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Softer, Better, Faster, Stronger

By Alexis de Mones

For several months last year Emerging Markets (EM) bonds were seemingly trading as a leveraged play on financial conditions. Performance was highly correlated with the price of a 2-year treasury futures contract: falling when Fed Funds hikes seemed more imminent, and rallying when this prospect seemed further out in the future. This lasted until September, when the relationship broke down and the global macro data did not matter so much anymore. A growing focus on the December QE taper, country-specific events (mostly political in nature like in Turkey and Russia), and fears of slower growth in China swept all before them, putting significant pressure on EM equities and currencies in particular. Since March, however, EM assets have been rallying strongly. There are several factors underpinning this renewed strength. We outline four, with apologies to Daft Punk whose 2001 tune (with minor revision) describes them quite well: **Softer, Better, Faster, Stronger**.

Softer refers to the global economic data and the more dovish policy reaction from the Fed, as well as the ECB's more dovish stance in the face of lower-than-expected inflation. This has been an important factor behind the most recent leg of the rally, though not the initial catalyst; **Better** describes the economic policy response by EM officials, starting with the interest rate hikes delivered in Turkey or South Africa in January, which stopped the rot and set the stage for the recent rebound; **Faster** illustrates the speed of the recent price action in local markets such as Brazil notably, which is forcing investors to cover their short positions and is pushing prices higher; Finally the rally is also **Stronger** because it is not just a short-covering trade; participation has been broadening from long-term strategic investors to cross-over investors, and finally retail investors, who are returning to the EM asset class (both fixed income and equities) after months of continuous outflows and have posted two consecutive weeks of strong inflows into dedicated mutual funds and ETFs.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1015	–	1.15%
MSCI EM Small Cap	1056	–	0.59%
MSCI FM	658	–	1.82%
GBI EM GD	6.78%	–	0.85%
ELMI+	3.70%	–	0.45%
EMBI GD	5.44%	279 bps	0.61%
EMBI GD IG	4.64%	194 bps	0.62%
EMBI GD HY	7.38%	503 bps	0.61%
CEMBI BD	5.35%	309 bps	0.36%
CEMBI BD HG	4.44%	219 bps	0.45%
CEMBI BD HY	7.22%	497 bps	0.17%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1816	-1.54%
VIX Index	17.03	9.38%
5 year UST	1.58%	-10 bps
10 year UST	2.63%	-7 bps
US HY	5.36%	0.07%
European HY	4.34%	0.14%
EURUSD	1.3830	0.64%
USDJPY	101.75	-1.33%
Brent	106.87	1.35%
Copper	310.91	1.12%
Gold	1323.65	1.99%

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

Emerging Markets

In a busy week for EM news, the first theme was a packed election season kicking off with polls in India, Indonesia, Hungary.

- **Hungary:** In Hungary, the Fidesz Party had another success in the general election and is again close to securing a two-third 'super-majority' in parliament for another four years. The economic backdrop has been favourable, with low but positive GDP growth supported by the external sector and a sizeable external surplus, and domestic demand now starting to benefit from loser fiscal policy.
- **Indonesia:** In Indonesia, the initial results of the legislative elections held on Wednesday 9 April indicate that the main opposition party PDI-P gathered the greater count of the popular vote at close to 20%. However, the recent announcement that Joko Widodo (or 'Jokowi') would lead the party into the presidential race later this year was not enough to give the PDI-P a 25% share of the vote, which would have allowed it to run on a single ticket. Jokowi, who is more a technocrat than a career politician, will thus have to enter into coalition talks with other opposition parties and needs to pick a VP running-mate carefully. This creates some uncertainty, and has led to some profit-taking in local markets.

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Emerging Markets

- Brazil: In Brazil, another poll confirmed the government's recent drop in popularity. In the Datafolha survey conducted between April 2-4 the share of the public giving an 'excellent' or 'good' rating to the current administration dropped to 36% from 41% in the poll conducted in late February by the same institute. This was welcome by investors who have been growing increasingly frustrated with the ineffectiveness of the president and her economic team and are calling for change after October presidential elections.

- Ukraine: Political risk has clearly risen in Ukraine where the government has launched an 'anti-terrorist' military operation against pro-Russian activists who had taken control of the police headquarters in the Eastern city of Slovyansk. The government has given non-loyalists an ultimatum and Russia seems intent to escalate, or at the very least extract a huge political price to remain on the sidelines, bringing the stand-off to a new level.

The second theme of the week has been the release of a number of trade and current account statistics, which taken together paint the picture of a slow stabilisation in external accounts across a number of Emerging Markets.

- Russia: In Russia, the current account balance came out at USD 27.6bn in Q1 14. On a four-quarter rolling basis, the current account surplus increased to USD 36.1bn (c.1.7% of GDP) from USD 32.8bn (1.5% of GDP) in 2013, which suggests a stabilisation in the steady decline in the current account surplus since Q1 12.

- Chile: Chile posted a larger-than-expected USD 1.7bn trade surplus in March, up from a surplus of USD 515m a year ago. The 12-month cumulative trade surplus increased to USD 4.2bn in March, up from USD 0.3bn a year ago. The improvement was notably due to a slowdown in investment spending that reduces the need for imported capital and intermediate goods.

- Turkey: Turkey's February trade data showed further progress in the country's external rebalancing process as domestic demand weakens and exports benefit from price competitiveness and the recovery in European markets: the seasonally adjusted current account deficit narrowed to -USD 3.1bn, from -USD 4.1bn in January and -USD 6.1bn in December. The balance, net of energy and gold, posted a surplus for the second month in a row. February data also showed that consumer lending was growing at a more modest clip and that Turkish companies have no difficulty in finding long-term financing from abroad. Despite this smooth economic adjustment thus far, Moody's changed the outlook on Turkey's external debt rating to 'negative' from 'stable', while keeping the rating unchanged at Baa3.

- China: In China, where the balance of payments is obviously much less of a concern than Turkey, the March trade balance revealed poor Exports and Imports numbers, at -6.6% and -11.3% yoy respectively, a very weak outturn almost entirely due to base effects. The drop in exports is explained by the huge over-invoicing of exports to Hong Kong that boosted exports numbers last year. The details reveal that exports to the EU, the US and ASEAN rose 6.4%, 1.2%, and 10.3% yoy respectively in March.

Besides external accounts, economists and investors are also scrutinising inflation and monetary policy information for signs that the macro-economic re-balancing process is not generating unwanted cost-push inflation, and to make sure that EM central banks are ready to act. For the most part inflationary pressures have remained muted and central banks have responded adequately.

Last week saw the central banks of Poland, Korea and Peru leave their policy rates unchanged at 2.5%, 2.5% and 4.0% respectively. The Bank of Indonesia also left its key policy rate, including its key lending facility (the 'BI rate') at 7.5% unchanged for the fifth consecutive meeting, having accomplished its main objective of reducing local consumption and credit growth to sustainable levels, resulting in lower inflationary pressures and a milder current account deficit.

The inflation data from Mexico, Hungary, Romania and China were also benign. In Mexico the monthly headline CPI rate came at 0.27%mom vs. 0.30% expected, helped by a fall in the price of food and beverages. The outturn was well below the 10-year average for that month and took annual inflation down to 3.76% yoy. In Hungary and Romania the headline number came in at 0.1 and 1.0% yoy, respectively. China's headline CPI rebounded to 2.4% yoy in March from 2% yoy in February, mainly due to a lower base last March.

The one notable exception was Brazil, where March IPCA inflation reached 0.92% mom (6.2% yoy) the highest figure for monthly inflation in March since 2003, when IPCA inflation ended the year at 9.3%. The main driver of the inflation uptick was unprocessed food. Interestingly, the minutes of the latest rate setting meeting (Copom) released this week specifically sought to downplay the risk of food price inflation and stressed the lagged effect of the current hiking cycle, which sent another strong message that the cycle was coming to an end and led to some steepening in the BRL yield curve.

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Global backdrop

As discussed above, global macro developments have provided a favourable backdrop for EM debt and equities. The rally in US treasuries that started with the employment report the week before extended significantly with the release of the FOMC minutes, taking the 2-year treasury yield down to 36bp and the 5-year yield to 1.60%, down 20bp on the week. The minutes confirmed the committee's constructive view of the economic outlook, albeit with some downside risk, but emphasized the members' focus on inflation, which they expect to remain significantly below target for some time. The minutes also showed the committee's efforts to de-emphasize the message sent by the 'dots', which was interpreted as a dovish signal, although there was nothing fundamentally new in substance.

Similarly, the ECB confirmed its shift to a more accommodative set of policies as president Draghi shared his concerns about the strength of the euro. The strong performance of the Eurozone, and particularly euro periphery bond markets, created ideal conditions for Greece's remarkable return to the capital markets. Just two years after the largest bond restructuring in history, Greece issued €3bn of 5-year bonds at a yield of less than 5% following a book-building exercise that saw the issue seven times over-subscribed. It is astonishing that Greece, with public debt four times the average EM public debt should be viewed as a good investment at a lower yield than EM debt. It serves to show the amount of liquidity that is available to follow a good story in credit markets, so once the periphery trade is exhausted maybe EM debt will benefit again.

So what shall we make of the recent rally in Emerging Markets?

Perhaps the recent rebound in EM performance was predicated on the benign interest rate backdrop and will not be able to survive a string of stronger US data. We don't think so. The rally in EM assets demonstrated its resilience when it shrugged off the hawkish tone of last March FOMC statement that shaved 25 basis points off the December 2015 Eurodollar contract.

The more striking aspect of recent markets was the out-performance of EM over developed market assets: the 4.7% and 5% month-to-date returns of the Brazilian and Chinese equity indices contrasting with the flat performance of the S&P 500 and the 3.5% drop in the Nikkei. Beyond the specific characteristics of each of these indices, this divergence is the mirror-image of the market regime that prevailed 6 months ago and one naturally looks for clues in the reversal of portfolio flows that has taken place in recent weeks. Retail fund flows provide a truncated but a pretty timely picture. In the week leading to April 9, EM dedicated equity funds recorded inflows of USD 2.9bn, or USD 5.4bn of inflows over two weeks. Likewise, EM bond funds attracted USD 1.8bn inflows last week, recording the first back-to-back weeks of inflows for the first time since last May. These are early days and the past trend in flows may not be broken yet, but with flows into EM picking up again, performance and perceptions can change very quickly indeed.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.2%	1.7%	1.6%	-2.6%	12.8%
MSCI EM Small Cap	1.6%	5.1%	2.8%	-1.8%	17.4%
MSCI FM	5.3%	12.7%	29.2%	8.7%	14.2%
S&P 500	-2.95%	-1.19%	16.37%	13.51%	18.67%
GBI EM GD	1.29%	3.22%	-8.70%	0.70%	8.73%
ELMI+	0.51%	1.05%	-2.29%	-1.31%	3.64%
EMBI GD	1.10%	4.87%	-0.72%	7.30%	11.21%
EMBI GD IG	1.03%	4.73%	-2.85%	6.13%	8.80%
EMBI GD HY	1.22%	5.17%	3.31%	9.50%	14.67%
5 year UST	1.09%	1.92%	-1.26%	3.58%	3.20%
7 year UST	1.34%	3.41%	-2.90%	5.18%	4.25%
10 year UST	1.67%	6.06%	-2.55%	7.59%	4.76%
CEMBI BD	0.71%	3.52%	1.20%	5.91%	11.80%
CEMBI BD HG	0.76%	3.81%	1.17%	6.48%	10.22%
CEMBI BD HY	0.60%	2.90%	1.30%	5.12%	17.23%
US HY	0.29%	3.55%	7.91%	9.68%	18.18%
European HY	0.50%	3.90%	12.44%	13.34%	21.66%
Barclays Ag	1.09%	3.52%	2.78%	3.12%	5.43%

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