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Europe and Russia get their act together

By Jan Dehn

Peace agreements are at the most fragile in the immediate aftermath of a cease-fire but, if the agreement sticks, the deal negotiated between Germany and Russia with the aid of Ukraine and France is very good news for all involved. Russia stands to gain the most, but we think a lasting settlement would also be a major feather in the cap of German Chancellor Angela Merkel.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	985	–	1.26%
MSCI EM Small Cap	1,015	–	1.19%
MSCI FM	592	–	0.32%
GBI EM GD	6.15%	–	-0.14%
EM FX spot	–	–	-0.01%
ELMI+	4.70%	–	0.37%
EMBI GD	5.60%	357 bps	0.07%
EMBI GD IG	4.34%	227 bps	0.06%
EMBI GD HY	8.37%	644 bps	0.07%
CEMBI BD	5.47%	359 bps	0.18%
CEMBI BD HG	4.34%	245 bps	0.03%
CEMBI BD HY	8.07%	621 bps	0.49%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2097	2.53%
VIX Index	14.69	-20.81%
5 year UST	1.54%	3 bps
7 year UST	1.86%	5 bps
10 year UST	2.05%	7 bps
US HY	6.71%	0.32%
European HY	4.91%	0.37%
EURUSD	1.1407	0.68%
USDJPY	118.59	-0.08%
Brent	60.95	2.61%
Copper	260.15	2.10%
Gold	1234.76	-0.43%

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

Emerging Markets

- Russia-Ukraine: A year ago all sides in the Russia-Ukraine dispute only saw political upside in engaging in conflict. Europe wanted to show Russia that annexing parts of other countries is unacceptable. Ukraine had an election to win. Russia saw arming rebels in Eastern Ukraine as a counter-weight to likely EU-US sanctions. Today, the political upside of further fighting has been exhausted on all sides, while the economic costs of the conflict have escalated considerably.

The key break-through, in our view, was the pronouncement late last year by Ukrainian Prime Minister, Arseniy Yatsenyuk, that the question of Crimea can be relegated to future generations. This pronouncement in effect removed the only genuinely intractable obstacle to ending the crisis and from then on it was just a question of time to get the 'ducks in line'.

The peace agreement reached last week between the members of the Normandy Quartet (France, Ukraine, Russia and Germany) and the cease-fire that came into effect at the weekend have good chances of success, in our view. The sharp deterioration of the situation on the ground in Eastern Ukraine in the past weeks was mainly due to efforts on both sides to position themselves more advantageously ahead of talks. Even so, peace is by no means assured: the likelihood that armed conflict resumes is always greatest in the immediate aftermath of a cease-fire. Weapons are still at the ready, trust is at low levels and emotions are raw.

Still, if the cease-fire holds it will be excellent news for Ukraine, for Russia and for Ukraine's Western backers, particularly the Europeans, who have not previously been adept at resolving international conflicts. German Chancellor Angela Merkel in particular stands out as a strong leader in a Europe sorely lacking in leadership in so many areas.

Beyond securing the peace on the battle ground, the next steps are the following: talks to establish as sustainable political arrangement for Eastern Ukraine; new gas supply agreements between Russia and Europe; economic and financial recovery in Ukraine; and a dismantling of sanctions against Russia.

As it stands, this settlement appears to be a victory for Russia. Russia keeps Crimea, which reverts to Russia exactly 60 years after General Secretary of the Communist Party of the Soviet Union, Nikita Khrushchev, ceded the island to Ukraine. A political settlement that keeps Donbass within Ukraine is also not a bad outcome for Russia, because Russia will now have direct influence in the Rada, the Ukrainian parliament, via pro-Russian representatives from Eastern Ukraine. If the peace agreement sticks, Russia can look forward to a gradual dismantling of sanctions.

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Emerging Markets

- Ukraine: Coinciding with the announcement of a cease-fire for Eastern Ukraine the government provided details on the latest four-year standby IMF agreement. Over this period, a total of USD 40bn will be required to close the financing gap. The IMF will provide USD 17.5bn, but the balance has to be split between bilateral assistance and bondholders via a re-profiling of the debt. The market has already priced re-profiling of debt and a haircut, but whether the current price is right will only be known once the full details of the re-profiling are announced. Early indications suggest that Germany is favouring less punitive treatment of bondholders – this, in our view, would be intelligent. After all, Ukraine's successful transformation from a failed war-torn state in a pro-Western democratic economic success story is only likely to occur if the country manages to attract private sector investment from the West. We think the debt re-profiling is likely to take place later this year.

- Venezuela: The government's attempts to adjust to lower oil prices continue to fall short of market expectations. Despite letting the free-floating part of its currency weaken by 69% last week in what can only be described as a meaningful devaluation, the government is only letting a relatively small part of imports go through the market-determined exchange rate. The remaining imports are subsidised at controlled exchange rates. Needless to say, as long as the government only applies the market determined exchange rate on a small number of imports the devaluation will not correct large distortions on the economy akin to the cost of subsidising FX and gasoline prices. The modest adjustments, however, are likely to continue, in our view. We think the government's willingness to pay is high and that it will have the required funds at an oil price of USD 60.95 per barrel in 2015. The slow, reluctant adjustment is due to fear on the part of the government of widespread social unrest ahead of elections in the final quarter of this year.

- Brazil: In a bid to overcome the politically challenging question of locating exactly what happened to the BRL 10-20bn of losses in Petrobras, local media reports that the company will use an impairment provision to account for the losses. The accounting trick will allegedly meet the requirements of the regulators and should also enable the firm to meet its basic reporting criteria. Even so, the scandal is unlikely to go away due to intense court and media scrutiny. Partly as a result of the Petrobras scandal the economy has weakened sharply. Retail sales fell sharply in December (-2.6% mom vs -0.6% expected). Industrial production also weakened, but the monthly indicator of broader economic activity declined less than expected. President Dilma Rousseff's approval rating has fallen from 42% in December to just 23% in February, according to a new poll from Datafolha.

- China: The government has expanded its short-term liquidity window – the so-called Standing Lending Facility (SLF) – will be expanded to cover PBOC branches in all provinces in China compared to the previous coverage in just ten provinces. The liquidity provision will help smooth the transition to fully liberalised interest rates. Inflation in China declined to just 0.8% yoy in January, nearly half the level of December (1.5% yoy). Slowing growth and falling inflation has been good news for Chinese bond investors – yields on local government bonds are down by 1.2% since the start of 2014, but real 5 year yields are still 2.4% – among the highest in the world for a sovereign bond market of this quality. The PBOC has been reluctant to cut rates even as inflation has fallen as part of its objective of liberalising interest rates, but may do so soon if prices continue to weaken. Needless to say, with real rates this high the scope for cuts is considerable (unlike many other economies).

- Saudi Arabia: Ratings agency, S&P, downgraded the country's credit rating outlook on the grounds that oil prices have fallen. This decision illustrates perfectly the problems with ratings agencies. First, they are behind the curve. Oil prices started declining meaningfully in Q3 2014 and have been stable in the current ranges for several months. Secondly, they are prejudiced. They downgrade EM countries purely in response to external shocks without taking into consideration each country's level of preparedness or the quality of its policy response. Saudi Arabia has spent the better part of the last decade reducing its total debt stock from more than 100% of GDP to less than 2% of GDP. One of the greatest systemic risks in the global financial system today is that regulation is based on sovereign risk ratings issued by ratings agencies, whose revenues are causally linked to the volume of debt issued by any given country. This leads to a severe bias towards assigning the highest ratings to the most indebted countries.

- India: Real GDP rose 7.5% in Q4, according to a new series with a revised base year and more comprehensive coverage of various sectors of the economy. This means that India – labelled one of the 'fragile five' by investment banks just over a year ago – is now growing faster than China. EM countries tend to experience rapid catch-up with richer countries, partly due to the emergence of whole new sectors of the economy. Since new sectors emerge all the time many are not captured in the base surveys that form the basis for annual GDP measurements. This is why EM countries often experience material ex-post upward GDP revisions. Under the new measure, India is likely to grow 7-8% per year compared to 5-6% under the old measure. Meanwhile, inflation continues to decline relative to expectations. In January, CPI fell to 5.1% versus 5.5% expected. January wholesale prices declined 0.4% yoy versus an expected increase of 0.1% yoy. The current account deficit declined to just USD 8.3bn in January compared to USD 15.7bn in September last year.

Emerging Markets

- **Argentina:** A UK court has ruled that English law covers payments of interest on Discount bonds made by Argentina in June 2014. This ruling appears to put the Trustee – Bank of New York – in a difficult situation, because a New York court has also required Bank of New York to comply with its ruling regarding the coupon payments. Argentina has continued to service its New York law bonds, but the funds have not reached bond holders due to legal restrictions.

- **Turkey:** Deputy Prime Minister Ali Babacan expressed strong support for the central bank, whose policies have recently been severely criticised by President Erdogan. Babacan has a good reputation and his presence in the government is rightly regarded as critical to maintaining confidence in economic policy in Turkey. The current account deficit narrowed to 5.7% of GDP in December.

- **Malaysia:** The economy was 5.8% larger in real terms in Q4 than at the same time last year. This was a significantly faster pace than expected (5.1% yoy). On a qoq basis, growth accelerated to 8.4%. Industrial production rose 7.4% yoy in December versus 4.1% expected. The market appears to have significantly over-estimated the impact of lower oil prices on Malaysia. Consistent with stronger than expected domestic demand and lower oil prices the current account surplus was somewhat narrower than anticipated (2.2% of GDP versus 3.5% expected).

Snippets:

- Thailand: Q4 real GDP growth was marginally stronger than expected. The economy expanded 2.3% yoy versus 2.0% expected, mainly due to exports and government consumption.
- Indonesia: The country's trade surplus was significantly larger than expected in January. Exports exceeded imports by USD 709m compared to USD 56m expected. Lower oil prices reduced the import bill.

Global backdrop

The US continues to slow. Q4 growth is now tracking about 2.0% in real terms and the outlook for Q1 is also fairly lacklustre at 2.5% (remember that the US reports quarterly growth in annualised terms, which means that the actual growth rate in any given quarter is roughly about a quarter of the headline figure reported). Recent higher frequency data has not pointed to a strong rebound in Q1 2015. Both retail sales and claims for unemployment benefit disappointed in the US. The University of Michigan consumer sentiment index declined to 93.6 in February from 98.1 in January. Looking ahead, we think the US economic expansion is likely to be very sensitive to real rates due to enormous debt stocks and the government's total inability to reform, which is required to meaningfully raise trend growth rates. For this reason, we do not fear that the Fed is about to engage in draconian tightening of monetary policy.

Europe struggles to find a compromise solution that will prevent Greece from having to leave the EUR, while at the same time not granting carte blanche for Athens on structural reforms. There is still denial about the debt stock – no matter how much reform Greece does it will never be able to recover without a major haircut of its debt. In order to leave room for talks the ECB increased the allowance for liquidity support for Greek banks to EUR 65bn. This means that even though the ECB no longer takes Greek bonds as collateral, banks in Greece will still be given the funding required to enable them to buy the bonds instead. Talks between Greece and the European Union will continue this week. Meanwhile, the European economy is picking up, led by Germany. Both Germany and France grew faster than expected in Q4 2014.

Japan's economy was able to generate positive growth in Q4, but at 2.2% qoq annualised the growth rate fell well short of expectations (3.7% qoq). On a yoy basis, the Japanese economy was 0.5% smaller in real terms in Q4 2014 than in Q4 2013. Private investment in particular was weak (+0.1% qoq).

Oil prices continue to go up – Brent first futures closed at USD 61.5 per barrel last week. The rise in oil prices was accompanied by a 10th consecutive decline in the US rig count of 98 rigs, which took the total to 1358. This means that the US rig count has fallen by a cumulative 30% since last year. We do not expect a straight-line recovery – there are distinct seasons in crude oil demand, particularly around April time due to annual maintenance at the main US refineries.

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Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.7%	3.3%	7.3%	0.7%	4.2%
MSCI EM Small Cap	0.8%	2.2%	4.0%	3.0%	4.7%
MSCI FM	0.7%	-3.4%	0.3%	11.5%	6.7%
S&P 500	5.28%	2.12%	16.96%	18.26%	16.70%
GBI EM GD	-0.67%	-0.34%	-3.64%	-2.93%	2.56%
ELMI+	1.09%	-1.71%	-7.55%	-3.04%	-0.54%
EM spot FX	0.36%	-2.65%	-13.05%	NA	NA
EMBI GD	0.22%	1.15%	8.13%	5.63%	7.77%
EMBI GD IG	-0.37%	1.41%	9.71%	5.04%	7.08%
EMBI GD HY	1.34%	0.68%	5.56%	6.57%	8.75%
5 year UST	-1.70%	0.74%	2.72%	1.12%	3.42%
7 year UST	-2.45%	1.05%	5.46%	1.91%	5.24%
10 year UST	-3.32%	1.32%	10.04%	3.34%	6.92%
CEMBI BD	0.52%	1.20%	5.06%	5.53%	6.69%
CEMBI BD HG	0.02%	1.48%	7.16%	5.82%	6.85%
CEMBI BD HY	1.63%	0.60%	0.74%	5.18%	6.58%
US HY	1.27%	1.72%	2.30%	7.73%	9.84%
European HY	0.72%	1.89%	6.15%	13.05%	12.28%
Barclays Agg	-0.62%	-0.78%	-1.81%	-0.05%	2.53%

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

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