Connecting Markets East & West

CEEMEA Sovereigns – trends and considerations

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Emerging Markets
Credit Trading Desk

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2018 global risk outlook is still driven by US-related events

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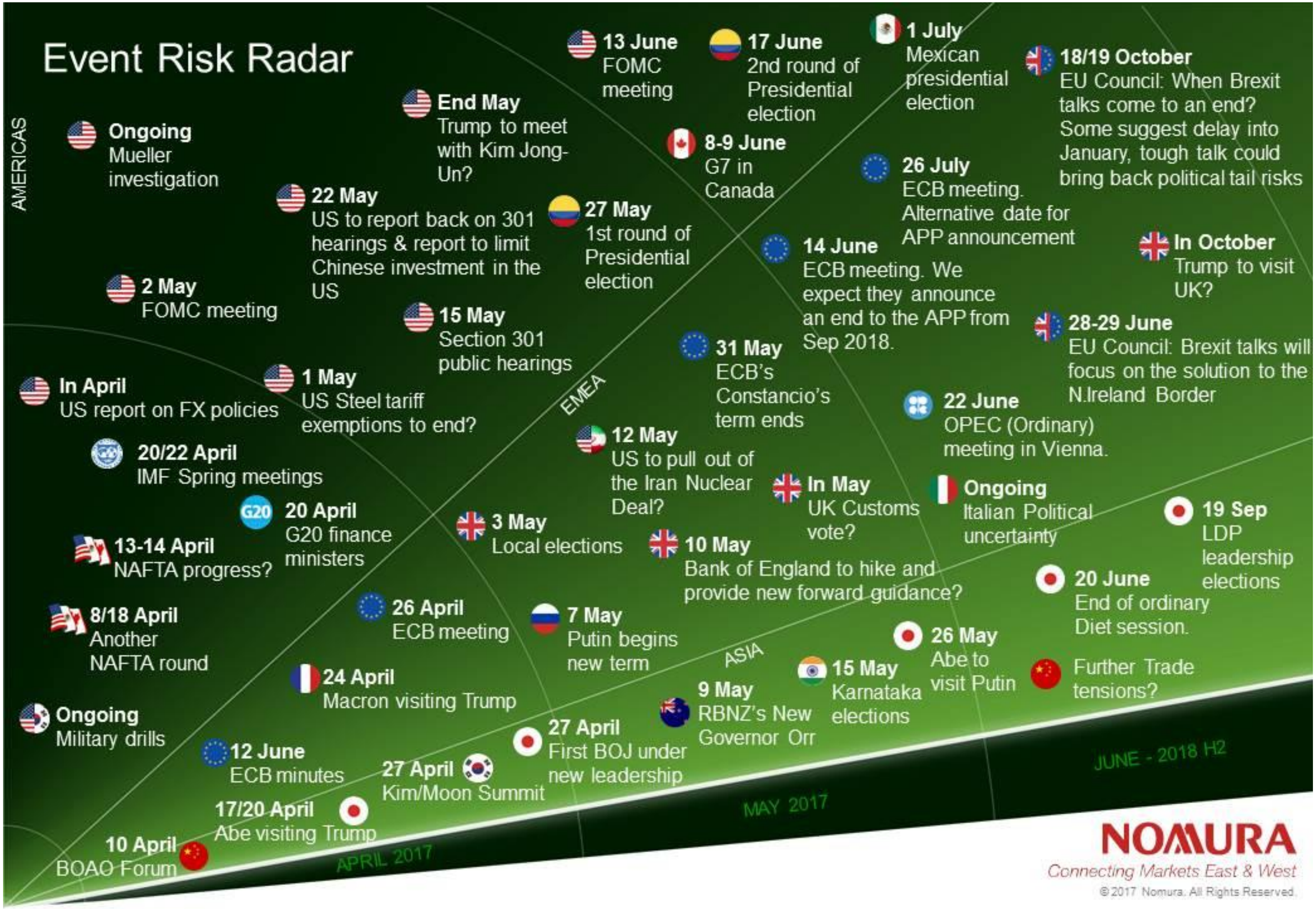

Source: Nomura Global Economics.

Despite protectionism risk, near-term growth outlook looks good

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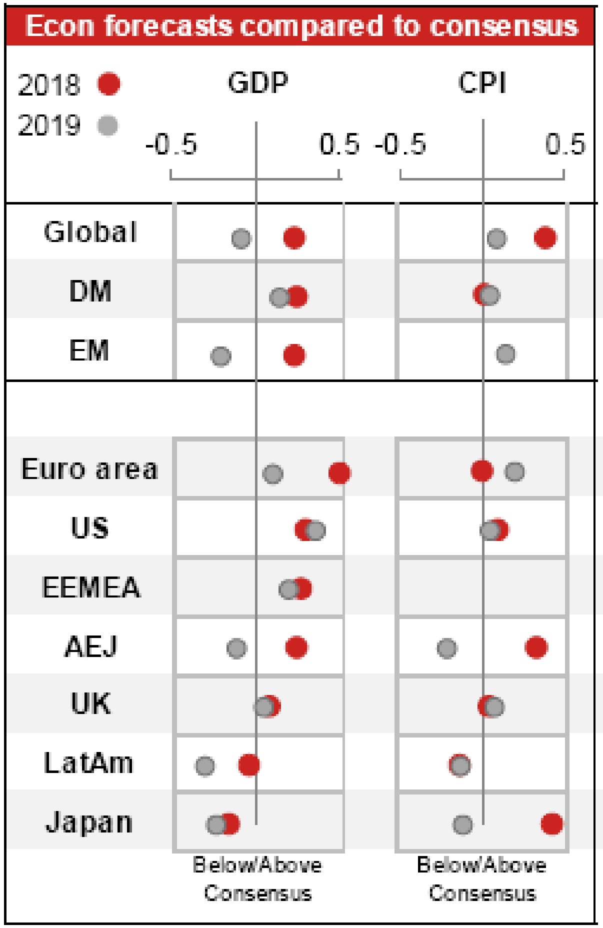

Source: Nomura Global Economics, Bloomberg.

- *Despite the growing threat of more protectionism, Nomura analysts remain upbeat regarding near-term outlook for the global economy. The latest global GDP growth forecast is for 4.0% in 2018 (revised down slightly from 4.1% last month) and 3.8% in 2019.*
- *Slightly faster policy normalisation is now expected in the US, including four Fed hikes this year (and two more in 2019). The euro area's relatively large loss of economic momentum has led to revision lower of our GDP growth forecast for 2018 (to 2.4%, from 2.8% earlier) and expectation of a 2-month taper of asset purchasing. The first hike is now expected in March 2019, rather than in December 2018. The BoE is expected to raise rates by a cumulative 50bps in both 2018 and 2019 while the BOJ should maintain its policy stimulus.*
- *In EM, continued steady growth and mostly low inflation are grounds to hope for the best, but investors need to stay vigilant, as large parts of EM have been recipients of the global QE-induced hunt for yield. For years, EM has been riding the wave of strong capital inflows, ample liquidity and low interest rates, which has led to a large build-up of debt and misallocations of capital. We stress the need for investors to distinguish among individual credit stories in each EM region, to identify likely outperformers.*

US: fiscal easing to sustain late-cycle growth surge

The late-cycle surge will likely continue through 2018, boosted especially by fiscal policy, with 4 hikes in 2018

- We expect the US economy to continue to grow above potential. A pick-up in government spending should support growth over the next year. Job gains remain above the long-term sustainable pace, pushing the unemployment rate down to levels not seen since 2001.
- Transitory factors that contributed to the weak inflation in 2017. In 2018 and 2019, core inflation is expected to pick up gradually as labour markets tighten.
- Nomura economists expect FOMC to continue withdrawing policy accommodation steadily, by raising short-term interest rates four times in 2018 and two more in 2019.
- The US and China escalated tit-for-tat threats of imposition of tariffs. At the moment, we continue to view these actions as opening positions for an eventual negotiated settlement.

United States: Details of the forecast

%	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	2017	2018	2019
Real GDP	1.2	3.1	3.2	2.9	1.6	3.1	3.4	3.4	2.4	2.1	2.1	2.0	2.3	2.7	2.6
Unemployment rate	4.7	4.3	4.3	4.1	4.1	3.8	3.7	3.6	3.4	3.3	3.2	3.2	4.3	3.8	3.3
Nonfarm payrolls, 000	177	190	142	221	202	205	195	190	180	165	150	140	182	198	159
Housing starts, 000 saar	1238	1167	1172	1256	1255	1258	1260	1265	1280	1295	1310	1330	1208	1259	1304
Consumer prices (y-o-y)	2.6	1.9	2.0	2.1	2.3	2.6	2.7	2.5	2.2	2.3	2.3	2.3	2.1	2.5	2.3
Core CPI (y-o-y)	2.1	1.8	1.7	1.7	1.9	2.3	2.4	2.5	2.4	2.5	2.5	2.6	1.8	2.3	2.5
PCE Deflator (y-o-y)	2.0	1.6	1.5	1.7	1.8	2.2	2.3	2.1	2.0	2.0	2.0	2.1	1.7	2.1	2.0
Core PCE (y-o-y)	1.8	1.5	1.4	1.5	1.7	2.0	2.1	2.1	2.0	2.1	2.2	2.3	1.5	2.0	2.1
Federal budget (% GDP)													-3.5	-4.0	-5.2
Current account balance (% GDP)													-2.4	-2.8	-3.1
Fed securities portfolio ($trn)	4.25	4.24	4.24	4.22	4.18	4.08	3.96	3.84	3.74	3.61	3.49	3.40	4.22	3.84	3.40
Fed funds target	0.75-1.00	1.00-1.25	1.00-1.25	1.25-1.50	1.50-1.75	1.75-2.00	2.00-2.25	2.25-2.50	2.50-2.75	2.50-2.75	2.75-3.00	2.75-3.00	1.25-1.50	2.25-2.50	2.75-3.00
TSY 2-year note	1.27	1.38	1.47	1.89	2.27	2.50	2.75	3.00	3.00	3.00	3.00	2.88	1.89	3.00	2.88
TSY 5-year note	1.93	1.89	1.92	2.20	2.56	2.75	3.00	3.13	3.13	3.00	3.00	2.88	2.20	3.13	2.88
TSY 10-year note*	2.40	2.31	2.33	2.40	2.74	3.00	3.25	3.25	3.25	3.13	3.00	2.88	2.40	3.25	2.88

Source: Nomura Global Economics, BEA, BLS, Federal Reserve, Bloomberg.,

Euro area: cuts to Q1 growth and inflation forecasts

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Nomura analysts have adjusted their Euro area's GDP growth and inflation forecasts for 2018 slightly lower.

- Economic growth unexpectedly slowed in Q1 (to expected 0.5% q-o-q). Most of this deceleration can be ascribed to temporary factors such as bad weather conditions, strike action in Germany and fears of a global trade war. Still, labour market activity is still strong, outlook for investment is good owing to still favourable financial conditions, and fiscal policy is now expected to be slightly more pro-cyclical in the coming months. In 2018 GDP is likely to grow 2.4%.
- Core inflation in March was below expectations. However, Nomura analysts still expect core inflation to grind higher in the coming months thanks to more acute capacity pressures and higher levels of inflation expectations.
- The weaker-than-expected growth and inflation data in recent months mean we now expect some tapering of the ECB's APP from EUR30bn in September to EUR15bn in October (and then to zero in November). We had previously expected the APP to stop in September. We now expect the first rate hike in March 2019 (rather than this December).

Euro Area: Details of the forecast

	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	2017	2018	2019
Real GDP (% q-o-q)	**0.6**	**0.7**	**0.7**	**0.7**	0.5	0.6	0.6	0.6	0.5	0.4	0.4	0.4	**2.5**	2.4	2.0
Real GDP (saar)	**2.6**	**2.9**	**2.8**	**2.7**	1.8	2.5	2.4	2.4	2.0	1.6	1.6	1.6	2.5	2.4	2.0
Unemployment rate	**9.5**	**9.1**	**9.0**	**8.7**	8.6	8.4	8.3	8.2	8.1	8.0	7.9	7.8	**9.1**	8.4	8.0
Compensation per employee	**1.4**	**1.6**	**1.6**	**1.8**	1.9	2.1	2.2	2.2	2.2	2.3	2.3	2.4	**1.6**	2.1	2.3
Labour productivity	**0.5**	**0.8**	**1.0**	**1.1**	1.3	1.3	1.4	1.4	1.4	1.3	1.2	1.0	**0.8**	1.3	1.2
Unit labour costs	**0.9**	**0.8**	**0.6**	**0.7**	0.9	1.1	1.2	1.2	1.3	1.3	1.3	1.3	**0.7**	1.1	1.3
ECB main refi. rate	**0.00**	**0.00**	**0.00**	**0.00**	0.00	0.00	0.00	0.00	0.00	0.10	0.30	0.50	**0.00**	0.00	0.50
ECB deposit rate	**-0.40**	**-0.40**	**-0.40**	**-0.40**	-0.40	-0.40	-0.40	-0.40	-0.25	-0.15	0.05	0.25	**-0.40**	-0.40	0.25
3-month rates	**-0.33**	**-0.33**	**-0.33**	**-0.33**	-0.30	-0.30	-0.30	-0.20	-0.05	0.05	0.25	0.45	**-0.33**	-0.20	0.45
10-yr bund yields	**0.33**	**0.47**	**0.46**	**0.43**	0.55	0.70	0.80	0.90	1.10	1.20	1.30	1.40	**0.43**	0.90	1.40
$/euro	**1.07**	**1.14**	**1.18**	**1.20**	1.20	1.23	1.27	1.30	1.33	1.35	1.39	1.40	**1.20**	1.30	1.40

Source: Nomura Global Economics, ONS, Bloomberg.

China – trade negotiation is underway

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Trade conflict with the US has escalated recently but we see room for both sides to negotiate

- We expect real GDP growth to slow gradually to 6.5% in 2018 after a robust 6.9% in 2017. The slowdown will be driven mainly by moderating investment growth (due to the peaked credit cycle and cooling property sector), structural reforms and environmental-protection efforts. Despite the solid global growth outlook, we believe the likely real effective exchange rate appreciation and China-US trade tensions will weigh on Chinese export growth in the coming quarters. In the longer term, we expect growth to slow further as the economy continues to rebalance.
- Nomura economists expect a mild rise in CPI inflation to 2.4% in 2018 from 1.6% in 2017 due to higher food and services prices and pass-through from high property prices. Comments by the new PBoC Governor suggests that the neutral monetary policy stance will be maintained and financial sector liberalisation will be pushed further.

China: Details of the forecast

% y-o-y growth unless otherwise stated	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	2016	2017	2018	2019
Real GDP	**6.9**	**6.9**	**6.8**	**6.8**	6.7	6.6	6.5	6.3	**6.7**	**6.9**	6.5	6.1
CPI	**1.4**	**1.4**	**1.6**	**1.8**	2.3	2.3	2.4	2.4	**2.0**	**1.6**	2.4	2.0
Core CPI	**2.0**	**2.1**	**2.2**	**2.3**	2.1	2.2	2.1	2.2	**1.9**	**2.2**	2.2	1.7
PPI	**7.4**	**5.8**	**6.2**	**5.9**	4.7	4.8	3.0	-0.3	**-1.4**	**6.3**	3.0	-0.6
Retail sales (nominal)	**10.0**	**10.8**	**10.3**	**9.9**	10.4	10.1	10.3	10.3	**10.4**	**10.2**	10.3	9.8
Fixed-asset investment (nominal, ytd)	**9.2**	**8.6**	**7.5**	**7.2**	7.2	7.0	6.8	6.5	**8.1**	**7.2**	6.5	6.0
Industrial production (real)	**6.8**	**6.9**	**6.3**	**6.2**	6.0	5.8	5.6	5.6	**6.0**	**6.6**	5.8	5.2
Exports (value)	**7.2**	**8.2**	**6.4**	**9.7**	6.0	5.5	4.5	4.0	**-7.7**	**7.9**	5.0	4.0
Imports (value)	**24.3**	**14.1**	**14.6**	**12.5**	10.0	9.0	7.0	6.5	**-5.5**	**15.9**	8.0	5.0
Trade surplus (USD bn)	**60.4**	**117.4**	**113.8**	**130.9**	47.0	108.4	107.5	124.2	**509.7**	**422.5**	387.1	382.8
Current account (% of GDP)	**0.7**	**1.7**	**1.3**	**1.8**	0.8	1.3	1.1	1.2	**1.7**	**1.4**	1.1	0.8
Fiscal balance (% of GDP)									**-3.8**	**-3.7**	-4.0	-4.0

Source: CEIC, Nomura Global Economics.

DM policy normalisation to test EM resilience

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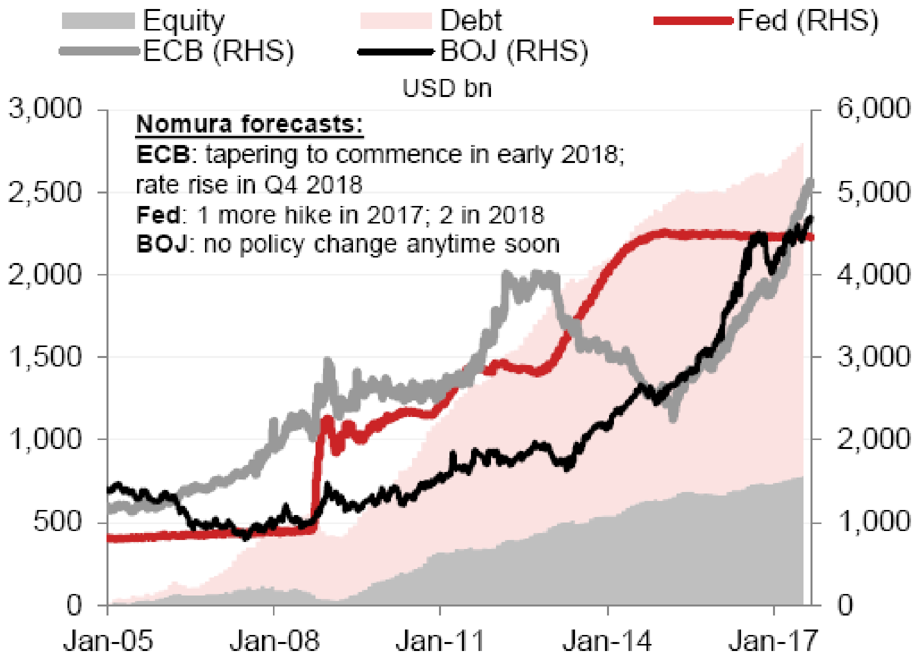
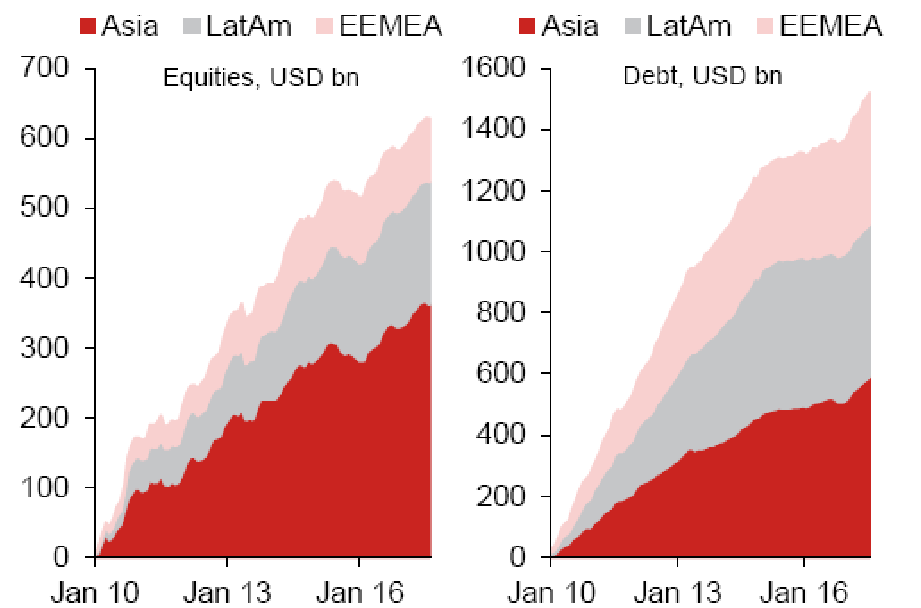
A reversal of $1.6trn bond and $0.7trn equity inflows into EM since 2009 would expose remaining vulnerabilities

Fig. 1: Central bank balance sheets and EM portfolio flows



Note: Shaded areas represent cumulative EM portfolio flows; lines are total balance sheet assets. Source: CEIC, IIF, Nomura.

Fig. 2: EM portfolio flows by region



Source: IIF, Nomura.

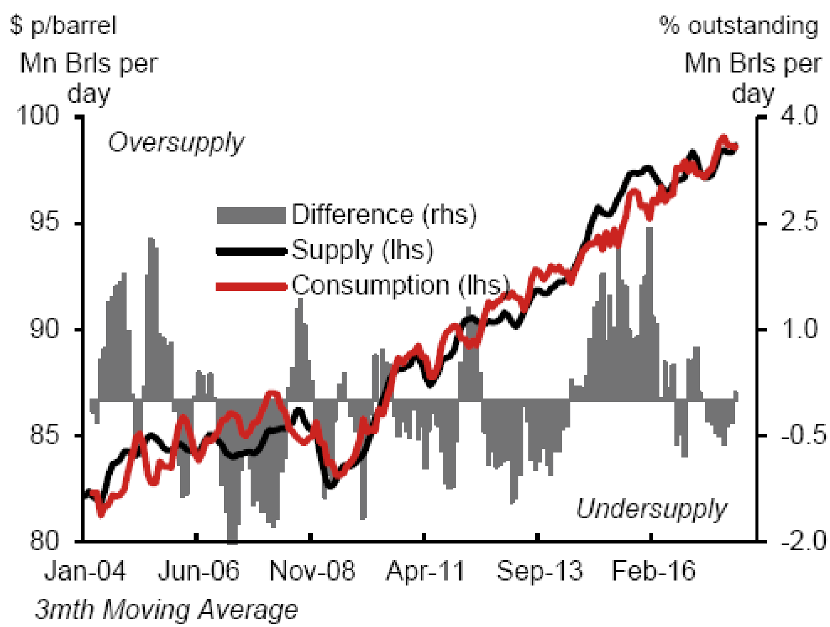
- Ongoing tightening of liquidity conditions globally will test resilience of EM economies, particularly those with large funding needs or recent rapid credit expansion.
- At the same time, acceleration of global growth should help many EM players, by supporting commodity prices and offering a possibility of improving debt profiles / ratios for those economies that are capable of growing with the help of FDI, without attracting significant debt creating flows.

OPEC / non-OPEC cooperation puts a floor to oil prices

Impact of a 10% change in oil prices on the region's key economies is material:

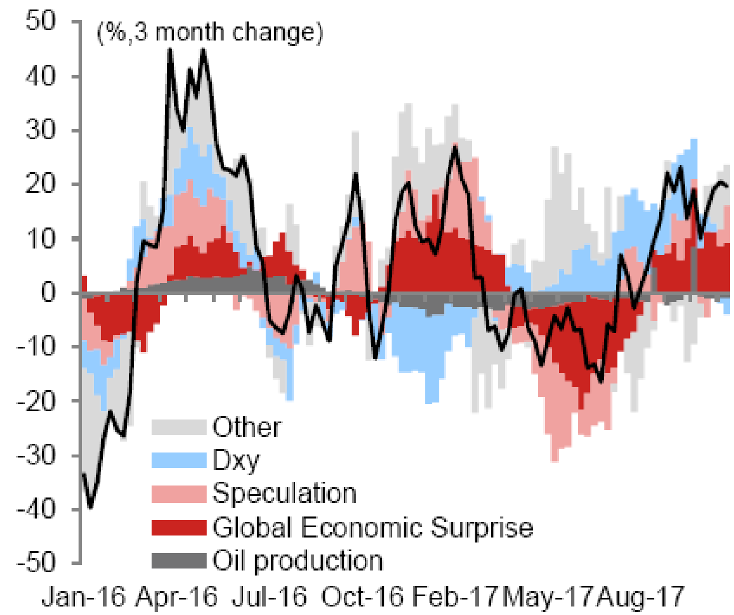
- Largest positive correlation: Nigeria (0.6pp, 0.8pp of GDP), Russia (0.7pp, 1.2pp), Saudi Arabia (1.0pp, 2.5pp, respectively).
- Neutral: Hungary, Poland, Romania.
- Small negative correlation: Egypt (a 0.1pp of GDP loss for current acct.), South Africa (a 0.5pp increase in inflation).
- Large negative correlation: Turkey (0.3pp of GDP in further current account deficit, 0.6pp higher inflation), Ukraine.

Positive oil market fundamentals should support prices



Source: Nomura, Bloomberg.

Oil price decomposition



Source: Nomura, Bloomberg. Breakdown of Brent oil prices is based on weekly data on US oil output, Global Surprise index, CSFC data, US dollar index.

CEEMEA spreads reflect liquidity, credit trajectories

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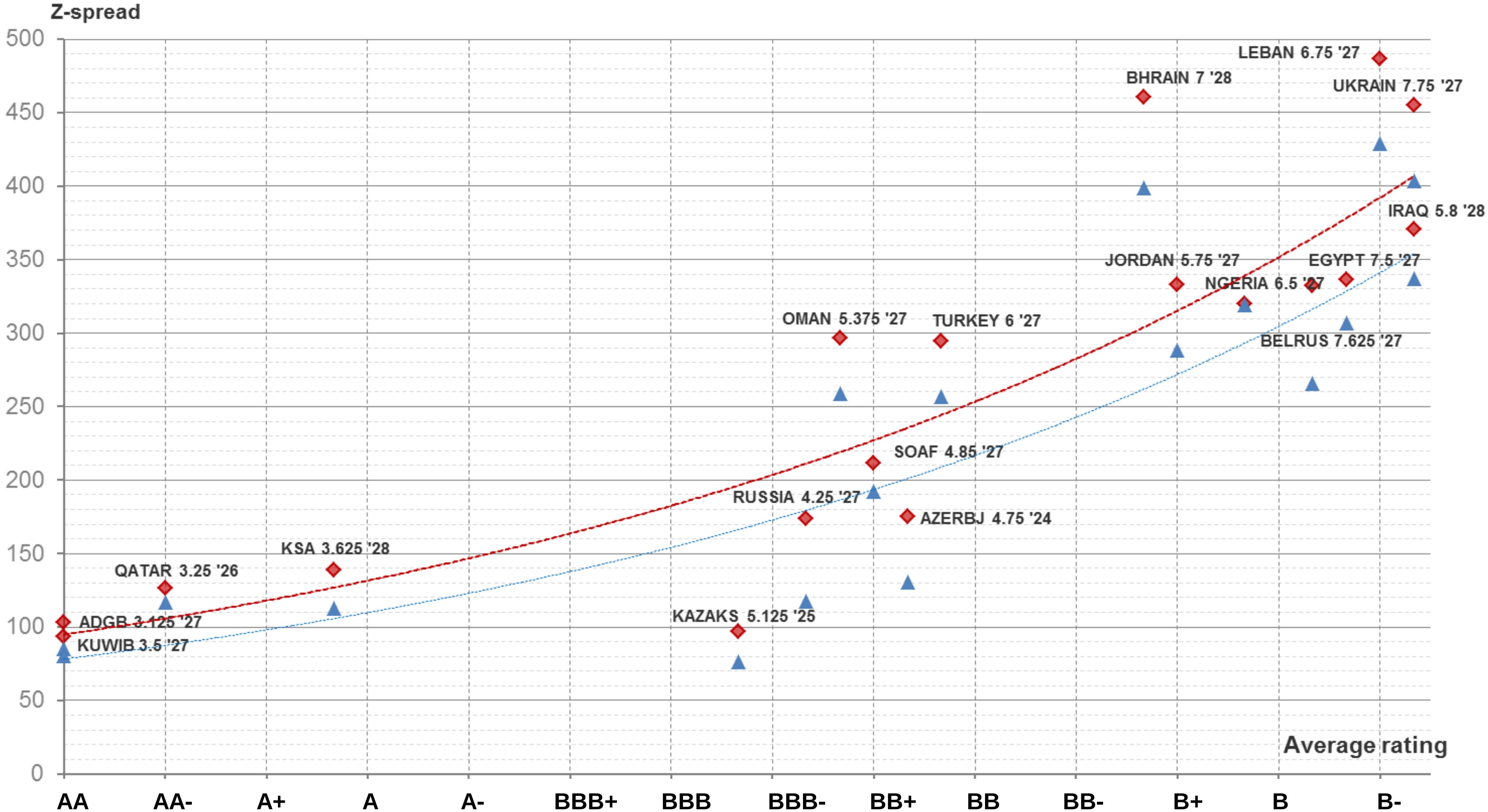
Selected CEEMEA 10-year sovereign spreads (1.02.18 - 18.04.18), bps



Average of ratings published by Moody's, S&P and Fitch.
Source: Nomura CEEMEA Credit Trading Desk, Bloomberg

Bahrain spreads are the widest in the longer end

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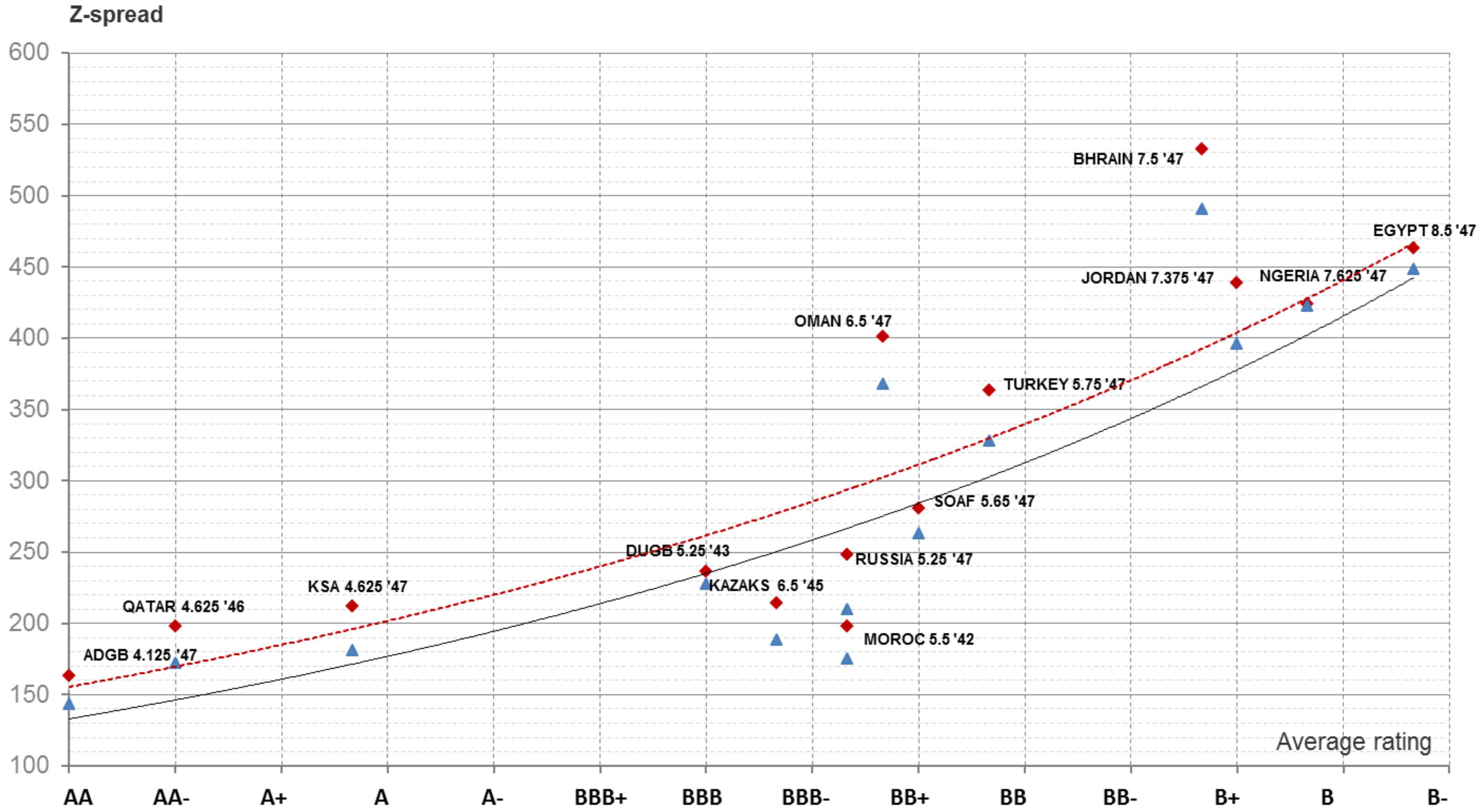
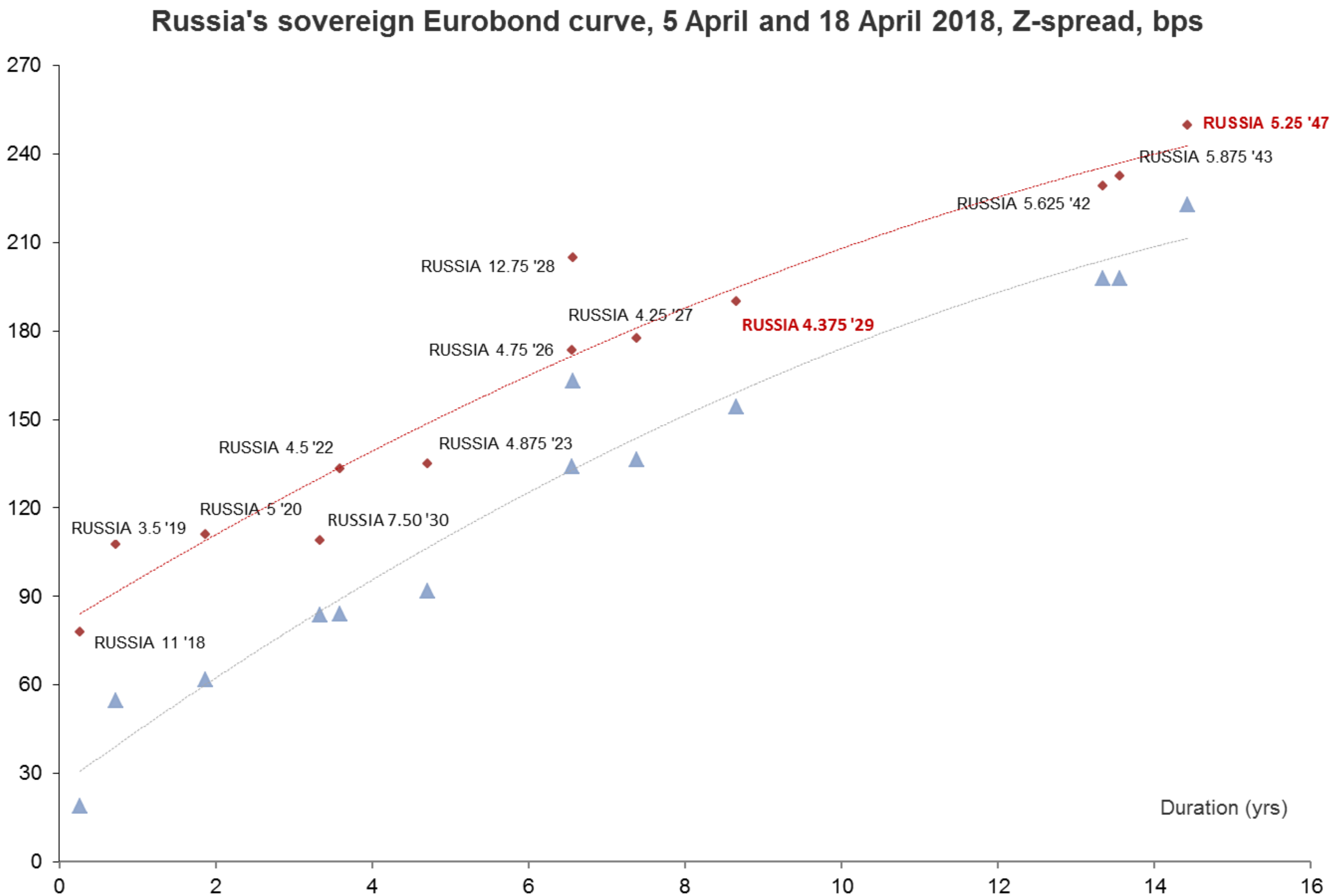
Selected CEEMEA 30-year sovereign spreads (1.02.18 - 18.04.18), bps



Average of ratings published by Moody's, S&P and Fitch. Dubai sovereign ratings have been approximated on the basis of published ratings for Dubai Electricity and Water Authority.
Source: Nomura CEEMEA Credit Trading Desk, Bloomberg

Russia's recently issued tranches look particularly interesting



Source: Nomura CEEMEA Credit Trading Desk, Bloomberg

Away from Russia, we see value in oil and in evolving sovereigns NOMURA

- Pending more clarity on the outcome of the Russia-US standoff, we expect other prominent oil/gas names in our region (in FSU and GCC) to do well.
- In absence of proactive fiscal reform or a CCC rescue package Bahrain is set to remain under pressure. Oman is facing some risk of a further downgrade by Moody’s (in November) but has clearly benefited from consequences of the conflict around Qatar.
- South Africa at the moment is the most promising credit story in the region, with both the rand and local currency bonds offering some advantages over hard currency debt. Some South African corporates offer attractive exposure to the resource sector.
- Turkey newsflow ahead of June 24th early election is set to stay volatile. However, the cheap currency and scope for some policy tightening point to potential upside for TRY and for banking sector assets.
- An alternative to the Russian sovereign risk at present is Belarus (which is likely to do well while oil prices are elevated, thanks to the resulting large energy subsidies). Ukraine looks cheap but would become cheaper if political tensions preclude an IMF deal.

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