EM Weekly

Saori Sugeno
+44 20 7597 8336
Saori.Sugeno@uk.daiwacm.com

Chris Scicluna
+44 20 7597 8326
Chris.Scicluna@uk.daiwacm.com

Overview

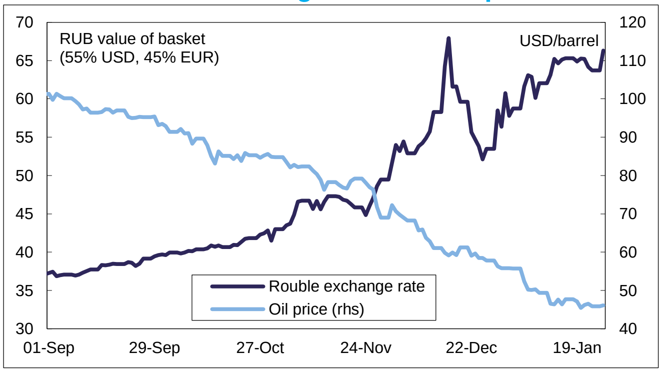
While S&P's downgrade of Russia's sovereign rating to sub-investment level on 26 January hardly came out of the blue, it sent the rouble immediately sharply lower. And despite a subsequent brief modest rebound, the rouble remains more than 6% weaker against the dollar from its level ahead of the announcement. With the decision possibly impacting future demand for Russian securities, and possibly set to add to foreign debt redemptions this year, pressure on the rouble and renewed capital outflows are possible.

Elsewhere, Turkish consumer confidence remains flat, pointing to subdued domestic demand. But data also suggest gradual improvement in the Polish labour market, although that country's deflationary trend remains a concern. And the impact of the fall in oil prices on the Mexican economy is evident, with growth subdued in Q4 but consumer prices down in the first two weeks in January.

Russia

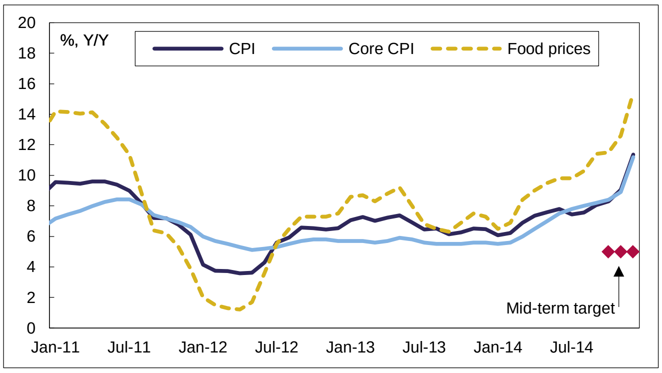
- On 26 January S&P downgraded Russia's sovereign rating by one notch to BB+, sub-investment status, for the first time in 10 years. While the downgrade was hardly unexpected, the earlier postponement of the announcement from mid-January raised hopes in some quarters that a downgrade might be avoided, prompting a sudden adjustment to asset prices following S&P's decision. Immediately after the announcement, the rouble briefly plunged more than 7% from its opening level that day through RUB69/USD, but recovered some ground thereafter to trade RUB67-69/USD in subsequent days, nevertheless still down more than 6% from a week earlier. The overall impact on the stock market has been only marginally negative. The impact on the bond market was somewhat more substantive, given the inability of some investors to hold sub-investment grade securities.
- With the ability of Russian companies to borrow on global markets already impeded by sanctions, the immediate impact of the downgrade might be limited from the perspective of corporate financing. However, we see an outside probability that foreign debt redemptions will rise by $20-30bn if investors insist upon activating certain contract covenants. If that happens, we might expect additional downward pressure on the rouble and heightened risks of capital outflows. And the most negative effects might be most evident on borrowing costs if and when any lifting of sanctions allows Russian companies to return to global markets.
- In mid-January, the Russian government unveiled its new anti-crisis programme, allocating RUB2.7trn (just over $40bn assuming an exchange rate of RUB65 for 1dollar) to fight the effects of recent market turbulence, with more than two thirds (RUB2trn or about $30bn) used to support the banking sector. About RUB1trn of Russian treasury bonds will be issued to systematically important banks via the Deposit Insurance Agency to strengthen bank capital in exchange for equity or similar instruments. Overall, government figures suggest that banking sector capital will increase by around 13%.
- The government also plans to offer guarantees amounting to about RUB200bn ($3bn) to support corporate borrowing. Support for agriculture, the auto industry, construction, and social security payments via pension indexation are also on the programme's list of priorities. Compounding the impact of weak tax revenues due to falling oil prices, and despite significant planned cuts to other main areas of government expenditure, the fiscal deficit, which in 2014 was 0.5% GDP, will jump. According to Russian officials' comments, the aim will be to keep this year's deficit below the 6% GDP level reached in 2009. As a basis for the final fiscal arithmetic, official macroeconomic forecasts are expected to be published on 1 February with subsequent amendments to the budget expected to be made before the end of February. An Anti-Crisis Committee will be launched to co-ordinate efforts. Sberbank CEO German Gref (former Minister of Economic Development and Trade from 2000-2007) and Alexey Kudrin (former Minister of Finance from 2000-2011, well-respected for his sound fiscal policy) will join the Committee.
- Prices continue to rise sharply, with weekly CPI at 19 January 0.7%W/W, only a touch below the previous week's reading of 0.8%. According to the latest comments from Russian central bank (CBR) governor, Elvira Nabiullina, the CBR might reverse its policy and cut interest rates if inflation shows signs of a sustaining a downward trend. But given the downward pressure on the rouble after Russia's sovereign rating was downgraded to sub-investment level, we do not expect a significant decision on rates to be made during the scheduled CBR Board meeting on 30 January. Certainly, the CBR will want to take its time to reassess the economic outlook. And the renewed capital outflows reflected in the further drop in Russia's foreign reserves (down 1.8%W/W to $379.4bn on 16 January, well in advance of the S&P decision) underscore the case for caution.

Russia: Rouble exchange rate and oil price*



*Brent crude. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Russia: Inflation



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Turkey

- The consumer confidence index in January remained unchanged at 67.7, the lowest since January 2010. While the survey index of households' financial situation continued its downward trend (to 81.8 from 83.0 a month ago) and the general economic situation index declined from 92.3 in December to 89.5, the measure of current spending of 68.9 was unchanged. However, the measure of willingness to purchase durable goods improved significantly (up more than 6%M/M to 86.1) hinting at the prospect of a more positive trend in domestic consumption.

Poland

- December's economic data were a mixed bag. The latest labour market figures were encouraging. Despite the deflationary trend, wages grew above market expectations, by 3.7%Y/Y the highest rate since May. Employment rose 1.1%Y/Y, up 0.2ppt from the previous month, above the consensus forecast and the firmest since 2011, while the unemployment rate rose less than expected, up 0.1ppt to 11.5%. If the upward trend in wage growth is maintained, and the zloty weakens once again, concerns about the current deflationary trend might prove short-lived, adding to the case for further postponing monetary easing. Of course, the steep depreciation of the zloty against the Swiss franc has also strengthened the case for the MPC to eschew further easing given the large share of Polish mortgages denominated in that currency. Nevertheless, with CPI set to fall further over the near term through -1%Y/Y, further easing can hardly be ruled out.

Hungary

- While the Hungarian National Bank left its base rate unchanged at 2.1% on 27 January, the Monetary Council's statement was explicitly dovish, suggesting that further easing would likely be required in order to steer inflation back to its 3% target by about 2017. Meanwhile, the latest GKI economic sentiment survey disappointed, suggesting a moderation of growth momentum, with the headline index down to a five-month low of -2.9 in January from 0.2 the previous month. The business confidence index fell from December's series high of 8.1 to 4.4, below the average for the past year, although the number of companies expecting improvement still outnumbered those anticipating deterioration in all sectors except construction. Meanwhile, the consumer confidence index fell to -23.8, the weakest in more than a year.

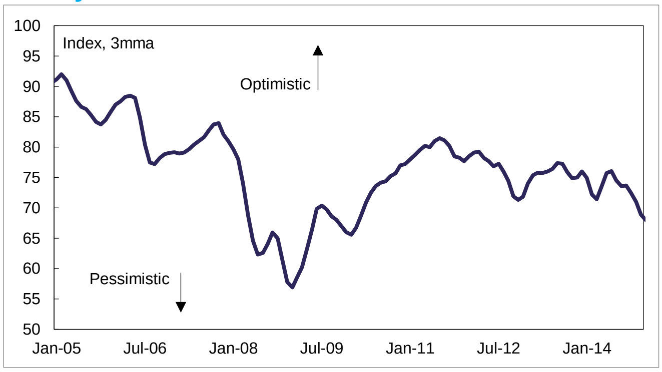
Mexico

- Following the global trend, consumer prices fell in the first half of January for the first time since 2013. CPI fell 0.19% in the two weeks to 15 January following a rise of 0.11% over the second half of December. Core CPI on the same basis fell for the first time in more than two decades, down 0.09% in the first two weeks of January compared to a rise of 0.05% two weeks earlier. On an annual basis, CPI plunged almost 0.9ppt to 3.08%Y/Y, only a touch above the medium-term inflation target. Plummeting oil prices represent the principal factor pushing inflation lower. And, with this effect likely to be temporary, we would not expect the central bank to cut interest rates.
- Nevertheless, November's economic data were softer than expected. Retail sales growth eased in November to 1.2%Y/Y, the lowest growth rate in four months and well below the consensus forecast, from growth of 5.6%Y/Y in previous month. Likewise, the GDP-proxy IGAE economic activity index slowed to 2.04%Y/Y below the consensus forecast and down from 2.69%Y/Y the previous month. While calendar effects partly explain the slowdown and certainly complicate interpretation of the data, overall GDP growth in Q414 might well have slowed to around 2%Y/Y, from 2.2%Y/Y the previous quarter.

South Africa

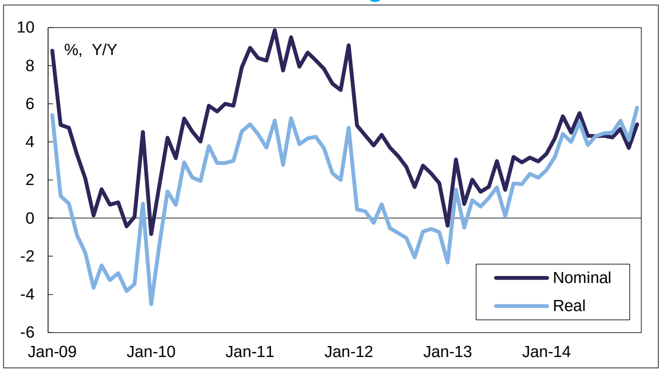
- In December, inflation fell to 5.3%Y/Y, below expectations of 5.5%Y/Y and 0.5ppt lower than the previous month, comfortably remaining within the inflation target band of 3-6%Y/Y. Food prices contributed the most inflation pressure, rising 7.4%Y/Y, while electricity and fuels prices increased by 7.2%Y/Y. But transport prices fell more than 1½% on the month to stand just 1.7% higher than a year earlier. Month-on-month headline inflation fell to -0.2%, below market expectations and down 0.2ppt compared to November, with goods prices falling 0.7%M/M. Core CPI declined 0.5ppt to 5.3%Y/Y, with such prices rising 0.2%M/M, the same rate as previously. Not least given the fall in the oil price, inflation seems bound to have eased further in the New Year.

Turkey: Consumer confidence



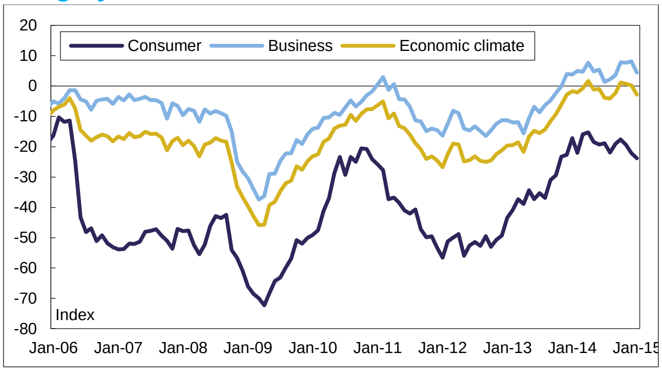
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Poland: Nominal and real wages



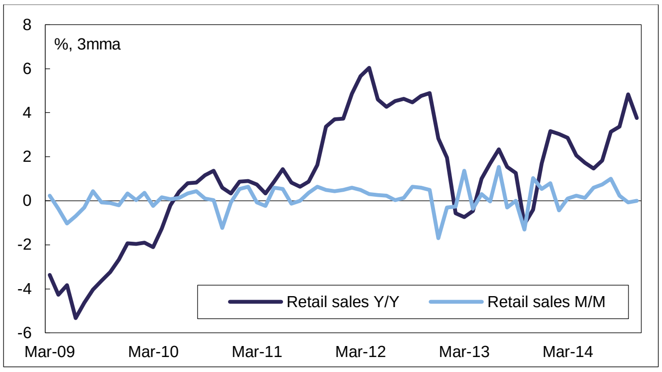
Source: Datastream and Daiwa Capital Markets Europe Ltd.

Hungary: GKI economic sentiment



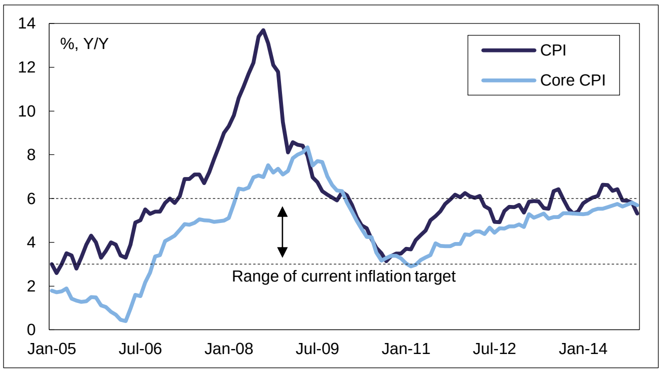
Source: Datastream and Daiwa Capital Markets Europe Ltd.

Mexico: Retail sales



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

South Africa: Inflation



Source: Datastream and Daiwa Capital Markets Europe Ltd

Exchange rates and recent changes

Currency	/US$	%W/W*	%YTD
Russian rouble	**69.30**	-7.39	-12.38
Turkish lira	**2.41**	-3.60	-3.14
Polish zloty	**3.75**	-0.07	-5.42
Hungarian forint	**276.3**	-0.52	-5.30
Mexican peso	**14.81**	-1.18	-0.37
South African rand	**11.66**	-2.22	-0.74

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

Economic Research

Key contacts

London		
Head of Research	*Grant Lewis*	+44 20 7597 8334
Head of Economic Research	*Chris Scicluna*	+44 20 7597 8326
Emerging Markets Economist	*Saori Sugeno*	+44 20 7597 8336
Euro Area Economist	*Robert Kuenzel*	+44 20 7597 8322
Economist	*Emily Nicol*	+44 20 7597 8331
Research Graduate	*Mantas Vanagas*	+44 20 7597 8318
Research Assistant	*Alice Tallents*	+44 20 7597 8332
New York		
Chief Economist	*Mike Moran*	+1 212 612 6392
Junior Economist	*Lawrence Werther*	+1 212 612 6393
Hong Kong		
Economist	*Kevin Lai*	+852 2848 4926
Research Associate	*Christie Chien*	+852 2848 4482
Economic Assistant	*Junjie Tang*	+862 2773 8736
London Translation		
Head of Translation, Economic and Credit	*Mariko Humphris*	+44 20 7597 8327

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[Standard & Poor's]

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The name and registration number of the Registered Credit Rating Agency in the group:
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