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Strong payrolls number solidifies summer rate hike scenario

By Gustavo Medeiros

A strong non-farm payrolls number in the US caused another shockwave. Global fixed income curves 'bear steepened' as a healthier labour market confirmed the momentum of the US economic recovery. The US dollar continues to be the only game in town as the yield differential between the 10yr US treasuries and 10yr German bunds widened to its highest levels since 1989. Real money investors are switching from negative yielding European bonds to US treasuries and have been recently followed by short-term investors as low levels of FX volatility encourage the G7 carry trade. Equity investors are enjoying a combination of economic recovery with still plentiful liquidity in the system, but the threat of an early tightening by the FOMC caused equities to sell-off from their highs following the strong payrolls number.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	962	–	-2.57%
MSCI EM Small Cap	1,016	–	-1.41%
MSCI FM	601	–	-0.01%
GBI EM GD	6.37%	–	-3.03%
EM FX spot	–	–	-2.16%
ELMI+	5.02%	–	-0.87%
EMBI GD	5.65%	339 bps	-0.72%
EMBI GD IG	4.44%	213 bps	-1.27%
EMBI GD HY	8.20%	605 bps	0.26%
CEMBI BD	5.45%	336 bps	-0.05%
CEMBI BD HG	4.35%	225 bps	-0.27%
CEMBI BD HY	7.93%	586 bps	0.43%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2071	-2.13%
VIX Index	15.20	16.56%
5 year UST	1.68%	10 bps
7 year UST	2.03%	12 bps
10 year UST	2.22%	14 bps
US HY	6.55%	-0.45%
European HY	4.42%	0.23%
EURUSD	1.0876	-2.78%
USDJPY	120.99	0.70%
Brent	59.36	-0.18%
Copper	264.50	-6.60%
Gold	1174.76	-2.82%

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

Emerging Markets

Emerging Markets (EM) USD-denominated debt continues to outperform core fixed income as credit spreads compression partly compensates for higher US treasury yields, allowing investors to reap positive total returns. Last week spreads tightened by 9 bps while 10-year US treasuries widened by 15 bps, leading to small negative returns of -0.5% on the EMBI GD versus a 2% decline from the Barclays Global Aggregate Index. High yield outperformed IG with Sovereign HY up 0.3% and Corporate HY up 0.4%.

In the local currency space, most curves widened in line with US treasuries, as changes in term premia tend to have stronger correlation globally. Currencies suffered versus the USD, a basket of EM currencies from the GBI-EM GD were down 2.6% on the week. Rather than poor performance in EM fundamentals, there is evidence that the stronger force operating in the FX space is actually the advance of the USD versus everything else. The EUR is down by an incredible 10.2% ytd, bringing the US USD index (DXY) down by 8.1%. EM FX is down much less at 6.2% (looking at the FX returns from the GBI-EM GD) but yield tightening means the Index is down by 4.55%. As a result, the return on the GBI-EM GD funded in Euros is up by 6.3% ytd. This is as a result of both currency appreciation and yield tightening. In fact, the long term Sharpe ratio of the GBI EM GD in EUR outperforms the same ratio for investors who funded the position in USD – or hedged the local currency exposure back to USD. Investors who believe in a strong USD would do well, in our view, to switch their funding currency while still enjoying the 6.37% yield to maturity offered by local currency bonds.

- Brazil: The trade balance posted a deficit of USD 2.8bn in February, wider than the market consensus of USD 2.4bn with exports falling faster than imports. Inflation surprised on the upside with the CPI reaching 7.7%, driven mainly by strong price increases from subsidy cuts in energy and other managed prices previously under control. The central bank hiked interest rates by 50bps to 12.75% and kept the door open for further hikes in future meetings as the weaker BRL increases the risk of spill-over from tradable to non-tradable goods.

The political situation remains delicate after the general prosecutor in charge of the investigations of the Petrobras scandal unveiled a list of 54 politicians, including the leaders of the Senate and the Congress, both from the PMDB party, a key ally of the governing coalition. Representatives of the executive power emphasised to the press the widespread presence of politicians from other parties in the crisis in an attempt to dilute the

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Emerging Markets

negative impact of the scandal. In retaliation, the leader of the Senate rejected the bill to revert payroll tax cuts, increasing concerns over the timing of the execution of the fiscal consolidation process. In a strong display of willingness to adjust, the president resubmitted the bill with urgency (giving a deadline of 4 months to be approved by the Congress).

- Mexico: Consumer confidence posted a 0.9% mom sa rise in February, but business confidence and manufacturing PMI continued to deteriorate. In the previous week, authorities published a bidding process for 9 shallow water areas in the Gulf of Mexico, a region that enjoys a relatively cheap cost of production. The bid submission deadline is 30 September and will be an important bellwether to the potential capex following transformational reforms implemented in the energy sector over the last two years.

- Chile: Annual inflation surprised on the upside at 4.4% in February, above the upper limit of the central bank's 2%-4% target. Core prices increased to a high of 5.7%, adding conviction that the central bank will not cut rates during 2015 and the next movement may be a hike in order to counterbalance the effects of weaker CLP pass-through to inflation.

- Russia: Manufacturing PMI rose to 49.7 in February from 47.6 in January.

Vimpelcom has launched a cash tender offer for up to USD 2.1bn for four bonds maturing between 2016 and 2021, in line with their stated intention to use the proceeds from the sale of 51% of a subsidiary in Algeria to repay upcoming debt.

- Poland: The National Bank of Poland cut rates by 50bps to 1.5%, more than economists' consensus expectations of a 25bp cut. However, the market had priced in a 50bp cut on the curve so the yield curve didn't rally much – particularly after the central bank said the monetary easing cycle is over.

- Indonesia: February headline CPI came in 6.3% yoy, materially below consensus expectations of 6.7%. Core inflation remained stable at 5.0%. For the first time Bank Indonesia officials admitted a slightly undervalued Rupiah might be supportive of manufacturing exports, but emphasised that they don't seek to manage FX and their actions simply seek to manage volatility.

- China: Prime Minister Li Keqiang opened the annual session of the National People's Congress, where nearly 3,000 representatives rubber stamp general policies to be implemented by the politburo in the year ahead. He announced a number of measures, including growth targets being reduced to around 7%, from 7.5% and that the central government will target a deficit of 2.3% GDP, slightly higher than the 2.1% from the previous year which compensates for less fixed asset investment from local governments. On the other hand, military spending is set to increase by 10%. Reforms on state owned companies and a continuous fight against corruption were also featured in his speech for the second consecutive year.

On the external balance side, February's trade balance was another incredibly strong USD 60bn, matching January's number. Stronger trade numbers led to a small appreciation of the CNY versus the USD. The RMB is 2.5% weaker against the USD from its highs on 31 October as strong trade numbers were outpaced by outflows of hot money. This is a relatively resilient performance, however, considering the EUR is down by 13.1% against the USD over the same period. The strong trade number on its own is evidence that the RMB is not overvalued. We believe the PBoC may continue to allow a gradual depreciation in the face of outflows, but will keep selling its excessive USD 3.84trn reserves to smooth the process. Therefore, the most important impact of outflows is liquidity tightening in RMB, which will demand continuous monetary easing in order to keep the economy growing at the pace announced this week.

- India: RBI Governor, Raghuram Rajan, cut the policy rate by 25bps in an unscheduled move following Modi's budget. In Rajan's own words: "This makes explicit what was implicit before – that the government and the Reserve Bank have common objectives and that fiscal and monetary policy will work in a complementary way."

Further cuts are expected as the easing of supply constraints such as power, land, minerals and infrastructure allow the economy to grow sustainably and generate inflation within the RBI target. India's Manufacturing PMI declined from 52.9 to 51.2.

- Korea: CPI inflation weakened further to 0.5% yoy in February, dragged down by the fall in fuel prices. Manufacturing PMI remained steady at 51.1 in February. January's current account surplus remained robust at USD 7bn, about twice as wide as the 2014 number.

Snippets:

- Costa Rica: In a light week for new deals, Costa Rica issued USD 1bn to March 2045 at a 7.158% coupon.
- Australia: Australia's RBA kept rates unchanged at 2.25%, but sounded more dovish.

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Global backdrop

Calling the US labour market strong would be an understatement. With another 295k new jobs created in February, the unemployment rate declined 0.2%, reaching the 5.5% 'neutral level' of unemployment defined by the Federal Reserve. The strong employment data contrasts with relatively poor economic growth figures for Q1 2015 so far, but a strong labour market is much more important for the economic outlook than backward-looking activity data from January and February. We believe that this makes it ever more likely that the FOMC will eliminate forward guidance 'patient' language at its next meeting, paving the way for the first hike between June and September.

US treasury market reaction was arguably not sufficient to re-price the risks of an early hiking cycle. In particular in the 5-year part of the curve could arguably reach 2% if economic data gets stronger in line with payrolls. That compares with 1.68% at Friday's close. An-earlier-than expected start of the cycle would probably mean a flatter curve, which will also be anchored by European QE, set to start today. Term premia are likely to remain low throughout the year after Draghi clarified that the ECB is ready to buy bonds trading at negative yields, but not below the -0.2% deposit rate. This means QE is likely to be concentrated on the belly and long end of the curve, particularly in core European economies where the front end of the curve trades firmly at negative yield levels, with two year bunds trading under the threshold.

The widening in interest rate differential between US treasuries and European core bonds continues to provide strong momentum to the USD, bringing the EUR to trade at its lowest levels since September 2003 at 1.088. Commodity prices were impacted by the stronger greenback, declining by 1.8% on the week. Brent futures declined by 4.5%, still hovering around the USD 60pb levels where it has been for nearly a month. The WTI contract was flat on the week trading around USD 50pb. Baker Hughes reported that the oil rig count fell 64 to 922, a three year low. That's down 43% from highs in April 2011, yet output is still rising.

European core CPI came in at +0.6% yoy, in line with expectations. Unemployment declined to 11.2%, more than the 11.4% expected. Euro area Manufacturing PMI in February was in line with expectations at 51 with positive surprises in Germany, Italy and Russia and slowdowns in France and Spain. Central European PMI's remain the strongest in the region, at around 55.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.9%	1.7%	3.0%	0.6%	2.8%
MSCI EM Small Cap	-0.7%	3.0%	0.8%	3.3%	3.7%
MSCI FM	0.1%	-1.1%	2.0%	11.6%	6.5%
S&P 500	-1.54%	1.00%	12.61%	18.02%	15.09%
GBI EM GD	-3.57%	-4.55%	-10.03%	-4.01%	1.07%
ELMI+	-1.16%	-2.95%	-9.55%	-3.25%	-1.11%
EM spot FX	-2.62%	-6.11%	-17.48%	NA	NA
EMBI GD	-0.69%	1.09%	6.05%	4.99%	7.21%
EMBI GD IG	-1.27%	0.80%	7.36%	4.35%	6.48%
EMBI GD HY	0.34%	1.56%	3.86%	6.08%	8.31%
5 year UST	-0.93%	0.08%	2.00%	0.86%	3.23%
7 year UST	-1.47%	-0.07%	4.36%	1.41%	4.91%
10 year UST	-2.16%	-0.35%	7.94%	2.64%	6.49%
CEMBI BD	0.02%	1.86%	4.71%	5.22%	6.44%
CEMBI BD HG	-0.21%	1.77%	6.38%	5.48%	6.60%
CEMBI BD HY	0.51%	2.04%	1.27%	4.91%	6.30%
US HY	-0.42%	2.58%	1.82%	7.79%	9.35%
European HY	0.33%	3.62%	6.39%	12.87%	11.93%
Barclays Agg	-1.96%	-2.91%	-4.47%	-0.59%	2.02%

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

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