Daiwa Capital Markets

EM Wrap-up

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Overview

With the rouble more stable and weekly price inflation having moderated, the Russian central bank's second rate cut this year was both expected and appropriate as a further step to easing the deleterious impact of December's panic monetary tightening.

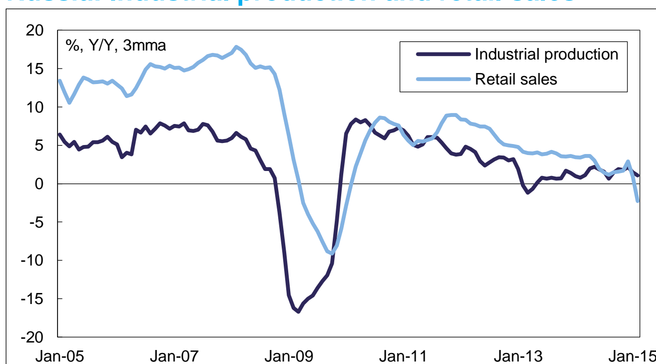
Elsewhere, Turkey's central bank kept rates unchanged as political pressure for further cuts appeared to have eased somewhat. Hungary's central bank cut rates to a new low. And the minutes of Poland's most recent monetary policy meeting suggested that rates might be cut further if needed, despite the National Bank's previous communication that the easing cycle had ended.

Meanwhile, the more dovish stance of the Fed has eased pressure on the major emerging market exchange rates, thus providing greater room for manoeuvre in monetary policy-making in several countries, including Mexico and South Africa, for a while to come.

Russia

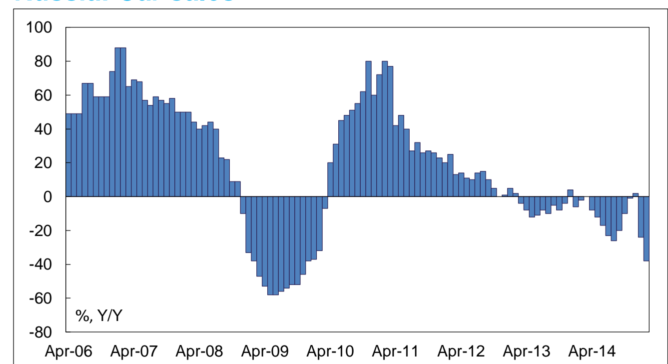
- As we expected, following its regular board meeting on 13 March the Central Bank of Russia (CBR) cut its key interest rate by 100bps to 14%. The cut was the second this year, after the 200bps reduction on 30 January, so that only slightly more than half of last December's 650bps tightening now remains intact. With the annual inflation rate up to 16.7%Y/Y in February, at first glance further monetary easing might have looked premature. But the authorities attribute between 10-11ppts of that figure to past rouble depreciation and sanctions. Importantly, the weekly inflation rate has eased significantly, down to just 0.2%W/W in each of the first three weeks of March, the weakest in four months. And so, not least given the need to set policy consistent with the outlook for economic growth and inflation, the latest interest rate cut was appropriate and welcomed by investors: indeed, supported also by the more dovish tone of the Fed, as well as corporate demand for local currency to pay tax bills, the rouble has appreciated more than 8% against the dollar since the decision to its firmest level this year.
- The firming of the rouble is consistent with a trade position that remains strong: the surplus of $15bn in January was above market expectations and up 16% compared to the previous month. However, the domestic economy continues to deteriorate. In February, industrial production decreased by 1.6%Y/Y – a significant step backwards after growth of 0.9%Y/Y in January and the steepest decline since February 2013 (-3.1%Y/Y). Retail sales decreased by 7.7%Y/Y, almost 2ppts weaker than market expectations and a particularly steep drop from the revised decline of 4.5%Y/Y in January. Nonetheless, the labour market has so far failed to reflect the depth of downturn – the unemployment rate rose 0.3ppt in February to 5.8%, well below the peak above 9% in February 2009 – and if the rise in joblessness remains muted then domestic consumption might start to show signs of bottoming in coming months.
- Car sales dropped by 38%Y/Y in February, far more than expected and down 14ppts from the previous month. While extremely deep, for the time being the scale of contraction remains less than in 2009 when sales fall between 40-60%Y/Y for nine consecutive months (sales subsequently rebounded from autumn 2010, with sharp growth of between 50-80%Y/Y between August 2010 and March 2011). However, due to high inflation and deteriorating real incomes we do not expect to see a rapid turnaround in the car market, at least not before the second half of the year when a disinflationary trend might start to prevail. Some manufacturers' efforts to promote and boost automobile sales by significant discounting etc., along with government efforts to stimulate car sales via, for example, the extension of the scrappage scheme until the end of 2015, may provide modest support for demand. However, some firms (e.g. VW and General Motors) have already announced plans to scale back production from their Russian facilities, and such action will have a material impact on industrial production over coming months.

Russia: Industrial production and retail sales



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Russia: Car sales



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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Turkey

- On 17 March, Turkey's Central Bank (TCMB) decided to leave unchanged its key one-week repo rate at 7.5% and left its other main rates unchanged at their prevailing levels too. The decision came days after a reconciliatory meeting between Central Bank Governor Basci and President Erdoğan – who had previously strongly urged cuts in rates to ease borrowing costs for domestic firms – which saw both jointly commit to preserve 'the present environment of confidence and stability'. The statement issued by the MPC following the meeting judged that the 'ongoing cautious monetary policy along with prudent fiscal and macro-prudential policies are having a favorable impact on inflation, especially inflation excluding energy and food'. Indeed, while headline inflation in February rose above expectations to 7.55%Y/Y, core inflation fell 0.9ppt to 7.7%Y/Y, the lowest in just over a year. While it expects inflation to decline further, the MPC also assessed that global financial market uncertainty and elevated food prices justified the decision to leave rates unchanged and, in eschewing the further rate cut previously demanded by the President, took the opportunity of the meeting to signal the independence of the TCMB.
- While the number of unemployed rose further towards year-end in line with the usual seasonal pattern, on an adjusted basis joblessness fell. Indeed, on a seasonally adjusted basis, the number of unemployed fell in December to 3.05mn, the lowest since August, with the unemployment rate down 0.2ppt to 10.4%, similarly the lowest in four months. Likewise, the adjusted youth (population aged 15-24) unemployment rate dropped by 0.3ppt to 19.1%. Nonetheless, as the continued double-digit unemployment rate suggests, significant slack in the labour market remains. And despite the recent modest improvement in employment, households are downbeat: consumer confidence fell in March to a six-year low with a deterioration recorded in all key survey sub-indices including labour market perceptions, financial situation and willingness to spend on durable goods.

Poland

- The deflationary trend appears to have continued to strengthen in Poland with CPI falling more than expected in February to a new series low of -1.6%Y/Y, down from a revised -1.4%Y/Y the previous month. Prices fell 0.1%M/M, the least since October but still 0.1ppt weaker than the market expectation. And while National Bank Governor Belka suggested following the most recent rate cut on 4 March that the end of the monetary easing cycle had been reached, we suspect that might not be the case. Indeed, the minutes of that meeting subsequently published on 19 March revealed that the 'announcement would not prevent an adjustment in interest rates in an event of unexpected strong shocks in the Polish economy or its environment' and – not least given the repeated failure of the National Bank to predict the recent weakness of inflation – we think that a further rate cut in due course cannot be dismissed.
- February's industrial production data were encouraging. Industrial output grew by 4.9%Y/Y, the highest rate since April last year, beating the consensus forecast by 0.8ppt and almost three times January's rate, which was admittedly distorted by the fewer number of working days compared to that month a year earlier. While mining and quarrying activity contracted by 11.3%Y/Y and energy output fell 1.8%Y/Y, manufacturing production grew by 6.6%Y/Y. While those manufacturing figures provide cause for optimism and are certainly consistent with our view that economic growth should be well maintained over the near term, the latest retail sales data were less buoyant. In nominal terms, retail sales in February declined by 1.3%Y/Y, the steepest decrease in more than in two years and significantly undershooting the consensus forecast of no change. However, the drop in nominal sales principally reflected lower prices, and in real terms sales were up 2.4%Y/Y, still nevertheless 0.9ppt weaker than January's rate. And with household real disposable incomes rising, unemployment falling and confidence trending higher, we continue to expect consumption to provide solid support to GDP growth over the near term.

Hungary

- As widely expected, following its regular MPC meeting on 24 March, the Hungarian National Bank (MNB) cut rates for the first time since July when it had previously suggested that the easing cycle had ended. The magnitude was slightly smaller than expected, with the key base rate reduced by 15bps to a new record low of 1.95% (compared to the consensus expectation of 1.90%) and reductions of the same size made to the overnight deposit and collateralized loan rates to 0.95% and 2.95% respectively. But MNB Governor Matolcsy subsequently made clear that further easing should be anticipated. With CPI having undershot expectations over recent months to stand at -1.0%Y/Y in February, the strong justification for the rate cut was a downwards revision to the MNB's inflation forecast to average zero this year and 2.6%Y/Y in 2016 (from the previous forecasts of 0.9% and 2.9% respectively). And the downside risks to that forecast were also judged to have increased despite an upwards revision to the MNB's forecast for GDP growth to 3.2% in 2015 and 2.5% next year (previous forecasts 2.3% and 2.1% respectively). To increase flexibility within the monetary policy framework, the MNB set a 'tolerance band' of 1 percentage point above and below its 3% inflation target, to be reviewed within three years. Nevertheless, we should expect rates to be cut further at 15bp increments at least until the MNB forecasts that CPI has a strong likelihood of reaching 3% within two years.

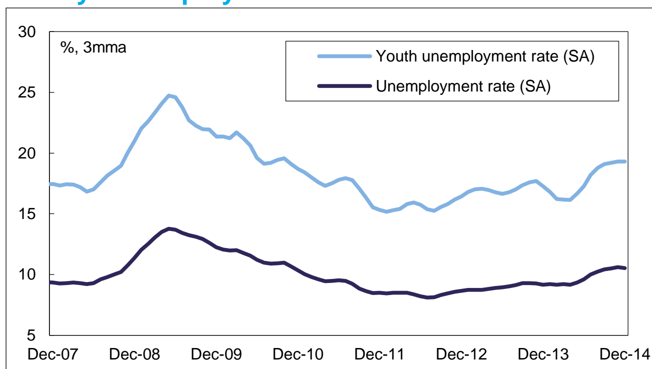
Mexico

- January's industrial production data were disappointing. Industrial output grew merely 0.3%Y/Y compared to 3.0%Y/Y a month earlier and the consensus forecast of 2.1%Y/Y. It was also the slowest growth rate since April and 0.8ppt weaker than the same month a year earlier. Against the backdrop of plummeting energy prices, mining output growth fell 5.9%Y/Y, the fourth consecutive drop in excess of 5%Y/Y. And the manufacturing sector is showing no signs of benefiting from those lower oil prices, with growth slowing 4.5ppts to 1.2%Y/Y, also the weakest since April. In contrast, however, January's retail sales data were encouraging. Sales grew above expectations at 4.7%Y/Y, almost double the rate compared to a year earlier. Moreover, inflation remains subdued, a small fraction below the 3% target in the first two weeks of March, suggesting limited pass-through from the more-than 10% depreciation of the peso against the dollar over the past six months. And with the Fed having adopted a more dovish tone at its most recent policy meeting, Banxico can feel more relaxed about the need to tighten policy for now.

South Africa

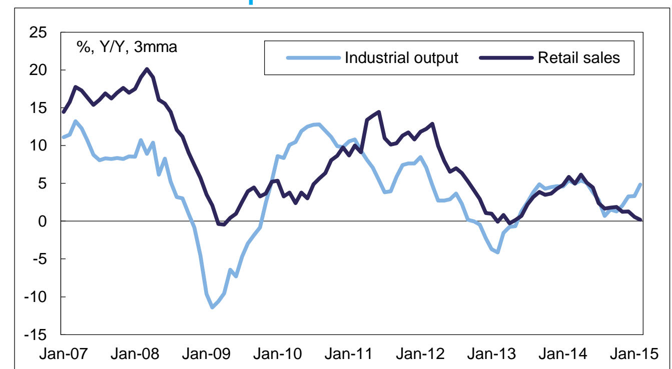
- South Africa's current account deficit declined 0.7ppt in Q414 to 5.1% of GDP, the lowest since Q114 and 0.2ppt lower than one year earlier. The improvement partly reflects lower oil prices, although subdued domestic demand also weighed on imports while exports picked up markedly thanks to reduced strike activity. The improvement in the trade balance was, however, partly offset by higher net income payments abroad. And the current account deficit remains an Achilles heel of the South African economy, leaving it particularly vulnerable to Fed monetary tightening policy. As such, the Fed's more dovish tone would have been welcomed by South African investors and policymakers alike.
- Retail sales growth moderated in January to 1.7%Y/Y, 0.7ppt below the market expectation, from a revised 2.0%Y/Y the previous month, suggesting that consumption (which grew 1.6%Q/Q annualized in Q414) remains relatively lacklustre. Meanwhile, inflation in February fell to a four-year low of 3.9%Y/Y, only a touch above market expectations and comfortably below the mid-point of the 3-6%Y/Y target range. Core inflation, however, remained stubbornly elevated at 5.8%Y/Y, contrary to expectations of a modest decline. And with oil prices more stable, food price inflation remaining high (prices of milk, cheese and eggs rose 11.8%Y/Y in February), and some effects of past rand depreciation still likely to feed through to prices, there remain upside risks to inflation over coming months. So, while the more relaxed stance of the Fed and associated rand appreciation means that we do not expect imminent tightening of policy, we also fully expect the South African Reserve Bank's MPC meeting on 26 March to leave its benchmark repurchase rate unchanged at 5.75%, the level prevailing since the 25bp hike last July.

Turkey: Unemployment rate



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Poland: Industrial production and retail sales



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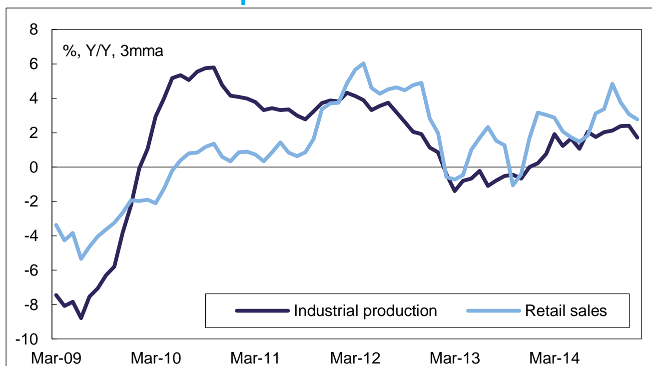
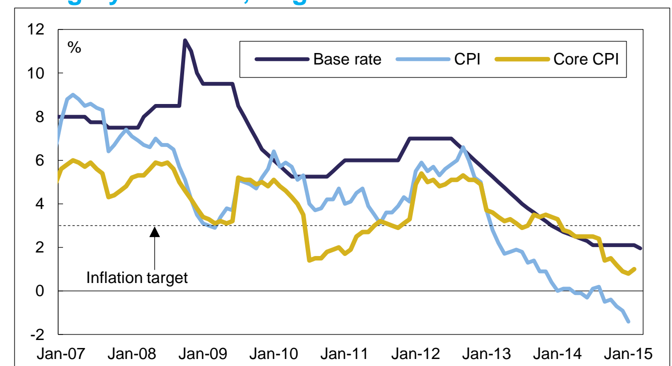
Mexico: Industrial production and retail sales



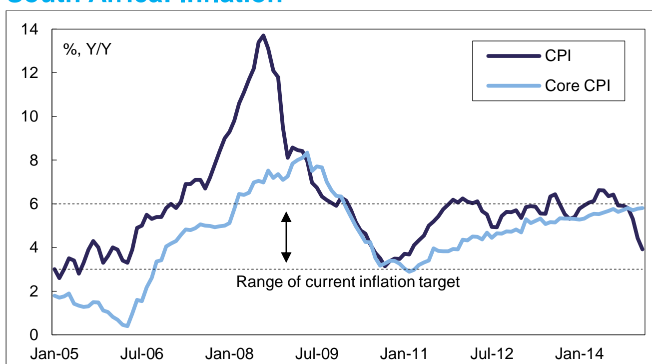
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Hungary: Inflation, target and interest rate



Source: MNB, Datastream and Daiwa Capital Markets Europe Ltd.

South Africa: Inflation



Source: Bloomberg and Daiwa Capital Markets Europe Ltd

Exchange rates and recent changes

Currency	/US$	%W/W*	%YTD
Russian rouble	57.50	3.39	5.64
Turkish lira	2.58	-0.27	-9.32
Polish zloty	3.72	2.23	-4.83
Hungarian forint	272.2	2.54	-3.87
Mexican peso	14.95	1.01	-1.29
South African rand	11.85	1.73	-2.30

**Change as at 4pm GMT 25 March. Source: Bloomberg*

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