Ashmore

Shale talks in Argentina could be a game changer

By Jan Dehn

Argentina's government and provinces embark on potentially game-changing talks over shale gas. In Ukraine, Poroshenko meets Putin to keep a diplomatic solution on track. Mexico cuts 50bps, having earned the ability to do so. Dilma's approval rating drops further. Thailand's consumers perk up. Malaysia produces another strong external surplus. China's reserves look set to exceed USD 4trn by the middle of this year following another strong trade surplus. Also, US mutual fund flows in Emerging Markets (EM) predictably pick up well into a five-month rally. The ECB's decision to ease further despite a cyclical upswing illustrates perfectly the structural nature of the economic challenges faced by developed economies. Monetary policy is not the right instrument, but there is no choice given inaction on reforms.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,047	–	1.76%
MSCI EM Small Cap	1,082	–	1.45%
MSCI FM	697	–	0.04%
GBI EM GD	6.48%	–	1.53%
ELMI+	3.02%	–	0.55%
EMBI GD	5.05%	243 bps	0.58%
EMBI GD IG	4.31%	164 bps	0.26%
EMBI GD HY	6.77%	439 bps	1.19%
CEMBI BD	5.08%	279 bps	0.19%
CEMBI BD HG	4.25%	196 bps	0.10%
CEMBI BD HY	6.78%	452 bps	0.39%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1949	1.32%
VIX Index	10.73	-7.34%
5 year UST	1.68%	9 bps
10 year UST	2.62%	9 bps
US HY	5.25%	0.18%
European HY	4.22%	0.51%
EURUSD	1.3624	0.21%
USDJPY	102.46	0.08%
Brent	109.42	0.12%
Copper	316.34	-2.73%
Gold	1255.79	0.92%

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

Emerging Markets

- Argentina: A potentially game-changing negotiation is now underway between the central government in Buenos Aires and Argentina's powerful provinces over control over the world's second-largest shale gas reserves. The parties are due to sign an accord defining parameters for the talks this week. It is important to follow this negotiation closely. A major imbalance between revenues and expenditures at central government and provincial level (in favour of the provinces) lies at the root of Argentina's dismal record as a serial defaulter. Naturally, these talks will not be smooth. In what may well be a sign of things to come, the governor of Mendoza province last week seized half of an exploration field operated by YPF, a state-owned energy company. In another positive development, Argentina re-opened its domestic bond market for the first time in five years with a USD 540m auction of three-year bonds. This week, the US Supreme Court is likely to decide how it will process Argentina's appeal of a lower court's decision that holdout investors should be paid from the payment stream intended for holders of performing bonds (we discussed this issue at length in previous versions of the Weekly Research).
- Ukraine: Petro Poroshenko was sworn in as president in Ukraine, but the far more important development last week was his meeting with Russia's President Putin. This meeting, while unlikely to bring about an immediate solution to the problems in Eastern Ukraine, marks yet another step along the long road towards an eventual diplomatic solution. Representatives of President Putin, President Poroshenko and the OSCE are having peace talks this week.
- Mexico: The central bank cut rates by 50bps to 3% in a surprise move. Banxico, as the central bank is called, cited persistent slow growth as the reason for the one-off cut. Mexico's economic authorities have a very high degree of credibility and the rate cut illustrates once again that they have broken the curse still faced by many EM countries that they are forced by investors to raise rather than cut rates when growth disappoints. Mexico's growth rate has been weak for several reasons, including slow US growth, a mini-crisis among home builders, slow execution of investment projects by the government and uncertainty caused by President Peña Nieto's many reforms. All of these factors are temporary in nature; the structural reforms however have increased Mexico's potential growth rate, which means that Mexico can grow faster before it raises rates once growth returns. This may also be playing a part in Banxico's decision to cut rates.

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Emerging Markets

- Brazil: Year-on-year inflation rose to 6.37% in May from 6.28% in April. Inflation remains uncomfortably close to the central bank's ceiling despite major rate hikes over the past 18 months. This illustrates the problem faced by the central bank in a country, where the government insists on inflating the size of the government while neglecting productivity enhancing reforms. With slowing population and little capital investment, given low savings rates, Brazil will struggle to grow much faster than 2% without inflation unless it increases productivity. Indeed, industrial production growth in April was soft, down 5.8% yoy as Brazil continues to face a real challenge in reigniting growth. No productivity enhancing measures are likely before the election, given the current economic team. President Dilma Rousseff continues to pay the political price for her economic policies; this week her approval rating dropped to 34% from 37% last month, according to a reputable pollster (Datafolha).
- Malaysia: The trade surplus in April was USD 2.7bn, which was another strong print following a USD 2.9bn trade surplus in March. Exports rose 18.9% yoy compared to 8.3% yoy in March. Malaysia is on the verge of implementing a USD 444bn program intended to raise productivity and ensure the country's continued expansion even as the currency appreciates against the USD.
- Thailand: Consumer confidence turned positive in May after thirteen months of decline. This follows the military's take-over in a recent coup, which has temporarily diffused an intractable political conflict between parties representing lower rural votes and wealthier urban voters.
- China: China's HSBC composite PMI rose in May to 50.2 from 49.5 in April. Services PMI was also higher. In addition, China recorded a much larger than expected trade surplus of USD 35.9bn as exports surged, while imports slowed. This is the largest trade surplus in Chinese history except for a brief period in 2008/2009. China continues to accumulate reserves, which now stand at USD 3.95trn. On current trends, reserves could exceed USD 4trn by the middle of this year.
- Flows: Flows by US mutual funds into EM rose to USD 2.2bn last week, the largest inflow since 2004. The surge in flows reflects recent strong performance in EM markets as investors once again prefer to buy once markets have already rallied significantly. Flows into and out of EM from US mutual funds are closely monitored by the market and the media, but they are in fact not at all representative of how most investors in EM behave. Throughout last year's EM sell-off total flows in EM remained positive, albeit slower, while US mutual fund outflows were among the largest ever recorded. Prices declined because marginally slower growth in demand coincided with roughly unchanged growth in supply.

Monetary policy:

- The Bank of Uganda cut policy rates by 50bps to 11%
- The Mexican central bank cut rates by 50bps to 3%
- Poland's central bank left rates unchanged at 2.5%

Global backdrop

At a time of record low European periphery bond spreads, an upturn in the Eurozone business cycle (retail sales, car registrations, consumer confidence, growth in several countries, etc.) and more than a year after the European debt crisis retreated from the headlines, the ECB decided to break new ground in monetary policy easing. The ECB not only introduced negative interest rates, but also launched targeted credit easing via long-term repo operations (LTROs), and hinted at outright QE in the not so distant future. Why?

The ECB's decision to embark on unprecedented easing makes no sense from a conventional cyclical perspective, but is entirely logical in the context of the structural economic challenges that have been exposed in the Eurozone since 2008/2009. These are too much debt, an insolvent banking system and 18 governments unwilling to do anything about it.

It is neither Europe's complex politics nor its excessive debt stock which make Europe fundamentally different from the US. After all, the US political system also ignores long-term structural problems, and the US economy is even more indebted than Europe.

Europe's unique challenge is that its banking system is insolvent, while the US recapitalised its banks right at the start of the crisis. This means that the US monetary transmission mechanism is likely to be able to generate inflation as soon as household deleveraging is complete, while in Europe the transmission mechanism will not work. Indeed, inflation in Europe declined to 0.5% yoy in May from 0.7% in April (and versus 0.6% expected).

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Global backdrop

For Europe this inability to generate inflation means that rising nominal US treasury yields will likely translate into rising real yields, since EUR yields are highly correlated with UST yields. And rising real yields are a massive problem given the large debt stock, not least in the periphery. Rising real yields will also slow the economy, strengthen the EUR, and increase the risk of deflation in Europe. Unlike Europe, the US will be able to ameliorate these effects by creating inflation. Indeed, in just a few years' time the indebted world will be yearning for inflation, because inflation keeps real interest rates low, erodes away debt and weakens currencies to increase export competitiveness.

The ECB sees this problem. It recognises that the EUR is likely to face relentless appreciation pressure versus the USD, not because Europe is a shining beacon of economic health, but because Europe cannot inflate, while the US can and will. This is why ECB President, Mario Draghi, is keeping his QE powder dry; he will need it later and he does not yet have approval from the governing council for QE.

The market reacted by pushing the EUR higher, not lower. The market saw the announcement that there will be no further rate cuts and no immediate QE, but more LTRO than expected as a sign that aiding monetary transmission was more important than weakening the EUR. Looser liquidity conditions are likely to encourage flows into the periphery and therefore also into the EUR. This just underlines the difficulties Draghi will experience in pushing the EUR lower barring the reappearance of some market panic about Europe.

German GDP expanded at a strong 3.3% qoq annualised rate in Q1. Growth also looks to be on track, given a strong pickup in exports amidst modestly rising imports in April. Positive net exports add to GDP.

Many celebrated the fact that the total non-farm labour force in the US finally reached the level prior to the subprime crisis in 2008. Still, to us that just illustrates the extent of the still significant slack in the US labour market, because the working age population has risen significantly in the past six years. We are extremely skeptical about the arguments that the decline in the participation rate since 2008/2009 is structural in nature. Still, last week's payroll number was marginally better than expected, although both ADP private payrolls and initial claims for unemployment benefit fell somewhat short of expectations. After growing -1.2% qoq annualised in Q1, US growth is set to expand about 3% in Q2, although last week this estimate was reduced somewhat following a wider than expected trade deficit in April.

In Japan, real wages dropped 3.1% yoy in April due to the effect on CPI of the recent consumption tax increase and weak nominal wage growth (+0.9% yoy). This comes following very strong GDP growth in Q1 2014 as consumers anticipated the tax hikes and moved forward their intended purchases. Thus, GDP expanded 1.6% qoq (seasonally adjusted) in Q1 compared to 1.5% in Q4 2013 and 1.4% expected.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.9%	5.2%	8.9%	-0.3%	8.7%
MSCI EM Small Cap	1.2%	7.9%	6.3%	0.1%	10.8%
MSCI FM	0.3%	20.8%	28.6%	12.4%	9.5%
S&P 500	1.40%	6.43%	22.67%	17.39%	18.15%
GBI EM GD	1.15%	6.16%	0.65%	1.11%	7.71%
ELMI+	0.29%	2.05%	1.08%	-1.18%	2.86%
EMBI GD	0.50%	8.82%	7.43%	7.64%	10.52%
EMBI GD IG	0.12%	8.35%	5.11%	6.16%	8.72%
EMBI GD HY	1.22%	9.75%	12.23%	10.29%	13.25%
5 year UST	-0.57%	1.80%	-0.26%	2.16%	4.01%
7 year UST	-0.82%	3.47%	-1.05%	3.37%	5.53%
10 year UST	-1.15%	6.08%	-0.66%	5.42%	6.24%
CEMBI BD	0.15%	5.82%	6.05%	6.10%	9.96%
CEMBI BD HG	0.03%	5.94%	5.80%	6.33%	8.97%
CEMBI BD HY	0.41%	5.56%	6.59%	5.96%	13.15%
US HY	0.21%	5.13%	10.29%	9.85%	14.85%
European HY	0.55%	5.90%	14.10%	13.36%	17.34%
Barclays Ag	-0.26%	3.90%	4.07%	1.99%	4.81%

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