Emerging Markets Weekly

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Overview

The Russian economy is stagnating, and risks sliding into recession in 2015. While industrial production is continuing to grow, partly due to import substitution, high inflation and a weakening labour market leave little hope that this trend will continue not to mention support economic recovery. On the positive side, since the central bank has stopped its regular intervention the decline in foreign reserves has moderated to an insignificant rate, offering hope of relief for Russia's private sector, which has around $130bn in foreign debt to redeem in coming months, and also perhaps to their investors.

Elsewhere, Turkey's central bank left its policy interest rates unchanged, arguing that the current restrictive monetary policy stance continues to play a constructive role in limiting inflation. The mild deflationary trend continues in Poland. And Mexican economic growth in Q3 was moderate, but a touch below expectations at less than 2½Y/Y.

Russia

- The latest economic data were a mixed bag, strongly suggesting that the Russian economy is now caught in stagflation. There was, however, a positive surprise, with industrial production growing 2.9%Y/Y in October, almost twice the expected rate despite weak domestic demand and trade sanctions. On a seasonally adjusted basis, output expanded 0.3%M/M. While mining sector output grew by 1.9%Y/Y, manufacturing output increased by 3.6%Y/Y. Certain sub-sectors related to processed agricultural items are benefiting from the ban on the equivalent EU and US products, with double-digit output growth (for example, production of vegetable oil rose 26.1%Y/Y and meat 12.0%Y/Y), supporting our judgment that import substitution partly lies behind the current positive trend of production. Nevertheless, as growth in investment in production capacity has ground to a halt we do not expect this trend to be long-lived.

- Despite the key interest rate hike in October (from 8.0% to 9.5%), Russia's central bank has (unsurprisingly) failed yet to ease the current inflation spiral. CPI in the year to 24 November was 7.9%, up 0.6ppt over the preceding two weeks. Moreover, in light of the likely upcoming seasonal (Christmas and New Year sales) increase in consumption and continuing rouble weakness, we expect upward pressure on prices to continue, with prospects for the year-on-year inflation rate to hit double digits in early 2015.

- Despite falling energy prices, which should have helped to ease manufacturing costs, PPI in October rose by 5.1% Y/Y (0.3% M/M and 5.6%YTD), with prices of coking coal and oil products up 10.1%Y/Y (-0.5% M/M, 12.2% YTD). So, despite being one of the world's leading producers of oil and other energy and non-energy commodities, Russia has been unable to benefit from the current downward trend in global market prices to reverse the domestic inflationary tendencies at home – an illustration of the urgent need for structural reforms. Manufacturing PPI was 7.0%Y/Y and 7.4% in the first ten months of the year, while producer prices of food, beverages and tobacco and (heavily import-dependent) chemical products rose respectively by 11.2%Y/Y and 9.3%Y/Y, reflecting tightening market conditions amid the agricultural product import ban and weakening rouble.

- Retail sales grew in October by 1.7%Y/Y (the same rate as in the previous month), slightly above the consensus forecast of 1.2%, but obviously losing its power of recent years to support economic growth – indeed, growth was roughly half the rate one year earlier, and a smaller fraction of the rates seen in the same month the previous two years. While real disposable income increased by 2.1%Y/Y in October, its 18-month downward trend leaves little reason to expect positive development in coming months. Indeed, real wages grew just 0.3% Y/Y, and the unemployment rate rose 0.2ppt to a six-month high of 5.1%, in line with market expectations, but negating any possible positive impulse from rising disposable income on consumption.

- As the central bank's (CBR) huge forex market interventions were halted as the target range for the exchange rate was abandoned, Russia's foreign reserves decreased by only $0.8bn between 7 and 14 November. We see this as positive news, not least as the CBR may well need to draw on its reserves to facilitate the redemption of private sector foreign debt (around $130bn in the coming year) from now on.

Turkey

- When the latest monetary policy committee meeting concluded on 20 November, the central bank (CBRT) left policy unchanged with the benchmark repurchase rate at 8.25%, overnight lending rate at 11.25% and overnight borrowing rate at 7.50%. In its press release, the MPC stated that the continued tight monetary policy stance and macro-prudential measures were containing loan growth at a reasonable level, helping to support the improvement in the current external account and also limit medium-term inflation pressures. As the CBRT has a difficult balance to strike between restraining high inflation and supporting economic growth, changes in monetary policy may be somewhat politicized rather than based on pure economic considerations. However, in the absence of new significant external shocks (whether economic, such as a particularly disorderly impact on global markets from Fed monetary tightening, or geopolitical, such as issues related to events on Turkey's borders) we expect the current monetary stance to be preserved.

- Turkey's real sector confidence indices, released on Monday, showed a slight decrease in both seasonally adjusted (SA) and not seasonally adjusted (NSA) terms, with the SA index of 108.4 down 1.5% and the NSA index of 102.5, down 3.9% compared to previous month. As these changes are well below 5%, we do not see a marked correction to the current economic trend. On the other hand, capacity utilization in November slipped to 74.5%, slightly below the reading of 74.9% in October, illustrating the persistence of significant slack within the economy.

Poland

- Poland's industrial production data for October were weak by recent standards. Industrial output grew 1.6%Y/Y, above the market expectation of 1.4% but the second lowest (after the 1.9%Y/Y decline in August) growth rate since June 2013. As there is little hope for an immediate improvement in demand from the euro area, the negative impact on Polish exports (given the near-80% dependence on the EU market) will, in our opinion, continue to add downward pressure on domestic production growth.

- October's PPI data were also discouraging. Producer price inflation remained in negative territory for the 24th month in a row, with prices down 1.2%Y/Y and 0.3%M/M. As the most recent deflationary tendencies relate to declining global energy prices, on which Poland has no influence, we cannot see any good reason for this trend to be reversed in the near future.

- Nonetheless, the labour market statistics provided a cause for cautious optimism. According to the data for October, wages grew 3.8%Y/Y (2.1% M/M), beating market expectations of 3.3%Y/Y (1.7% M/M) and up 0.4ppt on the previous month on an annual basis. At the same time, employment increased by 0.8%Y/Y (0.1%M/M) in line with the consensus forecast, maintaining the upward trend. If this trend continues, eventually we would hope to see a positive impulse to inflation emanating from the labour market, amid possibly firmer growth of domestic consumption too.

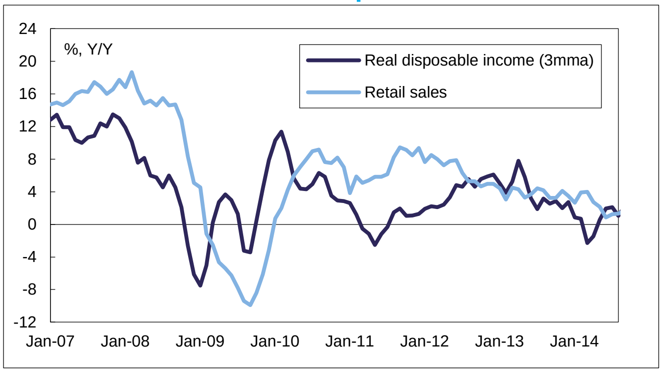
Mexico

- In Q314, Mexican GDP growth was moderate, up to 2.2%Y/Y (from 1.6%Y/Y previously) but falling short of market expectations of 2.3%Y/Y. Industry recorded a fourth consecutive quarter of positive annual growth (of 2.0%Y/Y) since the series of negative growth rates during the first three quarters of 2013. Service sector growth was also moderate, 2.0%Y/Y, falling short of the average rate in excess of 3%Y/Y recorded in the year to the same quarter in 2013. The data suggest that growth for the year will come in line with the central bank's expectation of 2-2.5%, with a pickup in 2015 to between 3-4% still realistic.

- The monthly data, however, suggest a pickup in September from a lull in August. The GDP growth proxy IGAE indicator accelerated to 2.9%Y/Y in September from 1.3%Y/Y in August. Retail sales also provided a relatively encouraging reading, growing by 4.5%Y/Y in September, 1.3ppt above the consensus forecast and 0.1ppt higher than the previous month. And more recently, the unemployment rate decreased from 4.77% (seasonally adjusted, revised) in September to 4.71% in October, very slightly below the market expectation.

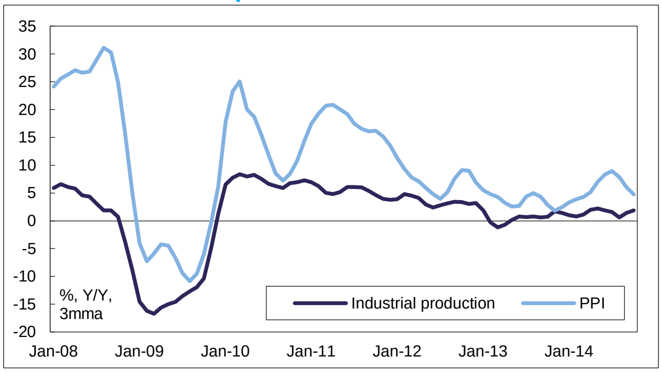
- General CPI for the first half of November was 4.16%Y/Y, in line with expectations, but 0.65ppt higher than a year ago (3.51%Y/Y). Core CPI for the same period was 3.3%Y/Y, also higher than a year ago (2.43%Y/Y). Upward pressure on inflation is coming from food and beverages, with prices of this group up 6%Y/Y in November. While the inflation rate in Mexico remains above the central bank's medium-term headline target of 3%, declining energy prices and the elimination of long-distance national telephone charges are expected to help to ease price pressures in coming months leaving CPI close to target from the middle of 2015 onwards.

Russia: Retail sales and disposable income



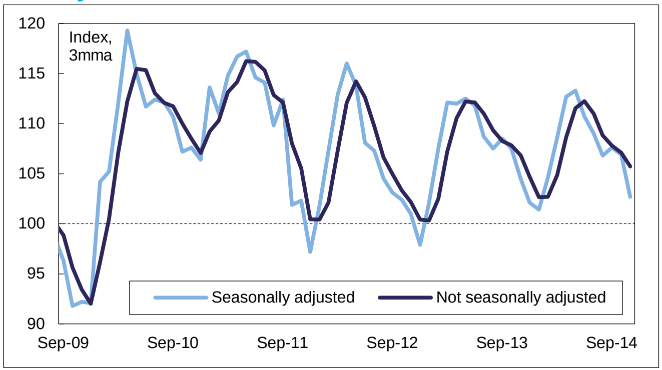
Source: Datastream and Daiwa Capital Markets Europe Ltd.

Russia: Industrial production and PPI inflation



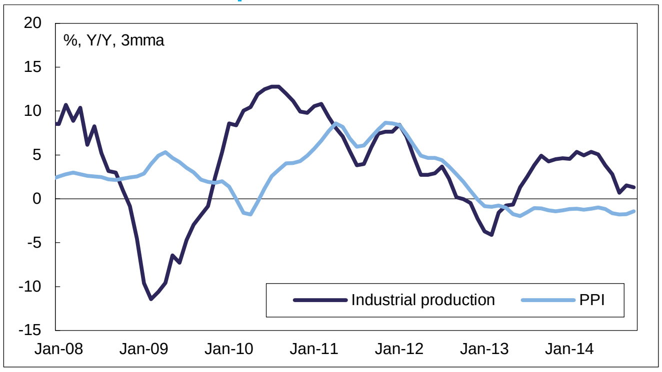
Source: Bloomberg and Capital Markets Europe Ltd.

Turkey: Real sector confidence



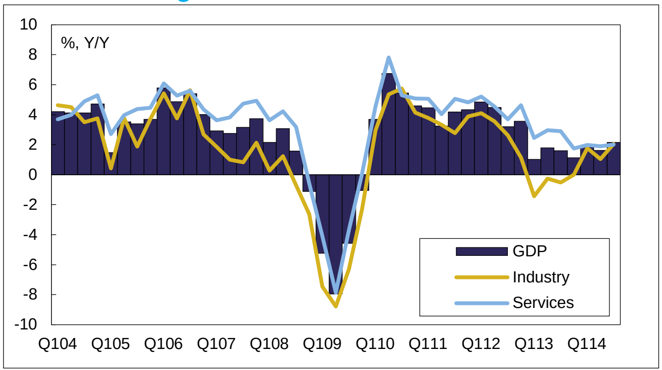
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Poland: Industrial production and PPI inflation



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Mexico: GDP growth



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Exchange rates and recent changes

Currency	/US$	%W/W*	%YTD
Russian rouble	47.01	-1.46	-29.33
Turkish lira	2.23	0.12	-8.66
Polish zloty	3.35	0.32	-7.54
Hungarian forint	246.0	-1.31	-10.44
Mexican peso	13.72	-0.51	-4.36

**Change from close previous Thursday as at noon GMT. Source: Bloomberg*

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