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Risk free (by definition only)

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Trade and current account balance data from a number of Emerging Markets showed material improvement over the past month. Meanwhile, the upturn in the global manufacturing cycle continued into September, according to new data released over the last week. Emerging Markets Purchasing Manager Indices (PMIs) appear to be lagging developed market PMIs by about a month, so we think the gentle tail wind from manufacturing will continue in October. Global risks continue to emanate from developed economies: Politicians in both the US and Italy last week held both their own countries and the global economy hostage to their narrow political objectives. The severe political tensions are a symptom of difficult economic and fiscal challenges in both regions. Developed market bonds are risk free, but only by definition.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,008		2.14%
MSCI FM	562		0.61%
GBI-GD	6.58%		1.41%
ELMI+	4.48%		0.80%
EMBI GD	5.83%	322 bps	0.41%
EMBI GD IG	4.85%	224 bps	0.43%
EMBI GD HY	9.34%	686 bps	0.37%
CEMBI BD	5.76%	357 bps	0.19%
CEMBI BD HG	4.86%	266 bps	0.20%
CEMBI BD HY	7.79%	565 bps	0.19%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,691	0.56%
VIX Index	16.74	0.84%
5 year UST	1.40%	0 bps
10 year UST	2.64%	1 bps
10 year Bund	1.82%	4 bps
EURUSD	1.3583	0.41%
USDJPY	96.96	-1.35%
Brent	$109	-0.64%
Copper	$332	-1.92%
Gold	$1312	-1.29%

Emerging Markets

A number of Emerging Markets released trade and current account data in the past week. This is topical, because external imbalances are widely perceived to be the Achilles heel for a number of larger Emerging Markets economies, including Indonesia, India, South Africa, Brazil, and Turkey. Each of these countries released data this week. Malaysia also issued trade balance data for August.

As it turned out, the data surprised moderately to the upside.

- Turkey's trade deficit shrank to a lower than expected USD 7.0bn from USD 9.8bn in last month's reading
- Brazil's trade surplus came at USD 2.15bn versus USD 2.0bn expected
- India's Q2 current account deficit at USD 21.8bn was narrower than the anticipated USD 23bn deficit
- Indonesia's trade balance swung into a small surplus of USD 132m versus an expected deficit of USD 811m
- Malaysia's trade surplus was the strongest in six months due to a 12.4% yoy surge in exports (versus 4.7% yoy expected)
- The big outlier was South Africa, where the August trade deficit widened sharply to USD 19.1bn from USD 13.4bn last release. South Africa's trade balance is particularly sensitive to the relative prices of gold and oil, which have moved strongly in favour of the latter lately.

Why are the markets obsessed about current account deficits? After all, Emerging Markets ought to be running current account deficits and importing capital to finance investment spending in order to further their economic convergence with richer countries. The reason is that current account deficits can also be a sign of domestic imbalances or a misaligned nominal exchange rate. For example, for too long Indonesia maintained a quasi-peg with the US dollar which was inconsistent with the pace of domestic demand. The result was a steady widening of the current account deficit and an accompanying steady loss of reserves. Thus domestic imbalances beget external imbalances.

No economies are permanently in equilibrium. Modest domestic and external imbalances are the norm in developed and Emerging Markets alike. Provided the imbalances do not go on for too long or become too large they are easily cured with the appropriate policies. The medicine typically consists of demand restraint to restore internal equilibrium (usually via tighter monetary or fiscal policies or a combination of both) and an adjustment of the currency which restores external balance by improving export competitiveness and slowing the pace of imports.

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Emerging Markets

Indonesia, India, Brazil, Turkey, and South Africa have all undertaken precisely these types of macroeconomic adjustment over the past few months, and last week's data showed that their efforts are beginning to bear fruit. In all five cases, the imbalances were largely self-inflicted, but in all five, adjustment also began before deficits (a flow problem) could turn into structural issues, such as unsustainable debt burdens, loss of import FX reserve cover, or other legacies resulting from protracted periods of economic mismanagement. All five economies have policy instruments, considerable arsenals of reserves, and generally sound debt dynamics. And herein lies the difference between a standard macroeconomic adjustment and a crisis. When a developed economy is experiencing a cyclical slowdown it is called a 'business cycle'. When the same thing happens in an Emerging Market it is called a 'crisis'.

Last week also saw the release of fresh data on manufacturing in a large number of developed and Emerging Markets. The September PMIs showed that the upturn in the global manufacturing cycle that took root in Q2 is continuing at a moderate pace. This means that the broader Emerging Markets economic cyclical upswing, which also began in Q2, is continuing to benefit from a gentle tail wind.

Both the US and Japan had strong PMIs, while Europe's PMIs were flat on aggregate for the month, though they remained above the 50 level, which signals expansion. In Emerging Markets, the manufacturing cycle recorded its second consecutive expansion in September. This upturn follows a particularly deep downturn in late 2012 and the first half of 2013. PMIs in developed economies appear to be leading PMIs in Emerging Markets by about a month in this particular cycle, so, in our view, it is reasonable to expect October to be another month of improvement in manufacturing.

The improvement in Emerging Markets PMIs in September was moderate and broad-based rather than spectacular. Aggregate PMIs were somewhat distorted by a 7-point drop in South Africa's strike-affected PMI, so the aggregate number probably understates the rate of improvement in Emerging Markets in general. The Czech Republic was the only other country in EMEA to record a decline in its PMI in September. Russia was flat. Turkey's PMI reading rose from 50.9 in August to 54 in September. In Asia, China's PMI rose modestly, while the manufacturing-intensive countries of Taiwan and South Korea both recorded stronger improvements. In Indonesia, manufacturing moved into expansion (50.2) versus 48.5 expected. Mexico was broadly flat in September, probably due to the softer final demand conditions in the US in Q3 compared to Q2. Brazil's services PMI moved from contraction (49.7) to expansion (50.7).

In normal business cycles, the end of recessions is typically signalled by a strong pick-up in the manufacturing cycle, especially new orders components and also, with a lag, the employment components. The manufacturing cycle is particularly revealing about the investment cycle, because capex (for new machinery, etc.) is typically required in order to increase output in the manufacturing sector, while in contrast, it is typically easier to expand services output without additional capital equipment purchases.

Despite the traditional role of the manufacturing cycle as an indicator of the broader business cycle we are sceptical about reading too much into capital spending dynamics from the current manufacturing cycle. Indeed, since 2008/2009, upturns in manufacturing cycles have repeatedly failed to turn into sustained capex led recoveries. Six years into the crisis, corporate cash levels remain high, and capex spending remains subdued. We think companies are waiting for a sustained pickup in final demand rather than doses of QE and other short-term stimulus programmes. De-leveraging, fiscal problems, uncertainty and structural problems continue to weigh on the recovery.

What then, should we read into PMI cycles? We think manufacturing cycles mainly reflect random shocks to demand and supply, or simply inventory corrections necessitated by inaccurate estimates of future final demand by purchasing managers. This means that the current pick up in the global manufacturing cycle is best regarded as a gentle and welcome tailwind, but not a development that is likely to unleash material and sustained changes in the global macroeconomic environment.

Global backdrop

At first sight, the shutdown of the US government and the dissolution of the Italian government appear to be entirely unrelated events. Yet they are related in the sense that both the US and Italian political crises originate in weak fundamentals and the resulting lack of easy solutions.

In the US, the failure to reach agreement on budget spending is concerning because of the still unresolved question of how Congress will reach agreement on raising the government's debt ceiling. The US is now moving close to a potential technical default for the second time in just three years. In Italy, Silvio Berlusconi withdrew his support from the governing coalition over tax precisely at a time when Italy is on the verge of breaching the European Union's deficit rules. The political fights in both countries are so bitter precisely because of the stretched nature of the public finances: only tough choices are now available.

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Global backdrop

The survival of Italy's Letta Administration through a confidence vote is clearly good news, particularly because the vote also weakened the convicted fraudster and populist former Prime Minister Silvio Berlusconi. But Italy's enormous debt burden and weak economy mean that both its and other European economies' economic survival continues to hinge on the existence of life support from the ECB's bond purchase programme.

The shutdown of the US government has virtually no impact on Emerging Markets fundamentals, though there may be temporary effects on asset prices resulting from delays in data releases, etc. A failure to raise the debt ceiling – which has to be done by mid-October to avoid a default – would be far more serious, not least because Emerging Markets central banks are so heavily exposed to US Treasuries. The entire financial system, including its regulatory framework, is based on the assumption that US government debt is risk free. While a default would likely to be cured fairly quickly there would be costs beyond the initial dent to confidence. Borrowing costs for all Americans would probably rise. In an economy with debts in excess of 400% of GDP even modest increases in borrowing costs will hurt growth (as the collapse in mortgage applications over the summer showed). Fortunately, in the final equation, there is nothing that prevents the Fed from buying even defaulted securities. After all, it can just print some more money.

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