Emerging Markets Weekly

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Overview

With greater autonomy granted to East Ukraine's pro-Russian regions for three years by the Ukrainian parliament, and the EU-Ukraine free-trade framework postponed to January 2016, conditions might have started to fall into place for a gradual easing of the conflict. However, Russia remains dissatisfied with the extent of recent concessions, suggesting that a compromise agreement – which might have unlocked an early end to sanctions – remains some way out of reach. So, we expect the tensions and associated sanctions to weigh on investor sentiment towards Central and Eastern Europe, and economic sentiment in the euro area, for several quarters to come.

But recent data from Mexico and Turkey provide cause for cautious optimism: domestic demand is picking up in Mexico, while Turkish manufacturers appear more confident on the back of the weakening lira. Nevertheless, with Mexico highly integrated with the USA economy and Turkey notoriously a member of the so-called "Fragile 5", we acknowledge that both economies remain vulnerable to sudden shifts in Fed policy and risk losing momentum when the first hike in the fed funds rate occurs.

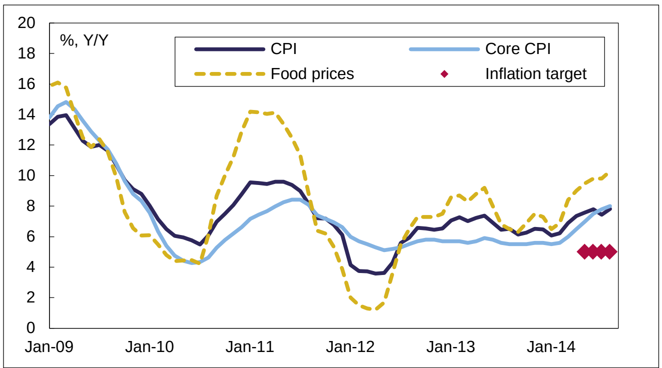
Russia

- The latest Russian inflation data continue to reflect the impact of the Ukraine conflict. Consumer prices were up a further 0.2% in the week to 22 September, leaving them up 6.1% – more than 1ppt above the Central Bank's 2014 target. Higher food price inflation is an inevitable side-product of the ban on food imports from the EU and US. And the impact on prices of the shortage of food supply has been compounded by continuing pressure on the cost of all imported goods from the depreciating rouble, down almost 17% in the year to date, a worse performance than all major currencies bar the Argentine peso (down more than 20%) and, perhaps inevitably, the Ukrainian Hryvnia (down more than one third).

- In its first assessment since the onset of the Ukraine conflict, the World Bank's latest Russia Economic Report presents three possible scenarios for Russia's economy in coming years. The baseline scenario, which assumes that sanctions remain in place, is one of 'near-stagnation', with economic growth of just 0.5% this year dropping to 0.3% in 2015 and 0.4% in 2014. The optimistic scenario, which is based on an assumption that all sanctions will be lifted by the end of this year, foresees firmer growth of 0.9% in 2015 accelerating gradually to 1.3% in 2016 – the same rate that prevailed ahead of the Ukrainian crisis in 2013. The pessimistic scenario acknowledges the possibility of additional sanctions, including EU sanctions to limit gas imports from Russia, with the consequence that Russian GDP falls 0.9% in 2015 and 0.4% in 2016.

- While not giving up hope that the optimistic scenario might come to fruition, we see a variant of the baseline as most realistic, with an easing in tensions around mid-2015 followed by a gradual lifting of sanctions but economic growth remaining subdued. We see only a small probability that the conflict will escalate significantly to provoke the additional sanctions envisaged in the pessimistic scenario. But, in our opinion, the consequences of such an outcome might feasibly be more severe than the contraction in GDP of little more than 1% forecast by the World Bank. Continued exclusion from global financial markets and foreign trade for an extended period would likely impact the ability of certain corporates, and perhaps banks too, to meet their external payments obligations. The strong net external creditor position, however, leaves the Russian government better placed to cope.

Russia: Inflation



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Russia: Rouble depreciation against US dollar

Source: Datastream and Daiwa Capital Markets Europe Ltd.

Turkey

- The latest trade data were disappointing, with the goods deficit rising more than 13% in August to above $8bn, the largest this year. Looking through recent volatility, however, the deficit has narrowed significantly from its peak (>$10bn) in 2013. And the lira's depreciation of more than 20% against the dollar since the start of 2013 is providing support for the manufacturing sector. Exports in the year to August were up 5.7% compared with the same period in 2013, while exports to the EU were up almost 13%. In contrast, imports were down 4.7% on the same basis, supporting the welcome rebalancing trend. While manufacturing capacity utilization in August slipped slightly to 74.4%, there appears to be no significant divergence from the positive trend in the sector underway since Q114.
- Indeed, economic sentiment has improved in tandem with capacity utilisation, with the headline manufacturing confidence index up 1.6pt in September to 107.6, broadly in line with the average of the past two years and comfortably above the average since 2007. Consumer confidence also improved this month, rising to its highest level since May and similarly broadly in line with the average of the past two years. Improved confidence suggests that, after a softer second quarter, domestic demand – including fixed investment – should also provide some support for GDP growth in Q3.
- The improved sentiment may well partly explain the decision of the Central Bank's MPC on 25 September to leave the key interest rates unchanged. The positive trends within the manufacturing sector, and rebalancing towards exports, are consistent with more sustainable growth, with no immediate need for further monetary easing to boost investment. And while elevated food prices have prevented inflation from falling just yet, the CBRT assesses declining commodities prices to limit the upside risks to inflation. So, the one-week repo rate remained at 8.25%, with the overnight borrowing and lending rates left at 7.50% and 11.25% respectively.

Poland

- Poland's unemployment rate fell 0.1ppt in August to 11.7%, the lowest level since October 2011 and below expectations, while the latest retail sales figures were also a touch firmer than expected. Nevertheless, sales still dropped 1.1%M/M in August to leave them down 1.7%Y/Y, following a drop of 2.1%Y/Y previously.
- Following the release of these data, Polish National Bank Governor Belka restated that interest rates would likely be cut soon. We expect that the first cut will be made no later than the next MPC meeting on 8 October, with the main question being the size of the initial easing (by 0.25% or 0.5%), with further cuts depending on the strength of demand.
- Despite the strengthening case for further monetary easing, the EBRD seems unconcerned. Indeed, it recently upgraded its Polish GDP forecast to 3.0% in 2014 and 3.3% in 2015 from its May forecast of 2.8% growth in each year. The EBRD cited solid export growth in the first half of 2014, while Polish exports to Russia account for little more than 2% of national GDP with items subject to Russian sanctions just 0.21% of GDP. We, however, would caution that Poland's high reliance on Russian energy, as well the likely hit to confidence by a protracted dispute, might well weigh on activity more significantly than the direct export exposure suggests.

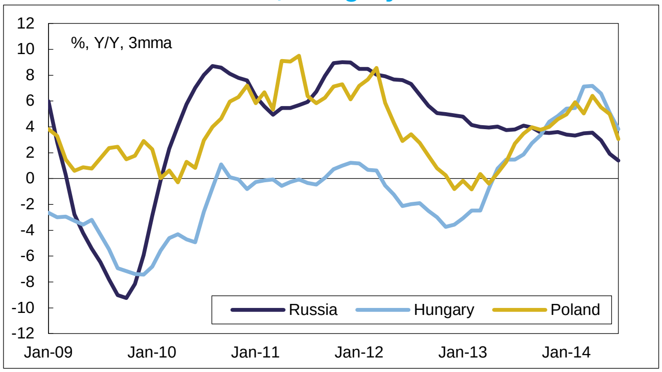
Hungary

- Judging by its latest Inflation Report published last week, Hungary's National Bank has drawn a line under the 2-year monetary easing cycle, which saw a cumulative 490bp reduction in the key interest rate, with the last cut, to 2.1%, coming in July. The benchmark rate is now expected to remain unchanged at this level for a considerable period of time. The National Bank expects inflation to stay close to zero this year, but subsequently to rise to 2.5% next year, and reach the 3% target in the medium term. In addition, it forecasts GDP growth of 3.3% in 2014, slowing to 2.5% in 2015 due to subdued demand from the euro area, not least due to the Russian-Ukrainian conflict.
- Hungary's external position has locked in improvements over the past two years. The current account surplus moderated in Q214 to €809mn, down from more than €1bn in Q1 but little changed from one year ago. Meanwhile, the labour market also continues to firm, with the unemployment rate falling further than expected to 7.6% in August, the lowest in six years.
- Having dipped a little in the summer, business confidence strengthened in September, with the headline index up 1.4pts to 3.6, well above the long-run average and consistent with the acceleration in industrial production growth in July to 12.3%Y/Y, the firmest since early 2011. Consumer confidence also improved in August and remains elevated by historical standards, consistent with solid consumption growth, which picked up to 1.6%Y/Y in Q214 compared to 1.3% in Q1.

Mexico

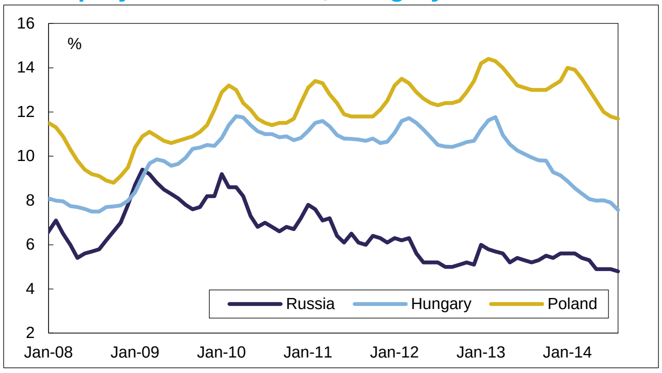
- The recovery in Mexico remains on track. The GDP proxy indicator – the index of economic activity IGAE – rose 2.5%Y/Y in July. While 0.2ppt weaker than in June, activity over the three months to July was up 2.3% compared to a year earlier, the firmest since January 2013. The strongest (but no doubt temporary) growth was recorded in the agricultural sector (7.1%Y/Y, compared with 2.35%Y/Y one year earlier), with industrial output up 2.1%Y/Y and services activity up 2.5%Y/Y.
- The latest labour market statistics also provided encouraging reading, with the unemployment rate falling a larger-than-expected 0.3ppt to 4.9% in August. While the unemployment rate remains above its pre-Lehman crisis norms, an increasingly tight labour market might in due course became a constraint on growth. Currently, however, the labour market seems unlikely to place upwards pressure on inflation or impede the economy's path to recovery.
- Retail sales grew 2.0%Y/Y in July, above consensus and 0.9ppt higher than the previous month. With industrial production to be supported by the weakening peso (down more than 3% in the year to September), firmer US and domestic demand, we expect that the Q3 GDP data will in due course paint a picture of balanced economic growth.

Retail sales in Russia, Hungary and Poland



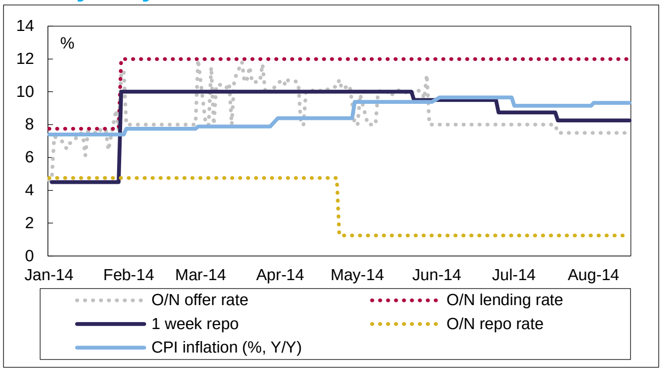
Source: Datastream and Daiwa Capital Markets Europe Ltd.

Unemployment in Russia, Hungary and Poland



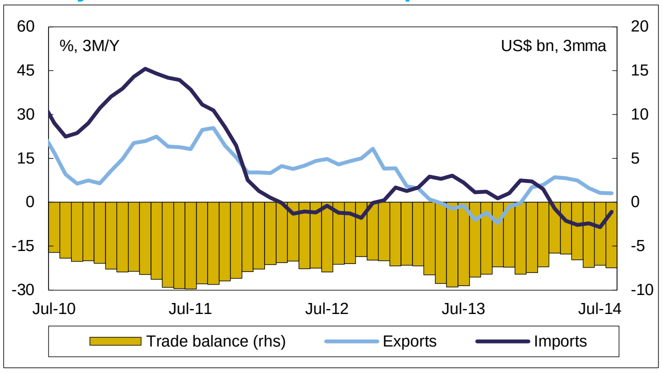
Source: Datastream and Daiwa Capital Markets Europe Ltd.

Turkey: Key interest rates and inflation



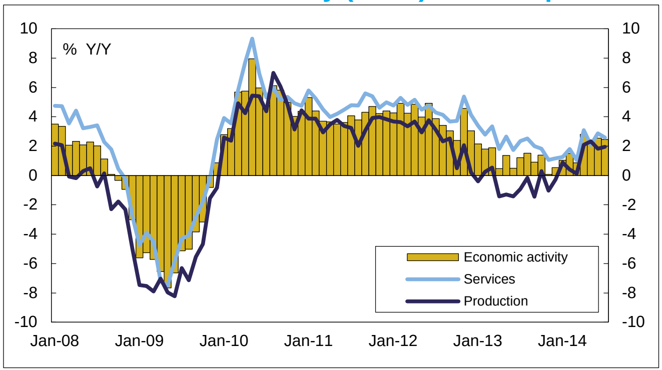
Source: Datastream. CBRT and Daiwa Capital Markets Europe Ltd.

Turkey: Trade balance and components



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Mexico: Economic activity (IGAE) and components



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Exchange rate movements

Currency	/US$	%W/W*	%YTD
Russian rouble	39.39	-2.01	-16.56
Turkish lira	2.28	-1.64	-5.62
Polish zloty	3.31	-1.71	-8.53
Hungarian forint	245.9	-1.45	-11.95
Mexican peso	13.48	-1.18	-3.56

**Change from close previous Tuesday as at noon BST. Source: Bloomberg*

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