Rating agencies' actions dominate headlines, not price action

By Gustavo Medeiros

In a week with solid price action, rating agencies stepped into the spotlight with notable downgrades of Russian Debt, both Sovereign and Corporate, as well as of Petrobras in Brazil. The market reaction was short lived, however. Prices appreciated in most of the Emerging Markets (EM) hard currency universe which finished February in positive territory. We summarise events in a range of EM countries, including a review of Brazil's fiscal consolidation, Mexican labour market strength, India's budget and the Turkish central bank's actions as well as finally seeing a little more clarity in the FOMC's often cryptic communication.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	991	–	0.83%
MSCI EM Small Cap	1,033	–	1.45%
MSCI FM	599	–	-1.36%
GBI EM GD	6.15%	–	0.08%
EM FX spot	–	–	-0.08%
ELMI+	5.04%	–	0.19%
EMBI GD	5.54%	352 bps	0.95%
EMBI GD IG	4.27%	221 bps	0.75%
EMBI GD HY	8.24%	632 bps	1.31%
CEMBI BD	5.42%	356 bps	0.45%
CEMBI BD HG	4.29%	242 bps	0.41%
CEMBI BD HY	7.97%	613 bps	0.54%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2105	-0.20%
VIX Index	13.34	-8.38%
5 year UST	1.52%	-3 bps
7 year UST	1.83%	-4 bps
10 year UST	2.01%	-5 bps
US HY	6.41%	0.73%
European HY	4.55%	0.68%
EURUSD	1.1232	-0.89%
USDJPY	119.74	0.71%
Brent	61.45	2.55%
Copper	271.65	12.40%
Gold	1217.36	1.42%

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

Emerging Markets

Rating agencies were in the news in spite of muted price action for the affected securities. The downgrades of Russian debt (Sovereign and Corporate) by Moody's and S&P and the unanticipated double-notch downgrade of Brazil's Petrobras by Moody's have led to fears of further 'falling angels'. Negative headlines highlighting the structural and short-term problems in these countries dominate the screens with an ominous tone dominating the ratings reports.

However, after the immediate 'shock and awe' effect of the Petrobras downgrade, the company's 2024 bonds recovered towards the end of the week ending just 1.2c lower (yields 0.24% higher), a much more muted reaction than expected. Russian 2030 bonds, the most liquid in the curve, had similar price action. And this time analysts can't blame it on low liquidity. Petrobras' bonds universe volumes were strong through the week, reaching close to USD 1bn on Friday when prices recovered from their lows – plenty of liquidity for investors holding prudent size.

The EM hard currency universe posted a positive performance in February, with high yield bonds outperforming Investment Grade in both Sovereign and Corporate debt. Local currencies had a small positive performance in spite of the strong USD versus the EUR after higher than expected core CPI in the US. The market seems to have 'selling fatigue' acknowledging most negative news on the asset class may be priced in after poor performance in Q4 2014, particularly in the high yield space. As the recovery gathers momentum, investors are likely to feel compelled to switch from negative yielding bonds – certain to cause a loss as well as bearing plenty of unpriced risks – into assets which are very likely to yield higher returns, compensating for the risks incurred (see *'Pay or be Paid'*, Ashmore weekly research, 26 February 2015).

Uncertainties are also subsiding as improvements in European data offer evidence of a gradual sequential recovery. Economic data in the US continues to give mixed signals, but a strong labour market adds confidence in its resilience. China is managing its rebalancing carefully and India 'positions for takeoff'. Oil prices show continuous signs of stabilisation with Brent consolidating around USD 60pb and WTI around USD 50pb. Geopolitical risks are receding as the cease-fire holds in Eastern Ukraine.

In this environment investors are likely to be encouraged to invest spare cash and switch out of low yielding assets. This is happening at a time when EM assets, particularly in the hard currency space, offer compelling value. Sub-IG credits, measured by the EMBI GD HY Index, trade at 632bps over US Treasuries (240bps wider than their 3 year lows) and investment grade assets currently change hands at 220bps on the EMBI GD IG Index (80bps wider than their 3-year lows).

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Emerging Markets

- **Brazil:** The economy continues to suffer from the effects Dilma Rousseff's poor first term, but the silver lining is that recent fiscal orthodoxy has already started to yield positive results in January.

On the negative side, the economy is performing as poorly as expected: business confidence in the industrial sector declined by a sizeable 3.1% mom sa in February, inflation was in line with expectations, jumping above 7% as a consequence of the cut in energy and transportation subsidies. Moody's downgraded Petrobras to Ba2, two notches below Investment Grade, citing concerns over the release of audited results and the timing of any eventual state support in case of a liquidity emergency.

On the positive front, January's consolidated fiscal budget surprised on the upside at a BRL 20bn primary surplus. The bulk of the effort came from sub-national government, which posted a record surplus for the month of January. Central government numbers were affected by the economic slowdown as revenues declined faster than expenditure cuts. However, Finance Minister Joaquim Levy, announced new measures limiting the amount of investment to be undertaken by the government in the first four months of the year and reversing tax benefits established in the first mandate of Dilma's administration. This was a recurrent source of revenues which allowed for more transparency on the revenue side, a crucial point for investors when assessing Brazilian future credit worthiness.

- **Mexico:** Mexico saw poor December retail sales, down 0.8% mom sa in December (+2.4% yoy). On the other hand, signs of recovery in the labour market have started to appear with the number of insured workers growing by 4.5% yoy (+752,000 new jobs). Bi-weekly inflation numbers posted a subdued 3% yoy inflation print, but the first signs of pass-through from weaker FX are evident in the rebound in durable goods inflation. A resilient labour market and rebounding inflation may lead the Banxico to raise rates close to the Fed decision.

- **India:** Finance Minister Arun Jaitley's new budget is likely to be well received by all communities. Business applauded the gradual cut of Corporate Tax from 30% to 25% in four years alongside major simplifications on exemptions. Local Governments were granted a larger share of revenues by 1% to 36% of GDP, likely to be a carrot for the implementation of a major simplification in the Indian tax system with the implementation of GST, promised for April 2016. Infrastructure will receive a strong 25% boost as the government focuses on railways, highways and energy sectors. Meanwhile, the central government deficit is reduced from 4.1% of GDP to 3.9%, slightly higher than the 3.6% anticipated. Cynical investors may ask how the government can increase expenditure and cut the deficit – but the answer is one word: growth. It will depend largely on the successful execution of future reforms such as land-law that would make it cheaper for businesses to install new industries in India. Sceptics may remain at bay, but the government is making good progress in India.

- **Turkey:** The Turkish central bank (CBT) cut the one-week repo rate (the main policy rate) by 25bps to 7.50%. The overnight borrowing rate (lower-end of the corridor) was also cut by 25bps to 7.25%, while the overnight lending rate (upper-end of the corridor) was cut by 50bps, which slightly reduces the CBT's ammunition to tighten liquidity in an emergency or to stem currency depreciation. Despite the cut, liquidity on the money market is likely to remain tight considering the policy statement's careful tone that acknowledges the risk of persistent inflation. The main risk for Turkish assets remains the high degree of political pressure on the central bank's governor to do more to support economic growth. Prime Minister Davutoglu, once thought to be a bulwark of monetary policy orthodoxy, said that the interest rate cut announced was insufficient in the face of commodity prices and inflation declines, adding that he expects the pace of rate cuts to have "more momentum".

In contrast to many EM countries, Turkey has relatively high levels of external debt and still large current account deficits. What the country does not need at the moment is a politically driven de-anchoring of its inflation and financial stability expectations.

- **Israel:** The Bank of Israel unexpectedly cut rates by 15bp to 0.10%. The authority justified the cut as needed in order to counter ILS appreciation and boost short-term inflation expectations. The committee downgraded the robust Q4 GDP print as it was mainly driven by public consumption against the background of the Gaza conflict.

- **South Africa:** Strong sequential improvement in the mining and manufacturing sectors boosted Q4 14 real GDP growth to 4.1% qoq annualised with the previous quarter GDP revised up to 2.1% qoq annualised (from 1.4%).

- **Russia:** Moody's downgraded Russia's Sovereign rating to Ba1, bringing it in line with S&P's note. Corporates were downgraded in sympathy. Russian assets were resilient with the RUB dropping below the level it traded just before the downgrade in spite of lower oil prices. In a more relevant event, Boris Nemtsov, a leader of the opposition Republican Party of Russia – the People's Freedom Party, was murdered in Moscow, an event that could revive anti-Government demonstrations which have been dormant since Russia's invasion of Crimea when Putin's approval ratings shot-up to record-high 80% levels.

- **China:** The PBoC cut the benchmark lending rates and deposit rates by 25bps, a surprise in terms of timing, but in line with analyst expectations. With the economic rebalancing slowing down growth, short term capital outflows tightening liquidity and inflation moving towards negative levels, the Chinese monetary authority is right to ease rates in our view and we believe that further Reserve Rate Requirement and base rate cuts will be forthcoming.

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Emerging Markets

Snippets:

- **Hungary:** The National Bank of Hungary kept rates unchanged at 2.1%, indicating it will wait until March to decide whether or not to cut rates further.
- **Uruguay:** Uruguay tapped their 2050 bonds with a USD 1.2bn reopening at a spread of 235bps over US Treasuries.

Global backdrop

Patience is needed to decipher the chaotic and often disconnected communication coming from FOMC members. Thankfully Janet Yellen's testimony last Tuesday has brought some clarity to the FOMC's glossary. Now we know that "patience" means "hikes are very unlikely for the next couple of meetings", making earlier-than-June hikes implausible. It's also clear that the absence of "patience" doesn't mean rates will hike in two meetings. All to say that the Fed is simply in 'data dependent' mode, as any central bank should indeed be.

So what about the data? In Yellen's words, the economic recovery "looks to be on solid ground" and the FOMC expects continuous progress in the labour market recovery. Higher than expected core CPI at 0.2% mom in January and an unanticipated small but encouraging European economic recovery will add to the pre-conditions for the first hike. All suggesting the Fed may run out of "patience" at its next meeting.

So why do bond investors remain so relaxed, pricing the first hike only after September and estimating a terminal rate at incredibly low levels (5y5y at 2.66%)? The answer lies in the structural problems in the US and the rest of the developed world. With extremely high levels of public debt and sluggish economic recovery in spite of six years of unconventional monetary policy, any significant rate hike could kill the nascent recovery. With USD 3trn of assets trading at negative levels and considerable momentum in central banks' race to the bottom, term premia is likely to remain depressed. Politicians would do well learning from India's Narendra Modi on how to reignite growth. A strong drive to reform, boosting business confidence together with a focus on fixing banks' balance sheets and investing in infrastructure could change the gloomy structural picture.

Granted, the US Treasury seems to price a lot of dovish-ness and marginally stronger data could push Yellen to move earlier leading some investors to panic. Still, unless something changes structurally, that will be another temporary bump in the road rather than a long-term reversal.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.1%	3.7%	5.4%	0.0%	4.0%
MSCI EM Small Cap	2.3%	3.7%	3.6%	2.7%	4.8%
MSCI FM	2.9%	-1.3%	1.2%	11.8%	6.8%
S&P 500	5.75%	2.57%	15.50%	18.01%	16.16%
GBI EM GD	-1.34%	-1.01%	-5.83%	-3.54%	2.14%
ELMI+	0.98%	-1.82%	-7.98%	-3.45%	-0.69%
EM spot FX	-0.61%	-3.59%	-14.68%	NA	NA
EMBI GD	0.85%	1.79%	6.86%	5.37%	7.57%
EMBI GD IG	0.30%	2.10%	8.89%	4.93%	6.93%
EMBI GD HY	1.88%	1.22%	3.42%	6.11%	8.49%
5 year UST	-1.43%	1.02%	2.80%	1.23%	3.40%
7 year UST	-2.09%	1.42%	5.37%	2.02%	5.19%
10 year UST	-2.82%	1.85%	9.70%	3.50%	6.85%
CEMBI BD	1.15%	1.84%	4.69%	5.30%	6.61%
CEMBI BD HG	0.52%	1.98%	6.61%	5.63%	6.78%
CEMBI BD HY	2.57%	1.53%	0.73%	4.83%	6.48%
US HY	2.56%	3.02%	2.27%	7.70%	9.68%
European HY	2.09%	3.27%	6.39%	12.74%	12.22%
Barclays Agg	-0.81%	-0.97%	-2.79%	-0.13%	2.35%

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

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