Daiwa Capital Markets

EM Weekly

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Overview

Economic conditions in Russia continue to deteriorate, with inflation surging to 15%Y/Y in January and all indications that a contraction in output is now underway. If sustained, however, the upward shift in the oil price so far in February offers a glimmer of hope that might help to stabilise Russia's financial markets. And should the latest diplomatic effort succeed in taking the heat out of the Ukraine conflict, a further source of negativity surrounding Russian asset prices might become a touch less potent.

Elsewhere, despite the persisting deflationary trend, Poland's national bank kept its reference rate unchanged, but did not rule out a rate cut should deflation intensify. In Hungary too, prices continue to fall faster than expected and we certainly expect the national bank to respond. And despite a slightly more encouraging IP report, Turkish monetary easing seems likely as political pressure ramps up. Meanwhile, there remain mixed signals on Mexican business sentiment, but South African economic confidence has deteriorated due to heightened disruption to power supply.

Russia

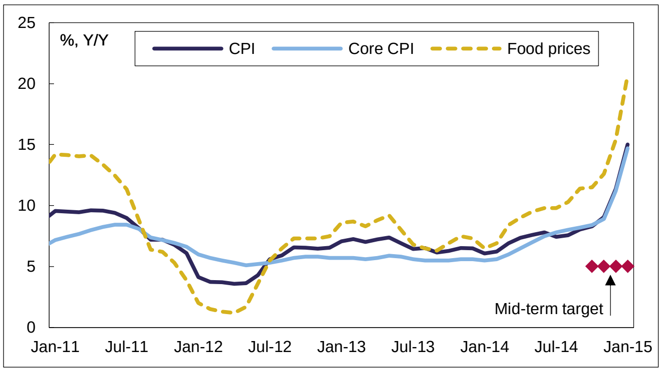
- In January CPI increased by 3.9%M/M, the highest monthly increase since February 1999 and also well above the consensus forecast. That took headline year-on-year inflation to 15.0%Y/Y in January, from 11.4%Y/Y in December and fully 2ppt higher than market expectations. Perhaps most notably considering the disproportionate impact on the poorest, food prices jumped by more than 20%Y/Y with prices of grains, beans and pulses surging by 45% compared to a year earlier. The data were thus very discouraging, not least coming less than a week after the central bank's (CBR) surprise key rate cut of 200bps to 15%. Nonetheless, while CBR Governor Nabiullina acknowledged that inflation will continue to rise over the near term, it should peak in Q215 before gradually subsiding as the impact of past rouble depreciation moderates. Therefore, she ruled out the possibility of a further U-turn on rates, supporting our expectation that further easing is likely in due course.

- The few economic data already published for January inevitably point to a deterioration in economic activity at the start of the year. Perhaps most strikingly, car sales plummeted by 24%Y/Y not least as payback from December's "sales fiesta" as purchases were brought forward amid (justified) fears of accelerating inflation. And double-digit car price inflation seems bound to prompt a further drop in sales over coming months.

- The latest PMI surveys also signal ongoing underlying deterioration in economic conditions. The composite index decreased by 1.6pt in January to 45.6, the lowest level since May 2009. The service and manufacturing PMIs similarly fell to their lowest since the first half of 2009, by 1.9pt and 1.3pt respectively to 43.9 and 47.6 in January. Perhaps surprisingly, the services incoming new business index rose slightly, but at 46.5 it continued to signal contraction ahead, particularly for the hospitality (hotel and restaurant) sector and also for transport and storage firms. Meanwhile, all subcomponents of the manufacturing survey were consistent with economic stress, with notable declines in the indices of new orders and employment, and an increase in the index of import prices to above 85, its highest since the 1998 rouble crisis. With the composite PMI below the key 50 level for the past fourth months, activity certainly appears to be contracting, probably by around 1.5%Q/Q in Q115. And that is also likely to be consistent with a full-year contraction of about 3-4%Y/Y.

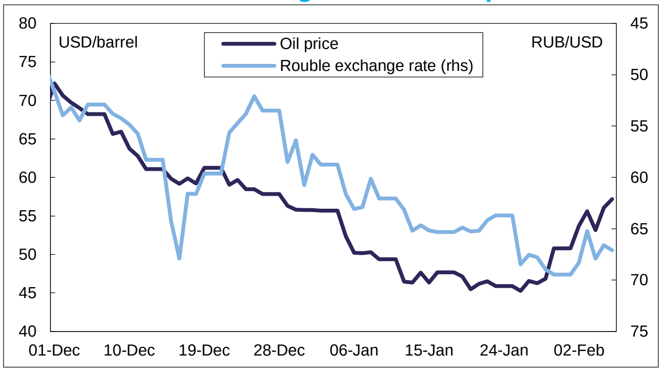
- Russia's official foreign exchange reserves declined 2.6%M/M in January to $376.2bn. However, the past week has seen somewhat greater stability in the rouble exchange rate, supported by the uptick in the oil price since the start of February and hopes that the latest diplomatic efforts undertaken by Chancellor Merkel and President Hollande to resolve the Ukrainian crisis – and hence help to defuse the confrontation between Russia and the West, and avoid an escalation in EU sanctions against Russian entities – might bear some fruit. Indeed, the eventual Minsk agreement on plans for a ceasefire from 15 February was a welcome step that might have positive economic consequences as well as the more important humanitarian benefits.

Russia: Inflation



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Russia: Rouble exchange rate and oil price*



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

Turkey

- Continuing pressure from President Erdoğan on Turkey's central bank (TCMB) to ease policy to promote domestic investment has weighed on asset prices as investors question its independence. So, for example, the lira depreciated through TRY2.50/$ on 11 November for the first time, while the Turkish lira yield curve has also shifted higher. Yet, while the TCMB will be concerned about such market events, we certainly do not rule out a rate cut at the next scheduled monetary policy meeting on 24 February. CPI inflation decreased in January to 7.24%Y/Y from 8.17%Y/Y the previous month, while PPI fell more than 3ppt to 3.3%Y/Y, the softest rate since May 2013 (2.17%Y/Y).
- December's industrial production data were relatively encouraging. Output increased by 2.6%Y/Y, well above the market expectation and up from 0.7%Y/Y previously. However, looking through the recent month-to-month volatility, the underlying trend remained relatively modest, with growth of 1.9%3M/Y the same rate as November's near-two-year low. Within the detail, the strongest growth in the latest month came from the mining and quarrying sector, which grew by 7.0%Y/Y, while manufacturing sector output rose by 2.8%Y/Y. Production of capital goods ended the year on a high note, up about 3½%3M/Y, with manufacturing of computer, electronic and optical products surging.

Poland

- At its MPC meeting on 3-4 February, Poland's National Bank (NBP) kept its reference interest rate unchanged at 2.0%, the level prevailing since August. The MPC assessed that economic growth had moderated in the final quarter, with stable growth in consumption accompanied by a weakening of capex growth. And it also noted that the drop in CPI inflation in December to -1.0%Y/Y had been steeper than expected, with the weakening in most measures of core inflation illustrating the absence of demand-side price pressures. The heightened volatility in financial markets associated not least with the sudden decision of the Swiss central bank to abolish the ceiling of the Swiss franc/euro exchange rate strengthened the case for the MPC to leave rates unchanged. However, it also recognized that the impact on household balance sheets of the zloty's depreciation against the Swiss franc might well weigh on consumption in coming quarters. So, the MPC did not rule out the possibility of a rate cut in the near future should extremely low inflation be expected to persist. And the finalisation of the NBP's updated inflation forecasts to in March would appear the most likely trigger for such an easing of policy.

Hungary

- December's retail sales and industrial production data offered further cause for optimism regarding the momentum of an economy which had already outperformed the expectations of many observers last year. While retail sales growth of 5.6%Y/Y was a touch below market expectations, it was the highest growth since April last year, 0.5pt above the previous month's revised number and also 2.1ppt higher than a year ago. Relatively strong retail sales growth in December was driven by a surge in mail order and internet sales, up more than one third on a year-on-year basis, and sales of cosmetics (13.8%Y/Y) and textiles, clothing and footwear (13.5%Y/Y). The same month, industrial production increased a seemingly robust 4.6%Y/Y. That failed to meet the consensus expectation of 6.0%Y/Y and also represented a decline of 1.0ppt compared to the previous month. Nevertheless, it maintained the clear industrial sector recovery trend in train since June 2013.
- Meanwhile, Hungary's external position remains strong with the preliminary estimate of the trade surplus in December comfortably exceeding expectations at €322.1mn, about €100mn than a year earlier. In 2014, the cumulative trade surplus of €6.4bn was only a touch lower than the equivalent figure for the previous year (€6.6bn). Exports and imports grew 9.2%Y/Y and 7.8%Y/Y respectively, in line with the firm recovery trend of industrial production and domestic demand.

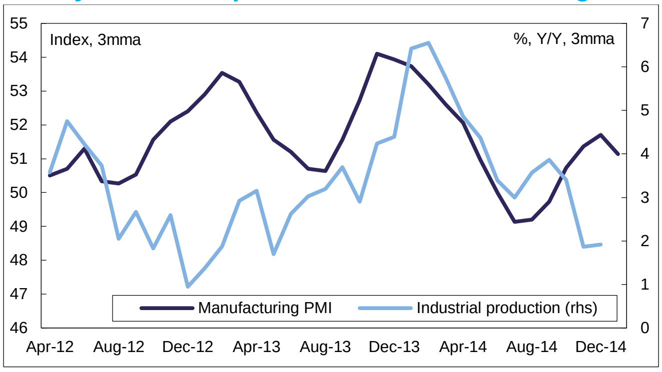
Mexico

- January's CPI data showed an intensifying disinflation trend in Mexico. CPI of 3.07%Y/Y was the lowest level since March 2011, a touch below market expectations and more than 1ppt less than the previous month. Monthly CPI of -0.09%M/M was the first negative reading since May last year. And while plummeting energy prices represented the principal cause of the drop in inflation, a 1ppt decline in core inflation to close to 2.3%Y/Y, a first ever negative monthly core rate, and services inflation of just 2¼%Y/Y illustrated the underlying weakness of price pressures. The probability of inflation undershooting the 3%Y/Y target at end-2015 appears to have significantly increased. But, not least given the uncertain impact on the peso of any Fed tightening this year, we certainly do not expect Banxico to ease policy unless the medium-term inflation outlook weakens significantly.
- Meanwhile, recent economic sentiment surveys have been mixed. The manufacturing PMI rose 1.3pts in January to 56.6, the highest level in two years on increased new orders and output. In contrast, the consumer confidence index fell to a three-month low of 91.1. But while the current conditions index decreased by 2.1pts, the future conditions index rose back above 90.0 following two weaker months, and the underlying improving trend underway since early 2014 seems to remain intact.

South Africa

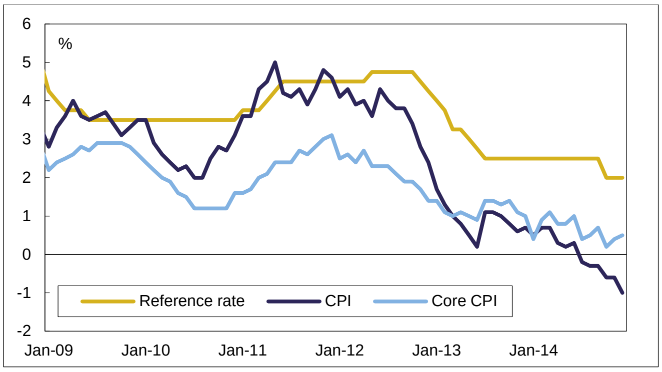
- January's South Africa Chamber of Commerce and Industry (SACCI) business confidence index was discouraging. While the headline index increased by 1.0pt to 89.3, it was the lowest January reading in eighteen years, as concerns about the worsening electricity crisis mount. Frequent "load-shedding" – scheduled power cuts to avoid the risk of uncontrollable blackouts – implemented by state-owned Eskom, which generates 95% of the electricity in South Africa, is increasingly representing a significant obstacle to economic growth. And uncertainty about ability of the government to resolve the power shortage problem is unsurprisingly on the rise. Further evidence of the impact of such supply-side disruption came in the shape of the January PMI, which decreased 0.4pt to 49.8, the first sub-50 reading since July 2014. All sub-indices including output, new orders and new export orders decreased, suggesting a weakening of growth momentum at the start of the year.

Turkey: Industrial production & manufacturing PMI



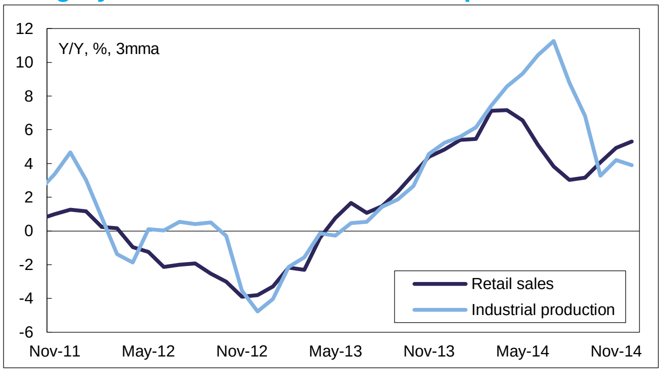
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Poland: Reference rate and inflation



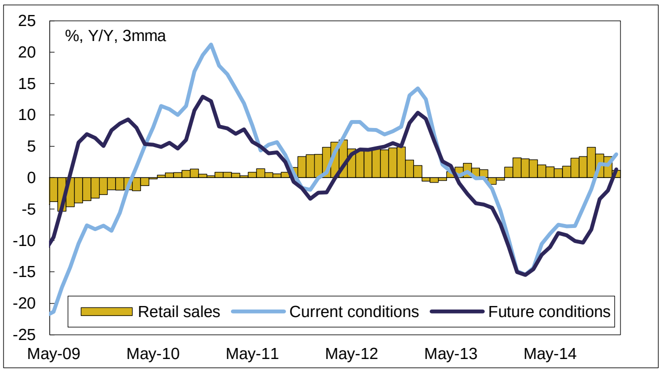
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Hungary: Retail sales and industrial production



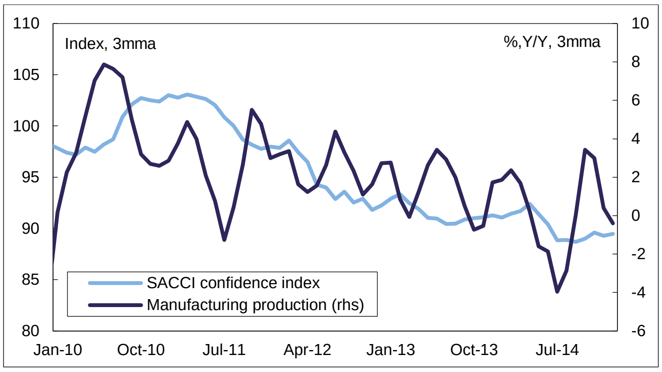
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Mexico: Consumer confidence & retail sales



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

South Africa: SACCI confidence index & manufacturing production



Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Exchange rates and recent changes

Currency	/US$	%W/W*	%YTD
Russian rouble	**65.08**	2.91	-6.43
Turkish lira	**2.47**	0.03	-5.66
Polish zloty	**3.65**	0.53	-3.03
Hungarian forint	**267.9**	0.90	-2.34
Mexican peso	**14.95**	-0.63	-1.31
South African rand	**11.74**	-2.03	-1.49

**Change as at 7:30 GMT 13 February. Source: Bloomberg*

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