MACRO REPORT

Emerging Markets: Economy Update

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Executive Summary

→ **ASIA:** It's Budget time for India and Indonesia: FY Fiscal Deficit Targets are 3.9% and 1.9% of GDP, respectively. Both countries are aiming to boost economic growth through capital and infrastructure expenditures. The room for fiscal action in Indonesia seems more evident in the numbers, thanks to the savings obtained through subsidies rationalization. India, by contrast, is in need of significant extra-budgetary funding. The divestment of public assets is a process that can take time.

→ **EMEA:** The Ukraine conflict has continued to be at the forefront of investors' concerns. The fragile Minsk I ceasefire agreement was followed by Minsk II in February; however it is not clear if this agreement will hold. Ukraine has announced likely government restructuring as part of the new International Monetary Fund (IMF) program. In Russia, we have revised our growth forecast down to -3.5% in 2015. In Turkey, excessive political pressure on the Central Bank risks the premature closing of the window of opportunity to improve the economy structurally.

→ **LATAM:** Negative growth has increasingly become the consensus outlook for Brazil, but we remain concerned about political and policy uncertainty into mid-year as economic conditions continue to worsen. President Rousseff has appointed an experienced technocrat, Joaquim Levy, as the new Minister of Finance. His task will be to implement the necessary fiscal adjustments in order to avoid rating agency downgrades. At the same time, the Central Bank is likely to continue hiking rates, as inflation has surprised to the upside despite the slowing economy.

Emerging Markets Macro Pulse

ECONOMIC CONDITIONS

Poor — Good

- **Asia**: Budget laws in India and Indonesia aim to boost growth through fiscal expenditure.
- **Russia**: Inflation likely to peak in first half of 2015, with growth decelerating sharply.
- **Brazil**: Inflation remains persistently high despite the "technical" recession. Monetary and fiscal policies will have to remain tight in 2015.
- **Turkey**: Central Bank of Turkey cuts rates cautiously, lower oil price means lower Current Account deficit and an improving economy. However, the window of opportunity will be short.

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STABILITY CONDITIONS

Poor — Good

- **India Politics**: Regional elections ahead, government will seek to increase its seats in the Upper House.
- **Russia**: The authorities are attempting to consolidate power ahead of the 2016 parliamentary elections.
- **Brazil**: High uncertainty surrounds government's commitment to reform at a time of economic slowdown.
- **Turkey**: Political pressures on Central Bank actions are not helping; political climate in general is worsening.

Source: Pioneer Investments. Data as of February, 27 2015.

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Asia

1. India

Economic Outlook

According to the recent monthly figures, domestic economic momentum in India weakened a bit in early 2015 along with the inflation dynamics; the external contribution to the growth appears resilient. In February, PMI moderated at 51.2 from 52.9 in January.

However, the latest revised GDP figures are simply amazing: in 2013 and 2014 the Indian economy has grown the fastest of all the G20 economies: 6.9% and 7.4% YoY, respectively. The base year has been revised and some more comprehensive sources of data have been considered.

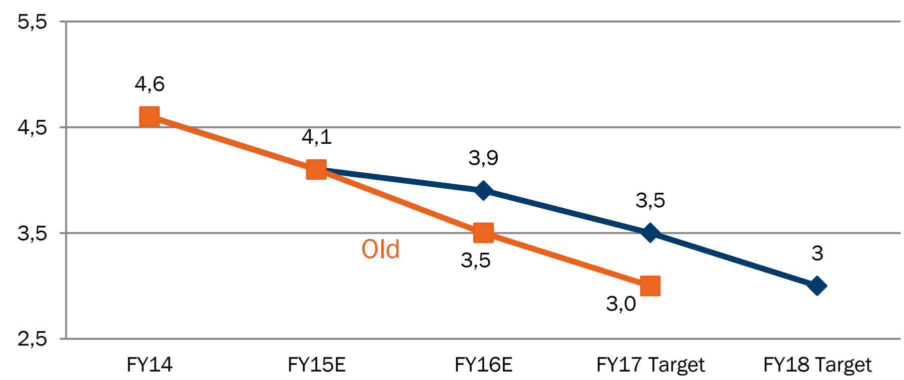
After the strong decline of recent months, the latest inflation figure of 5.1% YoY in January remained below the January 2016 target of 6%. Notwithstanding some potential inflationary initiatives mentioned in the Budget, we expect the inflation rate to fluctuate around that target for the coming year. In the latest data revision, the Food component of the CPI basket has been lowered to around 45% from about 50%.

Budget

India's budget clearly aims to boost growth.

At the end of March 2014, the Union Budget for the 2015/2016 Fiscal Year was released by the Indian Ministry of Finance. The headlines were as we expected: the Indian Government made a reality check and the fiscal targets are higher than the prior ones released in July. Clearly highlighted is the fact that private sector investments are not going to revive anytime soon; as a result, public expenditures will be needed to revive the investments cycle. The 3% Fiscal Deficit in relation to GDP target is still on the radar, but has been pushed back one year.

India Fiscal Deficit Targets (% GDP)



Source: India Ministry of Finance, Pioneer Investments. Data as of February, 2015.

Does the Budget reflect the qualitative benchmarks referenced by the Reserve Bank of India (RBI) last February?

The headline items are good, but the devil is in the details. As noted, the slippage from the previous target is reasonable. However, the manner of funding remains the classic (ambitious) plan to divest public assets. If we reduce the revenues coming from the disposal of public assets to a contribution more consistent with the level realized last fiscal year (57% of budgeted revenues), the Fixed Deposit (FD) target would be at 4.2%: no fiscal consolidation at all. Clearly, there is need of another way to finance expenditures. Funding will have to come from extra-budgetary sources: the decline in oil prices, keeping food and fertilizer subsidies flat in terms of the absolute amount (resulting in lower subsidies as a percentage of GDP), external sources and tax-free infrastructure bonds.

Monetary Policy

On the 4th of March, in a surprise action, the RBI cut the Policy Repo Rate by 25 basis points, to 7.5%. Our internal Taylor Rule is calling for a further 25bp in rate cuts.

At the end of his statement, Dr Rajan makes clear that further monetary actions will be conditioned on continuing progress on high-quality fiscal consolidation.
The main messages in the RBI statement are:

- The RBI doesn't want to be perceived as being behind the curve. On one side, they think the economy is steadily recovering; on the other side, they are not fully buying the strength of the latest revised GDP numbers. That robustness is at odds with the evidence provided by higher frequency measures of production, credit, imports and capacity utilization. The output gap is still there.
- In many aspects, the RBI statement is a full acknowledgement of the Government's efforts to meet qualitative fiscal standards.
  - → In the medium term, the Budget embeds important and valuable reforms to improve supply.
  - → In the short term, by postponing consolidation to a 3% FD by one year (to 2018), the Budget is adding to economic growth. The imbalance between supply and demand can be inflationary at the margin. However, that concern is mitigated by two considerations. First, the Government is still committed to fiscal consolidation (the new higher targets appear more realistic and the shift from spending on subsidies to infrastructure is welcome). Second, the Government is officially on board with the RBI in terms of monetary and fiscal objectives.

2. Indonesia

Economic Outlook

GDP growth in 2014 was at 5.1% YoY, below the 5.7% growth registered in 2013. While final internal demand was quite resilient, the net exports contribution was much lower than the year before. Notwithstanding a depreciation in the Real Effective Exchange Rate (REER), external demand was sluggish and the commodities that are Indonesia's main export struggled. We expect a mild recovery for growth in 2015.
With regard to inflation, we believe it peaked around the end of 2014/beginning of 2015. Going forward, we expect a consistent decline leading towards the Bank Indonesia (BI) target of 4%±1% by the end of the year. The main assumption behind our forecast is a relatively stable oil price, gently increasing towards $60.
The CA deficit has significantly improved since the tapering tantrum of May 2013 (from -4.5% to -2.9% of GDP), when Indonesia was identified as belonging to the fragile five countries among the EM universe. However, the external vulnerability is expected to remain in place for the time being.

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The fiscal deficit target has improved in 2015, and there is room for infrastructure spending.

Budget

On the 12th of February, the 2015 Budget Revision was approved by the Government. It is the first Budget of Jokowi's term, and the will and the *desiderata* of the President are quite evident in it. The fiscal deficit target has been set at -1.9% of GDP for 2015, lower than the most recent one of -2.4%. The improvement on the fiscal side has been obtained mainly through some subsidies rationalization, as Jokowi seized upon the sharp oil price decline.

In the new Budget, the President's commitment in terms of public expenditure is impressive; below we have summarized the main Ministers involved and the levels of spending they are expected to sustain.

The State-Owned Enterprises involved in the projects (Infrastructure, Construction, Mining and Electricity) are to receive capital and cut dividends to increase room to invest.

2015 Budget Revision – Funds for Ministers

Ministries	2015 Initial Budget (Rp tn)	2015 Revised Budget (Rp Tn)	2015 Revised Budget (USD Bn)	% Increase	Net Change
Public Works and Housing	84.9	119.4	9.4	41%	34.5
Reservoirs, Irrigation, Flood Management					8.5
Drinking Water, Housing					9.1
Roads					10
Toll Roads and Port Access					5.8
Social Affairs	8.1	28.9	2.3	257%	20.8
Transportation	44.9	65	5.1	45%	20.1
Sea Infrastructure					11.9
Ship Purchases					
Developing/revitalizing 77 ports					
Redistribution					2.1
Boat and Airplane Purchases					
Connectivity Infrastructure					6.9
Reactivation of moribund Sumatera Railways					
Agriculture	15.9	32.8	2.6	106%	16.9
Irrigation					2
Seeds, Fertilizer, Machinery					14.9

Source: Indonesia Ministry of Finance, Pioneer Investments. Data as of February, 2015.

Monetary Policy

The BI unexpectedly cut rates by 25bp in February, to 7.5%. With regard to the two pillars that the BI monitors in order to make Monetary Policy decisions, inflation is moderating but still far from target and the CA deficit has improved but is still in worrying territory. For these reasons, while we expected a rate cut by the end of this year, we didn't expect one in the short term. In our opinion, with the recent cut they simply erased last November's rate hike after the subsidy cuts had pushed inflation above 8%. In the near term, we do not expect any further intervention, pending clearer evidence of inflation declining towards the target and of the CA improving.

Triggers

- **Indonesia:** Jokowi could boost economic growth through the fiscal savings obtained through subsidies rationalization.

Risks

- **India:** Dr Rajan, unhappy with the lack or postponing of fiscal consolidation, could delay or reduce the monetary easing.

EMEA

1. Turkey

Central Bank of Turkey Cuts Rates Cautiously, as Core Inflation Declines

Despite heavy political pressures around the date of the monetary policy committee meeting, the Central Bank of Turkey (CBT) cut rates cautiously, by 25bp, on February 24. Specifically, the CBT cut one-week repo (the reference rate) and overnight borrowing by 25bp to 7.50% and 7.25% respectively. It also, however, cut the marginal lending facility by 50bp, signalling in general a less active stance in terms of squeezing out excess liquidity or exhuberant credit growth in the system. The market expected a wider cut and a central bank "capitulation" to the political pressures. The CBT in the accompanying statement indicated that the prospect of further declines in core inflation justified the cut, which was in any case cautious. The outcome of February inflation, released on March 3rd, actually vindicated the view of the CBT. In many European countries, the moderate rebound in Brent Crude oil (which averaged 57 USD per barrel in February vs. 50 in January) caused headline inflation to recover a little (from 7.24% in January to 7.55% in February), while core inflation slowed down quite notably (from 8.63% to 7.73%).

Despite the small uptick in headline inflation, it is quite clear that the decline in oil prices is favouring an improvement in external equilibrium: in the two months of December and January the trade deficit declined by 4 bln over the corresponding period last year (from 16.8 bln USD to 12.8 for the two months). On this basis, according to our forecasts this year's CA deficit (including oil) could be in the 3.0-3.5% range, down from the nearly 6% level hit in 2014. However, the picture is unclear considering all the pressure coming from the Government (including rumors of the Minister of Economy's resignation).

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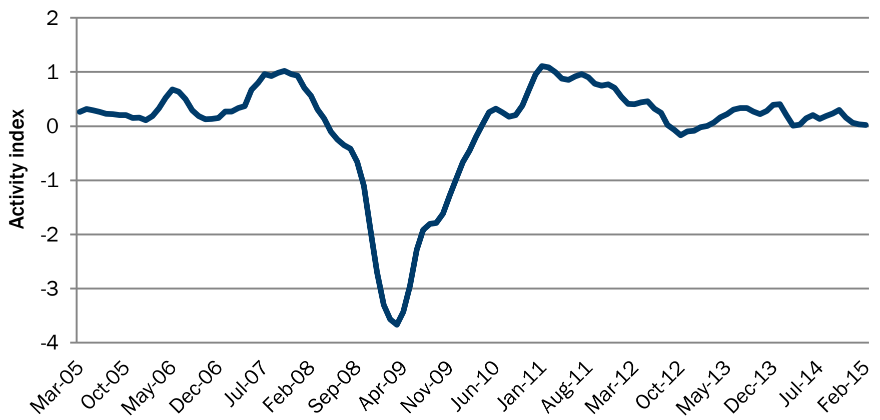
Inflation could Re-enter a Downward Path

In the February reading, a contribution to the rise in headline inflation again came from food prices that were up by a notable 13% YoY. This is partly related to the drought that hit Turkey's agriculture severely and that is playing a role in the slowdown of the economy. However, given last year's dynamics, it seems likely that headline inflation will reenter a downward path in the next two months, likely bottoming in April.

A fragile equilibrium, helped by the decline in commodity prices, is threatened by political tensions.

Turkey: Our Coincident Indicator



Source: Pioneer calculations, as of March 03, 2015.

The Economy is Slowing Mildly

External demand (particularly in the region) is not particularly strong, and the domestic tone is weak as well. In fact, the economy is slowing a bit: our coincident indicator has been declining for the last four months in a row, and it is now practically at 0, the long term average. Industrial output recovered a little in December, but all other figures are on the weak side of expectations, including November unemployment at 10.7% and business confidence declining a bit in both the PMI and the EU Commission survey. However, it is clear that the positive oil shock could have a beneficial impact on economic conditions, provided it is not counterbalanced by a weakening currency.

Politics is Key

The current juncture provides an opportunity, but it does not seem that politicians intend to seize it. The recipe would be to maintain a very cautious monetary policy while stepping up the pace of structural reforms, helped by more favorable external conditions. The political pressures for a much more expansionary monetary policy could undermine the credibility of the Central Bank. If it capitulates, there is the risk of overly weakening the currency, favouring a re-acceleration of inflation and closing this window of opportunity. The rumours of dissenting positions inside the Government are also not helping.

2. Russia

Economic Outlook

We have revised our growth outlook to -3.5% in 2015. The Minsk ceasefire failed to hold, and authorities were back at the table in February, with France and Germany helping broker the Minsk II agreement. However, we believe it is unlikely that either EU or US sanctions will be lifted in the coming year; in fact there is an increased probability of further sanctions. Together with the lower oil price, this will further damage access to funding (Russia's external credit, mostly private, is in excess of US$700bn), business and consumer confidence, and therefore output. December saw further rapid ruble devaluation amid very limited market liquidity. The authorities have stabilized the ruble with rate hikes and a commitment to interventions. Going forward, monetary and fiscal policies are likely to remain relatively tight. Nontheless, two rating agencies have downgraded Russia to sub-investment grade.

Inflation continues to move up as a consequence of ruble weakness, and is hurting consumers' purchasing power.

Real wages nosedived by -8.0% YoY in January, after averaging about 1.5% in 2014. Unemployment ticked up a little to 5.5% YoY in January, but remains low. Such historically low unemployment despite the sharp slowdown in the economy highlights the unfavorable demographic trend and supports our premise of low potential growth in Russia. According to our model, retail sales can be predicted by real wages, consumer confidence, and wealth effects. As expected, after a temporary devaluation-driven pick-up in December, retail sales fell sharply by -4.4% YoY in January.

Monetary Policy

Should the ruble remain relatively stable, we expect the Bank of Russia to focus more on domestic policy concerns. Following the rapid depreciation of the ruble and the subsequent severe tightening, the Bank of Russia used the first opportunity in 2015 to loosen monetary policy. Still the key policy rate is high at 15%, up from 5.5% just a year ago. Inflation surprised to the upside, hitting 15% in January from 6.5% at end-2013, despite the sharply decelerating economy. We believe the passthrough effect from the doubling of the ruble exchange rate (now mid-60s to the USD up from about 35 in early-2014) is yet to be fully seen. We expect inflation to peak in the second quarter of 2015. However, the Bank of Russia is likely to use any opportunity, assuming stable exchange rates, to support domestic credit conditions.

Triggers

- EU sanctions on Russia are lifted before summer 2015.

Risks

- Main risks are still on the geopolitical side: the Ukraine-Russia issue can impact via volatility in the market, commodities prices and also direct trade links.

Latin America

1. Brazil

Economic Outlook

President Rousseff's popularity has continued to fall since she took office in autumn 2014. Dilma Rousseff received 51.6% of the votes, edging out the opposition candidate Aécio Neves, who received 48.4% in the second and final round on a pro-markets platform. The tightest election in recent history should send a strong message to President Rousseff. Her most recent 23% approval rating compares to her past average of 47% and Lula's 54%. The President's room for maneuver is further constrained by the fact that her party does not control Congress.

The government drew a red line at the risk of losing Brazil's investment grade rating. Likely at the suggestion of former President Lula, President Rousseff has appointed an experienced technocrat, Joaquim Levy, as the new Minister of Finance. Levy has been given the task of implementing the necessary fiscal adjustments in order to avoid a rating agency downgrade. The market has reacted positively, and was further surprised to the upside as Mr. Levy proceeded to announce just short of 2% of GDP in fiscal adjustment measures, some of which even touch on politically sensitive areas. Risks stem from the Congress failing to approve the measures and a negative growth outlook; the budget was drafted assuming 0.8% growth in 2015. Fiscal data so far has been mixed, with the central government showing fair results and state and regional government surpluses surprising to the upside in January. We believe it is too early in the year and one should not read too much into monthly budget execution numbers.

Monetary Policy

The Central Bank surprised the market by hiking rates shortly after the elections, and likely to stay cautious in 2015. So **far, i**nflation has surprised to the upside in 2015, owing to the administrative price increases and sticky elevated inflation of other components. Exchange rate pass-through is also a threat. The Central Bank is likely to continue with some version of the swap program after it expires in March, and is most likely not ready to start reducing the stock of about USD$100bn of swap operations. We expect further rate hikes from the Central Bank, possibly to as high as 13%, and for a benchmark rate of 12.5% around year end.

Growth is likely to continue to surprise to the downside, while fiscal and monetary policy will need to remain tight.

Market consensus on the growth outlook has become increasingly negative, and further negative surprises cannot be ruled out. The consensus among leading market participants has moved towards a -0.5% GDP forecast in 2015. We believe that it is likely the contraction will be more severe, closer to -1.5%, on the back of a sharper deceleration in investments and consumption. The Petrobras corruption scandal has frozen investment activity and credit provision. By the end of April, Petrobras is required to provide audited financial statements that address the corrupt expenditures and propose measures to prevent this from happening in the future; an agreement with the auditors has yet to be reached. On the consumption side, unemployment worsened sharply, albeit from a very low base, to 5.3% in January from 4.3% a month earlier, while real wages have already turned negative. Business and consumer confidence have continued to decelerate.

Triggers

- Approval by Congress of the fiscal adjustment measures.
- Further hikes by the Central Bank while allowing for the currency weakness.
- Structural reforms.

Risks

- Social unrest as economic conditions continue to worsen.
- Petrobras corruption scandal broadening.
- Government giving up on adjustments.
- Loss of investment grade status.

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