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WEEKLY INVESTOR RESEARCH

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Mexican reform momentum gathers pace as the Fed prepares for Tapering II

By Jan Dehn

Elections will dominate the outlook for Emerging Markets (EM) in 2014. This year we had a taster of things to come in the shape of Mexico's reform effort. A review of market moves in Mexico over the past year or so shows that global events as much as Mexico-specific factors drove the price action. In the past week Mexico passed an important fiscal reform and is now moving onto the equally important energy reform. We expect this reform to pass and believe that the outlook for Mexico continues to brighten. Meanwhile in the United States the Fed is getting ready to have another go at tapering. This time they are likely to replace Bernanke's ineffective verbal intervention ('tapering is not the same as rate hikes!') with a commitment to keeping rates low until unemployment gets really low. But even with enhanced forward guidance how exactly will the Fed prevent the market from selling the long end absent direct market intervention via QE? The mortgage market may be part of the answer, but on its own may not resist a speculative movement if fast money tries to push long-term yields higher again.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	995		-3.13%
MSCI FM	572		0.18%
GBI-GD	6.62%		-2.08%
ELMI+	4.27%		-1.04%
EMBI GD	5.83%	306 bps	-1.21%
EMBI GD IG	4.92%	216 bps	-1.29%
EMBI GD HY	9.32%	678 bps	-1.06%
CEMBI BD	5.60%	331 bps	-0.46%
CEMBI BD HG	4.78%	247 bps	-0.40%
CEMBI BD HY	7.51%	526 bps	-0.16%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,771	0.24%
VIX Index	12.90	-0.23%
5 year UST	1.41%	6 bps
10 year UST	2.75%	14 bps
10 year Bund	1.74%	7 bps
EURUSD	1.3397	-0.85%
USDJPY	99.12	0.47%
Brent	$105	-0.05%
Copper	$330	-0.74%
Gold	$1285	-2.58%

Emerging Markets

One of the important investment themes in 2014 will be elections. A large number of elections are scheduled across the EM universe, including prominent countries such as India, Brazil, Turkey, and South Africa. The lessons from the numerous EM elections that have taken place since the end of the Cold War can be summarised as follows:

- Governments will do almost anything to maintain stability leading up to an election
- The post-election period is often characterised by a flurry of reform activity
- Speculative activity tends to increase in the period leading up to elections and during the subsequent reform approval process
- Election and reform-related volatility usually present excellent buying opportunities, although the occasional exception to this rule means that each case should be evaluated on its own merits

The run-up to and aftermath of Mexico's 2012 election is a great example of the kind of price action we can expect in the election countries next year. In Mexico's case the market began to rally early and strongly in anticipation of a benign election outcome (which subsequently materialised). The rally was interrupted briefly in May-June 2012 due to reasons entirely unrelated to Mexico, namely concerns about Spanish banks. This European risk triggered the usual mindless knee-jerk selling of EM assets, but subsequently turned out to be a wonderful buying opportunity, because Mexican bonds went on to rally a whopping 40% from the June lows. But from this point onwards the market rally was increasingly driven by momentum rather than fundamentals. In particular, the market paid less attention to an increasingly complex fundamental picture in Mexico, including intense political bargaining over reforms, the slowdown in the economy due to slower US growth, problems in the construction sector, and, most importantly, hesitancy among domestic economic agents pending the passage of reforms. When EM fixed income valuations adjusted sharply lower in late May 2013 on the back of Fed tapering talk Mexican fixed income did not escape the broader market correction. During the most intense phase of selling the market briefly appears to have lost sight of the fact that Mexico is now addressing its deeper fundamental structural constraints for the first time in many years.

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Emerging Markets

In summary, Mexican asset prices moved all over the place, often departing from fundamentals for reasons entirely unrelated to matters Mexican. Volatility is volatility, but risk is ultimately about what actually happens in Mexico. In the past week, the Mexican Senate approved the income side of the budget, which includes major fiscal reform elements. The fiscal reform introduces taxes on capital gains, dividend taxes, mining royalties, and excise taxes on unhealthy food. The bill also eliminates important VAT exemptions and tightens up the fiscal responsibility law by imposing tight limitations on spending, regardless of the economic cycle. The measures will take full effect in the coming years, but already in 2014 there will be material improvements in fiscal revenues.

Attention now turns to passage of the energy reform, which for the first time since the 1930s looks set to allow private investment into Mexico inefficient state-run oil sector. The latest indications suggest that the opposition PAN party will support the energy reform in exchange for an even more investor friendly regime for private capital. The reform is likely to be passed by year-end, boding very well for Mexico's fiscal and broader economic future.

In conclusion, it is important not to get too caught up in the short term volatility caused by the shifting sentiment about tapering and other non-EM matters: Mexico is making the most important strides forward on structural reform in more than a decade and investors who recognise this fact are likely to do better than those who only gamble on short-term market momentum.

Another important development in Emerging Markets in the past week was the news that international oil companies Chevron and Shell committed to invest serious money to develop Ukraine's nearly 3 trillion cubic meters of shale gas reserves.

Why is this news so important? To see why, it is important to understand the complex and highly challenging domestic and external political landscape in Ukraine. On the external front, Ukraine is critically dependent on energy from Russia. Russia regularly uses its financial and energy might to put the squeeze on Ukraine in a bid to get Ukraine to cede its huge underground gas storage capacity to its Eastern neighbour. Control of Ukraine's gas storage facilities would confer onto Russia the ability to manage daily gas supplies to Western Europe more effectively, a hugely valuable geopolitical power.

Russia is also extending a carrot to Ukraine: Join the Eurasian Economic Community (EEC) and we will sell you gas at a significantly discounted price of USD 125 per cubic meter instead of today's USD 425 per cubic meter (adjusted for a discount of USD 100 per cubic meter for use of the Sebastopol naval base). Ukrainian entry into the EEC would be a big triumph for Russia, which hopes that all trade in the EEC can be eventually be settled in convertible Russian roubles. This would give Russia virtually unlimited ability – via central bank printing – to finance asset purchases in other EEC member states, again a hugely valuable geopolitical power.

Why then is Ukraine holding out against the Russians? Clearly, there is the fear of becoming the vastly weaker party in a formal EEC relationship with Russia and Ukraine also wishes to hold on to its valuable gas storage asset. There is also is a fear among Ukraine's oligarchs that they would become junior partners in a face-to-face contest with Russia's even more mighty oligarchs.

Finally, Ukraine has a genuine alternative to closer ties with Russia. Closer ties with the European Union would, in time, 'sanitise' Ukraine and thus allow its super-wealthy oligarchs to gain 'respectability'. But turning to the West is far from a no-brainer for Ukraine. Ukraine's economic ties with Russia are far deeper than its ties with Western Europe. For example, 30% of Ukrainian exports go to Russia. The main sector benefiting from EU membership would be agriculture as the industry is concentrated in Eastern Ukraine. Besides, European Union accession would take many years during which time economic interests in Ukraine are better served by maintaining business ties with Russia.

In this very complicated and finely tuned power balance, the Shell and Chevron news is important because it gives Ukraine the prospect of greater energy independence at the same time that it helps to make the case for joining the EU. Ukraine will be able to continue to play both sides for a little bit longer.

Global backdrop

The US dollar has gained a lease of life over the past week, especially against the Euro, but also against EM currencies due to a combination of positive data and favourable technical.

Consistently stronger US manufacturing data in the past week (Markit PMI, ISM, ISM New York, and ISM services), a stronger than expected Q3 GDP print, and a strong payroll print on Friday shifted expectations sharply in favour of tapering in December.

ECB's decision to cut rates by 25 bps further accelerated the Dollar recovery. Finally, as year-end draws nearer and liquidity can be expected to decline some investors will be squaring positions early, which also contributes to Dollar strength into year-end.

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Global backdrop

Tapering is coming back. The US stock market reacted negatively to the strong payroll number, illustrating precisely why the Fed has to scale back QE: The market pays more attention to the next QE sugar high than the economic data.

But the problem the Fed faces is how to prevent the long end of the treasury curve from sharply selling off. Between May to September, 2s30s steepened nearly 100bps and 30 year mortgage rates rose 115bps bps as Fed Chairman Bernanke's verbal guidance (that tapering is not the same as rate hikes) was completely ignored by the market. The US treasury market went on to price in nine rate hikes by Q3 2016.

This is so damaging because of the fragility of the US economy. Sure, GDP growth was 2.8% in Q3, but after adjusting for inventory accumulation, which may signal lower growth in Q4, the US economy expanded only at a 2.0% pace in the last quarter. And the economy carries debt of 405% of GDP.

In slow growing, debt-burdened economies higher long rates can cause serious economic damage. This summer sell-off in US treasuries caused mortgage applications to drop 65% as mortgage rates rose.

To avoid a repeat performance, the Fed now appears to be considering enhanced forward guidance in the shape of a materially lower unemployment threshold before it hikes rates.

Will a lower unemployment threshold stabilise the long end of the treasury curve? Very possibly not. After all, what tools would the Fed employ to manage the long end if the market chose to sell? The Fed only has very little 'twist' capacity left – only 16% of the assets on its balance sheet are less than 5 years to maturity.

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