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EM's Inflection

Authors
Drausio Giacomelli
+1(212)2507355
drausio.giacomelli@db.com

Hongtao Jiang
+1(212)250-2524
hongtao.jiang@db.com

Sameer Goel
+656423 6973
sameer.goel@db.com

Juliana Lee
(852)2203-8312
juliana.lee@db.com

www.dbresearch.com

Deutsche Bank Research Management
Stefan Schneider

Emerging Markets and the Global Economy in the Month Ahead: The source of the recent correction is benign: a repricing of US growth with the EU still poised to grow above potential. With few exceptions (such as Turkey and Argentina) EM inflation remains mostly near or below targets so that forex (FX) weakness is unlikely to trigger meaningful CB responses that could disrupt EM growth – which has yet to catch up with DM. However, USD strength poses a more binding and direct risk of tighter credit conditions for EM than US yields. Still, we would need to see EUR/USD closer to 1.05 for credit conditions to bind.

Fundamentals, valuation and positioning suggest that we are in the tail end of this correction. But we need to see USD stabilization for EM to retrace. EM FX also needs normalcy in credit and local markets for the unwinding of hedges. This and valuation could amplify the retracement when (and if) the USD turns. This is likely to be stronger where underperformance and fundamentals stand out.

We see the selloff in credit as overdone, but the predicament is that it will likely continue until the USD turns. While retaining a strategically constructive view based on fundamentals, we are compelled to move to be more defensive in our portfolio – by adding weight to names with lower USD sensitivity.

Brazil: Is This Time Different?

With policy rates reaching a trough, we look into the magnitude and path of normalization. We thus reassess Brazil's r* and dynamics of the policy rate around neutral. Based on several models, we find the (unobservable) r* to be in the 3-4.5% range, which is 50-200bp above the expected real Selic over the next year. Meanwhile, the market is pricing real Selic about 200-350bp higher than r* by end-2020.

Judging by inflation, output gaps and current policy stance, we expect an atypically smooth normalization and a terminal rate around 200-300bp below the priced Selic rate by end-2020. A likely pause or the end of the easing cycle could trigger flattening, but this would be technical in nature. Our analysis shows the curve to be too flat both on a forward basis and vs. fundamentals (with value concentrated in 1-3Y sector).

Turkey: Three macro misconceptions and policy choices

Market participants witnessed a concurrent rise in growth, inflation, and the current account deficit during 2017, and simply assumed this was an overheating story having led to runaway inflation and unwelcome widening in the external gap. While such a relationship has held several times before; in this note we discuss the fact that this has not been the case this time.

Market view #1: the current account deficit widened because of high growth: No – the main drivers were gold imports and higher global energy prices. More important, growth peaked in H2 2017, and a downward adjustment is already underway.

Market view #2: headline CPI was high because of high growth: Consistently high FX pass-through due to the consecutive advent of external and domestic shocks led to runaway inflation. Demand-pull factors exerted some non-linear upside pressure only from late Q3 2017 onward and at moderate levels.

Market view #3: a wider current account deficit is a key source of macro vulnerability this year: risks on the external front do not lie with the size of the external gap (flow) this year. They emanate from more pressing (stock) issues, such as the large amount of net foreign liabilities keeping external financing requirements at elevated levels against rising volatility in global markets, and due to policy choices, which seem disharmonious with Turkey's macro realities.

Fiscal ranking of India's key states

Stepping into FY19, we review the fiscal performance of India's 16 key states for the previous year and analyze the budget estimates provided by these states for the current fiscal year. We also provide a ranking of India's key states, based on their relative fiscal performance. We use three fiscal parameters: fiscal deficit, own tax revenue, and state debt, all as a percentage of gross state domestic product, to construct a composite fiscal ranking of the states.

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