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WEEKLY INVESTOR RESEARCH

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The difference between fragility and resilience

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Last year Emerging Markets (EM) clocked up 4.7% growth despite a 200bp rise on average in their borrowing costs (according to JP Morgan's GBI-EM GD local currency government bond index) and the largest outflow since the Lehman crisis. If developed economies had experienced a similar tightening of their financial conditions it would have been extremely damaging, bordering on catastrophic, in our view. Therein lies the most salutary lesson of the past year: EM is vastly more resilient than developed economies. Developed markets are sustained by deliberate policies of asset price inflation in lieu of reforms. If you want to protect the purchasing power of your capital you should consider staying well clear of them. We provide updates on Russia, Ukraine, Brazil, Turkey, India, Philippines, China, Indonesia and Argentina.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,090	–	0.51%
MSCI EM Small Cap	1,115	–	0.81%
MSCI FM	697	–	0.45%
GBI EM GD	6.53%	–	0.54%
ELMI+	3.19%	–	0.05%
EMBI GD	5.09%	272 bps	0.47%
EMBI GD IG	4.25%	184 bps	0.54%
EMBI GD HY	6.97%	477 bps	0.34%
CEMBI BD	5.06%	293 bps	0.23%
CEMBI BD HG	4.22%	206 bps	0.33%
CEMBI BD HY	6.92%	483 bps	0.03%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2003	0.32%
VIX Index	11.98	2.39%
5 year UST	1.63%	-4 bps
10 year UST	2.34%	-4 bps
US HY	5.53%	0.14%
European HY	4.62%	0.23%
EURUSD	1.3140	-0.44%
USDJPY	104.16	0.19%
Brent	101.87	1.11%
Copper	325.93	-0.76%
Gold	1289.69	0.90%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets

When former Fed Chairman Ben Bernanke announced tapering in May 2013 he inflicted a major shock on financial markets, impacting both developed and Emerging Markets, both in terms of fundamentals and asset prices. The effects on asset prices are of course familiar: the US treasury curve re-priced 100bps, EM sovereign borrowing costs rose by a whopping 200bps from 5.25% to 7.25%, and one third of all US mutual fund holdings in EM local markets were sold. This was the largest outflow since 2008/2009.

A year down the road, we can assess how these market moves impacted fundamentals in developed and Emerging Markets economies. Did the subsequent economic performance justify how the market traded at the time of the shock? More importantly, what did we learn about what financial tightening might do to economies and policy choices going forward?

The first observation is that Emerging Markets fundamentals were far more robust than last year's price action – and the hysterical media coverage that accompanied it – would have suggested. Last year Emerging Markets grew 4.7% in real GDP terms, which is actually 0.1% higher than the average growth rate from 1980-2013. The sell-off from May 2013 to January 2014 did not cause a single sovereign default,[1] no country ran out of FX reserves, China did not have a hard landing, and the 'Fragile Five' quickly turned into the 'Frugal Five'. The level of corporate defaults rose temporarily, it has since fallen and in any case the temporary increase in defaults was unrelated to anything that happened in the US treasury market. A small number of EM countries with self-inflicted cyclical challenges came under pressure, but quickly addressed their problems (mainly excessive demand). This year the IMF expects EM to grow about 4.9%, according to its April 2014 World Economic Outlook, though we think there is moderate downside risk to this forecast.

In short, there was no real fundamental story for EM in 2013 despite the violent market price action. Why then did markets sell? Partly there were technical reasons. Many investors had invested only very late in the recovery rally that followed the Greek default in Q3 2011. Speculative money had also tried to front-run illusory Japanese inflows. But the more important reason is tragically familiar: Tapering was a new piece of uncertainty on the global horizon. Rather than try to work out how tapering might actually impact – or not impact as it happens – EM fundamentals, many investors instead simply reverted to the simple rule of thumb of buying something in America and selling

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[1] Argentina has since defaulted, but this has nothing to do with tightening of US monetary policy.

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something in EM. Banks, sensing the opportunity to cross some bonds, started to flog all kinds of misleading arguments about EM's alleged fragility, while the media leapt on the opportunity to sell more papers.

A more sober assessment might conclude that developed markets fared less well than EM. Apart from the temporary and relatively short-lived 100bps rise in US treasury yields developed economies were largely spared a big shock last year. Yet, this 100bps move so damaged the US housing market that it prompted the Fed to abandon its attempt at tapering before the policy had even begun. When the Fed tried again in December the US economy soon fell into its weakest quarter of growth since 2008/2009 and now looks set to clock up another year of unexciting 2% growth. Europe's growth rate also showed very little dynamism. The bounce-back from the European debt crisis was tepid – did not even reach a 1% real GDP growth rate – before it gave way to renewed weakness. The ECB is now rapidly moving towards yet more monetary stimulus. And Japan slumped to -6.8% qoq annualised growth in Q2 due to a single tax hike. How on earth will Japan ever address its 200% public debt to GDP ratio?

How would developed economies have fared if *their* borrowing costs had gone up by 200bps last year? What if one third of *their* investors had fled? The answer is that the effect on developed economies would have been bordering on *catastrophic*.

The lesson is salutary. Developed economies are in no shape to handle any serious monetary shock in our view. The policy responses across the heavily indebted developed economies have been to lift asset prices, but precious little has been done to reform the underlying economies and dealing with serious underlying imbalances and debt problems. Underneath the thin veneer of asset price inflation, developed economies remain extremely fragile. Their performance was – and is – wobbly. Going forward, one does wonder how developed economies will handle the enormous tightening challenge that faces them. One thing seems certain: tightening will be slow and very long drawn out. And inflation seems to be the only way out of the debt.

• Russia, Ukraine: The excellent opportunity for the European Union to strike a deal with Russian President Vladimir Putin over Ukraine in the past few weeks has passed. Sadly, Europe managed once again to snatch defeat from the jaws of victory by failing to take advantage of the Ukrainian army's progress on the ground in Eastern Ukraine and the various olive branches extended by Putin following the latest round of sanctions some weeks ago. Instead, Ukraine over-extended itself on the battlefield at which point Russia struck hard and inflicted severe losses on the Ukrainians, including fresh loss of territory beyond the Donetsk-Luhansk regions. Russian involvement appears to have been stepped up significantly, marking a sudden and clear escalation. As a consequence of these latest developments, Russia's foothold in Eastern Ukraine has now been significantly extended, which places Putin in a far stronger negotiating position than just a week ago. It should therefore not surprise if Russia now calls for a ceasefire. For Ukraine and the West, a deal will now be far more expensive. Rather than take what is on offer, further sanctions against Russia followed by counter-sanctions and possibly more ground action in Eastern Ukraine now seem likely. This will only increase the Russian presence on the ground even further, and thus, ultimately, place Europe in an even weaker bargaining position.

What about the US? America will now likely become more vocal against Russia, but ultimately the US is of marginal importance in this conflict because it has far less 'skin in the game' than Europe. The US therefore mainly serves the role of 'bad cop' (against Germany's 'good cop').

We maintain the view that this crisis will find a diplomatic solution, though sadly now – it seems – only after a third round of needless escalation and loss of life. The economic interests on both sides are enormous. Thus, sanctions, if they materialise, which seems likely, are likely to be contained as it is already clear that the existing sanctions are hurting Europe as much as they are hurting Russia (or at least Russia seems more capable of living with the pain).

Ultimately, Russia is the stronger party economically and more willing to commit itself militarily. It has the money, the military might and the resilience, while Europe is divided, vulnerable, slow, and indecisive. Russia's deeper macroeconomic fundamentals are also vastly better than those of most European countries, including ten times less debt, huge reserves, flexible exchange rates, and control over some of the world's largest energy reserves. However, the sanctions are likely to trigger a recession and rises in consumer prices.

Of course, ultimately the NATO powers are far more formidable than Russia's armed forces, but a commitment of NATO forces in this conflict seems very unlikely. Perhaps most importantly, time is on Russia's side. As winter draws nearer Russia's leverage over Ukraine – and ultimately Europe – rises exponentially due to the latters' dependence on Russian gas.

• Ukraine: The IMF approved the latest USD 1.4bn disbursement of funds under the standby agreement. This disbursement is not a big surprise; the West remains strongly wedded to supporting the pro-Western Poroshenko administration in Kiev.

• Brazil: There were two noteworthy developments in Brazil this week: the economy and the polls. The economy is now formally in recession following a downwards revision to Q1 data (-0.2% real GDP) and a -0.6% real GDP growth rate in Q2. The slump is happening despite lavish fiscal spending and rapid extension of credit from government institutions. Brazil's economic problems are entirely self-inflicted. A deliberate choice to

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expand benefits to a broader part of the population at the expense of the overall fiscal balance plus confidence-sapping interventions in external markets under Finance Minister Guido Mantega have completely destroyed the will on the part of Brazilian firms to invest. Not all is lost. The central bank still has reasonable freedom to set interest rates and has not shied away from driving policy rates significantly above the nominal growth rate of the economy in order to keep inflation in check. The underlying fundamentals in Brazil are also still good – a sustainable debt burden, a (smaller) primary fiscal surplus and USD 380bn of FX reserves. As such, the largest casualty of Brazil's economic performance could well be President Dilma Rousseff herself. A poll released by Datafolha, a credible pollster, places opposition candidate Marina Silva level with Dilma Rousseff at 34%, and predicts Marina to win in the second round with 50% of the vote versus 40% for Dilma. This marks further gains for Marina compared to a previous poll, which had given her 21% compared to Dilma's 36%. Marina Silva released her economic program over the weekend. As can be expected, the program lacked detail (Marina's policy right now is likely to be to let Dilma self-destruct while avoiding exposing herself to attack). Still, we note a commitment to an independent central bank, reducing debt, adjusting managed prices, reduced indexation, a flexible exchange rate, ending discretionary interventions at microeconomic level of the economy, not using state-owned enterprises as instruments of macroeconomic policy, and improving economic efficiency.

- Turkey: Prime Minister Ahmet Davitoglu appointed Mevlut Cavusoglu, former European affairs minister, as Turkey's new foreign minister. This might signal a desire to move closer to Europe – or at least give Turkey the option to should the need arise. Importantly, he also re-appointed the entire economic team, including Ali Babacan and Mehmet Simsek as Deputy Prime Minister with responsibility for the Economy and Finance Minister, respectively. Babacan will remain overall in charge of economic policy. This is important, because he would likely oppose more heterodox economic policy measures such as capital controls. Turkey's central bank, always keen to err on the side of dovishness, cut the overnight funding rate marginally to 11.25% last week, while keeping the policy rate unchanged at 8.25%.

- India: Real GDP expanded at a yoy rate of 5.7% in Q1 FY 14/15, up from 4.6% in Q4 FY 13/14, and better than the expected rate of 5.5%. Encouragingly, investment rose 7% yoy compared to a contraction of 0.9% in the previous quarter. India's new government has yet to announce major measures. We think this is largely due to sequencing. We believe the government is likely to focus initially on building coalitions, then harvesting low hanging fruits such as project execution and cutting red tape, and then finally, with the economy picking up, tackling tougher reforms. As such, the upside surprise in growth in Q1 FY 14/15 was just what the doctor ordered.

- The Philippines: Growth in Q2 rose 6.4% yoy, higher than the expected growth rate of 6.1%. The Philippines is growing strongly in manufacturing, agriculture, and exports, despite an outright drag from low government spending. Looking across Asia more widely, the Philippines is just one of several strong stories. Malaysia is growing well, Indonesia has a new promising government, India has been infused with improving prospects, Thailand's consumer and investor confidence has been restored after the military restored political stability to the country, China is picking up relative to last year and Korea's industrial cycle is accelerating amidst extremely strong external balances (in July the current account surplus rose to USD 7.9bn despite a nearly 10% appreciation of the Won versus the Dollar since last year).

- China: The central bank announced a small additional program of credit support to the agriculture sector. This continues China's recent path of allowing the economy to come to terms with higher rates as part of the process of interest rate liberalisation, while at the same time channelling credit support to particularly vulnerable sectors. China's official manufacturing purchasing manager's index (PMI) declined marginally to 51.1 for August compared to 51.7 in July. We note in passing that China's congress approved legislation allowing local governments to issue bonds for payment of public services. Bonds will gradually replace much of the less transparent financing sources at local government level, in our view. This is positive. Bond financing introduces market discipline, helps transmission of monetary policy, and enables Chinese savers to augment their saving portfolios with bonds.

- Indonesia: The trade balance returned to outright surplus in July on the back of a sharp slowdown in imports. In another positive development core CPI inflation declined further in August to 3.99% from 4.53% in July. This does give room and opportunity for the new government in Jakarta to ease fuel subsidies later in the year once it has officially taken office.

- Argentina: The government announced that it has revoked the licence of Bank of New York Mellon (BoNY). BoNY is the payment agent responsible for disbursing coupon payments on Argentina's New York law bonds. Argentina has said that it will transfer the role of payment agent to a branch of Banco de la Nación, a government institution.

Monetary policy:

- Colombia's central bank hiked rates by 25bps to 4.5% citing strong growth (5% real GDP growth expected this year) and a moderate uptick in inflation to (2.89%).

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Global backdrop

The global backdrop did not change materially from recent trends. The EUR and JPY continued recent weakness versus the Dollar, while US treasury yields declined and US stocks continued to rise. Easy money in developed economies thus continues to push financial asset prices higher and higher. Much attention will be paid to the ECB this week ahead of Thursday's announcement – further QE is expected either in this meeting or later this year. Oil picked up to USD 103 per barrel after trading below USD 102 last week. In terms of fundamentals, Japan had a bad week, unemployment rose, household spending dropped sharply, retail sales fell, industrial production declined, corporate loans slowed, vehicle production declined and housing starts slumped. Enough said. European bank lending dropped at the fastest rate for eight months in July. Corporate lending in particular declined. US core durables goods declined marginally, house price appreciation slowed and personal spending weakened. On the other hand, there was an upwards revision of Q2 growth to 4.2% from 4.0% previously, though the increment was due to rising inventories. Consumer confidence rose and pending home sales and Chicago PMI were strong.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.2%	10.7%	20.4%	4.7%	8.3%
MSCI EM Small Cap	0.2%	12.4%	21.5%	5.4%	9.7%
MSCI FM	0.0%	21.0%	33.3%	15.5%	8.9%
S&P 500	0.00%	9.88%	25.24%	20.62%	16.88%
GBI EM GD	0.00%	5.38%	8.32%	0.49%	6.23%
ELMI+	0.00%	1.35%	3.35%	-0.82%	1.90%
EMBI GD	0.00%	10.02%	14.61%	7.02%	9.48%
EMBI GD IG	0.00%	10.19%	13.99%	5.60%	8.16%
EMBI GD HY	0.00%	9.75%	15.98%	9.46%	11.53%
5 year UST	0.00%	2.52%	2.88%	1.08%	3.55%
7 year UST	0.00%	5.34%	5.24%	2.01%	5.06%
10 year UST	0.00%	9.38%	8.24%	3.57%	5.95%
CEMBI BD	0.00%	7.17%	10.88%	6.53%	8.39%
CEMBI BD HG	0.00%	7.64%	10.97%	6.19%	7.77%
CEMBI BD HY	0.00%	6.13%	10.69%	7.55%	10.34%
US HY	0.00%	5.98%	10.98%	11.11%	12.87%
European HY	0.00%	6.39%	12.67%	16.01%	14.89%
Barclays Agg	0.00%	4.56%	6.24%	1.33%	3.71%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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