Beware the bandwagons

By Jan Dehn

In an environment where traditional market drivers have been scarce we highlight the dangers of bandwagons. We find the initial Ukraine election trade is over. We discuss inflation in Brazil and the country's growth challenge. We also note China's stronger PMI numbers, report how power shortages in India illustrate one of Prime Minister Modi's key challenges and highlight South Korea's strengthening external balances.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,030	–	-1.03%
MSCI EM Small Cap	1,068	–	-0.08%
MSCI FM	697	–	4.02%
GBI EM GD	6.63%	–	-0.47%
ELMI+	3.23%	–	-0.31%
EMBI GD	5.11%	262 bps	0.94%
EMBI GD IG	4.32%	177 bps	0.85%
EMBI GD HY	6.96%	471 bps	1.12%
CEMBI BD	5.07%	292 bps	0.56%
CEMBI BD HG	4.23%	207 bps	0.56%
CEMBI BD HY	6.82%	469 bps	0.55%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1924	1.25%
VIX Index	11.40	0.35%
5 year UST	1.55%	2 bps
10 year UST	2.49%	-5 bps
US HY	5.28%	0.26%
European HY	4.37%	0.29%
EURUSD	1.3604	-0.30%
USDJPY	102.02	0.11%
Brent	109.92	-1.25%
Copper	324.07	-0.29%
Gold	1245.62	-3.78%

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

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In recent years both markets and sections of the media have fuelled 'bandwagons' – where particular stories for some reason grip the market's attention. Bandwagons quickly become very powerful, resulting in a streamlining of thinking, an over-simplification of complexity and the erasure of nuances, in effect commoditising ideas. Successful bandwagons usually hold great emotional appeal, either because they lean on deep-seated market prejudices, or because they assign great structural importance to market moves that in many cases are merely technical in nature. This gives bandwagons the power to move large numbers of hapless investors in the same direction at the same time. A good analogy is a bunch of three-year olds playing soccer: picture ten kids in a headlong mass chase after the ball.

Bandwagons have risen to prominence out of necessity, the mother of all invention. They have become a replacement for structural changes, conventional business cycle dynamics and monetary policy changes both of which have become scarce since 2008/2009.

Bandwagons are popular both among market makers and the media, because they can be used to persuade a critical mass of investors to move, thereby engaging the enormous volumes of liquidity trapped in financial markets since the onset of QE policies. There also appears to be a somewhat cynical exploitation of investor myopia going on: many investors are finding that their economics education and past experiences offer little guidance in today's unprecedented macroeconomic conditions. This makes them more inclined to believe in fairy tales. Finally, regulatory pressures have undoubtedly helped to concentrate more and more money into narrower and narrower sets of securities, especially developed country bonds and stocks.

Bandwagons exercise an outright tyranny on markets when they feed on deep-seated prejudices instead of sober analysis; indeed, the rationale for several of most important bandwagons of recent times has been extremely tenuous and entirely baseless ex-post (see box below). Bandwagons drive trading volumes and market volatility unnecessarily high, increasing revenues for market makers, but offer no value for strategic investors. They also prey on those with weaker convictions, sucking them into their vortex, while stronger, more independent investors can experience considerable challenges in sticking to their positions, even if they are right, until a bandwagon has run its course. Bandwagons encourage momentum trading over value investing. Not only is this inefficient, it is also outright dangerous and ultimately fruitless for the majority of participants who end up chasing the market and more often than not buying at the top and selling at the bottom. By discouraging individual thinking, bandwagons create systemic macro risks through the homogenisation of investor behaviour. Emerging Markets (EM) investors are not immune; recent Morningstar data shows that tracking errors for US-based EM local bond market managers have halved since 2009.

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What adds a particular sinister twist to the commoditisation of ideas is that it has coincided with the commoditisation of trading. Long-gone are the days when markets evaluated individual investments on their merits, that is, analysed investments on a case-by-case basis to determine if the expected returns warranted the money put at risk. Today, most investors pool enormous numbers of individual investments into convenient buckets called asset classes, where they are given weights and benchmarked in indices that are then conveniently labelled as 'the market'.

The commoditisation of trading is risky, because investors tend to lose sight of the risks in the underlying investments. The tools used to alleviate this problem only provide a false sense of security. Ratings agencies tend to miss big problems and act late. Classification of some securities as 'risk free' only ignores the problem of risk, thus increasing the unperceived risk. Finally, the commoditisation of trading means that investors miss out on all those opportunities that are not captured in benchmark indices (this is a particularly big problem in EM, where there are major market failures in index provision).

The best way to avoid these pitfalls is to get back to the basics of investing: adopt a value investment approach, maintain a strong credit focus, think independently and follow a medium to long-term investment horizon.

A few recent groundless bandwagons

- **China hard landing:** Every time the economic data turns lower in China the market lurches to the conclusion that China's economy will crash.
- **Fragile Five:** The tendency to confuse cyclical imbalances, such as inflation or current account deficits with intractable structural problems.
- **Euro-zone breakup:** A powerful theme labelled as structural that gripped the market for two years, but which ended abruptly following a simple verbal intervention by ECB President Mario Draghi.
- **Abenomics:** The notion that Japan can fix all its structural problems with a dose of fiscal and monetary stimulus.

- Ukraine: The election trade is over. Many players were short, having bet on a worse outcome. They have closed their short or underweight positions lately in the rally, aiding the short squeeze. The next big focus will revolve around the terms Ukraine extracts on gas supplies from Russia, how Ukraine gets through a possible change of constitution and parliamentary elections later this year, plus how well President Poroshenko manages to balance the competing demands of Russia and Europe. If he proves successful it will be because he manages to turn the competition between Europeans and Russians to his advantage, by extracting better terms from both. If he is unsuccessful it will be because he gets torn apart by these competing interests or succumbs to domestic tensions if he chooses sides outright. Ukraine's sweet spot is somewhere in the middle, though this could prove to be a fine balancing act. So far, indications are that Ukraine is leaning towards closer ties with Europe. For example, Russia is going ahead with the Eurasian Economic Union without Ukraine among the prospective members. On the other hand, Kiev now looks close to striking a deal with Russia on gas. Ukraine last week paid part of the arrears owed to Gazprom. The deal is complex, involving lost gas assets in Crimea, energy security in Western Europe, arrears settlement and of course the price of gas.
- Argentina: The main court case between holdout investors and Argentina is now drawing closer to a critical decision point. On 12 June the US Supreme Court will decide whether to take the case, deny taking the case, or whether to 'kick the can down the road', for example by asking the Solicitor General to give an opinion on the matter (this could easily add another 6-8 months to the decision-making process). The 2nd District Court of New York has ruled that Argentina must make payments to holdout investors and, if these are not forthcoming, funds can be diverted to holdout investors from payments intended for holders of performing bonds. One reason to expect the Solicitor General to be consulted is that there are third party interests at stake. For example, if holdouts are granted payments in accordance with the standing ruling by the 2nd District Court of New York then this precedent may make it difficult to obtain bond holder buy-in to any future restructuring of bonds issued under New York law, because the incentives to hold out increase sharply.

Argentina has, sensibly, also been pursuing potential alternative sources of finance in the official sector arena, just in case the bond market becomes unavailable. Last week, the government formally reached agreement with the Paris Club to repay arrears of USD 9.7bn in instalments. Argentina secured an interest rate of just 3% on its outstanding obligations to the Paris Club, more than half of the rate it has paid in the past. This is a major piece of good news, because the agreement is likely to enable Argentina to tap into fresh sources of bilateral official sector finance from Paris Club members as well as export credit finance. Argentina has undertaken a number of positive steps to restore normal relations with the rest of the world this year, including publishing a new inflation index,

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talking to the IMF, compensating Repsol for taking its assets in Argentina in 2012, undertaking fiscal adjustment, devaluing the currency and now securing an agreement with the Paris Club. On the other hand, provincial bond issues are rising sharply with up to USD 2.4bn of bonds in the pipeline from issuers ranging from province of Buenos Aires to Cordoba, Mendoza and Rio Negro.

- Egypt: The Egyptian presidential election was won overwhelmingly by former head of the army Abdel Fattah al-Sisi. Preliminary results suggest that al-Sisi won more than 90% of the votes cast. Turnout was nearly 40%, enough to add legitimacy to the outcome, though clearly this election was somewhat predictable in terms of its outcome, which may have discouraged many voters from bothering to vote.

- Brazil: The central bank ended the hiking cycle by leaving rates unchanged at 11%, but signalled that hikes could resume unless inflation begins to moderate. At 6.3%, inflation is still close to the top of the central bank's ceiling despite the central bank's tightening of monetary policy from 7.25% in early 2013 to 11% now. We think the central bank has strong political backing to keep inflation under control, but still has its credibility eroded by allowing inflation expectations to de-anchor. The main challenge is growth. Investor confidence is low and Brazil has major supply side constraints. Restoring the former requires a change in direction of economic policy, followed by deeper reforms. We think inflation expectations can be anchored after the elections in October helped by an anaemic growth outlook and a new Central Bank administration, but we are less optimistic about the current administration's willingness to reform the economy more deeply. That is why the elections in October are pivotal if Brazil aspires to unleash its enormous economic potential.

Only a week after Brazil's highest court on non-constitutional matters, the STJ, issued a ruling that Brazilian banks have to compensate depositors for losses inflicted during the during the inflation of the 1980s and 1990s, the highest court on constitutional matters, the STF, suspended the case indefinitely. Brazil's central bank has estimated that the total cost to banks could be as high as USD 150bn. Many of the banks affected by the lawsuit are government institutions, so this case in large part involves one branch of the government inflicting potential losses on another part of the government.

- China: The Purchasing Managers Index (PMI) in China rose to 50.8 in May, up from 50.4 in April. The result was stronger than expected and was the highest print for nearly half a year. China is in the process of liberalising interest rates. This is pushing up borrowing costs and exposing weaknesses in some sectors of the economy, including parts of the housing sector. Still, we believe interest rates liberalisation is a healthy development. The government's comprehensive audit of the economy's debt profile last year means that the government is not entering into this process blindly. The government also has a huge arsenal of policy tools at its disposal to support any struggling sectors, which it is now employing selectively, including targeted reserve ratio cuts. We think China will maintain the course towards full interest rate liberalisation and eventually capital account liberalisation without encountering a hard landing.

- India: Higher new orders led a marginal rise in the PMI for India in May to 51.4 from 51.3 in April. However, Indian companies suffered from power shortages. This illustrates one of the major challenges faced by the new Modi administration, namely how to expand and modernise India's inadequate infrastructure. Q1 2014 real GDP growth was 4.6% yoy. This meant that growth accelerated in the past quarter, rising 4.8% qoq seasonally adjusted versus 4.0% qoq seasonally adjusted in the last quarter of 2013.

- Indonesia: The trade balance swung into deficit in April (contrary to market expectations of a small surplus). The deficit was mainly caused by a surge in capital goods imports. Capital goods imports are highly volatile and may have been boosted in April by an earlier Ramadan. Still, if sustained, the rise in capital imports may not be a bad thing at all, pointing to expanding output. Manufacturing is showing signs of picking up in Indonesia. HSBC's May PMI rose to 52.4 from 51.1 last month. Inflation remained unchanged at 7.3% yoy in May.

- South Korea: The strength in Korea's external balances continues. It racked up a strong USD 7.1bn current account surplus in April, taking the YTD surplus to USD 22bn, which is the highest level recorded since the early 1990s. This puts Korea on track to achieve a current account surplus in excess of 4.5% of GDP this year. Exports rose 10% yoy in April, while imports declined slightly. Investment by Koreans overseas rose, resulting in a capital account outflow of USD 6.2bn, which meant that the central banks' reserves rose by USD 670m in April. South Korea's FX reserves, currently USD 356bn, the highest level ever, are likely to end the year just south of 30% of GDP. Going forward, it is likely that Asian exports could soften somewhat in the near-term due to the sharp slowdown in retail sales observed in Japan following the recent consumption tax hike (see global section below).

- Russia: Russia is going ahead with the formation of the Eurasian Economic Union (EEU) with Belarus and Kazakhstan, but without Ukraine. Armenia aims to join on 15 June. The EEU is similar to the European Union except in one very important regard: whereas the EU uses a currency issued by an independent central bank the EEU will use the Russian Ruble as the main currency for current and capital account transactions within the union. This confers onto Russia an asymmetric capacity to buy strategically important assets in other member states, in effect restoring Russian dominance by economic (as opposed to military) means.

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- Philippines: Q1 2014 real GDP growth fell short of expectations, rising only 5.7% yoy compared to an expected 6.4% yoy pace of expansion. Beneath the bonnet, however, the growth story of the Philippines appears solid. The short-fall in growth was mainly due to disappointing agricultural output (often volatile) and less than expected infrastructure spending by the government (again, hardly a big surprise). Both private consumption and investment rose strongly, underlining the healthy domestic-demand led growth in the Philippines (7.2% yoy in Q1 2014 compared to 6.4% yoy in Q4 2013).

- Thailand: Manufacturing showed signs of stabilising in April, rising 1.2% mom. The military government also announced that a number of economic measures that have been held up by the political impasse will now be pushed forward, including expediting planned budgetary spending and infrastructure spending in particular. The pipeline of infrastructure spending is almost 3% of GDP, including major water management and railway investments. On the other hand, exports declined in April, probably in response to softer demand from Japan. Thailand's trade balance was in deficit to the tune of USD 1.45bn vs USD 0.6bn expected.

- Czech Republic: Finance Minister Andrej Babis put forward proposals for formal adoption of a government debt ceiling at 55% of GDP. Debt to GDP is currently 46%, which is about half the level of public debt to GDP in developed countries.

- Mexico: The trade balance swung into a surplus of USD 510m in April. This takes the 12 month rolling trade balance to USD 0.5bn compared to USD 6.0bn at the same time last year. The improvement in the trade balance reflects slow domestic demand caused by a combination of factors, including tax hikes, problems in the homebuilder sector, uncertainty arising from the rapid pace of reform and slow implementation of infrastructure projects by the government. All these drags are going to fade over the next 12 months, while Mexico's recent reforms means that the trend rate of growth is likely to have risen.

- South Africa: Manufacturing and mining in South Africa both contracted in Q1, which slowed the yoy pace of growth to 1.6% yoy versus 1.9% yoy expected, down from 2.0% in Q4 2013. In qoq terms growth was negative at 0.6% and higher frequency data point to continuing weakness in Q2, which could, technically, mean that South Africa goes into recession this quarter. The trade deficit also widened in April, taking the 12 month rolling deficit to 2.4% of GDP. The fact that inflation is running at 6% means that the South African Reserve Bank is between a rock and a hard place, unable to cut rates due to high, sticky inflation, but not keen to hike due to low and declining economic growth. South Africa's trend growth rate is substantially below potential on account of various supply-side constraints, particularly a poorly performing labour market. Herein lies a major challenge for the recently re-elected ANC government. Strong ties that date back to the Apartheid era link the ANC with South Africa's strong unions. Union power is particularly strong in the mining sector, which accounts for more than half of South African exports and a big chunk of GDP. South Africa today looks a lot like Great Britain in the late 1970s prior to the wave of market reforms in the 1980s.

- Venezuela: The US Congress voted in favour of sanctions on Venezuelan officials involved in alleged human rights abuses. This follows committee stage approval of a similar bill in the Senate last week. In order to progress further, the Senate bill would have to be approved on the floor of the Senate, then the House and Senate bills would have to be unified, approved by both houses, and then signed by President Obama. Even if this happened, it would target selected individuals, not sectors or financial markets. We think this bill is largely serving political purposes in the United States and is meant to act as a mild deterrent against excessive abuses by the government in Caracas.

- Poland: Real GDP growth accelerated in Q1 2014 to 1.1% qoq following a 0.7% qoq print in Q4 2013. This meant that growth tracked 3.4% yoy in Q1 2014. Poland's economy is driven by domestic demand. Consumption remains solid, while investment and exports rose, which bodes well for growth going forward.

Monetary policy:

- Brazil: Brazil's central bank left rates unchanged at 11%
- Hungary: Hungary's central bank cut rates by 10bps to 2.4%
- Colombia: The Colombian central bank raised policy rates by 25bps to 3.75%, citing rising inflation expectations amidst strong growth and expansion of credit.

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Global backdrop

Japanese retail sales plunged by 13.7% mom in April. A large drop was expected because consumers were well informed about a tax hike on consumer goods that came into effect in April. Still, the expectation was for a drop of retail spending of 11.7% so the turnout was worse than expected. In yoy terms, retail sales dropped 4.4% vs a 3.3% expected fall. The drop in retail spending was even larger in real terms. Compared to the response to a similar tax hike in 1997, this time around real spending fell about 1% more, because in 1997 Japanese inflation was running about 1% higher than today.

US growth in Q1 was revised down sharply from 0.1% to -1.0% qoq, annualised. This was even worse than most tracking estimates had suggested. The silver lining was that inventories were revised sharply lower, thus reversing the massive inventory build, which occurred in H2 2013 and probably accounted of the big decline in activity at the start of 2014 (weather also contributed). The outlook is now for the US economy to pick up speed in the second half of 2014. Continuing improvements in labour market indicators also offers ground for some optimism. Still, on-going deleveraging and the complete neglect of structural reforms and infrastructure investment in the US (and many other heavily indebted developed economies) are likely to continue to place important drags on growth. The other reason to continue to be very concerned about fragile growth in developed economies is that their interest rates will eventually have to rise; when this happens they will have to divert spending away from consumption and investment towards debt service.

In Germany, the number of unemployed surprised on the upside in May when 24 thousand people became unemployed, versus a 15 thousand decline in expected unemployment. That fed through the expectation that the ECB will act more decisively at its 5th June meeting, leading to acceleration on the bonds rally in Europe as yields from both core and periphery economies hit fresh all-time lows. Lower yields fed a similar rally on the other side of the pond as 10-year US Treasury yields touched 2.4% for the first time since June 2013.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.02%	3.30%	4.60%	-1.40%	8.70%
MSCI EM Small Cap	-0.10%	7.00%	2.80%	-0.40%	11.4%
MSCI FM	0.10%	20.10%	28.60%	11.90%	11.0%
S&P 500	0.01%	4.96%	20.44%	15.14%	18.37%
GBI EM GD	–	4.94%	-1.37%	0.97%	7.46%
ELMI+	–	1.76%	0.93%	-1.06%	2.74%
EMBI GD	–	8.28%	5.77%	7.60%	10.55%
EMBI GD IG	–	8.22%	4.50%	6.22%	8.60%
EMBI GD HY	–	8.43%	8.58%	10.06%	13.41%
5 year UST	–	2.39%	0.36%	2.51%	3.69%
7 year UST	–	4.33%	0.04%	3.88%	5.10%
10 year UST	–	7.31%	1.01%	6.00%	5.87%
CEMBI BD	–	5.66%	4.78%	6.06%	10.20%
CEMBI BD HG	–	5.91%	4.77%	6.36%	9.11%
CEMBI BD HY	–	5.12%	4.81%	5.79%	13.81%
US HY	–	4.92%	8.75%	9.71%	15.33%
European HY	–	5.32%	12.51%	13.10%	17.92%
Barclays Ag	–	4.18%	5.35%	2.35%	4.53%

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