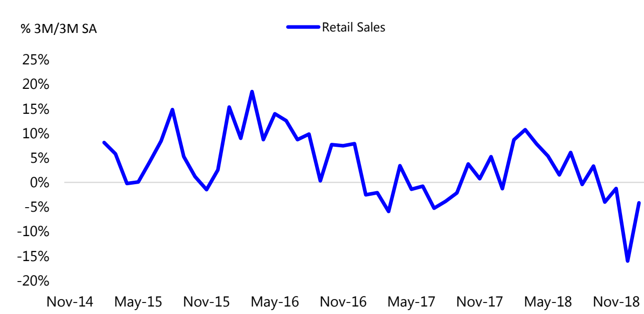
We were not surprised when Banxico announced its decision to keep the overnight rate on hold at 8.25% at the end of its board meeting on March 28. Yet, ahead of the meeting, the price action of local rates was consistent with there being investors that expected the tone of the statement to clearly signal that Banxico was seriously considering embarking on an easing cycle as soon as the next couple of monetary policy meetings. However, as we had expected, the tone of the statement seemed similar to the tone of the latest quarterly inflation report, especially in terms of the rising importance that Mexico's weakening activity has acquired during the board's discussions.

Figure 166: On the supply side, IP surprised on the upside…



Source : INEGI, Deutsche Bank

Figure 167: ...and retail sales suggest that private consumption has improved



Source : INEGI, Deutsche Bank

Banxico is aware that there is an ongoing weakening of global activity. As a result, the largest central banks have turned toward a more dovish monetary policy stance, which has been favorable for risk appetite. However, the board highlighted that the improved conditions in global financial markets relative to those prevailing in Banxico's February meeting and the balance of risks to activity remained negative.

On the domestic front, Banxico remains worried about the persistence of policy uncertainty and the recent downgrade of Pemex, and it even expressed concern over Mexico's sovereign debt. Once again, the central bank decided to highlight the importance of adherence to the government's fiscal goals in regard to financial stability, as well as the need for institutional reform in order to achieve long-term growth. Ahead of Banxico's last meeting, inflation data seemed to be consistently improving. Yet, the board considered that despite the strengthening of downside risks to inflation, the overall balance of risks to price growth was still skewed toward higher rates and subject to significant uncertainty. The improvement of inflation earlier in the year was mainly driven by non-core prices. Prices for core goods continue to grow at elevated rates, and they could be behind the stickiness of inflation expectations, which remain stable but too high.

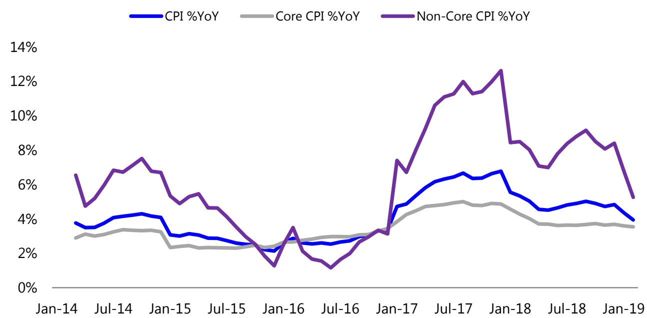
When it comes to listing the company's main worries regarding the inflation picture in Mexico, Banxico's board members seem to agree that the MXN would pose the greatest challenge to inflation in the event of a domestic or external shock that rattles financial markets. The central bank also mentioned the role of non–core prices as catalysts for a potential surge of headline inflation, especially in the event of an escalation of trade wars. When addressing the statement's readers, the board also cited the recent, sizeable 16% minimum wage increase as another potential trigger of stickiness in inflation expectations. As a last risk to inflation, the board once again sounded the alarm regarding how long inflation has remained above target, as that could dislocate expectations in a more permanent matter.

The post-meeting statement concluded with the board stating that over the past few months, it has not observed any data that suggests that the expected trajectory of inflation in Banxico's base case scenario needs to be revised. Thus, the central bank continues to estimate that the current monetary policy stance is consistent with inflation gradually declining and finally reaching its 3% target by 2021. In our view, the main message that Banxico is trying to convey is that while the board is keenly aware of the recent changes to Mexico's macro scenario (i.e. weaker activity and moderating inflation), there are enough relevant risks to skew the overall balance of risks in a way that leads Banxico to avoid erring and signaling the start of an easing cycle too early.

Is Banxico "too" hawkish? Activity, inflation, and political uncertainty

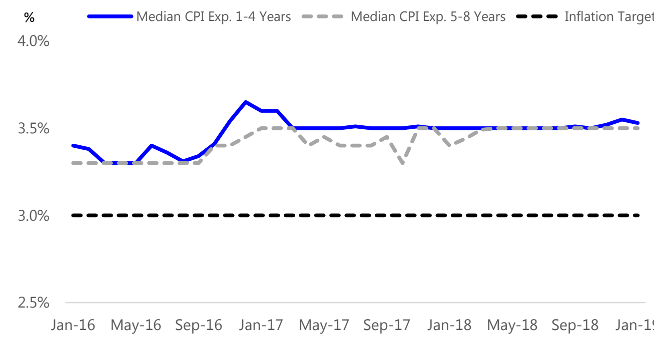
Although going into Banxico's March meeting, the most recently published activity and inflation data seemed consistent with easier monetary policy in the near term, the numbers released after Banxico decided to keep the overnight rate on hold tell a slightly different picture.

Figure 168: Seasonal factors should push inflation back above 4%...



Source : INEGI, Deutsche Bank

Figure 169: ...and inflation expectations remain too high for a dovish turn



Source : Banxico, Deutsche Bank

After declining for a couple of months, March's inflation returned to 4% y/y, while core inflation posted a 3.7% y/y print. On a m/m basis, core inflation picked up considerable speed and grew 0.34% m/m, mainly driven by processed foods. However, going forward, the changes to the CPI basket last year will result in y/y inflation prints that should once again be well above 4%, which will not help bring inflation expectations back toward the 3% target. Also, wage data suggests that labor costs are rising at a increased pace. March wage negotiations resulted in salary adjustments of 6.5% y/y, which is well above February's 6.1% y/y. The gradual incorporation of the minimum wage adjustment into prices should keep salaries growing at a relatively quick pace, which will likely make a decline in inflation difficult.

The Mexican economy expanded 2% in 2018. Yet, Q4 growth stood at only 1.7% y/y. The most recent activity data available – January's IGAE – are in line with a continued deceleration of the economy, as output rose 1.3% y/y over the month. However, activity expanded at a faster pace than consensus had expected. Industrial production had somewhat of a rebound in January as well, rising 0.6% m/m. This was the first time in four months that the IP index had grown relative to the previous month. While January's IP posted a -0.9% y/y growth rate, it was also above expectations, driven by a relatively robust expansion of manufacturing (1.3% y/y) and construction (1.7% y/y). Retail sales also posted marginally positive results in January, growing 0.9% y/y – while this was below expectations, it was a significant improvement relative to December's -1.3% y/y print. Gross fixed investment also rebounded in January, posting a 1.6% y/y print, which was above expectations and a significant improvement relative to December's -6.8% y/y print. Finally, February's trade balance posted a USD 1.2bn surplus, which was greater than expected – albeit driven by declining imports.

Is activity in Mexico turning around? Not quite. Aggregate demand data for 2018 shows that on the demand side it is investments that are slowing the economy down. In Q4 '18, aggregate demand expanded 0.5% q/q sa, explained by a -0.3% q/q sa decline of private consumption, a 0% q/q sa change in government spending, a 2% q/q sa contraction in overall investment, a 5.5% q/q sa increase in inventories, and a 0.1% q/q sa contraction in exports. Therefore, the recent moderation of the economy's deceleration is, in our view, an indication that the economic slowdown is not meaningful enough to single-handedly relieve inflationary pressures. Yet, the trend of decelerating growth is likely to continue to persist until investment bounces back.

One of the current obstacles for investment is policy uncertainty in Mexico. On one hand, the government seems committed to fiscal austerity. In the CGPE for the 2020 budget, the government reduced its growth expectations for 2019 from 1.5-2.5% to 1.1-2.1%. Yet, despite the implications for fiscal revenues of slower growth, the government restated its goal of delivering a primary surplus of 1% of GDP. For 2020, the goal is even more ambitious, as the government aims to deliver a primary surplus of 1.3% of GDP. Yet, the main fiscal risk at this stage is Pemex. The CGPE does mention the possibility of supporting the SOE by pre-paying some of its debt in 2019, only using funds currently in the FEIP. To do this, the government will need to amend Mexico's fiscal responsibility law and ideally that of Pemex. Yet, the lack of policy details in matters that are relevant to the overall future of Mexico's economy (such as Pemex' financial viability) form one of many examples of policy uncertainty that are unlikely to change in the near term, and that therefore remain an unsurmountable obstacle for growth.

Bottom line: Banxico unlikely to cut before Q4 '19

As we have mentioned in previous notes, we believe that the risks that Banxico faces (in terms of erring on the timing of the easing cycle's starting date) are asymmetric. More specifically, we believe that given the high persistence of inflation expectations, the economic costs of cutting "too early" far outweigh the costs of "taking too long to begin cutting".

Therefore, we continue to stand by our expectation that Banxico is likely to begin an easing cycle no earlier than Q4 '19. By then, there should be more clarity regarding the government's agenda and the 2020 budget, which should result in the dissipation of some of the existing policy uncertainty. By that time, Banxico will likely have gathered more data in order to empirically examine the question of whether inflation expectations have become permanently more persistent and whether this persistence reflects a loss of Banxico's credibility.

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Figure 170: Argentina: Deutsche Bank Forecasts

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	637.5	537.0	477.4	515.1
Population	44.1	44.5	44.8	45.2
GDP per capita (USD)	14.5	12.1	10.6	11.4
Real GDP (YoY%)	2.9	- 2.5	- 1.2	1.8
Private Consumption	3.5	- 2.4	- 2.3	2.1
Government consumption	2.2	- 3.3	- 6.4	- 0.7
Gross Investment	11.0	- 5.8	- 14.5	3.0
Exports	0.4	0.0	9.5	6.1
Imports	15.0	- 5.1	- 8.3	4.8
Prices, Money and Banking (YoY%)				
CPI (eop)	24.8	47.6	38.1	20.3
CPI (annual avg)	25.7	33.8	49.1	27.9
Broad Money (eop)	31.9	7.1	5.0	24.5
Credit Growth (eop)	50.7	36.9	16.5	20.5
Fiscal Accounts (% of GDP)				
Fiscal balance	- 6.7	- 5.2	- 2.9	- 1.5
Revenue	34.8	33.7	34.8	36.7
Expenditure	41.5	36.1	34.8	35.7
Primary Balance	- 4.2	- 2.4	0.0	1.0
External Accounts (USD bn)				
Goods Exports	58.4	61.6	70.0	75.0
Goods Imports	66.9	65.4	57.2	65.2
Trade Balance	- 8.5	- 3.8	12.8	9.8
% of GDP	- 1.3	- 0.7	2.7	1.9
Current Account Balance	- 31.3	- 28.0	- 9.5	- 12.4
% of GDP	- 4.9	- 5.2	- 2.0	- 2.4
FDI (net)	11.5	9.5	10.3	4.5
FX Reserves (eop)	55.1	65.8	62.2	68.3
ARS/USD (eop)	18.62	37.70	51.00	60.00
Debt Indicators (% of GDP)				
Government Debt	50.3	85.3	75.9	69.0
Domestic	27.9	20.4	16.1	14.9
External	22.4	64.9	59.8	54.1
External debt	36.8	51.8	56.7	50.0
in USD bn	235	278	263	265
Short-term (% of total)	22.9	28.6	27.0	25.3
General				
Industrial Production (YoY%)	1.7	- 4.6	- 2.0	2.0
Unemployment (%)	8.4	9.0	9.4	9.2
Financial Markets	**Current**	**19Q2F**	**19Q3F**	**19Q4F**
Overnight rate	67.2	60.8	54.4	48.0
1 month BADLAR	47.3	44.9	38.5	32.1
ARS/USD (eop)	43.4	45.8	48.4	51.0

Source : DB Global Markets Research, National Sources

Figure 171: Brazil: Deutsche Bank Forecasts

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	2 053	1 876	2 071	2 215
Population (mn)	207.7	209.2	210.7	212.1
GDP per capita (USD)	9 887	8 967	9 828	10 446
Real GDP (YoY%)	1.1	1.1	1.6	3.0
Private Consumption	1.4	1.9	1.8	3.2
Government consumption	- 0.9	0.0	0.6	0.9
Gross Investment	- 2.5	4.1	3.4	7.3
Exports	5.2	4.1	1.1	4.5
Imports	5.0	8.5	4.0	6.8
Prices, Money and Banking (YoY%)				
CPI (eop)	2.9	3.7	4.1	4.0
CPI (annual avg)	3.4	3.7	3.7	4.1
Money Supply M1 (YoY%)	5.7	6.3	5.0	3.5
Moneytary Base (YoY%)	9.8	8.2	8.0	7.5
Fiscal Accounts (% of GDP)				
Fiscal balance	- 7.0	- 6.4	- 6.5	- 5.2
Primary Balance	- 5.2	- 4.5	- 5.0	- 5.2
	-1.8	-1.8	-1.4	-0.2
External Accounts (USD bn)				
Goods Exports	217.7	239.9	230.0	241.5
Goods Imports	150.8	181.2	185.0	198.9
Trade Balance	67.0	58.7	45.0	42.6
% of GDP	3.3	3.1	2.2	1.9
Current Account Balance	- 7.2	- 14.5	- 40.0	- 35.0
% of GDP	- 0.4	- 0.8	- 1.9	- 1.6
FDI (net)	70.3	88.3	70.0	75.0
FX Reserves (eop)	374.0	374.7	382.0	380.0
BRL/USD (eop)	3.31	3.87	3.70	3.70
Debt Indicators (% of GDP)				
Government Debt	74.0	82.8	86.1	88.2
Domestic	67.0	79.6	83.0	85.2
External	7.0	3.2	3.1	3.0
External debt	26.5	29.8	30.9	28.6
in USD bn	545	559	641	633
Short-term (% of total)	10.2	9.5	15.0	10.0
General				
Industrial Production (YoY%, ann. avg)	2.5	1.1	6.0	7.5
Unemployment (%)	11.8	12.3	11.0	9.5
Financial Markets	**Current**	**19Q2F**	**19Q3F**	**19Q4F**
SELIC Overnight rate	6.50	6.50	6.50	6.50
10Y yield (eop)	8.97	8.50	8.50	8.50
BRL/USD (eop)	3.86	3.70	3.70	3.70

Source : DB Global Markets Research, National Sources

Deutsche Bank Securities Inc.

Figure 172: Chile: Deutsche Bank Forecasts

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	277.0	299.9	305.6	322.9
Population (mn)	18.4	18.6	18.8	19.0
GDP per capita (USD)	15 068	16 144	16 253	17 023
Real GDP (YoY%)	1.3	4.0	3.3	3.4
Private Consumption	3.0	4.0	3.3	3.5
Government consumption	4.4	2.2	3.5	3.5
Gross Investment	1.8	8.4	6.2	4.3
Exports	- 1.1	5.0	3.5	2.9
Imports	4.7	7.6	4.7	3.1
Prices, Money and Banking (YoY%)				
CPI (eop)	2.3	2.1	2.7	2.9
CPI (annual avg)	2.2	2.3	2.1	2.7
Broad Money (eop)	4.8	12.5	8.8	9.8
Private Credit (eop)	4.8	10.1	8.3	8.8
Fiscal Accounts (% of GDP)				
Fiscal balance	- 2.7	- 1.7	- 1.5	- 1.3
Revenue	20.8	21.8	22.1	22.4
Expenditure	23.5	23.5	23.6	23.7
External Accounts (USD bn)				
Goods Exports	68.9	75.5	78.3	80.7
Goods Imports	61.5	70.8	71.3	74.0
Trade Balance	7.9	5.4	5.5	5.0
% of GDP	2.9	1.8	1.8	1.6
Current Account Balance	- 6.0	- 9.2	- 8.9	- 8.7
% of GDP	- 2.2	- 3.1	- 2.9	- 2.7
FDI (gross)	5.9	6.1	9.7	10.5
FX Reserves (eop)	39.0	39.9	39.2	39.4
CLP/USD (eop)	615	696	650	640
Debt Indicators (% of GDP)				
Government Debt	23.5	25.6	27.6	27.9
Domestic	16.4	17.9	22.0	22.2
External	7.2	7.7	5.6	5.7
External debt	65.5	61.2	61.5	58.5
in USD bn	181.5	183.6	188.0	189.0
Short-term (% of total)	11.6	13.7	14.2	15.0
General (ann. avg)				
Industrial Production (YoY%)	-1.1	2.9	2.0	2.3
Unemployment (%)	6.6	6.9	6.4	6.2
Financial Markets	**Current**	**19Q2F**	**19Q3F**	**19Q4F**
Policy Rate	3.00	3.00	3.00	3.25
USD/CLP (eop)	663	657	653	650

Source : DB Global Markets Research, National Sources

Figure 173: Mexico: Deutsche Bank Forecasts

	2017	2018	2019F	2020F
National Income				
Nominal GDP (USDbn)	1 161	1 223	1 256	1 354
Population (mn)	124	125	126	126
GDP per capita (USD)	9 402	9 806	9 952	10 050
Real GDP (YoY%)	2.1	2.0	1.5	1.7
Private Consumption	3.1	2.2	2.8	2.9
Government consumption	1.0	1.4	- 3.4	1.1
Gross Investment	- 1.6	0.6	- 1.9	0.7
Exports	3.9	5.7	6.7	4.1
Imports	6.2	6.2	3.5	4.3
Prices, Money and Banking (YoY%)				
CPI (eop)	6.8	4.8	3.9	3.6
CPI (annual avg)	6.0	4.9	4.2	3.9
Broad Money (eop)	11.5	9.8	8.0	8.7
Private Credit (eop)	12.1	10.0	10.5	11.0
Fiscal Accounts (% of GDP)				
Fiscal balance	- 1.1	- 2.0	- 2.0	- 1.9
Revenue	22.6	21.7	21.5	23.4
Expenditure	23.6	23.8	23.5	25.3
Primary Balance	1.4	0.6	1.0	1.0
External Accounts (USD bn)				
Goods Exports	336.5	350.0	419.2	427.9
Goods Imports	342.3	357.5	427.7	436.1
Trade Balance	- 5.7	- 7.5	- 8.5	- 8.2
% of GDP	- 0.5	- 0.6	- 0.7	- 0.6
Current Account Balance	- 19.4	- 22.2	- 21.5	- 24.0
% of GDP	- 1.7	- 1.8	- 1.7	- 1.8
FDI (gross)	31.2	28.0	27.0	26.0
FX Reserves (eop)	172.8	174.8	174.0	173.5
MXN/USD (eop)	19.79	19.68	19.85	20.00
Debt Indicators (% of GDP)				
Government Debt	40.8	41.1	39.7	39.5
Domestic	23.6	24.5	21.5	21.4
External	17.1	16.7	18.2	18.1
External debt	37.6	36.5	21.7	22.3
in USD bn	436. 6	446. 1	272. 6	293. 8
Short-term (% of total)	10.1	12.6	8.0	8.0
General (ann. avg)				
Industrial Production (YoY%)	- 0.3	0.2	1.2	1.4
Unemployment (%)	3.4	3.3	3.6	3.7
Financial Markets	**Current**	**19Q2F**	**19Q3F**	**19Q4F**
Overnight rate (%)	8.25	8.25	8.25	8.00
USD/MXN (eop)	18.92	19.25	19.55	19.85

Source : Deutsche Bank estimates, National Sources

Theme Pieces

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- Brazil: Monetary Policy's Next Frontier
- Russia: Assessing External Buffers
- The ARS' future: harvest season, IMF dollars, and the electoral cycle
- EM Credit - A Quick Look at Country Positioning
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- Ecuador: Positive Policy Signals, Risks of Fiscal Complacency
- Latam Century Bonds in EM: Fair = Rich

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Policy Rate Forecast

Policy Rate Forecasts

-	Current policy rate	Q2-2019	Q3-2019	Q4-2019	Q1-2020	Q4-2020
Emerging Europe, Middle East & Africa						
Czech Republic	1.75	2.00	2.00	2.00	2.00	2.00
Hungary	0.16 ↑	0.30 ↓	0.25	0.25	0.25 ↓	0.25 ↓
Israel	0.25	0.25	0.25	0.50	0.50	0.75
Poland	1.50	1.50	1.50	1.50	1.50	1.50
Russia	7.75	7.75	7.50 ↓	7.50	7.25	7.00
South Africa	6.75	6.75	6.75	6.75	6.75 ↓	6.75 ↓
Turkey	24.60 ↑	24.00 ↑	21.00 ↑	20.00 ↑	20.00 ↑	16.00 ↑
Asia (ex-Japan)						
China	1.50	1.50	1.50	1.50	1.50	1.50
India	6.00 ↓	6.00	5.75	5.75	5.75	5.75
Indonesia	6.00	6.00	6.00 ↓	5.75 ↓	5.50 ↓	5.00 ↓
Korea	1.75	1.75	1.75	1.75	1.75	1.75
Malaysia	3.25	3.00 ↓	3.00	3.00	2.75	2.75
Philippines	4.75	4.50	4.25 ↓	4.25 ↓	4.00 ↓	3.25 ↓
Taiwan	1.375	1.375	1.375	1.375	1.375	1.375
Thailand	1.75	1.75	1.75	1.75	1.75	1.75
Vietnam	6.25	6.25	6.25	6.25	6.25	6.25
Latin America						
Brazil	6.50	6.50	6.50	6.50	7.00	7.50 ↓
Chile	3.00	3.00 ↓	3.00 ↓	3.25 ↓	3.50 ↓	4.00
Colombia	4.25	4.25	4.25	4.50	4.50	4.50
Mexico	8.25	8.25	8.25	8.00	7.75	7.00
Peru	2.75	3.25	3.25	3.50	3.50	4.00

↑/↓ 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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