Deutsche Bank
Markets Research

Emerging Markets

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Emerging Markets Monthly

Limiting Contagion

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Special Reports

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LMAP – The Next Generation

Deutsche Bank Securities Inc.
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Key Economic Forecasts

	Real GDP (%)			Consumer prices (% pavg)			Current account (% GDP)			Fiscal balance (% GDP)		
	2013F	2014F	2015F	2013	2014F	2015F	2013F	2014F	2015F	2013F	2014F	2015F
Global	**2.8**	**3.5**	**3.9**	**3.2**	**3.7**	**3.7**	**0.1**	**0.1**	**0.0**	**-3.4**	**-2.9**	**-2.5**
US	**1.9**	**3.2**	**3.8**	**1.5**	**2.1**	**2.3**	**-2.7**	**-2.4**	**-2.5**	**-4.0**	**-2.9**	**-2.5**
Japan	**1.5**	**0.5**	**1.3**	**0.4**	**3.0**	**1.7**	**0.7**	**0.7**	**1.7**	**-9.1**	**-7.1**	**-5.6**
Euroland	**-0.4**	**1.1**	**1.4**	**1.3**	**1.0**	**1.4**	**1.9**	**1.7**	**1.7**	**-3.1**	**-2.4**	**-2.0**
Germany	0.4	1.5	2.0	1.6	1.3	1.7	7.5	7.3	7.1	0.0	0.1	0.1
France	0.3	1.0	1.6	1.0	1.3	1.2	-1.7	-1.5	-1.3	-4.1	-3.6	-3.1
Italy	-1.9	0.7	0.7	1.3	1.0	1.4	0.8	1.4	1.9	-3.0	-2.9	-2.9
Spain	-1.2	0.8	1.2	1.5	0.8	1.1	0.7	2.1	2.5	-6.6	-5.8	-4.5
Netherlands	-0.8	0.7	1.3	2.6	1.0	1.5	10.3	10.5	11.0	-3.9	-3.3	-3.0
Belgium	0.2	1.2	1.6	1.2	1.3	1.5	-2.5	-2.0	-1.0	-2.8	-2.7	-2.6
Austria	0.4	1.4	1.8	2.1	1.5	1.7	2.7	3.0	3.0	-2.1	-1.8	-1.6
Finland	-1.4	0.8	1.4	2.2	1.7	1.8	-0.8	-1.1	-0.8	-2.3	-2.1	-1.9
Greece	-4.3	0.8	2.0	-0.9	-0.6	0.2	-0.5	0.5	1.0	-13.5	-2.0	-1.0
Portugal	-1.6	0.8	0.9	0.4	0.6	1.0	0.6	1.0	1.5	-5.7	-4.5	-3.5
Ireland	0.2	1.8	2.2	0.5	0.8	1.1	5.0	4.5	4.0	-7.4	-4.9	-2.8
Other Industrial Countries												
United Kingdom	1.8	2.7	2.0	2.6	1.8	1.7	-4.1	-3.5	-3.1	-6.1	-4.7	-4.1
Sweden	0.9	2.4	2.8	0.0	1.0	2.1	6.2	5.6	5.2	-3.6	-1.0	-0.5
Denmark	0.4	1.8	1.5	0.8	1.5	1.9	7.2	6.0	5.5	0.0	-2.0	-2.5
Norway	0.8	2.5	2.7	2.1	2.0	2.1	10.6	11.5	11.2	11.0	10.5	10.0
Switzerland	2.0	2.1	2.0	-0.2	0.4	0.8	11.9	11.5	11.5	0.0	0.8	0.9
Canada	1.8	2.8	2.9	0.9	1.7	2.1	-3.3	-2.5	-2.1	-1.4	-0.9	-0.3
Australia	2.4	3.7	3.8	2.4	3.0	2.7	-3.0	-3.0	-2.4	-2.1	-2.5	-1.7
New Zealand	2.7	3.3	2.2	1.1	1.8	2.3	-3.4	-2.1	-3.6	-1.3	-0.1	0.5
Emerging Europe, Middle East & Africa	**2.3**	**2.0**	**3.2**	**4.8**	**5.0**	**5.0**	**0.6**	**0.6**	**0.1**	**-1.0**	**-0.7**	**-1.5**
Czech Republic	-0.9	2.0	2.5	1.4	1.1	2.0	-0.6	-1.0	-1.4	-3.0	-2.8	-2.7
Egypt	2.1	3.0	4.2	6.9	8.6	10.5	-2.1	-0.4	-2.8	-14.7	-13.2	-14.3
Hungary	1.1	1.9	2.0	1.7	0.5	2.3	2.1	2.0	1.5	-2.5	-2.9	-2.7
Israel	3.3	3.7	4.2	1.5	1.6	2.2	1.6	1.9	2.1	-3.6	-3.0	-2.5
Kazakhstan	6.0	4.8	5.2	5.8	5.1	6.3	0.1	2.0	1.5	5.3	4.8	3.3
Poland	1.6	3.0	3.9	0.9	1.7	2.3	-1.5	-2.2	-1.9	-4.8	4.0	-3.1
Romania	3.5	2.8	3.2	4.0	2.0	3.3	-1.1	-2.0	-2.1	-2.5	-2.2	-1.9
Russia	1.3	0.6	2.2	6.8	6.2	4.9	1.5	2.0	1.6	-0.5	-1.1	-1.3
Saudi Arabia	3.7	4.3	4.3	3.5	3.6	3.5	16.4	9.8	8.0	11.9	7.7	7.4
South Africa	1.9	2.9	3.5	5.8	5.8	5.6	-6.0	-4.0	-3.9	-4.1	-4.0	-3.5
Turkey	4.0	2.2	3.8	7.5	8.1	7.8	-7.9	-5.9	-6.2	-2.1	-2.6	-2.6
Ukraine	0.0	-4.9	2.5	-0.3	2.8	5.8	-9.2	-5.9	-4.4	-4.5	-2.5	-2.2
United Arab Emirates	5.1	3.1	3.4	1.1	2.5	2.5	17.9	14.1	13.0	9.7	7.1	7.4
Asia (ex-Japan)	**5.9**	**6.8**	**6.8**	**4.3**	**4.0**	**4.0**	**2.1**	**1.8**	**1.3**	**-2.9**	**-2.9**	**-2.5**
China	7.7	8.6	8.2	2.6	3.5	3.2	2.5	2.3	2.1	-2.0	-2.1	-1.5
Hong Kong	2.9	4.2	4.5	4.3	3.5	3.2	-0.9	3.7	2.8	0.6	2.6	3.4
India	3.9	5.5	6.0	10.1	6.3	6.7	-2.6	-2.5	-3.0	-7.0	-7.0	-6.7
Indonesia	5.8	5.2	5.5	6.4	6.4	5.4	-3.3	-3.0	-2.7	-2.2	-2.4	-2.6
Korea	2.8	3.9	3.6	1.3	1.9	2.8	5.9	4.1	2.8	-0.7	-0.1	0.1
Malaysia	4.7	5.5	5.6	2.1	3.1	2.9	3.8	4.3	5.5	-3.9	-3.8	-3.3
Philippines	7.2	6.8	6.8	2.9	4.3	3.8	14.9	4.8	3.4	-1.4	-2.4	-2.2
Singapore	4.1	3.5	4.5	2.4	2.5	3.5	18.4	18.1	16.5	7.1	6.9	6.8
Sri Lanka	7.2	7.5	7.5	6.9	5.5	7.1	-2.1	-1.9	-2.0	-5.8	-5.5	-5.0
Taiwan	2.2	3.7	3.4	0.8	0.9	1.2	11.2	10.2	9.1	-2.3	-1.5	-0.8
Thailand	2.9	3.5	4.5	2.2	2.9	2.3	0.1	1.0	0.3	-3.0	-3.2	-3.3
Vietnam	5.4	5.8	6.3	6.6	7.0	9.8	3.2	2.0	-3.1	-6.0	-6.2	-5.5
Latin America	**2.3**	**2.1**	**2.9**	**9.0**	**12.4**	**11.3**	**-2.5**	**-2.4**	**-2.3**	**-3.5**	**-4.0**	**-3.8**
Argentina	2.4	-2.1	1.9	24.9	39.8	29.4	-1.1	0.1	0.4	-4.5	-4.8	-4.3
Brazil	2.3	1.7	1.7	6.2	6.1	5.7	-3.6	-3.5	-3.5	-3.2	-3.9	-3.5
Chile	4.1	3.8	4.1	1.9	3.5	3.0	-3.2	-3.7	-3.3	-0.6	-1.0	-0.8
Colombia	4.3	4.5	4.3	2.0	2.7	3.3	-2.6	-2.8	-3.0	-2.4	-2.3	-2.2
Mexico	1.1	3.1	3.7	3.8	4.0	3.8	-1.8	-2.1	-2.2	-2.9	-4.0	-3.6
Peru	5.2	6.0	6.5	2.5	2.7	2.9	-5.0	-4.8	-4.5	1.0	0.6	0.5
Venezuela	1.5	0.5	3.5	40.0	65.0	70.0	1.6	1.8	2.6	-14.3	-11.5	-13.5
Memorandum Lines: [1/]												
G7	**1.3**	**2.3**	**2.7**	**1.3**	**2.0**	**2.0**	**-1.1**	**-0.8**	**-0.6**	**-4.3**	**-3.3**	**-2.8**
Industrial Countries	**1.1**	**2.2**	**2.6**	**1.3**	**1.8**	**1.9**	**-0.7**	**-0.5**	**-0.4**	**-4.1**	**-3.1**	**-2.6**
Emerging Markets	**4.5**	**5.0**	**5.3**	**5.2**	**5.7**	**5.5**	**1.0**	**0.8**	**0.4**	**-2.6**	**-2.6**	**-2.5**
BRICs	**5.5**	**6.2**	**6.3**	**5.1**	**4.7**	**4.4**	**0.6**	**0.6**	**0.3**	**-3.1**	**-3.3**	**-2.8**

1/ Aggregates are PPP-weighted within the aggregate indicated. For instance, EM growth is calculated by taking the sum of each EM country's individual growth rate multiplied it by its share in global PPP divided by the sum of EM PPP weights.
For Egypt numbers are reported for financial year ending June.

Source: Deutsche Bank

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Bailing Out Ukraine
Ukraine faces an economic as well as a political crisis. With very limited reserves and substantial external debt service obligations, it urgently needs external financial assistance. While public debt is set to rise significantly, with a combination of external support and domestic adjustment, the situation is manageable and we think the case for aggressive private sector involvement is weak.......... 11

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Since 2008 the Local Markets Analytics Package (LMAP) has been a mainstay of our quantitative analysis of EM local currency fixed income markets. Over the past 5+ years the package has evolved and expanded to cover additional countries and market segments. We are now pleased to release the latest incarnation with a host of new features to help rapidly assess potential trades across EM local markets.. 40

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Emerging Markets and the Global Economy in the Month Ahead

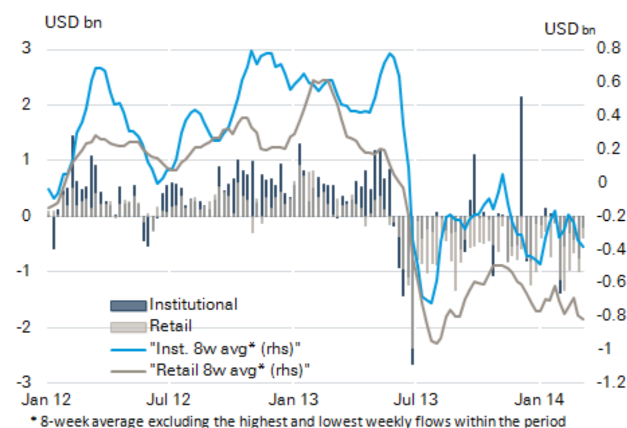
- Despite the crisis in Ukraine, economic adjustment elsewhere in EM, supported by tighter monetary conditions, and better valuation have tamed volatility and limited the downside for EM assets. Although this supports carry trades, the backdrop for risky assets remains unfavorable.
- Growth in the US and Europe seems strong enough for the Fed and ECB to avoid injecting further liquidity. But it is not yet strong enough to tame fears of deceleration in China and boost growth in EM more broadly. In the absence of more decisive signals on these fronts, intra-EM differentiation has become dominant and will likely remain so for the next month or two.
- In FX, higher carry supports narrower trading ranges, but still mixed growth data and unlikely additional accommodation should continue to weigh on EM currencies.
- Growth upturn favors core longs in PLN and tactical longs in HUF. Current account, policy, and political dynamics support long ZAR vs. TRY and INR vs. BRL. THB and SGD are our favorite funding currencies for USD longs in Asia. RUB and CLP are overshooting, but we see no clear catalyst of near-term reversal.
- Although premiums in EM rates seem insufficient to cover the risk that forward guidance is tested, this seems a remote possibility in the near term. We find EM rates now close to fair. Sensitivity to US yields has reduced, although risks still appear biased to the upside.
- We favor tactically receiving in Chile, Brazil (vs. paying the long end), Hungary, Israel (with a flattening bias), and steepeners in South Africa, Turkey, and Poland (vs. buying bonds in the belly vs. longer-dated swaps).
- Keep long rates in Singapore, Mexico, Peru, and Chile vs. the US, or outright long bonds in the belly of Colombia and Peru. We still recommend holding India assets, but are underweight duration in Malaysia and the Philippines.
- On sovereign credit, with spreads having retraced almost all the widening incurred during January, we stay close to the benchmark. We retain a bearish bias among EMEA credits (with underweights in Russia, Ukraine, and Turkey), while being more constructive on Asian and LatAm credits

Overcoming one more hurdle

The past month was another eventful month for EM. But rather than the confluence of shocks of January (China's disappointing PMI, devaluation in Argentina and Venezuela, emergency interest rate hikes in Turkey and South Africa, and Ukraine's political crisis), it was the escalation of the conflict in Ukraine that took center stage as it gained global geopolitical proportions. As we go to print the situation remains tense and prone to potential accidents that will likely continue to weigh on both Ukraine and Russia, in particular. The latter, in our view, was one of the most vulnerable EM credits heading into 2014 and further damage to its investment climate, trade, and capital flows should continue to expose its vulnerability, especially if oil prices recede as DB forecasts.

Besides highlighting EM vulnerabilities, the recent months have also strengthened our conviction that differentiation will remain the norm, and that both systemic and contagion risks are limited. As we stressed in our previous Monthly, policy response has been crucial in taming currency volatility – as most recently seen in Russia. Moreover, outflows have apparently become less sensitive to such shocks (chart), while emerging economies have retained easy access to funding. Even riskier sovereigns such as Venezuela have sourced new loans, while market flows have remained supportive for Argentina and Ukraine seems likely to secure significant official funding.

Institutional outflows have subsided



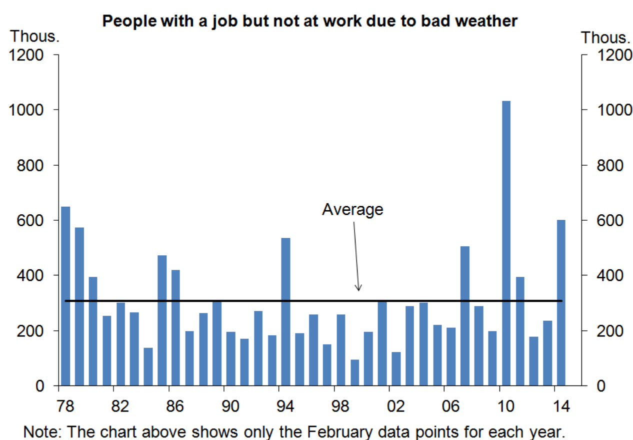
Source: DB Global Markets Research, Bloomberg Finance LP.

However, EM growth is still tentative and both external and domestic imbalances have only partially corrected. Growth in China could surprise to the downside this quarter before picking up later in this year. Performance in Asia's export-oriented economies has also been uninspiring but they should benefit as the drag from the Lunar New Year and the weather-related soft patch in the US begin to fade. Latin America seems poised to lag until growth in the US and China turns. In EMEA, the process of external adjustment in South Africa and Turkey has begun, and recent rate hikes have helped to stabilize markets, though upcoming elections in both cases have the potential to create concerns.

Until growth in DM firms and spills over more convincingly to EM in the coming quarters, as we expect, emerging assets will likely remain exposed to potentially higher US yields, which are trading near the low end of the range of the past 6 months. The resilience to both global and EM-specific shocks suggests that this re-pricing could be absorbed orderly – as long as forward guidance is not severely tested.

US labor markets seem to be finally thawing. More data is needed to shed light on the trend, but evidence that the weather has indeed distorted recent payroll numbers has mounted. The Household Survey shows that those unable to work due to bad weather surged to 601k vs. a long-term average of 309k for February (chart). The fact that jobless claims dropped to its lowest level since November is also encouraging, pointing to payrolls possibly above 200k.

Gauging the impact of bad weather



Source: BLS, Haver Analytics & DB Global Markets Research

The Survey also indicates that the weather hit nonfarm workweek hours harder and a sharp rebound in March seems in order. This suggests that Q1 real GDP growth near 3% remains within reach. As data surprise indices show, US data have improved but from low levels. Rising income and continued appreciation amid limited supply should continue to support housing, while higher capacity utilization bodes well for investment. Altogether, this means that the Fed will stay the course on tapering. However, there is no near-term threat to forward guidance, in our view. Not only data have yet to strengthen more broadly, but – with the help of fast productivity growth – wage pressures are low (unit labor cost dropped 1% oya).

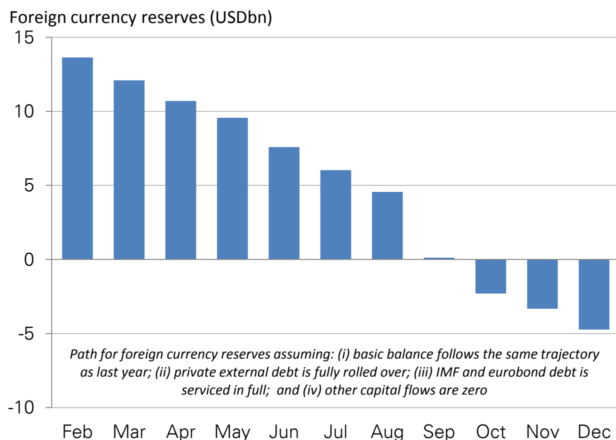
In Europe, no further accommodation is in sight. The ECB signaled via its forecasts that it is firmly on hold and. By forecasting inflation accelerating to just 1.7% by Q4 2016 the ECB has redefined what it means by deflation risk. The ECB also seems satisfied with the mild reduction in real policy rates this implies and the lower funding costs across the euro area. If anything, by stressing the time it will take to fill Europe's output gap, the ECB's guidance points to "low for longer" rather than lower rates or further accommodation. This has pushed the EUR/USD near 1.40 – a level that could be sustained in the near term by supportive trade flows and positioning. Unless it strengthens significantly further, it seems that the ECB would not respond. Altogether, DB now expects policy rates unchanged this year.

EM: The limits of contagion

While the crisis in Ukraine has taken centre stage, we view this as further evidence of diverging performance within EM rather than symptomatic of a broader systemic failure in the emerging world. The fact that contagion from Ukraine to the rest of EM has been limited underscores this view.

That Ukraine is facing economic collapse is not a surprise. Its government had long been heading down an unsustainable economic path, maintaining a fixed exchange rate at an overvalued level and running up large external and fiscal imbalances. Of all the countries that were ill placed to deal with the reduced availability of external financing flows, Ukraine was at the front of the line. As we discuss later in this monthly (see "Bailing Out Ukraine"), Ukraine is now in urgent need of external financial assistance. While government debt is likely to rise significantly, the position is not unsustainable and we think that an aggressive attempt to bail in private sector would have only a marginal impact on the success of any adjustment program. A voluntary exchange of short-dated for longer-dated bonds, however, could make sense.

Ukraine: foreign reserves under no adjustment



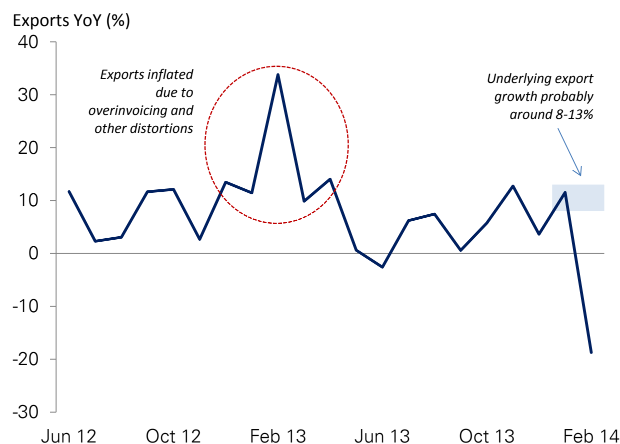
Source: Haver Analytics, Bloomberg Finance LLP, Deutsche Bank

Contagion from Ukraine has been mainly limited to Russia, prompting the central bank to intervene and hike rates by 150bps in response to pressure on the rouble. Later in this monthly (see "Russia: macro implications of increased geopolitical risk"), higher capital outflows, weaker sentiment, tighter domestic liquidity conditions, and higher inflation, will all weigh on economic activity. We have accordingly revised down our forecast for growth to 0.6% from 2.4%. Given Europe's reliance on Russian energy and other economic ties, we view aggressive economic sanctions as a tail risk at this stage, though fears of sanctions may add to outflows.

Elsewhere in EM, there have been some encouraging signs that others in the same high-yield bucket as Ukraine have recognized that current policies are unsustainable. Argentina not only devalued its currency in late January but also validated a meaningful increase in interest rates. The government has also tried to cap inflation expectations through price agreements and efforts to contain wage increases. Monthly inflation has accelerated to around 4% but expectations have stabilized around there pre-devaluation trend. Reserves continued to fall in February but by a modest USD 0.3bn, suggesting some stabilization in the external position. The situation is still challenging but further policy reactions might be enough to prevent major economic stress before presidential elections next year. In Venezuela, having earlier vowed to maintain its overvalued official exchange rate, the government has recently announced measures that would amount to a partial liberalization of the exchange rate regime. These would improve the allocation of hard currency resources and the fiscal situation, reducing current worries about debt payment capacity.

In the larger EMs, markets had been keenly awaiting the outcome of the early-March National People's Congress in China, which set an unchanged growth target of 7.5%. Looking at high frequency indicators such as railway freight traffic, power production, exports (adjusted for various one-off effects and distortions), and credit growth, we see the Chinese economy well set to achieve that presently, notwithstanding the weak PMI figures reported lately. We agree that Q1 growth could surprise to the downside given the prevailing weakness in manufacturing activity (due partly to suspension of production at coal-burning factories). But there is scope for upside in the remainder of the year, especially with regards to exports and public sector investment.

Fall in Chinese exports reflects earlier distortions

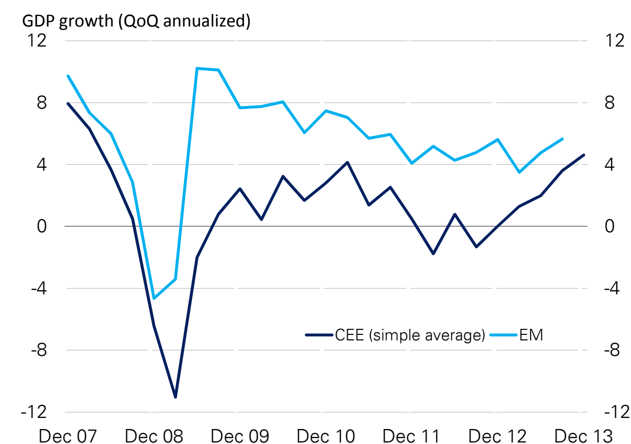


Source: Haver Analytics, Deutsche Bank

More broadly in emerging Asia, inflation remains tame, liquidity ample, and exchange rates relatively stable. Recent activity data has not been particularly promising but this is at least partly a reflection of weather-related issues in the US and the Lunar New Year drag in Asia. As these factors fade, growth in Asia's export-oriented economies should accelerate accordingly.

Finally, coming back to emerging Europe, later in this monthly we highlight one of the more promising developments in EM (see "Central Europe: A Good EM Story"). After a protracted period of economic stagnation, confidence is returning and recoveries across the region are gathering pace. The heavy lifting of fiscal austerity is mostly done. The pace of deleveraging in the private sector is easing. Inflation is low and spare capacity still significant, which should give central banks some breathing space before monetary conditions need to be tightened. External vulnerabilities have been much reduced since the last crisis, leaving the region less exposed than other EMs to Fed tapering. Currency adjustment during the EM sell off has been modest but the region appears to be relatively competitive and well placed to take advantage of strengthening external demand.

Central Europe: Closing the Growth Gap



Source: Deutsche Bank

Within Central Europe, the outlook in Hungary is more challenging. Despite impressive recent adjustment, debt remains high and much of it is still denominated in foreign currency, leaving private and public balance sheets exposed to currency weakness, albeit less so than in the past. Question marks also remain over the business climate and its ability to attract private investment. Recovery in Hungary is, therefore, likely to lag others in the region and will be more adversely affected by broader EM jitters, especially as the central bank continues to test the limits of easy monetary policy.

Strategy: Tactical and idiosyncratic

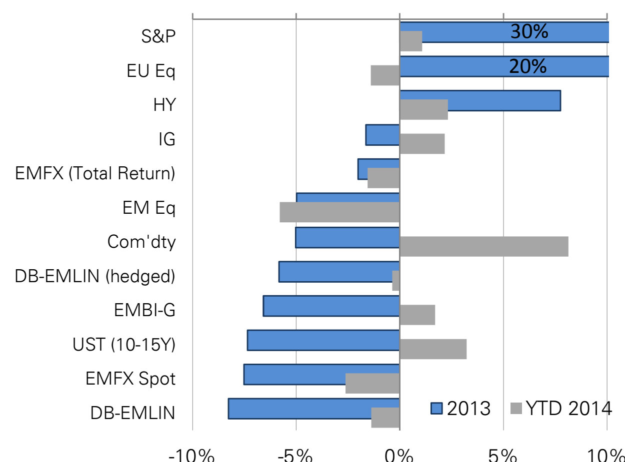
Some reduction in macro imbalances – more noticeable in Asia and Central Europe, tightening in monetary conditions and better valuation have tamed volatility and limited downside for EM assets – credit, FX, and rates. Although this supports carry trades, the backdrop for risky assets remains unfavorable. Growth seems strong enough for the Fed and ECB to avoid injecting further liquidity, but it is not yet strong enough to tame fears of deceleration in China and boost EM growth itself. Lacking a more decisive macro direction, not only intra-EM differentiation has become dominant, but cross-asset performance has also become more disperse, as the chart below shows.

In FX, higher carry supports narrower trading ranges, but still mixed growth data and unlikely additional accommodation should continue to weigh on EM currencies. Growth upturn favors core longs in PLN and tactical longs in HUF. Current account dynamics, combined with political risk plus quality of policy response differentials support long ZAR vs. TRY and INR vs. BRL. THB and SGD are our favorite funding currencies for USD longs in Asia. RUB and CLP are overshooting, but we see no clear catalyst of near-term reversal.

We find EM policy rates close to fair. Premium seems insufficient to cover the risk that forward guidance is tested, but we find this is unlikely to happen anytime soon. We favor tactically receiving in Chile, Brazil, Hungary, Israel (with a flattening bias), and steepeners in South Africa, Brazil, Turkey, and Poland (buying bonds in the belly vs. longer-dated swaps). We favor long rates in Singapore, Mexico, Peru, and Chile vs. the US, or outright long bonds in the belly of Colombia and Peru. We still recommend holding India assets, but are underweight duration in Malaysia and the Philippines.

On sovereign credit, increasing differentiation and valuation are supportive, but the risk of higher US rates possible setbacks in high-yielder will likely limit upside for now. With spreads having retraced almost all the widening incurred during January, we stay close to the benchmark. We retain a bearish bias among EMEA credits (with underweights in Russia, Ukraine, and Turkey), while being more constructive on Asian and LatAm credits.

More differentiation and more dispersion in returns



Source: DB Global Markets Research, Bloomberg Finance LP

EMFX: Better anchored

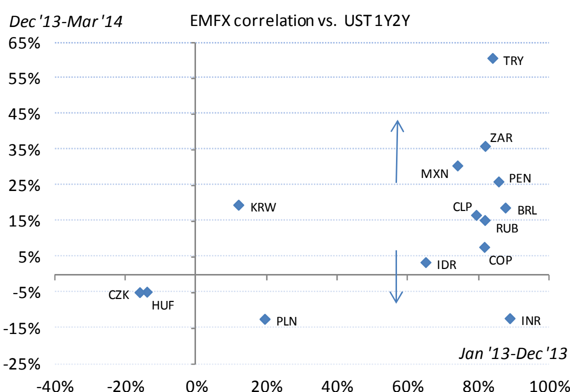
After quite a volatile start, EM currencies have recovered most of the ground lost early in the year. They have also settled in a narrower range that we expect to carry on into March[1]. Although it remains to be seen whether central banks will stay the course, we believe that policy response has played a crucial role in sending the correct signal and providing better footing

[1] A trade-weighted index of EM currencies is just about 2% weaker vs. the USD ytd.

for EM currencies. This has helped consolidate differentiation and limit downside even where political risks remains highest such as in Russia.

A stronger policy anchor should also tame EMFX sensitivity to US rates while US yields likely move higher in the months ahead. As the chart below shows, EMFX vs. US rates correlations were high during 2013, but they have dropped significantly over the past months. Countries where policy response took place earlier and more credibly so as in India have decoupled more clearly, but sensitivities across the other "fragile" EM currencies have also dropped.

More diverse sources of risk



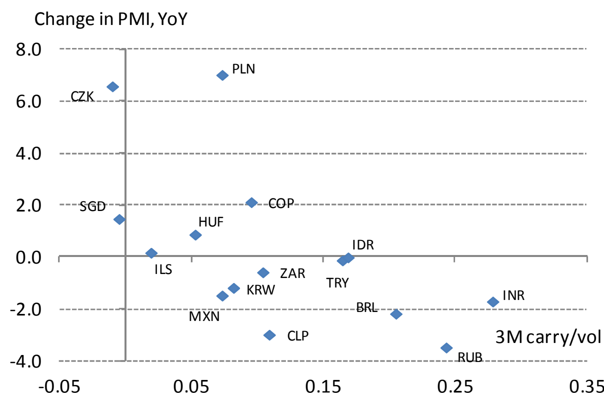
Source: DB Global Markets Research, Bloomberg Finance LP

Despite progress on macro and higher carry, we still believe it is too early to turn core bullish EMFX as this remains an environment where growth remains elusive and accommodation less likely. Current accounts still need to shrink further, several policymakers have to rebuild credibility, and – more importantly – EM growth still needs to post more convincing signs.

As the chart below shows, the benefits of higher carry-to-vol tend to be accompanied by less dynamic activity. Signs of growth acceleration are evident in Poland, where EUR/PLN is also trading near the top of its recent range. Better economic data, near term valuation, and positioning could also bide time for long HUF despite severe structural weakness.

In contrast, lackluster growth should continue to weigh on the BRL, although higher carry/vol seems now enough to keep it in the 2.30-40 range. Mexico's growth has disappointed, but so has the US. As the latter is likely on the cusp of reaccelerating, we maintain a constructive view on the peso. Downside risks to growth seem higher in Chile and Russia, although these currencies – especially the CLP – are in overshooting territory. While the drop in copper prices may soon ease as concerns over China's growth wane (as DB expects), tension (and thus capital flight) is

Trading off carry, vol, and growth prospects



Source: DB Global Markets Research, Bloomberg Finance LP

unlikely to subside in Russia before Ukraine's elections in May.

Following India, we are finally seeing marked improvement in South Africa's current account (DB forecasts 4% of GDP in 2014), which supports outperformance vs. its peers. In particular, we expect to see ZAR/TRY higher as political outcomes still seem quite binary in Turkey. In contrast, we remain skeptical on IDR fundamentals and would favor only tactical longs. We recommend keeping long RMB vols and find USD longs best expressed through SGD and THB.

- Asia: Long 1Y USD/CNH straddle; short SGD/MYR (target 2.5); long USD/SGD, (target 1.32); long USD/THB (target 34); short USD/INR via 62 put, with RKO at 57.
- EMEA: Short TRY/ZAR (target 4.70); short EUR/PLN (target: 4.125); short EUR/HUF (target 302).
- LatAm: Buy INR/BRL (target 0.044). Buy zero cost 3M ATMS 1x2 puts spread struck at ATMS, premium neutral in both USD/MXN and USD/COP. Keep short USD/PEN (target 2.85).

Local rates: Closer to "fair"

The normalization of EM rates has advanced substantially – both in terms of levels and in curve shapes. EM curves have tended to bear-flatten over the past few months and – in real terms – EM yields are trading around 400bp over comparable US TIPs. Although such spread is the highest in almost 5 years, it still seems insufficient to attract stronger inflows into local markets while EM currencies are vulnerable and FX hedging quite costly, as we discuss further below. Real yields in Asia, in particular, remain mostly unattractive.

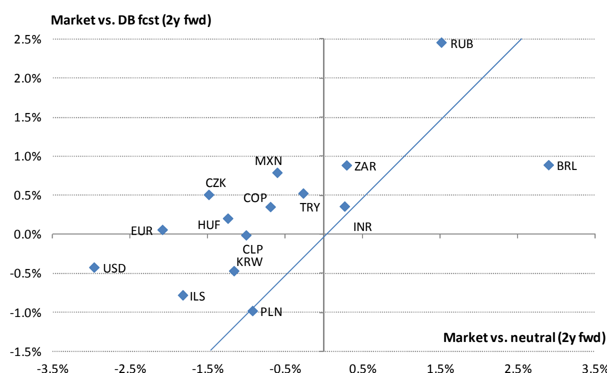
We expect EM curves to trade under some (contained) pressure. First, we see the soft patch in the US possibly coming to an end and US yields are trading close to the

lower bound of the past 6 months (both 10Y spot and on a forward basis). Second, rising food prices may also add some strain. Third, although the latest data from China have raised concerns, DB finds the underlying trend consistent with its bullish call on growth. As a silver lining, with valuation now more aligned with output gaps, inflation, and FX risk, we expect lower sensitivity of EM vs. US rates than in the past year – especially in the short end.

Monetary policy gaps have mostly closed vs. our baseline scenario, but there is still insufficient premium should global growth return to its historical norm, in our view. The chart below shows market-implied rates (2 years forward) vs. both our metric of "neutral" and vs. our forecasts 2 years ahead across selected curves[2]. Our forecasts assume that the Fed's and ECB's forward guidance would hold and thus policy rates in EM would initially rise to levels below pre-crises "neutral" rates (except for Brazil). In contrast, our "neutral" estimates tend to yield figures comparable to pre-crisis levels.

According to these metrics, markets already price some premium vs. our forecasts, with Poland, Israel, and Korea as notable exceptions. In contrast, when compared to "neutral" estimates, premia remain mostly negative – even if a lot less so than late in 2014. As we believe that forward guidance is not going to be tested in the near term, we see EM monetary policies – as priced – now more aligned with our outlook for EM central banks and we thus focus on country specifics.

Assessing policy normalization across EM



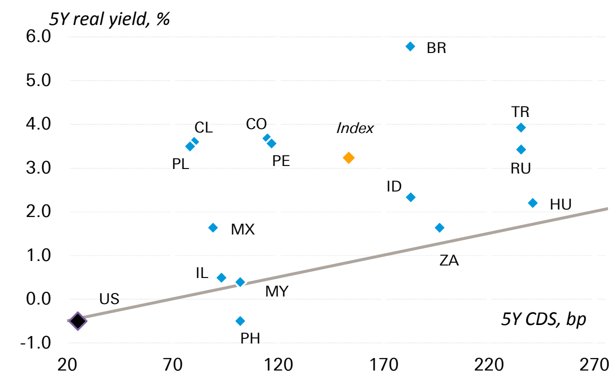
Source: DB Global Markets Research.

Political tension is resurfacing in Turkey and it is a reminder of its protracted electoral calendar. We expect monetary policy to remain tight for longer, which is at odds with what forwards indicate. Political risk is highest in Russia, in our view, where more tightening seems the least costly route to tame capital outflows (and thus the risk of recession) and RUB depreciation. The macroeconomic risks in Hungary appear less imminent as fiscal and BoP imbalances have been reduced and we keep (tactical) short-end receivers. However, for those looking for tail protection against the risk stemming from FX mismatches, we recommend 2s5s flatteners on favorable valuation and carry.

As the economy slows, we favor receivers in the short end of Chile, but prefer to express them via linkers to mitigate the risk of FX and oil prices pass-through. Our view that potentially more aggressive easing would have to be reversed quickly also bodes for paying the belly. We hold receivers in Singapore and in Peru versus the US. We have taken profit in short-dated receivers in South Africa, but see this sector well-anchored and favor steepeners, since long-dated (real) rates are still low.

Value in longer tenors has improved, but this has to be weighed against lingering FX and UST risk. Once deflated by available inflation expectations, real yields seem, as the chart below shows. But we prefer to focus on Poland, Mexico, Colombia, and Peru where we feel most comfortable about currency risk.

Assessing (relative) value in longer tenors



Source: DB Global Markets Research, Bloomberg Finance LP

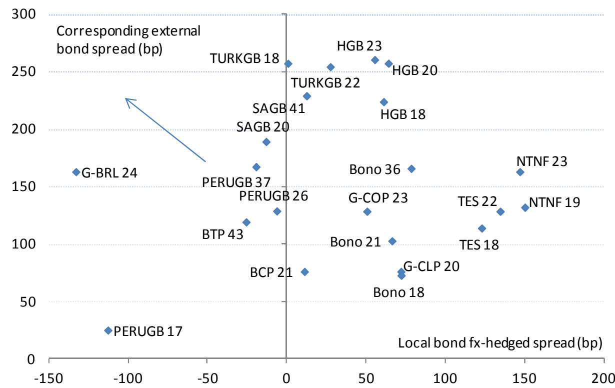
Although the chart above suggests that Brazil is very steep, we note that the curve has flattened vs. USTs. More importantly, we believe that the CB has turned more dovish on fiscal promises that may never materialize. In Asia, we hold Indian assets before supply picks up, but remain underweight on duration in Malaysia and the Philippines. We also expect a steeper curve in China.

Despite increased yield differentials vs. US rates, the benefits of duration tend to be more than offset by the cost of hedging for those that seek FX protection. As

[2] "Fair" is based on Taylor rules – adjusted to country-specifics in a few cases to improve fit and robustness.

discussed in the last Monthly, local bonds hedged into USD seem expensive when compared to hard currency bonds (see chart below). This is particularly so in South Africa and Turkey, but it also applies to several bonds across Peru, Hungary and Global 24s in Brazil.

Comparing local and external debt



Source: DB Global Markets Research, Bloomberg Finance LP

- Asia: Pay 2Y/5Y China repo IRS (target +45bp); Receive SNG 2Y3Y rates versus US (target +75bp); Buy 10Y Singapore bonds versus 5Y swaps (target -60bp); Pay 5Y5Y KRW swaps below 3.5%; Pay belly of 2Y/5Y/10Y THB fly (target +50bp)
- EMEA: Receive HUF in 6x9, (target 3.00); Keep ILS 1s5s flattener (target 115); Buy PLN Oct 17s vs Pay 10Y (target 90bps); Enter ZAR 2s10s steepener (target 170bps); Keep TRY 1s5s steepener (target 0)
- LatAm: In Brazil favor DV01 neutral steepeners – Jul15/Jul16 FRA vs. Jan 21 (target 35bp). In Chile, receive 1Y in UF vs. pay 5Y CLP/CAM (DV01-neutral, target 600bp). Also receive 10Y CLP/CAM vs. pay US in the 10Y sector (target 120bp in spread). In Colombia, buy TES20s (target 6%) and buy COLOM'27s vs. TES'24s.(target -100bp in spread). In Mexico, receive 5Y5Y in TIIE versus 5Y5Y in US swaps (target 380bp); buy MBONOS Dec24s vs. 16s and 36s as a fly (target 20bp). In Peru buy Aug20s (Sobs) vs. US 10Y swaps (target 220bp).

Credit: Neutral for now

The main themes for the sovereign credit market remain unchanged, but we feel that we are reaching an increasingly mature part of this cycle of EM credit underperformance. Fund outflows remain a drag on the asset class, but as we highlighted last month, this is increasingly an issue of retail investors. EM sovereign IG credit remains cheap to DM IG (the spread for BBB credits has remained close to 60bp for the past month).

The reason we feel that the cycle is maturing is that we are increasingly seeing evidence of differentiation within the market. This differentiation is not just been the 'good' EM and the 'bad' EM, but correlations within those groups are also breaking down. Idiosyncratic, country-specific factors are increasingly dominating price action.

We also see evidence of some of the weaker EM credits beginning to decouple from the general negative sentiment which has pervaded the asset class for the past few months. A good example of this is South Africa which seems to be benefitting from its credible monetary and fiscal policy response to the pressure it has faced. Over the past month it has outperformed its EM IG peers by close to 30bp and on a relative basis is at its strongest level since before the correction last June.

While we believe that we are getting closer to the point at which EM sovereign credits can finally begin to outperform DM credits, we do not think the risk-reward to position for this now is optimal. Event risk among the high yielders remains high and the strong rally in February will likely constrain near-term upside. We therefore stay close to the benchmark. We retain a bearish bias among EMEA credits (with underweights in Russia, Ukraine, and Turkey), while being more constructive on Asian and LatAm credits.

Among those underweights, Ukraine is clearly in the spotlight at present. Although we think aggressive PSI in the context of an IMF program is unlikely, we do believe that the market is underestimating the challenge the authorities face in following an IMF economic adjustment program. The new government must operate in an extraordinary political (and geopolitical) situation and as yet it is unclear whether the support it has from the population is broad enough for it to be able to execute the tough reforms which will be necessary.

Summary of recommendations:

- Overweights: Colombia and Poland
- Underweights: Venezuela, Ukraine, Russia, Turkey
- Basis trades: Short basis in Venezuela (5Y CDS vs. 24s)
- Curve trades: 5s10s CDS flattener in Brazil and 10s30s cash curve steepeners in both Turkey (22Ns vs. 41s) and South Africa (25s vs. 41s).
- Other: In Argentina switch from Global 17s to Pars. In Mexico, switch from 19Ns to 22Ns. In Poland switch from 19s to 2s

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Bailing out Ukraine

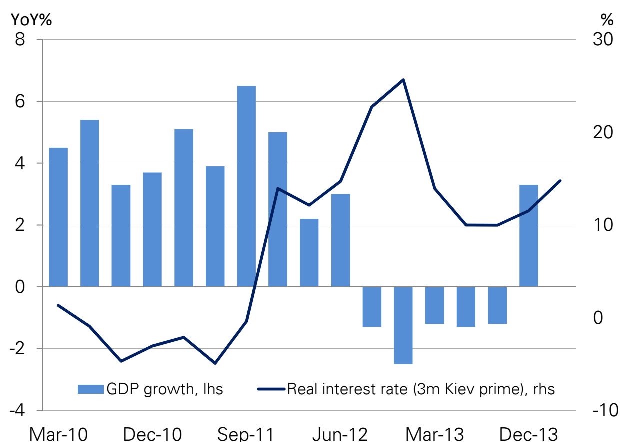
- The crisis in Ukraine is still at a dangerous stage and the political end game remains far from clear. There is, however, an economic element to the crisis that also needs to be resolved. Ukraine had been heading down an unsustainable economic path for a number of years, maintaining a fixed exchange rate at an overvalued level and running up large external and fiscal imbalances. With relatively limited FX reserves, the National Bank of Ukraine had to tighten domestic liquidity conditions to defend the peg, pushing the economy into back recession. Reserves are now more or less exhausted and exchange controls have therefore been tightened to prevent a freefall in the currency. This has bought a little time but is not a sustainable solution.
- External debt service needs are substantial and, in the absence of external financing and domestic adjustment, reserves could be fully depleted by September, if not sooner. We estimate that Ukraine will need about USD 35bn in external financial assistance over the next few years. This would allow for some rebuilding of foreign reserves to more comfortable levels but assumes a significant adjustment in the CA balance on the back of a weaker FX and a contraction in domestic demand. The gap could be larger or smaller than this depending on the degree of economic adjustment and the availability of foreign private capital. But this is roughly the size we would regard as credible.
- Public debt is moderate at 40% of GDP but will inevitably increase significantly. This is partly because about 60% of government debt is denominated in foreign currencies. The depreciation so far this year will have already added about 3% of GDP. We estimate that further currency weakness, recession, rising interest costs, existing fiscal imbalances, and official borrowing to support the balance of payments could push the debt burden to well over 60% of GDP in the next couple of year. But it would decline gradually thereafter as growth recovers, the fiscal position adjusts, and the FX stabilizes.
- Against this backdrop, we consider whether there is a case for bailing in the private sector. We find that an aggressive attempt to involve the private sector, through, for example, the application of significant notional haircuts to the existing stock of external debt, would have only a marginal impact on the eventual success of any adjustment program. This is because, even after accounting for new borrowing from the official sector, the stock of debt is not at levels that begin to stress sustainability. The majority of official financing would be going towards covering the balance of payments deficit, supplementing reserves, and financing government spending.
- An alternative approach to private sector involvement could involve the voluntary exchange of short-dated for longer-dated bonds. The nature of the situation in Ukraine (a relatively low debt stock, but considerable short-term uncertainty) make for ideal conditions for a “PSI-lite” approach such as this, which could be beneficial for Ukraine and for investors.
- The economic parameters and the incentives of the new Ukrainian government and its creditors all suggest that the situation is manageable and an economic adjustment, with support, should stand a high chance of success. However, the new Ukrainian government must operate in an extraordinary political (and geopolitical) situation. In our view, current secondary market prices of Ukraine’s USD bonds (in the 80-90 range) do not sufficiently reflect the risks

The political crisis in Ukraine remains at a dangerous stage. The territorial integrity of Ukraine is in doubt. The implications of the referendum in Crimea this weekend are far from clear. Sanctions are probable. Military conflict is possible. The relationship between Ukraine and its eastern and western neighbors will change depending on how these and other issues play out. But there is also an economic element to the crisis. Ukraine has been heading down an unsustainable economic path for a number of years and was in desperate need of external funding. We turn to these issues below, considering the scale of external support that Ukraine will need, the sustainability of the government debt, and whether bailing in the private sector would be helpful in this case.

The crisis is economic as well as political

Ukraine was an economic accident waiting to happen. It had all the hallmarks of a classic emerging market crisis, including a fixed and overvalued exchange rate, very low foreign reserves, large external and fiscal imbalances, heavy reliance on foreign currency funding, a fragile banking system, and low growth prospects. The proximate causes of crises often come from unexpected places. In Ukraine’s case, the failure to sign an Association Agreement with the EU in November triggered a chain of events that eventually brought down the government and resulted in the current political drama. Of all the emerging market countries that were ill placed to deal with the reduced availability of external financing flows, Ukraine was at the head of the queue. An economic crisis was inevitable in almost any circumstances.

High interest rates pushed economy into recession

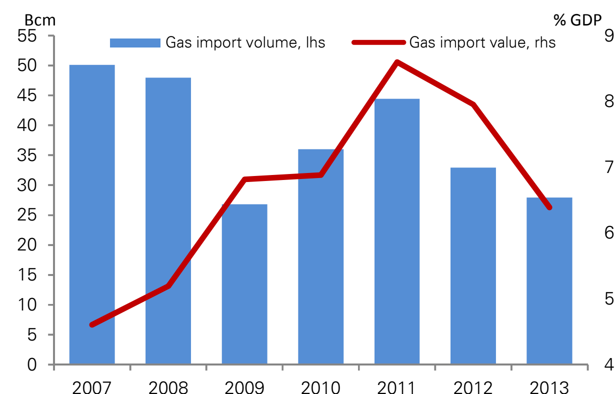


Source: Haver Analytics, Deutsche Bank

The economy has been stuck in recession for the last year and a half. The National Bank of Ukraine has been forced to keep domestic liquidity conditions extraordinarily tight to support the exchange rate peg, pushing domestic interest rates to crippling levels. Loose fiscal policy has provided some support but has exacerbated imbalances. Recovery from the last crisis therefore stalled towards the end of 2011. Notwithstanding a bounce in output in the final quarter of last year, which does not square well with other economic data and may be revised, the economy remains in a chronically weak condition. Output is still 9% below the peak reached in early 2008 before the last crisis.

Despite weak growth, the current account deficit has ballooned from a modest 2% of GDP in 2009-10 to 9% of GDP last year. Imported gas prices have doubled over the last 4-5 years but this has been offset by a reduction in import volumes.

Gas import bill has fallen

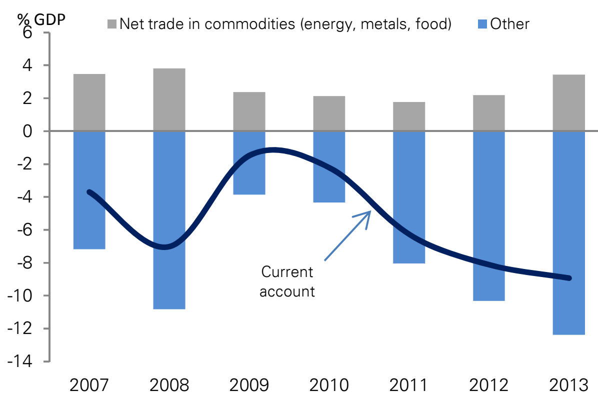


Source: Haver Analytics, Ukraine Ministry of Energy, Deutsche Bank

Low steel prices have weighed on metal exports but this has been offset by stronger food exports. Larger interest payments on Ukraine's rising stock of external debt and lower income from the reduced volume of Russian gas transiting through Ukraine have had a moderately negative impact on the balance.

The bulk of the deterioration in the current account balance comes from much higher imports of other goods, which have more than doubled in dollar terms since the crisis-related trough of 2009 to USD 50b.[3] Relative to GDP, these non-commodity imports are running well above their pre-crisis levels. We are somewhat surprised by this sharp rebound in the propensity to import but it is probably at least partially a reflection of an overvalued exchange rate.

Current account deterioration reflects other imports

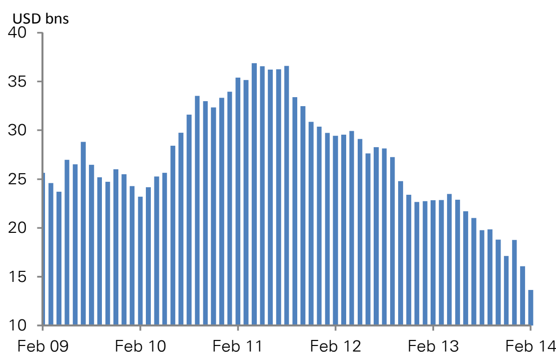


Source: Haver Analytics, Deutsche Bank

Capital flows have weakened, exacerbated recently by domestic capital flight, and liquid foreign currency reserves have collapsed, falling to USD 13.6bn at the end of February from USD 37bn in mid-2011. This is barely two months of import cover, less than one-quarter of the level of external debt falling due in the next year, and less than one-fifth of the domestic (private) deposit base. Reserves are enough to cover less than 40% of a risk-weighted measure of potential drains on reserves, our preferred measure of reserve adequacy, which is comfortably the lowest in EM and well below the IMF's recommended coverage ratio of 100-150%.

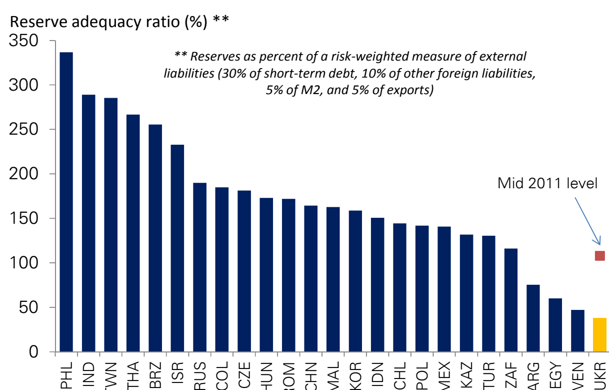
[3] This seems to be relatively broad based but the main contributors to this growth have been machinery, equipment and appliances, vehicles, pharmaceuticals, and plastics, i.e. a mixture of consumption and intermediate goods.

Foreign reserves have fallen precipitously



Source: Haver Analytics, Deutsche Bank

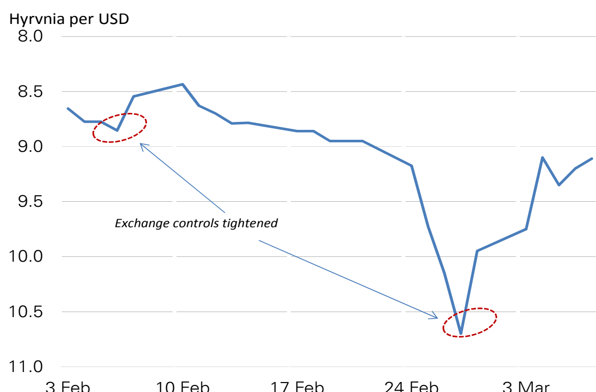
Reserve adequacy is the lowest in EM



Source: Haver Analytics, Deutsche Bank

Not surprisingly, therefore, Ukraine's currency peg broke, depreciating by 7% in the first five weeks of the year before the NBU tightened controls on resident purchases of FX on February 6. This failed to stem the pressure for more than a couple of days and the hyrvnia depreciated by a further 20% over the next two and a half weeks before exchange controls were further tightened on February 27, since then the currency has strengthened (chart).

Hyrvnia unpegged

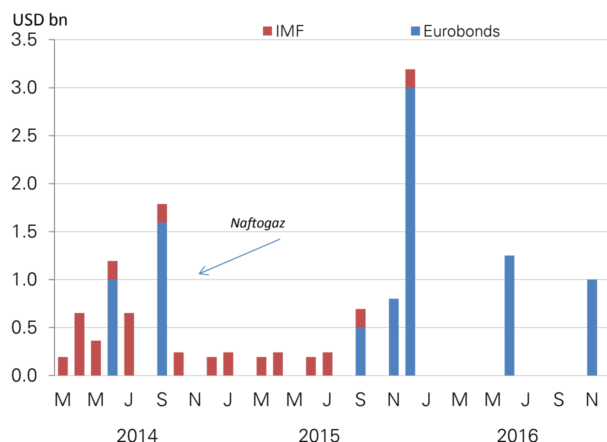


Source: Bloomberg Finance LP, Deutsche Bank

External financing gap

This bought time but is not a sustainable solution. Beyond its current account deficit, the public sector has substantial external debt redemptions falling due over the next few years. This includes USD 5.3bn in bond redemptions and repayments to the IMF in the remainder of this year and USD 5.8bn of bond redemptions and IMF repayments next year. The private sector also has significant external debt obligations. Some of this financing, such as trade credits, tends to be relatively stable. Rollover rates on other components, however, such as bank borrowing, have tended to fall below 100% during periods of stress.

External debt redemptions



Includes Eurobonds and IMF borrowing but not other loans.
Source: Bloomberg Finance LP, Deutsche Bank

In the table below, we present some estimates of these external financing needs and sources. This is based on the following assumptions:

- Currency weakness and a decline in domestic demand results in significant external adjustment with the current account deficit narrowing to 1% of GDP by next year.
- Rollover rates on private borrowing fall moderately below 100% over the next couple of years. Market access remains closed to the government.
- Other capital flows (including domestic capital flight) turn slightly negative this year before recovering moderately next year.

External financing sources and needs

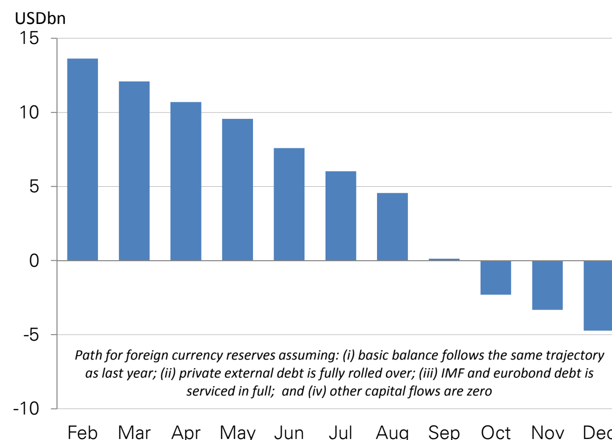
	2009	2010	2011	2012	2013e	2014f	2015f
				($ billions)			
Requirements	43.8	41.3	59.2	69.6	74.2	67.7	60.9
% GDP	37.4	30.2	36.2	39.5	41.1	45.9	41.3
CA deficit	1.7	3.0	10.2	14.3	16.1	5.8	1.5
Short-term debt	20.3	19.1	25.6	32.7	33.2	34.8	33.6
Public	0.0	0.0	2.1	2.0	0.1	0.0	0.0
Private	20.3	19.0	23.5	30.7	33.2	34.8	33.6
MLT debt repayments	21.7	19.2	23.3	22.5	24.9	27.1	25.7
Public	2.2	3.3	5.1	5.0	7.1	6.8	7.3
Private	19.5	15.9	18.3	17.5	17.8	20.4	18.4
Financing sources	43.8	41.3	59.2	69.6	74.2	67.7	60.9
FDI and equity inflows	4.8	6.1	7.5	7.1	4.5	3.0	7.0
Short-term borrowing	19.1	25.6	32.7	33.2	34.8	33.6	33.6
Public	0.0	2.1	2.0	0.1	0.0	0.0	0.0
Private	19.0	23.5	30.7	33.2	34.8	33.6	33.6
Long term borrowing	23.4	26.8	24.1	28.5	24.9	37.5	32.3
Public	7.4	10.0	6.2	6.1	6.0	20.0	15.0
Private	16.0	16.7	17.9	22.4	18.9	17.5	17.3
Other (capital flight)	-10.8	-8.5	-7.6	-6.9	6.6	-5.0	0.0
Use of reserves	7.4	-8.7	2.5	7.6	3.5	-1.4	-12.0
Foreign reserve level	25.5	33.3	30.4	22.6	18.8	20.2	32.2
Debt rollover rates (%)							
Public	341.7	362.7	115.0	87.3	84.3	294.6	204.3
Private	87.9	115.3	116.2	115.2	105.2	92.7	97.8

Source: Haver Analytics, National Bank of Ukraine, Deutsche Bank

Under these assumptions, which are not especially draconian, and with minimal foreign reserves on which to draw, Ukraine would face a significant external financing gap over the next two years. The government will also want to rebuild its foreign reserves. If we assume a target level of reserves of around USD 32bn, which is similar to the level of reserves at the end of 2010, this would imply a financing gap of about USD 35bn (over 20% of GDP) over the next two years, which is in line with the amount estimated by the Ukrainian authorities a couple of weeks ago. The gap could obviously be larger or smaller that this depending on the degree of external adjustment and the availability of private foreign capital. But we think that any external assistance package would need to be of roughly this order of magnitude in order to be credible, minimize the need for excessive domestic adjustment, and maximize the chances of attracting foreign private financing and retaining domestic capital.

The need for this assistance is already pressing. Between now and the end of June, the public sector has USD 3bn in debt service payments falling due on its external bonds and borrowing from the IMF. At this rate, if the basic external balance (i.e. current account balance and foreign direct investment) followed the same trajectory is last year, private debt was fully rolled, and other capital flows were zero, foreign currency reserves would be fully wiped out by September of this year.

Foreign reserves under no adjustment



Source: Deutsche Bank

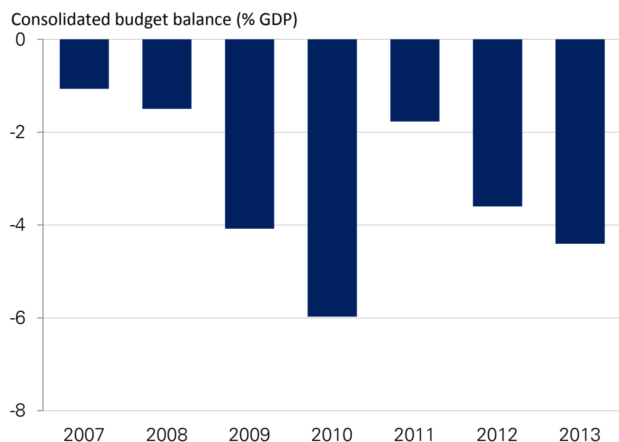
Debt sustainability

In addition to ensuring that it can meet its external payment obligations, Ukraine will also need to restore the sustainability of its public finances. The officially reported consolidated budget balance widened to 4.4% of GDP last year, though this does not include the cash deficit of Naftogaz, which the IMF recently estimated had increased to 2% of GDP last year. There are also arrears on VAT refunds due to exporters. Naftogaz is behind on its payments to Gazprom. The overall deficit is thus probably over 7% of GDP.

Public debt has increased moderately over the last few years to about 40% of GDP at the end of last year, of which about 33% of GDP is direct debt with the remainder representing government-guaranteed liabilities. Around 60% of this debt, or USD 43bn, is denominated in foreign currency, including almost USD 6bn of locally issued dollar debt.

We think the government's debt burden could increase substantially in the next few years. The depreciation in the currency so far this year will have already added over 3% of GDP to the debt ratio. Further currency weakness, weak growth, rising interest costs, fiscal imbalances, and official borrowing to support the balance of payments will likely add to this burden. We illustrate the trajectory for debt based on some plausible assumptions for these parameters in the table below. These assumptions are as follows:

Fiscal Loosening



Source: Haver Analytics, Deutsche Bank

- Real GDP falls by 5% this year before growth recovers gradually to 4% over the medium term. This is a significant economic contraction though mild compared to the 15% drop in GDP in 2009.
- The exchange rate weakens by 27% over the next two years from its earlier pegged level, which would take USDUAH to 11.0 by next year. Thereafter, we assume the exchange rate remains broadly constant in real terms, which implies a modest nominal depreciation.
- Inflation, as measured by the GDP deflator, accelerates to about 7.5% over the next couple of years due to the weaker exchange rate before decelerating to around 5.5% over the medium term.
- Primary fiscal adjustment of about 1% of GDP each year, which includes the elimination of the cash deficit of Naftogaz, which we are assuming is about 2% of GDP.
- We have not assumed anything about the possible need to absorb other liabilities onto the government's balance sheet. But this is certainly possible if, for example, there is a need to again provide support to recapitalize the banking system.

Under these assumptions, debt would jump to 58% of GDP by the end of this year and peaks at 66% of GDP. The main contributions come from the weaker exchange rate, increased external borrowing to boost central bank reserves, and the primary deficit.[4] Debt would decline gradually thereafter as growth recovers, the fiscal position continues to adjust, and the exchange rate stabilizes.

Public debt is likely to increase significantly

	2013	2014	2015	2016	2017	2018
Public debt	40.5	57.9	66.4	66.2	65.0	63.0
Change in debt:	3.9	17.4	8.5	-0.2	-1.2	-2.0
Primary balance 1/	4.1	3.6	2.6	1.6	0.6	-0.4
Debt dynamics 2/	1.5	8.5	1.9	-1.1	-1.2	-0.9
Privatization	-0.1	-0.4	-0.4	-0.4	-0.4	-0.4
Other 3/	-1.6	5.7	4.3	-0.3	-0.3	-0.3
Baseline assumptions						
Real GDP growth	0.0	-5.0	2.5	4.0	4.0	3.5
Average interest rate	6.4	7.9	6.9	6.5	6.7	6.7
FX rate vs. USD	8.0	10.0	11.0	11.2	11.4	11.6
Inflation	2.3	7.5	7.3	5.3	5.5	5.5

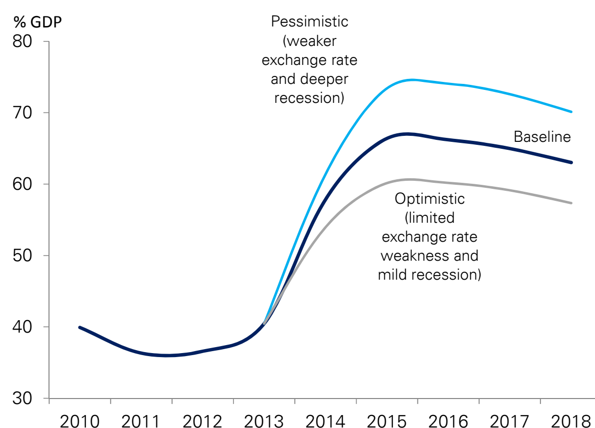
1/ Includes support for Naftogaz
2/ Contribution from exchange rate depreciation and differential between real interest rate and growth
3/ Includes changes in guaranteed debt, e.g. IMF lending to NBU
Source: Deutsche Bank

The trajectory for debt is, however, very sensitive to the path for the exchange rate and growth. This is illustrated in the chart below in which we contrast our baseline with an upside and a downside scenario for these parameters:

- In the optimistic scenario, we assume: a more modest recession in which output falls by only 2.5% this year with growth then rebounding quickly to 4% next year; and that the exchange rate depreciation over the next two years is limited to 15%. Inflation peaks at 6% under this scenario.
- In the pessimistic scenario, we assume: a deeper recession, with output contracting by 7.5% this year and remaining flat next year; and a larger currency depreciation of 35%, taking USDUAH to 12.0 next year. Inflation peaks at 9% under this scenario.

Debt peaks at 60% of GDP in the more optimistic scenario but at almost 75% of GDP in the most pessimistic scenario.

Public debt sensitivity to growth and FX assumptions

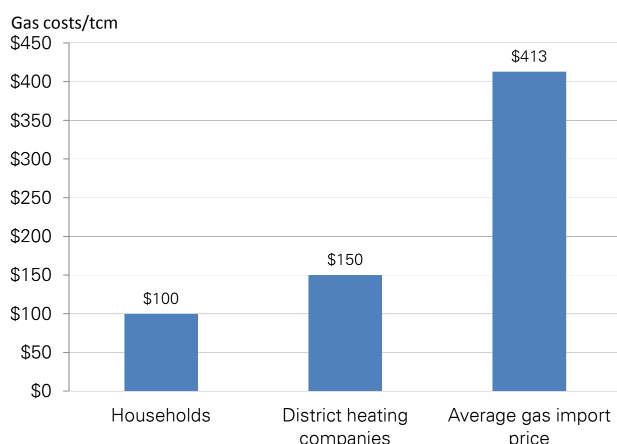


Source: Deutsche Bank

[4] We have assumed an IMF-led external financial assistance package of USD 35bn distributed over the next two years, in line with our assessment of external financing needs described above. We assume that half of this assistance is allocated to budget financing and the remainder towards the central bank.

Larger fiscal adjustment would of course bring debt to lower levels. The total adjustment that we have assumed in the calculations above is, arguably, relatively modest at just under 5% of GDP over five years, which is a little lower than envisaged under the last IMF program agreed in 2010. Reserves are lower, debt is higher, and imbalances are at least as large if not greater than they were four years ago when the last Fund program was agreed. Arguably, therefore, domestic economic adjustment needs to be correspondingly more aggressive. This may be feasible. Households, for example, pay only a small fraction of the full import price of gas (chart), resulting in a total cost of energy subsidies of about 7% of GDP in 2012. This clearly needs to be tackled.

Household gas subsidies



Source: World Bank, Deutsche Bank

Ultimately, the degree of targeted adjustment will come down to striking a balance between delivering enough to persuade markets that the adjustment is credible while at the same time maintaining social cohesion in what are clearly very challenging circumstances. A couple of percentage point difference in the headline adjustment will not make a huge difference to the debt dynamics. But consistent implementation of an adjustment program, something that Ukraine has not managed to deliver in the past, will matter greatly for the credibility of the program and hence the prospect of attracting new private capital.

Is there a case for PSI in Ukraine?

Considering the rise in debt stock described above and given the recent experience of IMF programs it is natural to ask whether some form of 'private sector involvement' (PSI) will be proposed as part of any package of support. The IMF itself recently published a consultation paper[5] arguing that private sector debt restructurings had "often been too little, too late" and that the fund should look at ways to avoid its "resources being used simply to bail out private creditors". The ongoing consultation process which this paper initiated is one reason why concerns over IMF-sponsored restructuring are more prevalent for Ukraine now than they have been in similar situations in the past. However, we think it unlikely that there will be a significant change in the Fund's approach towards Ukraine, given that the consultation is still ongoing, views are divided and its outcome remains uncertain. Nevertheless, that does not mean that some form of PSI will not be considered, condoned, encouraged or even mandated and so it is useful to consider the pros and cons from the perspective of the Ukraine (and its potential official sector financiers) and the implications for private sector creditors.

PSI can take many forms and there have historically been some good examples of private sector creditors being pre-emptively engaged in voluntary debt swaps to improve the structure of liabilities faced by sovereigns embarking on IMF-supported adjustments. Depending on the nature of the situation and the style of the PSI, a variety of benefits can be attained:

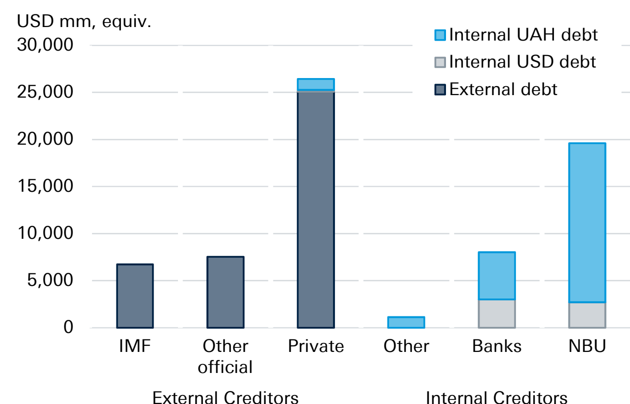
- Improved solvency through either (or both)…
  - a reduction in the nominal debt stock
  - reduced sensitivity to the future cost of private sector financing by extending maturities
- A reduction in the required fiscal adjustment by reducing the expenditure on interest payments
- A reduction in the amount of financing required from official sources
- Explicit burden-sharing which can have political gain and helps to mitigate the moral hazard risk

Set against the above benefits of PSI are the costs. These would likely be manifested as higher borrowing costs for the sovereign itself, but potentially also for other borrowers in the country. If the Fund were viewed as demanding the PSI then the action might also raise the borrowing costs for other countries which are perceived as being at risk of needing Fund assistance[6].

[5] Sovereign Debt Restructuring – Recent Developments and Implications for the Fund's Legal and Policy Framework, April 26, 2013

[6] Of course, such an increase in borrowing costs might be seen as a clear indication that moral hazard had made borrowing too cheap and hence encouraged the debtor to over borrow. It might be seen as beneficial therefore to dispel the myth. However such an argument ignores a key principle behind the concept of a 'lender of last resort' such as the IMF, that its very existence is designed to encourage creditors to continue to lend through short-term exogenous shocks and hence mitigate what would otherwise be a significant adverse feedback loop in capital markets.

Consolidated state debt by creditor group and jurisdiction



Source: Deutsche Bank

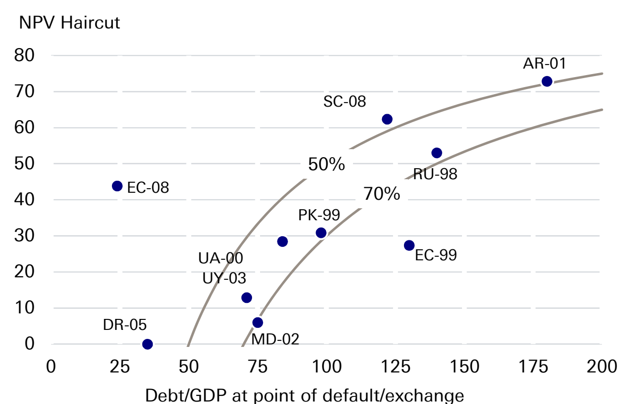
For the sake of illustration only, let us consider an aggressive PSI exercise, involving a haircut of 50% on the nominal value of all private sector external debt (direct and guaranteed, bonds and loans). How would this change the key parameters of an IMF program?

- The reduction in debt stock would be USD12.5bn, reducing the end-2014 debt/GDP ratio by 8.4pp to 49.5% in our baseline scenario.
- The decline in annual interest cost would be approximately USD900mm or 0.6% of GDP.
- Keeping all other key assumptions on the parameters of the program unchanged, the amount of official sector financing would reduce by 4.9bn, which is the saving on debt service costs over the next two years resulting from the haircut.
- The above example illustrates that even a substantial restructuring of private sector debt would have only a marginal impact on the eventual success of the adjustment program. It would be difficult to argue that the benefits outweigh the potential costs.

The key reason why an aggressive, upfront, nominal debt reduction has only a marginal impact on the program is that Ukraine's debt stock isn't at a level which begins to stress sustainability (even after accounting for the additional financing). Furthermore, the majority of the financing we assume would be going towards covering the balance of payments deficit, supplementing reserves and covering the fiscal deficit. A relatively small portion would be required to refinance upcoming private sector external debt maturities.

Historical cases of sovereign default also do not lend support for a deep PSI scenario in Ukraine. In our May 2010 article "Sovereign Debt Crises – Lessons from EM", we examined historical cases of EM sovereign defaults and restructuring during the past 20 years, and found that there is a relationship between the NPV haircut in the restructuring and Debt/GDP at the point of default for each case, with higher initial levels of debt resulting in larger haircuts, as illustrated in the graph below. The lines on the chart which represent the combinations which result in 50% and 70% debt/GDP, if we were to assume that the NPV haircut is applied as a simple principal reduction across the entire debt stock. We find that virtually all of the cases fall in the 50-70% range for the implied resultant debt/GDP (footnote: The main exception is Ecuador (both in '99 and in '08) which is very much a unique case in EM and Dominican Republic in 2005 which faced a pure liquidity problem and required no NPV haircut). Considering our baseline scenario, in which Ukraine's debt/GDP reaches 58% by end-2014, previous experience would suggest an NPV haircut of at most 10%.

Historical experience of EM sovereign debt restructuring



Note: The lines on the chart represent the combinations of initial debt/gdp and NPV haircut which would result in either 50% or 70% final debt/gdp, if the NPV haircut were applied across the entire debt stock as a principal reduction

Source: Deutsche Bank

The fact that such a debt reduction would have only a marginal impact on solvency would also make it very difficult to engineer as a voluntary, pre-default transaction. An alternative approach to PSI which might be considered could involve the exchange of short-dated bonds for longer dated bonds. While this would have no impact on the debt ratio or interest cost (assuming a notional-for-notional exchange with no change in the coupon), it could potentially result in a larger reduction in the required official sector financing than the example above.

For instance, consider that holders of the Sep-15 Eurobond are offered an exchange into longer-dated bonds with the same 6.875% coupon. If the long dated bonds trade at the same price, then the exchange is cash-neutral. The chart below shows the shape of the spread-duration curve for which this price-neutral

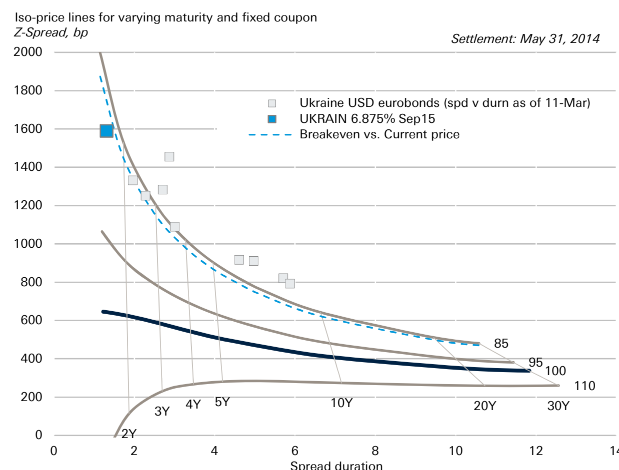
relationship would hold. This suggests that relative to the current price, a switch into a 10Y bond with the same coupon would be cash-neutral if the spread on the new bond is 620bp[7]. This is above the low reached by the spread of Ukraine's 2023 bond in early December 2014, following the news of financial support from Russia.

A success story of pre-emptive "PSI-lite" can be drawn from Uruguay 2003 (included in the graph above). In 2002, Uruguay suffered from a severe banking crisis (related to the crisis in Argentina) and a significant currency devaluation, raising doubts about the government's ability to service its debt. In early 2003, the government pre-emptively restructured its debt, mostly via extending the maturity of its bonds. The participation rate was high (>90%), with an NPV haircut estimated by the IMF in the range of 5-20% (12.9% on average). Among the major sovereign restructurings that occurred during the past 20 years, this was the mildest in terms of investor loss measured by NPV haircut around the time of restructuring.

Now of course, if such an exchange were successful, in conjunction with financing from the official sector, then it is likely that the short end of the curve would rally from current levels. The additional lines on the chart show how the curve could evolve such that one would be indifferent between the 15s and a new 10Y bond.

For such an exchange to be successful for the shortest bond on the curve (the June 2014s), spreads would need to compress to price the new bond at least at par (ie below 400bp for a 10Y bond, or 500bp for a 5Y bond). At this stage it seems unlikely that there would be sufficient political stability and confidence in the ability of the government to deliver the necessary adjustment for that to be the case. However, for slightly longer bonds such as the 2015s (and perhaps even the Naftogas 14s) the dynamics work better. Unless relations with Russia improve dramatically, we would expect the curve to remain somewhat inverted, even with the onset of an IMF program. Ukraine unfortunately does not have a good track record of successfully completing IMF programs. The new government will need some time to build its credibility in this regard and while many will no doubt want to give it the benefit of the doubt, it is clear that it faces a considerable challenge and one for which investors will

Breakeven scenarios for notional-neutral maturity extension



Source: Deutsche Bank

require a risk premium. Ironically however, this skepticism can actually make a voluntary debt exchange with maturity extension more likely to succeed. Such an exchange could also be made attractive for the shortest bonds (eg the June-14s) by including some form of 'sweetener', as often seen in historical restructuring cases. Such a PSI-lite scenario could be entirely voluntary and wouldn't even necessarily require the invocation of CACs (although their use could help) [8].

Current pricing is consistent with "PSI-lite"

As illustrated on the chart above (with the current level of bonds not far from the iso-price line), current market prices are relatively consistent with such a scenario of PSI-lite. Indeed, the current relative pricing of Ukrainian bonds are very unusual: the pricing of short-dated bonds are distressed, implying a relatively high probability that they won't redeem at par, but on the other hand the narrow range of prices across the curve suggests that the market assumes a high recovery in the event of a default/restructuring.

Such pricing would be fair, considering a baseline scenario involving an IMF program and an orderly adjustment. However, it leaves little compensation for a more disorderly scenario. Tensions with Russia show no sign of abating and could escalate further. Also there is no guarantee that the new government has a strong enough popular mandate to carry through the necessary reforms. PM Yatseniuk has emphasized that the road ahead for Ukraine will not be easy, but only time will tell how united the country will be in following the path he intends to take.

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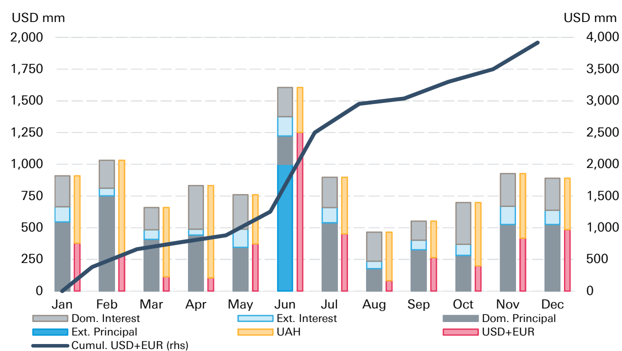
[7] This breakeven calculation accounts for the interest accrued between now and the assumed exchange date (May 31,2014).

[8] In the 2003 Uruguay restructuring, where the main form was through extension of maturity, a high participation rate of over 90% was achieved without the use of CACs.

For reference: 2014 Debt Service on domestic and external bonds



Source: Deutsche Bank

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Russia: macro implications of increased geopolitical risk

- Tensions over the situation in Ukraine escalated recently with Russia's legislature granting its President the right to send troops to Ukraine, which notably increases the scale of political risks in the near term. The latter are likely to lead to a significant rise in capital outflows, which adversely affects the currency as well as the growth trajectory, most notably on the fixed investment side.
- We assess the implications of political risks for Russia's economy through various scenarios for capital outflows. Our analysis suggests that capital outflows of USD75bn would prompt a surge in the ruble rate to more than RUB/USD36 and prevent Russia's economy from staging acceleration this year.
- We assess only the sensitivities associated with the direct effects of capital outflows on growth and the exchange rate, and do not take into account the effects of sanctions, changes in interest rates and other factors. With respect to sanctions, we believe their overall direct effect is likely to be limited for the economy but may add to capital outflows even if sanctions are not fully applied but simply discussed publicly. All this implies that the estimates of the costs to the ruble and growth resulting from capital outflows should be seen as the lower bound of the total effect, which takes into account other factors, including sanctions.

Ukraine's political turmoil poses risks to Russian economy

Putin authorized to send troops to Ukraine

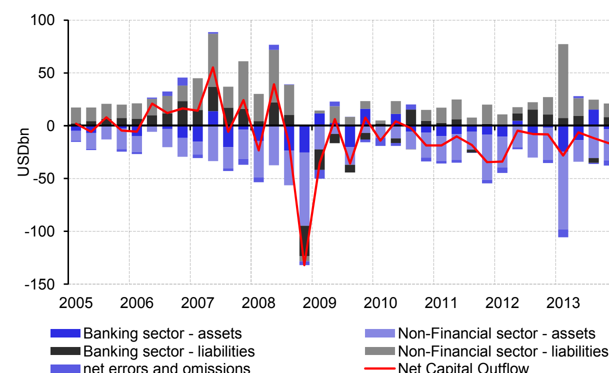
On 1 March, Russia's President Vladimir Putin issued a request to the Federation Council for authorization to send troops to the Crimea peninsula, where the Russian fleet is based. This request was swiftly granted, with Russia's officialdom noting that the decision to send troops had not yet been taken by Putin and that such a decision would depend on the course of events in Ukraine. These developments were accompanied by demonstrations in the eastern parts of Ukraine as well as in Crimea. Meanwhile, the latter is preparing for a referendum to get more autonomy from Ukraine or even to join Russia. The measures taken by Russia were met with the possibility of sanctions from the West, which may affect Russia's economy. These developments notably increase near-term sovereign risks pertaining to Russia and Ukraine, and are fraught with the potential for acceleration in capital outflows.

Capital flight may erode economic outlook

In terms of the economic impact, the main implication at the macro level for Russia is likely to be a significant rise in capital outflows, which adversely affects the currency as well as the growth trajectory, most notably on the fixed investment side. The overall impact on the ruble could be moderated in part by the relatively favourable global economic backdrop as well as by the tightening of monetary policy (the CBR already 'temporarily' hiked rates by 150bps at the beginning of March).

While in 2008-2009 the global economy was sliding into negative territory, which led to a sharp decline in oil prices, in 2014 the pace of economic growth may accelerate to well beyond 3% yoy, which should sustain oil prices at levels not too far off USD100/bbl (our commodities team projects USD97.5/bbl Brent). On the downside, however, the severity of economic isolation along with the resurgence of political uncertainty may exact costs, with considerations regarding macroeconomic fundamentals likely being overshadowed by negative sentiment.

Figure 1: Net private capital outflows, USDbn, 2005-13

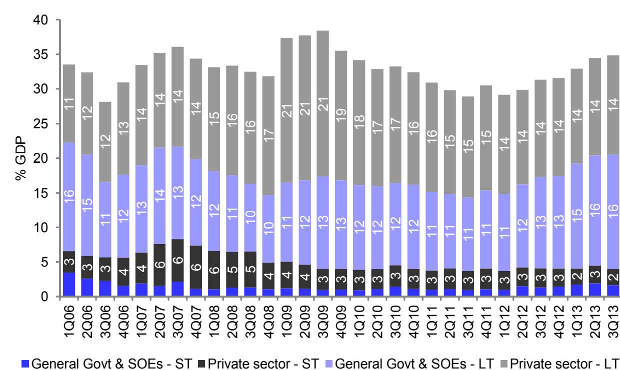


Source: CBR, Deutsche Bank

2014 vs. 2008: fundamentals are different

In terms of domestic economic development, the key difference now compared to 2008 is that the economy is not overheated. Back in 2008, the pre-crisis period was characterized by massive net capital inflows, a booming stock market and real estate segment growth, as well as high growth rates in GDP and lending. This time Russia's financial markets are less overheated and growth is approaching zero, with growth in lending decelerating.

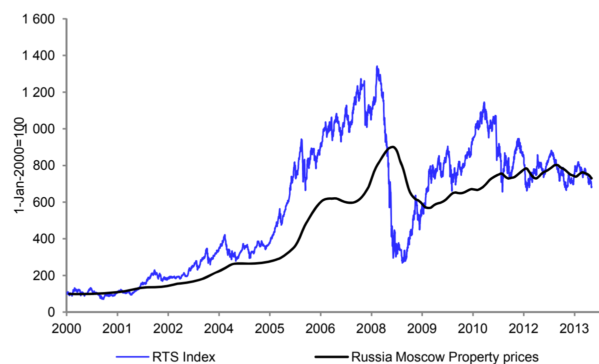
Figure 2: Russia's external debt profile, % GDP



Source: CBR, Deutsche Bank

In terms of debt levels, Russia's sovereign balance sheet is strong, even though the susceptibility to lower oil prices has remained high, as evidenced by the level of the non-oil budget deficit, which exceeded 10% of GDP last year. On the corporate side, the maturity of debt is less short term than in 2008 and has fewer currency mismatches.

Figure 3: RTS Index vs. Moscow Property Prices



Source: Bloomberg Finance LP, Deutsche Bank

At the same time, overall debt levels in the corporate sector remain significant, while the balance sheet of Russia's households is arguably more problematic now than in 2008 (to the degree that it represents one of the macro risks and concerns for the CBR) after Russia's household debt grew at a rapid pace over the past several years.

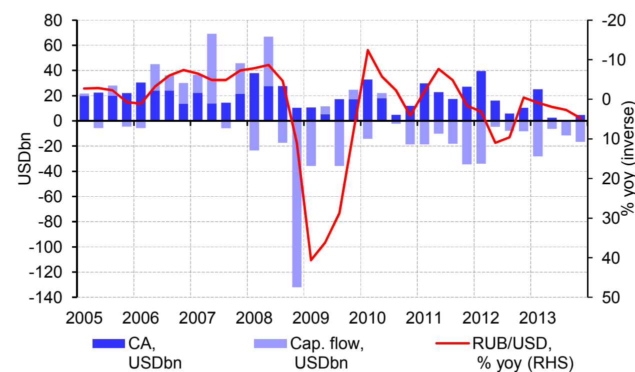
At this juncture there is scope for capital outflows to be significant this year given that, along with rising risks, oil prices are high and the current account is enjoying a surplus.

With respect to January data, the Ministry of Economy estimates net capital outflow from Russia at USD17bn in January 2014. Given the seasonality of this indicator, outflows appear to be in line with previous years (USD17bn in January 2013 and USD16bn in January 2012). According to Economy Minister Ulyukaev, this is related to an increase in FX assets in the banking sector. In addition, the population actively purchased currency in January, which contributed to the outflow. We now proceed to look at the sensitivity of Russia's economy to various scenarios of capital outflows.

Impact on the ruble

We base our sensitivity analysis for the ruble rate on the following capital outflow assumptions.

Figure 4: RUB/USD vs. CA surplus and capital flows



Source: Rosstat, CBR, Bloomberg Finance LP, Deutsche Bank

- Scenario 1: Capital outflows moderate to a level of USD30bn from USD62bn in 2013.
- Scenario 2: Capital outflows intensify to USD60bn, the level of 2011-2013.
- Scenario 3&4: Capital outflows intensify beyond/significantly beyond the average levels of the past several years, namely to USD75bn and USD100bn, respectively.
- Scenario 5: Capital outflows resemble 2008 and reach USD130bn.

Our analysis implies that capital outflows of USD75bn would prompt a surge in the RUB/USD rate to a year-average of RUB/USD36.5, while much higher outflows of USD130bn could lead to an average of RUB/USD40.

Figure 5: Impact of higher capital outflows on RUB/USD, scenarios

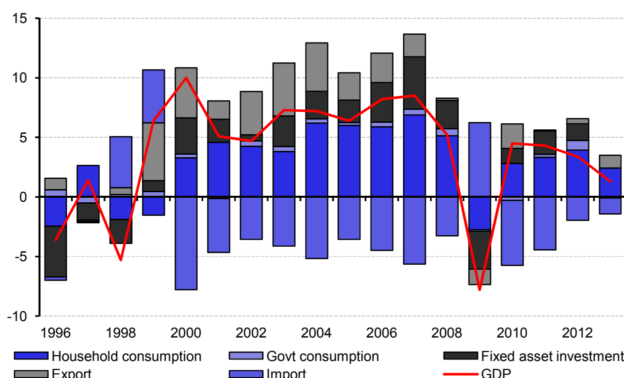
2014	Cap. outflow, USDbn	Impact on RUB, %	RUB/USD, pavg	RUB/EUR, pavg
Scenario 1	30	6.9	34.0	44.2
Scenario 2	60	11.9	35.6	46.25
Scenario 3	75	14.8	36.5	47.47
Scenario 4	100	19.8	38.1	49.52
Scenario 5	130	25.7	40.0	51.97

Source: Deutsche Bank

Impact on growth

In terms of the impact on growth, capital outflows undermine investment activity with the funds taken off-shore rather than invested in new production facilities.

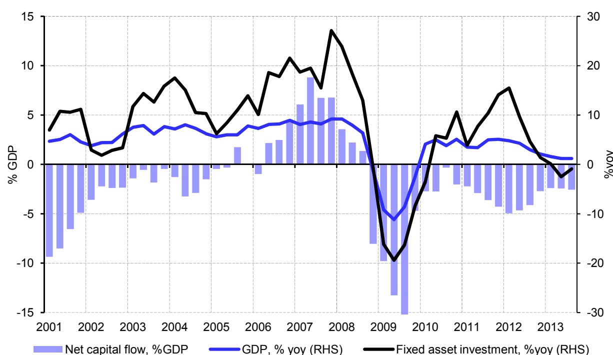
Figure 6: GDP growth and its components' dynamics



Source: CBR, Bloomberg Finance LP, Deutsche Bank

The uncertainty over the political and economic situation in Ukraine as well as concerns over possible sanctions imposed on Russian businesses could further exacerbate costs.

Figure 7: GDP, fixed investment vs. capital flows



Source: Rosstat, CBR, Bloomberg Finance LP, Deutsche Bank

We base our analysis on the same capital outflow assumptions that we used in the previous section.

- Scenario 1: Capital outflows moderate to a level of USD30bn from USD62bn in 2013.
- Scenario 2: Capital outflows intensify to USD60bn, the level of 2011-2013.
- Scenario 3&4: Capital outflows intensify beyond the average levels of the past several years, to USD100bn.
- Scenario 5: Capital outflows resemble 2008 and reach USD130bn.

In the figure below we illustrate the impact of higher capital outflows on GDP growth. The 'direct impact' column illustrates the first-round effect from higher capital flight, while the 'impact' column also accounts for some second-round effects and the resulting improvement in the CA balance.

Figure 8: Impact of higher capital outflows on GDP, scenarios

	Cap. outflow, USDbn	cap flow vs. 2013, USDbn	cap flow vs. 2013, % GDP	Impact on GDP, pp	GDP, % yoy
Scenario 1	30	-30	1.4	1.0	2.3
Scenario 2	60	0	2.8	0.0	1.3
Scenario 3	75	15	3.5	-0.5	0.8
Scenario 4	100	40	4.7	-1.3	0.0
Scenario 5	130	70	6.1	-2.3	-1.0

Source: Deutsche Bank

Our analysis suggests that capital outflows of USD60bn would prevent the Russian economy from staging a significant acceleration this year, with annual growth of an estimated 1.3% yoy vs. 1.3% yoy in 2013, 3.4% yoy in 2012 and 4.3% yoy in 2011.

Second-round effects are skewed to the downside

In this report we assess only the sensitivities associated with the direct effects of capital outflows on growth and the exchange rate, and do not take into account the effects of sanctions, changes in interest rates and other factors that may also have a significant effect on the macro outcomes this year. With respect to sanctions, we believe their overall direct effect would likely be limited for the economy but may add to capital outflows even if sanctions are not fully applied. In terms of the effects of interest rate changes, their temporary nature would likely result in a limited effect on lending and growth; however, if the current political uncertainty proves to be persistent, elevated rates could linger and have a greater adverse effect on growth this year. Another factor that may affect Russia's outlook for the 2014-2015 period is the risk to the sovereign credit rating, as stated by Moody's earlier this month. All this implies that the estimates of the costs to the ruble and growth resulting from capital outflows should be seen as the lower bound of the total effect.

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EMFX:"Good EM/Bad EM" tail opportunities

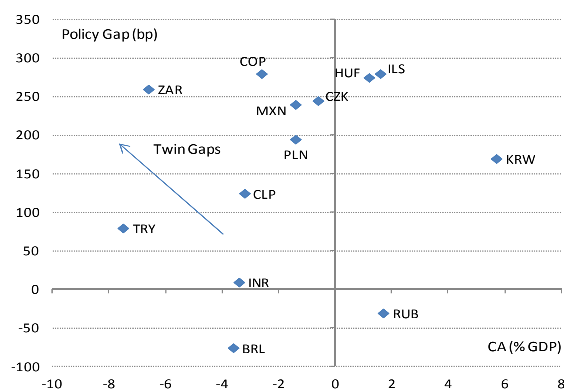
- The backdrop should remain challenging for EMFX as an asset class, boding well for the differentiation theme highlighted in our 2014 outlook.
- Along those lines and motivated by misalignments between EMFX volatility, skew and valuation, we look for option based implementations of the "good EM versus bad EM" theme
- Such misalignments help to either mitigate the negative carry associated with "short EMFX" positions or, alternatively, improve the risk-reward associated with "long EMFX".
- We present differentiation trades from both the bullish EM (puts/puts) and bearish EM (calls/calls) perspectives.
- On the bullish side, we see value in financing puts on USD/CLP or on USD/MXN with puts on USD/HUF. On the bearish, we like proxying an EUR short by financing a USD/CZK call with either USD/CLP or USD/MXN calls. .

EMFX: The challenge continues

So far 2014 has been a volatile year for EMFX. After the significant underperformance in January, EM currencies (and EMFX vol) have in general retraced to their late 2013 levels (a trade-weighted basket of EM currencies is just 2% weaker vs. the USD). Despite the recent rally, more attractive valuation (versus other financial drivers), and carry, we believe that backdrop continues to be challenging in the coming months for the asset class as a whole. The absence of local growth, reactive (rather than proactive) Central Bank policies, current account imbalances, outflows, and likely economic outperformance in the US vs. EM should continue to weigh on EM currencies, more so for countries facing policy mismanagement. Along those lines, in this piece we focus on intra-EM differentiation.

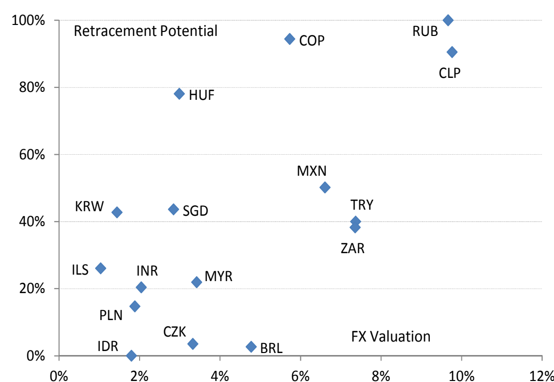
More specifically, we look for option implementations of "good EM versus bad EM" trade that take advantage of the current disconnects between EMFX volatility, skew and valuation. Such disconnects help either mitigate the negative carry associated with "short EM" positions or, alternatively, improve the risk-reward associated with longs. In terms of methodology, we search for opportunities from both the "bullish" and "bearish" angles. From the bullish angle we look, when possible, at financing cheap USD/EM puts in currencies that have higher valuation/retracement potential with expensive USD/EM puts in less attractive EM currencies (from the valuation perspective). From the bearish angle we do the reverse – when possible, finance cheaper USD/EM calls in more fragile currencies with expensive USD/EM calls in less fragile currencies. The result is a collection of "bullish" intra-EM trades (puts/puts) that should in principle work well in environments in which EM rallies, as well as "bearish" (call/call) trades that should work in environments in which EM sells-off.

Challenges continue in EMFX ...



Source: Deutsche Bank

Valuation however looks attractive..[9]



Source: Deutsche Bank

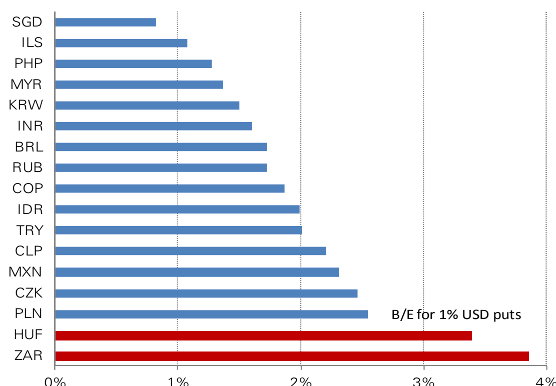
Bullish Intra-EM trades ("Puts/Puts")

Credible forward guidance, weaker than expected activity numbers in the US, "tapering of the taper" and proactive monetary policy in EM are examples of

[9] "Retracement potential" is the difference between the spot rate at end 2013 and the current spot rate. "Valuation" is the difference between the current spot rate and the fitted rate from an empirical FX fair value model. A higher number implies a cheaper current rate relative to the model-implied rate.

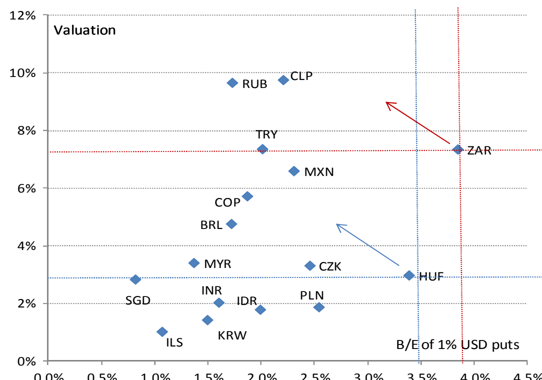
events that could spur a bullish environment for EMFX in the near term. Under this hypothetical backdrop, we would expect fundamental valuation to determine EMFX performance, leading to "bullish differentiation" within EM. Along those lines, we note the apparent misalignment between valuation and breakevens of USD/EM puts in selected EM. The information is summarized in the two charts below. Breakevens of OTM 3M USD/EM puts in ZAR and HUF (strikes associated with 1% premium, arbitrarily chosen) appear to be excessively wide versus their peers, especially when valuations versus "fair" are taken into account (see footnote). This suggests that USD/EM puts in ZAR and HUF could be used as financing legs for other USD/EM puts. Following this logic, the chart below suggests several attractive zero-cost long-short intra-EM "bullish" trades. As an example, one could sell a 3M USD/HUF put @ 2.5% OTMS for 1% (breaking even approximately 3.5% south of spot) and, for selected currencies (located at north-west of HUF on the second chart), buy 3M USD/EM puts that combine better valuation prospects and smaller breakevens (strikes that are closer to spot). Such is the case for the following USD crosses: CZK, MYR, BRL, COP, MXN, TRY, RUB and CLP. Repeating the same exercise for ZAR, skew and valuation suggest that 3M USD puts in the former might be used to finance 3M OTMS puts in TRY, CLP and RUB.

Puts on USD/HUF and USD/ZAR are rich..



Source: Deutsche Bank

..and could finance puts on lower-b/e, better-prospect currencies



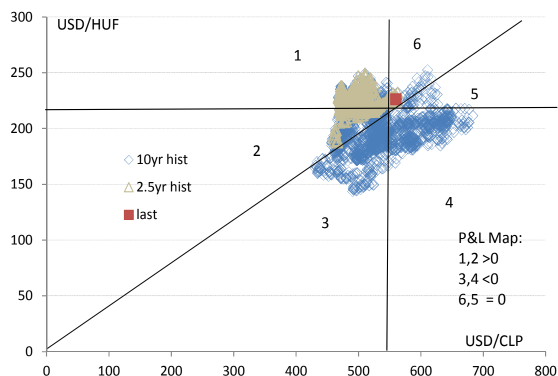
Source: Deutsche Bank

Given the NBH's accommodative monetary policy stance and despite the CA surplus, for this exercise we focus on HUF as the financing currency (e.g. we sell USD/HUF puts). As for "investment currencies", we focus on CLP and MXN. Starting with USD/CLP, we note that, notwithstanding the depressed levels of rates (1Y1Y yields are now close to their bottom) and Copper/Oil, the currency has been considerably undervalued versus its financial drivers besides bearing a substantial political risk-premium. Low strikes in USD/CLP (3M USD/CLP puts @ 2.2% OTMF, 1.2% OTMS) can be financed by USD/HUF at much lower strikes (3% OTMF, 2.4% OMTS). That gives about 7.5% potential upside for the USD/CLP leg (model-implied appreciation minus breakeven on investment leg). At the same time, the USD/HUF financing leg is struck below the model-implied appreciation level of 3%. Switching to Mexico, which is prone to receiving significant inflows on the back of energy reforms besides its positive spillovers with the US, the same option in USD/HUF can finance a 3M USD/MXN put @ 2% OTMF (1.3% OTMS). Valuation implies potential upside of about 4.5% on this leg.

Beyond attractive pricing and valuations, correlations obviously play an important role in these conditional trades. The combined horizon P&L diagrams below (for the two trades noted in the previous paragraph) show that despite visiting adverse regions more often in the past, the CLP/HUF combination has basically "lived" in positive P&L territory in recent history. Recent USD/CLP levels have been more in the money than recent USD/HUF levels, which have either been higher than strike (out of the money, region 1) or in the money, but less so than USD/CLP (region 2). And although to a lesser extent, recent history for the MXN/HUF combination, in the second chart, also looks

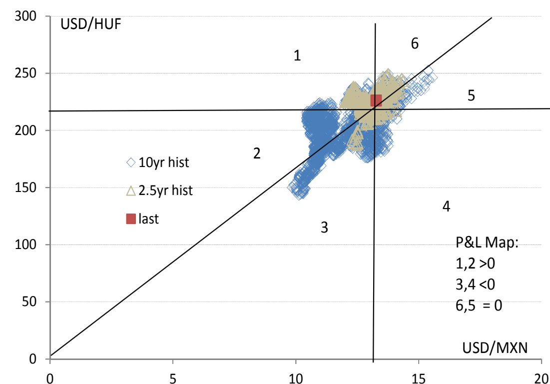
favorable, concentrated in the positive (1 and 2) and zero (5, 6) P&L regions. All that said, our valuation metric as well as the monetary policy management and external accounts reasoning behind the "good EM, bad EM" rationale point to region 1 as the most probable in both cases.

Historical levels support short USD/HUF put, long USD/CLP put..



Source: Deutsche Bank

..as well as short USD/HUF put, long USD/MXN put



Source: Deutsche Bank

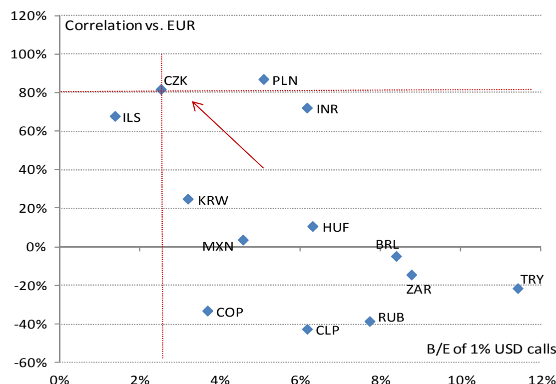
There are, of course, risk caveats to the aforementioned trades. Despite NBH's dovish stance, Hungary's CAS could result in outperformance of HUF vs. CLP, especially if copper prices remain subdued (regions 3 and 4 above). A switch in the monetary policy bias could also trigger a strong rally in the currency resulting in outperformance of the HUF versus both CLP and MXN.

Bearish Intra-EM trades ("Calls/Calls")

As expressed in our year-ahead outlook, we expect growth and rates differentials between the US and EUR to widen, resulting in EUR weakness/USD strength. We believe that these same factors should result in EMFX weakness, therefore boding for (bearish) EMFX proxies that synthesize a EUR short.

Comparing option breakevens to 4-month correlations vs. EUR,[10] (first chart below) suggests USD/CZK calls as an especially cheap EM proxy for EUR weakness: the breakeven is the lowest out of all currencies (except for ILS), and correlation with EUR is 82%.[11] Moreover and despite valuation, CNB's commitment to a weaker Krona makes, in our opinion, high strike exposure to CZK particularly attractive. On the flip side, the same chart suggests MXN and CLP as possible financing currencies as they combine higher breakevens than CZK with low or negative correlations vs. EUR (4% and -43%, respectively). As the chart shows, a 3M USD/CZK call struck approximately at 1.5% OTMS can finance a 3M USD/MXN call struck at 3.5% OTMS, or a 3M USD/CLP call struck at 5.5% OTMS (all costing approximately 1% premium). A general caveat to this "synthetic EUR short" strategy is that strong CA numbers could keep EUR (and consequently the CZK) range bound even in an environment of EM weakness.[12] For example, a scenario in which US tightening becomes more likely but EUR does not weaken could prove detrimental for the strategy. As the second chart shows, USD/CZK's correlation with the US 1Y2Y rate has been slightly negative (over the past 4 months), while that of USD/MXN and USD/CLP has been higher than 40%. That is, in such a scenario MXN and CLP might sell off far more than CZK, resulting in negative P&L.

Long USD/CZK call provides cheap exposure to EUR weakness..



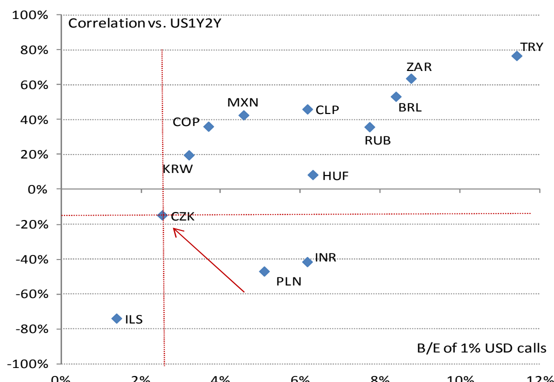
Source: Deutsche Bank

[10] We choose 4 months as the correlation window because the correlation structure of EMFX seems to have changed recently. This window also coincides with CNB's current intervention initiative in the Krona.

[11] Shortening the correlation window generates an even higher correlation coefficient.

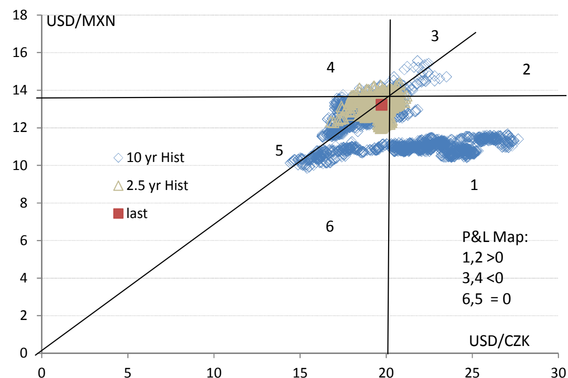
[12] Note that CNB has been intervening to keep EUR/CZK above its target rate (27). That is, CZK could very well strengthen vs. USD while maintaining its floor vs. EUR if EUR strengthens vs. USD.

..but does not seem attractive from US short rates exposure perspective



Source: Deutsche Bank

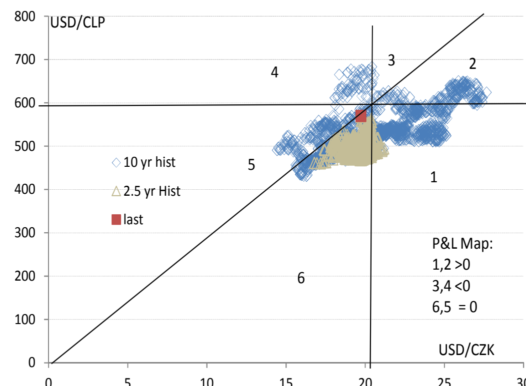
Historical perspective: long USD/CZK call, short USD/MXN call …



Source: Deutsche Bank

Despite valuations, we favor selling USD/MXN calls rather than USD/CLP calls as the better fundamentals of the former reduce, in our opinion, the potential effects of adverse idiosyncratic shocks to the financing leg. That said, the MXN version of the trade could also be hurt by hedging of foreign holdings in Mexico's local markets (MBONOS) resulting in MXN overshooting. As can be observed in the first cloud chart below, regions 3&4 (MXN weakness and CZK strength) have indeed been recently visited. This has especially been the case during periods of "fear of outflows". Such periods combined with EUR strength represent the main risk to our "bearish EM" trades.

..and long USD/CZK call, short USD/CLP call



Source: Deutsche Bank

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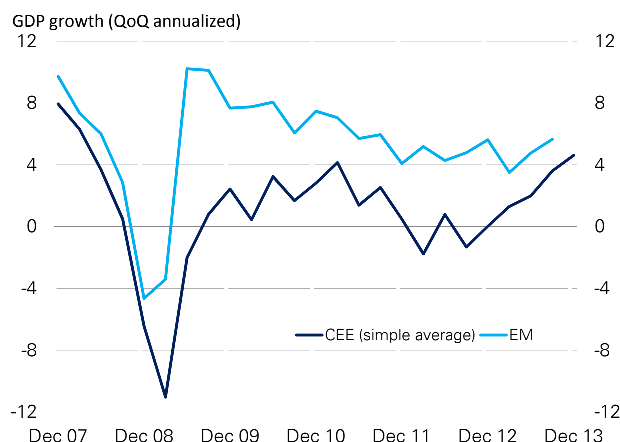
Central Europe: A Good EM Story

- Good EM stories are quite thin on the ground but we think there is a one unfolding in Central Europe. After a protracted period of economic stagnation, recoveries across the region are gathering pace.
- GDP growth exceeded 4% on average in the final quarter of last year, the strongest performance in over five years. Confidence is returning and other forward-looking indicators, such as recent PMI surveys, suggest that this pickup in activity is being sustained through the early months of this year.
- We think the region will continue to enjoy a solid expansion over the next few years. Recovery in the euro area, the dominant trading partner for the region, forms the foundation. But domestic conditions are also turning supportive.
- The heavy lifting of fiscal austerity is mostly done. The pace of deleveraging in the private sector is easing. Inflation is low and spare capacity still significant, which should give central banks some breathing space before monetary conditions need to be tightened. External vulnerabilities have been much reduced since the last crisis, leaving the region less exposed than other EMs to Fed tapering. Currency adjustment during the EM sell off has been modest but the region appears to be relatively competitive and well placed to take advantage of strengthening European and global recoveries. Further measures to boost productivity would of course be helpful but the need for painful structural reforms appears less pressing than elsewhere.
- Within the region, Hungary remains an exception insofar as its outlook is more challenging. Some of the headline numbers are impressive: inflation has fallen to historic lows; the fiscal deficit is below 3% of GDP; and the current account surplus exceeds 2% of GDP. But the stock of public and external debt remains large. Much of it is still denominated in foreign currency, leaving private and public balance sheets exposed to currency weakness albeit less so than in the past. Question marks also remain over the business climate and its ability to attract private investment. We think recovery in Hungary is therefore likely to lag others in the region and it will be more adversely affected by broader EM jitters.

Introduction

After a protracted period of economic stagnation, recoveries across Central Europe are gathering pace.[13] GDP growth exceeded 4% on average in the final quarter of last year, the strongest performance in over five years. Confidence is returning and other forward-looking indicators, such as recent PMI surveys, suggest that this pickup in activity is being sustained through the early months of this year.

Central Europe: Closing the Growth Gap



Source: Haver Analytics, Deutsche Bank

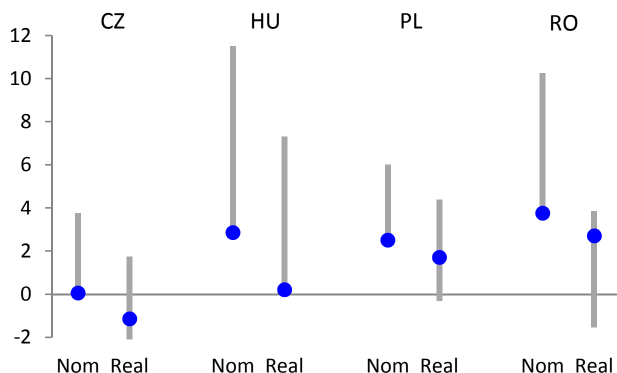
We take a closer look at some of the factors behind this recovery and conclude that the region is well placed to deliver a continued solid expansion over the next few years. Recovery in the euro area, the dominant trading partner for the region, forms the foundation. But domestic conditions are also turning supportive as the burden of economic adjustment following the last crisis is beginning to fade. We consider some of these issues in turn, including the scope for supportive monetary and fiscal policy, progress on private sector deleveraging, competitiveness, vulnerabilities to external stress, and the need for structural reforms.

Central banks have some breathing space

Monetary conditions are very accommodative with nominal policy rates at historical lows across the region (chart below). Headline and core inflation rates are also running below target after adjusting for tax changes where these have been significant. These low inflation rates partly reflect temporary factors, such as administered price cuts in Hungary and last year's bumper harvest in Romania, which will gradually unwind and push headline rates higher through the course of this year. But the outlook is still relatively benign.

[13] We define Central Europe throughout this report as comprising Czech Republic, Hungary, Poland, and Romania.

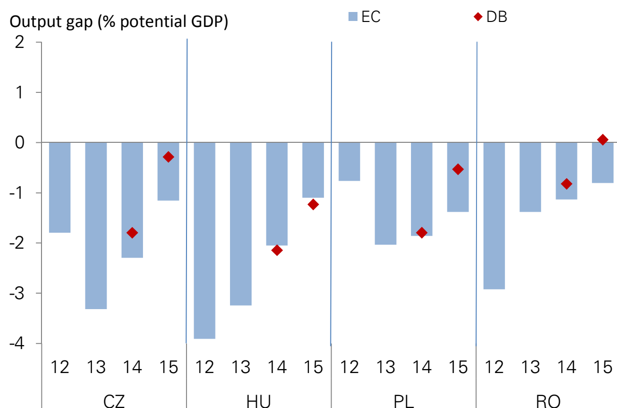
Monetary policy is still accommodative



Real rates are based on harmonized core inflation (excluding food and energy). The gray columns show the range of nominal and real rates since the beginning of 2005.
Source: Haver Analytics, Deutsche Bank

There is still significant spare capacity across much of the region. The degree of slack is hard to estimate with any degree of precision as potential growth rates have almost certainly fallen significantly in recent years. The European Commission, for example, estimates that potential growth rates in the region have fallen by about 2½ppts on average since pre-crisis period; but this would still leave output 1-2% below potential across the region even next year according to their estimates. Our growth forecasts for Czech Republic, Poland. and Romania, are somewhat more optimistic and we would see output gaps in these countries closing next year (chart below).

Output to remain below potential until next year



Based on European Commission estimates of potential output using production function approach.
Source: European Commission, Haver Analytics, Deutsche Bank

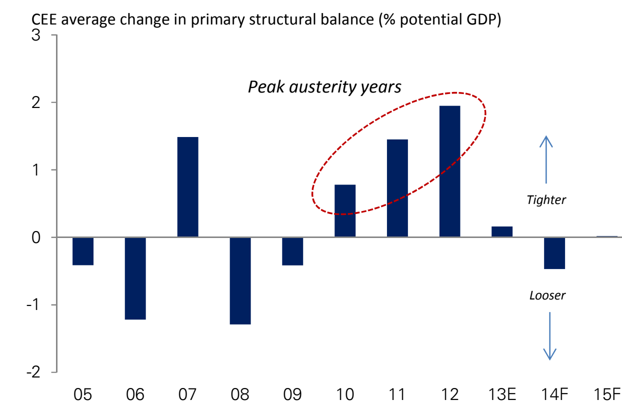
Demand pressure on inflation is likely to be correspondingly limited until output gaps are closed, which is likely to be next year at the earliest in Poland and later still in Czech Republic and Hungary. Central banks therefore have some breathing space before they need to begin reducing monetary stimulus. Poland is likely to be the first to embark on a tightening cycle, possibly as early as the final quarter of this year if our constructive view on growth is correct. Others will likely be able to wait a little longer before demand pressures begin to bite. There is a risk, however, that Hungary could be forced to tighten sooner than domestic demand conditions would otherwise warrant. It has been pushing the limits of easy monetary policy given its large FX liabilities. A significant depreciation in the forint would weigh on domestic balance sheets and could force the central bank to bring forward its hiking cycle to shore up the currency.

Fading Drag from Fiscal Austerity

Like much of Europe, the region has been through a period of significant fiscal consolidation over the last few years. This adjustment process began much earlier in Hungary, where very loose fiscal policies in the first half of the last decade had already placed government debt on a rapidly rising trajectory. Others in the region were able to loosen policies initially in response to the global financial crisis but have had to withdraw this support over the last few years as weak growth and currency weakness added to debt burdens.

This drag on growth is now fading. The fiscal stance across the region turned broadly neutral last year and is set to remain so over the next two years.

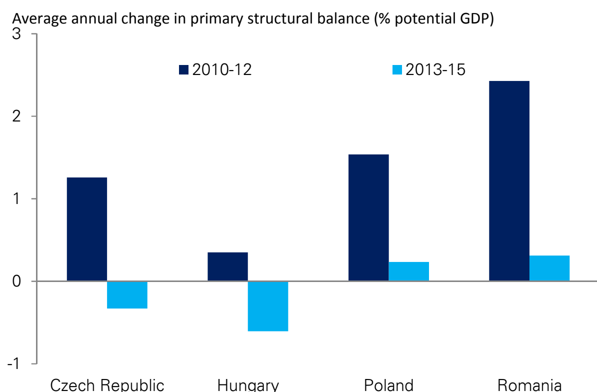
The Fading Drag from Fiscal Austerity



Source: European Commission, Haver Analytics, Deutsche Bank

The pattern differs a little from country to country (chart below). Fiscal stances are set to remain restrictive in Poland and Romania for the next couple of years but only mildly so. We should see some modest easing in fiscal conditions in Czech Republic following the election of a new centre-left government and in Hungary, especially in this election year.

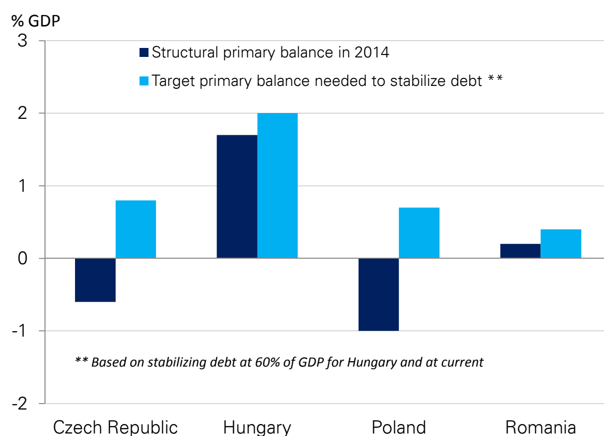
Fiscal Stances by Country



Source: European Commission, Haver Analytics, Deutsche Bank

Following recent consolidation, fiscal positions are now closer to sustainable levels but some further modest adjustment would be needed to stabilize debt at current levels. Assuming some further modest increase in interest rates, Czech Republic and Poland would need to run small primary surpluses of around 0.7-0.8% of GDP to stabilize debt at their current levels of just over 50% of GDP. This would require modest further structural tightening of about 0.3% of GDP each year over the next five years, which would provide only a

Further Fiscal Adjustment Needs are Modest



Source: Haver Analytics, Deutsche Bank

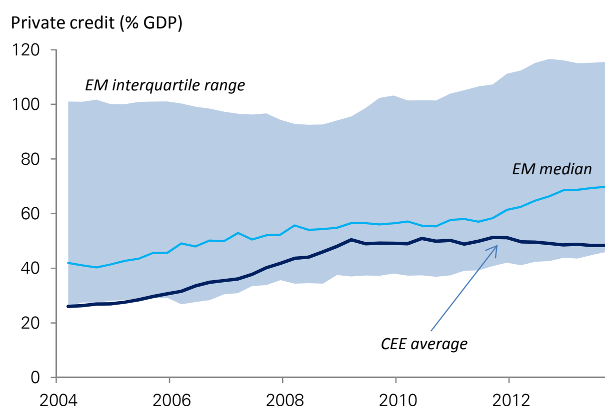
modest drag on growth. Hungary and Romania are already set to run primary structural budget surpluses this year and the adjustment needs would be even lower in their cases. Hungary's substantial primary surplus is already enough to stabilize debt at its current level of around 79% of GDP. The latter is high by EM standards, however, and some modest further tightening would be needed to bring debt down to 60% of GDP. The adjustment effort would, however, be greater should the forint weaken with given that about 40% of government debt is denominated in foreign currencies.

Progress in private deleveraging

Among the principal causes of the region's underperformance in recent years was the pre-crisis boom in credit, much of it in the form of foreign currency lending and much of it funded by external borrowing. The Czech Republic was something of an exception insofar as the increase in credit was in line with the rest of the region but borrowing continued to take place largely in domestic currency. This boom was followed by a period of painful deleveraging as the sources of foreign funding dried up, and as balance sheet mismatches were exposed by currency depreciation. The resulting credit crunch contributed directly to the contraction in domestic demand across the region.

The rebuilding of private sector balance sheets is ongoing but the pace appears to be slowing as the process reaches maturity. Private debt levels have stabilized or fallen slightly and are now relatively low by EM standards at 57% of GDP in the Czech Republic, about 50% of GDP in Hungary and Poland, and 36% of GDP in Romania.

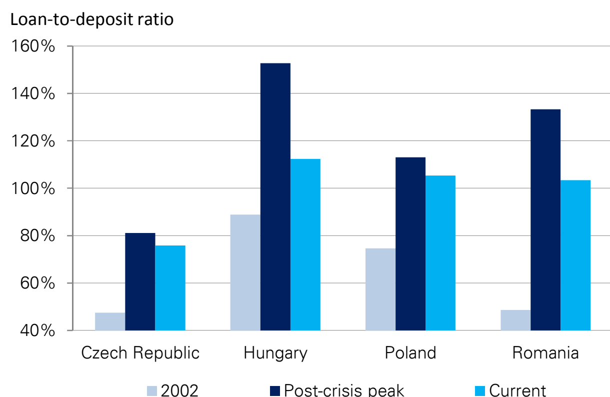
Private Debt Levels have Stabilized



Source: Haver Analytics, Deutsche Bank

Loan-to-deposit ratios have also fallen as foreign bank funding has been scaled back, especially in Hungary and Romania, although the ratio in the former remains somewhat elevated by EM standards at 113%. It has hard to say when enough is enough but these indicators suggest that the worst of past excess has been worked off.

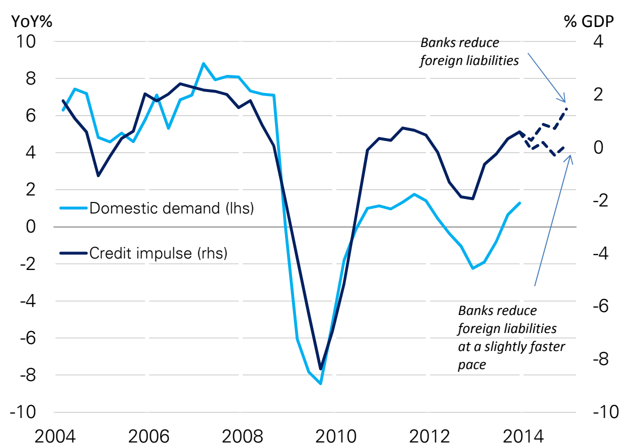
Loan-to-Deposit Ratios have Fallen



Source: Haver Analytics, Deutsche Bank

The pace of credit growth remains weak. After adjusting for FX valuation effects, the stock of credit is growing at around 4% YoY in Czech Republic and Poland and contracting at about the same rate in Hungary and Romania. The change in the flow of new credit, or the "credit impulse", however, turned slightly positive in the second half of last year as the pace of deleveraging across the region slowed a little.[14] We estimate that even if the pace of credit extension remained at these rates, the credit impulse would remain broadly neutral -- see the lower dashed line in the chart below.

Credit Impulse Turns Positive



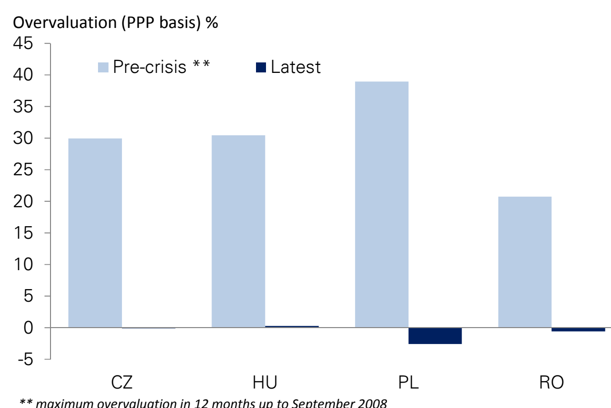
Source: Haver Analytics, Deutsche Bank

We think this is conservative. Even with only modest growth in deposits, in line with the growth of nominal GDP, this would imply an increase in the pace at which banks were reducing their foreign liabilities. If the latter instead halved, which would still imply that banks in Hungary and Romania were reducing their foreign liabilities at an annual rate of 10% and 7% respectively, this would create space for the resumption of positive credit growth in these economies – see the upper dashed line in the chart. The key point is that it would not take much for the credit impulse, especially in Hungary and Romania, to turn significantly positive and accordingly supportive of domestic demand.

Competitiveness has been restored

While currency depreciation in Central Europe during the latest EM selloff has been modest compared to some other EMs, significant adjustment had already taken place over the preceding years. Our productivity-adjusted PPPs, for example, suggest that exchange rates in the region were significantly overvalued going into the last crisis, by around 30% on average. But this overvaluation has been corrected: our latest estimates, for January, suggest that currencies in each case are now very close to this measure of fair value (chart below).

Overvaluation has been Corrected



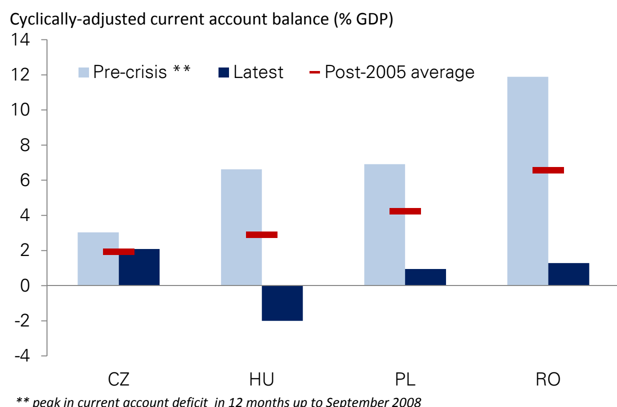
Source: Haver Analytics, Deutsche Bank

External balances have also corrected. With the exception of the Czech Republic, other countries in the region were all running unsustainably large current account deficits prior to the last crisis. These deficits have narrowed significantly and are now at comfortably sustainable levels.

This has generally enabled the region to at least maintain the improvements in competitiveness achieved during the initial stages of transition and integration into the EU, when countries saw their share of global export markets increase significantly. This has been supported in more recent years by the increasing integration of export sectors in these countries into the German export supply chain. Poland and Czech Republic have mostly held onto these gains. Having

[14] Our credit impulse measures the change in the flow of new credit relative to GDP.

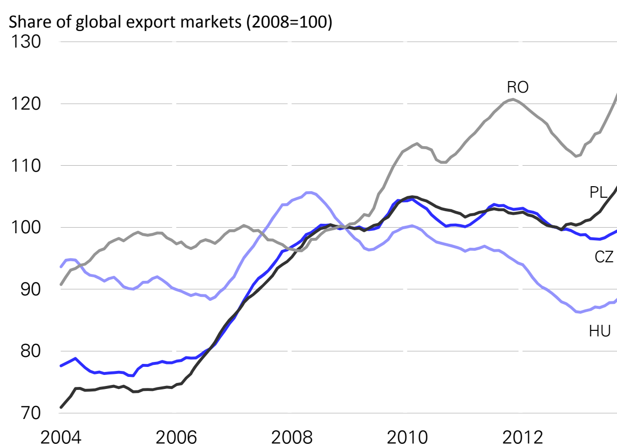
Current Account Balances are now Sustainable



Source: Haver Analytics, Deutsche Bank

lagged the others during the transition process, Romania's export performance has improved notably in recent years following broader economic reform efforts and its share of global markets has risen, albeit from a low base. Overall, our sense is that there are few obvious competitive problems. Much of the region, therefore, should be relatively well placed to take advantage of strengthening European recovery and, via the Germany supply chain, global recovery more broadly.

Export Market Shares



Source: IMF DOTS, Deutsche Bank

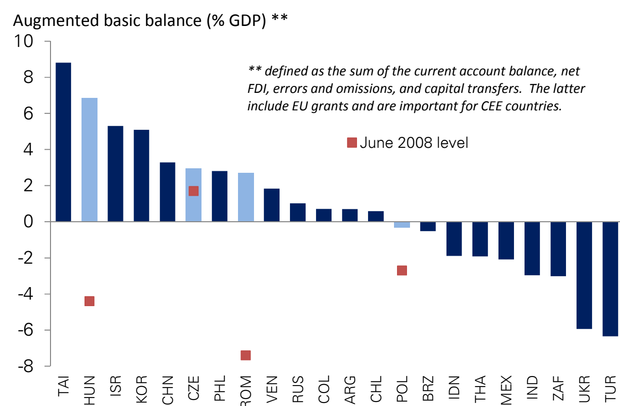
Hungary is the main exception and the only country that has seen a significant drop in its market share in recent years. This does not seem to be a reflection of price competitiveness: as noted above, the forint seems fairly valued from a fundamental perspective. It would seem therefore to reflect non-price factors. This could be bad luck or composition effects, i.e. Hungary simply got caught in the wrong product markets. Or it may reflect bad policies, resulting in a lack of investment in key export sectors.

Vulnerabilities have been reduced

From the previous discussion, it should already be clear that macroeconomic vulnerabilities in the region have been much reduced. Central European countries were among the most vulnerable in EM prior to the last crisis, with various combinations of large current account deficits, excessive credit growth, overvalued exchange rates, loose fiscal policies, and relatively low reserves. These flow imbalances have been mostly corrected and the region stacks up well relative to the rest of EM on these metrics.

This is certainly true of external balances, which have strengthened significantly. This is true even if we define these balances quite broadly. Poland, for example, has persistently large unclassified outflows ("errors and omissions") in its balance of payments. On the other hand, it also receives substantial external funding from the EU. In the chart below, we redefine basic external balances to incorporate these flows. These "augmented basic balances" have also improved across central Europe and also compare favorably with the rest of EM (see left chart below).

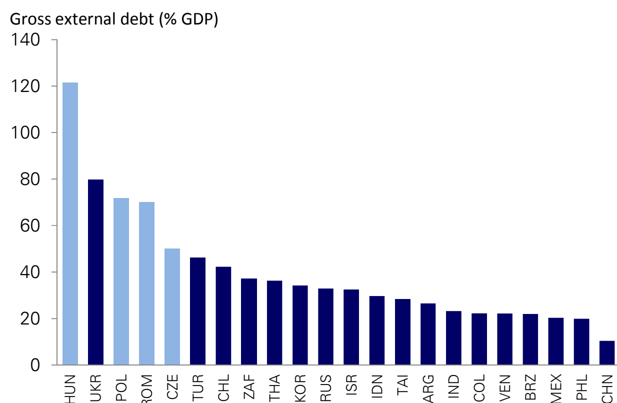
CEE External Balances are Healthy by EM Standards



Source: Haver Analytics, Deutsche Bank

While flow measures like fiscal and current account balances have clearly strengthened, the stock of debt accumulated during periods of past large imbalances remains relatively large. This is most obviously true for external debt (see right chart above) though public debt is also a little above the average for EM. In the case of Hungary, a relatively large share of this debt is denominated in foreign currency, rendering balance sheets vulnerable to further bouts of currency weakness. Debt levels in Hungary, including foreign currency debt, have declined from immediate post crisis peaks but remain elevated relative to the rest of the region and other EMs.

External Debt Levels Remain High



Source: Haver Analytics, Deutsche Bank

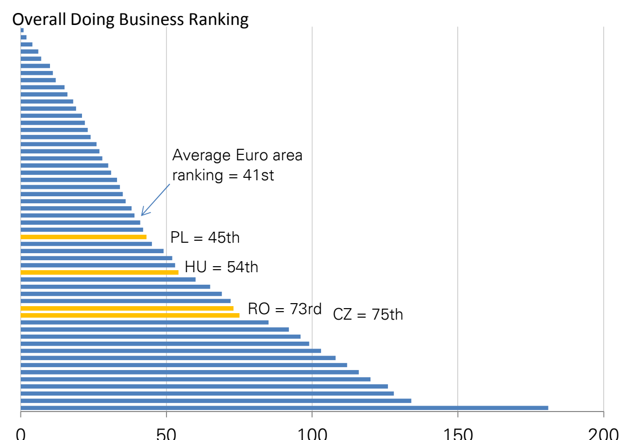
One new element of vulnerability that has increased in the last few years has been the rising exposure of foreign investors to local currency debt markets in the region, most notably in Poland and Hungary where foreigners now represent more than 40% of the creditor base for locally issued government debt. While this foreign investor base has proven relatively sticky during recent bouts of EM turbulence, further selling could put upward pressure on yields and squeeze growth.

The stock of debt needs to be further reduced and, in Hungary at least, its composition shifted further towards borrowing in local currency. This will limit the scope for fiscal easing and policymakers will need to ensure that current account positions remain sustainable even as growth recovers. But we think the region has started to differentiate itself from some of the other weaker EMs and will be less sensitive to Fed tapering.

Broader reform needs

As growth in developed markets has begun to recover and economic performance in some of the larger emerging markets has faltered, investors have begun to take a more critical look at the longer term growth prospects for EM. In some cases, the structural weaknesses that need to be address are relatively clear, whether it be infrastructure bottlenecks in Brazil and India, labor market problem in South Africa, or a weak investment climate in Russia. Reforms to boost productivity can be helpful in any country. According to the World Bank Doing Business Indicators, for example, there is certainly scope for improving the business climate in Central Europe. The region ranks among the middle of the EM pack according to this metric and somewhat below the average ranking for euro area countries.

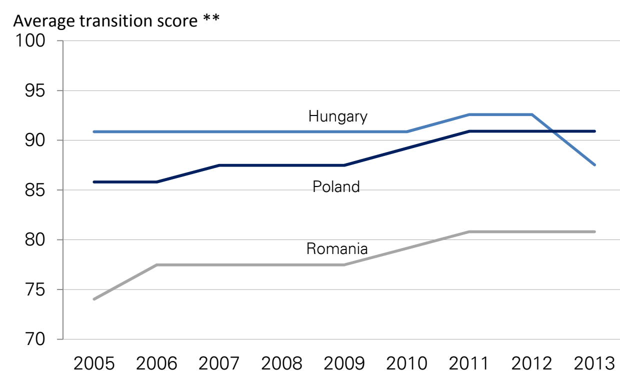
CEE Business Climate is Average



Source: World Bank Doing Business Indicators, Deutsche Bank

In general, however, the need for major structural reforms is less obvious in central Europe than in some other EMs. This is partly because these countries have already been through a period of structural reform, anchored around the EU accession process. Hungary has arguably gone backwards in some areas. In its latest transition report, for example, the EBRD argued that Hungary had moved further away from achieving the standards and performance of a typical advanced industrial economy (chart). This reflected heavy state intervention in a number of areas including, for example, the energy sector where the government has mandated cuts in utility prices and imposed a special levy on the sector.

EBRD Transition Indicator



The EBRD transition indicators range from 1 to 4+ with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy. We have recalibrated this scale from 0 to 100. Czech Republic graduated from the EBRD in 2007.

Source: EBRD, Deutsche Bank

Romania is at an early stage of its development – per capita incomes are still about 40% below levels in the other countries – and its transition score reflects this (see chart). Reforms are, however, heading in the right direction and continue to benefit from the anchor of an

IMF/EU program, its third such program since 2009. The program includes a number of structural reforms, including the deregulation of energy prices and reform of of state-owned enterprises (including privatization).

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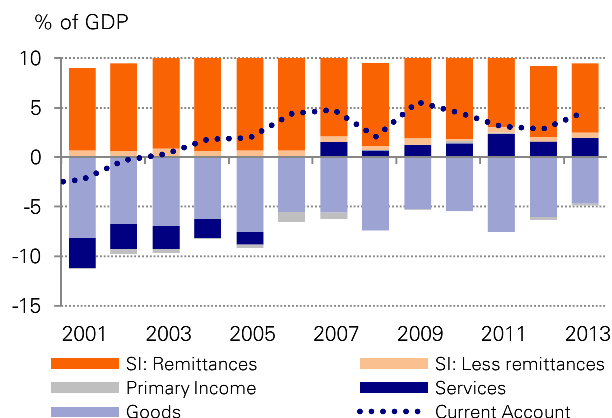
Is the Philippine Peso a (CA) Deficit Currency?

- We compare the value of imports as reported by Philippine authorities and the value of exports to the Philippines as reported by the country's top trading partners and find a growing discrepancy in the trade balances of the two datasets since 2012.
- The growing divergence is driven more by the discrepancy in the imports data than by exports. In 2013, the Philippines' total merchandise imports from China were 60% lower than what Chinese authorities reported as the value of China's exports to the Philippines.
- This discrepancy may be due to under-invoicing of imports. Indeed, President Aquino, in July last year, criticized the Bureau of Customs for the at least PHP200bn (USD4bn) that the government lost in 2012 due to smuggling.
- Accounting for the difference in the trade balance reported by Philippine authorities and trading partners, we reckon that the current account posted deficits in some periods over the past couple of years. This is contrary to the steady surplus suggested by data from Philippine authorities.
- Our findings suggest that the country's current account balance may not be as strong as reported, which would help resolve the puzzle of the currency's weakness in recent months.

An anomalous currency

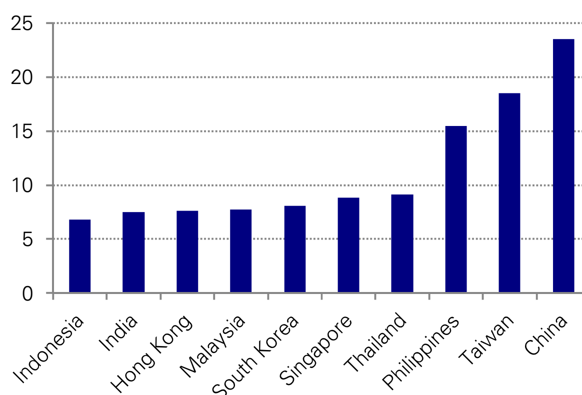
The Philippine peso is deemed resilient to external shocks given the country's comfortable current account surplus and ample reserves. The data show that the current account surplus has averaged 4% of GDP in the past five years; thanks to stable remittance inflows and growing revenues from the business process outsourcing industry that exceed the deficit in the goods account. Gross international reserves—amounting to USD80.3bn as of February 2014—are also sufficient to cover at least a year of goods imports and worth more than five times the country's short-term external debt by residual maturity. Its ample reserves cover puts the country above Indonesia, Malaysia, and Thailand and close to the ranks of Taiwan and China.

Enjoying a healthy current account surplus…



Notes: Data prior to 2011 refer to BPM5. 2013 covers the first three quarters only where current account data are available.
Source: CEIC and Deutsche Bank

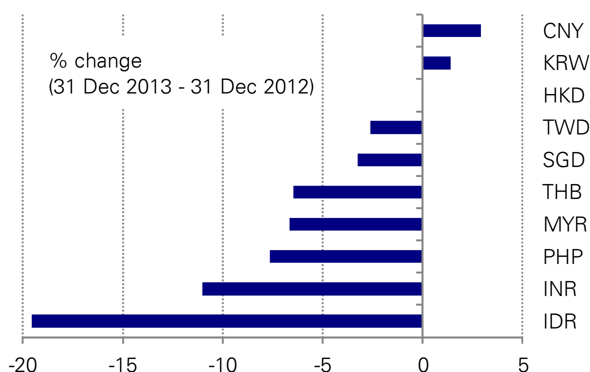
…ample reserves cover



Note: Country's latest international reserves divided by monthly merchandise imports.
Source: CEIC and Deutsche Bank

It is therefore surprising that the Philippine peso under-performed most of its current account surplus peers last year and behaved more in line with those in deficit. Even as remittances reached record highs and the trade deficit narrowed, the final quarter of 2013 saw the peso fall almost 8% on year against the dollar. This placed the peso's loss worse than the ringgit's (-7%), despite Malaysia's substantial foreign exposure in the bond market, and close to the currencies of India (-11%) and Indonesia (-20%), where economies were marked by greater external financing needs.

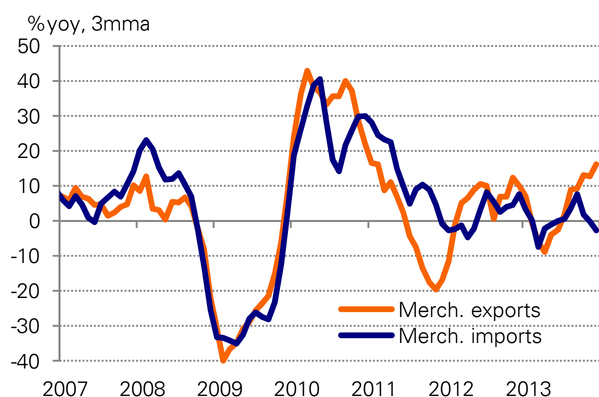
Peso (PHP/USD) underperforming CA surplus peers



Source: Bloomberg Finance LP and Deutsche Bank

Last year saw a declining trend in the goods trade deficit, which further boosted the surplus in the current account. In the first three quarters of 2013, the merchandise trade deficit narrowed to 4.7% of GDP from at least 6% in the past decade. This outturn helped the current account surplus improve to 4.6% of GDP in the same period from 3% in the previous two years. While we await the official current account data for the final quarter, monthly merchandise trade data for the last three months of 2013 continued to post lower trade deficits, falling 62% from the same period a year ago. The driver appeared to be growing exports against broadly flat imports. Goods exports for the whole year of 2013 grew 3.6%yoy whereas imports contracted by 0.7%, defying a historically positive correlation between the growth of exports and imports.

Exports and imports on a diverging path of late



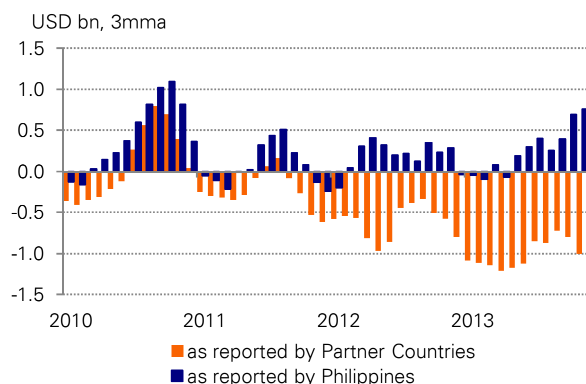
Source: CEIC and Deutsche Bank

Investigating discrepancy in trade data

We compare the value of imports as reported by Philippine authorities and the value of exports to the Philippines as reported by the country's trading partners (countries where Philippine imports originated). We specifically examined a combination of data for the country's top five export and import partners representing at least 60% of total trade (sum of exports and imports).[15] We use data from national sources rather than from the IMF Direction of Trade Statistics as the former carry data until end-2013 whereas the latter is two months behind.

The chart below shows a growing discrepancy in the trade balances of the two datasets since 2012, at least for the countries within our consideration. While the same partner country data posted a trade deficit in 2012 (-USD7.7bn), Philippine data from its reported showed a modest surplus (USD2.4bn). The inconsistency widened the following year when partner country data reported a greater deficit (-USD12.9bn) whereas figures from Philippine authorities showed a higher surplus (USD4.4bn), compared to a year ago.

Diverging trade balance

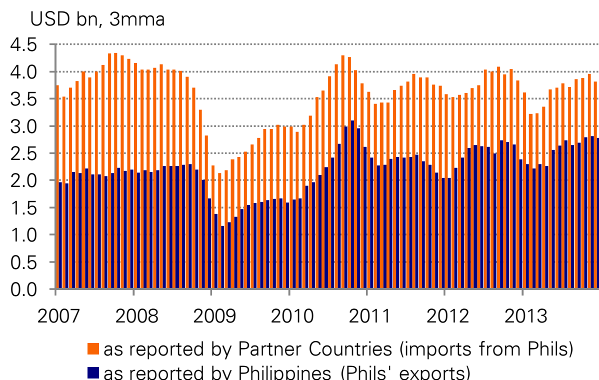


Note: Partner Countries refer to China, Hong Kong, Japan, Singapore, South Korea, Taiwan, and the United States.
Source: CEIC and Deutsche Bank

It appears that the growing divergence is driven more by the discrepancy in the imports data than by exports. Philippine exports were broadly flat in the past two years and moved in line with partner-country imports from the Philippines. Philippine exports figures are also lower than partner-country data, suggesting more conservative figures from Philippine authorities if not for differences in valuation. However, Philippine data on merchandise imports lagged the growth of its counterpart. As partner-country exports to the Philippines expanded almost 9% within 2012-13, Philippine statistics only recorded a modest 1% growth in imports within the same period.

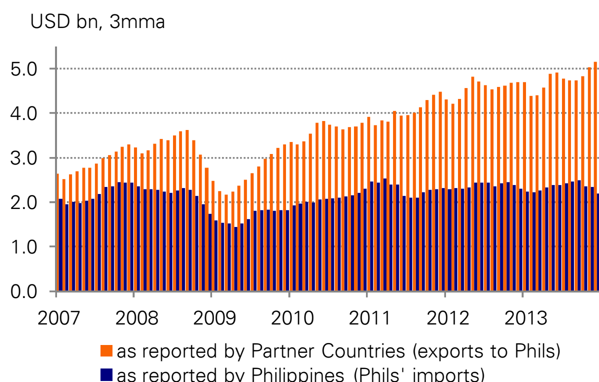
[15] Based on 2013 data, the Philippines' top five exports destinations are Japan (21% of total exports), United States (14%), China (12%), Hong Kong (8%), and Singapore 7%). Top five import sources of the Philippines are China (13% of the total import bill), United States (11%), Japan (8%), Taiwan (8%) and South Korea (8%).

Philippine exports broadly moved in line with partner-country data…



Source: CEIC and Deutsche Bank

…but Philippine imports lagged the growth reported by partner countries.



Source: CEIC and Deutsche Bank

We note that imports reported by one country do not necessarily coincide with exports reported by its trading partner. Differences could be due to various factors including valuation (imports valued in terms of cost, insurance and freight or CIF versus pricing by free on board or FOB), inclusion/exclusion of particular commodities, timing in recording data, and currency conversion practices used upon reporting. An advantage with Philippine data is that imports are valued on FOB basis which are then compared with partner-country exports that are priced in the same metric. Thus, the discrepancy owing to valuation is minimized at least on the side of Philippine imports. We cannot, however, say the same thing with Philippine exports as most countries (including China and Japan) report their import values based on CIF. This perhaps explains why partner countries' imports from the Philippines are greater than what Philippine authorities are reporting for the country's exports.

The charts we have presented above show some inconsistency in the bilateral data prior to 2012, which may be acceptable owing to reasons just cited. However, this inconsistency worsened after 2012 perhaps for reasons other than the usual problem in reporting conventions.

Philippine imports from all countries in our sample were undervalued, with bilateral trade data with China posting the widest difference. In 2013, total merchandise imports from China were 60% lower than what Chinese authorities reported as the value of China's exports to the Philippines. We also notice a striking discrepancy in matching trade data with Taiwan and the US, especially in 4Q2013. As Taiwan and the US reported increasing exports to Philippines, goods sourced by the Philippines from these countries fell.

We also examine another set of bilateral trade data (between Malaysia and China and between Singapore and China) to find that the degree of overvaluation is more substantial in the Philippines. An increasing difference in the trade data between Malaysia and China since 2012 is observed, although in terms of growth rates, Malaysia's imports from China still move in tandem with China's exports to Malaysia. In 2013, Malaysia's imports from China were also undervalued (by 27%) compared to China's data. But even after accounting for the difference in valuation (Malaysia's imports are valued in CIF whereas Philippines' are in FOB), Philippine imports would still turn out to be significantly undervalued (by greater than 60%). Meanwhile, Singapore's imports from China generally move in line with China's exports to the country. The 10% difference in bilateral data could be attributed to transportation costs.

Explaining undervalued imports

Research agency Global Financial Integrity recently reported that 25% of the value of goods imported by the Philippines went unreported to customs officials over the past decade. This practice of under-invoicing imports is said to be driven by a desire to reduce or eliminate the costs of customs duties and tariffs.

President Aquino, in his state of the nation address in July last year, criticized the Bureau of Customs for the at least PHP200bn (USD4bn) that the government lost in 2012 due to smuggling. And despite the President's strong anti-corruption campaign, news commentaries raise the issue that smuggling (estimated by comparing bilateral data from the IMF's DOTS or UN Comtrade) worsened during the current administration. The top five agricultural commodities smuggled from 1986 to 2009 were milled rice, refined sugar, beef, dry onion, and pork, according to a study by the Southeast Asian Regional Center for Graduate Study and Research in Agriculture (SEARCA).

More recently, reports of rice and oil smuggling have occupied news headlines. The government's crackdown on rice smuggling has led to the Bureau of Customs (BOC) seizing more than 1,900 shipping containers filled with rice worth USD16mn this January for lack of import permits. An oil company in the Philippines also noted price discrepancies (lower retail prices against landed cost) that suggest oil smuggling in the third quarter of last year. The suspicion was that mis-invoicing of imports heightened ahead of the planned revamp at the BOC.

President Aquino rolled out a reform program for the BOC in October last year to eliminate corruption within the agency. The program entails an oversight body to review existing Customs procedures and implement international best practices. In January, BOC launched a website to track the value and volume of goods imported and customs duties collected per port, as part of a radical data transparency campaign.

Four months into the program, cash collections by the BOC increased 19.3%yoy in November-January in contrast to the 4.8% growth in the pre-reform period (January-October 2013). The BOC's oversight bodies also reported that of the 142 shipments examined during the same period, 90% were found to be undervalued or misclassified, illustrating the rampant practice of mis-invoicing imports in the country.

Implications for growth

The Philippine economy benefitted from a lower trade deficit in 4Q2013 with net exports contributing 160bps to the 6.5%yoy real GDP growth in the same period. This is in contrast to previous quarters that saw negative contributions of net exports to GDP growth.

Had real imports growth been 200bps higher than 1.9%yoy in 4Q (to match trend growth), GDP growth for the same period would have been lower at 5.6%. This would pull down 2013 GDP growth by 20bps.

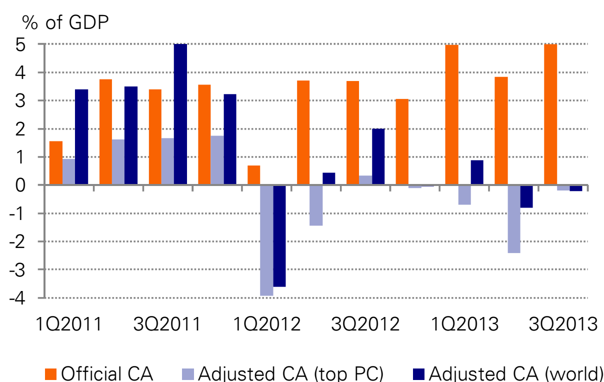
As current reforms in the Bureau of Customs take time to mature, Philippine imports (according to data from Philippine authorities) could continue to post subdued growth in the first quarter, thereby masking the true strength in imports that should track the pick-up in exports. This would result in a lower trade deficit that would appear supportive of growth.

Implications for external balance

As mentioned in the first part of this report, the country has enjoyed a current account surplus owing to remittance inflows and BPO revenues that exceed the deficit in the goods account. It turns out, however, that we cannot count on this same narrative after adjusting the current account for the differences in trade balance.

Accounting for the difference in the trade balance reported by Philippine authorities and all the country's trading partners, we see that the Philippines' current account had been posting deficits in some periods since 2012. This is contrary to the steady surplus suggested by data from Philippine authorities. The second and third quarters of 2013 saw the adjusted current account deficit at 0.5% of GDP as opposed to the 4.4% of GDP surplus reported by Philippine authorities. It is also possible to find this deficit persist in the fourth quarter due to the larger discrepancy in the trade balance. This is despite the record-high remittance inflows and upbeat outturn of service exports in 4Q2013.

Current account posted a deficit in 2012-13 after adjusting for the difference in trade balance.



Note: Adjusted according to the difference in the trade balance reported by Philippine authorities and trade balance reported by all partner countries (world). Top PC refers to China, Hong Kong, Japan, Singapore, South Korea, Taiwan, and the United States. World refers to all the trading partners of the Philippines as reported by the IMF Direction of Trade Statistics. Trade balance is the difference between goods exports and imports. 4Q2013 current account data have yet to be released as of this writing.
Source: CEIC, Haver Analytics, and Deutsche Bank

We note that partner country data are not free of errors and the discrepancy in the trade balance between the two reporting parties (Philippines and partner countries) may not be as large as we have estimated. Nonetheless, our findings suggest that the Philippines' current account balance may not be as strong as it seems and that the peso is not as resilient to sudden shifts in investor sentiment as we used to believe. The peso then could remain under pressure as capital flows out of EM economies back to developed markets in response to encouraging economic developments in the US and Eurozone.

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India’s heterogeneous state finances

Declining debt but weak fundamentals

India’s central government finances receive a great deal of attention, but state finances are sizeable too, with state level debt making about a third of the national debt stock. Below we present an assessment of state finances using the latest data released by the Reserve Bank of India. The latest data pertain to FY12/13, while FY13/14 figures are budget estimates.

The data show that on an aggregated basis, fiscal deficit of India’s states increased in FY12/13 to 2.3% of state GDP from 1.9% in FY11/12. The deterioration has been across the board. There has been a marked deterioration in the primary balance (deficit excluding interest payments), despite a 1% of state-GDP worth improvement in own-tax revenue collection. Debt/GDP ratio improved in FY12/13, both relative to the FY11/12 outturn as well as the pre-crisis average (see table below), thanks primarily to high inflation eroding the real interest payment burden.

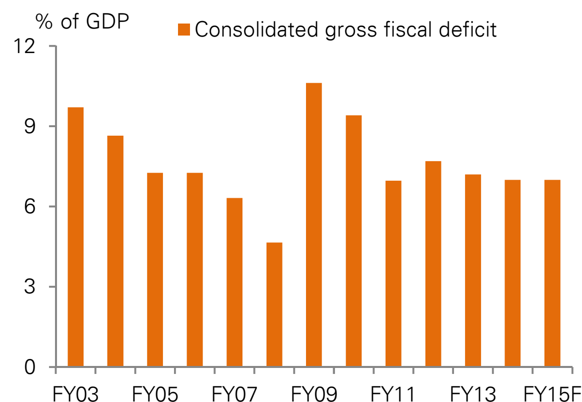
Summary of state finances

Key fiscal indicators	2004-08 avg.	2011/12	2012/13RE
Fiscal deficit/GSDP	**2.3**	**1.9**	**2.3**
Non-special category states	2.7	2.2	2.6
Special category states	3.1	2.9	3.4
Primary deficit/GSDP	**0.0**	**0.4**	**0.8**
Non-special category states	0.0	0.4	0.9
Special category states	-0.5	0.4	1.0
Own Tax Revenue/GSDP	**5.7**	**6.2**	**6.6**
Non-special category states	7.0	7.4	7.7
Special category states	4.9	5.8	5.8
Debt/GSDP	**29.5**	**22.2**	**21.7**

Source: RBI, Deutsche Bank. A negative sign denotes surplus in primary balance

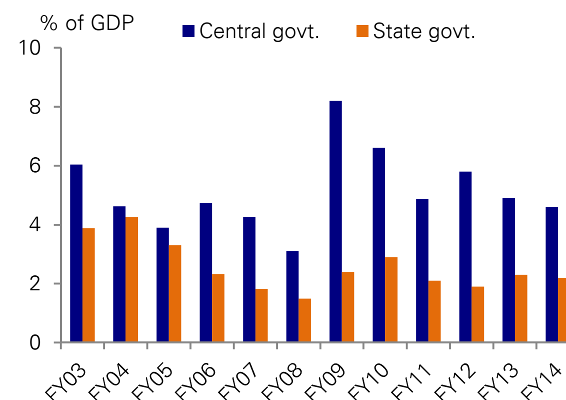
The states’ fiscal deficit combined with a central government fiscal deficit of about 5% of GDP, pushes India’s consolidated gross fiscal deficit above the 7% mark, making it one of the most fiscally challenged country in the region. Without substantial improvement in this area, taming inflation or freeing up resources for private sector led growth will remain elusive goals.

Consolidated gross fiscal deficit



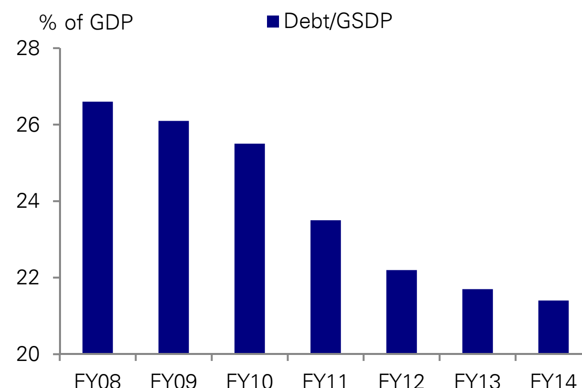
Source: RBI, Deutsche Bank

Gross fiscal deficit of central and state government



Source: RBI, Deutsche Bank

Steady improvement in states’ debt/GSDP ratio



Source: RBI, Deutsche Bank

The consolidated level data, however, fails to reveal the wide divergence that exists between India's states as regards to their fiscal health. We use the key available data to assess the relative fiscal performance of states (17 in total) since 2004. Four key fiscal metric are used – overall fiscal deficit, primary deficit, own tax revenue and debt – to show the extent of asymmetry across India's key states. Some observations:

- All states reduced their Debt/ GSDP ratio in FY13 as compared to their 2004-08 average, with the biggest improvement recorded in Bihar, Orissa, Rajasthan, Uttar Pradesh and Madhya Pradesh;
- Except for Haryana and Rajasthan, all the other 15 states managed to increase their own-tax revenue/GDP ratio in FY13 vs. the 2004-08 average;
- 7 states recorded an increase in fiscal deficit in 2012/13 as compared to the 2004-08 average; 2 states maintained status quo while 8 states reduced their GFD/GDP ratio. The biggest improvement was recorded by Jharkhand, while Bihar, Chhattisgarh and Goa recorded the biggest increase in the fiscal deficit;
- All states except Orissa recorded a primary deficit in 2012/13 as against a primary surplus in 7 states during 2004-08. The deterioration was most striking in Bihar, Chhattisgarh and Goa, while Jharkhand and Maharashtra were the only two states to record an improvement.

We put together the fiscal data observed separately so far to construct a normalized index of fiscal health. We restrict our analysis to the 17 non-special category states. We use four fiscal parameters – fiscal deficit, primary deficit, own tax revenue and state debt, all as a % of GSDP to construct a composite fiscal ranking of the states in the following way:

- We first calculate the sample mean and standard deviation for each of the parameters for different time brackets;
- Using those statistics, we construct state specific z-scores for each of the variables;
- For each state, a composite z-score is then constructed by taking the simple average score of the four fiscal parameters.

The adjacent table summarizes the findings. Orissa tops the fiscal scorecard, while Bihar fares the worst. Uttar Pradesh and West Bengal continue to be fiscally challenged, while states such as Goa and Kerala have seen a significant deterioration over the years. The most striking deterioration has been in case of Haryana, led by a sharp rise in fiscal deficit to 2.3% of GSDP, from an average of 0.4% of GSDP during the 2004-08 period. Jharkhand, which used to be the most fiscally challenged state during the 2004-08 period, has recorded the maximum improvement, with fiscal deficit falling to 1.9% of GSDP in FY12/13 versus an average of 7.4% of GSDP in 2004-08. The other two states which have shown good progress are Maharashtra and Orissa. States such as Tamil Nadu and Karnataka, which had traditionally strong fiscal record, continues to fare well, but have slipped one spot each from their respective rankings during the 2004-08 period.

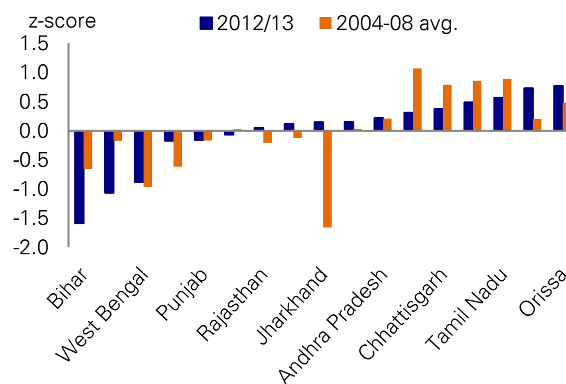
Given that Bihar, Uttar Pradesh and West Bengal together would account for more than one-third of the rise in India's population between 2010 and 2025, their poor fiscal ranking is particularly worrisome. These states also rank poorly in human development indicators, and have a low degree of urbanization and formal employment.

Ranking of states

States	2004-08 avg. Rank	2008-10 avg. rank	2012-13 Rank
Orissa	5	2	1
Maharashtra	7	5	2
Tamil Nadu	2	3	3
Karnataka	3	4	4
Chhattisgarh	4	1	5
Haryana	1	15	6
Andhra Pradesh	6	7	7
Gujarat	8	10	8
Jharkhand	17	9	9
Madhya Pradesh	10	6	10
Rajasthan	13	12	11
Kerala	9	8	12
Punjab	11	13	13
Uttar Pradesh	14	16	14
West Bengal	16	17	15
Goa	12	14	16
Bihar	15	11	17

Source: Deutsche Bank

Fiscal health score - 2012/13 vs. 2004-08 average



Source RBI,, Deutsche Bank

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Local Markets Analytics Report (LMAP) – The Next Generation

Since 2008 the Local Markets Analytics Package (LMAP) has been a mainstay of our quantitative analysis of EM local currency fixed income markets. Over the past 5+ years the package has evolved and expanded to cover additional countries and market segments. We are now pleased to release the latest incarnation with a host of new features, including…

- A new cross-market summary page, providing a birds-eye view of the key market variables across the entire EM local currency fixed income space.
- Analysis of both beta-weighted and dv01-weighted RV trades, with associated trade weights for both presented.
- A new, fresh, modern presentation style.
- Enhanced PDF features with embedded bookmarks and intra-document links to facilitate rapid navigation within the document.

The LMAP now covers 22 EM local currency fixed income markets. It examines over 1,100 trades a day, presents analytics on approximately 840 and selects 100 of these to show in chart form. These charts are selected dynamically every day based on algorithms which look for potentially interesting relationships.

The edition of the LMAP for March 12, 2014 can be found here http://pull.db-gmresearch.com/p/1315-090D/99730891/LMAP2_12032014.pdf

Introducing the LMAP

DB's Local Markets Analytics Package (LMAP) is designed to provide a comprehensive, systematic analysis of EM local currency interest rate markets. A key design objective of the report is to present the diverse EM local markets in a consistent framework, allowing simpler comparison between markets and facilitating a more rapid learning curve for new users to interpret the report.

Another key feature of the design of the LMAP report is its dynamic nature. Each individual local market includes a plethora of different instruments and relationships which may be of interest. It would be inefficient and cumbersome to present a report with all possible perspectives (levels and relative relationships) on each market. To address this, a large part of the LMAP is dynamically constructed based on algorithms designed to determine levels and relationships which might be interesting. The LMAP currently includes 843 fixed trades which are presented in each edition and a further 106 dynamically selected trades. From these 949 trades, 99 are dynamically selected and additional information is presented in chart form.

Essentially the LMAP provides the first stage of information filtering for the user every day. This makes it far more likely that there will be something of interest displayed each day, but also makes it far quicker for the user to find the item(s) of interest.

For each market, the LMAP considers a set of individual instruments, pre-defined two-instrument relative value relationships and some three-instrument relationships. Collectively these are all considered as potential 'trades' with any cash instruments being funded in the local currency. In order to determine which trades are potentially interesting from the super-set defined for each country, the LMAP computes a variety of characteristics for each one. These include:

- Steady-state return characteristics (carry and roll) and the associated breakeven changes in yield (or other relevant quantity).
- Time series analysis of the key quantity of the trade, examining the extent of recent changes, degree of mean-reversion, volatility, z-score and – for relative value trades – degree of directionality to a specified benchmark quantity.

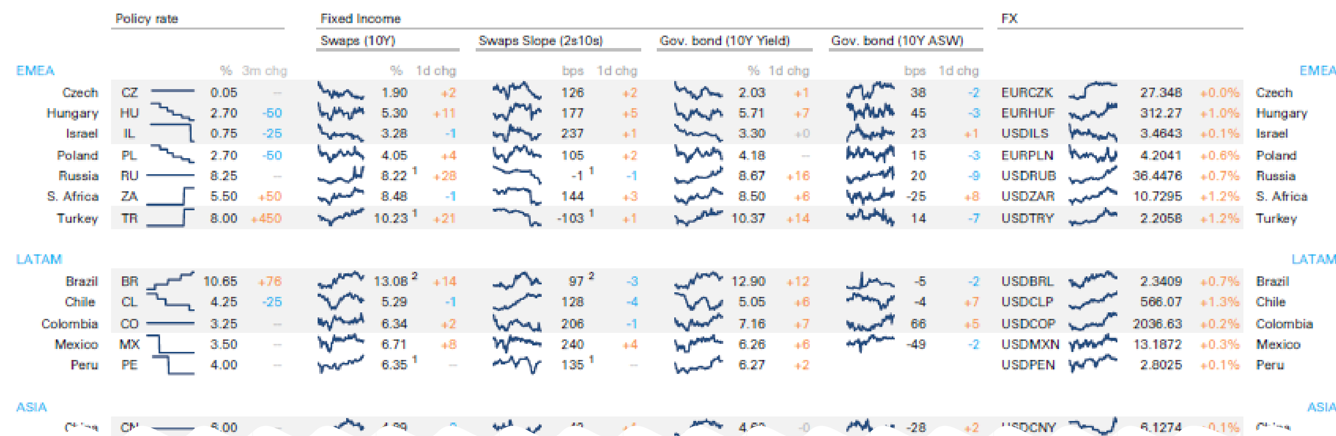
For the trades which are selected, the majority of these characteristics are presented in the report.

A closer look at the report

The market snapshot

The first page of the report – the market snapshot – provides a birds-eye view of the EM local currency fixed income market with a matrix of key market measures across different countries. The monetary policy rate, 10Y swaps, 2s10s swap slope, 10Y bonds, 10Y asset-swap and the exchange rate are all shown. For each measure the snapshot shows the past 6m as a spark-line (a miniature chart), the current level and the recent change. The period of change for the policy rate is always the past 3m, but for the other variables the period of change varies depending on the edition. For most editions it shows the change over the previous day but for end of week editions, end of month, end of quarter and end of year it will show the change over the longest applicable period.

An extract of the new intro page



Market Snapshot

7 March 2014

		Policy rate		Fixed Income: Swaps (10Y)		Swaps Slope (2s10s)		Gov. bond (10Y Yield)		Gov. bond (10Y ASW)		FX			
EMEA		%	3m chg	%	1d chg	bps	1d chg	%	1d chg	bps	1d chg				EMEA
Czech	CZ	0.05	–	1.90	+2	126	+2	2.03	+1	38	-2	EURCZK	27.348	+0.0%	Czech
Hungary	HU	2.70	-50	5.30	+11	177	+5	5.71	+7	45	-3	EURHUF	312.27	+1.0%	Hungary
Israel	IL	0.75	-25	3.28	-1	237	+1	3.30	+0	23	+1	USDILS	3.4643	+0.1%	Israel
Poland	PL	2.70	-50	4.05	+4	105	+2	4.18	–	15	-3	EURPLN	4.2041	+0.6%	Poland
Russia	RU	8.25	–	8.22 [1]	+28	-1 [1]	-1	8.67	+16	20	-9	USDRUB	36.4476	+0.7%	Russia
S. Africa	ZA	5.50	+50	8.48	-1	144	+3	8.50	+6	-25	+8	USDZAR	10.7295	+1.2%	S. Africa
Turkey	TR	8.00	+450	10.23 [1]	+21	-103 [1]	+1	10.37	+14	14	-7	USDTRY	2.2058	+1.2%	Turkey
LATAM															LATAM
Brazil	BR	10.65	+76	13.08 [2]	+14	97 [2]	-3	12.90	+12	-5	-2	USDBRL	2.3409	+0.7%	Brazil
Chile	CL	4.25	-25	5.29	-1	128	-4	5.05	+6	-4	+7	USDCLP	566.07	+1.3%	Chile
Colombia	CO	3.25	–	6.34	+2	206	-1	7.16	+7	66	+5	USDCOP	2036.63	+0.2%	Colombia
Mexico	MX	3.50	–	6.71	+8	240	+4	6.26	+6	-49	-2	USDMXN	13.1872	+0.3%	Mexico
Peru	PE	4.00	–	6.35 [1]	–	135 [1]	–	6.27	+2			USDPEN	2.8025	+0.1%	Peru
ASIA															ASIA
[illegible]	[illegible]	5.00	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	-0	-28	+2	[illegible]	6.1274	-0.1%	[illegible]

Source: Deutsche Bank

Country pages

After the initial market snapshot page, the LMAP is divided up by country. Each country is divided into a set of 'panels'. The overall format of each panel is identical with the aim of accelerating the learning curve for new users.

Each panel represents a specific market segment. At the simplest level this is likely to include a panel for the money-market curve and one for fixed-income instruments with maturity beyond one year (commonly titled the 'Nominal Curve'). However panels may also be included for corporate bonds, for inflation-linked securities or for looking at a specific aspect of the market in more detail (such as forward starting swaps relative to the EUR).

Each panel contains three regions, as shown in the exhibit on the next page. Across the top is a set of four standard charts. Below this is a table providing detail on a range of trades, some individual instruments, some relative value. For each trade some key characteristics are provided. The third region on the right of the panel consists of a set of trade-specific time series charts.

Region 1: Standard Charts

Four standard charts are included on every panel:

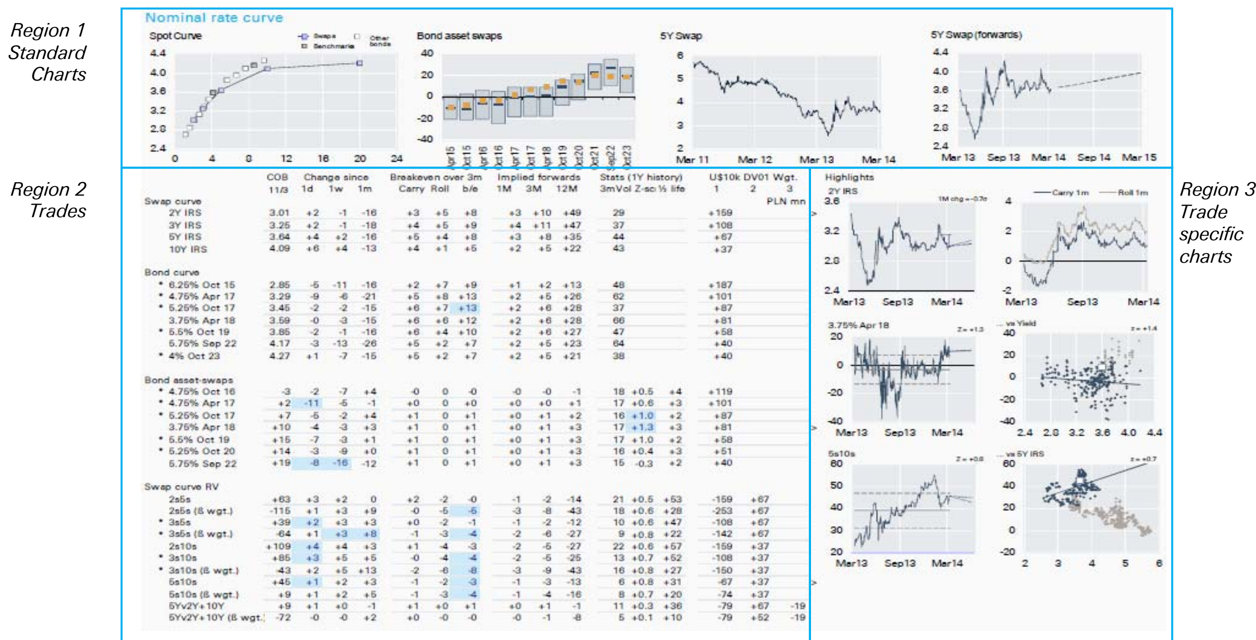
- A traditional yield curve illustration of the markets covered by the panel. In some instances this may illustrate a strip of forwards rather than a spot curve, for instance in the case of the CE3 markets where the study of forward swaps relative to euros is a particularly relevant measure of convergence.
- An indication of the basis between two of the products on the panel (in this case below of bonds and swaps). The shaded bars represent the 10-90% range of the distribution over the past 1 year. The horizontal blue bar shows the average for the basis over the past three months, while the dark blue square indicates the current level.
- Three years of history of one or two benchmarks for the market segment in question.
- One year of history for the same one or two benchmarks, plus one year of implied forwards for each.

Region 2: Trades

In the trade table some rows (trades) are defined as 'fixed' so that they will always appear, others are selected dynamically. The 'dynamic' trades – indicated by an asterisk – are selected based on a variety of factors such as highest carry, greatest z-score, recent large moves etc. For each trade the following quantitative information is provided:

- Current level of the relevant metric (yield, asset-swap, spread etc.) and recent moves (past day, past week and past month).
- Steady-state return characteristics. Even if we assume that market prices remain unchanged over a given period, a trade will commonly yield some degree of positive or negative return due to the different yields on the investment and funding legs of the trade (the carry) and the slope of the curve upon which it is priced (the roll). We express these components of steady state return in terms of the yield change in the underlying curve which would negate the return.
- Implied forwards. The approach for the implied forwards will depend on the type of trade. If the trade is a specific instrument with a specific

The LMAP is constructed with a series of panels such as this. Each panel has three regions.



Source: Deutsche Bank

maturity date then the forwards will correspond to the specific instrument. If instead the trade is a 'tenor' (e.g., a 2Y swap) then the forwards shown on the table will be for that particular tenor. For instance, consider a bond which matures in 2-years time and a 2Y swap and a forward horizon of 1Y. For the bond (which decays) the 1Y forward will be the change in the yield of the bond, hence it will reflect the yield of a 1Y bond, 1Y forward. For the swap however we maintain the same tenor (2Y) and thus present the 2Y swap, 1Y forward.

- Time series statistics. All of the trades within the LMAP are automatically classified into one of two 'Types'.
  - Type 1: *Non-Stationary trades*. All simple outright instruments and forward levels - i.e. first order variables - are considered to be non-stationary.
  - Type 2: *Stationary trades.* These are trades which represent some form of relative value – a spread between two instruments, or an asset-swap basis for instance.

  The specific time series statistics presented depend on the particular 'type' of trade.

  - The volatility of the time series is shown for all trades. This volatility is not annualised; rather, it represents the volatility over a 3-month horizon so that it is directly comparable to the breakeven values. This makes it easy to gauge the 'significance' of both the recent changes in the trade metric and the breakeven values. For instance, a total breakeven of +10bp is far more significant if volatility is, say 10bp than if it is 30bp. For the former, the trade can absorb an adverse move in the curve of 1 standard deviation before it begins to lose money.
  - In addition, for Type 2 trades the z-score of the time series is provided – relative to the mean of the time series. The half-life (number of days taken to retrace half the distance back to mean) of the mean-reversion is also given.

- Across the trades table, the most significant changes and the greatest breakevens (both adjusted for volatility) and the highest z-scores are all highlighted by shading of the relevant cells. Since a fixed number of cells will be highlighted on each panel, the degree of significance implied by these highlights will vary from panel to panel.

- USD 10k DV01 weights. The LMAP now presents the notional amounts needed for a USD 10k DV01 exposure to all trades. For two or three instrument relationships the notional amount required for each instrument is provided. A long (receiver) exposure is associated with a positive sign, a short (payer) position with a negative sign. For instance, to establish a USD10k DV01 flattener exposure to the 2s5s slope in Poland one needs to set up a payer position in the 2-year with a notional amount equivalent to PLN 167mn, and a long position in

the 5-year with a notional amount equivalent to PLN 71mn.

The trade details also provide the notional amount needed for an USD 10k DV01 exposure

	Stats (1Y history)			US$10k DV01 Wgt.		
	3m Vol	Z-sc	½ life	1	2	3
						PLN mn
Swap curve						
2Y IRS	30			+158		
3Y IRS	37			+107		
5Y IRS	45			+67		
10Y IRS	43			+37		
Swap curve R						
2s5s	21	+0.5	+51	-158	+67	
2s5s (ß w	18	+0.6	+30	-244	+67	
* 3s5s	10	+0.6	+45	-107	+67	
* 3s5s (ß w	9	+0.8	+24	-140	+67	

Source: Deutsche Bank

Swap curve RV trades – Beta-weighted trades

One of the most widely referred to section of trades in the LMAP since its launch has been the swap curve RV trades (within the 'Nominal curve' panel). Until now, the trades presented in this section were constructed as DV01-neutral trades which are the most popular way to express relative value views on the swap curve. However, swap slopes and curvatures in many EM markets display strong elements of directionality; often bear-flattening in a rising interest-rate environment whilst bull-steepening when interest-rate falls. In such circumstances focusing solely on the DV01 relationship may result in trades which exhibit significant unwanted directionality. In such cases one may wish to 'hedge' the directionality by implementing the trade on a 'beta-weighted' basis.

A significant new feature in the latest version of the LMAP is that it tests for such directionality and if it is found, presents the beta-weighted version of the trade in addition to the DV01 weighted version.

The basis of determination of directionality is as follows:

- for swap slopes, the 1-year time-series of the slope is regressed with the shorter tenor instrument of the pair.
- for swap curvatures, the 1-year time-series of the butterfly is regressed with the body of the butterfly.

An RV trade is determined to exhibit some directionality, if the r-squared of the regression is greater than 20%. For such cases, the LMAP presents the beta-weighted trade as a separate row right below the traditional DV01-neutral trade. The motivation for looking at directionality in greater detail in the new report stems from a powerful feature of the LMAP; its ability to identify outliers by measuring the z-score of the relationship (how far it is currently from its 1-year mean, in terms of number of standard deviations). However, upon investigating the highlighted DV01-neutral trade(s), it can be found that the high z-score is actually an artefact of its directionality and hence less 'interesting'. Therefore, the presentation of a beta-weighted trade helps us see the DV01-weighted trade, hedged for its directionality. Comparing the two trades simultaneously adds colour in understanding a RV trade.

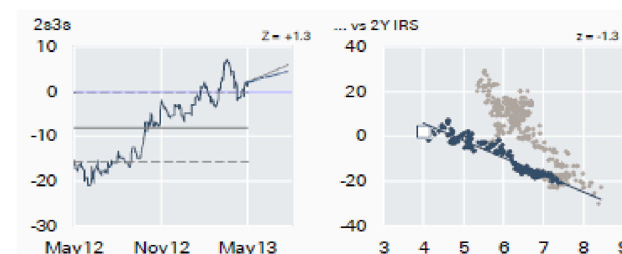
Take the example below (from the Hungarian forint swap curve on May 1, 2013). Looking at the DV01-neutral trades alone it would suggest the curve is steep (positive z-scores), with the 2s3s particularly so (+1.3sd). However, the HUF curve has exhibited strong directionality. The steepening which took place over the previous year was in conjunction with a substantial decline in the level of rates on the curve. Hedging out this directionality, the curve is too flat (negative z-scores). The directionality of the curve slope is very clear when we look at the scatter plot of the 2s3s slope against the level of 2s.

Directionality is tested for all swap curve RV trades

If a swap RV trade is determined to be directional, the beta-weighted version of the trade is presented as an additional row...

	COB		Stats (1Y history)		
	1/5		3m Vol	Z-sc	½ life
Swap curve RV					
* 2s3s	+2	3	4	+1.3	+117
* 2s3s (ß wgt.)	+32	2	4	-1.3	+11
2s5s	+8	13	9	+0.8	+116
2s5s (ß wgt.)	+69	-3 2	10	-2.4	+18

The strong directionality of these curve trades is very evident from the scatter plot...



Source: Deutsche Bank

Region 3: Trade-specific charts

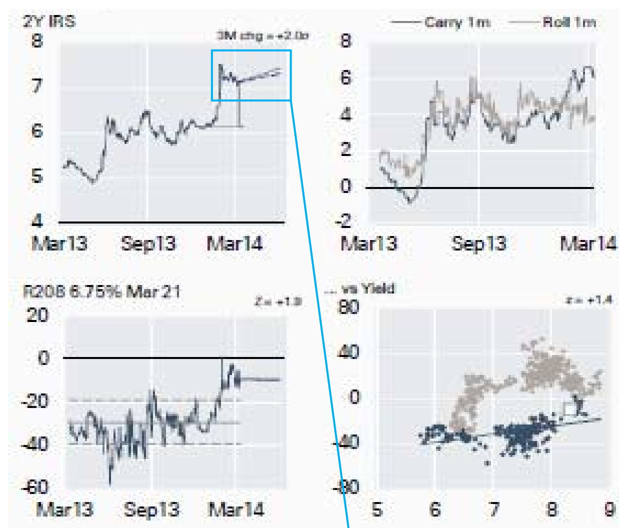
The new version of the LMAP has enhanced trade-specific charting. We now illustrate the potentially most 'interesting' trades with a pair of related charts placed adjacent to each other. A varying number of

such chart pairs can be included on each panel, depending on available space. The trades to which the charts relate are indicated by a small arrow '>' at the end of the trade details row.

Potentially interesting trades are highlighted in each panel

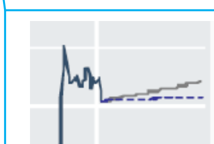
Chart1
For Type 1 (non-stationary) trades the past year is shown with an indication of the change which triggered the trade to be highlighted.

Chart2
This shows either a history of the carry+roll breakeven on the trade, or a scatter plot to illustrate any directionality in the trade



For Type 2 (stationary) trades, in addition to the history, the levels for the mean and +/-1 standard deviation are also shown

For both Type 1 and Type 2 trades, chart 1 also shows the projected breakeven for carry and roll (carry is the solid line, roll the dashed line)



Source: Deutsche Bank

The first chart (on the left) in each pair is a simple historical time series of the trade, along with two time series projection – breakeven carry and projected roll. Historical time series can take two formats, as shown in Figure 6, reflecting the two different types of trades. For Type 1 (non-stationary) trades the time series is presented along with an indication of the change which prompted the trade to be highlighted. For Type 2 (stationary) trades, in addition to the time series itself, three horizontal lines are shown. These represent the average of the level over the past 1Y in addition to the average +/- 1 standard deviation.

The adjacent chart to the right helps us evaluate the trade further and varies across panels and sub-panels. For instance, when a simple outright instrument like a swap rate is highlighted, the second chart shows the historical time series of the projected carry and roll of the instrument in the past 1-year. However, if a swap curve relationship is highlighted, the chart would present the directionality of the relationship as a scatter plot. For all scatter plots the white point indicates the latest data point, the darker blue points indicate all the points in the past 1 year, whilst the grey points indicate all data going back up to 3 years.

An illustration of the report in use

The LMAP can be used in a variety of ways. At the most basic level it can provide a rapid, condensed summary of the current pricing and recent behaviour of the markets. However, its real objective is to help guide the user to the aspects of a particular market which may be worthy of further investigation. Note that when the LMAP highlights a trade, either by indicating a significant move or deviation, or significant breakeven levels, it is of course not guaranteed that this will be good trade. Rather, such a signal should be interpreted as indicating that this trade might be worthy of further investigation.

Picking a bond on a yield curve to buy

There are many factors to consider when determining which bond to buy, but one which should always come into consideration is the steady-state characteristics of different bonds on the curve. By this we mean how would a trade behave if market pricing was unchanged? We illustrate this for the Israeli bond curve. The cushion provided by this steady-state, which we break down into carry and roll is highest at the belly of the curve. The +18bp for 4% Jan-18 bond indicates that if the entire yield curve were to move up (in parallel) by no more than 18bp over the 3-month horizon of the trade, then the trade would be profitable. To put this number into context, we compare it to the volatility of the bond. In this example, the cushion (+18bp) is 75% of the 3-month volatility (24bp) of this bond. In other words, a move of 0.75 standard deviations could be absorbed before losses are incurred. By comparing the carry and roll of each bond on the curve with the volatility, we get an indication of the significance of the cushion.

Carry and roll cushion – Israeli bonds

	COB	Change since			Breakeven over 3m		
	7/3	1d	1w	1m	Carry	Roll	b/e
Bond curve							
* 6.5% Jan 16	0.87	-0	-1	-23	+3	+8	+11
* 2.50% May 16	0.98	-0	-2	-25	+4	+9	+13
4% Jan 18	1.68	-0	-2	-25	+7	+11	+18
5% Jan 20	2.39	+0	+5	-23	+8	+9	+18
5.5% Jan 22	3.00	+0	+3	-25	+9	+7	+16
4.25% Mar 23	3.30	+0	+3	-25	+9	+6	+15
* 6.25% Oct 26	3.77	-0	+7	-22	+9	+3	+12

Source: Deutsche Bank

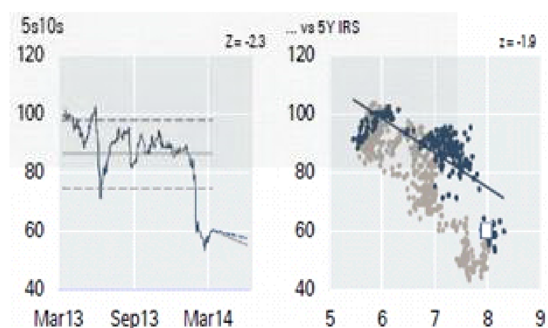
Identifying an outlier

The LMAP examines Type 2 (stationary trades) trades to identify degrees of mean-reversion and extent of outliers. For these trades there are two values to look at: the z-score of the relationship (how far it is currently from its 1-year mean, in terms of number of standard deviations) and the half-life of the relationship (how many days does it take to retrace half the distance back to the mean.

The example below of the 5s10s swap slope in South Africa shows that slope is trading at +60bp which is 2.3 stdev below its mean level. The LMAP has also identified that there is some directionality in this relationship, but even hedging this out the current level is still 2.1 stdev below its mean. The steady-state return on the trade is also good as it should still breakeven in the case of an additional 5bp of flattening over 3-months (0.4 stdev). Given the high z-score of this relationship relative to other relationships on the ZAR swap curve, the LMAP has chosen to display a time series of the spread and a scatter plot of the spread against the 5Y swaps to help in examining the trade further. The scatter plot, by including further history of the relationship, highlights one potential risk in the trade. The sharp flattening which took place in late January (around the time the SARB hiked rates by 50bp), while appearing anomalous in the context of the past year does appear to have brought the relationship back in-line with its longer term directionality.

Outliers – 5s10s swap curve slope in South Africa

	COB	Change ds		Stats (1Y history)		
	7/3	1d	1w Δ	3mVol	Z-sc	½ life
Swap curve RV						
2s5s	+84	+2	+36	31	-0.9	+39
2s10s	+144	+3	+53	36	-1.9	+52
5s10s	+60	+1	+18	12	-2.3	+137
5s10s (ß wgt.)	+151	+1	+11	12	-2.1	+28



Source: Deutsche Bank

Further information

The LMAP is produced daily and is available on the DB website http://gm.db.com. It is also available by email distribution under the periodical name 'Local Markets Analytics Package'.

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Asia Strategy

- With little guidance from data or global macro trends, and, given vols across asset classes are trading close to post 2008 lows, carry seems back in the driving seat. Like we had argued in these pages last month, the underlying factors for bearishness towards EM will likely remain with us through a challenging adjustment process, and will be demanding on both growth and policy credibility. But while markets defer their decision on global growth, and on re-pricing forward guidance by DM central banks; EM – and Asia in particular – has a case for at least a selective re-look, and for greater differentiation. Of the three axes along which adjustment can be broadly assessed, 1) valuations have clearly adjusted quite favorably in most of Asia; 2) basic external balances are showing improvement, even if the quality of the same remains questionable; but 3) real yields remain mostly quite unattractive. A possible fourth gauge of the adjustment – positioning – is maybe more mixed, with little by way of leveraged exposure, but with still an overhang of real money holdings of local currency assets accumulated over QE period.
- Our preferred macro trades in the region include being long RMB vol, and staying with our bias for steeper rates curves in China. We also remain long Indian assets, though we are more concerned now about a narrowing window for rates there to perform ahead of resumption in supply. We see scope for further tactical upside in IDR, but are not convinced by the fundamentals. Long USD is best expressed for us through SGD and THB, while we continue to be underweight on duration in Malaysia and the Philippines. We are also holding on to our relative value trades of receiving Singapore rates versus the US, and paying the belly of a Thai 2Y/5Y/10Y fly.
- We recommend an overall neutral exposure to Asia credit on the balance of strong market technicals that look increasingly overstretched to us and still heightened near-term macro-economic and political risks. We recommend buying PHILIP 5Y CDS vs. MALAY while selling CHINA 5Y CDS vs. KOREA. We see more value in the longer end of INDON curve as 10Y30Y slope is now too steep, but as sovereign cash valuations become too rich we prefer an exposure to Indonesia's quasi-sovereign credit in the longer duration bucket. We recommend entering a curve-steepening trade in Philippines (21s vs. 32s).

Local Markets

CHINA

- FX: Long 1Y USD/CNH straddle
- Rates: Pay 2Y/5Y repo IRS, target +45bp

Biased towards steepening. In the near term we expect liquidity conditions to remain stable due to favorable seasonal factors, and because the risk of negative transmission from RMB FX market to interbank liquidity is low. After the fairly volatile sessions in the FX market over the past few weeks, we expect a period of consolidation and USDCNY spot to fluctuate in a relatively narrow range till the end of Q1.The main risk at this stage is for potential capital outflows, and to effectively break the transmission from the same to domestic liquidity, we believe it would be prudent for the central bank to temporarily allow for a sufficient liquidity buffer. Note that onshore USD rates have stayed rather stable, for instance, 3M USD rate at 3.1% is 40bp below where it was in early February. Towards the end of March, quarter end demand for funds will likely bring interbank liquidity to what we believe is a normal range –overnight repo within 3-3.5% and 7D repo at between 4-4.5%. We think both liquidity renormalization and upside risks to long term rates support the steepening trend of the Repo IRS curve. We continue to hold our 2Y/5Y repo IRS steepeners (entry 15bp, target 45bp), and recommended on Feb 28th to use the temporarily stable liquidity to enter 1Y/5Y spread tactically.

HONG KONG

- FX: Neutral
- Rates: Pay 5Y/10Y Hi-Li steepener, target 15bp

Looking wobbly. Following the recent policy-driven RMB weakness, the worry of possible trust defaults and the slowdown in China growth has resulted in USD/HKD moving away from the bottom of the trading band. In our view, the transmission of weaker Chinese growth to Hong Kong will happen via two channels: (1) trade and (2) investment. On the former, although external data has not shown any sign of notable weakness, given China is the largest trade partner with Hong Kong, we are concerned that any worse-than-expected development in China would negatively affect Hong Kong's exports and domestic demand this year. In addition, a China slowdown will also result in further liquidation of positioning in HK in both the equity and property market. YTD the Hang Seng has been one of the worst performers in the Asia region, while the

 Deutsche Bank Securities Inc.

housing price index has recently been showing signs of declining. In our view, any worsening in China is likely to increase investors' anxiety about a much quicker contraction in Hong Kong property prices, which would be negative for the HKD. As such, until we see China's growth stabilizing, the risk for USD/HKD remains on the upside.

INDIA

- FX: Short USD/INR via 62 put with RKO at 57
- Rates: Long 5-7Y IGBs

Narrowing window for rates to perform. We have been constructive on India since late last year, arguing that the improvement in external accounts, the adjustment in valuation, the success of RBI policy, and the scope for portfolio inflows to rebuild, would all help INR distance itself from the "fragile" club. Indeed, the currency did distinguish itself through both the second round of concerns about Fed taper late last year, and then during EM's own hiccup from early part of 2014. A mix of largely positive data releases in the past few days (including Q4 CAD and Feb PMI), and the announcement of election dates, seem to have galvanized a breakout lower on spot, against a global backdrop of low vol across asset classes and return to carry as the favored thematic for markets. There are the obvious immediate concerns at these levels, including about repayment of oil swaps, reduction in gold import taxes, and dollar buying by the central bank to rebuild currency reserves. We remain as before less concerned than market consensus on all these issues. We believe almost all of the $10-12bn payables for oil companies have already been bought back. While gold imports will likely be relaxed at some stage, it is not clear to us that there is as yet consensus within officials (note recent comments from the Finance Minister, and the Chairman of the PM Economic Advisory Council) about the shape and quantum of the relaxation. In any case, we don't see this as particularly threatening to an outlook of a more financeable current account gap. Again, while RBI should at some stage start to rebuild its reserves, it's not obvious that they would either draw a line in the sand in doing so, or even lean particularly strongly against the wind. While the currency has performed, Indian debt has disappointed. Inflation we think has peaked, and we continue to believe that RBI's new policy framework will ultimately yield lower inflation and fiscal risk premia. But this intended shift in policy comes at a tough part of the economic cycle, and it's not clear how the tussle between developing credibility in fighting inflation, and supporting growth, will pan out. DB Economics remains of the opinion that the clamor for policy easing will grow in H2, and that should be supportive of fixed income. More immediately though, the threat of new supply in April, and as we enter the actual polling period, limits the window for rates to perform.

INDONESIA

- FX: Neutral
- Rates: Modest underweight

Last year's problem child becomes this year's star. IDR has been the best performing EM currency this year. Perceptions of external adjustment, more appealing valuations and a pile back into carry assets have underpinned gains. The large part of fundamental returns to these three drivers may however now be behind us. First, trade numbers have begun to deteriorate again as the flattering Q4 effect of mineral ore export front-loading drop out. Sustaining trade improvement will rely much more heavily on import compression, given a commodity-centric export basket. Second, the valuations case is more divided. After a 7% move in the currency, IDR is now looking much more fairly valued on a relative PPP basis. Bank Indonesia has also vocalized its intent to rebuild reserves, suggesting IDR may now be more fairly valued from authorities' perspective. The currency remains very undervalued on our BEER model, but is equally overvalued on our FEER framework. Third, investors are no longer as underweight Indonesian assets - if at all – as they were at the start of the year. While we do not find the fundamentals for the currency to be as compelling, there is a case to be made for remaining tactically constructive as election pre-positioning bolsters equity inflows and the continued appeal of carry sponsors debt flows. There is thus scope for a retest of October's 11,000 lows in spot, even if the fundamental case is no longer so inviting.

MALAYSIA

- FX: Short SGD/MYR, target 2.5
- Rates: Modest underweight

Upside risk to rates remain. Data released over the last month in Malaysia supports our economists' view of sustained modest improvement in growth going forward. Indeed, BNM noted in its most recent MPC statement that it expects further improvement in exports and continued expansion in private sector investment spending. Meanwhile, inflation is picking up too, primarily due to the fiscal consolidation efforts of the government. Real policy rates are now negative for a third consecutive month. Unsurprisingly, comparison of the last two MPC statements suggests that BNM has changed its tone on the inflation front to a slightly hawkish side. We note that the last time real policy rates went to negative 47bp in April-11, BNM hiked the OPR by 25bp in the following meeting. Whether the BNM acts again soon, especially with growth momentum too picking up, remains to be seen. But, in the meanwhile, market is likely to continue to price in rate hike expectations, thus keeping the upward pressure on rates. Bond market technicals too remain

mixed. Supply side of the equation will see an improvement, as we get a large MYR16bn of MGS redemption on 30-April. But the demand deficit remains a concern. Onshore real money – both pension and lifers – have been diversifying out of government bonds. EPF is seen to get interested only on considerable back up in yields. The demand gap is therefore acutely dependent on inflows from foreigners, which remains vulnerable to shifts in allocation out of EM debt as an asset class. Indeed, positioning is still a drag and limits the scope for sustained relief rallies. Moreover, with rising inflation, negative real policy rates, and rate hike concerns, foreigners are likely to remain on the sidelines. Against this backdrop, we maintain our modest underweight outlook on duration.

PHILIPPINES

- FX: Moderately bearish
- Rates: Modest underweight

Liquidity back in the driving seat, for now. Philippines local markets remain a tug of war between the overwhelmingly positive domestic liquidity technicals (supported by a robust current account surplus) and what we consider more alarming inflation fundamentals. Indeed, BSP itself has now on more than one occasion admitted to a narrowing window to keep policy rates steady. What we worry about though is the traction policy will be able to achieve when it does eventually get into tightening mode, given the wedge driven by abundant liquidity placed in the SDA window. The central bank's attempt to drive down the scale of that liquidity surplus has only been partly effective, with the outstanding still at close to P1.4tn, though now in large proportion routed via bank time deposits and UITFs instead of investment management accounts. BSP will have no choice but to increase the SDA price point when it wants to tighten policy, but will be accordingly faced with a higher interest and reserve cost on its balance sheet. It meanwhile remains confident that inflation pressures are mostly supply side in nature, and can be tackled without the need for policy tightening. On our recent visit to Manila, however, even anecdotal evidence like the truckers' strike, and proposals to restrict school weeks to 4 days to manage the traffic burden in parts of the city, were partly signs that the economy is indeed running beyond capacity. And while there are attempts underway to increase productive capacity over the medium term, we worry about the risk of more significant inflation upside in the interim. For now, liquidity is back in the driving seat, forcing bull steepening in the curve as the market scrambles to deploy cash for pick up in yield without risking excessive duration exposure. We stay with a small underweight on duration, and biased to look for renewed weakness in the peso though possibly only when there is a clearer dollar trend.

SINGAPORE

- FX: Long USD/SGD, target 1.32
- Rates: Receive 2Y3Y versus US, target +75bp. Long 10Y SGS versus 5Y swaps, target -60bp

MAS to tread water on policy. MAS will hold its semi-annual policy review next month, where we expect it to maintain its current bias of a 2% crawl to the S$NEER with no change to bandwidth or midpoint. On the surface, certain data points might appear to support an easing bias. Headline inflation has fallen sharply to 1.4%, imported price pressures are subdued, and the recovery in exports has been very disappointing thus far. But we think MAS should look past this. The headline drop in inflation is mostly on account of administrative COE prices, while MAS focuses more on core inflation which has been inching above 2%. The central bank is also likely to keep faith in the G2 recovery. With Singapore's Q4 2013 GDP surprising above expectations, and a tight labor market driving wage pressures, MAS will not ease. The case for tightening also looks very slim. Historically, MAS has only run a 3% appreciation bias against a backdrop of sharply rising commodity prices (2008 and 2010-11). This year, MAS is itself expecting commodity disinflation. MAS has now left policy unchanged for the last three meetings. If it repeats this next month, it will be its longest stretch on hold since the pre-2008 crisis period. We may well be returning to the pre-crisis regime where policy was kept very stable for a long period of time (2004-07) with MAS policy volatility no longer a driver of the SGD. Separately, it is notable that SGD NEER is trading at the mid-band at a time when a continued appreciation bias is likely. SGD NEER has bounced off the mid-band four times in the last one year alone. The last two times it broke into the bottom band occurred during times of sharp global sell-off (August 2008, Sept 2011) with MAS easing at the following meeting. Barring an extreme risk-off event in the near-term, SGD NEER is biased to trade stronger into the meeting. With MAS unlikely to ease and SGD NEER already at the mid-band, the burden of performance for our structural long USD/SGD trade rests on the broader USD strengthening against Singapore's trading partners in the coming months.

SOUTH KOREA

- FX: Neutral
- Rates: Pay 5Y5Y IRS at below 3.50%

Pricing out the bull factors. We believe the recent bullish factors have already been priced in and hence the scope of a rally is quite limited. The risk to KTB yields and KRW IRS rates is more skewed towards the upside in our view. Hence, we maintain our view of paying on dips for the KRW5Y5Y at below 3.50%. The KTB yields and KRW IRS rates have traded in a tight

range. Despite the backup in UST yields, a few bullish factors – fear of supply concession, hope of a dovish BOK, and external risk aversion factors such as Ukraine and concerns about the slowdown in China – have mitigated the upward pressure on KTB yields. Moreover, a muted inflation rate of +1.0% YOY in February also cast doubt on the prospect of rising inflation this year. Nonetheless, we believe the market will likely price out the bullish factors gradually after the Congress hearing for the new BOK governor (Mr. Lee Juyeol) on 19 March. However, we expect the correction to be gradual. The recent correction triggered by offshore liquidation in KTB futures due to the appointment of the new BOK governor, who is less dovish than other contenders, was milder than anticipated. Note that strong foreign KTB futures buying in the past two months had also failed to break through the supporting line, demonstrating that the current trade range has held strongly.

TAIWAN

- FX: Long USD/TWD 6M NDF, target 31.5
- Rates: Pay 2Y/5Y steepeners, target 45bp

Weakness to persist. Despite the recent improvement in data and equity inflows, TWD performance remains lackluster. This, in our view, is a function of: (1) the authorities' preference for a weaker currency policy due to global concerns, and (2) ongoing diversification by domestic residents. On the first factor, despite the rebound in data (exports and 4Q GDP), policymakers remain somewhat cautious about global recovery. In a recent speech by the CBC governor to the Legislative Yuan, the governor stated that: (1) Fed tapering, (2) a slowdown in the Mainland economy, and (3) weakening export momentum driven by slower import demand from advanced economies, are concerns the central bank is watching carefully. In addition, with China undertaking economic reforms, we believe Taiwan is likely to gain the least among its Asian peers. For example, as China gradually reforms, it is demanding fewer Taiwanese products, driven by the fact that Chinese corporates are integrating manufacturing internally in China. As a result, export volume has been declining. This phenomenon is also something the CBC governor talked about in his recent speech to the Legislative Yuan. As such, the CBC is likely to keep monetary policy loose and limit TWD strength until the global and domestic environment improves. Second, as we have highlighted in the past, given the strong RMB appreciation expectation and the attractive yields RMB deposits offer, domestics are converting more of their deposits into RMB. Over the course of 2013, the total value of RMB deposits increased remarkably, from $4bn to $30bn. This is the result not just of domestic savers diversifying overseas but also of domestic Lifers, who have been actively diversifying too. All in all, we expect the TWD to weaken this year.

THAILAND

- FX: Long USD/THB, target 34
- Rates: Pay belly of the 2Y/5Y/10Y fly, target +50bp

Outlook dependent on the political situation. Latest trade data for January disappointed, with exports contracting more than market expectations, indicating that economy's soft patch continues. Our economists, however, argue that a sharp rebound could be in store if the political situation gets close to a resolution. Indeed, BoT noted in its latest MPC statement following a 25bp cut that political uncertainties would continue to impede the recovery of private consumption and investment. Nonetheless, exports of goods should gradually improve on the back of a recovery in major economies, providing impetus to growth this year. Our economists now expect the BoT to remain on sideline for the rest of the year, with no room available for further rate cuts. Against this backdrop, we continue to recommend paying the belly of a 2Y/5Y/10Y butterfly to trade the dislocations in the curve. Current levels are attractive, as 5Y/10Y part of the swap curve is trading near historical highs, while 2Y/5Y on the other hand underperformed and has potential to steepen further. A long run history also indicates that this fly tends to push higher when BoT stays on hold after the rate cut cycle. Finally, the fly is also very directional to 10Y US yields, and thus stands to benefit from rising US rates over the medium to long-term. Meanwhile, ThaiGBs are likely to remain supported on back of weak domestic back-drop, positive technicals and compelling valuations. Indeed, Thai bond curve is the steepest in the region, judging by the current 2Y/5Y slope against the long run average. We thus stick with our 5Y swap spread widener, with the spread still hovering near multi-year lows and have a plenty of room to widen especially in the environment of rising US yields. We also stay long USD/THB and look for a grind higher, keeping a stop-loss at 32.

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Credit

INDONESIA

- Remain neutral
- We consider 10Y30Y cash slope too steep due to front-end outperforming. The value in the curve has shifted to the longer end, but overall INDON valuations become increasingly overstretched vs. underling fundamental risks;
- We see more value in quasi-sovereign bonds in the longer end of INDON curve where investors would get better risk/reward compensation. Sell INDON '43 vs. Buy PERTIJ '43 and Sell INDON '42 vs. Buy PLNIJ '42;

INDON 5Y CDS is reaching the point of being oversold, in our view. We closed our Sell recommendation on INDON 5Y CDS on 18-Feb-14 at 205bp. Currently, it trades ~185bp. We would be inclined to recommend buying INDON protection should the spreads break through ~180bp. We note that the relative weakness in CDS for such EM peers as Turkey and Russia has its country-specific reasons; hence their underperformance vs. INDON of late. We also believe that the assumption for INDON CDS to converge with that of Brazil appears to be overstretched for now, given the 1-2 notch ratings differential and the risks mentioned below. Our economics team remains quite bearish on Indonesia's near-term economic prospects and, aside from a turmoil-gripped Thailand, views it as the only Asian economy with a declining GDP growth this year. Considering the outstanding rally that sovereign and quasi-sovereign paper from Indonesia has demonstrated in past couple of weeks, the valuations appear to be more exposed to the potential downside risks should the political and macro stories get off-track of investor expectations (i.e. Jokowi becoming a President elect). We also believe Indonesia may surprise us on a downside with weaker than expected CAD data throughout 1H14 given the recent ore export ban in the country, which could potentially put additional pressure on the recently stabilised currency.

PHILIPPINES

- Stay neutral
- Recommend tactical curve steepening trade by switching out of the long end (e.g. PHILIP '32) into the belly (e.g. PHILIP '21) as we expect the long end to underperform;
- We continue to see more value in quasi-sovereign space on the shorter end of the curve: Buy PSALM '19 vs. Sell PHILIP 8.375% '19;

We remain of the opinion that a gradual improvement in Asian economies will be more pronounced only in 2H14, especially in Indonesia, India, Philippines and Korea. The curves of the latter two countries have continued to experience very strong technical support with PHILIP spreads trading by far beyond its ratings context, in our view. The strength of PHILIP spreads could be soon tested with growing pressure on the country's trade balance following the discrepancies in the official export-import data released earlier this week, which if proved wrong could potentially halve the country's ~5% CA surplus. With fiscal deficit also remaining at 2% level we expect Philippines to resort to external market borrowings at some point this year.

PHILIP cash curve: together with our Global EM strategists, we note that the curve now is abnormally flat vs. its historic trends and wider EM peers. We believe that the spread differential between PSALM '19 (Buy) and PHILIP 8.375% '19 (Sell) remains attractive hence we maintain this switch idea. In line with our EM strategists, we agree that at this junction a duration shortening makes sense and recommend switching from PHILIP '32 into PHILIP '21 as we expect the former to underperform.

SRI LANKA

- Introduce our neutral view;
- Credit spreads have compressed too much, increasing the downside risks for valuations should concerns over global EM come back to investors' agenda in near term;
- We also expect the sovereign to return to USD debt market as current valuations are conducive of new issuance and we view the sovereign in need of external borrowings;

Sri Lanka has become the latest HY darling of the market with credit spreads across its curve tightening by ~85bp on average in the past month alone. At the same time, we believe that its economic performance is still exposed to the series of risks, namely: 1) monetary policy remains too accommodative raising concerns of overheating as our economics team estimates that the current policy rate at 8% is 100bps lower than where it should be; 2) rapid increase in ST external debt; 3) these two factors in turn pose risks to exchange rate stability.

TACTICAL RV CDS IDEAS

- Buy PHILIP 5Y CDS vs. Sell MALAY 5Y CDS. We consider PHILIP CDS trading too rich to its rating and be under pressure of the narrowing CA surplus and potential new issuance. We

would be the outright Buyers of PHILIP 5Y at ~106bp or vs. MALAYS 5Y CDS as we believe the former will decouple from MALAY CDS more prominently. We expect more positive economic data from Malaysia and Malay CDS trending closer to the levels of Mexico 5Y CDS. We remain of the opinion that this year Fitch will remove its Negative outlook on Malaysia's ratings, while Philippines will skip their "annual" upgrade by Moody's. Our FV target for PHILIP 5Y CDS is ~125bp.

– Sell CHINA 5Y CDS and Buy KOREA 5Y CDS as the pair still is trading ~30bp apart and we think China CDS remains undervalued. Our trade recommendation is mainly driven by the recent widening of China CDS spreads, which we believe was overdone. The markets over-reacted severely to the news of a potential Trust Financing Product default following the weak PMI data. With a Trust Product default risk now behind us (although we do believe it was handled as a quick fix and still needs a long term resolution) and primary supply taking a breather, we think China CDS spread is bound to contract. We believe the pair should reach ~15bp spread differential. At that point, we will reassess risk/reward and expectation of rising new supply pressure from the quasi-sovereigns in both countries.

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EMEA Strategy

- In FX, we stay long PLN, and also stay positioned for ZAR outperformance vs TRY in an attempt to capture moderation in the USD/ZAR vs USD/TRY correlation in an environment increasingly driven by country specific factors (TRY) and less dominated by 'global beta' (ZAR). Elsewhere we see value in tactical longs in HUF vs EUR at current levels.
- In rates, we recommend keeping the 1s5s flattener in ILS. In Hungary we stay received in 6x9, but lock in profit by moving the stop to 3.40. We also keep the 1s5s steepener of the XCCY curve in Turkey, target flat, stop @ -110. Finally we recommend a 2s10s steepener in SA, targeting 170bps, stop @ 130bps.
- In credit, we recommend staying underweight in Russia, Turkey, and Ukraine, while moving Poland back to overweight. We keep long 5Y CDS in Russia, hold 10s30s cash curve steepeners in Turkey (22Ns vs. 41s) and South Africa (25s vs. 41s), switch from the 19s to 22s in Poland. Meanwhile, we recommend taking profit in 2s5s CDS curve steepeners in Turkey, cash curve steepeners (22s vs. 42s) in Russia, and Sberbank 22s vs. Russia 22s.

Local Markets

HUNGARY

- Go short EUR/HUF, target 302, with stop @ 316.50.
- Stay received in 6x9, keep target at 3.00 but move the stop loss down to 3.40 and lock in ~15bps of profit. For those interested in positioning for a tail risk event, a 2s5s flattener strikes us as good risk reward.

FX: We recommend tactical longs in HUF at current levels. EUR/HUF is currently towards the upper end of the trend channel for the past 6 months. The pair is overbought on our 'financial fair-value metrics'. Positioning is bearish (see latest dbSelect), and there is clear evidence of improvement in the domestic economy (unemployment rate at a 5y low, retail sales YoY close to highs from 2006, industrial production on a steady trend higher, trade balance firmly in surplus, etc). Also, the fact that core CPI now seems to decelerate as well (declined to 2.8% YoY in Feb from 3.4% in Jan), after having been sticky around 3.5% YoY over the past 4-5 months, provides the NBH with some lagged justification for having reduced rates further at the last couple of meetings, and should hence alleviate some of the concerns in the market about the NBH's commitment to rein in inflation. Go short EUR/HUF, target 302, with stop @ 316.5.

Rates: Following another weak inflation release further easing at the next NBH meeting (March 25th) is likely: DB Economics forecasts a 10bp cut taking base rates to 2.60%. Last EMM we recommended receiving the 6x9 FRA at 3.53 with an initial target of 3.00. We like staying in the trade and keep our target at 3.00 but move our stop down to 3.40 and thereby lock in ~15bp of profit. Inflation is likely to remain subdued in the months ahead due to the third round of utility price cuts announced in January (which take place in April, September and October). At this stage we think it is more likely that external risks (such as an escalation of political problems in Ukraine) and the ensuing FX depreciation is most likely to halt NBH's easing. As a reminder, we think that at levels around 325 in EUR/HUF is where NBH would become uncomfortable in continuing cutting rates. For those interested in positioning for a tail risk scenario, a flattener in 2s5s in IRS, which is close to its steepest since Jan 2000 stands out.

ISRAEL

- Keep 1s5s flattener. Target 115, stop at 145.

Rates: Despite BoI's consensus defying rate reduction, our recommendation to position for a 1s5s flattener has barely moved over the last month. The basic economic picture in Israel remains broadly unchanged over the last month. The Bank has noted some improvement in the high frequency indicators since January and house prices have continued to rise notably. Given the limited apparent effect of recent monetary easing on stemming currency appreciation pressure, we believe it is unlikely the BoI will cut rates yet again, although don't rule it out. We stick with our 1s5s flattener - target 115, stop at 145.

POLAND

- Currently we are close to the upper end of the 4.25-4.15 range, go short (4.23), targeting 4.1250, with a stop @ 4.27.
- Long Oct 17s vs Pay 10Y. Entry at 65bps, target 90bps and stop 50bps.

FX: Recent data has confirmed the upbeat trend in CEE, and in Poland in particular, with stronger than expected industrial output and retail sales. The improved industrial cycle is reflecting Poland's improved competitiveness over the past few years, something which now, and as external demand is returning, is reflected in hard economic data. The trend in retail

sales is in turn a sign that an export-led recovery is slowly translating into stronger domestic growth dynamics. While low spot inflation means the NBP will be in no hurry to hike rates, eventually the economic upturn is likely to translate into policy normalisation ahead of any of the major central banks, reflecting the limited output gap, as well as the relatively sound banking system, which means domestic credit growth is likely to continue to pick up in response to stronger demand. Longer-term FX valuation metrics continue to be consistent with a 'fair-value' around 3.80, suggesting that in an environment of stronger demand, the Bank is unlikely to be sensitive to zloty appreciation. Currently we are close to the upper end of the 4.25-4.15 range, go short (4.23), targeting 4.1250, with a stop @ 4.27. More medium-term, look for a gradual drift lower to 3.90 in EUR/PLN by the end of the year.

Rates: The market continues to price a very moderate hiking cycle - implying on ½ 25bp hikes priced in for 2014. As highlighted in recent months, we think this is at odds with strong German demand and the fact that domestic credit growth is grinding higher. Inflation dynamics, however, continue to undermine paid positions in the front end: NBP forecasts do not expect inflation to reach target for 2H '15. In the context of NBP extending forward guidance until 3Q-14, we do not recommend paying short end rates at this juncture - even if it is a trade we like from a fundamental perspective. The real-rate focused NBP are unlikely to be comfortable with any signs of a rise in inflation - we think this forms the clearest trigger for paying front end rates in PLN. As an aside, we think that asset swaps in the belly of the curve look wide (bonds cheap) and 5s10s looks to flat relative to recent history. We like combining these views by being long Oct 17s vs being paid in 10Y swaps. Entry at 65bps, target recent highs near 90ps and keep a stop at 50bps.

RUSSIA

- A 3m one-touch USD/RUB put, with a barrier @ 33.75 costs an indicative 5.5% of USD notional, a pay-out ratio of 18/1.
- Stay paid in 1Y xccy.

FX: We broadly agree with the CBR's assessment that there are no fundamental factors that could prompt further ruble weakness, with our estimates showing that the ruble is undervalued, in particular given the improving Terms of Trade & stabilisation in the current account, but also supported by the CBR returning real rates to positive territory, and positioning which remains very bearish. Against that heightened tensions on the Crimea peninsula will continue to underpin capital flight and weigh on growth and investments, thus suggesting near-term risks remain skewed to the down side for the ruble. However, on balance at these levels we prefer to position for retracement at some point over the next few months when/if the political tensions subside, rather than chasing the move higher in RUB. A 3m one-touch USD/RUB put, with a barrier @ 33.75 costs an indicative 5.5% of USD notional, a pay-out ratio of 18/1.

Rates: Last month we recommended paying the 1Y XCCY at 7.1%. Looking ahead, we prefer to keep a paid/short bias in RUB rates. The recent actions (rate hikes and interventions) underlined that the CBR is willing to do whatever it takes to protect the currency, at the inevitable expense of rates and bonds. We consider the first hike (+150bps) as sufficient to address both the lingering inflationary risk and the higher real rates for EM assets demanded by global investors. We stick with our bearish/paid bias in RUB rates. Further policy rate hikes can't be ruled out given that the CBR might want to support the ruble whilst minimising the drainage of reserves. Moreover, elevated political risks in Crimea might warrant even higher real rates from the Russian authorities than is available in other liquid EM markets. We continue liking payers in the 1y part of the curve to express this view.

SOUTH AFRICA

- Go/stay short TRY/ZAR for an extended move lower towards the 4.70 lows from January.
- 2s10s steepener. Entry at 143, target 170bps and keep a stop at 130bps.

FX: Our expectation for a continued, marked improvement in the C/A deficit is the key reason why we see scope for ZAR to outperform peer currencies from current levels. The improvement in the C/A balance is reflecting primarily an improvement in the trade balance, with exports continuing to pick up, but with a pull-back in capital equipment imports as well as in more price sensitive imports expected to contribute to an improving goods balance. Back in 2008-2011 the rand appreciated by more than 30% when the C/A balance flipped from a deficit of around 8% to a mere 1%-of-GDP ratio in early 2011. With domestic demand unlikely to collapse to the same extent as in 2008/2009, we do not anticipate a similar contraction in the C/A deficit, but DB Economics is still forecasting a reduction of the C/A deficit to around 4% of GDP by the end of 2014. Combined with generally attractive valuations (as per our PPP and BEER models) and bearish positioning, we believe this will be worth 10.25 in USD/ZAR over the next 3-6 months. Go/stay short TRY/ZAR for an extended move lower towards the 4.70 lows from January.

Rates: Last month, we recommended receiving 6x9 vs paying 1x4 for two main reasons. Firstly, we believed that market pricing at that time (a further 250bps of hikes) was too aggressive relative to what the SARB

were likely to deliver. Secondly, we were constructive on the ZAR from a valuation perspective. The trade hit our recommended target of 80bp now trading at 75bp. The recent improvement in the CA deficit (ZAR179bn, vs consensus of ZAR193bn) was encouraging because the trade balance improved markedly: stemming from a strong contraction in imports, whilst exports continued to grow. Looking ahead, DB Economics expect a further marked improvement in the C/A deficit over the next 12 months, a development we expect to drive ZAR outperformance vs peer currencies from current levels. We therefore maintain our constructive take on the short end but prefer expressing this through a 2s10s steepener to protect us against an aggressive sell off in US rates. Enter at 143, target 170bps and keep a stop at 130bps.

TURKEY

- We are short TRY/ZAR through a 6m dual digital 4% OTM USD/TRY call / ATMS USD/ZAR put from the Feb 13th EM Monthly (cost was 13.5% of notional). In spot, look for TRY/ZAR to extend lower towards the 4.70 lows in January.
- Keep 1s5s steepener. Target 0, stop at -110.

FX: TRY is undervalued on most of our metrics, carry is attractive, a moderation in credit growth and past currency weakness are now leading to an improvement in Turkey's external balances and positioning is bearish. Against all that political risk is likely to persist going into and during the end-of-March regional elections. While it is not so much the actual election outcome that is in doubt, the AKP looks certain to win, it remains uncertain what would constitute a market friendly outcome. If Erdogan wins Ankara and Istanbul will that result in some stabilisation, or growing polarization? If Erdogan wins, but not by much, will the response be a more autocratic rule, or will that 'guide' Erdogan towards a more conciliatory approach? We are short TRY/ZAR through a 6m dual digital 4% OTM USD/TRY call / ATMS USD/ZAR put from the Feb 13th EM Monthly (cost was 13.5% of notional). In spot, look for TRY/ZAR to extend lower towards the 4.70 lows in January.

Rates: The spread between the weighted average funding costs (currently around 10.2%) and the 1Y XCCY (around 12% at time of writing) implies roughly around 180bps of further tightening from the CBT over the next year. We think this looks excessive even in the context of inflation peaking in May (at below 9%) and strong US growth. Clearly, escalation in the current political problems and the resulting lira weakness might force the CBT to be even more aggressive than current pricing. Once the political uncertainty has settled, we like sticking with our recommendation to pay 1s5s in cross currency space. We widen the stop loss to -110 and keep the target to 0 (flat).

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Credit

RUSSIA

- Stay underweight, and keep long 5Y CDS.

The recent deterioration of Russia's fundamentals (driven by low investment levels and a diminished growth outlook on long-standing lack of reforms – both economic and institutional) has been masked by the sovereign's Russia's strong balance sheet. However, the direct military involvement in Ukraine has significantly changed the status quo, with sentiment decidedly biased to the downside for Russian assets. We recommended reducing exposure to underweight on March 3 (see *EM Daily*) immediately following its intervention in Crimea. The Russia constituent of the DB-EMSI index has underperformed the EM BBB average by more than 50bp since then, but we see further downside. In their special report "Russia: macro implications of increased geopolitical risks", our economists point out that increased political risks are likely to lead to a significant rise in capital outflows, adversely affecting the currency as well as the growth trajectory, most notably on the fixed investment side. In addition, potential escalation in the Ukraine situation will lead to more significant economic sanctions and increasing Russia isolation, adding to the already challenging economic problems and further damaging investors' sentiment towards Russia assets. A positive aspect to Russia eurobonds is from the technical side, with USD1.7bn repayment schedule in March, but this positive aspect is dominated by the severe geopolitical concerns at the moment. It is also perhaps negated by Tuesday's curiously timed announcement by the Finance Ministry that it had approached banks to organize a sale of foreign currency bonds.

We maintain our underweight recommendation even after the significant selloff during the past week, and we continue to recommend holding long 5Y CDS at the current level of 250bp (extend target to 275bp, reset stop at 230bp). In relative value, the cash curve has bear-steepened significantly, causing our recommendation of 22s vs. 42s to reach its target last week. Nevertheless, 10s30s in Russia remains flatter than the EM average but 5s10s has sharply steepened recently with 5Y bonds excessively expensive in our view. We hence favor 10Y bonds on the Russia curve. Finally, prospect of sanctions and their potential damages to Russian businesses and banks have caused quasi-sovereigns to generally underperform the

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sovereign curve, enabling us to take profit in our recommendation of switching from Sberbank 22s to Russia 22s.

UKRAINE

– Stay underweight.

In anticipating heightening volatility following the suspension of Russian aid we recommended reducing exposure to Ukraine to underweight from neutral in early February. While the escalation of the crisis validated our concerns and saw Ukraine's 5Y CDS widening further by almost 400bp, we see continued reasons for staying underweight. While the new government has gained strong support from the west (US and EU), both politically (directed towards an Association Agreement with the EU) and financially (with pledged support from EU and US, and an IMF package under discussion), the political situation is likely to remain highly volatile with the end game far from clear. We doubt that Russia will accept the status quo of the current political construction and will continue to seek to destabilize the situation until there is a government it can accept. The Crimean Referendum on annexing to Russia is scheduled to take place this coming weekend, providing a potential source for further conflict. The economy is on the verge of collapse as the country is facing a significant external liquidity crisis and in need of about $35bn[16] external financial assistance. On the positive side, western financial support appears to be forthcoming, with the EU having pledged USD15bn (conditional on an IMF program), the US having offered USD 1bn, and an IMF package being worked out. However, both initiation and continuation of these financial aids will depend on how the political (and geopolitical) situation evolves. There is also no guarantee that the new government has a strong enough popular mandate to carry through the necessary reforms.

As we analyze in the special report "Bailing out Ukraine", the case for an aggressive PSI is not compelling (and hence appears unlikely), but a “PSI-lite” exercise involving voluntary extension of maturity might be feasible and beneficial for Ukraine and for investors. Nevertheless, in our view, current market prices of Ukraine’s USD bonds (in the 80-90 range) - while perhaps fairly pricing a baseline scenario involving an IMF program and an order adjustment - do not sufficiently reflect the risk of a more disorderly scenario.

[16] This is our estimate of the size of assistance needed to cover the gap in the external accounts for the next two years and to replenish reserves to an adequate level. See the special report “Bailing Out Ukraine”.

TURKEY

– Stay underweight, hold 10s30s cash curve steepener

Turkish credit has recovered somewhat relative to the EM investment grade average since the CBT's emergency hike at the end of January, but we see reasons to maintain underweight at this juncture given the proximate political risk. The economy has shown some resilience in the face of political turbulence, weaker capital flows, and higher interest rates, and the lira has stabilized since the CBT policy correction, but the overall political environment remains toxic as the situation surrounding the clashes between PM Erdogan and the Gulen movement remains volatile ahead of the local election scheduled at the end of this month and likely also through to Presidential elections later this summer. It is possible that Moody's or Fitch could lower their outlook on the sovereign’s credit quality in April, though a rating downgrade looks less likely. In addition, Turkey will likely be among the first EM credits to suffer if stronger US data prompts markets to price earlier rate hikes by the Fed, the risk of which has risen recently.

On the bond curve, we recommend taking profit in 2s5s CDS curve steepener, which is close to target after about 20bp steepening since last summer, but we hold 10s30s cash curve steepener (22Ns vs. 41s) as Turkey remains one of the flatter curves in EM even after the recent steepening. Finally, the shorter end of the cash curve has substantially steepened – a correction move in our view, removing some of the excessive cheapness in short-duration bonds on the curve. CDS/bond basis also widened recently though remains tight in comparison with rest of EM.

POLAND

– Move to overweight. Switch from the 19s to 22s

Poland had its long-standing outperformance snapped last month, widening by about 15bp from the lows relative to the EM investment grade average. This was likely a reflection of the general weakening of EMEA credits relative to their LatAm and Asian counterparts on closer contagion from the Russia/Ukraine situation. At -85bp to EM investment grade average, valuation of Polish bonds does not look very attractive within an EM portfolio, but the recent underperformance nevertheless represents an improvement in valuation. In addition, Poland’s credit spreads remain slightly cheap in comparison with the developed market.

Fundamentals remain strong, with continued growth recovery on the back of improving domestic demand and subdued inflation and inflation expectations. Our economists believe Poland’s economic exposure to the

Ukraine is limited despite its geographical and geo-political link to the country. Technicals are also supportive, with the bulk of external issuances fulfilled (almost USD5bn bonds sold), and USD3.5bn principal and interest scheduled to be repaid during the remainder of the year (including USD1bn in March).

We therefore recommend moving Poland (as a "good EM") back to overweight to partially balance our underweight recommendations on Russia, Turkey, and Ukraine in the EMEA part of the portfolio. We had previously reduced it to neutral from overweight in our January Monthly mostly on valuation ground.

On the bond curve, the 19s look expensive and 22s cheap, and generally speaking that section of the curve is at its steepest in more than a year. We recommend switching from the 19s to the 22s (entry: 40bp, target: 20bp; stop: 50bp).

HUNGARY

- Neutral

Hungary's extended rally relative to the rest of EM (200bp in spread terms over the past year) came to an end earlier in 2014 and we see the risk-return profile becoming asymmetric, biased towards the downside going forward. Hungary's cash bonds spreads have corrected by about 20bp relative to the overall benchmark since early February. We cut our recommendation to neutral from overweight in early February (see our 4-Feb-14 EM Sovereign Credit Weekly) and maintain this position. There have been positive developments - the forint has been relatively stable recently, both fiscal and current account are in surplus and look fairly stable, FX liabilities have been gradually reduced. However, market participants are increasingly focusing on policy credibility, which is not a strong suit for the ruling Fidesz party, which is set to be re-elected on April 6. Absent an intense pressure on the forint, the NBH is continuing to push the limits of loose monetary policy, even with real rates at very low levels (negative if measured using core inflation). After the election, Fidesz may be tempted to change the constitution, especially if it gains a two-thirds majority in the parliament. Hungary also still has plans to issue on the eurobond market this year (USD4.5bn projected, vs. USD3.5bn total repayment during the remainder of the year).

SOUTH AFRICA

- Neutral. Hold cash curve steepener of 25s vs. 41s.

South Africa has outperformed EM investment grade average by almost 30bp over the past couple of months, with its economic data having surprised moderately on the positive side, especially in its CA deficit which has narrowed to below 5% on improving trade deficit. Our economist's views on both CA (-4%) and growth (2.9%) for this year are stronger than the consensus. In addition, the central bank has continued to be credible, which is important as the market is paying much greater attention to policy gaps. The rand, which is now among the most undervalued currencies in EM has strengthened since the end of January following the 50bp rate hike. This alleviates the need for future hikes. South Africa's 2014 budget announced at the end of February also looked credible with some moderate fiscal tightening, a commendable move given that it is an election year.

On the negative side, wage strikes continued with negotiations breaking down and sporadic violence, but 2012-like violence remains unlikely in our view. A ratings downgrade is likely this year (by S&P and/or Fitch) but will not come before June due to EU regulated rating change schedules. Inflation remains a concern, and the structural problems in the economy may take many years to solve. The elections are drawing near (in May) but they are likely more predictable and less disruptive than the ones in some other EM countries, such as Turkey. South Africa has yet to come to the market (we project USD 1.5bn issuance in Eurobonds in 2014).

Our constructive views above have been mostly reflected in the recent outperformance and so we retain a neutral view on the credit. On the bond curve, we hold a cash curve steepener via long 25s vs. 41s (current: 2bp; target: 20bp).

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LatAm Strategy

- **LatAm FX**: Buy INR/BRL (target 0.044). Buy zero cost 3M ATMS 1x2 puts spread struck at ATMS, premium neutral in both USD/MXN and USD/COP. Keep short USD/PEN (target 2.85).
- **Rates**: In Brazil, we favor DV01 neutral steepeners – Jul15/Jul16 FRA vs Jan 21, targeting 35bp and stopping at -70bp. In Chile, receive 1Y in UF vs pay 5Y CLP/CAM (target 600bp in spread, stop at 300bp) and receive 10Y CLP/CAM vs pay US in the 10Y sector (target 120bp in spread, stop at 300bp). In Colombia, buy TES20s (target 6% in yields, stop at 7%), and buy COLOM 27s vs TES 24s. (target -100bp in spread, stop at 75bp). In Mexico, receive 5Y5Y in TIIE versus 5Y5Y in US (swaps) – we target 380bp and would stop at 435bp. In MBONOS, buy Dec24s versus 16s and 36s on the fly (target 20bp in spread, stop at 60bp). In Peru, buy Aug20s (Sobs) vs US 10Y swaps (target 220bp in spread, stop at 360bp)
- **Credit**: Stay underweight Venezuela, overweight Colombia and marketweight the rest of LatAm credits. In Argentina, we favor the Pars in Argentina (switching from Global 17s to Pars) and look to enter long GDP Warrants on dip. In Venezuela, we recommend entering short basis (e.g. selling 5Y CDS vs. 24s) and hold long PDV 14s. In Mexico, we recommend switching from 19Ns to 22Ns and continue to favor Pemex 45s over UMS 45s. Finally, we hold long 5s10s CDS curve flatteners in Brazil.

Local Markets

BRAZIL

- FX: Buy INR/BRL (target 0.044 and stop at 0.037)
- Rates: Favor DV01 neutral steepeners – Jul15/Jul16 FRA vs Jan 21, targeting 35bp and stopping at -70bp. In the cash space the Jan17 seems cheap versus the Jan23s.

FX: The hawkish/fiscally responsible tone recently adopted by the local authorities led to a considerable retracement of the BRL, the best performer in the region last month. All that said, adverse effects caused by weather, exposure to China, high CAD and structural issues related to economic policy mismanagement persist, exposing the BRL to significant downside risk especially if data improves in the US. Yet, considerable reserve accumulation, FX carry and favorable valuation continue to cap the currency downside. In the near term we see the USD/BRL range bounding between 2.30 and 2.50. Despite the recent underperformance, we still like buying INR/BRL, targeting 0.044 and stopping at 0.037.

Rates: Despite the tightening of monetary policy and the promise of further fiscal adjustment, inflation persistently rises, leading to re-pricing of a more aggressive policy path. Front-end futures now suggest around 75bp of hikes before the election followed by another 200bp of hikes after the election, creating a "hump" around the 1Y1Y point. Besides being considerably higher than our forecast of the SELIC (11%), we believe that the priced pause in Q2 followed by the "re-start" of the cycle after the elections is a low probability event. Polls suggest that the current government will most likely remain in power, reducing the changes in post-election policy changes. Therefore, we expect the "hump" to correct and for the curve to continue to steepen on continued inflation concerns and re-pricing of US growth. Along these lines, we like receiving the Jul15/Jul16 FRA vs Jan21, targeting 35bp in spread (70bp in profit) and stopping at -70bp (30bp of loss). In the cash space, Jan 17 looks cheap both on the curve (vs Jan 23s) and versus swaps.

CHILE

- FX: Stay neutral CLP
- Rates: Receive 1Y in UF vs pay 5Y CLP/CAM (target 600bp in spread , stop at 300bp) receive 10Y CLP/CAM vs pay US in the 10Y sector (target 120bp in spread , stop at 300bp)

FX: It has been a rough year for the CLP, so far the main outperformer in LAFX. Despite being almost 10% undervalued versus financial drivers, lackluster of economic performance, decreasing rates differential and concerns about China's copper demand will probably continue to dent the performance of the peso going forward. Besides the extreme valuation, low implied volatilities, FX carry and cheapness of low strike skew all bode well for retracement trades, but before scaling into a long we would rather stay on the sidelines waiting for bouts of USD (or EUR) weakness or stabilization of copper prices.

Rates: Together with continued weakness in economic activity, concerns about China's growth increase, in our opinion, the probability of accommodation beyond what is currently being priced. The latter should

translate into further bull-steepening of the nominal curve given the BCCh's average response to overall economic weakness. Inflation pass-through has been relatively low but further weakness of the CLP could translate into wider breakevens especially in the front end. We keep our exposure to steepeners moving the currents 2s10s in CLP/CAM to hybrid real/nominal position: receive 1Y in UF vs pay 5Y in CLP/CAM. Further down the curve we keep our core box receivers vs the US (10Y) predicated on the current countercyclical nature of the economies. In the cash space, bonds have been outperforming swaps with the Jan-18s leading the pack on the belly of the curve – we believe that the bond is a bit on the rich side especially when compared to the Jan-20 or the Jun-17.

COLOMBIA

- FX: Range bound between 2050/00 – Buy zero cost 3M ATMS USD/COP puts 1x2s
- Rates: Buy TES20s (target 6% in yields, stop at 7%). Buy COLOMS 27s vs TES 24s.(target -100bp in spread, stop at 75bp)

FX: COP seems to have stabilized in a new range after a volatile beginning of the year. Given the bearish stance that the authorities have taken towards the peso, we expect this range-bound behavior to continue going forward despite the supportive valuation and higher oil prices. From the political side, the rise of the coalition's popularity (Santos' party) could in principle bring some volatility to the currency but we would expect such effect to be temporary. We see the currency trading in the 2050/00 range with vol decreasing. To lock that range, we would recommend buy zero cost 3M ATMS USD/COP puts 1x2s.

Rates: Low inflation and the current level of economic activity are still supportive of the current stance of monetary policy. With the beginning of the tightening cycle priced for mid-year, we believe that market implied expectations are in line with the fundamentals and that up to 2s the IBR curve is roughly fair. Further out, 2s10s looks steep versus 2s (but fair versus the US), while 5s look fairly expensive on the butterfly. In TES, receiving interest continues on Jun-16 (roll-capture), while belly and longer ends issues continue to look cheap on the curve and versus swaps (20s, 22s, 24s and 28s). Of those, the yield pickup on the 20s is the most attractive. The basis (vs swaps) bears some residual FX risk but stabilization of the COP should help the compression. In Globals, we believe that the COLOMS are cheap on a FX hedged base beyond the 21s. We also continue to believe that the COLOMS 27s are still cheap versus the 24s despite the recent move.

MEXICO

- FX: Buy 3M USD/MXN 1x2 puts spread struck at ATMS, premium neutral.
- Rates: Receive 5Y5Y in TIIE versus 5Y5Y in US (swaps) – we target 380bp and would stop at 435bp. For MBONOS, buy Dec24s versus 16s and 36s on the fly (target 20bp in spread stop at 60bp)

FX: For the MXN the song remains the same, with the currency range-bounding vs USD on the month and outperforming LatAm ex-Brazil. Overall supportive valuation (6.6%), spillovers from the US, favorable reforms backdrop and balanced CA continue to support MXN longs, while low FDI, weak activity with relatively high inflation are the main challenges to the currency. Altogether we believe that MXN will continue to trade better than its peers, eventually retracing on USD weakness and trading mostly range bound otherwise. Favorable strikes benefit 1x2s receiver spreads and outright USD/MXN puts with RKOs

Rates: In Mexico, the gap between front-end real rates and the "natural" fair level continues to support bear flatteners in the long run. Activity, however, remains subdued with prospective growth heavily dependent on the US. As a consequence the front end continues to be trapped in a range after the re-pricing of early hikes observed early in the year. On the curve slopes continue to grind lower as the term premium built during the "tapering days" continues to be slowly priced out. We keep our core positions in TIIE -2s10s flatteners and receive TIIE – pay US 5Y5Y box as we expect flattening to eventually resume as growth picks up in 2014. That said, continued weakness in activity might justify some retracement trades especially in cash which, differently from the previous sell-off, underperformed swaps especially in the belly end of the MBONOS curve. Dec 24 continues to look cheap versus surrounding issues (more specifically Dec 23) and versus TIIE, while in the front end the Jun17s and Nov36s look rich versus swaps – one could, for example, long the 24s vs 16s and 36s on the fly.

PERU

- FX: Short USD/PEN targeting 2.75, stopping at 2.82
- Rates: Buy Aug20s (Sobs) vs US 10Y swaps (target 220bp in spread, stop at 360bp)

FX: PEN continues to be rather stable despite market jitteriness. From the valuation perspective the currency is mildly cheap (around 2% vs the USD) and with the authorities happy with the current levels we expect PEN to continue to grind lower, being relatively immune to external shocks given the current policy of

currency management. From the BoP perspective, the rather wide CAD (5%) is safely covered by FDI, and should not pose a threat to PEN's stability.

Rates: The reduction political risk-premium that followed Peru's newly appointed cabinet members led to considerable bull-flattening of the back end of the Soberano's curve (beyond Feb 29s) with some bonds rallying as much as 20bp in the last two weeks. We continue to believe that long tenor forwards are high vs fundamentals and bonds beyond Aug20s – especially the Aug20s and Aug26s where the duration adjusted yield pick is higher – look attractive either outright or versus US swaps.

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Credit

ARGENTINA

- Stay neutral, favor Pars among global bonds (switching from the Global 17s to Pars) and look to enter long Warrants on dip.

The recent developments have been more encouraging in Argentina. The peso has stabilized to the 7.85 area, as the Central Bank hiked its reference rate by 900bp (although the real rate remains negative), eliminated reserve requirements on foreign investment, limited banks' ability to hold US dollars, reached a settlement with Repsol on YPF appropriation, and more importantly, the government has surprised the market with its new CPI release for January of 3.7% of GDP, much closer to reality. The adoption of the new CPI methodology was a critical development as it forces the government to finally accept a difficult inflationary situation and provides better instruments for individuals and corporation to minimally hedge against inflation through indexed assets, reducing demand for dollars.

These policy initiatives have apparently helped stabilize capital flows and slow down the pace of reserve depletion and fueled a strong rally of Argentina assets. Additional help on the balance of payment front could come in April as agriculture exports are expected to pick up, though it remains to be seen whether the current nominal equilibrium is good enough for exporters to be willing to sell their crops. However, policy responses have been inconsistent as overall policies have remained expansionary and the government has continued to resort to price controls to tame inflation. To that end, the risk of a disorderly currency adjustment still cannot be ruled out.

While the improvement on the policy front warrants a more positive view on the credit, the recent rally (e.g. +10pts in USD Discounts since beginning of February) and the pending pari-passu ruling, which could result in a technical default even in 2014, serve as counter balancing factors. We remain neutral.

Regarding Argentina's writ of certiorari with the US Supreme Court, we remain of the idea that the process is likely a protracted one so that the final resolution will likely be reached in 2015 rather than 2014, and the probability for the SC to reverse the injunction will still be less than 50%, although the US government (solicitor general) has supported Argentina in some other NML vs. Argentina cases (especially the so-called discovery case). However, the risk for the SC to reach a quick decision to deny a review of the case – while being low – cannot be discarded. If that happens, the current injunction against Argentina would be binding and a default event would take place at the end of the grace period of the first compromised coupon payments following such decision by the Court (see table below for the schedule for debt repayments by Argentina in 2014 and 2015). In our view, this risk alone should preclude any overweight consideration after the recent rally in prices.

Argentina global bonds repayment schedule for 2014 and 2015

Date	Bonds	Currency	Payment Type	Amount (in USDmn)
31-Mar-14	Par	USD	Interest	66
	Par	EUR	Interest	96
2-Jun-14	Global 17	USD	Interest	42
30-Jun-14	Discount	USD	Int & Principal	285
	Discount	EUR	Interest	297
30-Sep-14	Par	USD	Interest	66
	Par	EUR	Interest	96
2-Dec-14	Global 17	USD	Interest	42
31-Dec-14	Discount	USD	Int & Principal	285
	Discount	EUR	Interest	297
31-Mar-15	Par	USD	Interest	66
	Par	EUR	Interest	96
2-Jun-15	Global 17	USD	Interest	42
30-Jun-15	Discount	USD	Int & Principal	285
	Discount	EUR	Interest	297
30-Sep-15	Par	USD	Interest	66
	Par	EUR	Interest	96
2-Dec-15	Global 17	USD	Interest	42
31-Dec-15	Discount	USD	Int & Principal	285
	Discount	EUR	Interest	297

Source: Deutsche Bank

GDP Warrant: new methodology will not materially impact the valuation; look to enter on dip

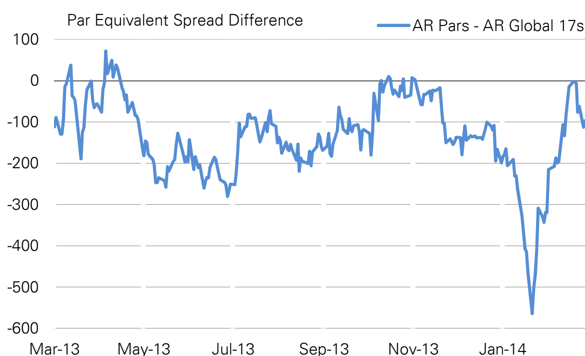
As we point out in our recent Sovereign Credit Weekly, the new methodology of national accounting will not materially impact the valuation of the GDP Warrants.

We believe the coupon due in December 2014 will be paid; the alternative scenario will likely be priced out in the coming months. That said, any consideration on the value of the Warrants has to be weighed against Argentina's growth prospects in 2014 and 2015, on which our economists hold a rather bearish view (recession in 2014 and likely below trigger growth in 2015). The recent run-up in prices makes entry levels somewhat less appealing, and we recommend entering long USD Warrants on dips in the coming weeks (price target: 7.5).

Favoring the Pars on the global curve

On the global curve, we favor the Pars over the Discounts and Global 17s. The Pars have underperformed as measured by par-equivalent spreads during the recent rally, and are looking relatively cheap. In addition, we also like the defensive nature of the Pars – with the market having significantly rallied over the past month, it is prudent to be more defensively positioned with the risk of technical default still hanging. We recommend switching from the Global 17s to the Pars at the current par-equivalent spread differential of -95bp, targeting -200bp, risking -40bp.

Pars are looking attractive to the Global 17s



Source: Deutsche Bank

Finally, we prefer global bonds to local law bonds. The latter will likely see supplies at the longer end of the curve as a result of recent YPF settlement; while at the front end of the curve, Boden 15s (with USD6bn redemption due in October 2015) are the assets with the most exposure to the risk scenario of reserve depletion in 2015.

BRAZIL

– Stay Neutral. Hold dv01-neutral 5s10s CDS curve flatteners.

The market has reacted positively since the budget announcement last month. The consolidated primary fiscal surplus target of 1.9% of GDP for 2014, while still more optimistic than our economists' forecasts, was more realistic than most market participants had expected. This suggests the government is making efforts to improve its fiscal policy, but performance will again depend on extraordinary revenues. So combined with continued monetary tightening by the Central Bank, there is indeed some policy improvement, but the October elections remain a constraining factor limiting the scope for significant changes in economic policies. We believe a one-notch downgrade by S&P still looks likely over the coming months, and after the outperformance during the past month, it is no longer clear if such a scenario is still being priced in.

In relative value, we hold dv01-neutral 5s10s curve flatteners (entered at 58bp, current 54bp, target 45bp, stop 70bp), as well as switching from BNDES 20s to 23s and switching from Petrobras 3% 19s to 7.875% 19s on these quasi-sovereign curves for further gains.

COLOMBIA

– Remain overweight. Favor 10Y sector of the curve.

Colombia's credit spread has closely tracked EM BBB average over the past couple of months, but slightly underperformed its regional peers, likely reflecting concerns over the parliamentary elections. Indeed, the election results showed a weakened majority of President Santos' coalition in the congress, potentially negative for the peace negotiation process with the FARC. However, this is not a game changer in Colombia's political dynamics and we do not see any policy risk in Colombia at this juncture. We remain overweight and view Colombia more favorably than Peru, the latter of which has recently outperformed but is more exposed to the risk of China's slowdown via reduced demands for mineral exports. Colombia, on the other hand, is more tied with the US. Technicals are also supportive as Colombia has completed its external debt issuance plan, with more than USD1.6bn repayment scheduled during the remainder of the year.

In relative value, we first note that the 21s have recently cheapened to the curve; we recommend switching from the 19s to the 21s at the current par-equivalent spread differential of 20bp (targeting 0bp). In addition, the CDS/bond basis has widened and we recommend taking profit in the long basis position of. 19s vs. 5Y CDS at the current level of 0bp (entered at -25bp).

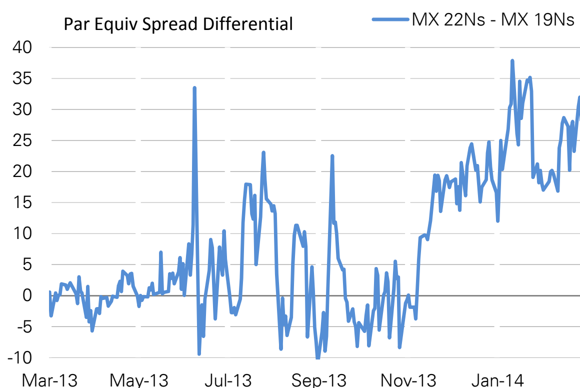
MEXICO

- Neutral but continue to see better potential in Pemex via switching to Pemex 45s from UMS 45s.

Mexico has been the best performer so far this year among its regional peers, with the Mexican constituents of DB-EMSI index having tightened by 10bp in March and 20bps YTD relative to the BBB sub-index. This reflects continued credit improvement, affirmed by Moodys who upgraded Mexico to A3 from BBB in early February. Trade deficit for Jan '14 came out unexpectedly large, raising concern about recovery of exports but our economists' view is that this was likely due to the temporary effect of adverse US weather. Overall, we continue to like Mexico as an undisputed "good EM", but valuation is very tight with its DB-EMSI component trading at -70bp vs. EM investment grade average.

However, Pemex bonds continue to offer more attractive valuation, in our view, especially at the long end of the curve. Specifically, we hold Pemex 45s vs. UMS 45s at the current spread differential of 80bp (targeting 60bp). Pemex will be one of the biggest beneficiaries of the energy reform, in our view, which will reduce the company's tax burden and help increase its production. When it upgraded Mexico to A3 on 6 February, Moody's also put Pemex under review for potential upgrade, which we believe should materialize within the next few months. Moody's could wait until the secondary legislation is passed in the congress in April before it upgrades Pemex, but there is also likelihood for the ratings agency to act even sooner.

Attractive cash switch from 19N to 22N on the UMS curve



Source: Deutsche Bank

At the shorter end of the UMS curve, the 19N is expensive while 22N is cheap; we recommend switching from the 19Ns to 22Ns at the current par-equivalent spread differential of 28bp (target 5bp). See chart above.

PERU

– Remain neutral. Continue to favor 10Y sector of the curve.

Peru has outperformed EM BBB average by 10bp in March and 14bps YTD. However, large CAD (-5.5% GDP), though more than 100% financed by FDI, remain a source of concern especially with the recent fall in mineral prices which could lead to weakening of foreign investment down the road. From that point of view, we continue to favor Colombia over Peru. On the issuance front, Peru may consider reopening sale of US dollar bonds due 2050, after seeing weaker demands for sole denominated bonds, according to Finance Minister Miguel Castilla. If that materialize, it will likely put some pressure on the bonds at the long end of the curve. We therefore continue to favor 10Y sector of the curve (preferring 25s) even though the curve has steepened over the past month.

VENEZUELA

- Stay underweight for now though we stand ready to become more positive if SICAD 2 proves effective. Hold long PDVSA 14s. Favor PDVSA 17Ns for duration exposure. Enter short basis via 5Y CDS vs. 24s (though a number of other bonds could be considered).

The market has rallied over the past two weeks on expectations of SICAD 2, for which the government has published the rules on Tuesday (March 11). However, bond prices remain a couple of points lower than the levels seen in mid January when we changed to underweight to express our disappointment on the then underwhelming devaluation measures.

Indeed, SICAD 2, if implemented smoothly, would ease FX restrictions and help alleviate economic imbalances in the economy, but the question is how much and whether it will be enough. We remain somewhat skeptical about its effectiveness given the potential bottleneck in the supply of US dollars (even with the participation of PDVSA which is believed to provide the bulk of the dollars to this market). Given the smaller volume that is expected to be transacted through SICAD 2, to reach an effective exchange of 20 VEF/USD (a level close to the PPP rate for the Venezuelan economy according to our economists estimate), the SICAD 2 exchange rate would need to be at 50, a level that is possible but difficult to reach. Furthermore, the government has a rather poor track record in implementing new market mechanisms due to bureaucratic inefficiency and internal disagreement

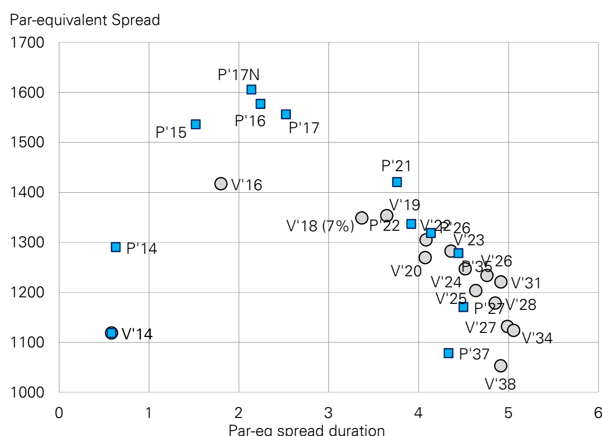
(this has been exposed again earlier this week as the government failed to launch the system on Monday as planned).

Finally, the ongoing protest remains an acute source of risk as we continue to be of the idea that the political unrest represents an active opposition strategy in the absence of the electoral calendar and adds a permanent risk premium to the credit spreads.

In terms of strategy recommendations,

- We continue to hold long PDVSA 14s to maturity;
- For investors to position for continued spread tightening, we favor PDVSA 17Ns, which remain the cheapest bonds on the curve. PDVSA will likely be the biggest beneficiary of SICAD 2. The cash flow of PDVSA, both in US dollars and in bolivars, will be affected positively after this implicit devaluation given that they will receive more local currency for the dollars that they sell in this market and will need to sell fewer dollars to pay royalties, taxes, and dividends to the central government. So we also hold a slight bias in favor of PDVSA bonds over their sovereign counterparts, despite the recent outperformance of the former.

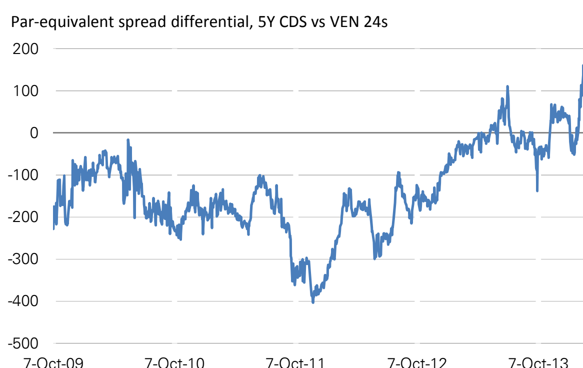
Par-equivalent spread curve of the Venezuela complex



Source: Deutsche Bank

- Enter short basis on sovereign curve. In our recent note *Trade Recommendation – Venezuela: enter short basis* (12-March-14), we highlight the attractiveness of selling 5Y CDS vs. bonds at longer end of the Venezuela curve, with basis at multi-year wides, very attractive carry, and negative exposure to jump risk and moderate directionality to the market. We track our recommendation via 5Y CDS vs. 24s (current: 175bp; target: 0bp), but other bonds, such as 23, 25s, and 28s (among others), could also be considered – it is the matter of liquidity in terms of ability to short the bonds.

CDS/bond basis on Venezuela curve is close at multi-year wides



Source: Deutsche Bank

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China

Aa3/AA-/A+
Moody's/S&P/Fitch

- Economic outlook: A soft patch of February Chinese data has been released recently, including: weaker export growth, lower PMIs, and a sequential drop in the PPI. However, the reality may be less bearish than what these numbers suggest, as seasonal and temporary factors may explain a large part of the data weakness.
- Despite the recent RMB depreciation, we believe that economic fundamentals continue to support a stronger currency in the medium term. We maintain our forecast of a 2% appreciation of the RMB vs. the USD in 2014 with an increase in its two-way volatility. One shouldn't read too much into February's trade deficit in forecasting the longer term RMB movement, as the February data are seriously distorted by the CNY effect and 'over-invoicing' early last year.
- Highlights of the NPC: fiscal policy may be slightly more expansionary than we had expected, while monetary policy will likely remain largely unchanged. On reforms, healthcare, internet and the environment will likely receive strong government support. SOE reforms and deregulation will likely advance aggressively in the year ahead.
- Main risks: Q1 growth could surprise to the downside given weaker-than-expected manufacturing activity due partly to suspension of production at coal-burning factories.

Weaker Feb data on data distortion

February exports disappointed while imports surprised the market to the upside. Exports fell on two distortions: CNY holidays and over-statement of exports in early 2013. The underlying trend growth of Jan-Feb exports is likely to be around 10%, after adjusting for those distortions.

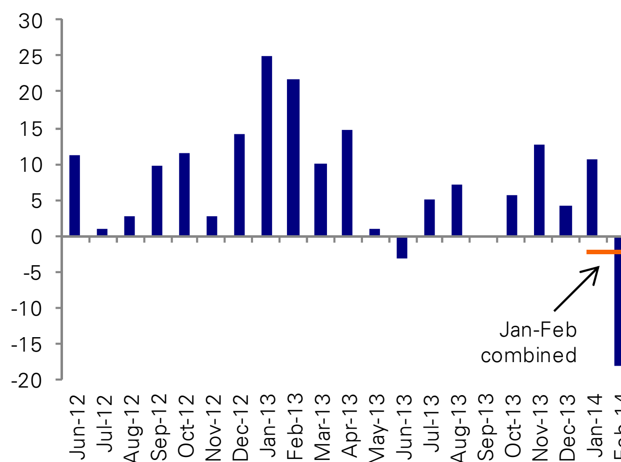
Merchandise exports declined by 18.1%yoy in February, down from the 10.6%yoy increase in January, and lower than the consensus expectation of 7.5%.

To exclude the CNY effect, we look at the combined Jan-Feb exports, which declined by 1.6%yoy. However, we believe the underlying export growth in Jan-Feb was much higher than this due to the distortion to exports figures from December 2012 to April 2013 by over-invoicing or churning of exports to disguise capital inflows as export earnings. We estimate that export growth in Jan-Feb 2013 was inflated by 10-15ppts, and that in March-April 2013 was inflated by 5-10ppts. This means that the "true" export growth in Jan-Feb this year could be between 8% and 13% versus the reported -1.6%.

Imports grew 10.1%yoy in February, better than the consensus expectation of 7.6%yoy, which may signal a healthy outlook both for exports and domestic demand. A trade deficit of USD25 billion was recorded for the month, but it is not uncommon for China to report trade deficits during the first quarter of the year.

We remain positive on China's export outlook this year on improving external demand especially from the US and the Euro area. DB economists expect the aggregate G3 GDP growth to accelerate to 2.0% in 2014 from 0.9% in 2013.

China export growth, yoy%



Source: Deutsche Bank, WIND

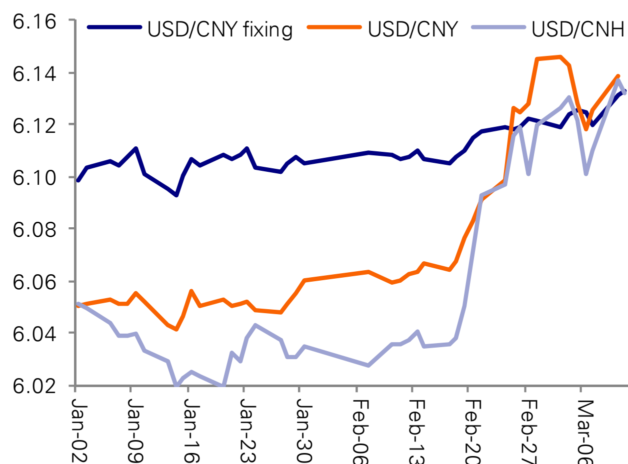
Economic fundamentals continue to support a stronger RMB.

Despite the recent RMB depreciation, which we believe was somewhat "intended" by the PBOC to increase volatility, we maintain our forecast of a 2% appreciation of the RMB vs. the USD in 2014 as a whole. One shouldn't read too much into February's trade deficit in forecasting the RMB movement in medium term, as this monthly data is highly distorted by the CNY effect and over-invoicing issue in early last year.

We believe a mild 2% appreciation is justified by the following: A) China's economic growth will remain substantially stronger than all other major economies, and would thus attract continued foreign investments; B) stronger G2 growth this year should push up Chinese exports and lead to a wider trade surplus, which will in turn be supportive of a strong RMB; C)

reforms to open up the capital account imply stronger portfolio flows to the domestic securities market and the interbank bond market, which we believe can more than offset the likely portfolio outflow; and D) China will reduce its market access restrictions on foreign investment via implementing a "negative list" system. This reform should boost foreign investments in many services sectors such as health care, education, entertainment, and value added telco businesses.

RMB exchange rate



Source: Deutsche Bank, WIND, Bloomberg Finance LP

Engineering an "orderly default" process in credit market

Over the past month, China reported three cases of defaults on trust loans and bonds, including the China Credit Trust product, Jilin Trust, and Chaori bond. We believe that the government recognizes the need to allow some "orderly defaults" to correct the mispricing of trust and credit products, and eventually "price out" some most risky borrowers from the market.

The recent case involved Chaori Solar Energy, which announced on March 4 that it would be unable to make annual coupon payment due on March 7th on its bond with RMB1bn outstanding balance. It is the first domestic corporate bond default event, although it did not come as a surprise to the market as the bond has been suspended from trading in the Shenzhen Stock Exchange since July last year due to the issuer's deteriorating operating performance.

We see three important implications from these developments:

- More "orderly defaults" in the trust and bond markets are likely to be allowed. The fact that three defaults were permitted within a month demonstrates a change in government policy towards not bailing out weak borrowers and gradually removing the market perception of implicit government guarantees for WMPs, bonds, and small financial institutions. In other words, we believe that China is more determined in engineering an "orderly default" process with limited systemic impact in a broader range of credit intermediation channels, such as the trust product market and the credit bond market. By allowing defaults, China will gradually correct the mispricing of credit risks, and will eventually reduce the systemic risks.

  Moreover, China's ability to manage orderly defaults in different markets suggests its solution in dealing with credit default events is more comprehensive than the market expects.

- Market's muted reaction to the Chaori default suggests that "orderly default" is more feasible than what the market initially perceived.

  In contrast to the market's strong reaction to the initial announcement of CCT's near default, the muted reaction to the Chaori default reflects that credit risk of Chaori probably has been re-priced significantly since mid of 2013 and the market does not expect significant spillover from this event. The credit market closed with credit spreads roughly unchanged for the day, although the credit market initially responded with modest flight to quality flows and the credit spread of top-rated (AAA+) credit bonds once tightened by a moderate 5bps.

- We expect the credit market re-pricing to continue for the remainder of this year given elevated rollover risks in the credit bond and trust products market. Looking ahead, we expect China continues to permit a few more "orderly defaults" and explore market-based solutions in dealing with default events. Over the medium term, we expect more defaults and a gradual reduction in the recovery ratio to help the market discover the fair credit matrix pricing, develop more transparent forms of financing, and improve financial stability.

February NBS PMI declined but slightly better than expectations

The official manufacturing PMI fell to 50.2 in February, 0.3pts lower than that of January but slightly better than the consensus forecast of 50.1. For two more reasons, the official PMI could be a modest positive surprise. First, compared with the HSBC flash PMI, which fell 1.2pts in Feb, the official PMI's decline was significantly more modest. Note that the official PMI is based on a survey of 3000 firms while the HSBC PMI is a survey of only 1000 firms. Second, seasonality suggests that the official PMI normally falls noticeably in February -- e.g., a 3.8pts decline in the February of 2010, 0.7pts decline in 2011, 0.2pts increase in 2012 and 0.3pts decline in 2013 -- so the underlying PMI trend is probably stable in February. This point is

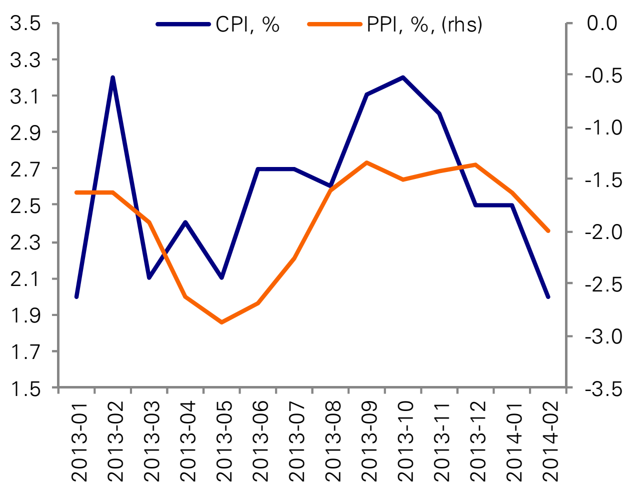
confirmed by the NBS statement that "the decline in February manufacturing PMI was largely due to seasonal Chinese New Year factor".

Looking forward, we see several catalysts for improvement in the PMI from March. First, by mid-March most Northern China cities would stop coal burning for heating, and thus some “emergency measures” to suspend production in coal burning factories would end. Second, the stronger loan growth since January may begin to boost investment activities from Q2. Third, the more aggressive reforms to be outlined during the NPC should boost sentiment from March and subsequently economic activities as private investments accelerate.

Both CPI and PPI inflations decelerated in February and were slightly below market expectations, partially due to the seasonality and the "emergency measures" to suspend production of coal-burning factories.

February CPI inflation came in at 2.0%yoy, down from 2.5%yoy in January, slightly lower than the consensus of 2.1%. The CPI inflation deceleration was largely driven by the easing food inflation in February and a high base effect. On a mom basis, the CPI increased by 0.5%, in line with normal seasonality. February core CPI inflation was 1.7%yoy, lower than the 2.0%yoy in January, but about the average level of that in 2013.

China CPI inflation, PPI inflation



Source: Deutsche Bank, WIND

February PPI deflation widened to 2.0%yoy in February from January’s 1.6%, slightly sharper than the consensus forecast of 1.9%. On a mom basis, PPI declined by 0.2%, a bit faster than the 0.1% drop in Jan. Within the PPI components, coal prices fell a significant 0.8% mom. We believe this has to do with the "emergency measures" taken by many local governments to suspend production of coal-burning factories when the air pollution index (PM2.5) surged in Jan-Feb (seasonally the index is the highest in these two months in a year). The CNY holidays also reduced demand for construction materials in February.

Looking forward, we expect coal prices to gradually recover as the above mentioned "emergency measures" are removed when PM2.5 falls after mid-March (when coal burning for heating ends in China). The resumption of manufacturing production of the firms affected should begin to push up other raw material prices. Nevertheless, the weaker-than-expected inflation rates in Jan-Feb should help reduce the annual average inflation and thus help keep the accommodative monetary policy stance for a bit longer than we previously thought.

Highlights of the NPC on growth and reforms

On March 5, Premier Li Keqiang delivered the government work report to the National People's Congress. The key message at the macro level is that fiscal policy will be slightly more expansionary than it was last year, while the monetary policy stance will remain largely unchanged. Another key message is on reforms. Sectors such as healthcare, internet, and environment will likely receive strong government support. SOE reforms and deregulation will advance aggressively in the year.

- Marco economic targets:

GDP, inflation and M2 targets are unchanged: the official GDP growth target for 2014 remains at 7.5% for this year, in line with our expectation but higher than market consensus. Premier Li noted that there is a need to maintain this target and it is also feasible. Historically, actual GDP growth almost always (in 90% of the past ten years) exceeded the official target. The CPI inflation target for 2014 is set at 3.5%, the same as last year. The M2 growth target is also maintained, at 13%.

Higher fiscal deficit: the budget deficit of the general government (including central and local) is set at RMB1.35tr (including RMB950bn for the central government and RMB400bn for local governments), up from RMB1.2tr last year. This is in line with our expectation, and represents a slight expansion of the fiscal stance. The increase in the government deficit will be mainly used to finance VAT reform (which we expect to generate tax savings of about RMB200bn for firms) and higher social spending.

Fiscal priorities: The draft central government budget envisages the following growth rates for spending: health care (up 15.1%yoy, vs. 27.1%yoy in 2013), national defense (up 12.2% vs. 10.7%), social security and employment (up 9.8% vs 13.9%), culture, sports and media (up 9.2% vs. 9.3%),education (up 9.1% vs. 9.3%), public housing (up 9% vs. 5.3%),science and technology (up 8.9% vs.10.4%),agriculture, forestry and water conservancy (up 8.6% vs 12.8%),energy

conservation and environmental protection (up 7.1% vs.18.8%), public security (up 6.1% vs. 7.9%),transportation (up 5.1% vs. 0.1%), and general services (up 2.6% vs. 1.5%),

- Highlights of the reform program:

Acceleration of SOE reform and deregulation: the government work report specified seven key sectors in which SOE reform and deregulation (i.e., introducing private capital) should speed up. These are financial, oil, electricity, railway, telecommunication, other natural resources and public utilities. 200 items of administrative approvals will be abolished or decentralized this year. These reforms should boost private sector investment and support overall growth this year.

Expansion of the local government bond program: China is to increase the new issuance of municipal bonds by RMB50bn to RMB400bn. This will help alleviate some funding pressures on local governments and help LGFVs to refinance their bank and trust loans with bonds.

Financial reform: China will establish a deposit insurance system this year, and proceed with interest rate liberalization, capital account liberalization, and reduce market access restrictions on private investment in the financial sector. In our view, the formal announcement of the setting up a deposit insurance scheme, together with the expansion of the local government bond program, should help improve financial stability and lead to improved market sentiment on banks.

Expansion of VAT reform to railway, postal and telco sectors: the VAT reform will be expanded to sectors such as railway transportation, postal and telecommunication. The legislation of the environmental protection tax is to be expedited.

In sum, we believe that this year's macro policies and reform program will be supportive of growth, especially via tax cuts (under the VAT reform program) and the deregulation/SOE reform program. Market sentiment on banks will benefit from the establishment of a deposit insurance scheme and the expansion of the local government bond program.

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China: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	7986	8957	10271	11712
Population (mn)	1355	1362	1369	1374
GDP per capita (USD)	5894	6576	7502	8521
Real GDP (YoY%)[1]	7.8	7.7	8.6	8.2
Private consumption	8.4	8.0	8.7	8.7
Government consumption	8.4	8.5	8.7	8.5
Gross capital formation	7.9	7.9	9.0	8.0
Export of goods & services	7.0	7.0	12.0	9.0
Import of goods & services	7.8	8.2	13.0	10.0
Prices, Money and Banking				
CPI (YoY%) eop	2.0	2.5	3.7	3.5
CPI (YoY%) ann avg	2.6	2.6	3.5	3.2
Broad money (M2)	13.8	13.6	**14.0**	14.0
Bank credit (YoY%)	15.0	14.1	14.5	14.0
Fiscal Accounts (% of GDP)				
Budget surplus	-1.6	-2.0	**-2.1**	-1.5
Government revenue	22.7	22.8	23.0	23.0
Government expenditure	24.3	24.8	**25.0**	24.5
Primary surplus	-0.9	-1.3	**-1.3**	-0.8
External Accounts (USD bn)				
Merchandise exports	2048.0	2210.0	2519.4	2796.5
Merchandise imports	1818.0	1950.0	2242.5	2511.6
Trade balance	230.0	260.0	276.9	284.9
% of GDP	2.9	2.9	2.7	2.4
Current account balance	193.0	220.0	236.9	244.9
% of GDP	2.4	2.5	2.3	2.1
FDI (net)	140.0	120.0	110.0	85.0
FX reserves (USD bn)	3312.0	3690.0	3800.0	3900.0
FX rate (eop) CNY/USD	6.3	6.1	6.0	5.9
Debt Indicators (% of GDP)				
Government debt[2]	19.0	18.9	18.0	17.5
Domestic	18.5	18.4	17.5	17.0
External	0.5	0.5	0.5	0.5
Total external debt	10.4	10.4	10.7	10.7
in USD bn	830.0	930.0	1100.0	1250.0
Short-term (% of total)	65.0	60.0	60.0	60.0
General (YoY%)				
Fixed asset inv't (nominal)	20.3	19.6	22.0	21.0
Retail sales (nominal)	14.4	13.1	**14.1**	14.0
Industrial production (real)	10.0	9.7	11.0	10.2
Merch exports (USD nominal)	7.9	7.9	14.0	11.0
Merch imports (USD nominal)	4.3	7.3	15.0	12.0
Financial Markets	*Current*	*3M*	*6M*	*12M*
1-year deposit rate	3.00	3.00	3.00	3.00
10-year yield (%)	4.48	4.60	5.00	5.00
CNY/USD	6.13	6.08	6.04	5.97

Source: CEIC, DB Global Markets Research, National Sources
Note: (1) Growth rates of GDP components may not match overall GDP growth rates due to inconsistency between historical data calculated from expenditure and product method. (2) Including bank recapitalization and AMC bonds issued

Hong Kong

Aa1/AAA/AA+
Moody's/S&P/Fitch

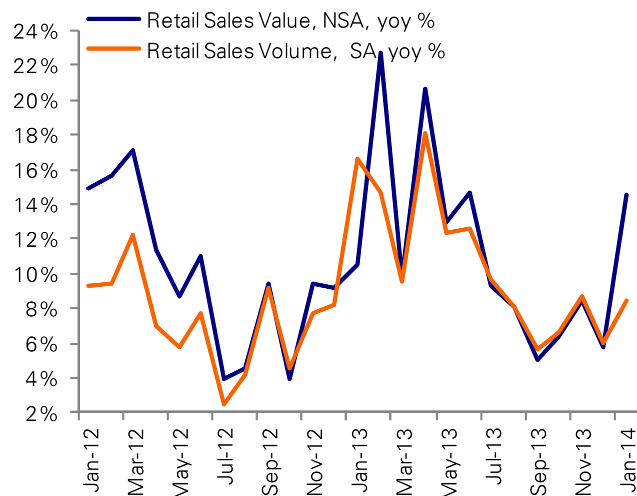
- **Economic outlook:** Recent data offered mixed indications. We saw an accelerating retail sales growth, a stronger February composite PMI, weak exports, large build-up in inventory and slight decrease in new orders suggested by the PMI sub-indexes. We expect the economic momentum to accelerate moderately in the near term, with the support of resilient labor market condition, strong tourism and improving exports.
- **Main risks:** Export growth could remain subdued if the external demand remains soft, which would pose risks on consumption.

A mixed set of data

Retail sales growth spiked in January

Retail sales rose by 14.5%yoy in January, up from the 5.7% in December, well above the market expectation of 7.8%. It is the highest reading in past 7 months. In real term, the volume of retail sales rose by 16.8%yoy, up from December's 6%yoy. The sharp rise of retail sales growth may be partly explained by the seasonal factor of the Chinese New Year (CNY). Note that this CNY fell on January 31 while previous one fell at mid-February in 2013. Consumer spending tends to rise significantly right before this major festival. After adjusting the seasonality, real retail sales grew at 8.5%yoy this January, up from the 6% in last December.

Hong Kong retail sales growth rates



Source: Deutsche Bank, CEIC, Haver Analytics

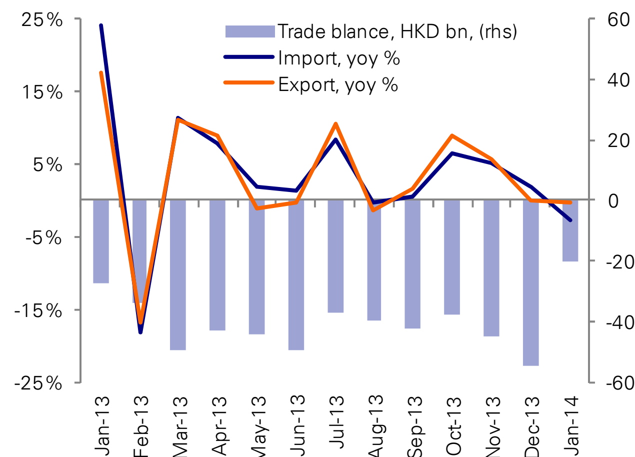
Due to the potential swing in the data for the first two months, we may need February numbers for a precise assessment on the underlying demand. However, looking forward, we think that on a trend basis, retail sales growth is likely to improve further, due to the favorable labor market and income conditions, as well as sustained inbound tourism.

The growth acceleration of retail sales in January was mainly contributed by the strong sales in miscellaneous consumer durable goods, supermarkets, food products, clothing & footwear. This January, miscellaneous consumer durable goods rose 90.5%yoy (vs. 18%yoy in last December), commodities in supermarkets grew at 20%yoy (vs. 5.2%yoy), food products rose by 20%yoy (vs. 6.9%yoy), clothing & footwear increased by 16%yoy (vs. 5.8%yoy). Jewellery, watches & clocks also registered higher growth rate of 10.8% in January (vs. 9.2%). In contrast, fuel reported weaker growth of 1.7%yoy in January (vs. 3.9%yoy).

Weak exports in January

Hong Kong's exports contracted by 0.4% yoy in January, slightly better than consensus expectation of -1%, yet worse than our expectation of 4.0%. The deterioration in Hong Kong exports was led by a sharp decline in shipment to major destinations of Asia (-4.1%yoy), in particular, to Mainland China (-6.5%), Taiwan (-22.6%) and Singapore (-7.9%). Declines were also registered in UK (-7.4%) and Germany (-0.3%), while exports to the US increased by 9.7%yoy in January. Within industries, exports of telecommunications, sound recording and reproducing equipment declined by 5.1%yoy, exports of miscellaneous manufactured articles went down by 13.4%, while exports of electrical machinery and electrical parts increased by 3.6%yoy and exports of office and automatic data processing machines increased by 6.3%yoy in January.

Trade and trade balance



Source: Deutsche Bank, CEIC, Haver Analytics

As of imports, it fell by 2.7%yoy in January from 1.8% rise in December. As a result, the trade deficit narrowed to HKD20 bn, from the deficit of HKD54.4bn in last December.

Hong Kong's export data were in line with region's trend of a moderate pick up in electronics exports. Nevertheless, the trade figures for January were somewhat distorted by the different timing of the Chinese New Year. It would thus be more meaningful to analyze the trade figures for January and February combined for a clearer picture of the underlying trend, according to the spokesman of the Hong Kong Census and Statistics Department. Looking ahead, Hong Kong's exports are likely to be supported by the further improvement in global economic conditions.

February composite PMI improved while the sub-index of new orders declined slightly and the sub-index of final goods inventory built up.

Sequential growth momentum may improve in the near term, suggested by the 0.7ppts increase in Hong Kong composite PMI from January's 52.7 to February's 53.3.

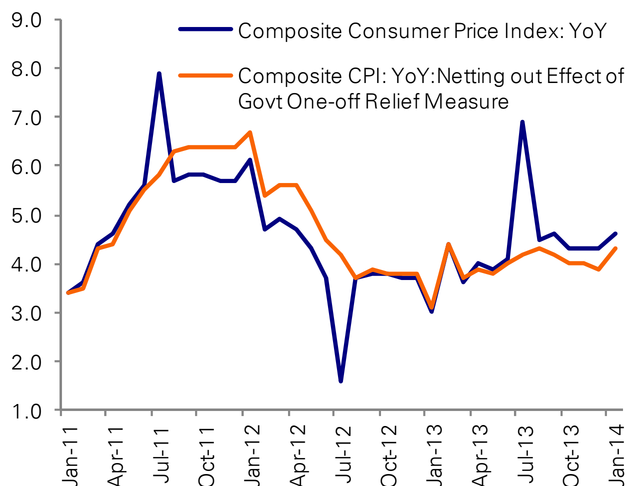
Within the sub-index of the PMI, new orders decreased by 0.1ppts in February compared to January reading, however still remained at a rather expansionary level of 54.8; employment increased by 1ppt to 50.4, first time in past 12 months being at the expansionary territory; We see some final goods inventory buildup in February, as indicated by the increase in the sub-index of stocks of purchases which improved to 53.4 from 51.2 in January.

CPI inflation accelerated likely on Chinese LNY effect

January composite CPI inflation accelerated to 4.6%yoy from 4.3%yoy in December, slightly higher than the consensus forecast of 4.4%. The underlying CPI inflation was 4.3%yoy in January, also higher than 3.9% in December, after netting out the effect of government relief measures.

This acceleration was primarily guided by larger increases in charges for package tours around Chinese Lunar New Year. This year's LNY was in late January and early February while last year's LNY was in the mid-February. Looking into the sub-components of the CPI, inflation acceleration was seen in the price of miscellaneous services (6.9%yoy in January vs. 4.6%yoy in December), transport price (3.0%yoy vs. 2.6%yoy), food price also edged slightly higher to 4.2%yoy in January; Meanwhile, inflation of electricity, gas and water decelerated to 6.1%yoy from December's 7.4%yoy, and the inflation of clothing and footwear was 2.0%yoy in January, down from 2.2%yoy in December.

Hong Kong CPI inflation



Source: Deutsche Bank, CEIC, Haver Analytics

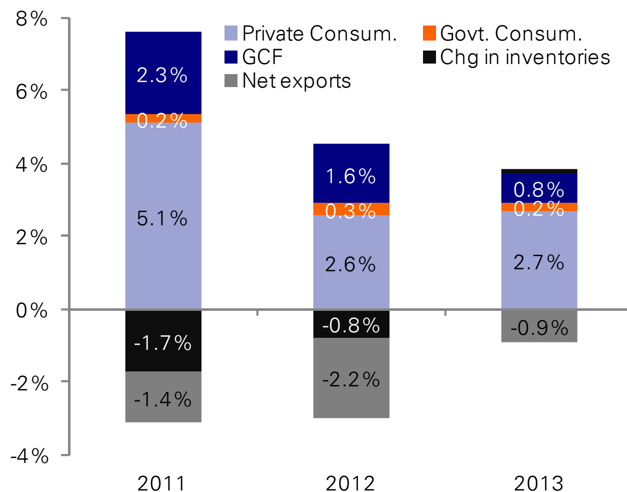
Looking forward, CPI inflation is expected to remain contained in near term as a result of high base effect of February 2013 and subdued imported inflation, as well as the moderated increase in fresh-letting residential rentals since early 2013.

Major Q4 economic numbers prompt revision on 2014 GDP growth forecasts

- Q4 GDP expanded at 3.0%yoy, in line with market expectations, but lower than our forecast.

GDP posted sequential growth of 1.1%QoQ (sa) in the Q4 2013, up from 0.7% in Q3. The sequential growth rate of GDP in Q4 has been continuing its upward trend since Q1 2013. Compared with the prior year, GDP growth accelerated by 1.4ppts to 2.9% in 2013.

Contribution of GDP growth rate



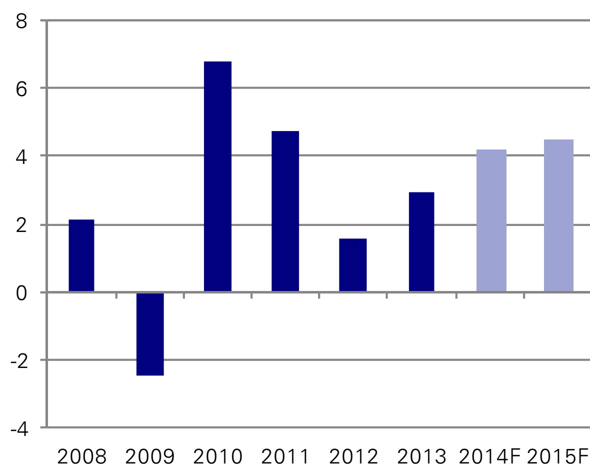
Source: Deutsche Bank, CEIC, Haver Analytics

Although 2013 growth was only 2.9% and below our expectation of 3.2%, the economy showed its strength by ending the year with a 4.4%QoQ annualized (saar) growth rate. The main drivers of the overall GDP growth in 2013 were private consumption and fixed asset investment. Private consumption increased 4.2%yoy in 2013 and contributed 2.7ppts to overall GDP growth. Although the growth rate of fixed asset investment decelerated to 3.3%yoy in 2013 from 6.8%yoy in 2012, fixed asset investment managed to contribute 0.8ppts to total growth. Government consumption grew at a slower pace of 2.7% in 2013, compared with 3.6%yoy in 2012, and contributed 0.2ppts to total GDP growth. Net exports remained a drag of economy. With total exports and total imports of goods/services growing at 6.5%yoy and 6.9%yoy respectively in 2013, net exports contributed a negative 0.9ppts to overall GDP.

In sum , the Hong Kong economy appeared resilient in 2013, as indicated by the steady consumption growth and low level of unemployment rate, although dragged by weak demand from the US and European economies. Exports of goods to the US shrank by 4%yoy and those to the European Union declined by 1%yoy in 2013.

- We revise 2014 GDP growth rate down to 4.2%yoy from previous forecast of 5%yoy, on the lower base of 2013 mostly.

Hong Kong GDP growth, %yoy



Source: Deutsche Bank estimate, CEIC, Haver Analytics

In the meantime, we remain optimistic on Hong Kong's economic recovery and believe that it will be led by the improving global trade, in particular the demand picking up from the US, EU and China. Domestic consumption and strong tourism will continue to support the economic activities in 2014. We expect the growth rate of GDP to accelerate in 2014, though at a lower rate than previous forecasts. With last Q4's GDP growth below expectation, we are paring our 2014 GDP growth forecast to 4.2%. We note that the government's forecast is 3-4%.

The government budget for FY14/15 largely in line with market expectations

Financial Secretary John C Tsang tabled the FY14/15 budget on February 26. Despite a stronger growth outlook, the FS forecasted a 4%yoy decline in consolidated revenues, and a 5.7%yoy decrease in expenditure was budgeted for the fiscal year of FY14/15. The one-off "relief measures" offered are much less generous than last year. Rent subsidies to public housing tenants and waivers of property rates are cut by half, the electricity subsidy is cancelled. In the meantime, the budget for recurrent spending grows by 7.8% in FY14/15 (vs. 10.5% in FY13/14). For major recurrent expenditure items, growth rates are much decelerated as well, e.g. social welfare (9.7% vs. 31%), infrastructure (1% vs. 12.5%) and healthcare (5.2% vs. 5.8%). Growth of recurrent expenditure on education will accelerate to 5.3% in FY14/15 from the 3.7% in FY13/14. Overall, the budget delivered was in line with what the market expected: a smaller size of stimulus in an environment of further economic recovery and prudent fiscal planning with more consideration of longer term factors.

- One-off relief measures cut, recurrent spending lifted

As the FS forecasted a potential GDP growth rate acceleration from 2.9% in 2013 to 3-4% in 2014, the budget offered fewer growth enhancing measures compared to last year. Tsang estimated that policies introduced in last year's budget provided a stimulus of 1.3ppts to total GDP growth in 2013 and forecasted that measures in this year's budget plan would provide a stimulus of 0.7ppts in 2014.

The total package of "relief measures" shrank to HKD 20bn in FY14/15 from HKD 33bn in FY2013/14. Policies this year include a reduction in personal salary tax of up to HKD10,000 (same as last year); a reduction in profits tax of up to HKD10,000 (same as last year); a waiver of property rates of up to HKD1,500 per quarter for Q1 and Q2 (previously Q1-Q4); one months' free rent for public housing tenants (previously two months); one month extra allowance to CSSA recipients, etc (same as last year); and an increase in the allowance for maintaining a dependent parent or grandparent (new this year). The previous measure of electricity subsidy has been removed from the list this year.

In the meantime, the budget for major recurrent expenditure items will still grow and continue to support the economy but to a lesser degree. Expenditure on education should be up 5.3%yoy in FY14/15 (vs. 3.7% in FY13/14, spending on healthcare

should grow by 5.2%yoy (vs. 5.8%), and expenditure on welfare should increase by 9.7%yoy (vs. 31%). In addition, the infrastructure spending should be 70.8bn in 2014/2015, slightly up from 70.1bn in FY2013/14. A HKD3bn for the Low-income Working Family Allowance proposed by CY Leung in his policy address is budgeted.

- Prudent fiscal planning

With one quarter left in this fiscal year, revenues in FY13/14 are estimated to exceed the original budget forecast by 2.9%, leading to a fiscal surplus of HKD12bn instead of the HKD4.9bn deficit estimated by Tsang in his last year speech. The fiscal reserves are expected to reach HKD746bn in March.

Nonetheless, the FS forecasted that consolidated government revenues will decline 4% and the expenditure is budgeted to shrink by 5.7% in FY14/15, implying a fiscal surplus of HKD9.1bn. It is for the first time in seven consecutive years that Tsang foresaw a surplus for the coming fiscal year. In each of the past six budgets, he forecasted a deficit yet ran a surplus.

We believe such "fiscal prudence" demonstrates that the government now tries to stick to the principle of "living within our means". According to the working group on Long-Term Fiscal Planning set up by Tsang in last June, the trend growth of Hong Kong real GDP in the next 20~30 years will slow to 2.8%yoy from an average of 4.5% in the past 10 years. Government revenues should grow at an average annual trend growth rate of 4.5%yoy in the next 20~30 years, while the recurrent expenditure could rise at a faster trend annual growth rate of 7.5%yoy during the projection period (up from the 4.7% average annual growth rate of expenditure since reunification), if the services were to be enhanced by 3% per annum on top of adjustments for demographic and price factors. In this case, a structural deficit would emerge in seven years' time.

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Hong Kong: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	263.1	282.1	302.4	325.1
Population (mn)	7.15	7.20	7.26	7.31
GDP per capita (USD)	36802	39159	41654	44448
Real GDP (YoY%)	1.5	2.9	4.2	4.5
Private consumption	3.0	4.2	4.6	5.2
Government consumption	3.7	2.7	2.4	2.2
Gross fixed investment	9.4	3.3	4.5	5.2
Exports	1.9	6.5	11.3	12.3
Imports	2.8	6.9	11.4	12.5
Prices, Money and Banking				
CPI (YoY%) eop	3.8	4.3	3.5	3.0
CPI (YoY%) ann avg	4.1	4.3	3.5	3.2
Broad money (M3)	10.5	12.5	9.5	9.0
HKD Bank credit (YoY%)	5.7	8.2	8.3	8.0
Fiscal Accounts (% of GDP)[1]				
Fiscal balance	3.1	0.6	2.6	3.4
Government revenue	21.4	20.9	20.5	20.0
Government expenditure	18.3	20.4	17.9	16.7
Primary surplus	3.2	0.6	2.6	3.4
External Accounts (USD bn)				
Merchandise exports	464.7	503.6	543.9	606.4
Merchandise imports	487.4	547.3	584.1	644.3
Trade balance	-22.7	-43.7	-40.2	-37.8
% of GDP	-8.6	-15.5	-13.3	-11.6
Current account balance	3.5	-9.0	5.8	9.0
% of GDP	1.3	-0.9	3.7	2.8
FDI (net)	-9.4	-22.9	-25.1	-30.8
FX reserves (USD bn)	317.3	315.0	329.5	353.8
FX rate (eop) HKD/USD	7.76	7.76	7.80	7.80
Debt Indicators (% of GDP)				
Government debt[1]	8.8	9.0	8.7	8.6
Domestic	8.3	8.5	8.2	8.2
External	0.5	0.5	0.4	0.4
Total external debt	397.7	420.2	420.3	384.9
in USD bn	1046.5	1150.0	1250.0	1300.0
Short-term (% of total)	71.9	72.0	72.0	72.0
General				
Unemployment (ann. avg, %)	3.3	3.4	3.1	3.0
Financial Markets	*Current*	3M	6M	12M
Discount base rate	0.50	0.50	0.50	0.50
3-month interbank rate	0.37	0.38	0.50	0.60
10-year yield (%)	2.27	2.25	2.40	3.00
HKD/USD	7.76	7.78	7.78	7.78

Source: CEIC, DB Global Markets Research, National Sources
Note: (1) Fiscal year ending March of the following year. Debt includes government loans, government bond fund, retail inflation linked bonds, and debt guarantees.

India

Baa2/BBB-(Neg)/BBB-
Moody's/S&P/Fitch

- Economic outlook: Latest BOP and inflation data have pleased markets and given rise to expectations about an improving economic outlook. The outlook for fiscal outperformance, however, is bleak, given constraints of both revenue and spending side.
- Main risks: Imports could rebound sharply if domestic demand recovers, giving rise to renewed concern about the rupee..

Politics stake centre stage

There has been a remarkable change in investor sentiment and focus about India. The key discussion points of recent years, direction of the current account/INR and upside risk to inflation, have conspicuously slipped from the top of the discussion agenda. On the former, weak domestic demand, expectation that import compression measures will remain in place through the elections, and some upside to exports are seen as factors driving a relatively stable and financeable current account deficit of about 2-2.5% of GDP for the rest of the year. On the latter, a benign commodity price outlook, continued easing of food prices after the spikes of last year, no further risk of INR weakness driven pass-through, flat wages, and a strong and relatively credible anti-inflation stance by the RBI are seen as reasons for inflation and inflation expectations to ease in the coming months.

Discussions instead revolve around the forthcoming elections, the seemingly endless deliberation on the math of coalition-building post-elections, and the challenges of reviving growth for the new government. We remain of the view that regardless of the nature of the coalition that leads India from this summer onward, the reforms put in motion in recent years will continue, especially in the areas of fuel price adjustment, FDI liberalization, project clearance, and disinvestment.

We do however see challenges to further fiscal consolidation and coordination between the center and the RBI in fighting inflation. The former may struggle to cut spending further in the near term as capital spending has been compressed substantially in recent years and fuel price reform has been largely accomplished, while given the state of the economy revenues may not display buoyancy for a while. The latter (RBI) could maintain positive real interest rates for a while as it puts together its inflation targeting framework, but if growth does not recover by the second half of the year, both civil society and the center (which will be staring at a higher debt service bill) may clamor for monetary policy easing.

A primer on Indian politics

Political system: India is a Parliamentary democracy, with the Parliament designated the supreme legislative body. The Parliament comprises the President and the two Houses--Rajya Sabha (Council of States) and Lok Sabha (House of the People). The President has the power to summon and prorogue either House of Parliament or to dissolve Lok Sabha. Parliamentary elections are held every five years. The 545 seat (all but 2 of which are contested) Lok Sabha's term expires on May 31. The 16th Lok Sabha elections will be held between 7 April – 12 May in nine phases; results to be announced on 16th May.

Key Parties and key personalities

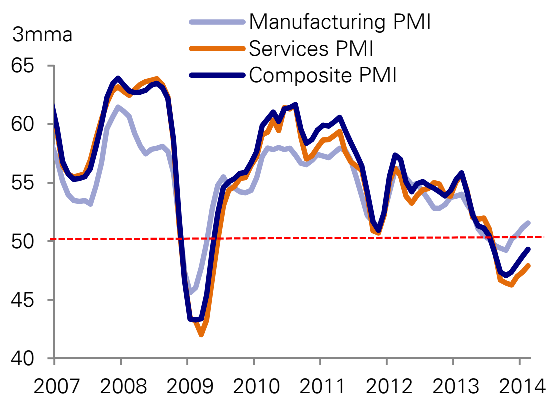
Indian National Congress (INC)	Bharatiya Janata Party (BJP)	Aam Aadmi Party (AAP)
Rahul Gandhi	Narendra Modi	Arvind Kejriwal
The oldest party in the country, the INC has been heading a coalition (United Progressive Alliance, or UPA) in power since 2004 (re-elected with a larger majority in 2009). Under Prime Minister Manmohan Singh (who has announced his intention to step down after the 2014 elections), it has enjoyed fairly widespread support from urban and rural voters, majority Hindus, minority Muslims, and both upper and backward castes. Its support has eroded in recent years, however, reflecting growing disenchantment with lapses in governance, slowdown in reform, and weakness in the economy.	Leads the National Democratic Alliance (NDA), and is the key challenger to INC's long run at the office in this year's general elections. First coming to prominence in the early 1990s, the BJP has become a Hindu nationalist counterpoint to INC's secular agenda, which the BJP has tended to regard as essentially appeasement of minorities. Having formed a government in 1999-2004, the BJP saw its popularity decline subsequently, and has only lately been reenergized. Part of its resurgence reflects anti-incumbency sentiments; but the party has also lately been successful in widening its support base to backward castes in recent years.	The AAP is the new player in India's political landscape. Formed at the culmination of a popular anti-corruption in late-2012, the party has risen through its campaign for clean governance. Its rhetoric found resonance in the 2013 Delhi Legislative Elections, where it won 28 out of 70 seats, allowing it to form a minority government (along with INC). AAP's reign in Delhi was short-lived and controversial, however, as it resigned just six weeks after taking office as it was unable to push through its preferred ombudsperson bill. The party is going ahead into the general elections with pledges to run for a large number of seats, challenging many well-entrenched candidates.

Source: Deutsche Bank

FY15 growth forecast maintained at 5.5%

Real GDP grew by 4.7%yoy in Oct-Dec'13, a tad lower than the previous quarter's outturn (4.8%yoy). The Indian economy has recorded a sub-5% GDP growth for over a year now, but recent data (PMI, auto sales, external trade) shows that economic momentum is picking up.

PMI indicating that economy has bottomed



Source: Haver Analytics, Deutsche Bank

Non-farm sector growth remained below 5%, but marked a slight improvement over the previous quarter (4.9%yoy vs. 4.8%yoy), led by a better performing services sector (6.7%yoy vs. 5.8%yoy). Meanwhile industrial sector production declined (-1.2%yoy vs. 1.5%yoy), with all sub-sectors – mining (-1.6%yoy vs. -0.4%yoy), manufacturing (-1.9%yoy vs. 1.0%yoy) and electricity (5.0%yoy vs. 7.7%yoy) – recording a lower growth rate compared to the previous quarter.

Within services, except for construction (0.6%yoy vs. 4.3%yoy), all other sub-sectors - trade/hotels/transport (4.3%yoy vs. 4.0%yoy), financing/insurance/ real estate (12.5%yoy vs. 10.0%) and community/social/personal services (7.0%yoy vs. 4.2%yoy) recorded an improvement from the previous quarter.

We had expected agriculture sector growth to be robust in Oct-Dec, reflecting the impact of a good monsoon and record harvest, but we were disappointed, as growth moderated to 3.6%yoy, from 4.6%yoy in July-Sep.

Expenditure side GDP, which tends to be volatile and less credible, showed a sharper deterioration in economic momentum. According to this metric, real GDP growth was 4.6%yoy in Oct-Dec, down from 5.6%yoy in the previous quarter. Private consumption (2.5%yoy vs. 3.0%yoy) and investment (-1.1%yoy vs. 1.8%yoy) momentum deteriorated, while government consumption increased sharply (4.0%yoy vs. 1.5%yoy). Exports growth was robust (11.4% vs. 14.8%yoy), though somewhat lower than the previous quarter, while imports growth weakened further (-3.8%yoy vs. 2.1%yoy), leading net exports to contribute 3.9% to overall growth (4.6%yoy). Adjusting for discrepancy (-0.6% drag to growth), real GDP growth was 5.2% in Oct-Dec vs. 7.2%yoy in the previous quarter.

Real GDP growth has averaged 4.6%yoy in the first three quarters of FY13/14. We expect economic momentum to improve slightly in the current quarter, but even then real GDP growth will likely continue to be below 5%. Factoring in 4.8%yoy growth for Jan-March'14, we estimate the full year FY14 real GDP growth to be 4.7%yoy, slightly lower than our previous estimate of 5.0%. Despite this downward revision, we maintain our FY15 growth estimate of 5.5% at this stage, on the premise that investment and growth momentum will start recovering once election uncertainty gets out of the way.

FY15 fiscal deficit target of 4.1% of GDP unlikely to be met

The government presented the interim budget for FY14/15 last month. In line with the medium-term fiscal framework, the government's goal is to reduce the fiscal deficit further to 4.1% of GDP in the next fiscal year (from 4.6% of GDP in FY13/14). The 50bps improvement is premised on higher revenue collection (0.2% of GDP), and simultaneous expenditure compression (0.3% of GDP).

We find the following assumptions of the FY14/15 budget striking:

- Gross tax revenues are projected to rise by 19%, about 300bps higher than the long-term average, and strikingly higher than 11.8% growth in FY13/14;
- Personal income tax receipts are budgeted to rise by 26.8%, 700bps higher than long-term average;
- Indirect tax receipts also have rather heroic assumptions (18.8% growth vs. 14.1% long-term average);
- INR570bn, amounting to 0.4% of GDP, would be raised through disinvestment, while the recent collection average is 0.2% of GDP;
- On the spending side, fuel and fertilizer subsidies are expected to top out at 0.5% of GDP each, although this would require perhaps about 0.3% of GDP of arrears (to be settled in the 1Q of the following budget year);
- Non-plan spending growth is budgeted to held down to 8.3%yoy, which would be extraordinary as over the long-term, spending has risen by, on average, 13.4%yoy.

Finally, the nominal GDP growth assumption of 13.4% seems optimistic, especially if real growth remains below 6% and inflation also heads down toward 6% next year. Indeed, along with nominal GDP running the risk of being projected too high, debt service may turn out to be higher if real interest rate on government debt rises owing to RBI's adoption of an inflation target regime. Given these considerations, and the fact that fiscal operation will be impacted by the elections, we expect the fiscal stance to be broadly neutral in FY14/15, i.e. the primary deficit would be unchanged at 1.3% of GDP, which corresponds with a 4.5% of GDP central government deficit.

Fiscal forecast

% of GDP	FY13, actual	FY14, revised est.	FY15, budget est.	FY15, DB forecast
Central govt. balance	**-4.9**	**-4.6**	**-4.1**	**-4.5**
Govt. revenue	9.1	9.4	9.6	9.0
Govt. expenditure	14.0	14.0	13.7	13.5
Central primary balance	-1.8	-1.3	-0.8	-1.3

Source: Budget Documents, Deutsche Bank

Current account outlook improves further

India's current account deficit (CAD) eased further in the last quarter of 2013 to a four-year low figure of USD4.2bn (0.9% of GDP). Trade deficit remained unchanged at USD33bn in Oct-Dec'13 vis-à-vis July-Sep, while net invisibles improved slightly from the previous quarter (USD28.9bn vs. USD28.1bn), leading to a further narrowing of the current account deficit.

Imports growth remained weak (14.8%yoy), particularly gold imports (-83%yoy). Exports growth remained broadly healthy (7.5%yoy) in Oct-Dec'13, aided by strong momentum in sectors such as engineering goods, readymade garments, iron ore, marine products and chemicals. Meanwhile, net invisibles remained robust, led by software services (USD16.8bn) and private transfers (USD16.2bn).

Capital account surplus increased sharply to USD24bn in Oct-Dec (after an outflow of USD5bn in July-Sep), but mainly on account of one-off FCNR (B) related flows. FDI flows remained broadly stable (USD6bn), while portfolio flows turned positive (USD2bn), leading to an improvement in foreign investment (USD8bn in Oct-Dec vs. USD6bn in July-Sep).

The improvement in the capital account coupled with the low current account deficit, led to a sizable net accretion of FX reserves (USD19bn) in Oct-Dec, helping more than offset the negative BOP balance seen in the previous quarter (in April-Dec'13, BOP balance was USD8bn on a cumulative basis).

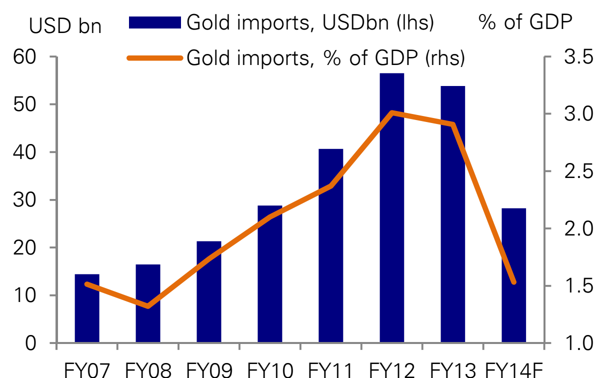
Balance of Payments snapshot

USD bn	Apr-Jun, 2013	July-Sep, 2013	Oct-Dec, 2013	Apr-Dec, 2013
Exports	74	81	80	235
Imports	124	115	113	352
Trade balance (a)	-50	-33	-33	-117
% of GDP	-11.3	-7.8	-6.9	-8.6
Invisibles (b)	29	28	29	86
Current account balance (a + b)	**-22**	**-5**	**-4**	**-31**
% of GDP	**-4.9**	**-1.2**	**-0.9**	**-2.3**
Capital account balance	**21**	**-5**	**24**	**40**
of which: Foreign investment	6	1	8	16
- FDI	6	8	6	21
- Portfolio	0	-7	2	-4
Loans	4	0	3	6
- ECB	1	2	4	7
Banking capital	10	1	16	27
- NRI deposit	6	8	21	35
Other capital	0	-7	-3	-10
BOP balance*	0	-10	19	8

Source: RBI, Deutsche Bank

In the first 9 months of FY14 (April-Dec'13), India's current account deficit was USD31.1bn (2.3% of GDP), significantly lower than the corresponding period of FY13 (USD69.8bn). Based on the recent trade deficit trend (about USD10bn per month), it is clear that current account deficit will be in the USD5-5.5bn range in Jan-March'14 as well, which should lead to a full year outturn of USD36.6bn (2% of GDP). This will constitute a USD51bn narrowing of CAD in one year, or about 2.7% of GDP worth correction from FY13. About half of the USD51bn improvement in CAD is due to lower gold imports, which should be around USD28bn in FY14 versus USD54bn in FY13.

Gold imports have come off sharply in FY14



Source: CEIC, Deutsche Bank

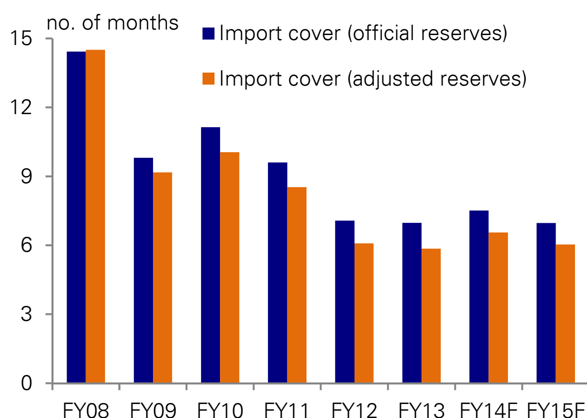
In FY15, we expect the current account deficit to be higher than this year (USD50.5bn vs. USD36.6bn), on the back of stronger imports growth (10%yoy in FY15 vs. -5.3%yoy likely in FY14). As restrictions on gold

imports ease and economic momentum picks up, imports growth should turn positive and raise the trade and current account deficit. But we don't expect gold imports to increase as sharply as in FY12 and FY13, to lead to renewed concerns on the CAD front. Funding a current account deficit of USD50bn (2.5% of GDP) should not be a problem as long as there is no negative fallout of the upcoming general election in April-May. Consequently, we remain constructive on the rupee.

FX reserves update. India's gross FX reserves currently stand at USD294.4bn (as of end-Feb), about USD19bn higher than the cyclical low seen in August 2013 (USD275.5bn), at the height of the currency turmoil. Based on our BOP forecast of merchandise trade, we estimate that gross FX reserves are now sufficient to provide an import cover of 7.5 months, an improvement over the outturn of the last two years (the import cover in FY12 and FY13 was about 7 months).

In FY15, the reserve adequacy position is likely to weaken somewhat, as imports recover from the current year's depressed levels, led by improvement in domestic demand and removal (at least partial) of restrictions on gold imports. If our BOP forecasts turn out to be correct, then the import cover should moderate to 7 months in FY15, but this will still be in line with the trend seen in FY12 and FY13. While 7 months' of import cover is sufficient from a reserve adequacy perspective, we think the Reserve Bank of India would still want to augment FX reserves, to insure itself against any potential volatility in global financial markets through 2014 and 2015. Consequently, we expect the RBI to buy Dollars as and when the rupee shows any sign of trend appreciation. This, in our view, will form a floor for the rupee, which in our view is around 61 against the Dollar.

Reserve adequacy not a concern but could be better



Source: IMF, RBI, Deutsche Bank

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India: Deutsche Bank Forecasts

	2012	2013	2014F	2015F
National Income				
Nominal GDP (USD bn)	1835	1859	1989	2176
Population (mn)	1218	1236	1255	1274
GDP per capita (USD)	1507	1504	1585	1709
Real GDP (YoY %) [1]	5.1	3.9	5.5	6.0
Private consumption	6.3	2.8	4.3	5.5
Government consumption	7.2	3.9	4.3	5.0
Gross fixed investment	2.2	0.1	4.5	6.5
Exports	6.7	5.9	11.7	13.2
Imports	10.8	1.0	6.4	11.0
Real GDP (FY YoY %) [1,2]	4.5	4.7	5.5	6.0
Prices, Money and Banking				
CPI (YoY%) eop	10.6	9.9	5.5	5.8
CPI (YoY%) avg	9.7	10.1	6.3	6.7
Broad money (M3) eop	11.2	14.9	15.0	15.8
Bank credit (YoY%) eop	15.1	14.1	16.7	18.2
Fiscal Accounts (% of GDP) [2]				
Central government balance	-4.9	-4.6	-4.5	-4.2
Government revenue	9.1	9.4	9.0	9.3
Government expenditure	14.0	14.0	13.5	13.5
Central primary balance	-1.8	-1.3	-1.3	-1.2
Consolidated deficit	-7.2	-7.0	-7.0	-6.7
External Accounts (USD bn)				
Merchandise exports	301.9	319.7	341.2	371.0
Merchandise imports	503.5	475.8	513.0	565.5
Trade balance	-201.7	-156.1	-171.8	-194.5
% of GDP	-11.0	-8.4	-8.7	-8.9
Current account balance	-91.5	-49.2	-48.5	-61.0
% of GDP	-5.0	-2.6	-2.5	-3.0
FDI (net)	15.4	26.3	25.0	30.0
FX reserves (USD bn)	294.9	295.7	299.7	308.3
FX rate (eop) INR/USD	54.8	61.8	61.0	63.0
Debt Indicators (% of GDP)				
Government debt	66.9	66.7	66.2	65.0
Domestic	63.1	62.9	62.4	61.3
External	3.8	3.8	3.8	3.8
Total external debt	20.5	23.1	24.2	25.2
in USD bn	376.3	429.0	480.5	547.7
Short-term (% of total)	24.4	25.7	27.1	28.5
General				
Industrial production (YoY %)	-0.6	-0.6	6.0	3.8
Financial Markets	*Current*	*3M*	*6M*	*12M*
Repo rate	8.00	8.00	7.75	7.50
3-month treasury bill	8.93	8.70	8.20	8.00
10-year yield (%)	8.74	8.70	8.50	8.30
INR/USD	61.3	62.1	61.0	62.0

Source: CEIC, Deutsche Bank. (1) By convention, we report "production-side" GDP growth rates (both FY and CY). The expenditure components may not add up to the headline GDP growth rate (even for historical data) due to discrepancies between these GDP figures and the "expenditure-side" GDP estimates. (2) Fiscal year ending March of following year.

Indonesia

Baa3/BB+/BBB-
Moody's/S&P/Fitch

- Economic outlook: Recent improvement in the trade data and FX market dynamic has reduced risks to the outlook only marginally. We are concerned that the trade deficit may well be structural and will not improve materially even if the cyclical weakness dissipated.
- Main risks: Indonesia is far from being insulated from global market volatility. As for domestic risk factors, Inflation could prove to be sticky if demand remains strong, and the rupiah could be just one poor trade data away from feeling depreciation pressure again.

A false dawn?

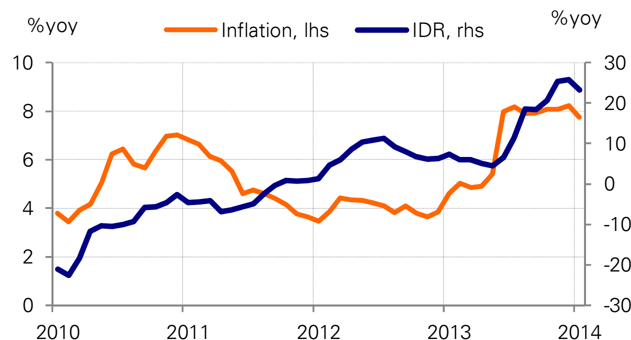
CPI inflation came in a tad weaker than expectation, rising by 7.75%yoy in February. The CPI index rose by 0.3%mom on the back of 0.4% increases in both the food and processed food categories. Clothing rose by 0.6%mom for the second consecutive month, thus keeping the core inflation momentum up (+4.6%yoy, +0.4%mom). Looking ahead, we see inflation remaining in the 7-7.8% range in the first half of the year, with some upside risks, especially if the economy continues to overheat.

We find it surprising that so much enthusiasm has been generated around the latest price data. The market, in our view, is pricing Indonesia's markets under the assumption of sharp disinflation in the second half of the year. This assumption rests simply on extrapolating the base effect stemming from last summer's fuel price increase.

We see several risks to that benign scenario. First, demand remains very strong in the economy, which could pull up prices in the coming months, especially around the elections. Second, the sharp depreciation of the rupiah has yet to manifest in pass-through, but the risk has by no means abated as importers begin to reset their prices. Third, the holy month of Ramadan, which tends to be associated with sharp rise in prices (which are seldom reversed) begins in late June, threatening to neutralize a large part of the favorable base effect. Fourth, with core inflation heading toward 5% in a matter of months, Bank Indonesia's benign view of the inflation dynamic may well be challenged. Finally, with the local price of fuel products falling considerably below international prices, the magnitude of suppressed inflation is considerable, which has adverse implications also for the fiscal position and balance of payments.

As per our forecast, inflation is unlikely to go below 5% this year even without a fuel price hike. Inflation could breach the top end of BI's inflation target (4.5%±1%) by the end of the year under middle-of-the road assumption about the price dynamic. If global market volatility were to rise as US rates rose during the same time, BI may be compelled to hike rates, in our view.

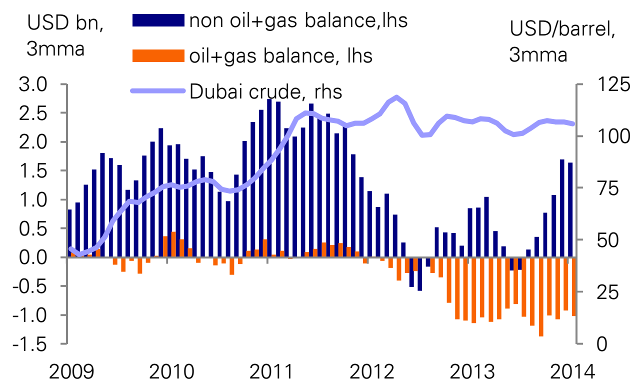
FX to inflation pass-through risk remains



Source: CEIC, Deutsche Bank

While inflation has been a source of some relief, data on the trade front has not offered that much respite. December's data was characterized by front loaded iron ore exports, the payback for which was in January, bringing the trade balance back to deficit territory (-USD0.4bn). Exports fell by 8.8%yoy, led by a collapse of mineral ore exports (-70%yoy; it was +40.4% in January). Imports were down 3.5%yoy, driven primarily by a contraction in oil imports.

Hardly any improvement in the oil+gas balance



Source: CEIC, Deutsche Bank

Unlike consensus views, we find Indonesia's trade and current account dynamics to be still unhealthy. There is a temptation to see the mild improvement in trade deficit in Q4 as the beginning of an adjustment trend, but we think that trade balances will remain firmly in negative territory as imports re-surge, helped by low interest rates, ample liquidity, and record high consumer confidence.

Our major concern is that Indonesia's commodity exports are on a structurally declining path. Crude oil production has been on a decline for a number of years due to poor investment in the oil sector. Exports of liquefied gas could be in jeopardy as the shale gas production spurt in the US pushes up supply and lowers prices. Coal exports to China may have limited upside as the world's second largest economy embraces cleaner energy and entertains import from the US (another byproduct of the shale revolution). Finally, latest legislative efforts to restrict exports of raw materials would almost certainly hurt the trade outlook. As these realities set in, expectations of a return to the old days of trade surplus may have to be re-examined.

In addition to lingering issues on inflation and balance of payments, both areas where our views are less sanguine than consensus, we are somewhat uncomfortable about the direction of economic policy-making both leading and subsequent to the 2014 Parliamentary and Presidential elections. Recent months have seen laws favoring local businesses and restricting primary mining product exports as well as import of inputs. Ostensibly, the goal is promote higher value added domestic industries and some element of import substitution. Restricting competition and foreign access are however the wrong ways to go about that, in our view. Studies on growth have repeatedly shown that economic openness and increased competition help investment, foster efficiency, and enhance consumer welfare. In the name of supporting domestic industries, Indonesian policy makers risk undermining many such benefits.

The fact that there has been virtually no opposition voiced by any of the major political parties or likely Presidential candidates about Indonesia's worrisome move toward economic nationalism suggests to us that this trend goes beyond election year politics. We are concerned that regardless of the make-up of the government later this year, issues like fuel price liberalization, improvement in the regulatory environment, and promotion of competition will remain in the back-burner. The medium-term outlook for the economy, therefore, is at risk of policy slippage.

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Indonesia: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	878.3	868.4	864.1	967.7
Population (mn)	247.2	250.4	254.8	259.2
GDP per capita (USD)	3553	3468	3392	3733
Real GDP (YoY%)	6.2	5.8	5.2	5.5
Private consumption	5.3	5.3	5.0	4.8
Government consumption	1.2	4.9	3.6	4.0
Gross fixed investment	9.8	4.7	5.0	6.5
Exports	2.0	5.3	7.0	6.3
Imports	6.6	1.2	6.5	5.5
Prices, Money and Banking				
CPI (YoY%) eop	3.7	8.1	**5.5**	**5.6**
CPI (YoY%) ann avg	4.0	6.4	**6.4**	**5.4**
Core CPI (YoY%)	4.4	5.0	5.0	4.5
Broad money (M2)	13.5	13.0	13.0	15.0
Bank credit (YoY%)	24.7	21.0	16.0	20.0
Fiscal Accounts (% of GDP)				
Budget surplus	-2.3	-2.2	-2.4	-2.6
Government revenue	16.5	16.6	16.2	15.8
Government expenditure	18.8	18.8	18.6	18.4
Primary surplus	-0.3	-0.2	-0.4	-0.6
External Accounts (USD bn)				
Merchandise exports	188.5	183.5	188.2	199.8
Merchandise imports	179.9	177.4	181.8	192.8
Trade balance	8.6	6.1	6.4	6.9
% of GDP	1.0	0.7	0.7	0.7
Current account balance	-24.4	-28.5	-25.9	-26.1
% of GDP	-2.8	-3.3	-3.0	-2.7
FDI (net)	13.7	14.8	14.0	20.0
FX reserves (USD bn)	112.8	99.4	101.9	110.2
FX rate (eop) IDR/USD	9646	12087	11700	12000
Debt Indicators (% of GDP)				
Government debt	23.0	22.2	22.0	22.5
Domestic	12.2	11.2	11.0	11.0
External	10.8	11.0	11.0	11.5
Total external debt	28.7	29.7	32.8	30.5
in USD bn	252.4	260.0	290.0	300.0
Short term (% of total)	17.8	19.2	19.0	19.0
General				
Industrial production (YoY%)	8.0	8.0	7.0	7.0
Unemployment (%)	6.8	6.5	6.0	6.0
Financial Markets	Current	3M	6M	12M
BI rate	7.50	7.50	8.00	8.00
10-year yield (%)	8.05	8.30	8.50	8.50
IDR/USD	11500	11500	11600	11850

Source: CEIC, DB Global Markets Research, National Sources

Malaysia

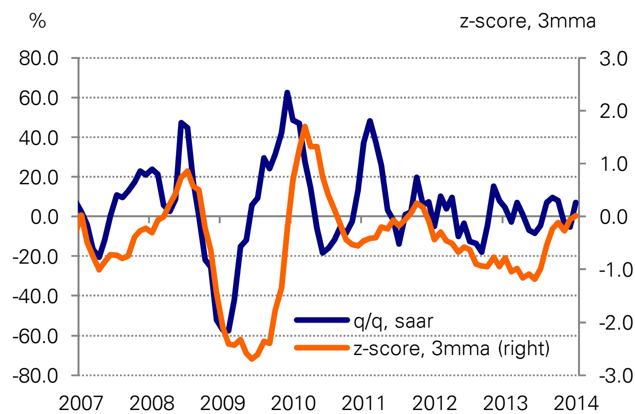
A3/A-/A-(Neg)
Moody's/S&P/Fitch

- Economic outlook: Exports and investments are expected to guide GDP growth higher this year.
- Main risks: Rising inflation could dampen consumer spending more than expected.

Exports, investments to guide growth

The recovery in Malaysia's exports is crucial for the economy to grow above 5% this year especially as domestic demand eases due to tight fiscal policy. After falling in the first half of 2013, export revenues have regained momentum and grew at an average annual rate of 11% in November-January, in line with long-run exports growth. But this pick-up in growth may still be partly due to a low base effect as exports were on a downward trend in late 2012 through early 2013. In fact, the quarter-on-quarter seasonally adjusted annualized rate still bodes for an uncertain recovery in the demand for Malaysia's exports.

A still fragile recovery in Malaysia's exports



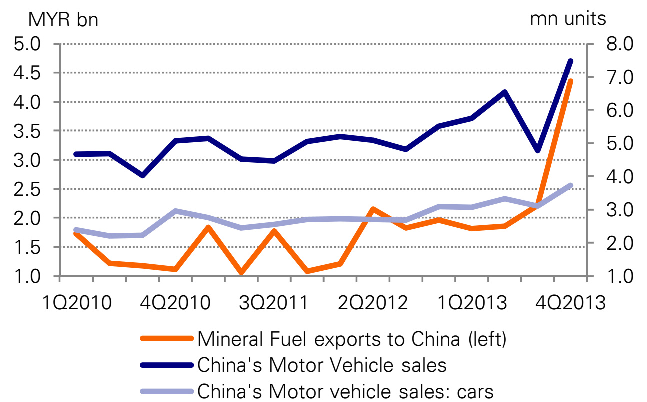
Source: CEIC and Deutsche Bank

The acceleration of exports since August last year has been driven by stronger demand coming from China and the EU, which account for 14% and 9% of total export revenues, respectively. Exports to the US, which account for 8%, however, have remained below their 2012 levels while exports to Singapore (14% share) have been broadly flat.

By commodity, electrical and electronic products fueled the rise in exports but we also saw shipments of petroleum products, crude petroleum, and liquefied natural gas growing steadily towards early 2014.

Mineral fuel exports to China, accounting for 10.6% of Malaysia's total exports to the country, surged 65%mom in November-December (150%yoy). This trend perhaps reflects China's rapidly growing demand for automobiles and serves as a relief to Malaysia's commodity exports. That is, Malaysia still stands to gain from strong demand for mineral fuel despite a possible fall in prices due to better supply. Likewise, exports of manufactured goods to China (13.6% share) trended upwards starting in July last year. But what took the biggest share of Malaysia's exports to China was machinery and transport equipment (44%), which grew more modestly at 13%yoy in the past months.

China's rising demand for mineral fuels



Source: CEIC and Deutsche Bank

Exports to the US have yet to pick up significantly since the contraction early last year. But as economic activities in the US firm up, Malaysia's exports to the US could rebound as well. Thus, Malaysia's exports could well benefit from a firmer recovery in the US, bottoming out of the Eurozone, and acceleration of the Chinese economy.

The government is also counting on private investments to support growth this year as it plans to cut down spending (in real terms) to meet the fiscal deficit target of 3.5% of GDP. Approved investments, both domestic and foreign investments, grew 30%yoy in the first half of 2013 to reach MYR97.4bn, with more than half going into the services sector. Investment indicators such as loans disbursed to the construction sector, production of iron and steel, and sales of commercial vehicles also continue to grow, suggesting upbeat investment activity going forward. Malaysia's foreign direct investments, which tend to be export-oriented, are also expected to grow as the external environment improves.

The government, however, will have to step in to support growth should private investments fall short of the 12.7%yoy (real) projected growth for this year. This move would entail the government to carry out further consolidation measures to meet the fiscal deficit target.

Authorities we saw in Kuala Lumpur back in January shared that further measures are necessary to meet the MYR7bn reduction in the subsidy bill under the 2014 Budget. These include a toll rate adjustment and another round of fuel and natural gas subsidy cut. Toll rates, however, are now out of the picture as the government already announced it will not raise toll rates this year. This implies it could cut fuel subsidies by more than 10 sen per litre as we earlier expected. We expect these two measures to be rolled out in the latter half of the year.

Estimated subsidy savings in 2014

Date	Reforms (price increase)	Est. savings
3-Sep-13	Cut in petrol, diesel subsidies (+MYR0.20 per litre)	2.475
26-Oct-13	Removal of sugar subsidy (+MYR0.34 per kg)	0.231
1-Jan-14	15% hike in electricity tariffs (+MYR4.99 per kWh)	4.000
Date (DB)	**Possible reforms in 2014**	**Est. savings**
NA	Toll rate hike (+MYR0.30-2)	NA
Jul-14	Cut in petrol, diesel subsidies (+MYR0.10 per litre)	0.825
Sep-14	Cut in domestic LNG subsidy (+MYR1 MMBtu)	0.797
	Less: Additional subsidy allocation in 2014	
	Extended financial assistance (BR1M 3.0)	-1.600
	Total	*6.728*

Notes: Estimated savings are pro-rated. Sugar subsidy saving based on 2012 expenditure. LNG subsidy cut saving based on June 2011 subsidy cut savings.
Source: Fiscal Policy Committee under the Prime Minister's office, Ministry of Finance Economic Report 2013/14, and Deutsche Bank

Meanwhile, we maintain our view that the BNM will hike the OPR by 25bps in July. The BNM expects inflation to gradually rise going forward due to higher domestic costs. And it also seems to send the message that it will only hike rates if inflation is driven by domestic demand. The past two monetary policy statements this year have seen a slight change in rhetoric with the recent report stating that "subdued external price pressures and moderate domestic demand conditions will, ***to some extent***, contain the impact of these cost factors on the underlying inflation." Definitely, room for steady rates is narrowing.

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Malaysia: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	305.1	310.5	327.2	356.1
Population (mn)	29.3	29.6	29.9	30.2
GDP per capita (USD)	10400	10483	10942	11792
Real GDP (YoY%)	5.6	4.7	5.5	5.6
Private consumption	7.7	7.6	5.4	6.3
Government consumption	5.1	6.3	5.3	2.8
Gross fixed investment	19.9	8.7	5.9	5.4
Exports	-0.1	-0.3	3.7	5.3
Imports	4.7	2.0	4.1	5.2
Prices, Money and Banking				
CPI (YoY%) eop	1.2	3.2	2.8	2.4
CPI (YoY%) ann avg	1.7	2.1	3.1	2.9
Broad money (M3)	13.4	8.1	10.3	9.2
Bank credit (YoY%)	12.5	9.9	10.3	9.2
Fiscal Accounts (% of GDP)				
Federal government surplus	-4.5	-3.9	-3.8	-3.3
Government revenue	22.1	21.7	20.8	21.7
Government expenditure	26.7	25.6	24.5	25.0
Primary fed. gov't fiscal	-2.4	-1.9	-1.6	-1.2
External Accounts (USD bn)				
Merchandise exports	227.9	217.9	238.9	261.3
Merchandise imports	187.2	185.5	205.9	225.8
Trade balance	40.7	32.3	33.1	35.5
% of GDP	13.3	10.4	10.1	10.0
Current account balance	18.6	11.7	14.0	19.5
% of GDP	6.1	3.8	4.3	5.5
FDI (net)	-7.0	-1.3	-1.5	-0.1
FX reserves (USD bn)	139.7	134.9	133.8	131.6
FX rate (eop) MYR/USD	3.05	3.25	3.20	3.16
Debt Indicators (% of GDP)				
Government debt*	68.5	70.8	67.0	68.2
Domestic	67.6	69.1	65.5	66.6
External	1.8	1.7	1.5	1.6
Total external debt	27.0	32.3	22.3	23.9
in USD bn	82.6	96.9	73.9	85.3
Short-term (% of total)	36.8	40.3	43.3	41.7
General				
Industrial production (YoY%)	4.5	2.7	3.1	3.3
Unemployment (%)	3.0	3.1	3.0	3.1
Financial Markets	*Current*	*3M*	*6M*	*12M*
Overnight call rate	3.00	3.00	3.25	3.25
3-month interbank rate	3.31	3.31	3.55	3.55
10-year yield (%)	4.11	4.25	4.40	4.60
MYR/USD	3.29	3.32	3.33	3.21

**Includes government guarantees*
Source: CEIC, DB Global Markets Research, National Sources

Pakistan

Caa1(Neg)/B-
Moody's/S&P

- Economic outlook: The ongoing fiscal consolidation and monetary tightening in Pakistan has expectedly impacted economic momentum.
- Main risks: The main risk is that the IMF program gets suspended at some point, given the inability of the Pakistani authorities to meet the reform targets. In such a scenario, Pakistan will be engulfed in a full blown external crisis which is likely to have disastrous consequences for the economy.

Adjustment underway

Pakistan's economy continues to be under considerable stress, despite its formal engagement with the IMF since last September [17] through the USD6.6bn Extended Fund Facility program. The financial and technical assistance from the IMF has played a pivotal role so far, to avert a full blown external financing crisis in Pakistan, but the near-term economic outlook continues to be challenging.

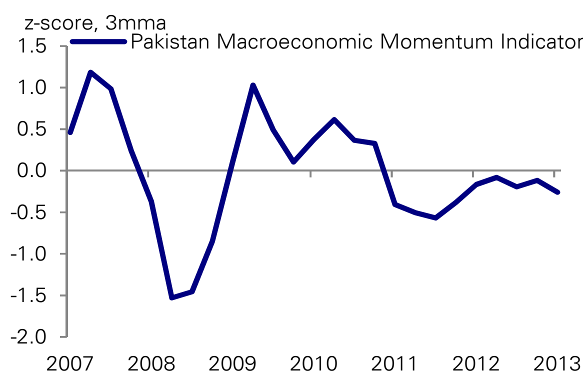
However, this is not surprising, as the structural reforms embraced by the Pakistani authorities (fiscal consolidation, energy sector reforms, privatization etc.), was bound to have painful consequences in the near term. Not that Pakistan had much choice in this regard. If the authorities did not embrace key reforms, the IMF would not have lent Pakistan the required money to meet its external debt obligation (bulk of it to the IMF itself), which would have led to a potential debt default and caused even greater stress in the near term. The medium- to long-term economic outlook would have deteriorated even further in such a scenario. At least the current IMF program, while being painful in the near term, holds a promise for a better future, if Pakistan can endure with the reforms agenda for the next few years.

In this piece, we provide an update on the latest macro developments in Pakistan, with an aim to assess how the economy has fared in the last six months.

Growth momentum slowing

The ongoing fiscal consolidation and monetary tightening in Pakistan seems to have impacted economic momentum, in our view. Pakistan does not release quarterly GDP figures; so in order to assess the underlying strength in the economy (relative to its own history), we construct a macroeconomic momentum indicator (MMI) for Pakistan, using yoy growth rate of five high frequency indicators (manufacturing, exports, imports, bank credit and vehicle sales). To construct the MMI, we normalize the data since 2007 for each indicator by calculating their z-scores (subtracting the mean and dividing by the standard deviation). We then average across the z-scores for all indicators to calculate the MMI. Our calculation shows that the MMI has fallen in Oct-Dec'13 from July-Sept'13 (z-score -0.3 vs. -0.1), indicating slowdown in growth momentum.

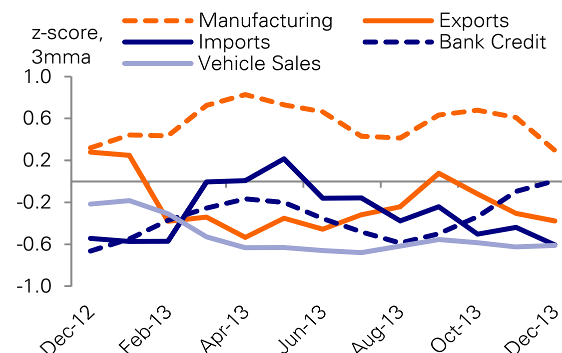
Pakistan Macroeconomic Momentum Indicator



Source: State Bank of Pakistan, CEIC, Deutsche Bank

Among the five sub-components, only credit growth momentum has recorded an improvement, albeit from a very low base, while other components have slowed further in Oct-Dec'13, from the previous quarter.

Sub-components of Pakistan MMI



Source: State Bank of Pakistan, CEIC, Deutsche Bank

We see little scope for growth momentum to improve in the remaining part of this fiscal year. There could be some support from exports growth, if the global recovery gains momentum, but this will get offset by

[17] "Special Report: Pakistan – a new innings on a precarious wicket, 25th September 2013"

weak domestic demand, led by further monetary tightening and fiscal contraction. We maintain our forecast that Pakistan's real GDP growth will moderate to 3% in FY14 (from 3.6% in FY13), which will be in line with the average growth outturn of the last five years (2.9%). If the authorities manage to stabilize the economy and improve confidence, by enduring with fiscal and energy reforms, then the growth outlook could start improving gradually from next year, but there is no way that Pakistan can avoid a growth slowdown in the current fiscal year, in our view.

Fiscal concerns remain

The Pakistani authorities aim to reduce the FY14 general budget deficit to 6.3% of GDP, from 8.0% of GDP in the previous year. The IMF wants the government to aim for a sharper fiscal consolidation, so as to bring down the deficit to 5.5% of GDP in FY14.

How realistic are these forecasts? Is there a risk of fiscal slippage? The table below, which shows the fiscal position of the government in the first half of FY14 (July-Dec) can help provide some insight. As shown below, revenue collections – especially tax revenue – are running short of target (only 44% of FBR tax revenue was collected in 1HFY14, when at least 50% should have been collected), which implies that tax collection growth will have to pick up pace in the 2H of FY14 to offset the shortfall in the 1H. This essentially means that FBR tax revenue growth would have to be higher in 2H FY14 (Jan-June 2014) than the 27.8%yoy target set for the year as a whole, which is virtually impossible, given the weak growth environment.

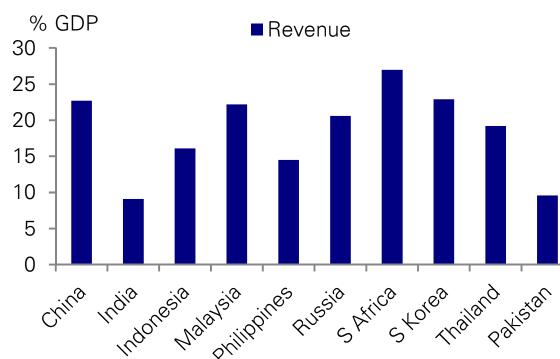
Pakistan has one of the lowest tax/GDP ratio in the region. Acknowledging this shortcoming, the Pakistani authorities announced a number of measures in this fiscal year to strengthen tax administration and revenue collection, which included increase in tax rates, removal of exemptions and broadening of the tax base. We think these measures will help to improve tax collection to some extent in FY14, but not as much as the government expects. We have factored in an improvement in tax/GDP ratio to 10.0% of GDP, from 9.6% of GDP in FY13 versus the government's expectation of tax/GDP ratio increasing by 1%point to 10.6% of GDP in FY14.

Fiscal position: July-December 2013

PKR bn	FY13	FY14BE	July-Sep 2013	July-Dec 2013	July-Dec, % of BE
Total revenue: o/w	**2982**	**3640**	**830**	**1685**	**46.3**
FBR Tax revenue	1936	2475	495	1084	43.8
SBP profit	220	200	80	145	72.5
CSF money	172		-		
3-G license fee		120	-		
Current exp.: o/w	3676	3964	868	1888	47.6
Interest	991	1154	301	598	51.8
Development & net lending	1140	1327	170	326	24.6
Total expenditure	**4816**	**5291**	**1117**	**2225**	**42.0**
Budget Balance	**-1834**	**-1651**	**-287**	**-540**	**32.7**
% of GDP	**-8.0**	**-6.3**	**-1.1**	**-2.1**	**33.3**

Source: State Bank of Pakistan, Deutsche Bank

Revenue/GDP ratio: cross-country trend



Source: State Bank of Pakistan, Deutsche Bank

The likely slippage in tax collection is going to make it even more crucial for fiscal authorities to achieve the non-tax revenue target, within which some items are of one-off nature such as proceeds from spectrum auction (PKR 120bn) and Coalition Support Fund. Pakistan has received USD352mn from US out of a total of USD1.4bn CSF budgeted during the current fiscal year; any delay in receiving the rest of the funds could weaken the revenue position of the government further.

With revenue expected to fall short of the budget estimate, it is imperative that expenditure compression happens at a larger scale to meet the headline budget deficit target. With little scope for current expenditure to be cut aggressively (given the sticky nature of expenditure items within this category), the adjustment therefore will need to happen on the capital expenditure front. This is what the government seems to be doing at present. In 1HFY14, the government has only spent 25% of budget estimate on development expenditure as against 48% on current expenditure. We

think the government has no other option but to continue under-spending on development expenditure (which would be a drag on growth), if it wants to meet the headline budget deficit target (we forecast development expenditure to be only 4.5% of GDP vs. budget estimate of 5.1% of GDP, with a risk of it to be cut even more aggressively, if revenue slippages turn out to be higher than anticipated).

Fiscal deficit forecast: Government vs. DB

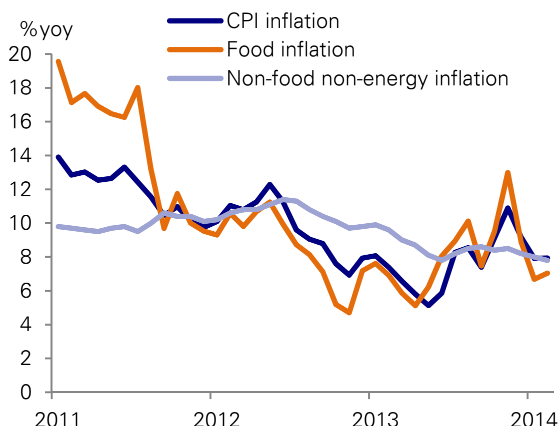
% of GDP	FY12*	FY13*	FY14BE	FY14DBF
Government revenue	12.8	13.0	14.0	13.2
Tax	10.2	9.6	10.6	10.0
Non-tax	2.6	3.4	3.4	3.2
Government expenditure	21.5	21.0	20.3	19.7
Current	17.8	16.0	15.2	15.2
Development & net lending	3.7	5.0	5.1	4.5
General government balance	**-8.8**	**-8.0**	**-6.3**	**-6.5**

Source: State Bank of Pakistan, Deutsche Bank. Note: FY12 and FY13 fiscal balance includes the impact of debt consolidation of the power sector*

More rate hikes to come

Measures taken in the last six months to reduce the fiscal deficit (hike in electricity tariffs, upward revision of GST, withdrawal of exemptions) have adversely affected the inflation dynamic in Pakistan. Headline CPI inflation touched 11% in November last year, up from 5.1% in May 2013, primarily reflecting the impact of the fiscal adjustment. Since then, headline CPI inflation has eased somewhat in December - February, led by decline in food prices (food items constitute 36% weight in overall CPI), but is still hovering around high single digit levels. Demand side inflation pressure (non-food non-energy inflation), on the other hand, has not accentuated materially, given weak growth momentum.

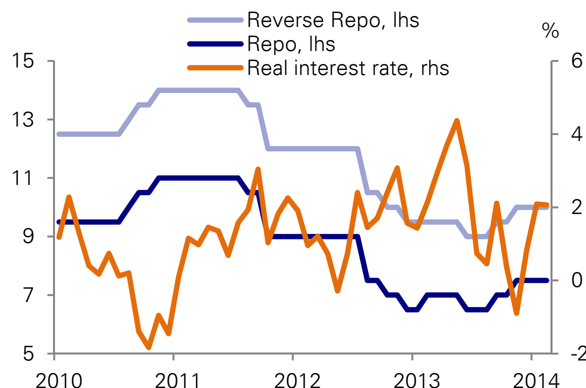
Inflation trend



Source: State Bank of Pakistan, CEIC, Deutsche Bank

The State Bank of Pakistan has increased the policy rate by 100bps in FY14 so far (50bps each in September and November of 2013), which has helped increase the real interest rate and reduce the depreciation pressure on the rupee to some extent.

Policy rates and real interest rate

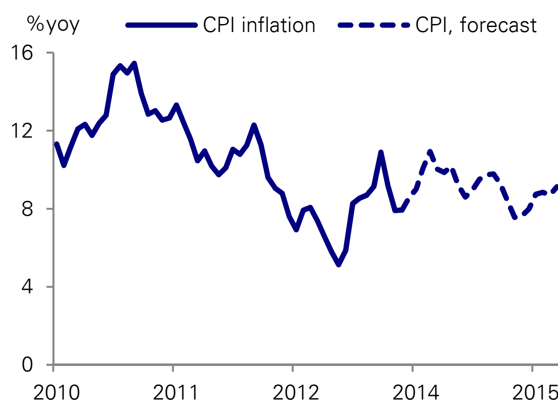


Source: State Bank of Pakistan, CEIC, Deutsche Bank

But we see scope of further increase in policy rate in the months ahead. Indeed, the yield curve in Pakistan's bond market is reflecting similar sentiments – while the entire yield curve has shifted upward post the rate hikes, the increase has been more in the shorter-tenor relative to the longer-tenor, likely reflecting the prospect of further rate hikes. We see three factors that can induce the SBP to favor further rate hikes in the months ahead:

i) The inflation trajectory is likely to worsen in the remainder period of FY14, led by a negative base effect, which may warrant further rate hikes to anchor inflation and inflation expectations;

Inflation forecast



Source: State Bank of Pakistan, CEIC, Deutsche Bank

ii) Without further rate hikes, real interest rates will decline, which may have negative consequences for deposit mobilization and exchange rate stability;

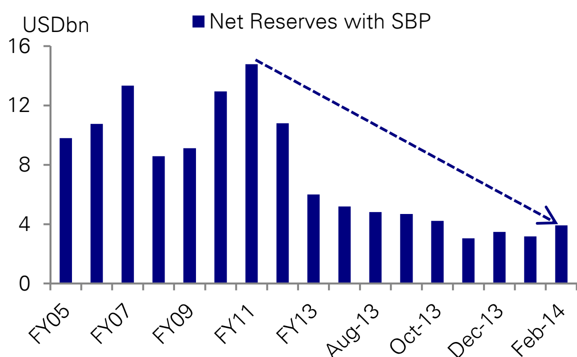
iii) Increase in policy rate would incentivize the government to aim for a faster and more substantive fiscal consolidation, failing which, the debt/GDP ratio could be adversely affected.

We forecast SBP to hike the policy rate (currently at 10%) by another 50-100bps in the remainder period of this calendar year. Inflation pressure may not subside immediately (we forecast CPI inflation to average 9.0% in FY14 and FY15), even with these rate hikes, given the weak transmission mechanism, but at least it will reflect the central bank's commitment to anchor inflation expectations and help maintain exchange rate stability. For inflation to ease materially and sustain at mid single-digit levels, supply-side reforms would have to play a major role. Unless supply-side bottlenecks are tackled decisively (by accelerating infrastructure investment, raising electricity production, enhancing efficiency in supply-chain management) and the fiscal situation improves substantively, the likelihood of achieving a growth-supportive low and stable inflation environment remains dim, in our view.

External sector remains vulnerable

Pakistan's external sector outlook continues to be negative. Despite receiving two tranches of financial support from the IMF totaling USD1.1bn (Sept and December 2013), Pakistan's net reserves have fallen to USD3.9bn in February, from USD6bn in June last year. Pakistan's debt servicing related payments have turned out to be larger than the disbursements received from various multilateral institutions, leading to a net drain of foreign exchange reserves. Repayments to IMF alone were USD1.9bn in 1HFY14, higher than the funds received under the EFF program.

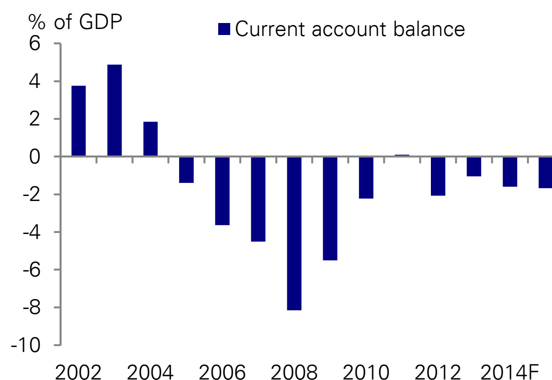
Reserves position has deteriorated in FY14



Source: State Bank of Pakistan, Deutsche Bank

The higher-than-anticipated rise in current account deficit (CAD) during 1HFY14 has complicated matters further. As per recent data, CAD amounted to 1.3% of GDP in 1HFY14, significantly higher than the previous year's outturn during the comparable period (0.1% of GDP). Given the latest data, we think the full year CAD should be close to 1.6% of GDP (USD4bn), about 50bps higher than that of the previous year (1.1% of GDP).

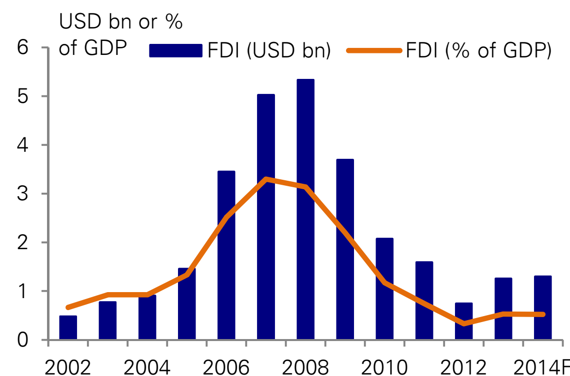
Current account deficit likely to increase in FY14



Source: State Bank of Pakistan, CEIC, Deutsche Bank

A higher current account deficit (we had earlier forecasted CAD to be 0.7% of GDP in FY14) amidst weak financial inflows imply a negative BOP balance and increases the Pakistani authorities' dependence on financial assistance more than ever to bridge the external financing gap. It would have obviously been a big help to Pakistan, if the IMF authorities agreed to make the EFF disbursements more front loaded, but the likelihood of this happening is low, given Pakistan's dismal track record of program completion in the past.

FDI flows need to improve appreciably to reduce pressure on current account deficit financing



Source: State Bank of Pakistan, Deutsche Bank

Recent IMF press statements suggest that the Pakistani authorities have broadly met the end-December 2013 program targets, which should qualify them to receive financial assistance of USD550mn next month. This should help to ease some pressure on the BOP front, as Pakistan's net financing from IMF should start to increase from here on (as the financial assistance expected from IMF would be higher than the repayments that the Pakistani authorities need to make in the coming quarters). Besides the financial support from IMF and other multilateral organizations, prospective inflows need to materialize in a timely manner to improve the BOP position. These include realization of arrears worth USD800mn from the privatization of PTCL, USD500mn through issuance of Euro bonds and receipt of the balance USD1bn from the Coalition Support Fund. It is difficult to say with certainty how much of these inflows will materialize in the remainder period of FY14; as a result the near-term outlook regarding Pakistan's external position is likely to remain uncertain for now, in our view.

Balance of Payments

USD mn	FY13 July-June	FY13 July-Dec	FY14 July-Dec	FY14 DBF July-June
Exports	24802	12154	12548	26786
Imports	40157	20060	20852	43370
Trade a/c balance	-15355	-7906	-8304	-16583
Invisibles, net	12859	7823	6715	12600
Services	-1564	-47	-1431	-2200
Income	-3669	-1712	-1967	-3400
Transfers: o/w	18092	9582	10113	18200
Worker remittances	13922	7117	7790	14790
Current a/c balance	**-2496**	**-83**	**-1589**	**-3983**
% of GDP	-1.1	-0.1	-1.3	-1.6
Capital & Financial a/c	**813**	**-464**	**119**	**3070**
Capital a/c	264	98	135	270
Financial a/c: o/w	549	-562	-16	2800
FDI	1258	521	329	1000
Portfolio investment	26	104	59	250
Other investment	735	1187	402	900
Errors and omissions	-309	-84	-392	-100
Overall Balance	**-1992**	**-631**	**-1862**	**-1013**

Source: State Bank of Pakistan, Deutsche Bank

Is the worst over for the rupee? In line with the deterioration in FX reserves position, the Pakistani rupee depreciated sharply during July-December 2013 (about 8% against the US dollar). Since then, the rupee has recovered smartly, primarily led by SBP's intervention in the FX market.

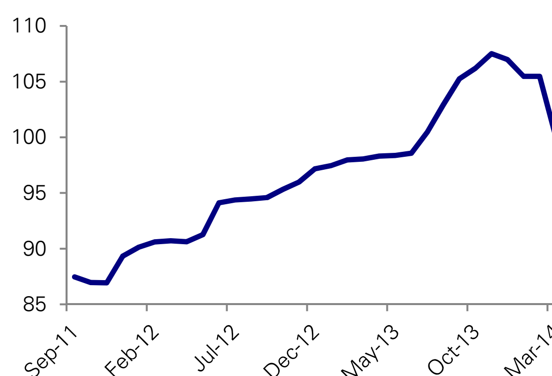
Given the vulnerable external position, the worst may not yet be over for the Pakistani rupee. We see the rupee continuing on a gradual depreciation path, led by three factors:

Negative BOP balance: We forecast BOP balance to be negative, as financial flows are unlikely to be sufficient to finance the CAD in FY14, leading to a weak rupee.

Dollar buying need to augment FX reserves: Given the critical reserves level, the SBP may need to continue buying US dollars to improve reserve adequacy, which would lead to depreciation of the Pakistani rupee.

Broad US dollar strength: Fed tapering will likely add to the depreciation pressure on the rupee, as the US dollar continues to strengthen against all major currencies in the months ahead.

PKR/USD has stabilized; but not out of the woods yet



Source: CEIC, Deutsche Bank

As long as the rupee depreciation remains orderly, we think Pakistan will be able to bear its consequences. This is in fact our base case scenario, in which we expect the rupee to depreciate to 105 by June this year and to 110 by June next year against the US dollar. The risk however is that beyond the immediate near term, Pakistan fails to meet the program targets set by the IMF, which leads to a termination of the EFF program, thereby resulting in a full blown external crisis and a disorderly depreciation of the rupee. The consequences could be catastrophic in such a scenario, which the Pakistani authorities would try to avoid at all costs, in our view. A relatively easier alternative for the authorities would be to endure painful reforms at this stage to pave the path for a better future for Pakistan in the years ahead.

Pakistan and IMF – a relationship fraught with disengagement risks

Pakistan joined the International Money Fund in 1950 and so far has engaged in 16 programs (including the recent one) with the fund starting from1958. Pakistan's track record of program completion has been dismal; only 8 out of the last 15 programs have been completed successfully with the rest terminated midway due to the Pakistani authorities' inability to meet the program targets.

During the seventies and eighties period, most of the IMF programs were short-term oriented (1 year arrangements) aimed at temporary assistance but since the nineties this trend changed. During the nineties, Pakistan entered into both short-term and multi-year programs with the IMF, with the latter requiring the Pakistani authorities to embrace various structural reforms in exchange of financial assistance. In the last decade (2000-2010), Pakistan availed financial assistance three times from the IMF; two of these programs were completed successfully, while the last one (a 23-month SBA initiated in November 2008) was terminated in September 2011, due to failure on the authorities' part to implement GST and constrain fiscal deficit and power sector subsidies.

Pakistan is yet again confronted with the same economic challenges, though the complexity and magnitude of the problems have increased manifold. The assistance by IMF through the 3-year EFF programme has prevented an outright Balance of Payments crisis and given time to the Pakistani authorities to embark on structural reforms aimed at reducing growth-constraining large deficits and debts.

But will the authorities manage to achieve the targets and complete the program successfully? Going by past experience, it is hard to arrive at a conclusive answer. But this time Pakistan is in a far tougher spot and does not have any choice but to stick to the reforms agenda, in exchange of financial assistance to tide over its large repayment obligations. This do-or-die situation could however turn out to be the much needed catalyst that was missing earlier to endure with growth-critical reforms, in our view, and may help transform the present crisis into an opportunity for the future. With the IMF backstop firmly in place, it is up to the Pakistani authorities now to leverage the opportunity to its maximum advantage.

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Pakistan: Deutsche Bank forecasts

	FY12	FY13	FY14F	FY15F
National Income				
Nominal GDP (USD bn)	225.1	236.8	243.2	268.5
Population (mn)	180.7	184.4	188.0	191.8
GDP per capita (USD)	1246	1285	1294	1400
Real GDP (YoY %)	4.4	3.6	3.0	3.5
Private consumption	5.8	4.0	2.5	3.3
Government consumption	7.3	9.7	5.0	4.0
Gross fixed investment	1.5	0.8	0.5	2.0
Exports	-15.3	12.2	4.0	6.0
Imports	-3.6	-2.4	0.0	4.0
Prices, Money and Banking				
CPI (YoY%) eop	11.3	5.9	11.0	7.6
CPI (YoY%) avg	11.0	7.4	9.0	9.0
Broad Money, M2 (YoY%) eop	14.1	15.9	13.3	14.4
Credit growth, (YoY%) eop	0.1	1.9	6.9	3.7
Fiscal Accounts (% of GDP)				
Federal government balance	-8.8	-8.0	-6.5	-5.0
Government revenue	12.8	13.0	13.2	13.5
Government expenditure	21.5	21.0	19.7	18.5
Primary balance	-4.3	-3.7	-2.2	-1.0
External Accounts (USD bn)				
Merchandise exports	24.7	24.8	26.8	28.7
Merchandise imports	40.4	40.2	43.4	46.4
Trade balance	-15.7	-15.4	-16.6	-17.7
% of GDP	-7.0	-6.5	-6.7	-6.6
Current account balance	-4.7	-2.5	-4.0	-4.5
% of GDP	-2.1	-1.1	-1.6	-1.7
FDI (net)	0.7	1.3	1.3	1.5
FX reserves (USD bn)	10.8	6.0	5.0	7.0
FX rate (eop) PKR/USD	94.1	98.7	105.0	110.0
Debt Indicators (% of GDP)				
Government debt	64.3	63.2	63.9	62.9
Domestic	38.0	41.5	44.5	45.8
External	26.3	21.7	19.4	17.1
Total external debt	29.1	25.2	24.0	23.0
in USD bn	65.5	59.6	59.7	62.3
Short-term (% of total)	0.6	0.0	0.8	0.9
General				
Industrial production (YoY %)	1.6	4.4	4.7	5.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.00	10.50	11.00	11.00
PKR/USD	100.9	105.0	107.4	108.5

Source: National Sources, CEIC, Deutsche Bank. Note: Financial year starts from 1 July and ends on 30 June of the following year.

Philippines

Baa3(Pos)/BBB-/BBB-
Moody's/S&P/Fitch

- Economic outlook: Growth could improve in the first quarter on the back of buoyant investments and net exports.
- Main risks: Inflation could surprise prompting the BSP to hike rates earlier than expected.

Public investments to support growth

GDP growth in the first quarter is expected to improve from the 6.5% reading in 4Q2013 on the back of buoyant investments and government consumption. Despite a potential slowdown in private construction in the first quarter (based on the decline in construction permits in 4Q), the economy stands to gain from the government's plan to increase infrastructure spending by 37%yoy this year. Already, infrastructure projects such as the construction of roads under the PPP scheme linking major parts of the main island of Luzon have started in February. Also scheduled for construction within the coming months are 13 more public infrastructure projects in Metro Manila, which are expected to be completed by 2016 when the President ends his term of office. Moreover, the government is planning to roll out six more PPP projects this year on top of the six that have already been awarded.

Awarded and soon-to-be awarded PPP projects

Project	Estimated Cost (PHP bn)	Stage
Daang Hari-SLEX Link Road	2.01	Awarded
PPP for School Infrastructure Project Phase I	16.28	Awarded
NAIA Expressway Project	15.52	Awarded
PPP for School Infrastructure Project Phase II	3.86	Awarded
Modernization of the Philippine Orthopedic Center	5.69	Awarded
Automated Fare Collection System	1.72	Awarded
Mactan-Cebu International Airport Passenger Terminal Building	17.52	For issuance of NOA
Cavite-Laguna Expressway	35.42	For bid submission
LRT Line 1 Cavite Extension and O&M	64.9	For bid submission
Integrated Transport System - Southwest Terminal Project	2.5	For bid submission
Bulacan Bulk Water Supply Project	24.4	For issuance of ITPB
Integrated Transport System - South Terminal Project	5.2	For roll-out

NOA = Notice of Award; ITPB = Invitation to Pre-qualify and Bid; O&M = Operation and Maintenance.
Note: There are 46 projects listed under the PPP scheme but most of these are still in their early stages (either under conceptualization or undergoing feasibility studies).
Source: Public-Private Partnership Center and Deutsche Bank

All these projects are part of a plan to increase public infrastructure spending to 5% of GDP by 2016. This is because the last five years (2008-2012) had seen an at most, only 2.1% of GDP spending in this area. As such, the Philippines is lagging behind its ASEAN peers in terms of quality of infrastructure.

Ranking in terms of infrastructure quality

Country	Quality of Overall Infra.	Quality of Roads	Quality of Port Infra.	Quality of Air Transport Infra.
Singapore	5	7	2	1
Malaysia	25	23	24	20
Thailand	61	42	56	34
Indonesia	82	78	89	68
Philippines	**98**	**87**	**116**	**113**
Vietnam	110	102	98	92

Note" A total of 148 countries were ranked.
Source: Global Competitiveness Report 2013-14 and Deutsche Bank

The 2011-2016 Public Investment Program shows that more than half (57.9%) of the total infrastructure investment target is for the transport sub-sector and about a third on social infrastructure and water resources. Most of the investment targets for 2013-2016 (of which more than 50% is for infrastructure development) are proposed to be funded by the national government (77%), including proceeds from ODA loans and grants. The private sector is expected to assume 12% of the cost while the 10% would be borne by government-owned and controlled corporations. The remainder would then be provided by local government units and other funding sources.

Authorities we have spoken expressed their concern on how the government will be able to maintain a 2% fiscal deficit–to-GDP ratio while attaining its investment targets. Despite containing the deficit to 1.4% of GDP last year, the fiscal deficit could grow from this year on especially as typhoon-related reconstruction adds to investment projects in the pipeline. The government will have to make significant improvements in tax effort, if tax reforms are not an option, to meet targets. It appears to be on the right track though with the tax-to-GDP ratio increasing to 13.3% last year from 12.9% in 2012 owing to greater tax collections by the Bureau of Internal Revenue and Bureau of Customs. In late 2013, the President launched major reforms in the Bureau of Customs to thwart corruption, which in most part could be due to under-invoicing of imports and smuggling, within the agency.

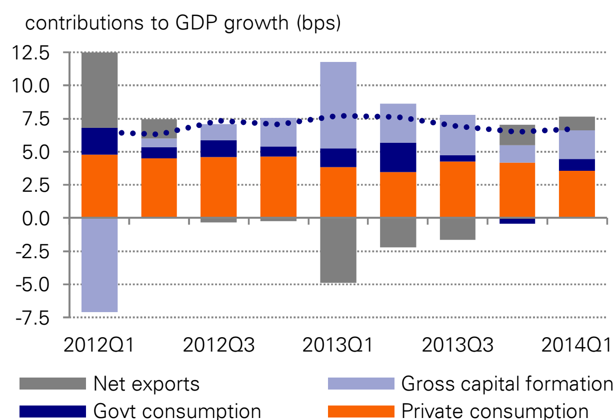
These reforms in the Bureau of Customs and rising infrastructure spending could increase the value of imports this year, placing downward pressure on the

current account surplus which stands at 5% of GDP, per latest data from Philippine government authorities. We emphasize the data source as our exercise adjusting the current account surplus by the growing discrepancy in the trade balance reported by government authorities and partner countries shows that the Philippines had already posted deficits in the past couple of years. This weaker current account balance coupled with capital outflows could place the peso under pressure in the months ahead.

To speed up project implementation and lessen corruption, 86% of the 2014 budget had already been released to designated agencies by the start of year. Projected government spending in 2014 is 13% higher than last year, of which infrastructure spending is expected to account for at least 3% of GDP.

This accelerated public spending early this year could offset the deceleration in private consumption as suggested by weakening sentiments from consumer and business expectations surveys. The composite leading economic indicator is also pointing to softer economic activity in the first quarter although we think this indicator says more about private consumption activity. This is because most of the indicators that make up the LEI are indicators of consumer spending such as the CPI, visitor arrivals, electric energy consumption, and import demand, to name some.

Growth in 1Q to be driven by investments and net exports amid weakness in private consumption.



Note: Statistical discrepancy excluded from the breakdown.
Source: CEIC and Deutsche Bank

With electricity rates unlikely to be adjusted (owing to a recalculation of spot electricity prices as ordered by the Energy Regulatory Commission) and tight domestic supply starting to wane, we are pushing our 25bps rate hike (repo rate) call to June from May. Another 25bps rate hike is also expected in September this year.

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Philippines: Deutsche Bank Forecasts

	2012	2013	2014F	2015F
National Income				
Nominal GDP (USD bn)	250.2	272.0	294.0	336.2
Population (mn)	97.6	99.5	101.3	103.1
GDP per capita (USD)	2562	2735	2903	3261
Real GDP (YoY%)	6.8	7.2	6.8	6.8
Private consumption	6.6	5.6	5.7	6.0
Government consumption	12.2	8.6	6.3	6.8
Gross fixed investment	10.4	11.7	12.0	9.4
Exports	8.9	0.8	9.5	10.6
Imports	5.3	4.3	9.4	10.9
Prices, Money and Banking				
CPI (eop, YoY%)	3.0	4.1	4.1	3.6
CPI (YoY%) ann avg	3.2	2.9	4.3	3.8
Broad money (M3, YoY%)	8.9	32.7	10.6	14.3
Credit to private sector	14.1	17.3	10.1	10.0
Fiscal Accounts (% of GDP)				
Fiscal balance	-2.3	-1.4	-2.4	-2.2
Government revenue	14.5	14.9	14.5	14.5
Government expenditure	16.8	16.3	16.9	16.7
Primary surplus	0.7	1.4	0.3	0.5
External Accounts (USD bn)				
Merchandise exports	46.3	-1.4	54.0	60.5
Merchandise imports	61.5	14.9	66.8	77.8
Trade balance	-15.2	16.3	-12.8	-17.3
% of GDP	-6.1	1.4	-4.4	-5.1
Current account balance	7.1	-1.4	14.1	11.5
% of GDP	2.8	14.9	4.8	3.4
FDI (net)	1.0	16.3	2.0	2.6
FX reserves (USD bn)	83.8	1.4	88.0	90.8
FX rate (eop) PHP/USD	41.2	-1.4	44.1	42.8
Debt Indicators (% of GDP)				
Government debt[1]	56.2	55.6	52.0	48.9
Domestic	34.2	33.7	31.9	30.5
External	22.0	21.9	20.1	18.5
Total external debt	24.1	20.0	17.7	14.6
in USD bn	60.3	54.4	52.0	49.2
Short-term (% of total)	14.1	12.9	15.4	16.9
General				
Industrial production (YoY%)	7.7	9.5	7.8	7.7
Financial Markets	*Current*	*3M*	*6M*	*12M*
BSP o/n repo	5.50	5.75	6.00	6.25
BSP o/n reverse repo	3.50	3.75	4.00	4.25
3-month Tbill rate	1.46	1.66	1.96	2.51
10-year yield (%)	3.95	4.20	4.50	4.80
PHP/USD	44.6	44.4	44.8	43.7

(1) Incl. guarantees on SOE debt.
Source: CEIC, DB Global Markets Research, National Sources

Singapore

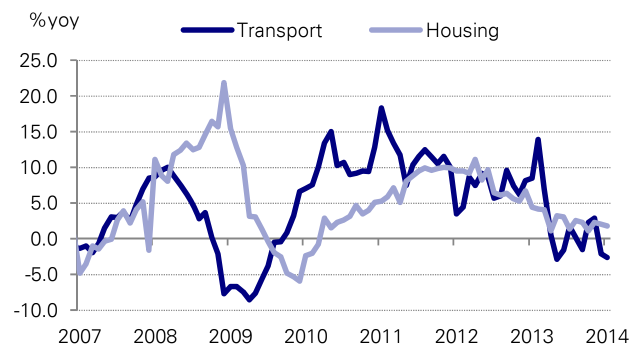
Aaa/AAA/AAA
Moody's/S&P/Fitch

- Economic outlook: Ending 2013 on a strong note, Singapore has started 2014 with mixed industrial production and trade data, but the outlook for stronger economic activity and exports remains relatively solid.
- Main risks: Partner country demand could disappoint; housing market could undergo a disorderly adjustment, rising rates could stress household and company balance sheet.

Disappearing inflation, mixed trade data, and a conservative budget

CPI inflation moderated to 1.4%yoy (0.1%mom) in January, from 1.5% in December. This was primarily due to decline in private transport costs (-3.5%), supported by falling Certificate of Entitlement (COE) premiums in December. Accommodation cost (2.4% vs. 2.9%) also rose at a slower pace during the month. Inflation, both measured as headline and momentum, has eased considerably in recent months, and has room for further softening in the coming months, as per our estimates.

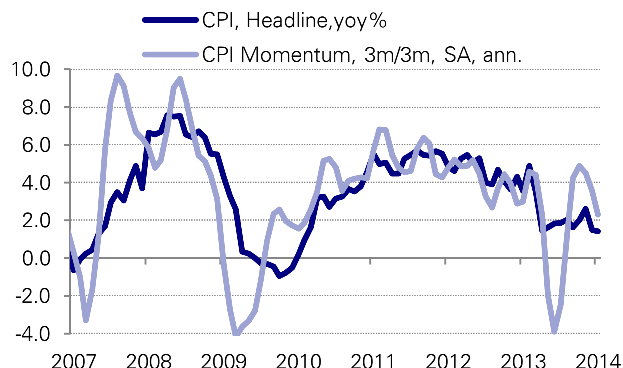
Transportation and housing inflation rates keep easing



Source: CEIC, Deutsche Bank

With respect of monetary and exchange rate policy, we don't think the authorities would entertain steepening the NEER band further under the current macro mix. An unchanged stance looks likely for April, with the focus of policy making on prudential measures to ensure that the economy transitions into the higher rate plain with as little friction as possible. At the same time, we see no urgent reason to ease monetary policy or any of the macroprudential measures to cool the property in the near term.

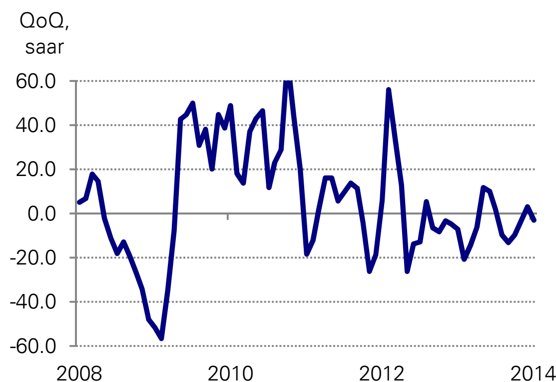
Headline CPI heading down, along with momentum



Source: CEIC, Deutsche Bank

Trade data has been mixed, but given the poor weather in the US and LNY effect in the region, that is to be expected. After ending 2013 strongly, exports moderated in January, rising by 4.2%yoy vs. 8.9% in December. We see export momentum reviving shortly, however, as partner country demand is picking up.

Modest rise in export momentum

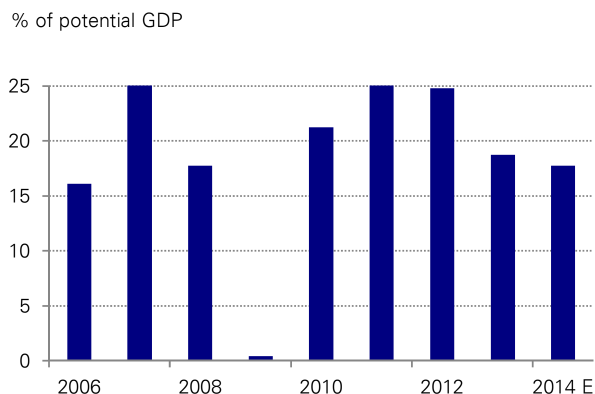


Source: Deutsche Bank

Budget 2014 embraces long-term challenges

On February 21 the authorities presented FY14 budget (fiscal year ends in March in Singapore). In the official presentation, the budget was essentially flat in terms of overall balance (-SGD1.1bn), but once investment returns from the country's sovereign wealth fund are included, the budget runs a comfortable (if declining) surplus. Indeed, adjusting for the cycle, Singapore's fiscal regime is characterized by a sizeable structural fiscal surplus, as per IMF estimates (see chart below).

Fiscal structural balance is beginning to worsen

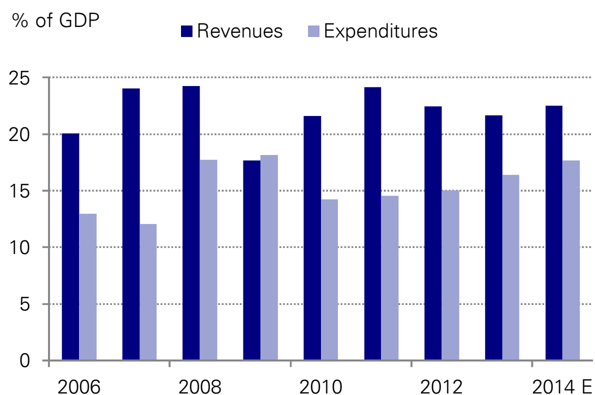


Source: IMF, Deutsche Bank. Structural balance cyclically adjusted

The budget's focus was unsurprising: firstly, efforts to boost productivity continued through allocations for productivity credit, tax incentive for innovation, wage credit, and jobs training. Second, with a goal to reduce reliance on foreign workers, measures such as hikes in foreign worker levy and requirement of basic labor-replacing productive technologies were implemented. A key thrust of the budget was widening of the social safety net, particularly on healthcare and elderly care, along with further investment in education and income support for the needy.

As costs rise and the society ages, Singapore will likely see a structural rise in expenditure over the medium- and long-term. The trend is already visible on the last four years' public spending data. Given the track record of fiscal prudence, further revenue enhancement measures are likely in the coming years.

Public spending is rising; revenue is broadly flat



Source: IMF, Deutsche Bank

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Singapore: Deutsche Bank Forecasts

	2012	2013	2014F	2015F
National Income				
Nominal GDP (USD bn)	284.5	295.8	305.9	332.6
Population (mn)	5.3	5.4	5.5	5.6
GDP per capita (USD)	53547	54594	55618	59399
Real GDP (YoY%)	3.5	4.1	3.5	4.5
Private consumption	3.7	2.7	2.2	3.2
Government consumption	-1.3	11.2	1.3	3.3
Gross fixed investment	8.9	-2.6	5.0	5.9
Exports	0.5	3.6	4.5	7.0
Imports	3.7	3.0	4.4	7.2
Prices, Money and Banking				
CPI (YoY%) eop	4.3	1.5	2.9	3.7
CPI (YoY%) ann avg	4.6	2.4	2.5	3.5
Broad money (M2)	10.4	9.7	8.5	11
Bank credit (YoY%)	12.9	9.8	10.4	10.5
Fiscal Accounts (% of GDP)				
Fiscal balance	7.8	7.1	6.9	6.8
Government revenue	22.8	21.9	22.1	22.3
Government expenditure	15.0	14.8	15.2	15.5
External Accounts (USD bn)				
Merchandise exports	434.6	436.9	463.1	495.5
Merchandise imports	371.7	369.0	391.2	422.5
Trade balance	62.9	67.9	71.9	73.1
% of GDP	22.1	22.9	23.5	22.0
Current account balance	49.4	54.4	55.3	55.0
% of GDP	17.4	18.4	18.1	16.5
FDI (net)	47.6	36.9	10.0	12.0
FX reserves (USD bn)	259.3	273.1	305.3	335.4
FX rate (eop) SGD/USD	1.22	1.26	1.27	1.26
Debt Indicators (% of GDP)				
Government debt	106.1	110.9	115.6	117.7
Domestic	106.1	110.9	115.6	117.7
External	0.0	1.0	1.0	1.0
Total external debt	416	410	391	362
in USD bn	1151	1208	1214	1220
Short-term (% of total)	69.5	68.8	69.0	70.0
General				
Industrial production (YoY%)	-1.2	2.8	1.6	3
Unemployment (%) (eop)	2.6	2.8	2.6	2.5
Financial Markets	*Current*	*3M*	*6M*	*12M*
3-month interbank rate	0.41	0.50	0.70	0.90
10-year yield (%)	2.49	2.55	2.70	2.90
SGD/USD	1.27	1.29	1.27	1.29

Source: CEIC, DB Global Markets Research, National Sources
Note: includes external liabilities of ACU banks.

South Korea

Aa3/A+/AA-
Moody's/S&P/Fitch

- Economic outlook: While South Korea's economic data soften in Q1, its macro and structural policies take clearer shape.
- Main risks: Weaker-than-expected external demand poses the greatest risk to our outlook.

Clear policies amid hazy data

A soft-patch in exports... Although export growth rebounded in February, rising to +1.6%yoy from -0.2% in January, the Jan-Feb average stood only at 1.3%, below the 1.8% growth reported in Q4, suggesting a soft patch in growth in Q1. This relative weakness in export growth was shared by its Asian neighbours, like Taiwan and China. With the recent run of weak US economic data attributed to intense winter storms in the country, we are inclined to character this weakness in Korea's exports as a soft patch and expect its rebound in months ahead.

...while inflation falls... CPI inflation fell to 1.0%yoy in February, from 1.1% in January, led by falling prices of food and transport. All other items also reported easing inflationary pressure, with the exception of miscellaneous goods and services, the cost of which rose at a faster pace of 1.6% in February vs. 1.1% in January, led by personal care cost. While we see inflation heading higher more meaningfully in 2H, we see it remaining well within the lower half of the target band of 2.5% and 3.5%. Assuming such a benign growth and inflation outlook, we continue to expect the BoK, with its new chief, to remain on the sidelines.

...but a veteran BoK man gets the top post... President Park has appointed respected, veteran central banker Professor Lee Ju-Yeol as the next Bank of Korea (BoK) governor. He started his career at the BoK in 1977 and headed research and monetary policy departments, among others, before becoming the BoK's senior governor serving as an MPC member before leaving the bank in 2012. He has been working as a professor at one of the country's top universities, Yonsei University, since 2013. Professor Lee is known for his strong research background and pragmatic and balanced approach toward monetary policy. As such, given the BoK's assessment of relatively balanced risks to growth and inflation, we see Professor Lee taking a neutral monetary policy stance when he assumes his role as BoK governor. Under his guidance, we also see the BoK strengthening its surveillance and policy tools to ensure financial system stability. While we see the BoK maintaining its independence, we expect the new governor to adopt an open, direct communication style with the market, adding to the BoK's transparency and coordination with the government.

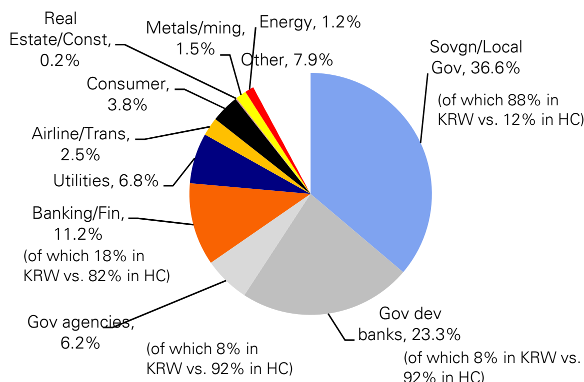
...and the government's debt policies take clearer shape. The government announced its "three-year economic innovation plan," which included a series of deregulatory reform and restructuring measures, among other things, to promote investment and boost growth. The latter includes normalization of the public sector, to limit its debt, while the former includes application of a cap on the total number of regulations (ease or eliminate existing regulations when introducing new ones), adoption of a from the zero point principle (by removing excessive regulations) and introduction of a negative list system (no regulations except for the listed ones). In particular, the government seeks to improve regulations regarding services, the development of which has been hampered in its view by existing stakeholders. The government has selected health, education, tourism, finance and software as "promising" areas, which will benefit from deregulation and, for some, financial incentives and support. And, as part of a three-year plan, the government aims to improve households' balance sheet, lowering their debt-to-income ratio by 5ppt, suggesting a prudent management of household debt and thereby limiting potential fiscal burden. The government's move to tighten its grip on the country's debt bodes well for its credit outlook.

The government's plan to normalize the public sector has been well anticipated, given its high debt level and the government's view that public sector inefficiency is limiting the country's economic competitiveness. The nonfinancial (public sector) corporation (NFP) debt stood as high as the national debt (the central and local government, 35% of GDP), at about 30% of GDP in 2012. Enforcing a greater and transparent debt and fiscal discipline on quasi corporates is a positive development, not just for the corporates themselves, but also from a broader systemic risk perspective. Credit metrics for Korean quasi corps have been deteriorating since the peak in 2009 and this move by the government to limit further deterioration is a welcome move. As for the national debt, the Korean government seeks to limit it to mid-30% of GDP by adopting a "pay-go" system. That is, increases in any item in fiscal expenditures should be offset by a fall in another, ensuring the growth in expenditure remains below revenue growth.

While the amount of debt maturing this year more than doubles against 2013, with its relatively small size against the debt market outstanding (<4%), it does not pose a systemic risk'; however, there is some residual

risk of credit events for some names in those stressed sectors, such as construction/real estate, metals & mining, and transport/shipping. Again, we do not expect those sectors to pose a systemic risk considering their small share of total refinancing/repayment requirements is around 4%.

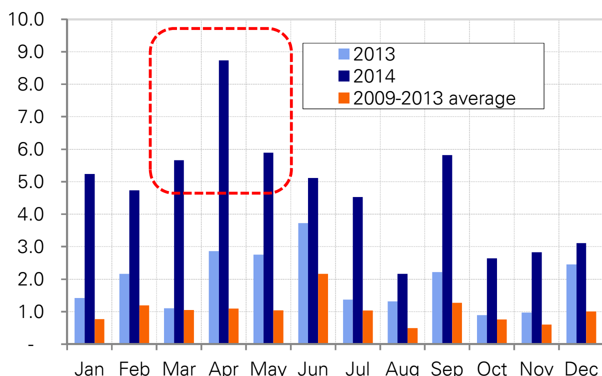
Refinancing/repayment led by sovereign and financials



Source: Bloomberg Finance LP, Deutsche Bank

On the other hand, we may see intermittent increases in volatility in rates and FX due to bunching up on maturities. Within this year, this refinancing/repayment pressure will likely peak in April. As usual, bond redemptions will be front-loaded to the first half of this year. However, unlike in previous years, April should mark the peak month, with about USD8.7bn coming due, up 205% against the level seen in 2013 and nearly 8x higher than the last 5-year average. This coincides with the seasonal large income repayments in March and April. (Please see our report published on 4 March titled "South Korea: Managing debt risks" for details.)

Refinancing/repayment pressure peak in April



Source: Bloomberg Finance LP, Deutsche Bank

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South Korea: Deutsche Bank forecasts

	2012	2013	2014F	2015F
National income				
Nominal GDP (USDbn)	1130	1208	1290	1351
Population (m)	49.8	50.0	50.2	50.4
GDP per capita (USD)	22704	24159	25688	26840
Real GDP (YoY %)	2.1	2.8	3.9	3.6
Private consumption	1.8	1.9	2.8	2.3
Government consumption	3.9	3.0	1.9	1.9
Gross fixed investment	-1.6	3.8	4.6	3.1
Exports	3.8	4.3	8.2	7.3
Imports	2.1	3.5	7.4	6.0
Prices, money and banking				
CPI (YoY %) eop	1.4	1.1	2.7	2.9
CPI (YoY %) ann avg	2.2	1.3	1.9	2.8
Broad money (M3)	8.8	9.0	9.5	8.0
Bank credit (YoY %)	5.0	4.0	6.0	5.0
Fiscal accounts (% of GDP)				
Central government surplus	1.9	-0.7	-0.1	0.1
Government revenue	24.5	23.2	23.2	23.3
Government expenditure	22.5	23.8	23.3	23.2
Primary surplus	2.7	0.6	1.4	1.6
External accounts (USDbn)				
Merchandise exports	552.6	570.9	616.6	644.5
Merchandise imports	514.2	510.2	565.0	607.9
Trade balance	38.3	60.7	51.6	36.6
% of GDP	3.4	5.0	4.0	2.7
Current account balance	43.1	70.7	53.4	38.1
% of GDP	3.8	5.9	4.1	2.8
FDI (net)	-18.9	-13.1	-14.0	-12.0
FX reserves (USDbn) [1]	327.0	346.5	352.9	350.3
FX rate (eop) KRW/USD	1064	1050	1060	1090
Debt indicators (% of GDP)				
Government debt[2]	36.0	36.3	36.5	34.8
Domestic	35.3	35.4	35.5	33.7
External	0.6	0.9	1.0	1.1
Total external debt	36.6	34.2	30.4	28.0
in USDbn	413.6	415.0	400.0	385.0
Short-term (% of total)	30.7	28.4	27.0	25.5
General				
Industrial production (YoY %)	1.0	1.3	5.0	4.5
Unemployment (%)	3.2	3.1	3.1	3.1
Financial markets	*Current*	*3M*	*6M*	*12M*
BoK base rate	2.50	2.50	2.50	2.75
91-day CD	2.65	2.68	2.75	3.05
10-year yield (%)	3.56	.3.65	3.80	4.00
KRW/USD	1069	1075	1060	1070

Source: CEIC, Deutsche Bank estimates, Global Markets Research, National Sources
Note: (1) FX swap funds unaccounted for (2) Includes government guarantees

Sri Lanka

B1(stable)/B+/BB-
Moody's/S&P/Fitch

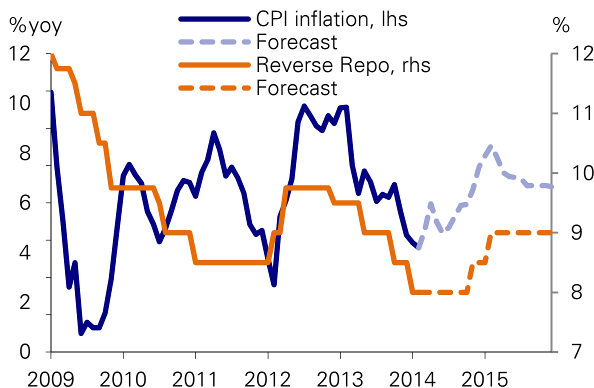
- Economic outlook: Sri Lanka will likely end 2013 on a strong note, with real GDP growth expected to be 8.0%yoy in Oct-Dec'13 vs. 7.8%yoy in the previous quarter.
- Main risks: Excess monetary accommodation can potentially sow the seeds for future imbalances in the economy and can threaten exchange rate stability.

Inflation moderates further; but CBSL should be on the sideline

Sri Lanka's CPI inflation was 4.2%yoy in February (down from 4.4%yoy in January), lower than our and consensus estimate of 4.7% and 4.4% respectively. Food and non food prices were up 0.2%mom (0.9%yoy vs. 1.3%yoy) and 0.1%mom (7.0%yoy vs. 7.1%yoy) respectively in February, but a favorable base effect helped the yoy inflation rate in both the categories to moderate from the previous month's outturn. Core inflation also moderated in February to 3.1% (vs. 3.5% in January), remaining significantly below the long-term average.

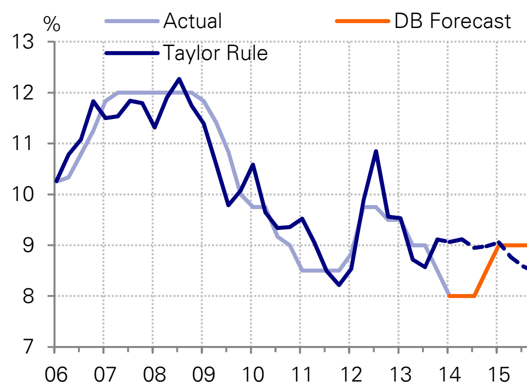
The 12- month moving average of headline CPI inflation eased to 6.0% in February, from 6.5% in the previous month. Our forecast shows that headline CPI inflation will remain in mid single digit level through the first half of this year, but rise to 7-7.5% in the fourth quarter of 2014, led by strong domestic demand. Despite the benign inflation trajectory, we think that the CBSL should stay on the sideline, as monetary policy is over accommodative even at this stage.

CPI inflation and repo rate forecast



Source: CEIC, Deutsche Bank

Policy rate should be 100bps higher according to Taylor Rule formula

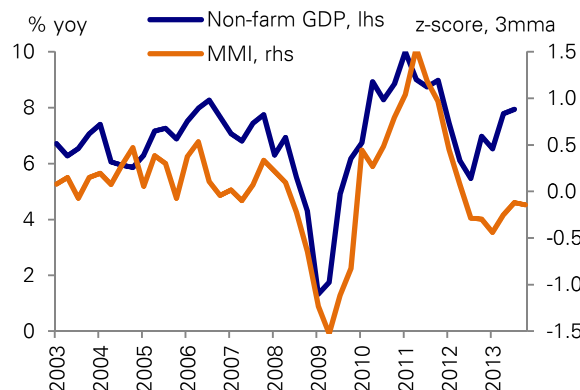


Source: CEIC, CBSL, Deutsche Bank

Growth momentum remains strong

Sri Lanka will likely end 2013 on a strong note, with real GDP growth expected to be 8.0%yoy in Oct-Dec'13 vs. 7.8%yoy in the previous quarter. This is corroborated by our Sri Lanka Macroeconomic Momentum Indicator (a composite index constituting high frequency macro variables such as exports, imports, bank credit and tourist arrivals) which has historically shown a strong correlation with the trend of non-farm GDP growth (82% correlation since March 2003). Agriculture sector growth is also likely to be robust in Oct-Dec'13, given a particularly supportive base effect, which should help sustain real GDP growth around the 8% mark.

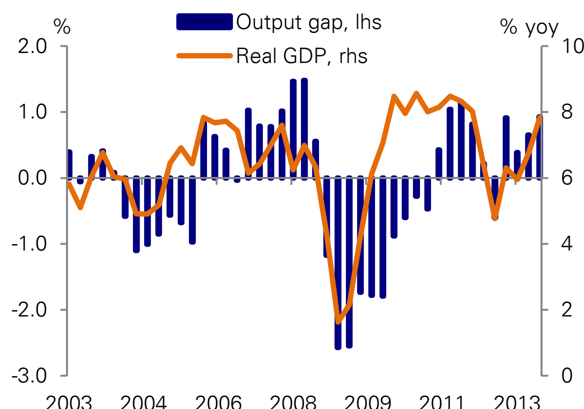
Sri Lanka macroeconomic momentum indicator vs. non-farm GDP growth



Source: CEIC, Deutsche Bank

Is Sri Lanka showing tendencies of overheating? This is a question which we are often asked, especially in the backdrop of the accommodative monetary policy stance that is being pursued by CBSL, notwithstanding real GDP growth being at around 8% levels.

Output gap and real GDP growth



Source: CEIC, Deutsche Bank

Although the output gap is positive, we don't think Sri Lanka faces any immediate risk to its macroeconomic stability. Current account deficit of about 2% of GDP remains significantly below the long-term average, nominal credit growth rate remains below nominal GDP growth rate and CPI inflation is well within the comfort zone of the central bank authorities.

But this apparent "goldilocks" scenario is worth being cautious about from a medium term perspective. There have been numerous episodes in the past, when a couple of years' above-trend growth in Sri Lanka has led to build up of macro imbalances, which has eventually impacted macroeconomic stability when remedial measures were initiated.

Also in an environment, where almost all EM economies are tightening monetary policy, to ensure exchange rate stability is not compromised, the Central Bank of Sri Lanka is doing just the opposite, which is a risky strategy, in our view. Sri Lanka's external metrics may have improved somewhat from the recent past, but continues to be considerably vulnerable (FX reserves are still not sufficient to cover ST external debt + CAD combined) to potential external shocks.

Apart from external risks, a significant threat to Sri Lanka's medium-term macroeconomic stability therefore arises from policy error risks, which hopefully will not be repeated this time around.

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Sri Lanka: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	59.0	66.8	75.9	87.9
Population (mn)	21.1	21.3	21.5	21.7
GDP per capita (USD)	2799	3136	3532	4049
Real GDP (YoY %)	6.4	7.2	7.5	7.5
Total consumption	5.5	6.2	6.7	6.8
Total investment	10.7	11.0	11.1	11.7
Private	9.2	11.0	12.0	13.0
Government	16.0	11.0	8.0	7.0
Exports	0.2	8.6	9.5	10.0
Imports	0.5	9.0	10.0	11.0
Prices, Money and Banking				
CPI (YoY%) eop	9.2	4.7	7.4	6.7
CPI (YoY%) avg	7.6	6.9	5.5	7.1
Broad money (M2b) eop	17.6	16.0	15.8	17.5
Bank credit (YoY%) eop	17.6	7.5	17.0	20.0
Fiscal Accounts (% of GDP)				
Central government balance	-6.4	-5.8	-5.5	-5.0
Government revenue	13.2	13.8	14.0	14.2
Government expenditure	19.7	19.7	19.5	19.2
Primary balance	-1.1	-0.7	-1.1	-0.7
External Accounts (USD bn)				
Merchandise exports	9.8	10.4	11.1	12.0
Merchandise imports	19.2	18.0	19.4	21.4
Trade balance	-9.4	-7.6	-8.3	-9.4
% of GDP	-15.9	-11.4	-11.0	-10.7
Current account balance	-3.9	-1.4	-1.4	-1.8
% of GDP	-6.6	-2.1	-1.9	-2.0
FDI (net)	0.8	1.2	1.3	1.7
FX reserves (USD bn)	6.9	7.2	8.2	9.2
FX rate (eop) LKR/USD	127.7	130.8	130.0	128.0
Debt Indicators (% of GDP)				
Government debt	79.1	78.0	75.7	72.5
Domestic	42.6	41.8	40.1	38.1
External	36.5	36.3	35.6	34.5
Total external debt	48.2	46.9	45.3	43.4
in USD bn	28.4	31.3	34.4	37.9
Short-term (% of total)	17.0	18.6	18.6	19.4
General				
Industrial production (YoY %)	6.0	7.5	8.0	8.5
Unemployment (%)	4.2	4.1	4.0	4.0
Financial Markets	*Current*	*3M*	*6M*	*12M*
Reverse Repo rate	8.00	8.00	8.00	9.00
LKR/USD	130.6	130.3	130.3	130.0

Source: CEIC, DB Global Markets Research, National Sources

Taiwan

Aa3/AA-/A+
Moody's/S&P/Fitch

- Economic outlook: While high frequency data point to a soft patch in growth in Q1, the authorities warn households about the potential impact of higher rates.
- Main risks: While weak exports pose risks to growth, households' heavy indebtedness may be a drag on growth for a long term.

Cold winter, hot homes

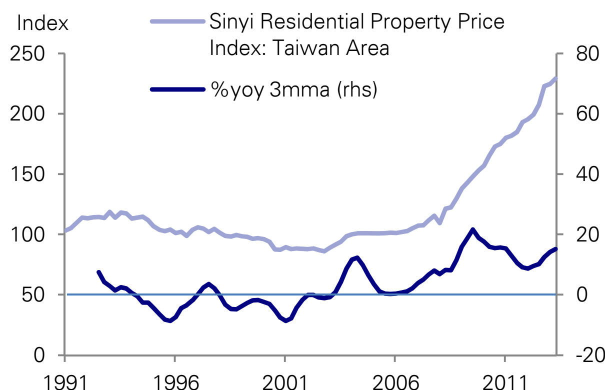
Despite the weak demand... With the Lunar New Year holiday effects in play, Taiwan's exports too bounced around in the first two months of the year, surging 7.9%yoy in February after falling 5.3% in January. By destination, the usual suspects suffered the most, with exports to China surging 11.3% in February after falling 13.5% in January, overshadowing the upward trend in exports to the US and Europe, which rose 4.7% and 3.2%, respectively, in Jan-Feb, up from 0.1% growth and 0.3% fall in Q4. As a result, exports continued to disappoint, falling 1.1% in Jan-Feb after rising 1.2% in Q4. At the same time, indicators for domestic demand also worsened, with imports of capital falling at 2.1% in Jan-Feb vs. a 12.3% rise in Q4, while imports of consumer goods rose at a slower pace of 1.1% vs. 10.2% in Q4. With the recent run of weak US economic data attributed to intense winter storms in the country, we are inclined to character this weakness in Taiwan's exports as a soft patch, which was shared by its neighbours, and expect its rebound in months ahead.

Taiwan's manufacturing survey too pointed to a weakness, with the PMI index falling to its lowest level in a year, to 50.3 in February from 54.1 in January, as new orders fell below 50 and export orders continued to fall for the second consecutive month in February. On a positive note, the manufacturing employment indicator turned, hinting that it has troughed, consistent with the turnaround in overall payrolls growth, at 0.9% at end-2013. Consumer confidence on employment reflected this, supporting a higher level of overall consumer confidence, its highest level since October 2011, at 82.9 in February vs. 80.8 in January. Consumers were particularly optimistic over the stock market as the government mulled means to boost market transactions.

...and low inflation, the CBC warns of higher rates. Again led by the LNY holiday effects, CPI inflation fell sharply to -0.1%yoy in February from +0.8% in January. Demonstrating this, on a month-on-month nsa basis, the headline CPI index declined 0.4% in February vs. A 0.2% rise in January, as nursery and nursing care prices fell 33.5%mom in February after surging 39.8% in January due to bonuses paid. Given the low inflation and soft-patch in growth, we expect the Central Bank of China (CBC) to keep the policy rate unchanged on 27 March, despite the CBC's ongoing concerns about asset price inflation. The governor warned about the potential impact of higher rates, given that much of the mortgages use adjustable rates. Moreover, the CBC governor expressed his concerns about inflation, noting that recent sharp increases in pork prices remain a point of concern, posing upside risks to the DBGAS's forecast of 1.1%.

The CBC governor's ongoing concerns about the housing market were echoed by the finance minister, who warned that there are signs of a real estate bubble. In connection, the finance minister referred to various ratios, such as housing prices to income, rent to income, mortgage to GDP, and vacancy rates, according to the *China Post*. According to the minister, housing prices are now 10 times that of the average annual income now, up from about 8 times in 2012 and higher than South Korea's 8 times. Meanwhile, the governor noted that the average mortgage payments accounted for more than 30% of household income, vs. South Korea's debt service ratio (DSR) of about 13%, albeit the latter's relatively low level was due largely to the fact that much of Korean households' debt payment obligations exclude principle pay down, instead requiring only interest payment. Note that Taiwan's debt-to-disposable income ratio stood at 1.22, below vs. South Korea's 1.35.

Housing market: from hypo to hyper



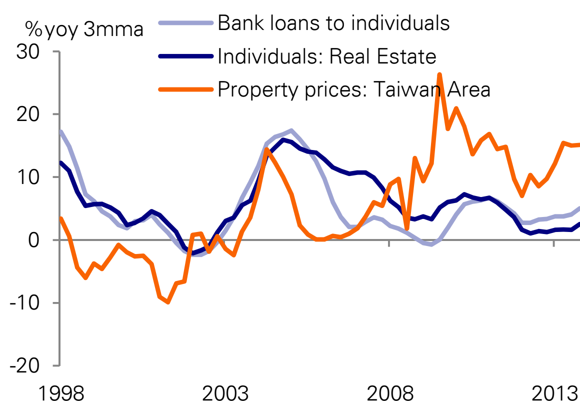
Source: CEIC, Deutsche Bank

These warnings follow the various prudential measures that the government has adopted to enhance the soundness of the housing market since 2010. These

measures follow a decade of increases in housing prices, after a decade of decline in housing prices, from the early 1990s. The CBC's measures included macro-prudential measures on land collateralized loans and housing loans in specific areas and high-value housing loans, while the FSC introduced several measures to supervise the real estate lending risks of banks, including raising the risk weight from 45% to 100% for new loans collateralized by non-owner-occupied houses. The government has also reviewed the suitability of house taxes and land taxes, such as verifying the current value of the house, limiting the applicability of the land value tax exemption, and abolishing the regulation of temporary exemption for vacant lot tax, while imposing a luxury tax of 10-15% on sales prices for those properties acquired not for personal use but sold within 2 years of its purchase, to curb short-term selling, which is blamed for pushing housing prices even higher. The government is set to review related property taxes next year.

The authorities' measures helped to bring down the LTV ratio to 57% in Q2 2013 from 64% in Q2 2010, and kept the NPL and past due loan ratios low, at 0.2 and 0.4, respectively, in 2013. Barring a severe economic downturn and/or surge in rates, we do not expect a hard landing in Taiwan's real estate market. We believe that the upturn in housing prices was supported not only by mortgage loan growth but also by inflow of capital following the government's decision to cut inheritance tax, to 10% from 50% in 2009. Moreover, if needed, the authorities may also reverse those prudential regulations to support the market. Having said that, households' indebtedness limits the speed at which the CBC may hike its policy rates. We maintain our call of no change in rates this year, followed by a moderate pace of normalization in 2015.

Loans were not the only cause of higher housing prices



Source: CEIC, Deutsche Bank

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Taiwan: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National income				
Nominal GDP (USDbn)	476.4	497.7	514.4	533.1
Population (m)	23.3	23.3	23.4	23.5
GDP per capita (USD)	20472	21324	22010	22687
Real GDP (yoy %)	1.5	2.2	3.7	3.4
Private consumption	1.6	1.8	2.3	2.0
Government consumption	1.0	-0.4	0.2	0.3
Gross fixed investment	-4.0	5.8	5.2	2.8
Exports	0.1	3.8	7.2	6.7
Imports	-2.2	4.0	7.5	5.6
Prices, money and banking				
CPI (yoy %) eop	1.6	0.3	1.0	1.6
CPI (yoy %) annual average	1.9	0.8	0.9	1.2
Broad money (M2)	4.9	4.3	6.0	6.5
Bank credit[1] (yoy %)	3.3	2.7	3.5	4.0
Fiscal accounts (% of GDP)				
Budget surplus	-2.5	-2.3	-1.5	-0.8
Government revenue	16.5	16.6	17.0	17.3
Government expenditure	19.0	18.9	18.5	18.0
Primary surplus	-0.8	-0.6	0.4	1.3
External accounts (USDbn)				
Merchandise exports	300.4	304.9	325.6	346.0
Merchandise imports	268.8	268.3	289.6	310.1
Trade balance	31.6	36.6	36.0	35.9
% of GDP	6.6	7.4	7.0	6.7
Current account balance	50.7	55.8	52.7	48.5
% of GDP	10.6	11.2	10.2	9.1
FDI (net)	-9.8	-12.0	-13.0	-15.0
FX reserves (USD bn)	403.2	416.8	430.3	430.9
FX rate (eop) TWD/USD	29.2	29.8	29.6	29.8
Debt indicators (% of GDP)				
Government debt[2]	42.9	43.7	43.6	42.8
Domestic	42.2	43.0	42.9	42.1
External	0.7	0.7	0.7	0.7
Total external debt	27.6	28.3	27.4	26.4
in USDbn	130.8	140.0	140.0	140.0
Short-term (% of total)	89.1	89.3	89.3	85.7
General				
Industrial production (YoY%)	0.0	0.9	3.8	3.5
Unemployment (%)	4.2	4.2	4.1	4.1
Financial markets	*Current*	*3M*	*6M*	*12M*
Discount rate	1.88	1.88	1.88	2.00
90-day CP	0.80	0.82	0.88	1.00
10-year yield (%)	1.59	1.65	1.75	1.90
TWD/USD	30.3	30.0	29.7	29.7

Source: CEIC, Deutsche Bank Global Markets Research, National Sources
Note: (1) Credit to private sector. (2) Including guarantees on SOE debt

Thailand

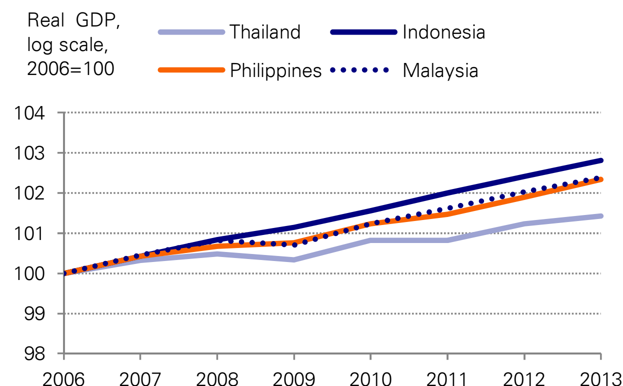
Baa1/BBB+/BBB+
Moody's/S&P/Fitch

- Economic outlook: The economy's soft patch continues, but a rebound could be in store if the political situation gets close to a resolution. An acceleration in exports could also enhance the outlook in the coming months.
- Main risks: Weakness in partner country demand, violent exacerbation of the political situation, and global market volatility could leave Thailand's economy and markets particularly under pressure. The ongoing drought, if prolonged, could hurt agriculture production.

Growth slowdown and politics

Ending 2013 with nearly 3% growth, Thailand has begun 2014 on a weak footing, with investor sentiment affected by the ongoing political crisis. The weak state of the economy, however, is not a recent phenomenon. Between various natural disasters, political upheaval, and poor economic management, Thailand's economy has lagged its peers for a number of years, as glaringly illustrated in the chart below.

Thailand's performance lags its peers



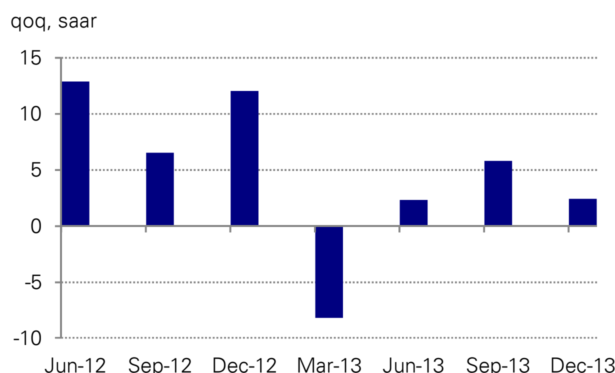
Source: CEIC, Deutsche Bank

There has a mild easing of tension in recent weeks as the opposition has reduced protest visibility, leading to hopes that the opposition and the government could be moving closer to a deal to end the political impasse. The emergency decree is due to expire on Mar 22, which could be another source of easing of tensions. Nevertheless, headwinds to growth may dissipate only marginally in the near term as investment sentiment is likely to remain poor in the absence of any major initiative to boost infrastructure.

Such initiatives seem unlikely in the near term owing to the legal challenges posed to the government's BHT2trln investment program. The rice pledging scheme, also under judicial scrutiny, is unlikely to resume, removing another source of support (albeit distortionary and inefficient) for income and consumption.

Could a turnaround be near?

Real GDP growth pick-up could be around the corner



Source: CEIC, Deutsche Bank

Still, the economy is not in as dire a shape as would appear from reading the dismal political news. The economy has expanded, slowly but steadily, since the political crisis began last year (see above chart). This is not a trivial achievement considering the sharp decline in investment, removal of income support for farmers, expiration of the auto buying scheme, a virtual standstill in public works, and weak exports.

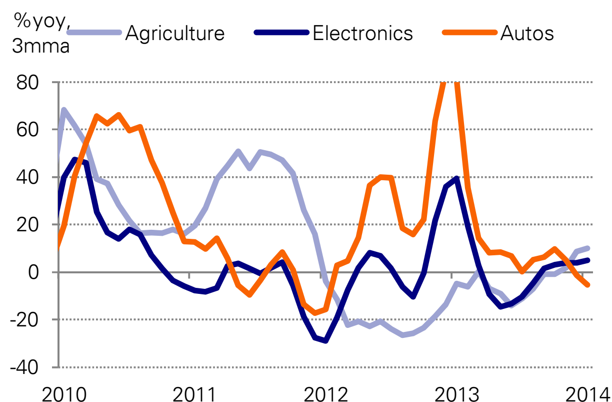
Growth has been helped, to some extent, by accommodating monetary conditions, aided by ample liquidity and low rates. Indeed, as inflation has begun to rise, real rates are set to decline in the coming months, while the recent weakening of the baht would further contribute to an easing of monetary conditions.

Growth has also been helped by robust agriculture production, steady tourism flows, and export related manufacturing activities. If sentiments revive in the coming months, growth prospects could turn around rather expeditiously, in our view.

Another factor that is likely to support growth in the immediate future is exports. We see partner country demand picking up, and already see in the export data that Thai agriculture and electronics exports have

begun to head upward. Autos, which have undergone a few lean months due to changes in car model years, will perk up shortly as well, we reckon.

Other than autos, exports are moving up



Source: CEIC, Deutsche Bank

While newspaper headlines have not helped the cause, tourism has been well supported in areas outside of Bangkok. Indeed, recent data show that room rates are rising, hotel occupancy is high, and tourism arrival remains in positive growth territory. An improvement in sentiment could boost the outlook even further.

There is a risk that Russian tourism would be affected due to the ruble's recent, sharp depreciation. Making up nearly 10% of total tourist arrivals, a decline in the spending capacity of Russian tourists could be a negative, but given Thailand's popularity among visitors and the likely upside from an improvement in the political situation, there is more to be hopeful than concerned about this dynamic sector.

Tourism sector is holding up despite the political unrest

Source: CEIC, Deutsche Bank

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Thailand: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USDbn)	370.5	367.6	398.1	413.3
Population (m)	64.5	64.8	65.1	65.4
GDP per capita (USD)	5749	5675	6115	6317
Real GDP (yoy %)	6.5	2.9	3.5	4.5
Private consumption	6.7	0.2	2.5	4.5
Government consumption	7.5	4.9	1.9	2.0
Gross fixed investment	13.2	-1.9	2.9	6.0
Exports	3.1	4.2	2.8	11.4
Imports	6.3	2.3	4.1	12.9
Prices, Money and Banking				
CPI (yoy %) eop	3.6	1.7	**2.3**	3.0
CPI (yoy %) ann avg	3.0	2.2	**2.9**	2.3
Core CPI (yoy %) ann avg	2.1	1.0	1.6	1.4
Broad money	10.4	7.3	7.5	8.0
Bank credit[1] (yoy %)	15.3	9.4	9.0	10.0
Fiscal Accounts[2] (% of GDP)				
Central government surplus	-3.5	-3.0	-3.2	-3.3
Government revenue	19.2	18.8	19.0	19.0
Government expenditure	22.7	21.8	22.2	22.3
Primary surplus	-3.6	-3.1	-1.9	-2.0
External Accounts (USDbn)				
Merchandise exports	225.9	225.4	246.7	270.8
Merchandise imports	219.9	219.0	238.8	267.6
Trade balance	6.0	6.4	7.9	3.1
% of GDP	1.6	1.7	2.0	0.8
Current account balance	0.2	0.5	4.0	1.1
% of GDP	0.0	0.1	1.0	0.3
FDI (net)	-2.0	-3.0	-3.0	2.8
FX reserves (USDbn)	181.6	186.1	193.1	199.2
FX rate (eop) THB/USD	30.7	32.4	32.0	32.5
Debt Indicators (% of GDP)				
Government debt[2,3]	43.7	45.5	46.0	46.5
Domestic	41.5	43.6	45.0	45.5
External	2.2	1.9	1.0	1.0
Total external debt	35.3	36.3	34.6	34.4
in USDbn	130.7	135.0	140.0	145.0
Short-term (% of total)	44.5	45.0	45.0	45.5
General				
Industrial production (yoy %)	2.5	2.6	4.0	5.0
Unemployment (%)	0.8	0.8	0.7	1.0
Financial Markets	*Current*	*3M*	*6M*	*12M*
BoT o/n repo rate	2.00	2.00	2.00	2.50
3-month Bibor	2.37	2.45	2.60	3.00
10-year yield (%)	3.75	3.75	3.90	4.00
THB/USD (onshore)	32.4	32.5	32.7	32.0

Source: CEIC, Deutsche Bank Global Markets Research, National Sources
Note: (1) Credit to the private sector & SOEs. (2) Consolidated central government accounts; fiscal year ending September. (3) excludes unguaranteed SOE debt

Vietnam

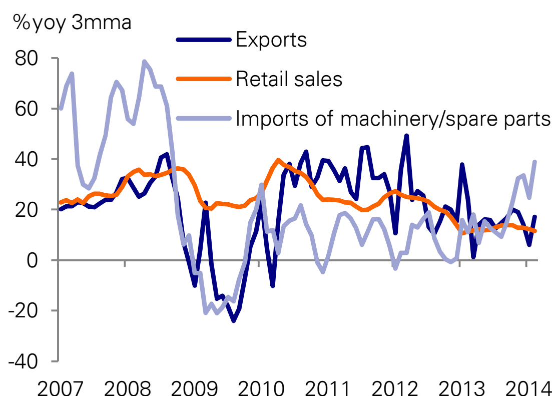
B2/BB-/B+
Moody's/S&P/Fitch

- Economic outlook: Economic data improve, modestly, while reform efforts gather steam.
- Main risks: Reform may require Vietnam to be more patient, settling for a relatively modest rebound in growth this year, for a healthier, stronger growth in 2015.

Reform for brighter days ahead

Rebound in demand, albeit limited… As the Tet holiday effects reversed, export growth rebounded sharply, to 34.3%yoy from a 0.1% fall in January, leaving the first two-month average at 17.1%, up slightly from 16.8% in Q4. While commodities, like oil (with its contribution to export growth at -1.1%), coffee (-0.3p%) and rubber (-0.7%) weighed on overall exports, manufactured goods like textile/garments (4.1%) and phones and spare parts (3.7%) provided relatively strong support. With imports rebounding faster, rising 21.4% in Jan-Feb vs. 19.0% in Q4, Vietnam's trade balance narrowed to USD0.2bn from USD0.6bn in the same period.

While investment rebound, consumption remains weak

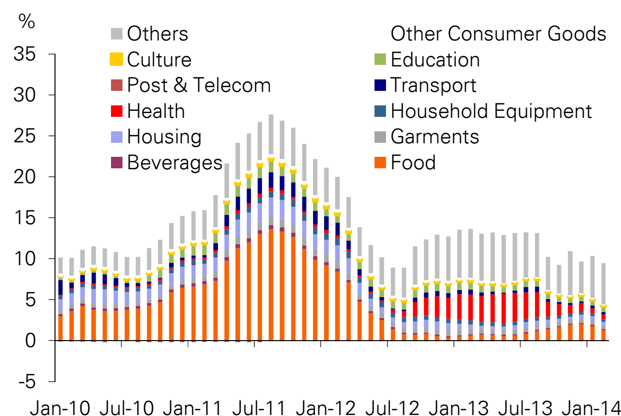


Sources: CEIC, Deutsche Bank

By goods, contributing to this rebound in headline imports, machinery tools/parts imports surged, rising 42.5% in Jan-Feb, up from 33.5% in Q4, indicating strong facility investments in Q1. Meanwhile, as in exports, industrial production growth rebounded sharply, to 18% in February from a 2.1% decline in January, albeit the two-month average stood at 7.9%, unchanged from Q4. In contrast, retail sales growth disappointed, slowing to 11.1% in Jan-Feb from 12.8% in Q4.

As private consumption continued to struggle, CPI inflation fell more than expected to 4.7%yoy in February from 5.5% in January. While weak demand for commodities weighed on overall exports, they also kept overall inflation low. Inflation moderated across categories with food/food stuff (comprising 40% of the CPI basket) leading the way, falling to 3.3% in February from 4.5% in January. Meanwhile, the rate of increase in health care prices slowed to 10.4% in February from 11% in January, in the absence of large adjustments that resulted in a 46.6% rise in prices in 2013. Inflation in other categories such as textiles (4.9% in February vs. 5.8% in January), beverages/tobacco (3.7% vs. 4.6%), and household appliances (3.4% vs. 3.8%) also slowed. Although we expect recovery in demand and further hikes to education and health cost to guide prices higher, we see inflation averaging 7% this year, meeting the government's target.

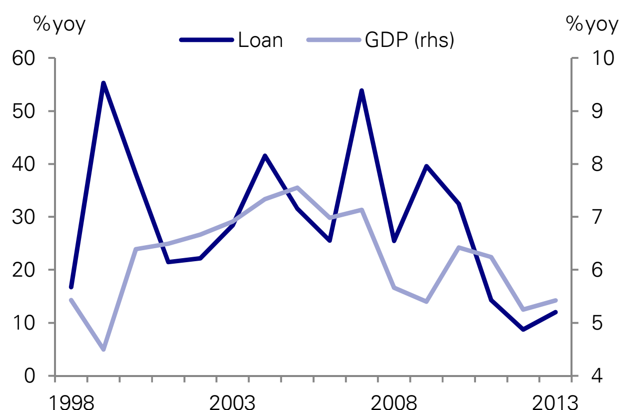
Inflation kept low by weak food price inflation



Sources: CEIC, Deutsche Bank

…despite weak credit growth… With inflation remaining low, we expect the State Bank of Vietnam (SBV) to continue to call for lower lending rates, while keeping ample liquidity to support credit growth. The latter stood anemic at 1.7%ytd in February, vs. the government's target of 12-14%. Moreover, we think the SBV may allow banks more room to maneuver in resolving bad debt, by delaying adoption of the international account standards or extending Decision 780/2012, which allowed restructuring of loans without identifying them as bad debt. Despite this, however, we expect the SBV to move ahead in improving its regulatory oversight capacity of the banking system.

Waiting for credit growth rebound



Sources: CEIC, Deutsche Bank

...while SOE reform efforts gather steam. The government seeks to equitize 500 SOEs and divest their non-core businesses by 2015. There are two important aspects of the government's SOE reform plan that would give it credibility and hope for speedier resolution of debt overhang. For the former, there is a question of accountability, which may be addressed by making SOE managers and related government organizations responsible for the successes and failures of their reform. For the latter, SOEs would be allowed to divest at lower than book value (at a loss), albeit with government approvals. Moreover, there are pending revisions to the Laws of Housing and Laws of Real Estate Business Activities, which may allow a more flexible foreign participation, thereby increasing demand for local real estate and bringing about a speedier revival of the real estate market. With foreign investors likely to focus more on the higher-end segment of the real estate market, we see the government furthering its efforts in supporting local demand for the lower end of the market segment. We expect that the government to address procedural impediments to allocating the public housing fund, worth VND30tn, while opting to provide longer-term loans to low income households. Note that less than 4% of the fund was allocated thus far since its announcement in late 2013.

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Vietnam: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	154.8	170.3	188.6	212.5
Population (m)	88.8	89.8	90.7	91.7
GDP per capita (USD)	1742	1897	2079	2318
Real GDP (yoy %)	5.2	5.4	5.8	6.3
Private consumption	4.9	4.5	5.0	6.5
Government consumption	7.2	6.0	7.0	6.5
Gross fixed investment	1.9	2.0	5.0	8.0
Exports	11.0	11.5	16.0	14.0
Imports	3.2	10.5	15.8	15.5
Prices, Money and Banking				
CPI (yoy %) eop	6.8	6.0	8.4	9.4
CPI (yoy %) ann avg	9.3	6.6	7.0	9.8
Broad money (yoy %)	18.5	16.0	17.0	19.0
Bank credit (yoy %)	8.7	12.0	14.0	16.0
Fiscal Accounts[1] (% of GDP)				
Federal government surplus	-6.0	-6.0	-6.2	-5.5
Government revenue	27.5	27.2	27.5	28.0
Government expenditure	33.5	33.2	33.7	33.5
Primary fed. govt. surplus	-4.5	-4.7	-4.2	-3.0
External Accounts (USD bn)				
Merchandise exports	112.0	130.0	165.0	195.0
Merchandise imports	109.0	131.0	168.0	206.0
Trade balance	3.0	-1.0	-3.0	-11.0
% of GDP	2.1	-0.6	-1.7	-5.6
Current account balance	8.0	5.0	3.5	-6.0
% of GDP	5.7	3.2	2.0	-3.1
FDI (net)	7.0	8.0	8.0	8.0
FX reserves (USD bn)	25.4	36.0	42.0	44.0
FX rate (eop) VND/USD	20900	21100	21800	22500
Debt Indicators (% of GDP)				
Government debt	53.0	56.0	60.0	61.0
Domestic	22.0	24.0	27.0	28.0
External	31.0	32.0	33.0	33.0
Total external debt	43.3	40.2	39.0	37.4
in USD bn	61.0	63.0	68.0	73.0
Short-term (% of total)	16.4	19.0	19.1	20.5
General				
Industrial production (yoy %)	3.6	7.7	8.8	9.5
Unemployment (%)	3.2	3.2	3.2	3.0
Financial Markets	*Current*	*3M*	*6M*	*12M*
Refinancing rate	7.00	7.00	7.00	8.00
VND/USD	21105	21250	21600	22000

Source: CEIC, DB Global Markets Research, National Sources
Note: (1) Fiscal balance includes off-budget expenditure, while revenue and expenditure include only budget items.

Czech Republic

A1(stable)/AA-(stable)/A+(stable)

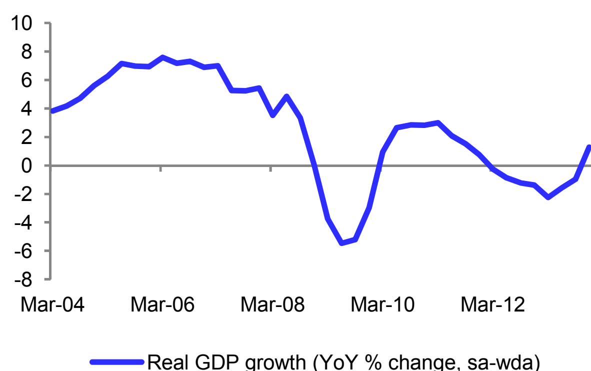
Moodys/S&P/Fitch

- Economic Outlook: GDP growth in Q4 was a strong 1.3% YoY, bringing full-year growth for 2013 to a better-than-expected -0.9%. Details show that the Q4 growth was broad-based, and domestic demand has started to turn around. We expect the economic recovery to pick up pace over the next two years. The new government comprising of the coalition between the Social Democrats, Christian Democrats and ANO was confirmed last month.
- Main Risks: Both upside and downside risks to the economic recovery in the Czech Republic come from the strength of growth in the euro area (and particularly Germany). With substantial disputes between the three parties forming the governing coalition (in particular between the Social Democrats and ANO), it remains a distinct possibility that the new government will not serve the full parliamentary term.

Economic recovery continues; new government takes office

Q4 GDP shows strong upside surprise. Real GDP growth in Q4 2013 was reported at 1.3% YoY – the first YoY expansion in quarterly GDP for two years – comfortably beating market expectations (-0.2%) as well as the Czech National Bank's (CNB) forecast (0.1%). In QoQ terms, GDP growth was also strong at 1.9%, the largest reading since 2007. For full-year 2013, the economy contracted by 0.9%.

GDP growth profile



Source: Deutsche Bank, Haver Analytics

Details show that the growth in Q4 was broad-based. Net exports increased by 6.2% YoY, while consumption and investment also expanded (by 1.2% YoY and 0.3% YoY respectively). Domestic demand has contributed positively to GDP growth in the past two quarters, after nine consecutive quarters of contraction prior to this. Recent high frequency indicators (particularly the Purchasing Managers' Index) have also been strong and the CNB's fx intervention is set to continue, indicating that the economy is likely to expand in Q1 2014 as well. Therefore, the signs on the economic front imply that the recovery is well underway, and is likely to continue (and become increasingly broad-based) over the next two years – we forecast real GDP growth at 2% in 2014 and 2.5% in 2015.

Inflation at the start of 2014 very low. Both January and February CPI were reported at 0.2% YoY, down sharply from 1.4% in December. Inflation is therefore well below the CNB's 1pp tolerance band around its 2% target. However, this sharp drop in inflation was largely expected, and was due to administered price cuts (electricity, natural gas and healthcare) and last year's VAT increase dropping out of the base. Further, inflation is expected to remain subdued (and below the bottom limit of the CNB's target band) for the next two months, after which it is expected to rise gradually throughout the year and breach the 2% target in December 2014 or January 2015 (on the back of improving domestic demand and the fx intervention).

No changes in monetary policy expected. Though January and February inflation were well below the CNB's target and YoY CPI in February was slightly below the CNB's forecast (0.4%), the inflation path is generally in line with the CNB's expectations. Further, it is likely that January and February CPI would have been negative (in YoY terms) in the absence of fx intervention. The CNB forecasts inflation to breach the target only in Q4 2014, and has maintained that fx intervention will continue at least until the start of 2015. In our view, it would take a series of negative inflation surprises – which have not yet materialized – to make the CNB consider targeting a higher (weaker) level for EURCZK (the current target level for EURCZK is 27). Governor Miroslav Singer has repeatedly indicated that the CNB would look to weaken the koruna even further only in an "extraordinary" case. Additionally, he stated this week that the CNB would prefer to continue fx intervention with the current target EURCZK level (27) for longer if required, rather than change the target level (as stability is a major concern). We therefore expect no changes in monetary policy in the near future – that is, we expect fx intervention to continue with the same target level for EURCZK.

New government appointed. On 17th January, President Milos Zeman officially appointed the leader of the Social Democrats (CSSD), Bohuslav Sobotka, as the new Prime Minster. Two weeks later, Zeman also appointed the new government, consisting of the coalition between the Social Democrats, businessman Andrej Babis' Action of Disgruntled Citizens (ANO) party and the Christian Democrats (KDU-CSL). While there were initially some concerns regarding whether the President would agree to the nominees for cabinet ministers put forward by Sobotka, eventually the composition of the cabinet was the same as that proposed by Sobotka (after the President individually met with each of the candidates). The new cabinet consists of 17 ministers – eight from the CSSD, six from ANO and three from KDU-CSL. In particular, right-leaning Andrej Babis (ANO) was appointed as the finance minister.

In mid-February, the new government won a confidence vote in the lower house of parliament (as required by the constitution). This was largely expected, as the coalition holds a comfortable majority – 111 of the 200 seats – in parliament. Supporting economic growth remains a focus of the governing coalition. Its policy statement indicates that it plans to do this by creating jobs (by efficiently using EU funds and prioritizing EU-funded projects), promoting projects with large R&D components, supporting SMEs, investing in infrastructure and improving incentives for foreign investors. However, the statement does not include sufficient specifics and details on how these measures will be implemented. Further, concern remains over how these populist, pro-growth reforms will be financed. In order to secure the participation of pro-business ANO in the governing coalition, the CSSD had to make substantial concessions on its (left-leaning) original agenda, including agreeing to not raise taxes until at least 2015. Even at a later date, ANO is likely to block any major tax hikes. Additionally, there are no details about where savings in the budget would be made. Any excess spending on growth programs would threaten the 3% of GDP Maastricht threshold for the budget deficit; the government has pledged to contain the deficit within this threshold.

While the coalition holds a comfortable majority in parliament, there are sufficient underlying ideological differences between the three coalition partners (in particular, ANO's very pro-business stance conflicted with the CSSD's plan for higher corporate taxes), as well as internal disputes within the CSSD and ANO, to undermine the stability of the government in the long run. This, along with the historic prevalence of volatility in Czech politics and the relatively short average tenure of governments, leads us to believe that the current government is unlikely to serve the full parliamentary term (the next election is scheduled for 2017).

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Czech Republic: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	196.5	198.3	192.8	184.7
Population (mn)	10.6	10.6	10.6	10.6
GDP per capita (USD)	18617	18753	18200	17399
Real GDP (%)	-1.0	-0.9	2.0	2.5
Priv. consumption	-2.1	-0.1	1.0	1.7
Gov't consumption	-1.9	1.9	1.0	1.2
Investment	-5.0	-4.0	0.6	2.3
Exports	4.7	0.2	5.1	5.8
Imports	2.5	0.5	4.4	5.4
Prices, Money and Banking				
CPI (YoY%, eop)	2.4	1.4	1.6	2.0
CPI (YoY %, pavg)	3.3	1.4	1.1	2.0
Broad money (M2)	4.5	2.9	5.1	5.0
Fiscal Accounts (% of GDP)				
ESA 95 fiscal balance	-4.4	-3.0	-2.8	-2.7
Revenue	40.1	40.0	40.8	41.4
Expenditure	44.5	43.0	43.6	44.1
Primary balance	-2.9	-1.5	-1.3	-1.2
External Accounts (USDbn)				
Exports	131.9	139.8	153.1	136.5
Imports	124.5	129.3	142.3	126.9
Trade balance	7.5	10.5	10.8	9.7
% of GDP	3.8	5.3	5.6	5.2
Current account balance	-4.8	-1.1	-2.0	-2.6
% of GDP	-2.4	-0.6	-1.0	-1.4
FDI (net)	6.9	4.0	5.0	5.0
FX reserves (USD bn)	37.4	42.4	42.9	43.4
CZK/USD (eop)	19.0	19.9	21.6	23.6
CZK/EUR (eop)	25.1	27.3	27.0	26.0
Debt Indicators (% of GDP)				
Government debt	46.2	47.7	47.0	49.7
Domestic	31.4	34.9	34.1	36.2
External	14.7	12.7	12.8	13.4
Total external debt	51.8	49.9	49.8	50.7
in USD bn	101.9	99.0	96.0	93.6
Short-term (% of total)	25.7	27.7	26.8	26.8
General (% pavg)				
Industrial production	-0.7	0.9	4.0	4.4
Unemployment	6.8	7.5	7.0	6.7
Financial Markets (eop)	**Current**	**14Q2**	**14Q3**	**15Q1**
Policy rate (%)	0.05	0.05	0.05	0.05
CZK/EUR	27.4	27.0	27.0	27.0
CZK/USD	19.7	20.5	20.9	22.3

Source: Haver Analytics, CEIC, DB Global Markets Research

Hungary

Ba1(neg)/BB(neg)/BB+(stable)
Moody's/S&P/Fitch

- Economic Outlook: GDP growth in 2013 was a higher-than-expected 1.1%; the details indicate that it became increasingly broad-based, with a rebound in investment. Growth is expected to accelerate further over the coming two years. Inflation remains very low however, which could lead to further monetary policy easing.

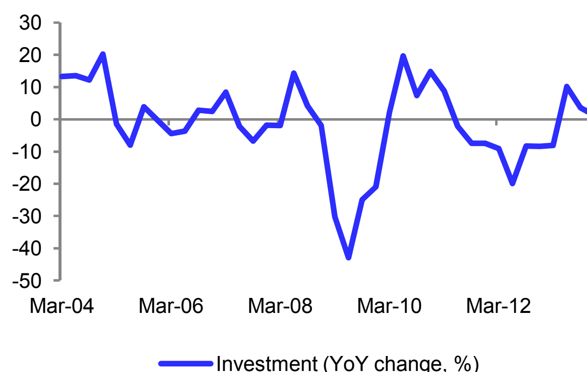
- Main Risks: Economic growth in Hungary is dependent on the pace of the euro area recovery. Upward risks to growth also come from the possibility of another strong agricultural harvest, while downward risks come from the possibility of reduced EU funds. General elections in April represent another source of uncertainty.

Growth is strong but inflation remains subdued; further monetary policy easing may follow

Growth in 2013 driven by agriculture. GDP details confirmed that economic growth in 2013 was driven mainly by agriculture. Real GDP growth in Q4 2013 was 2.7% YoY (up from 1.8% in Q3), bringing full-year growth in 2013 to 1.1% (agriculture contributed 0.9pps to this). However, compared to the previous three quarters, the positive contribution of agriculture was mitigated in Q4, while manufacturing and construction showed strong growth. High frequency economic indicators also remain strong; in particular, the unemployment rate is at a five-year low.

After four quarters of negative QoQ growth in 2012, GDP expanded in QoQ terms in all four quarters of 2013, providing further evidence that the economic recovery in Hungary is firmly underway. GDP details also show that investment (boosted by the increase in EU funds) and domestic demand rebounded in 2013, contributing positively to YoY GDP growth in the last three quarters of 2013, after eight consecutive quarters of decline prior to this. While net exports contributed positively to GDP growth in 2013 (fueled by the euro area recovery), its impact was lower than in 2012. Therefore, there is evidence that growth is becoming increasingly broad-based. We expect growth to accelerate in the next two years – rising to 1.9% in 2014 and 2% in 2015 – as the economic recovery picks up pace. The risks to this forecasts are balanced – another good agricultural harvest would likely cause growth to overshoot our forecast, while downside risk comes from the possibility of a decrease in the availability of EU funds.

Investment rebounded in 2013



Source: Deutsche Bank, Haver Analytics

Inflation at record low. Inflation in January was reported at a low 0% YoY, while that in February was only slightly higher at 0.1% YoY (both readings were well below market expectations). The subdued inflation at the start of this year was primarily due to the continued effect of the 11% cut in household energy prices implemented in November as well as weak fuel price inflation. Headline inflation is expected to remain well below the National Bank of Hungary's (NBH) 3% target all through 2014, but should rise gradually throughout the year before rising sharply at the start of 2015 on the back of base effects.

After remaining largely stable since September (while headline inflation was falling sharply), seasonally-adjusted core CPI, which excludes electricity and fuel prices, was reported at 2.8% YoY in February, down significantly from 3.4% YoY in January. This is the lowest reading since May 2011, and highlights the reduction in significant upward pressures on inflation.

Given the low inflation environment and persistently negative output gap – as well as the expectation of subdued inflationary pressures over the medium term – the NBH cut the policy rate by 15bps for the second consecutive month at its MPC meeting in February, bringing the policy rate to a record low 2.70%. In light of the NBH's strong concerns regarding the subdued inflation (it has repeatedly flagged this in its monthly statements), combined with the lower-than-expected headline inflation and fall in core CPI in February, we believe that the NBH will cut rates again, albeit by a smaller magnitude of 10bps, at the next MPC meeting on 25th March. Additionally, the forint has not depreciated markedly since the last MPC meeting, increasing the likelihood of further monetary policy easing.

Our call for another rate cut (which should be the last of the easing cycle, with rates on hold in the near term thereafter) is also supported by the dovish rhetoric from NBH members. MPC member Gyula Pleschinger stated this week that the current weak forint levels pose no threat to the NBH's inflation target or to financial stability. He reiterated that the NBH has no exchange rate target and its only concern on the fx front is the impact of the exchange rate on inflation. NBH deputy governor Adam Balog said last week that the fluctuations in the forint exchange rate fit into global trends and that Fed tapering has only caused a small disturbance in Hungary's money markets.

However, the NBH are wary of the risks posed by the external environment (including market jitters over the Ukraine crisis) and the vulnerability due to Hungary's large stock of fx debt, as highlighted by Pleschinger. Further, in its February statement, the NBH provided a more balanced and cautious commentary on future policy; it removed the regular dovish statement that "further cautious easing of monetary policy may follow", instead stating that the NBH would decide on the possibility of continuing the easing cycle "after a comprehensive assessment of the macroeconomic outlook and developments in perceptions of the risks about the economy in view of the baseline projection and alternative scenarios of the March forecast". We believe that a sharp depreciation of the forint between now and the next MPC meeting would deter another rate cut (with rates on hold in this scenario).

Opposition support falls amid corruption scandal. Early last month, Hungarian newspaper Magyar Nemzet reported that it had uncovered a hidden Austrian bank account of Gabor Simon, the vice president of the main opposition Socialist party (MSZP). Simon had placed EUR 770,000 of undeclared funds in this account over the past five years. Shortly after the report was published Simon gave up his parliamentary seat and resigned from all his MSZP positions; he was unable to provide a satisfactory explanation for the origin of the funds. In the wake of this scandal, support for the opposition coalition (named the Unity alliance) – which consists of MSZP, ex-PM Gordon Bajnai's E14-PM, the Democratic Coalition (DK) party and the Liberal party – has fallen significantly. The most recent opinion poll conducted by pollster Nezopont in late February shows that support for the opposition coalition fell by 6pps compared to the previous month, to 18% among all voters. Meanwhile, the incumbent Fidesz party enjoys 37% support among all voters (down 1pp from January). Fidesz are therefore expected to comfortably win the general elections, which will be held on 6th April; however, it remains to be seen whether it will secure another supermajority in parliament.

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Hungary: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	125.1	128.5	128.8	126.1
Population (mn)	10.0	9.9	9.9	9.9
GDP per capita (USD)	12554	12930	12983	12731
Real GDP (%)	-1.7	1.1	1.9	2.0
Priv. consumption	-1.7	-0.1	1.1	1.6
Govt consumption	0.1	4.3	1.3	1.2
Investment	-3.7	5.9	1.3	3.8
Exports	1.7	5.3	6.2	5.1
Imports	-0.1	5.3	7.5	5.5
Prices, Money and Banking				
CPI (YoY%, eop)	5.0	0.4	1.3	2.2
CPI (YoY%, pavg)	5.7	1.7	0.5	2.3
Broad money (M3)	-3.3	2.0	3.7	4.7
Fiscal Accounts (% of GDP)				
ESA 95 fiscal balance	-2.1	-2.5	-2.9	-2.7
Revenue	46.2	46.3	46.2	44.8
Expenditure	48.3	48.8	49.1	47.5
Primary balance	2.2	1.3	0.9	1.1
External Accounts (USDbn)				
Exports	97.3	104.3	112.2	105.3
Imports	92.8	98.1	105.9	100.1
Trade balance	4.6	6.3	6.3	5.2
% of GDP	3.7	4.9	4.9	4.1
Current account balance	1.3	2.8	2.7	1.9
% of GDP	1.0	2.1	2.0	1.5
FDI (net)	2.6	1.5	1.7	2.0
FX reserves (USDbn)	41.9	37.6	37.6	37.1
HUF/USD (eop)	220.9	216.3	233.6	256.4
HUF/EUR (eop)	291.4	297.2	292.0	282.0
Debt Indicators (% of GDP)				
Government debt	79.8	78.0	76.2	80.2
Domestic	45.1	39.5	38.7	47.7
External	34.7	38.5	34.9	32.5
Total external debt	131.5	121.6	120.0	118.0
in USD bn	164.4	156.3	154.6	148.7
Short-term (% of total)	13.9	16.7	16.4	15.7
General (% pavg)				
Industrial production (YoY%)	-0.8	1.6	4.5	4.9
Unemployment	10.9	10.2	10.0	9.9
Financial Markets (eop)	**Current**	**14Q2**	**14Q3**	**15Q1**
Policy rate (%)	2.70	2.60	2.60	3.25
HUF/EUR	312.7	303.1	297.5	289.5
HUF/USD	225.4	229.6	230.6	238.7

Source: NBH, DB Global Markets Research, Haver Analytics

Poland

A2(stable)/A-(stable)/A-(stable)
Moodys/S&P/Fitch

- Economic Outlook: The recovery is now tangible, and we expect growth to accelerate further on the back of improving domestic demand. The eventual pick up of inflation from the current unusually low levels should pave the way for rate hikes by the end of the year.
- Main Risks: A slow recovery of the Euro zone remains the main external risk. The pension reform has come into force and we think the risks from a judicial review of the reform are contained. Polish links to Ukraine is a geographical and geo-political fact, but we think that the economic exposure is limited.

Domestic demand has started recovering

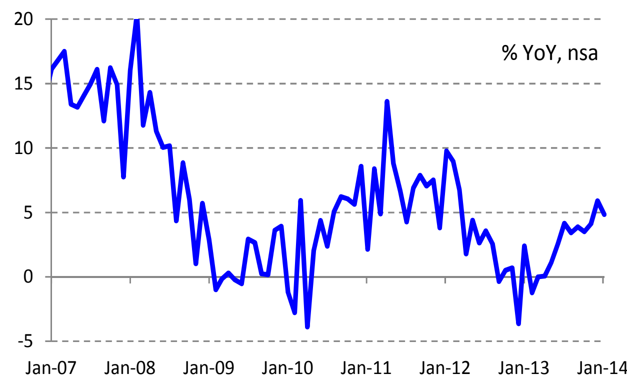
Real activity data are improving on all fronts

The second reading for Q4 GDP growth print confirmed the 2.7% (YoY) flash estimate. Very positive details highlight a pick-up of domestic demand, the continuation of strong export progress, and an acceleration in net investment. Private consumption accelerated swiftly from a 1.2% YoY print in Q3 by gaining 2.1% YoY in Q4 —in light of which the retail data below should bode well for 2014. On the trade-data front, domestic demand improvements translated in imports gaining 2.9% YoY in Q4, consolidating the 3.4% YoY progress from Q3.

Exports on their end confirmed their buoyancy, printing for the second quarter in a row north of +6% YoY. The only, on the surface, weaker spot in this picture would be the investment segment that lost 1% in Q4 compared to last year. But there again, the record is impacted by inventory draws in a context where fixed capital formation actually improved by 1.3% YoY, accelerating from a 0.6% YoY gain in Q3.

In terms of forward looking indicators, very strong February manufacturing PMIs confirmed the recovery pattern. Headline manufacturing PMI recorded a 3-year high, reaching 55.9, a level last seen in the last months of 2010. New orders breached the 60 ceiling last reached as far back as April 2004. And the new export component also rebounded swiftly at 56.0, from the mild deceleration (at 54.0) in December. The couple of soft months in Q4, which could have underscored the lingering risk of Poland's exposure to the slowly recovering Eurozone seem now past. All in all, recent data are very encouraging and we continue to forecast growth of 3% in 2014 —now become consensus, and 3.9% in 2015 —only 0.15ppts below the NBP March central forecast.

Retail sales accelerating

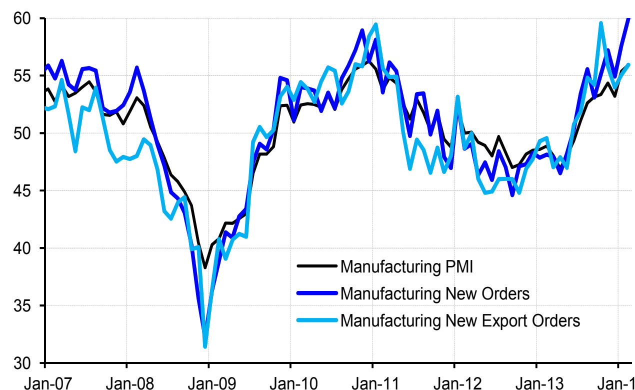


Source: Haver Analytics, Deutsche Bank

The inflation outlook appears benign

Headline inflation remained at 0.7% YoY in January, not recording the acceleration that consensus expected. This January, print consolidates the 0.7%YoY average inflation recorded in Q4, far below the 2.5% NBP target. The impact of the excise tax hike was very limited in January, with alcohol and tobaccos prices gaining only 0.8% MoM. From past experiences of such tax changes we nevertheless expect the increase in prices to take place over the course of several months. Base effects from last year regulated energy price cuts dropping out of the YoY computations also had a limited impact on the rent/energy segment YoY figure (only level of details available at this point) which added 0.2ppts to 2.5% YoY in January.

PMIs at historical highs



Source: Haver Analytics, Deutsche Bank

In the light of a subdued inflation start of the year and the confirmation of weak inflationary pressures globally, we have revised downward our inflation profile and now expect Polish prices to grow on average 1.7%YoY in 2014, printing by year-end near 2.2%. Our forecast is still 0.5 ppts higher than that of the NBP which we think may underestimate the impact of domestic demand progresses on prices.

The pension reform went through seamlessly, and 2014 budget financing needs were already 60% covered by February-end.

The assets transfer stemming from the pension reform is now fully implemented and its implications on various market indexes are also behind us. The last hurdle remains the ongoing constitutional review. But with the asset ownership question off the debate, we do not expect any impactful ruling. On the fiscal front, the Cabinet has approved on Feb-25 a draft bill that should lower by 7ppts of GDP the public debt thresholds to trigger automatic stabilization mechanisms. In the details the 55% debt to GDP threshold which forces a budget surplus should be reduced to 47%, and the 50% rule that imposes a budget with decreasing deficit to revenue structure would fall to 43%. The 60% debt ceiling which is stated in the Constitution—and triggers a 1ppt VAT hike together with expenditure cuts— remains unaffected.

Guidance of hold has been extended to Q3, and we now expect a potential tightening cycle initiation in Q4

As was suggested last month, the NBP extended this March their guidance to Q3, indicating that they expect rates to remain unchanged in July and September (with no meeting in August). This commitment led us to push back our rate hike profile and now expect a 50bps initiation of tightening cycle in Q4. Although Governor Belka disclosed that the MPC discussed the possibility of extending the hold-guidance through the fourth quarter, in a context where inflation should have started to regain some ground, and growth to have built up healthily, we think that the first hikes in Poland could occur before the end of the year.

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Poland: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	490.0	513.9	502.1	515.9
Population (mn)	37.6	37.6	37.5	37.4
GDP per capita (USD)	13019	13685	13400	13799
Real GDP (%)	1.9	1.6	3.0	3.9
Priv. consumption	1.2	0.8	3.0	3.5
Gov't consumption	0.2	2.0	1.2	1.5
Gross capital formation	-0.5	-0.9	4.0	5.5
Exports	3.9	4.3	8.0	8.5
Imports	-0.6	0.7	7.0	8.0
Prices, Money and Banking				
CPI (YoY%, eop)	2.4	0.7	2.2	2.5
CPI (YoY %, pavg)	3.7	0.9	1.7	2.3
Broad money (M3)	10.0	5.0	7.1	8.7
Fiscal Accounts (% of GDP)				
ESA 95* fiscal balance	-3.9	-4.8	4.0	-3.1
Revenue	38.3	36.7	45.3	37.5
Expenditure	42.2	41.5	41.3	40.6
Primary balance	-1.1	-2.1	6.2	-0.9
External Accounts (USDbn)				
Exports	190.8	205.4	218.8	214.6
Imports	197.5	202.7	219.0	214.8
Trade balance	-6.7	2.6	-0.2	-0.2
% of GDP	-1.4	0.5	0.0	0.0
Current account balance	-18.3	-7.8	-11.0	-9.9
% of GDP	-3.7	-1.5	-2.2	-1.9
FDI (net)	5.3	0.1	6.3	5.9
FX reserves (USD bn)	96.1	102.4	94.1	83.3
PLN/USD (eop)	3.09	3.02	3.48	3.55
PLN/EUR (eop)	4.08	4.15	4.00	3.90
Debt Indicators (% of GDP)				
Government debt	52.7	54.9	47.4	48.2
Domestic	36.1	37.1	29.2	29.3
External	16.6	17.8	18.2	18.9
Total external debt	71.1	72.0	77.8	79.8
in USD bn	348.7	369.9	390.7	411.8
Short-term (% of total)	24.9	24.8	25.0	24.9
General (YoY%)				
Industrial production	1.4	2.9	4.3	6.0
Unemployment	12.8	12.9	11.8	11.0
Financial Markets (eop)	**Current**	**2014Q2**	**2014Q3**	**2015Q1**
Policy rate	2.50	2.50	2.50	3.50
PLN/EUR	4.21	4.09	4.05	3.98
PLN/USD	3.04	3.41	3.43	3.49

Source: Haver Analytics, CEIC, DB Global Markets Research
** Under ESA-95, the general government balance would improve in 2014 by the value of the assets transferred to ZUS from OFEs. Under ESA-2010, which comes into force in September 2014, this one-off transfer would not count as revenue any more.*

Russia

Baa1(stable)/BBB(stable)/BBB(stable)

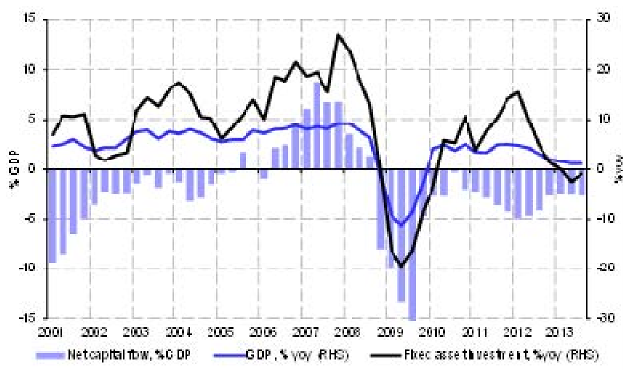
Moody's/S&P/Fitch

- Economic Outlook: Growth to decline on the back of geopolitical risks; investment likely to be adversely affected by higher capital outflows.
- Main Risks: Worsening of geopolitical risks related to Ukraine, scale of sanctions against Russia

Geopolitical risks stoke capital flight

In February, the crisis in Ukraine, which entered the spotlight at the end of last year and grew in scale throughout January, resulted in the dismissal of the government and the takeover of power from President Yanukovich by pro-western representatives of the opposition. Regional tensions further escalated after Russia's President Vladimir Putin was granted permission by the Federation Council to send troops to Ukraine, which led to an abrupt increase in tensions between Russia and Ukraine, as well as between Russia and the West.

Russia: Dynamics of real GDP, fixed investment and net capital outflows, 2001-2013



Source: Rosstat, CBR, Bloomberg Finance LP, Deutsche Bank

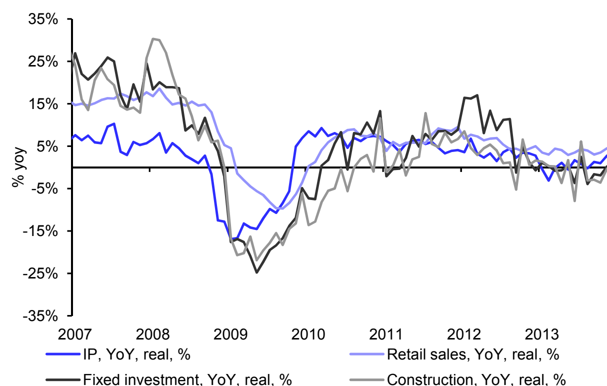
The key vulnerability for Russia's macroeconomic development in the near term is likely to be an increase in the scale of capital outflows. We revise our base case scenario on capital outflows, from USD30bn to USD75bn for this year, the level of the last few years. At the same time, we acknowledge the possibility of downside risks if tensions intensify. Our analysis implies that capital outflows of USD75bn would prompt a surge in the RUB/USD rate to a year-average of RUB/USD36.5 (see our publication in this EM Monthly *'Russia: macro implications of increased geopolitical risk'*) and engender a marked slowdown in GDP growth.

We believe that although the Sochi Olympics are likely to have led to some positive effects in terms of consumption (the CBR estimates the impact on GDP at 0.3pp), the year-on-year effects related to fixed investment growth/infrastructure development could put further pressure on headline growth rates. Accordingly, we downgrade our 2014 forecast from 2.4% yoy to 0.6% yoy, which is coming on the back of higher capital outflows, lower business and consumer confidence, higher interest rates and inflation as well as sanctions (the latter, however, are still hard to gauge at this stage). In addition we revise our 2015 GDP growth forecast from 2.8% yoy to 2.2% yoy.

Russia's economic growth remains a key focus

January's key economic figures point to a weakening dynamic, with an emphatic decline witnessed on the investment front and the continued deceleration in Russia's household consumption growth. On the production front, industrial production declined by 0.2% yoy in January after rising 0.4% yoy in December and 2.8% yoy in November. Across the industries, the main drag on industrial production was from the gas/water/electricity segment, due to a relatively warm first part of January: -3.9% yoy from -10.1% yoy in December and -5.9% yoy in November. As was the case in previous months, the main driver of IP growth was mineral extraction: 0.9% yoy vs. 2.0% yoy in December and 1.8% yoy in November. Meanwhile, manufacturing was flat after growing 1.7% yoy in December and 4.8% yoy in November.

Russia: Key economic indicators



Source: Rosstat, Deutsche Bank

Other production indicators appeared to be in line with the trend of the previous months: construction was down 5.4% yoy after -3.0% yoy in December and -0.3% yoy in November; the transportation segment added

3.1% yoy after 2.5% yoy in December and 0.7% yoy in November; agriculture added a somewhat marginal 0.8% yoy after 1.4% yoy in December.

The main disappointment in the beginning of this year was in fixed assets investment, which saw a major decline of -7.0% yoy after 0.3% yoy in December and 0.2% yoy in November. As was the case during the 2008-2009 downturn, fixed investment growth appears to be the weakest component in Russia's growth performance, primarily due to weaker business confidence and capital outflows. Later this year, inflationary pressures together with higher interest rates may further exert downward pressure on investment growth.

On the consumer side, retail sales grew 2.4% yoy after 3.8% yoy in December and 4.5% yoy in November, constrained by the decline in real disposable income (-1.5% yoy after 1.5% yoy in December and November), and the relatively low growth in real wages, 2.5% yoy vs. 1.9% yoy in December and 4.8% yoy in November. Unemployment remained unchanged at 5.6%.

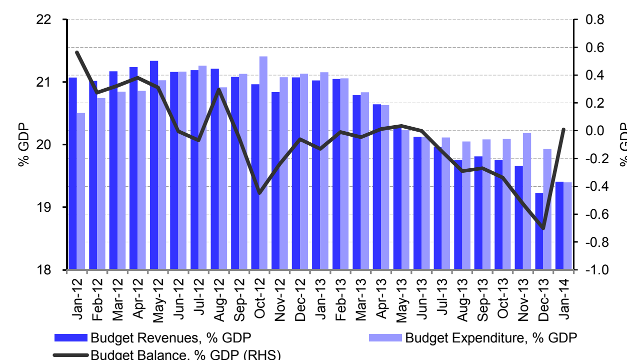
All in all, the core economic indicators index, Rosstat's proxy for GDP growth, declined in January for the first time since September, by 0.9% yoy; during the previous period of contraction the decline was -0.1% yoy. Although the January trends are unlikely to be representative, as the number of working days in January was quite small, we believe that the slowdown in economic growth could be partially explained by the Sochi Olympics effect, due to lower infrastructure spending in January, while the outlays on new projects from the NWF, i.e. the Central Moscow Ring Road and Far East Development, have not started yet.

Overall, the EMFX crisis at the beginning of the year as well as the geopolitical stand-off with the West over Ukraine has increased political risks in Russia. We downgrade our growth projections for 2014 from 2.4% yoy to 0.6% yoy, partly on the back of higher capital outflows, which we revise from USD30bn to USD75bn in 2014.

Federal budget surplus at RUB466bn in January

On the fiscal front, according to the Ministry of Finance, the federal budget posted a surplus of RUB466bn (0.7% T12M GDP) with revenues at RUB1,324bn (2.0% T12M GDP) and expenditure at RUB858bn (1.3% T12M GDP). Oil and non-oil revenues amounted to RUB615bn (46% of total) and RUB709bn, respectively.

Russia: Federal budget implementation, T12M



Source: Rosstat, Deutsche Bank

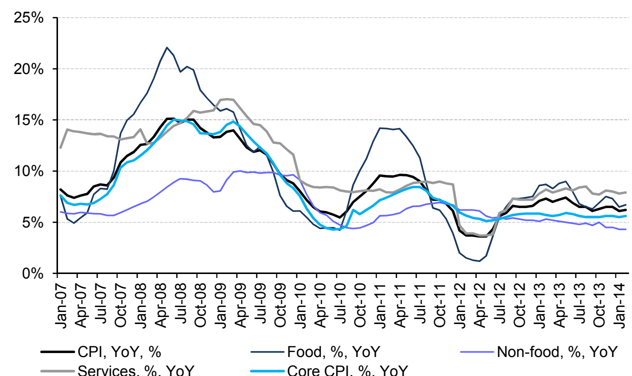
Overall, given the seasonality of the budget execution, the surplus was quite high vs. the results of January 2012 and 2013, thanks to a favorable ruble and commodity prices environment. With respect to the year ahead, the authorities project a deficit of 0.5% GDP in 2014. Revenues are expected at RUB13,570bn and expenditure at RUB13,960bn, resulting in a deficit of RUB389bn. The non-oil budget deficit is expected at 9.4% GDP compared to more than 10% of GDP in 2013.

Given our changes to the growth outlook and fx forecasts, we revise our deficit outlook downwards to 0.5% GDP instead of 1.1% GDP projected earlier, with the weakness in the ruble (and the resulting improvement on the revenue side of the budget) having a dominant effect on balance.

Russia's CPI increases to 6.2% yoy in February

Growth in Russia's consumer prices accelerated in February to 0.7% mom, from 0.6% mom in January. On a yoy basis, inflation increased to 6.2% yoy, from 6.1% yoy in January. Core inflation inched up to 5.6% yoy, from 5.5% yoy in January.

Russia: CPI and its key components



Source: Rosstat, Deutsche Bank

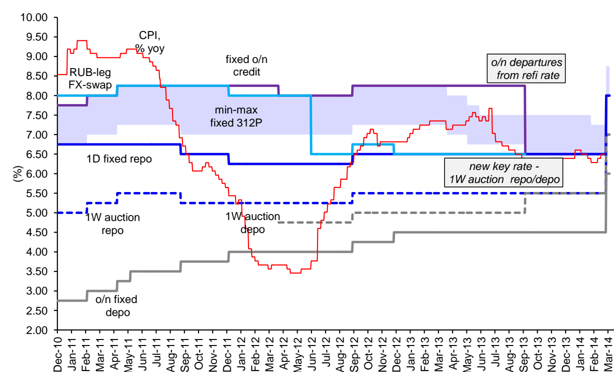
Across the key components, consumer prices witnessed a 0.2ppt acceleration in the food segment, to 6.7% yoy. Prices in the services segment were up 7.9% yoy vs. 7.8% yoy in January, while in the non-food segment, price growth remained unchanged at 4.3% yoy.

The persistence of the exchange rate weakness in view of the significant pass-through from exchange rate to prices (which is asymmetric and is greater on the case of exchange rate weakness) will likely drive inflation towards a higher-than-targeted CPI level (the CBR's target for 2014 is 5.0% yoy). Given the pace of devaluation, its persistence and changes to our currency forecasts, we revise our CPI projection for 2014 from 4.8% to 5.5% yoy.

CBR raises interest rates amid volatility in the ruble

On the back of the volatility on the forex market, and given the sharp sell-off in the market at the beginning of March, the Central Bank of Russia 'temporarily' raised the key interest rate (and the whole interest rate band) by 150bp from 5.5% to 7.0%. The CBR's decision was motivated by the need to counter inflationary risks and vulnerabilities associated with financial instability. However, the monetary authorities did not clarify how long they were going to maintain the new interest rate level. Our view is that the higher level of the key interest rate is likely to be maintained until pressure on the ruble and the underlying risks moderate.

Russia: Key policy rate

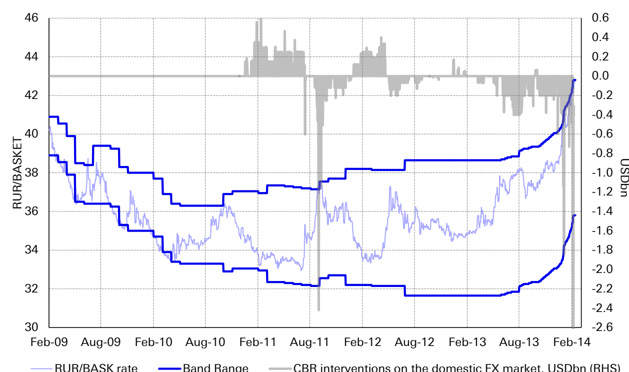


Source: CBR, Rosstat, Bloomberg Finance LP, Deutsche Bank

The CBR's measure came as a response to the sharp decline in market dynamics on March 3, which resulted in the RTS Index plummeting by more than 8% in the first few minutes of trading and the ruble depreciating by more than 3%, hitting the RUB/USD37.0 level. Later in the trading session, the ruble stabilized on the back of the CBR's interventions and the announced rate decision.

In addition to raising the key policy rate, the monetary authorities reviewed their accumulated interventions policy by determining the parameters of the exchange rate operations on a daily basis, based on the assessment of the current situation. On 3 March, the CBR set the amount of cumulative interventions triggering a 5-kopeck shift in the operational band borders at USD1.5bn from USD350bn used earlier. Other parameters of the Bank of Russia exchange rate policy remained unchanged. This adjustment resulted in lower sensitivity of the operational band borders to the amount of the CBR's FX interventions.

Russia: Exchange rate policy parameters



Source: CBR, Bloomberg Finance LP, Deutsche Bank

Overall, the CBR does not see any fundamental factors that could prompt further ruble weakness. Indeed, the estimates of the CBR show that the ruble is undervalued, given the improvement in the trade balance and current account, with the former growing by 11% yoy and the latter increasing by 14% yoy over the first two months of the year. However, CBR head, Elvira Nabiullina, underscored that the only reasons for future ruble appreciation could be improving macroeconomic dynamics, due to higher growth and lower capital flight.

According the CBR head, the external environment has stabilized after the capital flight relating to QE tapering, while the main factor weighing on the ruble is the political uncertainty, which led the monetary authorities to increase rates and step up forex interventions (CBR undertook the largest daily intervention over a four-year period on 3 March, which amounted to USD11bn).

Overall, our view is that the monetary authorities will gradually ease monetary policy as tensions on the forex market fade. We expect 50bps in 3Q14 and another 50bps in 4Q14, with the year-end interest rate going to 6.0% in the key rate. On the exchange rate front, the increase in the estimate of net capital outflows for this year together with lower growth projections lead us to revise our end-2014 ruble/dollar forecast from RUB/USD33.6 to RUB/USD 35.6 with an average rate over 2014 going to RUB/USD36.2. We downgrade our projection less than using only abovementioned sensitivity as we believe that there will be some compensation from higher current account surplus.

CA to gain on weaker ruble and higher oil

On the external front, the fresh trade prints of this year show notable strength. According to the data released by the Federal Customs Service, the trade balance surplus reached USD20.7bn in January 2014, increasing by 10.1% yoy. Regarding overall external trading activity, the turnover amounted to USD57.6bn, down 2.4% yoy. We believe that the two main reasons for such strong growth are a low base in January 2013 and a sharp decline in imports. Across the components, exports grew 0.6% yoy to USD39.2bn while imports declined by 8.3% yoy to USD18.4bn.

In light of the revision of our forecasts, we believe that the weaker ruble environment is likely to support the current account balance over 2014. As a consequence, we revise our 2014 forecasts for both the trade balance and current account from 7.1% GDP and 1.1% GDP to 8.3% GDP and 2.0% GDP, respectively.

Although we upgrade our trade balance and current account projections, we also see risks to our forecasts, most notably on the export side. In particular, we note that in light of the developments in Ukraine there are risks associated with the reliability of gas supplies to Europe. At this stage our base case is that such supplies continue; Ukraine depends on the financial support from Europe, which in turn is very much interested in the seamless delivery of fuel from Russia. At the same time, in the beginning of March Gazprom CEO Alexei Miller announced that the Ukrainian gas debt (at around USD1.5bn in March) has created a possibility of a return to the scenario of 2009, when Gazprom stopped gas deliveries to Ukraine due to non-payments, Ukraine diverted volumes from the transit volumes and Gazprom stopped any gas transit into Europe through Ukraine. We believe that the additional hike in the Russian gas price for Ukraine would increase the risks of Ukrainian gas debt accumulation and raise the probability of the suspension of Russian gas supplies into Ukraine.

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Russia: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USDbn)	2 004	2 223	2 091	2 284
Population (m)	143	143.2	143.2	143.2
GDP per capita (USD)	14 009	15 527	14 606	15 956
Real GDP (yoy %)	3.4	1.3	0.6	2.2
Priv. consumption	6.6	4.7	3.0	3.3
Govt consumption	0.0	-0.1	-0.5	0.1
Investment	6.0	-0.3	-3.6	2.1
Exports	1.8	3.8	2.2	2.6
Imports	8.7	5.9	3.4	3.2
Prices, Money and Banking (eop)				
CPI (YoY%) eop	6.6	6.5	5.5	5.4
CPI (YoY%) ann avg	5.1	6.8	6.2	4.9
Broad money	11.9	14.0	10.3	12.2
Credit	19.1	17.1	15.6	15.0
Fiscal Accounts (% of GDP)				
Federal budget balance	-0.1	-0.5	-1.1	-1.3
Revenue	20.5	19.1	18.0	18.1
Expenditure	20.6	19.6	19.0	19.4
Primary surplus	0.5	0.1	-0.5	-0.7
External Accounts (USDbn)				
Exports	529.1	521.6	508.3	520.4
Imports	335.8	344.3	335.0	347.3
Trade balance	193.3	177.3	173.3	173.1
% of GDP	9.6	8.0	8.3	7.6
Current account balance	74.8	33.0	41.1	36.4
% of GDP	3.7	1.5	2.0	1.6
FDI (net)	1.8	4.5	4.0	4.0
FX reserves (USDbn)	537.6	510.0	460.0	483.0
RUR/USD (eop)	30.5	32.9	35.6	35.2
Debt Indicators (% of GDP)				
Public debt	11.5	11.7	12.0	12.1
Domestic	8.0	8.1	8.6	8.7
External	3.5	3.6	3.4	3.4
Total external debt	31.8	32.9	36.5	36.5
in USDbn	636.4	732.1	763.2	832.7
General (% pavg)				
Industrial production (% yoy)	2.6	0.0	-1.2	1.6
Unemployment	5.7	5.5	6.0	6.3
Financial Markets (eop)	**Spot**	**2Q14**	**3Q14**	**1Q15**
Policy rate	7.00	6.50	6.00	6.00
RUB/USD	36.40	36.80	36.60	36.40

Source: Source: Official statistics, Deutsche Bank Global Markets Research

South Africa

Baa1 (negative)/BBB (negative)/BBB (stable)

Moody's/S&P/Fitch

- Economic Outlook: The better-than-expected budget and current account deficits have reduced some of the risks related to the credit, economic outlook and the exchange rate. The rand's recent resilience attests to this positive news probably being priced to an extent. By implication, short-term inflation risks have dissipated, and as such we have revised our call for a rate hike to May this year, if not July.
- Main Risks: Electricity supply has deteriorated into a state of emergency. For now, the economy may be able to bear this brunt, but conditions will be extremely tight. Elections are the next "risk" stop, but should not derail current progress on economic reform in our view. If anything, the envisaged outcome could help to refocus the state.

Slow but steady improvement in risks

Stronger rand-dollar push rate hike forecast out to Q2. The exchange rate showed significant resilience over the past month despite ongoing issues in Ukraine and Russia, continuing mining strikes and the escalation of electricity supply constraints. A stronger currency lowers the likelihood that the SARB will hike the repo rate at the end of the month, as we initially predicted. However, risks to dollar-rand remain skewed to the upside in the short-term if we consider DB's bullish outlook for the US economy and lingering tension in Ukraine and Russia. Stronger data on the US economy are likely to emerge from next month onwards as negative weather patterns dissipate. While we still hold an out-of-consensus view on China this year, growth is more likely to pick up from the middle of the year. This supports our call on the current account deficit and underpins our forecast of rand strength into year-end (DBe 10.50). On balance, we thus retain our existing short-term forecast for dollar-rand to trade near 11.50 in Q2, which will likely shift timing of the next rate hike to May, if not July.

Key domestic risk events (i.e. National Budget Review and the Q4 current account deficit) have yielded relatively favourable market outcomes over the past month. In light of ongoing uncertainty around global growth and capital flows to EM in general, further improvement in these balances will be necessary to lower the vulnerability of the economy to any shocks. The Budget Review for 2014 was seen as market friendly, as Treasury managed to revise its fiscal deficits lower by between 0.1% and 0.3% over the medium term, on the back of revised revenue growth, while keeping expenditure ceilings intact. This helped to lower expected debt issuance over the medium-term, limiting significant upside drift in the debt ratio that is already under pressure from rising borrowing cost. From a credit perspective, reactions were mixed. Fitch and Moody's were slightly more positive regarding the outcome of the budget. In contrast, S&P was more bearish, citing concerns over the strength of capital flows and questioning the underlying revenue assumptions. Though S&P views expenditure ceilings as positive, this practice may not be sufficient to arrest the deterioration in debt dynamics.

The current account deficit for Q4 improved to -5.1% of GDP (from -6.4% in Q3), broadly in line with our expectations. A substantial moderation in imports was behind this compression, reflecting much weaker-than expected domestic demand growth. Further improvement in the trade deficit is expected over the duration of the year, though not necessarily in a straight line. While the trade deficit spiked to R17bn in January (virtually the same as in 2013), it should be viewed in context of a 20% weaker currency, which implies a continuation in negative import volume growth that started in Q4. Given the recent disappointment in growth within the US and China, there could be upward pressure on the Q1 CAD print.

As for the growth implications of recent mining strikes and electricity supply constraints, there are downside risks to Q1 growth. But our forecast of a moderation to 2.4% from 3.8% in Q4, reflects this in our view. At this stage the extent of the negative growth impact is still uncertain. Though production losses at affected platinum mines could shave a few points from growth, inventory levels have reportedly been stretched so that main contracts can still be delivered in the event of the strike becoming more protracted. As a result, exports may thus not decline as dramatically as feared. In addition, precious metal export volumes supposedly already declined in Q4, despite the overall improvement in total exports last year. We expect the strike to be resolved by month-end.

Electricity supply is in state of crisis. Eskom raised its fourth power emergency since November 2013 on 6 March, and had to resort to rotational black-outs even after emergency reserves and contributions from users have been exhausted. This was the first such incidence since 2008, but only lasted one day. Loadshedding was triggered due to a rundown in dry coal stockpiles (including strategic inventories), following a protracted period of strong rains. Up to 12.3k MW of generation capacity was out of service (c. 29% of installed capacity of 41.9k MW), as a result of planned (4.5 MW) and unplanned (7.5k MW) maintenance shutdowns.

Growth will be constrained, but increased fuel requirements pose a threat to imports. The power grid will remain exceptionally tight until 2016, but especially over the next two months. Without any emergency use of open cycle gas turbines (which comes at high cost[18] owing to its fuel-intensity), Eskom predicts a demand shortfall of between 2k and 3.5k MW over the next two months. As it stands, the load factor of OCGTs has already been increased to c. 80% from the previous average of 20% and will have to be sustained up to winter. This is bad news for imports. Scheduled maintenance should free-up electricity supply on time for winter, but 5k-6k MW will be out of service up to end of April. A further issue is unplanned maintenance shutdowns, which due to the age of these power plants[19] have become more frequent, posing the largest risk to the outlook. Eskom has made an allowance for unplanned maintenance of up to 4.5k MW between April and June.

…but Eskom and companies are better prepared, limiting the risk of a 2008-style crisis. Though current conditions are extremely dire, compared to 2008, there Eskom has several procedures in place to better manage the tightness of the grid. This means a nationwide blackout will be avoided, but rotational loadshedding could become a feature in months ahead. During severe distress periods, in which 6k MW of electricity cutbacks are necessary to restore stability (i.e. stage 4 loadshedding), exports to SADC counties will be halted, and up to 20% demand cuts will be necessary until this emergency is lifted. In the meantime, large industrial and residential users are forced to lower demand by 10%, but are better equipped to do so.

All in all, electricity supply will be extremely tight in 2014, and will lift as and when new generation capacity comes on stream from the existing build programme. Confusion still exists around the timing of availability of new generation capacity. Though Eskom states that the first units of Medupi and Ingula will come "on line" in 2H14, this does not mean that power will immediately be generated. A six-to-eight month phase of testing and synchronization occurs before the plant becomes commercially viable. These power plants exist of several units, which are phased in over time. As such, electricity will gradually become available as and when the units have been fully commissioned and power sent to the grid. This should start in 1H15, but could still be below the forecast amounts as contained in Eskom's interim results last year.

South Africa: Eskom new electricity generation[20] capacity*

	2014	2015	2016	2017	2018	2019	Total
Grootvlei	30						30
Komati	100						100
Medupi		1,588	1,588	1,588			4,764
Kusile		800	800	800	1,600	800	4,800
Ingula		1,332					1,332
Sere		100					100
Total planned	130	3,820	2,388	2,388	1,600	800	11,126
Current capacity							41,900
REIPPPP							3,900
Total generation capacity (incl current)							56,926
New capacity uncommitted (up to 2030)							*42,539*

** Refers to the fiscal year, April to March. Source: Deutsche Bank, Eskom, July 2013*

Next stop: Elections on 7 May

The next event on the radar screen is the national elections. The significance of this year's event is that it will mark the 20th year of democracy. Though there has been improvement in the provision of public services and a reduction in inequality over this period, public protests have never been higher. This doesn't bode well for the ANC, who is widely predicted to win the lowest share of votes (c.60%) since 1994. Though the ANC is fragmenting, the outcome of the elections is difficult to predict. The Ipsos survey reports a significant drop to 53% in voter support for the ANC, which compares to 63% in the November 2008 survey, also six months ahead of the elections.

South Africa: Voting trends in national elections

	ANC		DA/DP		Other	
Portion of:	Votes cast	Eligible voters	Votes cast	Eligible voters	Votes cast	Eligible voters
1994	62.7	53.9	1.7	1.5	35.6	30.6
1999	66.4	46.5	9.6	6.7	24.1	16.9
2004	69.7	39.7	12.4	7.0	17.9	10.2
2009	65.9	38.7	16.7	9.8	17.4	10.2

Source: Deutsche Bank, South African Institute for Race Relations

This outcome is not a given. The poll was done ahead of the passing of former president Nelson Mandela, and may reflect a host of negative factors that built up over the year (i.e. corruption issues, significant money spent on upgrading the president's personal residence, leadership struggles within unions etc.). **So the outcome of the elections could be shaped by the "halo effect" of the late former president.** In addition, the ANC has deeper pockets than other parties to fund its election campaign, and could also capitalize on the Freedom Day celebrations on the 27th of April.

[18] One MW of power produced by an OCGT plant costs between 16 to 18 times more than the comparative from a coal-fired power station. This is also subjected to oil price fluctuations.

[19] Seven coal plants of the 27 power stations are past their design life of 35 years.

[20] The fourth bidding round for the Renewable Energy Independent Power Producer Procurement Programme (REIPPPP) opens in July and will be finalized next year. There are five bidding rounds, and 3.9k MW has already been procured in the first three rounds. So far, projects with a combined capacity of 2.4k MW are in development and some electricity supply has already been generated.

Voter apathy is on the rise. This is especially evident at provincial level, where the number of eligible voters who did not vote in the 2011 local elections rose to 60%. The ANC lost ground, while the DA gained support. But, a lower voter turnout may actually favour the ANC, as those who are likely to pitch tend to be the stalwart party supporters. As it stands, opposition does not appear strong enough to affect national voting trends. The main opposition party, the DA, has publically professed that it aims to win 30% of the votes (from 24% at provincial elections in 2011). But its confidence appears to have been sapped following failed attempts to merge with Dr Ramphele's Agang. The seeming interest of especially black voters in Julius Malema's party, the Economic Freedom Fighters (EFF) may also be factor in this regard. Some political analysts predict that the newly formed EFF could win between 4% and 8% of the vote. Though chiseling away at ANC support might be a challenging task, there is room for the DA and EFF to gain some ground owing to the potential decline in national support for the ANC-splinter party, Cope (Congress of the People), and the IFP (Inkatha Freedom Party) – the third and fourth runner ups at the 2009 national elections. Although not strictly comparable, these parties lost significant ground in the 2011 local elections with a combined vote of 5.8%, from 11.3% in the 2009 national elections.

The question remains as to how the ANC will respond post the elections. There are several scenarios, but it is very hard to anticipate the ANC's reactions to either outcomes. Moreover, the members of the new cabinet will be of particular interest to the credit rating agencies. There is no evidence to suggest that there will be any radical fundamental changes in policy if the ANC's share dwindles. As it stands, the left within the ANC has been weakened, and so has the alliance. The Budget was mildly more restrictive, and the State of the Nation Address contained nothing more than mainstream observations. An outcome close to 60% may spark motivation to fast-track reform contained in the National Development Plan. Even if the ANC vote slides to the low 50's as suggested by recent polls, some speculate that this could force the ANC to chase more populist votes. Perhaps if it is the DA that wins a larger share (at or above 25%), the ANC will receive a major wake-up call. Though this may energise the ANC to focus on particular matters within regions (e.g Gauteng in general, but Marikana and Nkandla in particular) where support has fallen significantly. We think it would be hard to break away from the ANC's mainstream agendas without threatening the credibility of the NDP. On the flipside, if the EFF gains significant ground, it may actually embolden the ANC's to the shift more towards the center as it needs to distance itself from the leftist policies promoted by Mr Malema. There is no clear extreme left party just yet. However, the trade union Numsa's split from Cosatu, and the stated intentions of forming a socialist party, will leave this point open for debate probably at the next local elections in 2016.

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South Africa: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	383.3	349.5	331.4	413.9
Population (mn)	52.3	53.0	53.5	54.0
GDP per capita (USD)	7331	6596	6193	7658
Real GDP (%)	2.5	1.9	2.9	3.5
Priv. consumption	3.5	2.6	2.4	2.9
Gov't consumption	4.0	2.5	1.9	2.8
Gross capital formation	4.4	4.7	3.5	4.1
Exports	0.5	4.2	8.7	6.7
Imports	6.2	4.7	4.4	2.7
Prices, Money and Banking				
CPI (YoY%, eop)	5.7	5.4	6.2	5.2
CPI (YoY %, pavg)	5.7	5.8	5.8	5.6
Fiscal Accounts (% of GDP) [1, 2]				
Budget balance	-4.2	-4.1	-4.0	-3.5
Revenue	32.5	32.8	32.6	32.0
Expenditure	28.3	28.7	28.6	28.5
Primary balance	-1.3	-1.0	-0.9	-0.4
External Accounts (USDbn)				
Exports	99.5	94.6	88.7	106.4
Imports	104.3	102.4	92.6	111.6
Trade balance	-4.8	-7.8	-3.9	-5.2
% of GDP	-1.3	-2.2	-1.2	-1.3
Current account balance	-20.1	-20.9	-13.1	-16.1
% of GDP	-5.2	-6.0	-4.0	-3.9
FDI (net)	0.4	1.1	0.8	0.8
FX reserves (USD bn)	50.7	49.0	51.0	55
ZAR/USD (eop)	8.5	10.1	10.5	9.3
ZAR/EUR (eop)	11.2	13.2	13.1	10.2
Debt Indicators (% of GDP)				
Government debt [1]	42.5	44.8	46.5	47.5
Domestic	38.6	40.5	42.8	43.7
External	3.9	4.3	3.7	3.8
Total external debt	37.1	37.1	36.9	33.8
in USD bn	142.3	130.0	135.0	145
Financial Markets (eop)	**Current**	**14Q1**	**14Q2**	**14Q4**
Policy rate	5.5	5.5	6.0	6.0
3-month Jibar	5.6	5.9	6.2	6.3
10-year bond yield	8.7	8.9	9	8.8
ZAR/USD	10.9	10.8	11.5	10.5
ZAR/EUR	15.1	15.1	15.2	13.2

(1) Fiscal years starting 1 April.
(2) Starting with the November EM Monthly, numbers are presented using National Treasury's new format for the consolidated government account.
Source: Deutsche Bank, National Sources.

Turkey

Baa3 (stable)/BB+ (negative)/BBB- (stable)

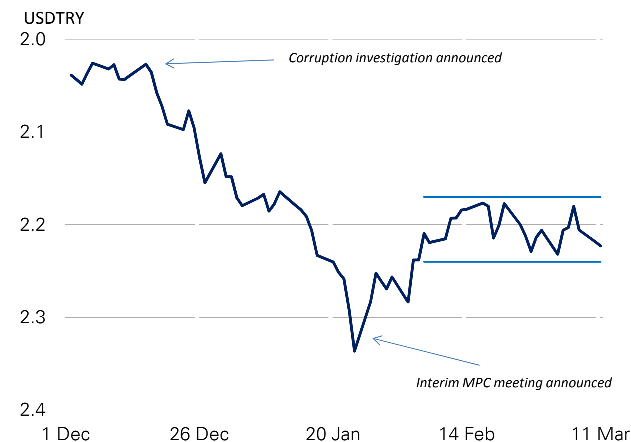
Moody's / S&P / Fitch

- Economic outlook: economic activity has remained surprisingly resilient in the face of political turbulence, weaker capital flows, and higher interest rates. Confidence and other forward looking indicators, however, have weakened and we expect growth to follow suit this year. Inflation has continued to accelerate and will likely average over 8% this year, with upside risks from food and energy prices.
- Main risks: political uncertainty may well linger beyond local elections later this month. Turkey would also be affected if stronger US data prompted markets to price earlier rate hikes by the Fed and this led to renewed jitters in EM. The crisis in Ukraine should have a limited impact though disruption to gas transit through Ukraine would add to upside inflation risks.

Inflation up but economy yet to slow

By recent standards, the last month was a calm one for the economy and markets. The lira, for example, has traded in a relatively narrow range of ±1.5% since early February. The emergency rate hike at the end of January undoubtedly helped. The recent soft spot in US data has also been supportive. Our US economists think that this is largely weather related and hence temporary. Nevertheless, it has tempered expectations of more aggressive Fed tapering, which has provided a welcome reprieve for Turkey and other EMs.

Lira stabilizes



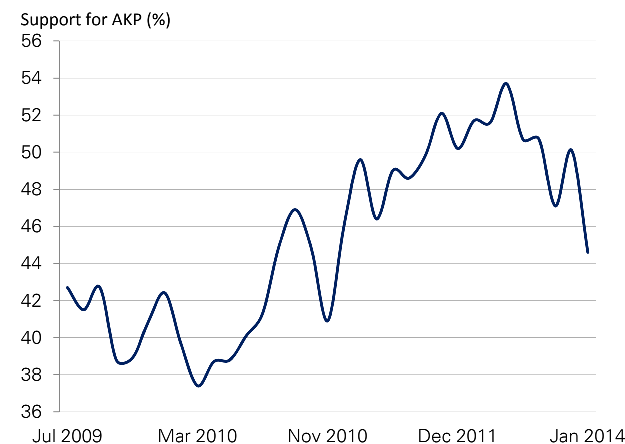
Source: Haver Analytics, Deutsche Bank

Local election outcome difficult to predict

The domestic political environment, however, has remained turbulent heading into local elections on March 30. The results will provide an important indication of the degree of support for Prime Minister Erdoğan and the AK Party and hence their prospects in Presidential elections later this year. The buildup has been noisy, not least following the release of audio tapes allegedly implicating Erdoğan in the corruption probe. Erdoğan has dismissed the tapes as part of a campaign orchestrated by the Gulen movement to destabilize the government. The government has also passed two laws perceived as controversial by some in the media and opposition, who argued that they represented a tightening of government control of the judiciary and the internet. This triggered protests in Istanbul and raised concerns among some EU representatives. Both laws were signed last month by President Gül.

Local political analysts have argued that winning about 45% of the national vote, and retaining the Istanbul and Ankara mayoral seats, would give Erdoğan a good shot at winning the Presidency. Whether this threshold will be met is unclear. The latest opinion polls are inconclusive, with support for the AK Party reported at anywhere between 40% and 49% -- we show one such poll in the chart below. Our sense remains that the current political uncertainty may well extend beyond this month's local elections and through to Presidential elections later this summer.

Support for AK Party

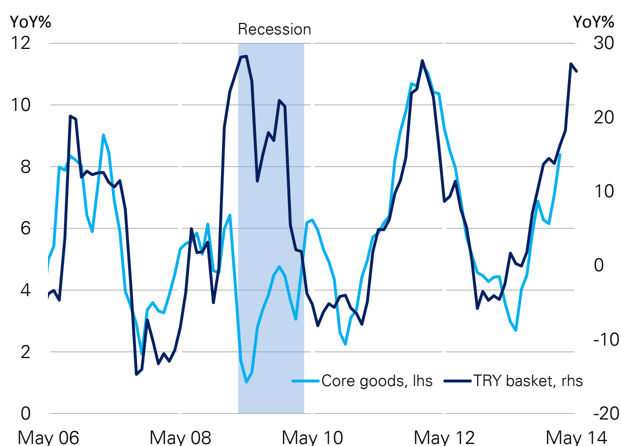


Source: Konsensus, Deutsche Bank

Core inflation still accelerating

The main economic surprise last month was the jump in core inflation, which accelerated to 8.4% in February from 7.6% the preceding month. With hindsight, perhaps we should not have been. There is quite a strong relationship between core good prices and the exchange rate. Last month's spike in core inflation is not out of line with this relationship and indeed there is probably more to come even assuming no further weakness in the lira (see chart). We are expecting core inflation to peak at close to 10% later this year.

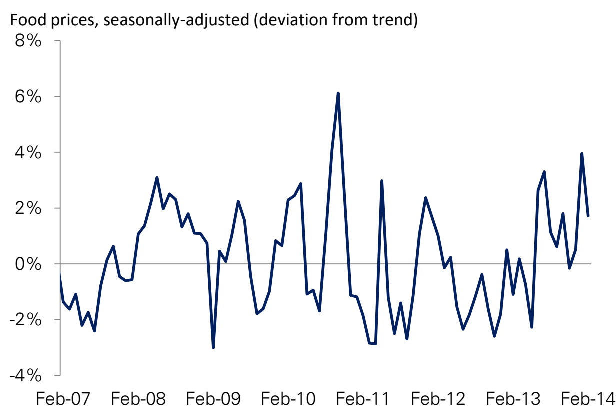
Core inflation still accelerating



Source: Haver Analytics, Deutsche Bank

The headline rate of inflation, however, edged up only marginally last month to 7.9%. This was because food prices fell by 1.6% MoM in seasonally-adjusted terms, correcting some of the spike in prices over the preceding two months. Food prices are still above their trend level and have rarely deviated from this level for very long (chart). We have therefore assumed that this gap will again be closed over the next few months. This would offset some of the upward pressure from core prices and limit the average headline inflation rate for this year to 8.1%. However, there are concerns about drought following unusually low rainfall in the key grain area of Anatolia. This could affect not only the price of food but also energy – hydroelectric power accounted for about one fifth of electricity generation last year. This is an upside risk to our inflation forecasts.

Food prices are above their trend level

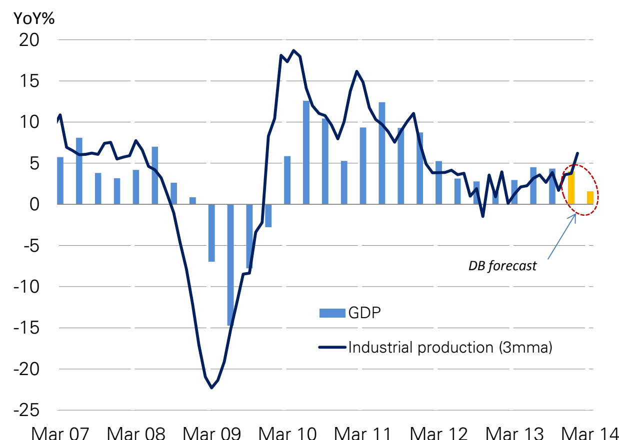


Source: Haver Analytics, Deutsche Bank

Economic activity surprisingly resilient

The other surprise last month was the resilience of industrial production, which increased by 7.3% YoY in January. This series can be a volatile but the three month moving average production level is also up 6.2% on the preceding year. It tracks quite well with GDP growth (see chart). This suggests that recent political turbulence, lower capital inflows, and higher domestic interest rates have had only a relatively limited effect on economic activity through the turn of the year. We should get confirmation of this when GDP for the fourth quarter is released at the end of this month, which we expect to show an increase of 4% YoY.

Industrial production remains robust



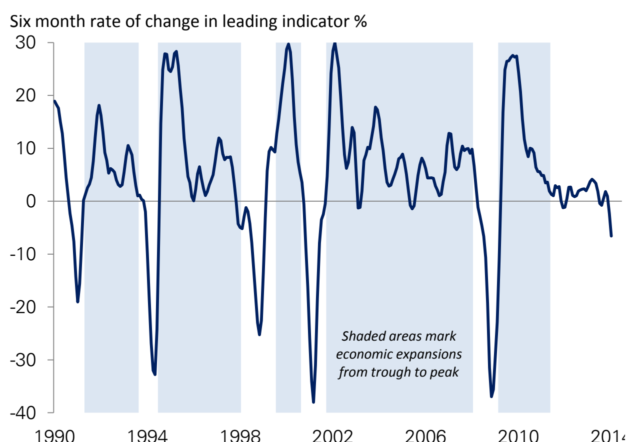
Source: Haver Analytics, Deutsche Bank

Other data have been more mixed. Credit growth has slowed. Though this deceleration is not especially dramatic, as we argued last month, the credit impulse is set to turn negative in the coming quarters and this will weigh on the growth of domestic demand. Confidence indicators have also weakened in recent months. The manufacturing PMI survey, however, has recovered from a soft patch immediately following the Gezi Park protests last May and remains comfortably in expansionary territory.

The Central Bank of Turkey's leading indicator, a composite measure of various high-frequency data series designed to track the economic cycle, has weakened and has been running below trend since mid-2012. The six month rate of change in this indicator, which should in theory provide an earlier signal of turning points in the economic cycle, turned

negative in January (chart). But all this is really telling us is that we are still in a downswing and have not yet hit a cyclical trough in activity. Indeed we think this trough is probably still several quarters away. Predicting the path of GDP growth this year is a bit of a leap of faith against this backdrop, but we still think that tighter domestic liquidity conditions and weaker confidence will translate into lower growth. Despite the recent resilience in industrial production, for now we are retaining out forecast of 2.2% growth for the full year.

Economy has yet to hit its cyclical trough



Source: Haver Analytics, Deutsche Bank

Risks from Ukraine are limited

As in many other countries, the main pressure point for Turkey could come from possible disruption to its supplies of natural gas. Turkey imports a little under 60% of its natural gas from Russia. About half of this is shipped via Ukraine and the rest via the Blue Stream pipeline across the Black Sea. The latter is running close to full capacity and gas storage facilities in Turkey are limited. Any disruption to the transit route through Ukraine could quickly force Turkey to look for alternative and likely more expensive sources for its energy, especially if production of hydroelectric power is also low due to recent low rainfall.

Beyond this, the direct impact of the crisis in Ukraine should be small. Links with Ukraine are quite small. Russia is more significant and we now think its economy will expand by less than 1% this year as a result of the crisis. Even Russia and Ukraine combined, however, still account for only 6% of Turkish exports, which is about 1% of GDP. Turkish banks also have relatively limited exposure to Russia – about USD 0.5bn according to BIS data. As such, we think the direct contagion to Turkey should be limited.

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Turkey: Deutsche Bank Forecasts

	2012	2013E	2014F	2015F
National Income				
Nominal GDP (USD bn)	788.0	819.7	751.4	805.0
Population (mn)	74.9	75.8	76.8	77.8
GDP per capita (USD)	10523	10809	9785	10353
Real GDP (%)	2.2	4.0	2.2	3.8
Priv. consumption	-0.6	4.6	0.2	2.6
Gov't consumption	6.1	5.4	5.0	4.0
Gross capital formation	-2.7	4.1	0.3	3.1
Exports	16.7	1.2	6.6	7.6
Imports	-0.3	7.8	1.1	4.3
Prices, Money and Banking				
CPI (YoY%, eop)	6.2	7.4	8.6	7.5
CPI (YoY %, pavg)	8.9	7.5	8.1	7.8
Broad money (YoY%)	12.9	20.3	10.4	11.8
Bank credit (YoY%)	18.5	33.3	18.8	24.6
Fiscal Accounts (% of GDP)				
Consolidated budget	-1.9	-2.1	-2.6	-2.6
Interest payments	2.8	2.7	2.6	2.5
Primary balance	0.9	0.6	0.0	-0.1
External Accounts (USDbn)				
Exports	163.2	163.4	173.1	184.5
Imports	228.6	243.3	234.7	252.7
Trade balance	-65.3	-79.8	-61.5	-68.2
% of GDP	-8.3	-9.7	-8.2	-8.5
Current account balance	-48.5	-65.0	-44.2	-49.7
% of GDP	-6.2	-7.9	-5.9	-6.2
FDI	9.2	8.2	6.7	9.5
FX reserves	99.9	110.9	115.0	120.0
TRY/USD (eop)	1.79	2.14	2.25	2.42
Debt Indicators (% of GDP)				
Government debt	36.2	35.4	34.7	33.8
Domestic	25.4	25.1	24.7	23.8
External	10.8	10.3	10.0	10.0
Total external debt	42.8	46.3	54.2	54.3
in USD bn	337.5	379.7	407.5	437.4
Short term (% of total)	29.9	30.3	30.0	30.0
General (%)				
Industrial production (YoY)	2.5	3.4	2.1	3.7
Unemployment (pavg)	9.2	9.7	9.9	9.8
Financial Markets (eop)	**Current**	**14Q2**	**14Q3**	**15Q1**
Repo rate	10.0	10.0	10.0	10.0
Overnight lending rate	12.0	12.0	12.0	12.0
Effective funding rate	10.2	11.3	10.5	10.0
10-year bond yield	10.5	11.2	10.8	10.2
TRY/USD	2.22	2.35	2.30	2.35

Source: Deutsche Bank, National Sources.

Ukraine

Caa2(negative)/CCC(negative)/CCC(negative)

Moody's/S&P/Fitch

- Economic Outlook: Political turmoil continues; refinancing risks escalate; growth headwinds persist.
- Main Risks: A weak external position could be exacerbated by uncertainty over the eventual vector of Ukraine's integration.

Political turmoil leads to economic uncertainty

Political tensions continue in Ukraine, which is hampering the much-needed transition to addressing the country's economic issues. After the Maidan protesters drove Yanukovich out of Ukraine and the opposition forces formed a new government in February, political tensions escalated further in March as Russia's President Vladimir Putin issued a request to the Federation Council to send troops to the Crimea peninsula, where the Russian fleet is based. This request was swiftly granted and was accompanied by demonstrations in the eastern parts of Ukraine as well as Crimea.

Meanwhile, the latter is preparing for a referendum (scheduled for 16 March) to get more autonomy from Ukraine or to join Russia. The Crimean parliament has declared the region's independence from Ukraine, while Russia's legislature has declared that Crimea has the right to secede. These developments notably increase near-term sovereign risks pertaining to Russia and Ukraine, and imply that political uncertainty is likely to linger or even escalate in the near term.

Apart from the Crimean referendum, the longer-term political uncertainty includes the presidential elections scheduled for 25 May. At this stage it appears that the pro-Western forces are likely to have a significant margin of victory. One of the most recent polls on the upcoming presidential elections undertaken by Socis (in the period of 25 February to 4 March) shows pro-Maidan oligarch Petro Poroshenko in the lead with 21.2% of the vote. Klitchko is second with 14.6%, while Tymoshenko is third with 9.7%. All of the top three contenders are from the pro-Western camp, with Poroshenko playing a crucial role in organizing the Maidan protests in the past several months. Representatives from the eastern, pro-Russian part of Ukraine are trailing significantly, with Sergey Tyhypko (former Deputy PM from the pro-Yanukovich Regions party) garnering 7.1% and the communist Petro Simonenko with just 5% of the vote.

As regards the economy, political tensions have in effect accentuated the macroeconomic imbalances characterized by high fiscal and CA deficits as well as low growth and meager reserves. In particular, in the real sector activity continued to deteriorate in January. Industrial production was down 5.0% yoy in the first month of 2014, continuing the trend witnessed in 2013. Agriculture posted growth of 6.0%, while construction registered another 16% yoy decline in January with fixed assets investments ending the year down -11.1% yoy in 4Q13. On the consumer side, retail sales growth continued to slow down to 5.2% yoy in January after 5.6% yoy in 12M13, in line with real average wage growth of 4.6% yoy vs. the 6.7% yoy witnessed in December 2013.

In terms of monetary conditions, consumer prices accelerated in February to 0.6% mom from 0.2% mom in January. As a result, on a yoy basis, consumer prices accelerated to 1.2% yoy after 0.5% yoy in January and December. Meanwhile, producer prices grew 3.3% yoy in February following 1.9% yoy in January and 1.7% yoy in December. The money supply continued to exhibit high growth rates although it has slowed down considerably in the past several months to 14.6% yoy in January after 17.6% yoy in December and 20.8% yoy in November.

On the fiscal front, the state budget deficit started the year at UAH1.6bn, with revenues of UAH25.3bn and expenditures of UAH26.9bn. At the beginning of January, the authorities approved the budget for 2014 with a deficit of UAH78bn (4.3% of GDP) given revenues of UAH393bn and expenditures of UAH471bn. These parameters are likely to be revisited by the new government, with IMF conditions likely seeking to significantly downsize the expenditure side of the budget. Based on the redemption schedule, redemptions should not be significant in March (USD500m), while in April more than USD1.2bn is due on domestic bonds, IMF loans and Eurobonds.

Regarding Ukraine's external sector performance, the trade balance ended January with a deficit of USD613m, but on a yoy basis the deficit widened by as much as 16% yoy on the back of a 12% yoy fall in exports to USD4.6bn and 9% yoy decline in imports to USD5.12bn. The CA deficit widened by 20% yoy to USD137m.

Meanwhile the country's reserves continued to decline quickly, down in March to an eight-month low of USD15bn, vs. USD17.8bn at the end of January. Moreover, acting Ukrainian authorities recently

suspended any payments by sovereign and state-owned corporates except for wages and salaries. Deposit outflows in the second half of February amounted to about 7% of the total, with depositors withdrawing close to USD3.1bn in the period of 18-20 February. With the introduction of capital controls and pressure from FX conversion by the population, Ukraine's hryvnia breached the psychological level of 10.0 per US dollar, setting a new record low. As progress was made in starting talks with the EU on an aid package as well as the IMF on a new arrangement, the currency recovered closer to UAH/USD9.5.

The main focus at this stage is on the talks with the IMF, with the IMF mission working in Kiev throughout 4-14 March. According to Ukraine's Finance Minister Shlapak, the authorities are seeking USD15bn IMF support, are progressing in their negotiations with the IMF, and expect the first tranche from the IMF no later than April 2014. At the same time, he highlighted that the condition for securing IMF support will be for the Rada to approve the budget sequester. According to MoF estimates, the cut in budget spending should amount to UAH50bn and could focus on current and capital expenditures as well as social outlays. According to Shlapak, in previous years the budget was based on inflated/unrealistic assumptions, which adversely affected budget implementation and caused an increase in the level of state debt. In addition to IMF talks, the EU is seeking to offer a sizeable package of financial support to Ukraine. Earlier this month the EC revealed a EUR11bn package over 2014-2016 for Ukraine. EU representatives also suggested that Europe could supply Ukraine with gas in the near term from reverse gas supplies. In addition, Brussels intends to unilaterally liberalize its trade with Ukraine within the framework of the provisions of the free trade area (FTA) accord.

Meanwhile, financial and economic support from Russia is unlikely to be continued as Russian Prime Minister Dmitry Medvedev questioned the legitimacy of the acting Ukrainian government, which in turn implied issues over getting financial support and gas discounts from Russia. The planned second tranche of the USD2bn Eurobonds purchase by Russia was suspended in March. Medvedev noted that the gas agreement with Ukraine is for a fixed period (one quarter) and any extension would depend on consultations with the Ukrainian government and companies. If an agreement between Russia and Ukraine is not reached for any reason, the gas price would return to its original level, i.e. from USD268.5/mcm to c. USD400/mcm.

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Ukraine: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USDbn)	176.1	175.5	171.6	186.2
Population (m)	45.3	45.1	45.0	45.0
GDP per capita (USD)	3 887	3 892	3 813	4 137
Real GDP (yoy %)	0.2	0.0	-4.9	2.5
Priv. consumption	11.7	6.5	-3.3	4.8
Govt consumption	2.2	2.3	-5.3	1.5
Investment	0.9	-5.4	-8.2	2.5
Exports	-7.7	-6.5	-2.8	2.8
Imports	1.9	1.2	2.4	6.6
Prices, Money and Banking (eop)				
CPI (YoY%) ann avg	0.5	-0.3	2.8	5.8
Broad money	12.0	17.6	16.0	14.0
Credit	1.7	11.7	8.0	10.0
Fiscal Accounts (% of GDP)				
State budget balance	-2.5	-4.5	-2.5	-2.2
Revenue	23.5	24.2	22.8	22.6
Expenditure	26.0	28.7	25.3	24.8
External Accounts (USDbn)				
Exports	70.2	64.9	66.2	68.4
Imports	89.7	84.5	82.3	80.1
Trade balance	-19.5	-19.6	-16.1	-11.7
% of GDP	-11.1	-11.2	-9.4	-6.3
Current account balance	-14.4	-16.1	-10.2	-8.1
% of GDP	-8.2	-9.2	-5.9	-4.4
FDI (net)	6.6	4.3	4.5	4.2
FX reserves (USDbn)	24.5	20.4	15.0	19.3
UAH/USD (eop)	8.1	8.4	9.7	10.2
Debt Indicators (% of GDP)				
Government debt	28.4	36.7	52.0	62.0
Domestic	14.8	14.7	17.7	20.8
External	22.0	22.0	34.3	41.2
Total external debt	75.5	79.8	88.0	93.0
in USDbn	133.0	140.0	151.0	173.1
General (% pavg)				
Industrial production (%) YoY)	-1.8	-4.7	-5.8	-3.2
Unemployment	7.8	8.1	10.0	9.2
Financial Markets (eop)	**Spot**	**2Q14**	**3Q14**	**1Q15**
Policy rate (refinancing rate)	6.50	6.50	6.50	6.50
UAH/USD	9.20	9.55	9.70	9.90

Source: Source: Official statistics, Deutsche Bank Global Markets Research

Argentina

B3(stable)/CCC+ (negative)/CC(stable)
Moodys /S&P/ /Fitch

- Economic Outlook: A sizeable devaluation finally brought policies to reality, bringing some stability in international reserves. The prevailing relaxation in the policies remains an issue of concern though, as inflation may still erode the new competiveness in a matter of months. The Central Bank is tightening monetary conditions and reducing the banks' ability to hold dollars, but overall policies remain expansionary. Stricter capital and trade controls might gain some time, but the adjustment mechanism might need to be a recession and a challenging political and social equilibrium ahead.
- Main Risks: Further depletion of international reserves remains the main short-term risk, while continued exchange rate controls and across-the-board state intervention still block any potential recovery. A recession with high inflation is now the base case scenario. A negative US Supreme Court take on the final holdout ruling could trigger a default on international debt, although recent intervention by the US administration has provided some reason for hope.

Attempting to reduce the policy gap

Stabilizing capital flows; temporarily at least

Absent other more traditional policy measures, the Central Bank request for banks to reduce their net positioning in hard currency was decisive for the apparent stability achieved in recent weeks. Communique A 5536 of the Central Bank obliged private banks to sell an estimated USD1.9bn in the market during the month of February. Further compliance to the new regulatory restrictions might imply another USD700mn of bank selling, but within the next couple of months. There were also some USD7.5bn net positions in the local NDF market affected by the restriction, more than half owned by the banks. In this regard, compliance with the new norm permitted a rapid reduction in implied rates in the local NDF curve, which initially came down to negative levels in the short end, to stabilize at around 20%-25% for tenors in the first three months.

The combination of lower implied devaluation rates in the local NDF curve and higher rates in Central Bank papers also contributed to a rapid change in the hard currency equation. In the last auction of Central Bank paper, reference rates were set at 28.78% for 91 days and 30.31% for 371 days. The Central Bank has been also mopping up excess liquidity after a massive expansion at the end of last year, cutting so far this year ARS45bn from money aggregates. By the end of February, money base went back to the levels of late October, representing annual growth of 18% compared to accumulated inflation in the last 12 months of 30%.

As a result, international reserve losses during February amounted to only USD202mn, after USD3.1bn in January. In this environment the Central Bank enjoyed the luxury of letting the ARS appreciate up to 7.75 in mid February from 8.00 at the beginning of the month, to later accept a gradual slide in the currency, accumulating 2% depreciation until reaching a new plateau. It is still unclear what the new depreciation trend will be, but the sooner the Central Bank allows the ARS to follow inflation the better. Otherwise, the whole effort of devaluating the currency while risking nominal stability would fade at the pace of rapid inflation.

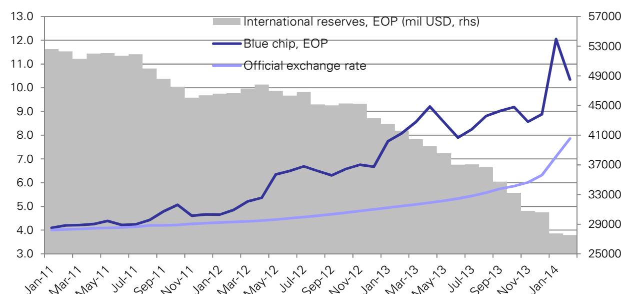
The confirmation of a final settlement with Repsol regarding YPF nationalization plus the reporting of a more credible inflation record for January also revealed a more proactive approach by the authorities, further recognizing the increasing constraints their policy making would be facing otherwise.

February exchange rate performance was also helped by soybeans. Soybean prices have been moving up since late January, pushed by a drought in Brazil and political jitters in Ukraine. Uncertainty surrounding the Crimea peninsula has been fading recently and soybean prices came off partly this week, but remain 9% higher than last month, almost going back to average price of last year. Similarly, the price of soybean oil has remained 13% higher than the level in January, also close to the average of 2013. This, together with a new harvest expectation, for this year of 55mn tons, or 15% more than in 2013, also fueled some further confidence in the power of future agriculture flows. In principle, it added around USD2.5bn of fresh dollar inflows to the system in the months to come, with more than USD10bn coming to the market during the second quarter of the year.

As noted, the combination of a weaker currency, higher agriculture supply, lower imports, and remaining controls on capital flows could significantly improve the outlook for international reserves this year. Under a conservative basis, it is now possible to foresee international reserves not declining beyond USD20bn by December 2014, or leaving enough cushions for muddling through the last months of the current administration. However, this would remain contingent on the authorities avoiding new deviations. In particular, it would demand the government to sooner than later let the currency slide at the pace of inflation to maintain part of the improved competitiveness. It will also require the government to maintain a tough stance

in wage negotiations, which remains the most important nominal anchor currently.

Exchange rates and international reserves



Source: Central Bank, Bloomberg Finance LP, and Deutsche Bank

Yet threatened by inflation acceleration

Finally revealing the product of many months of work with the advice of the IMF, the Minister of Finance reported that January inflation was 3.7% MoM. There was no reference to the year on year inflation, nor a comparison with the immediate past. Some history would have simply meant accepting a higher inflation than was reported last year. Although private sector estimates reported 4.6% MoM inflation for January the day earlier, the difference could be explained by specific price shocks (i.e. public transportation) in the city and greater Buenos Aires area that did not occur in other districts. It is worth recalling that the new CPI does report inflation at the national level, so it is not comparable with previous estimates of either official or private inflation.

We see the new official release as another real try to amend, at least marginally, the unsustainable situation generated by the same government decisions of the past. A new CPI index that is more accurate is, in our view, a critical development for two main reasons. First, it forces the government to finally accept a difficult inflationary reality and address it accordingly – 30% inflation cannot be ignored even in Argentina. Second, it provides better instruments for individuals and corporation to minimally hedge against inflation through indexed assets. Thus, similarly to the peso devaluation, we take this as another sign that the government is finally weighting higher the cost of policy inaction than the political cost of unpopular decisions. Whether this is enough to stabilize the economic condition will depend on additional efforts.

Initial estimates for inflation in February are pointing to another high number, in the 4.0%-4.5% area. This was expected as the impact of the late January devaluation was only partially reflected in last month's inflation. Nevertheless, an accumulated inflation of 8.0%-8.5% in the first two months after 20% devaluation does not seem such a bad outcome absent direct policy measures aimed at containing inflation acceleration. The government did decide to increase interest rates but at a relatively low level on a real basis. In addition, it essentially promoted price agreements and a relatively tough stance in wage negotiations with labor unions. Partly for this reason, classes have not yet started in public schools as a result of a teachers strike since Wednesday last week.

The lack of more efficient tools to coordinate inflation expectations downward places most of the burden on the government's initiatives to achieve broad price and wage agreements. A more stable exchange rate behavior could help in the short term. But the understanding that some future exchange rate correction will be inevitable unless tighter policies are introduced remains the blocking factor for a meaningful success by the government.

The continuation of an expansionary fiscal stance is indeed the major obstacle to find a new sustainable nominal equilibrium soon. The Ministry of Finance stated last week that public expenditures grew by 42.2% in January, or much faster than nominal GDP growth, which is probably moving at a 30% pace. As a result, the primary fiscal surplus reached a value of ARS798.5mn during January on a cash basis. There was a significant increase in tax revenues of 42.2%YoY, which climbed to ARS40.0bn, and social security contributions, which advanced by 32.3%YoY, ARS28.24bn. This surplus compares with a primary surplus of ARS815mn in January 2013, but helped this year by ARS2.9bn from rents received by the federal government as current revenues in excess of the transfers last year. The latter partly reflected the impact of the devaluation in the assets of the Social Security and the Central Bank. January's financial result was a deficit of ARS3.1bn, or twice the deficit recorded in January last year.

During February, tax revenues came below expectations, advancing by 33.3%YoY. VAT revenues expanded by 35.3%YoY, while income taxes advanced by 41.2%YoY. Accumulated revenues during the first two months of the year are advancing by 35.5%YoY. These first two months of the year were favored initially by the devaluation, with a sharp pick up in taxes on international trade. However, the expectation is for the economy to enter into a recession, weakening further the current fiscal position.

Government officials, including the Ministry of Finance and the Ministry of Social Works and Infrastructure, did hint already the government plan to make energy and transportation subsidies more efficient. These subsidies represented almost 5.5% of GDP in 2013 and the weaker currency and raising inflation does not actually help to improve their outlook for 2014. The government is analyzing ways to fine tune a tariff/fare increase targeted mostly to high income earners. This is not only convoluted but also likely to not have a meaningful impact on the total subsidy bill. As a result, we are not

optimistic to see any major progress on this regards. Unfortunately, this is probably the only fiscal policy tool the government is willing to consider. Cuts in spending are very unlikely, although slow correction to a faster inflationary equilibrium could help in the short term. The fiscal deficit is the expected to remain slightly below 5% of GDP once current revenues from Central Bank and the social security administrator (ANSES) profits are excluded.

But improving the chances of muddling through …

As noted, even a poorly managed devaluation is likely to have consequential effects on import demand, both goods and services. Although a costly achievement, done through a recession, this should at least help to have wider margins regarding the international reserves position in the months to come. As of March 3, 2014, the Central Bank had USD27.6bn in total reserves, of which USD9bn are now estimated to be owned by the banks.

Looking at potential uses of reserves, there is the current account balance, which could be close to zero this year. The expected improvement in the trade accounts is explained by a 5% contraction in imports through the standard price and income and price effects, although conservatively calculated as rationing already constrained imports last year. Likewise, exports are likely to be up by 5%, mostly due to a higher harvest among stable prices. There is a possibility of some stocks being sold too if the exchange rate looks attractive enough. Similarly, the deficit in the service account is also expected to be reduced meaningfully, or some 25%, as the weaker peso and the increased taxation eliminate the huge subsidy that fostered the doubling of the service deficit in the last two years.

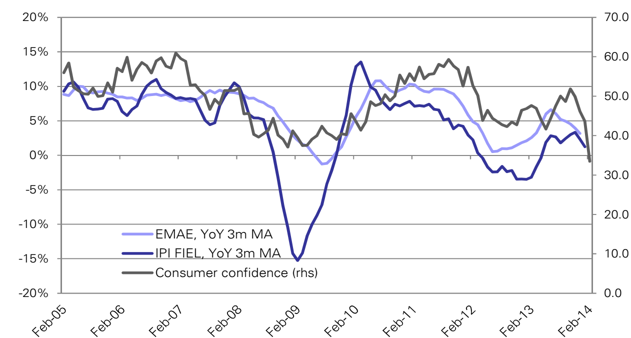
In addition, the government faces debt amortization for USD2.3bn, plus the GDP Warrants payment for some USD3.0bn. Most of the official debt coming due are loans with multilateral organizations, with the possibility of rolling over most of it after the settlement agreed with companies within the International Centre for Settlement of Investment (ICSID). The financial sector has some USD1.0bn in external claims coming due in 2014, but they are also likely to be renegotiated except for USD250mn in bonds and other obligations. Finally, in theory, the non-financial private sector confronts external obligations of up to USD30bn this year, but this debt is mostly explained by commercial loans, trade financing and obligations that have been successfully "controlled" by the authorities in the last few years. This notwithstanding, on average 10% of this debt has been paid in the previous two years, which could be repeated this year, totaling at most USD7.0bn from the whole capital account. All together this could mean some USD600mn outflows a month on average in the remainder of 2014, pushing reserves down to above a borderline level of USD20bn by the end of this year, or before facing pending debt payments of at least USD7bn in 2015.

…at a risk of a recessionary shock

Lacking a new nominal equilibrium, the current economic situation might soon resemble the one that triggered the devaluation in January. The current account improvement has to be proved sustainable and will significantly depend on a more competitive peso or new financing sources will need to be found. The government has tried many alternatives for new external financing, but might only get some forced financing by trading companies (USD1.0-2.0bn at most). In our opinion, the key remains achieving a new, credible nominal equilibrium for exporters to be willing to sell their crops and individuals to start investing their dollars in ARS assets. This would probably demand an even weaker currency, possibly higher interest rates and some fiscal tightening eventually.

In the meantime, the negative income shock promoted by the devaluation together with higher nominal uncertainty has simply accelerated the slowdown in economic growth. According to the official INDEC, economic activity only grew 0.1% MoM, seasonally adjusted in December last year. This brought annual growth in 2013, based on the monthly GDP proxy, to 4.9%. Similarly, industrial production as reported by INDEC was up just 0.1% on the month in January this year, but down by 2.6% YoY. Interestingly, the private sector think tank FIEL reported that its own estimated industrial output declined 1.2% MoM, seasonally adjusted in January, after growing only 0.7% during 2013.

Growth proxies tending downwards again



Source: Central Bank, FIEL, UTDT, and Deutsche Bank

But better reflecting the forward looking impact of recent events, consumer confidence reported a record fall in February. The Research Centre for Finances (CIF) of the Di Tella University stated that consumer confidence plunged to 33.46 pts, or 23.4% on the month. This is the largest inter-month drop since the creation of the index in 1998. Similarly, in an inter-annual comparison, the index decreased by 27.9%. All the sub indexes reported drops, and the largest one was registered on durable goods and real estate, which decreased by 59.1% MoM.

US administration legal support seems critical

As expected, Argentina filed its appeal to the US Supreme Court on the pari-passu case by the due date, without surprises. But a new critical development was the filing of an Amicus Curiae Brief by the US administration on March 3, supporting Argentina on the so-called discovery case. In this case the District Court, upheld by the Appeals Court, ordered Bank of America Corp. and state-owned Banco de la Nacion Argentina to turn over information about the country's assets. The filing came after the US Supreme Court accepted Argentina's petition for certiorari following explicit support from the Solicitor General as reported in its December brief to the Supreme Court.

In the latest brief by the US Solicitor General, the US administration reinforced its "substantial" interest in the proper interpretation and application of the Foreign Sovereign Immunity Act's (FSIA) provisions and in the treatment of foreign states in United States. In doing so, the Solicitor General argued that both the District Court and the Appeals Court improperly disregarded the significant comity, reciprocity, and other foreign-relations concerns that a foreign state faces when treated as a mere private litigant. More importantly, and generally, the Solicitor General also argued that the courts disregarded a key element: the separate immunity for foreign-state property that applies under the FSIA even when jurisdiction over a foreign state is proper. The latter could easily be applied to the pari-passu injunction even if Argentina is clearly violating the pari-passu rule.

Therefore, we are now more confident than before that the US Solicitor General could prompt the Supreme Court to request again the US administration opinion, but now on the pari-passu case. If so, the US administration is expected to repeat many of the arguments just presented, further questioning the interpretation of the FSIA by the lower courts. After going through that process, the US Supreme Court could accept the courts' ruling on the pari-passu but not necessarily uphold the attachment arrest and execution imposed by it.

Meanwhile, Argentina's officials continue to expect the Paris Club to accept its negotiation proposal presented few weeks ago. As discussed, Argentina seems to be seeking some restructuring of this debt, but the most it can likely achieve is full payment in a few annual installments. Based on the Paris Club track record and governance, any restructuring would demand at least a blessing from the IMF, which might not be the Argentine government's idea if this were to require the usual surveillance work by the Fund.

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Argentina: Deutsche Bank forecasts

	2012	2013E	2014F	2015F
National Income				
Nominal GDP (USDbn)	496	512	450	450
Population (m)	41.0	41.5	41.9	42.4
GDP per capita (USD)	12,101	12,343	10,740	10,623
Real GDP (YoY%)	1.2	2.4	-2.1	1.9
Priv. consumption	4.6	4.2	-3.5	2.0
Gov't consumption	6.7	4.5	-1.8	2.0
Gross capital formation	-11.1	0.5	-3.3	4.0
Exports	-5.6	1.7	2.5	2.5
Imports	-4.4	9.3	-6.5	6.0
Prices, Money and Banking				
CPI (YoY%, eop) *(*)*	25.2	27.5	38.9	25.8
CPI (YoY%, avg) *(*)*	24.0	24.9	39.8	29.4
Broad money (M2)	34.3	24.0	20.0	20.0
Bank credit (YoY%)	30.8	30.5	25.0	22.0
Fiscal Accounts (% of GDP)				
Budget surplus	-3.8	-4.5	-4.8	-4.3
Gov't spending	32.2	34.1	31.4	29.2
Gov't revenue	28.4	29.5	26.6	24.9
Primary surplus	-1.5	-2.8	-2.5	-2.3
External Accounts (USDbn)				
Merchandise exports	80.9	83.0	87.1	90.9
Merchandise imports	68.5	74.0	71.5	75.4
Trade balance	12.4	9.0	15.6	15.5
% of GDP	2.5	1.8	3.5	3.4
Current account balance	-0.1	-5.8	0.5	1.9
% of GDP	0.0	-1.1	0.1	0.4
FDI (net)	11.1	7.8	5.4	7.5
FX reserves (USDbn)	43.3	30.6	21.0	14.3
FX rate (eop) ARS/USD	4.92	6.52	9.62	12.57
Debt Indicators (% of GDP)				
Government debt	19.1	19.0	22.0	22.8
Domestic	5.9	7.2	8.5	10.6
External	13.2	11.8	13.5	12.1
Total external debt	28.4	26.5	30.3	28.9
in USDbn	140.9	135.8	136.3	130.1
Short-term (% of total)	36.9	38.3	38.2	40.0
General				
Industrial production (YoY)	-1.2	1.5	-3.5	2.1
Unemployment (%)	7.8	8.0	9.0	9.0
Financial Markets (EOP)	*Current*	*1Q2014*	*2Q2014*	*4Q2014*
Overnight rate	29.0	29.0	29.0	31.0
3-month Badlar	29.0	29.0	31.0	33.0
ARS/USD	7.87	8.16	8.84	9.96

Source: DB Global Markets Research, National Sources
**Inflation reported by Congress*

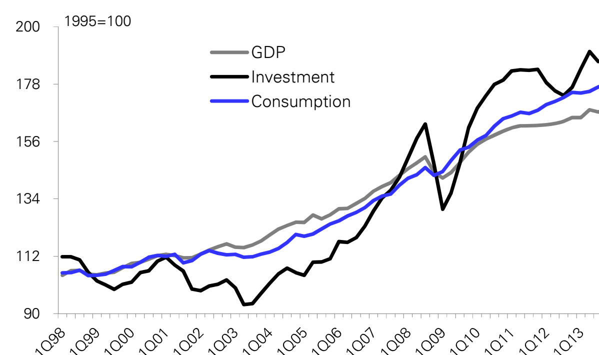
Brazil

Baa2/BBB(neg)/BBB
Moody's/S&P/Fitch

- Economic Outlook: Persistently high inflation keeps interest rates under pressure, while the currency remains vulnerable due to the current account deficit. The October elections reduce the scope for significant changes in economic policies. Despite the government's efforts to stimulate private investment through infrastructure concessions, its interventionist bias continues to hurt sentiment and hinder growth.
- Main Risks: While the government has tightened monetary policy and is promising to adjust fiscal policy, inflation remains high. Higher interest rates abroad could lead to further currency depreciation and even slower domestic growth. The risk of energy rationing has increased due to adverse climate conditions.

GDP grew 2.3% in 2013, roughly in line with expectations. GDP grew a stronger-than-expected 0.7% QoQ in 4Q13 (we expected 0.3%) after contracting 0.5% QQ in 3Q13. The main surprise was the 0.3% QoQ increase in investment, following a 2.0% QoQ decline in the third quarter, and especially in light of the sizeable exports of oil platforms in 4Q13. Household consumption slowed to 0.7% from 1.0% QoQ, and public consumption decelerated very little to 0.8% from 0.9% QoQ. Also, in contrast with the previous quarter, the external sector had a net positive contribution to growth, as exports rose 4.1% (boosted by exports of oil platforms) and imports fell 0.1% QoQ. On the supply side, a 0.7% QoQ increase in the services GDP more than offset a 0.2% QoQ decline in industrial output. GDP grew 2.3% in 2013, slightly above our forecast of 2.2%, and compared to 1.0% in 2012. As we expected, household consumption slowed to 2.3% from 3.2% in 2012, reflecting the deceleration in labor income growth and tighter credit conditions. Moreover, government consumption decelerated to 1.9% from 3.3%, and the external sector's contribution to growth was negative, as exports rose 2.5% and imports jumped 8.4%. On the other hand, investment grew 6.3% after contracting 4.0% in 2012, reflecting a rebound in production of transportation equipment (which had declined sharply in 2012 following the introduction of more expensive models to comply with tighter environmental rules), increased production of agricultural machines (due to the large harvest), and subsidized loans offered by government banks. However, investment still accounted for only 18.4% of GDP (vs. 18.2% in 2012). The economy's saving rate declined further to 13.9% from 14.6% in 2012. Since domestic saving is not enough to finance investment, the country needs external saving (current account deficit). On the supply side, the agricultural sector led growth with a hefty expansion of 7.0% (including a 24.2% surge in soybean production), after contracting 2.1% in 2012. The industrial sector recovered and expanded 1.3% after falling 0.8% in the previous year, as both manufacturing and construction grew 1.9%, and utilities rose 2.9%, boosted by residential energy consumption. Services, the largest sector of the economy, accelerated slightly to 2.0% from 1.9%, as retail advanced to 2.5% from 0.9%, transportation rose to 2.9% from 1.9%, and financial services accelerated to 1.7% from 0.7%.

Brazil: GDP



Source: IBGE

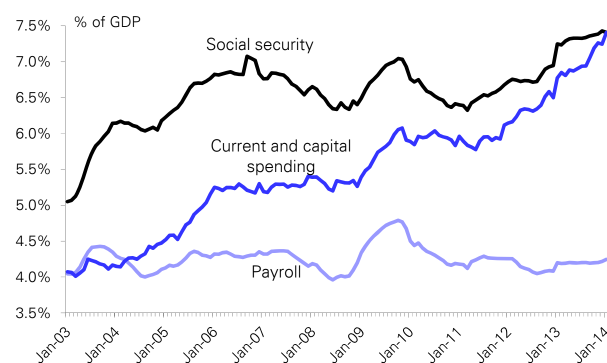
We are keeping our 2014 GDP growth forecast unchanged at 1.7% for now. The higher-than-expected 4Q13 GDP data increased the statistical carryover for 2014 to 0.7% from our previous estimate of 0.4%, thus favoring this year's growth. Moreover, the external sector will likely have a positive contribution to growth this year due to improving demand in developed economies, and import substitution arising from the exchange rate depreciation (although Argentina's economic crisis is taking a toll on Brazilian manufacturing exports). However, we expect household consumption to slow further and grow by only 1.8% this year due to a steady deceleration in labor income growth and sluggish credit origination amid rising interest rates. We believe investment will be the key variable to determine growth. On the one hand, the government is moving forward with its important program of infrastructure concessions, even though investments related to these projects may not start before 2H14. On the other hand, investment could be hurt by higher interest rates, slowdown in subsidized lending, lower demand for transportation equipment following last year's surge, and decline in business confidence due to strong government

intervention in the economy and growing risk of energy rationing.

The government is making an effort to improve its fiscal policy, but performance will again depend on extraordinary revenues. The government announced a consolidated primary fiscal surplus target of BRL99bn, or 1.9% of GDP for 2014. The federal government's primary surplus target is BRL80.8bn (1.55% of GDP), and the local governments' target is BRL18.2bn (0.35% of GDP). We believe the local governments' revised target is more realistic than the previous target of 1.0% of GDP (in 2013, the local governments posted a primary surplus of 0.34% of GDP). The authorities also lowered their GDP forecast from 3.8% to 2.5%. While the revised GDP growth remains optimistic considering our forecast of 1.7%, it would be politically difficult for the authorities to present a lower estimate at this juncture. The official forecast for total revenues was lowered by BRL28.9bn to BRL1,303bn, which we believe is a reasonable estimate, although the risk is on the downside due to slow growth. A crucial component of the fiscal announcement was the federal budget cut of BRL44bn (0.8% of GDP). Out of this total amount, BRL13.5bn was just a revision to mandatory spending, including BRL1.4bn in social security payments, BRL6.7bn in subsidies, and BRL6.0bn in compensations to the social security system for the reduction in payroll taxes. We believe these revisions are on the optimistic side (the government expects the social security deficit to fall to BRL40bn from BRL50bn in 2013, for example). Discretionary spending cuts amounted to BRL30.5bn, including BRL13.3bn in pork barrel (i.e. the congressional "amendments"), which would not be executed anyway, and BRL7bn in investment. The remaining BRL10.2bn will come from reducing administrative costs in several ministries, which is difficult to monitor. All in all, the government has presented a better budget based on more realistic assumptions and a more credible target. However, there is no indication that the authorities are making an irreversible commitment to produce a primary surplus of 1.9% of GDP. We note, for example, that the government did not change its allotment of BRL9bn in aid to the electricity sector, even though the higher cost of operating the thermal power plants due to the drought will probably require twice as much as that. It seems that the authorities are counting on a large inflow of extraordinary revenues again to mend the gap. Also, there is no guarantee that the government will not abandon the spending cuts if the economy continues to underperform during the year. Consequently, we are keeping our consolidated primary surplus forecast at 1.5% of GDP for 2014 for now.

The fiscal results obtained in January did not provide much encouragement. The central government posted a primary fiscal surplus of BRL13.0bn in January, lower than our forecast of BRL20bn and the market consensus of BRL19.2bn. Federal revenues rose 6.6% YoY to BRL125.1bn, while spending surged 19.5%YoY to BRL90.1bn. In our view, the main surprises were the large increases in the account "abono salarial e seguro desemprego" (which includes some welfare payments and unemployment benefits) and in administrative costs, which totaled BRL5.6bn and BRL19.6bn, respectively. After posting a surprisingly small deficit in December, the unemployment benefit account in January returned to a level consistent with large disbursements posted in the previous months. Administrative costs also surged in January after remaining surprisingly subdued in December. Therefore, the data seem to corroborate local press claims that the government postponed some expenditure in December so as to improve the primary surplus obtained in 2013. While bygones are bygones and the government may very well stick to its recently announced plan to cut spending, the January data reinforce our view that it will be quite difficult for the government to rein in spending in the near term, and any fiscal adjustment will probably have to rely heavily on revenues.

Brazil: Federal spending



Source: STE

We raised our 2014 inflation forecast to 6.0% from 5.8%. After posting a lower-than-expected increase of 0.55% in January, the IPCA consumer price index accelerated to 0.69% in February. While this increase was mainly caused by a seasonal spike in school tuitions, core inflation remained under pressure, climbing 5.8% YoY. Moreover, service prices continued to expand at a hefty pace of 8.2% YoY, mainly reflecting the tight labor market. We do not expect relief in March, as wholesale agricultural prices have accelerated sharply again, mainly due to the adverse effect of the ongoing drought on production. We project that the IPCA will rise 0.70% MoM and 5.92% YoY in March. We expect 12-month inflation to accelerate further in the next months and peak at 6.50% in July, before receding to 6.00% in December. Our forecast assumes an average exchange rate of BRL2.45/USD for the year. The currency is trading at a stronger level now, and a smaller-than-expected depreciation could remove some pressure from inflation. On the other hand, there remains enormous

uncertainty about electricity prices. The drought has depleted the reservoirs of hydroelectric plants, thus forcing utilities to employ much more expensive thermal generation, and it is not clear whether the government will just foot the extra bill (which would hurt the fiscal accounts) or allow the electricity companies to pass higher costs to consumers.

The BCB has kept the door open for more rate hikes. After hiking the SELIC rate by 50bp to 10.50% in January, the COPOM reduced the pace of tightening and raised rates by 25bps to 10.75% in February. We believe this decision was mainly motivated by weak economic data and also by the government's pledge to adjust fiscal policy. The COPOM kept its communiqué almost unchanged, thus not indicating the end of the tightening cycle. The COPOM minutes had very few changes as well, also keeping the door open for more hikes, in our opinion, although subtle comments about the diminishing mismatch between aggregate supply and demand and the cumulative effect of interest rate hikes suggested that the cycle might be coming to an end soon. We continue to expect the BCB to wrap up the tightening cycle with another 25bp hike in April.

The BRL has regained some ground, but the balance of payments continues to show vulnerability. After trading close to 2.45/USD in January, the BRL recovered and moved below 2.35/US in February, reflecting a similar movement in other emerging markets, and to some extent the government's fiscal announcement. Regarding the balance of payments, a positive piece of news was the surplus posted in January, the first since July 2013, thanks to a steady flow of foreign direct investment and an increase in foreign portfolio flows. However, the trade balance continued to disappoint and posted a large deficit of USD6.2bn in 2M14 (compared to USD5.3bn in 2M13), as daily exports fell 3.4% YoY. Although exports to China surged 25.5% YoY (led by soybeans and mining products), exports to Argentina (Brazil's third largest trade partner, which imports mainly manufactured goods) plunged 16.0% YoY, and shipments to Europe fell 12.8% YoY. In light of the latest data and Argentina's economic doldrums, we have cut our 2013 trade surplus forecast to USD7bn from USD10bn. While this forecast still seems optimistic in light of the latest results, it is important to stress that it is based on an average exchange rate of BRL2.45/USD for 2014, as we are keeping our year-end exchange rate forecast at BRL2.50/USD, despite recent appreciation. We also raised our current account deficit forecast to USD75bn (3.5% of GDP) from USD72bn.

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Brazil: Deutsche Bank forecasts

	2012	2013	2014F	2015F
National Income				
Nominal GDP (USDbn)	2,253	2,242	2,129	2,218
Population (m)	199	201	203	204
GDP per capita (USD)	11,306	11,159	10,512	10,862
Real GDP (YoY%)	1.0	2.3	1.7	1.7
Private consumption	3.2	2.3	1.8	1.4
Government consumption	3.3	1.9	1.2	1.7
Gross capital formation	-4.0	6.3	0.3	1.8
Exports	0.5	2.5	3.0	4.0
Imports	0.2	8.4	2.0	3.0
Prices, Money and Banking				
CPI (YoY%, eop)	5.8	5.9	6.0	5.5
CPI (YoY%, avg)	5.4	6.2	6.1	5.7
Money base (YoY%)	8.3	7.6	7.0	6.5
Broad money (YoY%)	5.3	11.2	8.0	6.0
Fiscal Accounts (% of GDP)				
Consolidated budget	-2.5	-3.2	-3.9	-3.5
Interest payments	-4.9	-5.1	-5.4	-5.5
Primary balance	2.4	1.9	1.5	2.0
External Accounts (USDbn)				
Merchandise exports	242.6	242.2	245.0	259.0
Merchandise imports	223.2	239.6	238.0	245.0
Trade balance	19.4	2.6	7.0	14.0
% of GDP	0.9	0.1	0.3	0.6
Current account balance	-54.2	-81.4	-75.0	-78.0
% of GDP	-2.4	-3.6	-3.5	-3.5
FDI	65.3	64.0	60.0	70.0
FX reserves (USDbn)	378.6	375.8	372.8	372.8
FX rate (eop) BRL/USD	2.04	2.34	2.50	2.55
Debt Indicators (% of GDP)				
Government debt (gross)	58.8	57.2	58.6	60.9
Domestic	55.9	54.1	55.6	58.0
External	2.9	3.1	3.0	2.9
Total external debt	19.6	21.6	23.3	23.0
in USDbn	440.6	485.1	497.1	511.1
Short-term (% of total)	7.4	6.7	6.5	6.5
General				
Industrial production (YoY%)	-2.5	1.1	2.0	2.0
Unemployment (%)	5.5	5.4	5.7	6.1
Financial Markets (EOP)	*Current*	*1Q14*	*2Q14*	*4Q14*
Selic overnight rate	10.75	10.75	11.00	11.00
3-month rate (%)	10.8	10.8	11.1	11.0
BRL/USD	2.36	2.40	2.45	2.50

Source: National Statistics, Deutsche Bank forecasts

Chile

Aa3 (stable)/AA- (stable)/A+ (positive)
Moodys /S&P/ /Fitch

- Economic Outlook: Monthly economic activity has continued to surprise on the downside, and the labor market is starting to reflect the weakening outlook. The new administration's ambitious fiscal agenda financed by corporate taxes is also increasing investors' worries. The Central Bank is likely to keep relaxing monetary policy as needed, but policy prudence and some fiscal accommodation might be needed to avoid a sharp economic slowdown this year.
- Main Risks: An abrupt deceleration in China's economic expansion remains the main risk for Chile. Diminishing expectations about the new government's ability to promote investment, particularly in mining and infrastructure, is another important risk. A solid economic status and skillful policy making remains a strong backing for the country in the medium term.

A new government, a new weakening

Activity continues to surprise on the downside

Aggregate growth as measured by the Central Bank's monthly economic activity proxy (IMACEC) contracted on a seasonally adjusted basis by 0.6%MoM in January, increasing by 1.4% in twelve months. This figure represents the lowest expansion rate posted since March 2010, when activity declined by 0.1%YoY as it was seriously affected by an 8.8-magnitude earthquake. It is worth noting that this January had the same number of working days as January 2013. January data was partly affected by a port strike during the month, although the effect is hard to quantify precisely. A strong base of comparison last year contributed to such a poor performance as well. According to the CB, growth during the first month of the year was mainly driven by the increase in corporate and personal services. Conversely, the fall in mining, manufacturing and wholesale trade more than overshadowed those positive stories.

The industrial sector contracted by 1.7% YoY in January, recording the first negative figure since December 2012. The meager industrial performance was the result of weakening mining and manufacturing, which shrank by 2.7%YoY and 1.4%YoY, respectively. Additionally, services advanced by a modest 1.9%YoY, decelerating from the 3.6% posted on average during 2013. Meanwhile, retail sales advanced by 6.8%YoY during the month, decelerating for the fourth consecutive month on its YoY growth pace. In addition, supermarket sales showed an increase of 6.7%YoY, accelerating from the modest expansion of 0.8%YoY, recorded in December.

In line with economic deceleration, the labor market has finally been affected. The unemployment rate increased to 6.1% during the moving quarter November-January, posting the highest rate in seven months. The figure increased by 0.4pp from the previous period, and by 0.1pp in the inter-annual comparison. The rate was the result of the labor force increasing by 2.4%YoY while employment increased by 2.2%YoY. Self-employment was the main contributor to total employment as employees in the formal sector increased by only 1.2%YoY, the lowest expansion since 2011. Employment increased the most in the retail sector (98K), real estate (52K) and education (41K). Conversely, agriculture led job destruction (65.5K) followed by hotels and restaurants (31.3K).

Inflation shows temporary acceleration

The CPI index increased by 0.5%MoM during February, bringing twelve-month inflation to 3.2%YoY, or above expectations of 2.9% as per Bloomberg Finance LP's poll. The products leading the inflation print were transportation, up by 1.7%MoM, with an incidence of 0.243pp, and housing and basic services, up by 1.0%MoM, with an incidence of 0.147pp. Conversely, the biggest drops were seen in recreation and culture, down by 0.9%MoM, and communications, down by 0.6%MoM, falling 0.058 and 0.030, respectively. Both core measures CPIX, excluding fuel, fruits and vegetables, and CPIX1, CPIX less other perishable items, indexed and administered prices, increased by 0.4%MoM and 2.7%YoY. The increase in fuel prices was the main driver of the variation during February, limiting any worries regarding inflation for the time being.

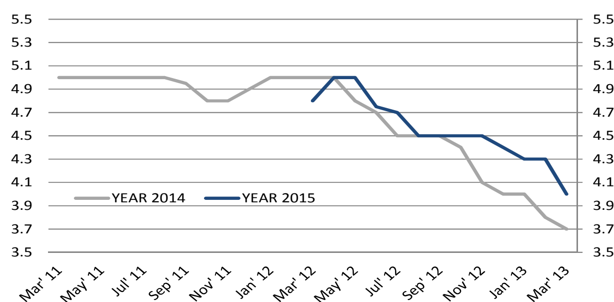
Supporting the CB inclination to further ease

The minutes of the last monetary policy meeting held on 18 February, when the Board decided to cut its reference interest rate by 25bp, showed some increased concern regarding worsened growth prospects for the Chinese economy offsetting improved outlook for the Eurozone and a stable path for Fed actions. More importantly, the CB Board revealed greater preoccupation regarding the local economy. In particular, some indicators related to actual and projected investment were highlighted as coming below expectations, implying a downward correction to the short-term forecasts of activity and demand. Private consumption and the labor market were reported yet denoting good dynamism. The minutes revealed some concern on secondary effects streaming from peso depreciation and imported inflation but they also suggested some sense of room to maneuver in this regard. All Board members agreed on the desirability of maintaining the bias of the last meeting

and some even considered the possibility of a more aggressive relaxation without a clear bias.

The results of its latest monthly survey of economic expectations corresponding to the month of March showed that median inflation expectations for this month increased to 0.5%MoM and for April a lower expansion of 0.2%MoM is expected. Despite the latest inflation figure for February, median inflation expectations in the 12- and 24-month horizon are all running at 3.0%YoY. Regarding a monetary policy decision, the market expects a cut of 25bps during the March meeting. Moreover, market players project the policy rate to remain unchanged at 4% during the next sixteen months, and to increase by 25bps in seventeen months from now. Projections for monthly economic activity expansion (IMACEC) during February were marked at 2.6%YoY while estimated GDP growth during 1Q of 2014 reduced to 2.6% from the 3.2% forecast on last month's survey. Finally, growth expectations for this year deteriorated from 3.8% to 3.7% and from 4.3% to 4.0% for 2015.

Diminishing growth expectations



Source: Central Bank of Chile, and Deutsche Bank

New government faces important challenges

The new administration's ambitious fiscal agenda financed by corporate taxes is undoubtedly increasing investors' worries. In particular, diminishing expectations about the new government's ability to promote investment, mainly in mining and infrastructure, are a serious risk to performance in the short term. The Central Bank is likely to keep relaxing monetary policy as needed. A weaker currency is also expected to improve competitiveness and risk appetite. While improved human capital would be beneficial from a medium-term perspective, policy prudence and some fiscal accommodation might be needed to avoid a sharp economic slowdown this year. The medium term should remain supported by skillful policy makers and a pragmatic political leadership. However, this may delay President Bachelet's plans to achieve meaningful social inclusion in the country.

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Chile: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National income				
Nominal GDP (USDbn)	268.2	279.1	274.3	294.1
Population (m)	17.4	17.6	17.7	17.9
GDP per capita (USD)	15,409	15,898	15,488	16,463
Real GDP (YoY%)	5.6	4.1	3.8	4.1
Priv. consumption	6.1	5.0	4.9	5.2
Gov't consumption	4.2	4.0	5.0	4.0
Investment	12.3	5.7	4.5	7.0
Exports	1.9	4.0	3.3	5.9
Imports	9.7	5.6	4.5	6.5
Prices, money and banking				
CPI (YoY%, eop)	1.5	2.8	3.0	3.0
CPI (YoY%, avg)	3.0	1.9	3.5	3.0
Broad money (YoY%, eop)	7.6	14.4	10.1	8.0
Credit (YoY%, eop)	13.5	10.1	11.7	10.0
Fiscal accounts (% of GDP)				
Consolidated budget balance	0.6	-0.6	-1.0	-0.75
Government spending	21.4	20.7	22.4	23.5
Government revenues	21.9	21.3	21.4	22.5
External Accounts (USDbn)				
Exports	78.3	77.4	79.0	85.0
Imports	74.9	75.0	78	82.7
Trade balance	3.4	2.4	1.0	2.3
% of GDP	1.3	0.8	0.4	0.8
Current account balance	-9.5	-8.9	-10.1	-9.8
% of GDP	-3.5	-3.2	-3.7	-3.3
FDI	9.2	10.2	14.0	15.6
FX reserves	41.6	41.1	43.5	42.0
FX rate (eop) USD/CLP	479	550	580	570
Debt indicators (% of GDP)				
Government debt	6.9	6.3	6.0	5.6
Domestic	4.5	4.3	4.5	4.2
External	2.3	2.0	1.5	1.4
Total external debt	43.9	42.3	43.1	40.3
in USDbn	117.8	118.0	118.2	118.4
Short-term (% of total)	18.6	14.1	14.5	14.5
General				
Industrial production (YoY%)	3.0	3.1	3.9	4.1
Unemployment (%)	6.5	6.0	6.3	6.0
Financial markets (eop)	*Current*	Mar-14	Jun-14	Dec-14
Overnight rate (%)	4.25	4.00	4.00	4.00
6-month rate (%)	4.24	4.00	4.15	4.15
USD/CLP	572	575	580	580

Source: DB Forecasts and, National Statistics

Colombia

Baa3 (positive)/BBB (stable) /BBB (stable)
Moodys /S&P/ /Fitch

- Economic Outlook: Activity indicators have improved in the last few months, pointing to a brighter outlook ahead. Inflation has gradually accelerated, but the headline rate is still close to the lower bound of the target range, and expectations are still well anchored. Political uncertainty has decreased regarding the re-election chances of President Santos given that the government coalition retained a majority in the Congressional elections. However, former President Uribe's movement obtained a considerable number of Senate members that oppose the agreements reached with the FARC guerrilla group in the ongoing peace process.
- Main Risks: The risk balance in the coming months is geared toward growth decelerating as a result of a negative contribution from the external sector and failing to deliver the proposed public investment projects. Monetary policy has remained expansionary for more than a year and inflation has not yet reacted because of temporary supply shocks in fuel and food prices, the tax reform enacted in January 2013, and currency appreciation pressures. The risk remains that a negative supply shock can accelerate prices faster than expected.

Bright economic outlook amid cloudy politics ahead

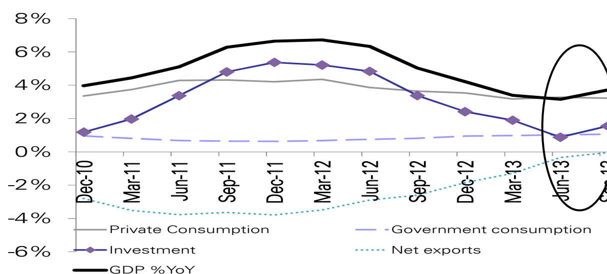
Activity numbers improving

The National Planning Department (DNP) stated that GDP is expected to grow by 4.7% in 2014 boosted by a higher investment in infrastructure, housing, and royalty disbursements to regions. Furthermore, GDP growth would be boosted by better-than-expected private investment, which currently represents 30% of GDP, due to the higher flow of FDI. Activity growth, according to the official estimates, will be also stimulated by an improved performance of transportation, retail, construction, mining, and financial services sectors. This estimate is slightly higher than our 4.5% rate of growth for 2014. In our opinion, the likelihood of the government meeting the ambitious targets of public investment is lower than what official figures represent.

Fedesarrollo reported that growth in industrial confidence turned positive in January. The index jumped to 6.7% from the negative prints experienced for most of 2013, reaching the highest level since January 2012. The improvement in industrial confidence predicts a larger-than-expected recovery in the manufacturing industry for 2014, confirming the brighter prospects from official numbers. The recovery in industrial production already started in December, when it grew by 1.5% after showing deceleration for most of the past year.

As the figure below shows, the turn in the business cycle has followed closely the contribution of investment, as consumption and government expenditure have remained more stable. Monetary policy and credit have remained expansionary for the last year and given that the effect on investment is lagging, it should translate into an increasing contribution of investment that would support a recovery in the overall growth of economic activity.

GDP growth and contributions of demand components



Source: Deutsche Bank and National Sources

Prices gradually accelerating

The producer price index (PPI) increased on a seasonally adjusted basis by 1.22% MoM during February. In the inter-annual comparison, the figure increased by 1.27%, which is 3.74pps higher than in the previous year when producer prices fell by 2.47% YoY. The higher variations were in products related to agriculture (2.82%) and industries (0.58%). The consumer price index (CPI) inflation was 2.32% YoY, accelerating from the 2.13% a month before. This gradual acceleration in prices is expected to continue as the effects of temporary supply shocks, the appreciation trend in the nominal exchange rate, and the one-off effect of the tax reform from the beginning of 2013 wind down. Inflationary risks are tilted to the upside given the possibility of a rebound in food prices.

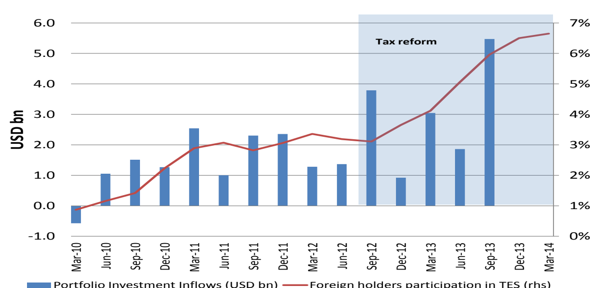
Regulatory and tax reform affecting the TES market

The Director of Public Credit stated in an interview that the reform to modify the law that calculates minimum returns to pension funds will most likely be presented to the next Congress and the discussion would be delayed until next year. Furthermore, he informed that

the country has to increase the participation of foreign investors in the local market of TES. The current level of participation is around 7% after the change in withholding taxes enacted in last year's tax reform; the government considers a participation of between 15% and 20% of foreign investors as appropriate for the Colombian economy.

In our opinion, it is still too soon to determine the total effect of these reforms, but most likely the change in the calculation of minimum return would decrease the exposure of pension funds to TES, favoring investments in foreign currency. However, the impact of this change will depend on the weights used for each asset class in the construction of the benchmark. Similarly, further decreases in withholding taxes on foreigners (currently at 14%) could have a positive impact on demand for TES, as the increase in the figure below shows the change after the most recent tax reform.

Portfolio inflows and foreign share in TES market



Source: Deutsche Bank and Ministerio de Hacienda

A thorn on President Santos' side

Congressional election results can be interpreted as a bittersweet win for the Santos administration. On the one hand, the coalition of parties that support his government retained the majority in both chambers of Congress, even if the conservative party (a member of the coalition in the first 4 years) does not align with the President. On the other hand, former President and elected Senator Uribe and his newly created party will continue being a thorn on Santos' *right* side. In our opinion, re-election chances are still high, but governability will be diminished and the legislative process, which should include education, health, justice, and tax reforms, will face fierce opposition. This will be particularly challenging for the ratification of the peace process with the FARC guerrilla movement. Uribe's opposition has been centered on the peace process, but it has not been restricted to this area topic. The negative effect on the government's popularity when Uribe was only making statements through social media and interviews has been considerable; the sting on the government, in our opinion, will be magnified from Congress.

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Colombia: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	376.5	380.8	394.6	411.7
Population (m)	46.0	47.0	47.0	48.0
GDP per capita (USD)	8,185	8,101	8,397	8,578
Real GDP (YoY %)	4.2	4.3	4.5	4.3
Priv. consumption	4.4	4.7	4.4	4.6
Gov't consumption	5.1	5.2	5.2	5.0
Gross capital formation	5.7	5.6	6.2	8.0
Exports	5.3	4.0	3.5	3.2
Imports	8.0	7.0	6.5	6.0
Prices, Money and Banking				
CPI (Dec YoY %)	2.4	1.9	3.0	3.6
CPI (avg %)	3.2	2.0	2.7	3.3
Broad Money	17.0	15.0	14.5	14.0
Bank Credit	18.2	13.0	14.0	12.0
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-2.3	-2.4	-2.3	-2.2
Interest payments	2.6	2.5	2.5	2.4
Primary Balance	0.3	0.1	0.2	0.2
External Accounts (USD bn)				
Exports	60.6	69.0	75.0	74.6
Imports	55.0	69.0	76.0	77.7
Trade balance	5.6	0.0	-1.0	-3.0
% of GDP	1.5	0.0	-0.3	-0.7
Current account balance	-12.2	-9.8	-11.0	-12.4
% of GDP	-3.2	-2.6	-2.8	-3.0
FDI	15.7	15.0	14.5	15.0
FX reserves	37.5	42.0	44.0	46.0
COP/USD	1768	1950	2100	2250
Debt Indicators (% of GDP)				
Central Government debt	36.1	35.0	35.5	34.0
Domestic	25.7	27.5	26.0	25.0
External	10.4	12.0	9.5	9.0
Total external debt	21.0	22.3	22.8	23.1
in USDbn	79.1	85.0	90.0	95.0
Short-term (% of total)	13.5	14.0	14.5	14.0
General				
Industrial production (YoY %)	2.4	-2.6	-1.5	2.0
Unemployment (%)	9.6	9.5	8.2	7.8
Financial Markets (end period)	*Current*	*1Q2014*	*2Q2014*	*4Q2014*
Overnight rate (%)	3.17	3.18	3.20	3.75
3-month rate (%)	3.18	3.20	3.55	3.80
COP/USD	2042	2060	2070	2100

Source: Deutsche Bank and National Sources

Mexico

A3 (stable)/BBB+ (stable)/BBB+ (stable)
Moody's/S&P/Fitch

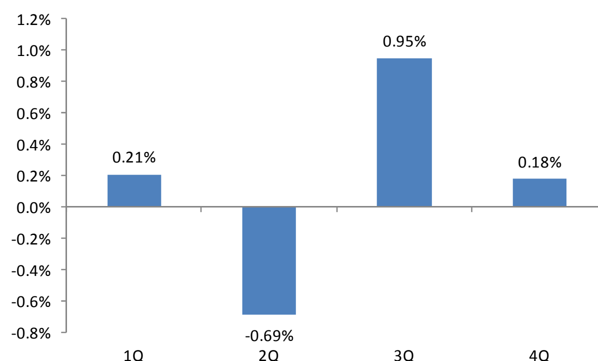
- Economic Outlook: The Mexican economy finished 2013 growing slowly and indicators for early 2014 suggest that a strong recovery may take longer. The marked deceleration of economic activity in 4Q2013, together with weak exports in January, prompted a generalized deterioration of growth expectations for this year. While the subpar performance of exports in early 2014 can be partly explained by temporary factors (mainly weather conditions in the US), a slow start this year subtracts some points to our previous GDP growth base scenario. In this regard, we now expect GDP to grow 3.1%YoY in 2014. Notwithstanding, we reiterate our view that positive surprises for growth may lay ahead in terms of a stronger recovery of US demand for Mexican exports, a faster execution of infrastructure projects, and a surge in credit that boosts private consumption. In this context of uncertain growth ahead, inflation pressures that followed the new taxes in the fiscal program for this year, have receded faster than expected. So, the inflation outlook for 2014 has improved in recent weeks. However, even in absence of shocks to prices, we expect that the CPI jump caused by the new taxes will keep headline inflation above the Central Bank's target range in 2H2014. Finally, we see the process of reforms that started last year moving slowly in the first quarter of 2014. So far, only the secondary law proposal for the economic competition constitutional reform has been sent to Congress, while the bills for energy and telecommunications remain behind.
- Main Risks: We have reviewed our growth forecast due to a slow start in 2014, but our balance of risks for the Mexican economy remains basically the same. We still see limited downside risks, as there is evidence that the main elements that dragged growth in the first semester of 2013 were removed later in the year. In particular, we see the US cycle trending upwards and government spending in infrastructure gaining traction. On the other hand, external and domestic demand may recover faster than expected, in a context of favorable conditions for Mexico in global markets with respect to other EMs. On the reforms front, we see a risk of delays in processing the secondary laws, but not beyond the end of 2014.

Weak growth in late 2013

And a slow start in 2014

The Mexican economy finished 2013 losing steam. Economic activity fell 0.3%MoM in December, a marked deceleration with respect to November. These results rounded up a picture of weak growth in the last quarter of 2013, in which GDP grew 0.2%QoQ, clearly losing dynamism with respect to 3Q2013. GDP growth for full year 2013 stood at 1.1%YoY, same as our forecast and well below the 10-year GDP growth average of the Mexican economy (2.7%YoY), which includes a major contraction of activity seen in 2009.

GDP growth in 2013 (%QoQ)

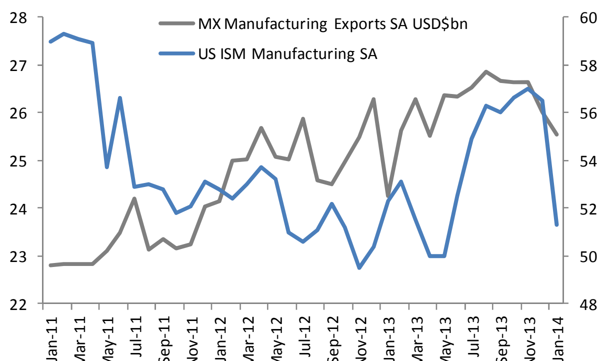


Source: INEGI. Seasonally-adjusted data

Growth in 2013 was sustained mainly by services while industrial production remained weak. Last year, secondary activities fell 0.7%YoY while services grew at 2.2%YoY. Broadly speaking, weak industrial production was explained by a combination of falling construction and flat non-autos manufacturing activity. Thus, our central scenario for 2014 is a recovery based on a normalization of these two activities. Nevertheless, disappointing growth at the end of 2013 and weak indicators at the beginning of 2014 suggest that a stronger recovery can take longer than expected. Two indicators in early 2014 were disappointing:

- Exports were weaker in January, as they fell 3.2%MoM and 1%YoY. Total exports were affected by lower energy prices, so oil exports dropped 10.6%MoM and 15.8%YoY. More importantly, seasonally-adjusted data showed that non-oil exports also were weaker in January, dropping 2.1%MoM. In our view, the weakness of exports in January is likely to be temporary and is associated to the timing of US orders. The monthly drop in exports is in line with monthly drops in the ISM manufacturing index and manufacturing production in the US, which so far have the weather as the most likely cause. It is worth noticing that the IMEF index suggests that February numbers for Mexico's manufacturing and exports may improve.

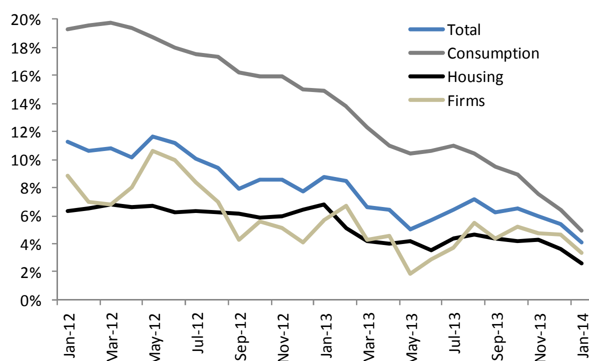
Exports and manufacturing ISM



Source: INEGI and ISM

- Net outstanding loans decelerated further and grew 4.3%YoY in real terms in January. Among the major components, consumption loans increased 5.1%YoY in real terms, followed by loans to companies, 3.6%YoY, and mortgages, 2.8%YoY. All components grew on a yearly basis more slowly in January than in late 2013. Bank loans as a proportion of GDP now stand at 14.9%, below ratios observed in other developing counties. In our view, bank loans keep growing well below potential, as suggested by comparing the current pace with that seen back in 2011/2012.

Bank loans (%YoY)



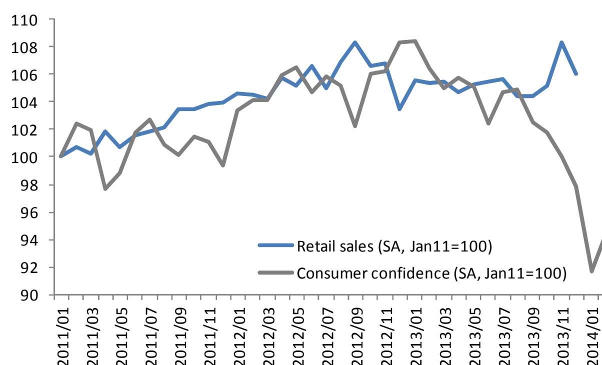
Source: Banco de México

These indicators on the demand side, exports and bank loans, point to a slower-than-expected start in 2014. On the other hand, positive indicators for January and February have not added to our growth prospects, as they either show an incipient recovery or remained on a positive trend contained in our base scenario:

- The market of motor vehicles was strong in January and February. The National Automotive Industry Association (AMIA) anticipates that domestic sales will stay strong in the coming months and will reach 1.14m in 2014. Similarly, exports are expected to remain at current levels of around 2.5m units per year, in line with a strong US demand for autos. Thus, total production continued to grow strongly in January and February, reaching near half million units in the first two months, 1.7%YoY, the highest production in record for such a period of the year. The production of motor vehicles and parts was the main support of industrial production in 2013 and we expect it to remain a strong source of IP growth in 2014. Nevertheless, we do not expect an acceleration of production that delivers additional growth this year with respect to 2013, so the prospects for faster growth should come from other manufactures.

- Seasonally-adjusted data shows an improvement in consumer confidence in February, as the index went up 3%MoM. This increase is explained by three out of the five components of consumer confidence. While it is too soon to anticipate a change of trend in consumer confidence, February data broke a streak of five consecutive monthly falls. In our view, diminishing consumer confidence was largely explained by the effect of new taxes in the 2014 fiscal program. However, as the year goes by and such taxes are assimilated, we expect consumer confidence to recover moderately. This scenario may be further improved as increased credit availability due to the financial reform could reinforce the perceived capacity of households to purchase durable goods in the second semester of 2014.

Retail sales & consumer confidence



Source: INEGI

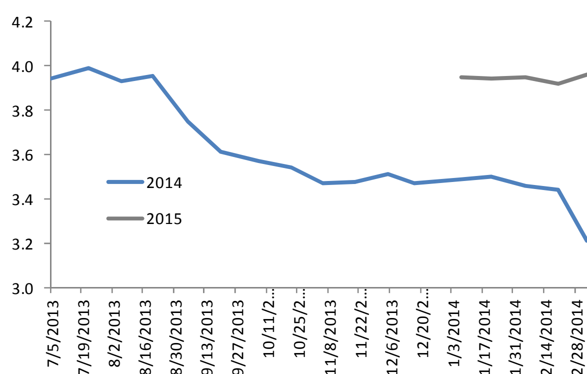
- In line with the incipient recovery of consumer confidence, the National Retailers Association (ANTAD) released same-store sales for February, which fell annually less than expected, -0.2%YoY. While no seasonally-adjusted data is available to determine whether there was a monthly acceleration in ANTAD's same-store sales, this result is likely to anticipate stronger results for the broader measure of retail sales calculated by INEGI.

However, we maintain our view that retail sales will stay relatively weak in the first semester of 2014.

- Labor market indicators continued to improve in January. The unemployment rate came at 5.05%, which compares favorably to 5.42% a year before, particularly because the participation rate increased from 57.7% to 58.6% in that period and economic activity was remarkably weak in 2013. Similarly, the rate of underemployment fell to 8.55%, from 8.78% a year before. These results for early 2014, together with the evolution of past year's indicators, now form a medium-term trend that suggests that formal labor markets have developed more resilience.
- Finally, the amount of remittances (basically, money sent from workers outside Mexico) was above expectations in January. Remittances were up 8%YoY and the number of transactions stood at 5.5m, up 7.6%YoY. An increased number of transactions reflect a trend of improving conditions in US labor markets, particularly in those activities more intensive in Mexican workers' labor, mainly construction and agriculture. Stronger remittances should come as positive news, particularly as current account deficits are becoming a concern about EMs.

As a result of the weak recent indicators, growth expectations deteriorated across-the-board. The Banamex survey of economic analysts reported an expected GDP growth for 2014 of 3.2%YoY, down from 3.4%YoY in the last survey and from its peak of around 4%YoY in mid-2013. Similarly, Banxico released its monthly poll, which showed that expected GDP growth for 2014 is now 3.2%YoY, down from 3.4%YoY in the previous survey. The deterioration in growth expectations for 2014 was foreseeable, as it was prompted by a slow growth of economic activity in late 2013 and weak exports in January 2014, both indicators released after the last survey.

Expected GDP growth (%YoY)



Source: Banamex survey

In spite of the broad-based deterioration of growth expectations for 2014, forecasts for 2015 even went up on average to 4.0%YoY from 3.9%YoY in the last Banamex survey. Similarly, expected growth for 2015 in Banxico's poll remained stable at 3.9%YoY.

Subpar performance of exports in January is likely to have been caused by weather conditions in the US and to be temporary. However, regardless of the causes, we see a slower-than-expected start in 2014 that will affect the first quarter. Even if the economy accelerates later in the year, as we expect, the likely persistence of weak activity in the first months of the year subtracts some points from our previous GDP growth base scenario. In this regard, we now expect GDP to growth 3.1%YoY in 2014. Notwithstanding, we reiterate our view that positive surprises for growth may lay ahead in terms of a stronger recovery of US demand for Mexican exports, a faster execution of infrastructure projects, and a surge in credit that boosts private consumption. On the other hand, we do not see significant downside risks to this central scenario, as there is evidence that the main elements that dragged growth in the first semester of 2013 were removed later that year.

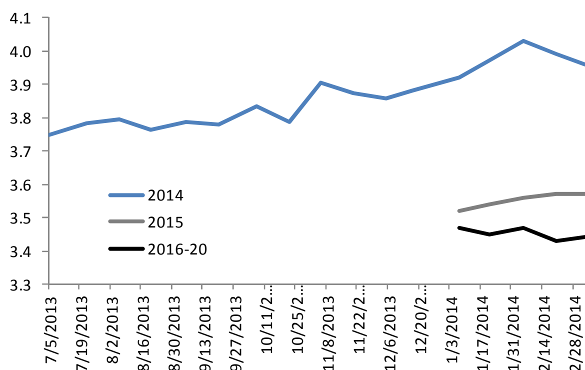
In this context of weak growth in early 2014, headline CPI inflation has been dropping faster than expected. Monthly inflation in February was well below the 10-year average for that month, so annual inflation is now at 4.23%YoY, down from 4.63%YoY by mid-January. Similarly, core inflation dropped in February and is now below the center of the target range at 2.98%YoY. The drop of CPI inflation in February shows that the seasonal easing of pressures from some non-core items (mainly agriculture products) is running its course. This strongly suggests that the effects of the 2014 fiscal program on prices were limited to early January and explains recent improvements in the inflation outlook for this year.

In fact, recent surveys point out clearly that inflation expectations have improved. According to the Banamex survey, expected annual headline CPI inflation for December 2014 stood at 3.96%YoY, down from 3.99%YoY in the last survey. Similarly, expected core inflation for year-end 2014 is now 3.50%YoY, down from 3.62%YoY in the last poll. Inflation expectations for 2015 remained unchanged at 3.57%YoY and 3.27%YoY for headline and core inflation, respectively (3.57%YoY and 3.25%YoY in the last survey). Similarly, expectations for 2016-2020 remained stable at 3.44%YoY for headline inflation (3.43%YoY in the last poll).

We expect annual CPI headline inflation to run slightly below 4% in March and April and rise well above the upper limit of the Central Bank target for the remainder of the year due to seasonal factors. Even in absence of major shocks, the CPI jump caused by the new taxes is

likely to keep the headline annual rate persistently above 4% in the second semester of 2014. Therefore, we expect year-end headline inflation at 4.1%YoY.

Expected year-end headline inflation (%YoY)



Source: Banamex survey

The second quarter of this year is becoming decisive for the monetary policy outlook, as two possible scenarios may emerge then. First, if inflation remains close to 4%YoY in 2Q2014, later seasonal factors may deliver uncomfortably high inflation rates in the second semester. Secondly, growth prospects may improve in 2Q2014 as activity will look stronger due to a low base effect in the inter-annual comparison and the temporary effects of weather in the US that clouded expectations disappear. If both scenarios materialize, the possibility that the Central Bank will hike the policy rate by the end of 2014 will increase.

Reform process goes on more slowly than expected

The process of reforms that started last year with a series of constitutional changes has moved slowly in the secondary laws phase. This should be an increasing concern as the end of the first period of Congress sessions approaches. If secondary laws are not processed in the current period, there is a risk of serious delays, as the possibility of calling for an extraordinary period of sessions is somewhat limited.

Among the constitutional reforms that require secondary laws to be processed in Congress, only the proposal for the economic competition bill has been submitted. Broadly speaking, the project sent to the Lower Chamber seeks to: i) create an authority to conduct investigations that is independent of the anti-trust commission, ii) broaden the scope of practices that can be ruled as anti-competitive and iii) make the processes of the authority to impose sanctions more expedite and efficient. Nevertheless, some rulings contained in the proposal have raised concerns in the private sector, allegedly the discretionary powers of the new anti-trust commission to impose sanctions and the poor protection of the companies' right to a due process. We expect these issues to be addressed by Congress in the near future, so the secondary laws on competition will be passed after some adjustments to the original proposal without significant delays.

Secondary laws for telecommunications and energy reforms are likely to be sent to Congress in the coming weeks. Nevertheless, they will probably have very different paths for discussion and approval. In the case of secondary laws in telecommunications, they may be further delayed if negotiations shaping the bill proposal to be sent move slowly. Moreover, pressure on the players involved may have been reduced as the new regulator, the Federal Institute of Telecommunications (IFT), moved ahead alone and issued far-reaching pro-competition rulings. This is not the ideal scenario, as there is some risk that the secondary laws end up being inconsistent with the regulator's rulings after the legislative process. This may create additional legal uncertainty for both incumbents and new entrants and hinder investment further. In any case, we anticipate that the secondary legislation on telecommunications, which modifies or replaces approximately 16 existing federal laws, will not be approved by Congress until the second half of the year.

In our view, the pro-competition rulings issued by the IFT are a significant step to promote competition and level the playground on the telecommunications and broadcasting markets. In the case of telecommunications, the regulator declared that America Movil (mobile telephony) and Telmex (landlines and broadband) are preponderant companies and imposed obligations in terms of infrastructure sharing, unbundling their networks and services (mainly, the local loop or last-mile), accounting standards, roaming services, interconnection rates and consumer protection, among others. In the case of broadcasting, Televisa and its affiliates were declared preponderant with special obligations in terms of infrastructure sharing, sales of advertising, exclusive rights on contents and channels unbundling, among others.

In both cases, the measures announced are expected to promote competition in the respective markets. Nevertheless, the extent to which the rulings can reshape telecomm and broadcasting is still uncertain for two reasons. First, as mentioned before, the secondary laws are not passed yet and their final form may be not be fully consistent with IFT's rulings and, thus, revert or jeopardize them legally. Secondly, the obligations mentioned are only broadly defined in the rulings, so further detailed highly-technical regulation in terms of prices and conditions is necessary to ensure that they are truly effective. In this regard, the rulings on preponderant players are basically a kick-off for the regulatory agenda in both markets in the years to come.

We see a different scenario for the secondary legislation of the energy reform. The broad political consensus built around the energy reform anticipates a smooth process for the secondary laws and will

discourage some of its opponents from blocking it. The intensity of the legislative process of the constitutional part suggests that most of the technical and political works leading to the secondary legislation may be already done. Moreover, by shifting the focus of the new legal framework to well-known schemes such as production-sharing contracts and licences, the challenges for the design, approval and implementation of the secondary legislation have been reduced. In our view, the secondary legislation of the energy reform will be full processed in the first semester of 2014, so the model contracts and mechanisms for awarding the new rights will be prepared in the second half.

Even if the secondary laws move slowly, the combination of good prospects created by the constitutional reforms and higher growth due to the exposure to the US cyclic upturn, will translate into favorable conditions for Mexico in global markets. This is likely to shield Mexico partially from current volatility and maintain some degree of differentiation with respect to other EM countries.

In this context of favorable long-term prospects about Mexico, some attention will be paid to the possibility of sovereign debt upgrades. After Moody's recent upgrade to the A-region and S&P's recent change to restore Mexico's grade, we would see Fitch Ratings as the next candidate for an upgrade. Nevertheless, Fitch published a report this week in which points out that some governments in Latin America will face challenging financing needs due to expansionary fiscal policies, Mexico among them (See: "Necesidades de Financiamiento de Soberanos Latinoamericanos en 2014 - Impulsadas por Mayores Déficits Fiscales" March 10, 2014). While this report may not have a direct implication on the rating decision, it reflects some concerns about the fiscal position of Mexico in 2014. Thus, in our view, an upgrade to Mexico's sovereign debt is unlikely in the coming months.

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Mexico: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	1177	1238	1328	1428
Population (m)	117	119	121	124
GDP per capita (USD)	10063	10400	10977	11519
Real GDP (YoY%)	3.8	1.1	3.1	3.7
Priv. consumption	4.6	3.8	4.3	4.7
Gov't consumption	2.4	2.2	3.0	5.0
Investment	5.5	-0.1	4.1	4.7
Exports	4.2	1.4	3.2	3.8
Imports	6.0	2.0	4.5	5.1
Prices, Money and Banking				
CPI (Dec YoY%)	4.1	4.0	4.1	3.7
CPI (avg %)	4.1	3.8	4.0	3.8
Broad Money	10.8	11.5	11.0	12.0
Credit	12.0	10.0	15.0	19.0
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-2.6	-2.9	-4.0	-3.6
Primary Balance	-0.6	-0.9	-1.9	-1.5
External Accounts (USD bn)				
Exports	371.4	376.6	388.7	403.4
Imports	371.2	378.6	395.7	415.8
Trade Balance	0.2	-2.0	-7.0	-12.4
% of GDP	0.0	-0.2	-0.6	-0.9
Current Account Balance	-14.1	-22.3	-27.9	-31.4
% of GDP	-1.2	-1.8	-2.1	-2.2
FDI	15.4	13.0	22.0	30.0
FX Reserves	163.5	186.5	205.0	225.0
MXN/USD (eop)	13.0	13.0	12.9	12.8
Debt Indicators (% of GDP)				
Government debt	33.7	35.6	36.5	36.8
Domestic	23.1	24.4	25.0	25.2
External	10.6	11.2	11.5	11.6
Total External Debt	19.3	20.3	21.8	23.4
in USD	227.2	250.2	289.3	334.5
Short term (% of total)	19.0	18.0	17.0	19.0
General				
Industrial Production	2.8	0.9	3.0	3.3
Unemployment	4.9	4.6	4.4	4.0
Financial Markets (end	**Current**	**1Q14**	**2Q14**	**4Q14**
Overnight rate (%)	3.50	3.50	3.50	3.75
3-month rate (%)	3.80	3.90	4.00	4.25
MXN/USD	13.20	13.20	13.00	12.90

Source: DB Global Markets Research, National Sources

Peru

Baa2 (positive)/BBB+ (stable)/BBB (neutral)
Moodys /S&P/ /Fitch

- Economic Outlook: Activity is expected to pick up in 2014 to above 6%, the average rate of growth of the economy in the last few years. Even though inflation has picked up in recent months, authorities have recognized the source of the increase in prices as a temporary supply shock from the food sector. The sudden drop in copper prices has started to take a toll on the trade balance that until recently showed a strong performance.
- Main Risks: The widening of the trade deficit due to the fall in copper price could be compounded by missing targets of production in the coming months. This would expose the economy to a slowdown in economic activity because of the lack of impulse from external demand that economic authorities are expecting for the rest of the year. If this bleak outlook materializes, the already high current account deficit could continue increasing accompanied by a slowdown in FDI responding to lower commodity prices and tighter liquidity conditions.

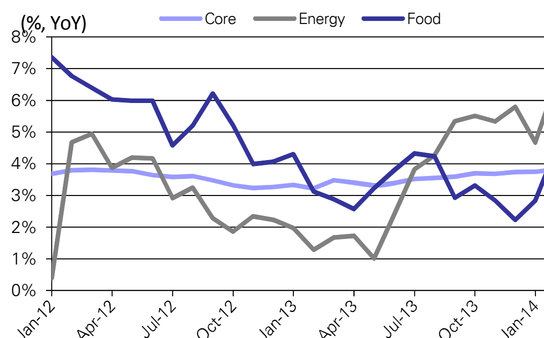
External sector sputters as economic policy direction is confirmed

Expecting acceleration in activity amid stable inflation

Real GDP increased by 5.2%YoY during the 4Q2013 mainly explained by a positive evolution of consumption, and in a lower extent by the increase of investment. During the last quarter of last year, all components of domestic demand increased with private consumption up by 4.2%YoY, government consumption rising by 5.6%YoY and investment growing by 1.7%YoY. During 2013, GDP advanced by 5.0%, with domestic demand increasing by 5.5% and imports by 2.0%. Conversely exports decreased by 2.3% in 2013.

The National Institute of Statistics INEI reported that consumer prices in the Lima Metropolitan area increased by 0.60%MoM and by 0.53%MoM at the national level in February. These figures were mainly driven by an increase in food and beverages (0.83%MoM), and housing, fuel and electricity (1.65%MoM), jointly adding 0.478pp. Accumulated inflation for the last twelve months reached a value of 3.79%YoY for the national indicator, as the chart below shows, and 3.78%YoY for the Lima Metropolitan area. Wholesale prices increased by 0.20%MoM in February.

Inflation above target due to food and energy



Source: Deutsche Bank, BCRP

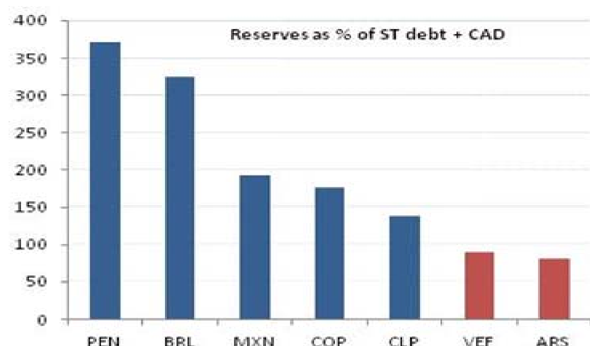
In our opinion, even though these numbers are above the upper limit of the target range, the Central Bank will continue with the expansionary monetary policy stance. On its most recent meeting the BCRP decided to keep the monetary policy rate unchanged at 4.0%. This policy rate is assessed by the BCRP as compatible with a projected inflation of 2% for 2014 and 2015. The statement considered factors such as anchored inflation expectations, GDP growth rates below potential, recovery of the global economy and the likely moderation of supply shocks that caused higher inflation rates in the last year. The monetary authority is expecting inflation to remain close to the upper limit of the target range. Moreover, the expansionary monetary stance has being kept by decreasing reserve requirements for credit in soles, a policy that also serves the purpose of gradually de-dollarizing the Peruvian economy.

Trade deficit to continue due to declines in copper price

The BCRP released a forecast of a continued trade deficit during the first half of 2014 due to the drop in export prices, despite the expected increase in the volume of exports, especially in traditional products. Copper prices, the most important export product, have dropped by 8.1% during the last week, negatively affecting the dollar value of this item's sales abroad. The BCRP forecasts a recovery in the second half of the year driven by the reversion in prices and a higher supply of products in mining and fishing sectors. For the entire year the monetary authority anticipates a trade surplus of USD450mn. Economic activity for the rest of the year is relying on the increase of copper exports as new projects come to full production. If the fall in prices continues this could pose a challenge to the widening current account deficit.

Although the Central Bank has more than enough foreign exchange reserves to withstand a shock to external financing, the lack of nominal exchange rate flexibility required due to the high degree of dollarization, precludes a large depreciation as an adjustment mechanism to stabilize external accounts if copper prices were to continue declining.

Foreign exchange reserves cover financing needs



Source: Deutsche Bank Research and National Sources

Cabinet appointments predict continuation of sound policies

President Humala decided to change part of its cabinet in the latest quarrel over domestic politics. He appointed Rene Cornejo, former Minister of Housing and Construction, as the fifth Prime Minister (Chief of Cabinet) during his mandate, replacing Cesar Villanueva who resigned due to apparent discrepancies with the First Lady, Nadine Heredia, and the Finance Minister Luis Miguel Castilla. Mr. Villanueva stated in public that economic authorities were discussing an increase in the minimum wage, a possibility he endorsed; the First Lady and the Finance Minister publicly denied these discussions. President Humala took this opportunity to include new members to the cabinet. Four new Ministers were appointed and three members of the previous cabinet were shuffled to other cabinet positions.

The new members have all been considered as specialists in their fields and their appointment sends a positive signal regarding the continuation of the policies that economic authorities have given to the country under Humala's presidency.

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Peru: Deutsche Bank forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USDbn)	196.9	194.3	202.4	225.2
Population (mn)	30.0	30.5	31.0	31.5
GDP per capita (USD)	6,562	6,369	6,529	7,150
Real GDP (YoY%)	6.3	5.2	6.0	6.5
Priv. Consumption	6.5	5.0	6.0	6.2
Gov't consumption	8.0	8.5	8.0	7.0
Investment	11.0	6.0	9.0	9.5
Exports	14.0	10.0	10.5	12.0
Imports	23.0	12.0	15.0	15.0
Prices, Money and Banking (YoY%)				
CPI (YoY%)	2.7	3.0	2.5	2.7
CPI (avg%)	3.7	2.5	2.7	2.9
Broad money	16.5	15.0	16.0	16.0
Credit	16.0	15.0	15.5	17.0
Fiscal accounts, % of GDP				
Balance	2.1	1.0	0.6	0.5
Interest payments	1.1	0.7	0.9	0.8
Primary surplus	3.2	1.7	1.5	1.3
External accounts (USDbn)				
Exports	45.2	52.0	60.0	62.0
Imports	39.8	46.0	52.0	55.0
Trade balance	5.4	6.0	8.0	7.0
% of GDP	2.7	3.1	4.0	3.1
Current account balance	-6.1	-9.7	-9.6	-10.1
% of GDP	-3.1	-5.0	-4.8	-4.5
FDI	12.2	11.0	10.9	12.5
FX reserves (USDbn)	64.1	74.0	80.0	78.0
FX rate PEN/USD (eop)	2.55	2.80	2.92	2.87
Debt Indicators (% of GDP)				
Government debt	23.4	23.7	23.0	21.0
Domestic	9.8	10.0	10.4	9.5
External	13.6	13.7	12.7	11.6
Total external debt	24.8	27.2	27.7	27.6
in USDbn	48.8	52.9	56.0	62.2
Short-term (% of total)	15.1	14.8	14.5	15.0
General				
Industrial prod (%)	10.3	9.0	10.0	11.0
Unemployment (%)	6.9	6.8	6.9	6.8
	Current	*1Q2014*	*2Q2014*	*4Q2014*
Policy rate (interbank o/n)	4.00	4.00	4.00	4.50
3-month rate	4.90	4.90	5.00	5.00
PEN/USD	2.80	2.82	2.86	2.90

Source: DB Global Markets Research, National Sources

Venezuela

Caa1 (negative)/B (negative)/B+ (negative)
Moody's/S&P/Fitch

- Economic Outlook: Violent clashes between students and members of the opposition on one side and government forces on the other have worsened the political and economic conditions in the last month. We do not expect the protests to stop but to gradually reduce its intensity in the coming days. The partial liberalization of the exchange rate regime implied by the introduction of SICAD 2 should alleviate the need to use direct monetary financing from the Central Bank, a major source of domestic imbalance in the last year. Hopefully it could soon help reduce scarcity too.
- Main Risks: The civil unrest that has been added to the already difficult economic conditions exacerbating the risk of continued stagflation. If economic authorities do not constrain the monetary financing of the fiscal deficit, the introduction of SICAD 2 will not be able to solve domestic and external imbalances. The lack of basic policy fixes would further increase political instability and market concerns on payment capacity.

Social unrest added to dire economic conditions

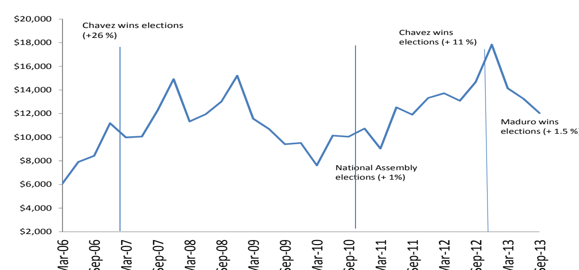
Violent clashes continue as political climate worsens

The events experienced in Venezuela in the last month portray a rapid worsening in the overall situation, currently characterized by a negative feedback loop in which economic conditions tighten the political constraints that the government faces, and vice versa. As we went to press, students were facing government forces and two more deaths. This latest incident takes the total death toll to around 25 since these demonstrations started one month ago.

Dire economic conditions have certainly impacted the political climate and vice versa. Civil unrest, started by the student movement and fueled by the incarceration of opposition leaders and the deaths of protesters after violent repression, has tightened the political margin of maneuver. Such a fragile governability seriously limits the possibility of taking hard measures to straighten economic conditions. Even though lack of security, freedom of speech, and human rights have been cited as causes of the protests, deteriorating economic conditions have also mobilized sectors of the middle class, that were not as strident when it came to protest against the government, to lead these marches and demonstrations. The student movement, has vowed to continue protesting until a series of demands are addressed. The position of the government has been to call for dialogue while facing protests with violence and failing to address their demands.

As the chart below shows, periods in which the government has needed political support (such as elections) have been accompanied by fast increases in imports. The next elections are scheduled for the end of 2015, and the government might be calculating an efficient management of existing resources between now and then. However, the government is already facing severe constrains to sustain the same degree of expenditure (and of imports) due to the stagnation in the value of oil exports and the real currency appreciation. This has been reflected in a current account surplus that is today half of what it was in 2012 and a quarter of what it used to be before that.

Imports per quarter and political events (US bn)



Source: Deutsche Bank, IMF, and BCV

The political climate started heating up at the beginning of February when members of the opposition tried to capitalize on the discontent produced by economic conditions. The student movement was the first to take this call and since then protests have extended throughout the country, now largely backed by the middle class. These protests were at first rejected by opposition leader Henrique Capriles, especially because he initially argued the protests were deviating attention away from the government's responsibility on the economic backdrop. In the last few days he has backed them and called for protests to continue although condemning violence.

We expect the protests to persist although with less intensity than in the end of February. The opposition strategy has shown that the government's political position is weak and this has also impacted in the foreign image of the Maduro administration. As we went to press, a commission from UNASUR, the organization that is composed by all countries in the Americas except the United States and Canada, was studying the possibility of sending a commission to mediate between the opposition and the government.

Earlier, when the Panama representative brought the same proposal to the Organization of American States, President Maduro announced the breaking of diplomatic and economic relationship with Panama and rejected to receive such a commission.

SICAD 2 implies partial FX liberalization

More details on the new exchange rate regime were delivered by Rafael Ramirez, vice-president for economic affairs. The publishing on the official gazette of the "Exchange Accord # 27" on March 11 effectively creates a third system, dubbed SICAD 2, in which the private sector can access hard currency-denominated assets and satisfy liquidity needs.

In our opinion, this system is definitely a positive development for at least three reasons. First, it will supply hard currency to sectors of the economy that had been deprived so far, as the government did not consider them as a priority. The same is the case for companies that would like to liquidate their excess position in local currency and were not able to do it because of the illegality of the black market. Second, it will allow PDVSA to sell dollars at a higher exchange rate thus alleviating its cash flow in dollars as well as in local currency. Third, and perhaps the most important reason, this flexibilization had been opposed fiercely by the radical group inside the economic team led by Minister of Planning Jorge Giordani. In his opinion, the government will need to supply a large quantity of dollars to sustain this market or accept all economic prices to adjust to a devalued exchange rate fueling inflation. Getting closer to a market value for the currency could indeed fuel further inflation acceleration but this negative effect is more than compensated by the potential reduction in rationing in the system. Thus, the partial liberalization of the exchange rate system, if fulfills current expectations, could spur other much needed pragmatic reforms in economic policy.

There are at least two hurdles that this new system should surpass for this reform to impact the economy positively. The first one is related to the exchange rate and the share of the total dollar supply that will be used to maintain this system. At an exchange rate of around 50, the weighted average of the exchange rate would reach around 20 VEF/USD to year end, a level close to the PPP rate for the Venezuelan economy. The second one is that if economic authorities do not restrict the monetary financing of the fiscal deficit, demand for dollars will continue increasing and the government will need to restore the quantitative restrictions on the supply of dollars. It remains to be seen in the coming days if the system delivers the partial liberalization needed.

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Venezuela: Deutsche Bank Forecasts

	2012	2013F	2014F	2015F
National Income				
Nominal GDP (USD bn)	381	449	767	584
Population (mn)	30	31	31	31
GDP per capita (USD)	12,918	14,722	24,747	18,826
Real GDP (YoY%)	5.6	1.5	0.5	3.5
Priv. consumption	7.0	5.0	3.5	5.0
Gov't consumption	6.3	2.7	3.0	7.0
Investment	23.3	1.0	2.5	8.0
Exports	1.6	3.0	0.1	4.0
Imports	24.4	7.0	8.0	10.0
Prices, Money and Banking				
CPI (Dec YoY%)	20.1	56.5	70.0	75.0
CPI (avg%)	23.8	40.0	65.0	70.0
Broad Money (% YoY)	60.1	65.0	50.0	62.0
Credit (% YoY)	49.0	55.0	45.0	50.0
Fiscal Accounts (% of GDP)				
Consolidated budget balance	-18.0	-14.3	-11.5	-13.5
Interest payments	2.5	2.8	3.5	3.5
Primary Balance	-15.5	-11.5	-8.0	-10.0
External Accounts (USD bn)				
Exports	98.0	92.0	95.0	98.0
Imports	58.0	55.0	50.0	60.0
Trade balance	40.0	37.0	45.0	38.0
% of GDP	10.5	8.2	5.9	6.5
Current account balance	14.0	7.2	14.0	15.0
% of GDP	3.7	1.6	1.8	2.6
FDI	0.0	0.0	1.0	1.5
FX reserves	29.9	21.7	25.0	30.0
VEF/USD	4.30	6.30	6.30	15.0
Debt Indicators (% of GDP) (*)				
Government debt	37.9	34.6	28.8	36.9
Domestic	15.6	15.5	17.5	22.0
External	22.4	19.1	11.3	14.9
Total external debt	25.8	22.2	13.1	17.5
in USDbn	98.4	99.6	100.9	101.8
Debt Service (USD bn)	8.6	13.0	14.0	13.7
General				
Industrial production (YoY%)	2.4	1.0	2.0	2.5
Unemployment (%)	8.0	8.3	8.5	8.0
Financial Markets (eop)	Current	1Q2014	2Q2014	4Q2014
Overnight rate (%)	20.6	25.0	25.0	25.0
3-month rate (%)	14.5	15.5	15.5	17.0
VEF/USD	6.30	6.30	6.30	6.30

(*) Includes PDVSA external debt
Source: DB Global Markets Research, National Sources

Deutsche Bank Securities Inc.

Theme Pieces

February 2014
- Vulnerabilities, Policy Inaction, and Stigma in the Recent EM Sell Off
- Divergent Pricing of Local and External Sovereign Bonds
- India: CPI Target Means Higher Rates for Longer
- Asia Vulnerability Monitor
- Inside Fragile EM: Trip Notes from Turkey and South Africa

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Policy Rate Forecast

Projected Policy Rates in Emerging Markets

		Policy Rate Forecasts				
	Current policy rate	Q1-2014	Q2-2014	Q3-2014	Q4-2014	Q4-2015
Emerging Europe, Middle East & Africa						
Czech	0.05	0.05	0.05	0.05	0.05	0.50
Hungary	2.70 ↓	2.60 ↓	2.60 ↓	2.60 ↓	3.00	4.00
Israel	0.75 ↓	0.75 ↓	0.75 ↓	0.75 ↓	1.00 ↓	2.00 ↓
Kazakhstan	5.50	5.50	5.50	5.50	5.50	5.50
Poland	2.50	2.50	2.50	2.50 ↓	3.00 ↓	4.00 ↓
Romania	3.50	3.50	3.50	3.50	3.50	4.50
Russia	7.00 ↑	7.00 ↑	6.50 ↑	6.00 ↑	6.00 ↑	6.00 ↑
South Africa	5.50	5.50 ↓	6.00	6.00	6.00	7.50
Turkey	10.00	10.00	10.00	10.00	10.00	10.00
Ukraine	6.50	6.50	6.50	6.50	6.50	6.50
Asia (ex-Japan)						
China	3.00	3.00	3.00	3.25	3.25	3.25
India	8.00	8.00	8.00	7.75	7.50	8.00
Indonesia	7.50	7.50 ↓	7.50 ↓	8.00	8.00	7.00
Korea	2.50	2.50	2.50	2.50	2.50	3.50
Malaysia	3.00	3.00	3.00	3.25	3.25	3.50
Philippines	3.50	3.50	3.75	4.00 ↑	4.00	4.50
Taiwan	1.875	1.875	1.875	1.875	1.875	2.325
Thailand	2.00 ↓	2.00 ↓	2.00 ↓	2.00 ↓	2.50 ↑	2.50 ↑
Vietnam	7.00	7.00	7.00	7.00	7.00	10.00
Latin America						
Brazil	10.75 ↑	10.75	11.00	11.00	11.00	12.00
Chile	4.25 ↓	4.00	4.00	4.00	4.00	4.50
Colombia	3.25	3.25	3.50	3.75	4.00	5.00
Mexico	3.50	3.50	3.50	3.50	3.75	4.50
Peru	4.00	4.00	4.00 ↓	4.25	4.50	4.50

↑/↓ Indicates increase/decrease in level compared to previous EM Monthly publication; a blank indicates no change

Source: Deutsche Bank

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