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WEEKLY INVESTOR RESEARCH

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The biggest risks in Brazil are now to the upside

By Jan Dehn

Recent political developments in Brazil have increased the odds that President Dilma Rousseff is impeached and that former President Lula will not run in 2018. Both are positive for sentiment towards Brazilian assets. China's 2016 budget and economic program suggest that the government is confident about the direction of travel – and so are we. India is making significant inroads on PSU Banks. A major policy shift is underway in Argentina. Russia is harvesting the fruits of its prudent macroeconomic response to lower oil prices. In global markets, recent nonsense correlations are breaking in favour of something much more sensible and, incidentally, favourable for Emerging Markets (EM).

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.4	–	6.90%
MSCI EM Small Cap	11.2	–	5.39%
MSCI Frontier	8.9	–	1.28%
MSCI Asia	10.8	–	5.28%
Shanghai Composite	10.9	–	3.86%
Hong Kong Hang Seng	6.2	–	6.51%
MSCI EMEA	9.0	–	8.31%
MSCI Latam	12.3	–	14.79%
GBI-EM-GD	6.71%	–	3.91%
ELMI+	3.75%	–	2.44%
EM FX spot	–	–	2.83%
EMBI GD	6.12%	422 bps	1.38%
EMBI GD IG	4.60%	263 bps	1.12%
EMBI GD HY	8.20%	641 bps	1.68%
CEMBI BD	6.11%	438 bps	1.14%
CEMBI BD IG	4.64%	291 bps	0.62%
CEMBI BD Non-IG	8.67%	692 bps	2.04%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	14.8	–	2.71%
1-3yr UST	0.89%	–	-0.16%
3-5yr UST	1.40%	–	-0.48%
7-10yr UST	1.90%	–	-0.95%
10yr+ UST	2.71%	–	-1.19%
10yr+ Germany	0.21%	–	-1.99%
10yr+ Japan	-0.05%	–	1.57%
US HY	9.06%	766 bps	2.94%
European HY	6.19%	633 bps	1.48%
Barclays Ag	–	228 bps	0.21%
VIX Index*	16.86	–	-2.95%
DXY Index*	97.53	–	-0.68%
EURUSD	1.0969	–	0.88%
USDJPY	113.57	–	0.78%
CRY Index*	168.55	–	6.88%
Brent	39.4	–	9.40%
Gold spot	1271	–	2.57%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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- **Brazil:** The biggest risks in Brazil are political and they are tilted towards the upside. This was already evident last week, when Brazilian asset prices rose strongly in response to various political developments. Specifically, former President Ignacio Lula was called for questioning by the police and the PT Party's Justice Minister José Eduardo Cardozo resigned, allegedly for losing control over the so-called 'Carwash' scandal (a corrupt racket involving public contracts in exchange for political party campaign contributions).

The market rallied, because these developments increase the odds that (a) President Dilma Rousseff will not serve out her term and (b) Lula will not be able to run for president in 2018. Early impeachment of Dilma would break the current political deadlock, which is preventing reforms, while Lula's exclusion from future elections would remove the single largest threat to a more market friendly administration in a post-Dilma Brazil.

Beneath the surface, the optimism was also fuelled by the arrest of two less high-profile officials. One, João Santana, was the architect of both Dilma's election victories in 2010 and 2014. His potential knowledge of the murkiest aspect of the campaign finance scandal means that his testimony could provide the evidence needed to annul the entire 2014 election result on the basis of election fraud. This would trigger completely new elections, which in turn could clear the political waters sooner than any impeachment process. The other arrest was that of Delcidio Amaral, a PT Senator, whose questioning appears to have led directly to the interrogation of Lula and the market's perception that the odds that he comes back in 2018 are now substantially lower.

Looking ahead, attention now shifts to the PMDB party conference on 12 March. PMDB is critical to the balance of power in parliament and is expected to decide at this conference on its strategy with respect to its coalition with the Dilma administration. Will PMDB stay with the government or will they throw Dilma (and the PT party) under the bus in the hope that Dilma and Co become the lightning rods for the political fallout from 'Carwash'? Large scale public protests against the government have been called in all major cities of Brazil for 13 March.

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It is clear that if PMDB makes a clean break with the Dilma administration and if protests are large enough to show public support for impeachment across Brazil (not just in São Paulo), then the process for removing the President could proceed quickly with crucial votes in parliament as early as the end of April and a potential new government in place, led by PMDB Vice-President Michel Temer, by the end of May.

But the risks to this scenario are numerous. For example, Dilma, Lula and the PT party are likely to resist their political demise and could call on unions to engage in public protests. Also, the 'Carwash' investigation could yet envelop more politicians, including leading opposition politicians. 'Carwash' is, after all, an independent judicial process led by Prosecutor Sérgio Moro, who may continue his quest regardless of what parliament decides to do with Dilma. Finally, as noted above, there could be entirely fresh elections if the election process itself is deemed to have been fraudulent. Current uncertainties notwithstanding, however, the current momentum clearly points to a brighter political future for Brazil, albeit not without some fireworks along the way.

On the economic side, there are also grounds for cautious optimism. The economic downside risks in Brazil are largely known and priced. For example, an exceptionally poor services PMI number (36) did nothing to dampen the euphoria in the market last week. But there were also some outright better than expected data releases. Industrial production rose 0.4% in the month of January, when markets had expected a decline of 0.4%. The sequential pace of decline of GDP was also slower than expected in Q4 2015, when the economy 'only' contracted 1.4% qoq (sa) versus -1.6% qoq (sa) expected and -1.7% qoq (sa) in the previous quarter. Finally, the Brazilian trade balance posted a very strong result, producing the largest 12-month running surplus since 2011 (USD 29.6bn). The details were particularly encouraging. Rising exports are now an important driver of the trade surplus, not just shrinking imports. This puts Brazil on track for its first current account surplus since 2007. This is exactly what the Central Bank is counting on, so they left rates unchanged at 14.25%.

- China: The National People's Congress (NPC) – China's parliament – approved the 2016 economic program and budget. The key message from the NPC is that China remains confident about its chosen development path, which centres on rotating the economy from export to consumption led growth and using reforms to increase the quality growth. In our view, this is exactly the right path for China.

China will make greater use of fiscal levers to support the economy through the challenges of transition. The challenges, of course, are numerous. Reforms themselves create uncertainty. Interest rates liberalisation delays private investment. The greater flexibility of exchange rates also weighs on sentiment and encourages speculation. Markets need to deepen. Labour needs to shift from less to more productive uses, etc. To support the economy through these challenges, the fiscal deficit will be increased to 3% of GDP in 2016 from 2.3% of GDP in 2015. The aim is to make the growth target for 2016 of 6.5-7.0% achievable.

The government has also explicitly set aside funds to finance the re-deployment of workers from declining industries into more productive areas of the economy. This is strongly suggestive of a continuing aggressive push towards productivity enhancing reforms. Related to this, the budget also provides tax breaks for innovation and specific targets for reform of state-owned enterprises.

The development of the domestic bond market is once again given absolute prominence in the economic program. Between central and local government agencies, the budgeted increase in gross bond issuance will be nearly 35% yoy (an increase to RMB 2180bn versus RMB 1620bn in 2015). It is important to note in this context that much of this issuance merely replaces non-tradable loans and other types of less transparent financing. The development of the onshore bond market is a critical element in the reform process, because the bond market will:

(a) become the main avenue of transmission of monetary policy in China;

(b) help to impose market discipline on borrowers, especially local governments; and

(c) contribute to stabilising savings and therefore stimulate consumption. Bonds can do this because they are counter-cyclical savings instruments that complement highly pro-cyclical stocks and property.

- India: Following the Indian Supreme Court's recent request to the Reserve Bank of India (RBI) to disclose large bad loan positions on the balance sheet of banks, there are now major changes afoot in India's public sector banks (collectively known as PSU banks). The government last week adopted new capital requirements for PSU banks that bring them more into line with the capital requirements prescribed by the Basel Committee on Banking Supervision. It also announced capital injections for PSU Banks as part of the 2016/2017 Budget. These developments are fundamentally positive. The PSU Banks were used extensively – and recklessly – under the previous administration to stimulate the economy with the result that many PSU Banks were rendered effectively insolvent. The best way to restore them to health is to change the way they are run. This is now happening. A new board has been appointed that will act as a governing body for the PSU banks. It starts its work on 1 April 2016. The competent membership of this board will be responsible for appointing new CEOs and Chairmen for the PSU Banks. The government is likely to keep the PSU banks on drip-feed for capital in order to keep up the pressure for the banks to recover bad debt from borrowers. Behind the scenes, we expect that the RBI is strongly supportive of the efforts to improve the credit quality of PSU banks,

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because strong banks are critical to establishing the pre-conditions required to open the Indian bond market to foreign investors. A more open capital market would in turn enable India to achieve a lower equilibrium policy interest rate over the business cycle than is currently possible, which in turn is good for Indian growth.

- Argentina: The direction of macroeconomic policy has started to shift meaningfully in Argentina as the country moves ever closer to a final deal with holdout investors (over 85% of so-called litigating holdout investors have now agreed to the deals on offer and legislation has been presented to parliament in Buenos Aires that would overturn the ban on dealing with holdout investors). Last week the Central Bank tightened monetary conditions meaningfully by allowing interest rates on 35-day Central Bank paper (so-called Lebacs) to rise by almost 600bps to 37.0%, while rates on one-year paper were pushed up by nearly 300bps to 31.5%. These moves are significant, in our view. They suggest that the Central Bank is confident about a successful resolution to the holdout issue and an early return to global capital markets. This should facilitate a major shift away from monetary towards debt-financed fiscal stimulus.

- Russia: Russia is harvesting the reward of its policy orthodoxy over the past couple of years of falling oil prices. Inflation dropped sharply to 8.1% yoy in February from 9.8% yoy in January. With policy rates still at 11%, inflation should continue to decline, and soon pave the way for the Central Bank to cut rates. On the fiscal front, the government can also boast a still very strong position despite much lower oil prices. The Finance Ministry reported last week that the combined stock of the Reserve Fund and Wellbeing Fund in February was marginally higher than in January (USD 121.2bn versus USD 120.9bn in January). This suggests that the government has not been tapping into these funds to finance spending at all this year.

Snippets:

- El Salvador: The trade deficit narrowed by a hefty 8.5% in January to USD 378mn (1.4% of GDP). This compares to a deficit of USD 413mn (1.6% of GDP) at the same time last year.
- Indonesia: Inflation rose in line with expectations in February (4.4% yoy for headline and 3.6% yoy for core). Indonesia's foreign exchange reserves climbed to USD 104.5bn in February from USD 102.1bn in January.
- Malaysia: The trade surplus for the month of January moderated to MYR 5.4bn from MYR 8.25bn in December. The decline in the size of the trade surplus was almost exclusively due to changes in the world prices of Malaysian exports in global markets.
- Mexico: Gross fixed investment rose much more than expected in December (up 1.1% yoy versus -1.4% yoy expected)
- Philippines: Inflation declined to just 0.9% yoy in February compared to a market expectation of 1.3% yoy. Core inflation was also lower than expected (1.5% yoy versus 1.6% yoy expected)
- Poland: Growth accelerated to 3.9% yoy in Q4 2015 from 3.5% yoy in Q3 2015. This pushed the country's growth rate to 3.6% for 2015 as a whole compared to 3.4% in 2014.
- South Korea: Inflation in February reached 1.3% yoy versus 0.9% yoy expected. Core inflation also rose marginally from 1.7% yoy to 1.8% yoy. The current account surplus was USD 7.1bn in January compared to USD 7.4bn in December. This keeps South Korea on track for a USD 100bn current account surplus this year.
- Thailand: Inflation was 0.0% mom in February, taking yoy inflation to -0.5%. Core inflation rose 0.7% yoy, which was marginally higher than expected (0.6% yoy).
- Turkey: There was no inflation in February. Inflation, on a yoy basis, declined to 8.8% from 9.6% yoy in January. Going forward, inflation is by no means dead due to the excessively easy stance on monetary policy adopted by the Turkish Central Bank.
- Ukraine: Speculation is rife that Natalie Jaresko, finance minister, could replace Arseniy Yatsenyuk as prime minister. Yatsenyuk's reputation has declined sharply in recent months due to allegations of corruption that recently led to the resignation of a senior government official. Jaresko last year negotiated a market-friendly restructuring of Ukraine's external debt. The Central Bank left policy rates unchanged at 22%.

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Global backdrop

Economists are generally wary of correlations, but financial markets love them. For economists, the most infamous of all correlations is that, which is often found between the price level and cumulative rainfall.[1] Prices and cumulative rainfall both go up over time, which makes them highly correlated, but few would argue that rainfall determines the price level or vice versa.

Financial markets are far less concerned about causality. Quite the contrary, in fact, investors love when markets move in unison for extended periods of time because then they can abandon all brain activity, sit back and enjoy the ride, provided, of course, that they have put on the position. Hedge funds and other momentum players basically rely on identifying turning points for short-term correlations and then applying leverage to extract the maximum amount of return from any given move.

Unfortunately, what works for the few does not work for the many. There are rarely sound theoretical or fundamental reasons behind most of the correlations found in the market. They are often caused by technicals, changes in positioning, which in turn owes more to investor behaviour than to fundamentals. After all, the market is notoriously herd-like and many investors are heavily influenced by short-term market moves. So much so, in fact, that they are quite ready to abandon even carefully researched long-term investment strategies at the first sign of price action contrary to their original convictions.

This fickleness among many investors tends to get ruthlessly exploited by brokers and other market makers to encourage unnecessary trading in order to make money on bid-offers spreads. This exploitative behaviour has become more pronounced since the Developed Market Crisis of 2008/2009 due to regulatory changes. As banks' balance sheets have shrunk and broking business has become more important to overall trading revenues so the incentive has increased to induce as much unnecessary trading as possible. This is done precisely by exploiting weak convictions among investors with constant references to risk on/risk off, etc.

Investors should be wary of falling into this short-term trap. Short-term correlations that exist solely due to investor behaviour are bound to break. And when they do many investors will find themselves not only exposed to bad technicals, but also long assets that may be massively overpriced relative to their riskiness (bubbles). Or alternatively they may find themselves underinvested in relatively cheap and safer assets.

The price action of the last couple of weeks suggests that one of the more powerful (and nonsense) correlations of recent times – the negative relationship between better US data and sentiment towards EM – has lapsed. US stocks are down 1.7% for the year, yet EM local currency bonds are up 5.3% so far in 2016. Even EM currencies are up about 2% versus the USD.

Correlations are as fickle as investor sentiment, so there is no guarantee whatsoever that the current correlations will last for any meaningful period of time. Still, at least there is some fundamental justification for a positive correlation between better US data and EM sentiment. EM has more than priced in whatever rate hikes the Fed is likely to deliver in the foreseeable future, while the USD appreciation should accompany better US economic fortunes which have already been reflected in weaker EM currencies over the last four years. Stronger US data should also be good for the world economy, including EM.

The recent improvement in US data not been accompanied by a sharp rally in the USD versus EM currencies. Our view is that the US avoids recession this year, but that the growth picture is not particularly strong. The US economy is behaving as if rates were already at 5%. Serious USD strength or rate hikes from this point onwards would quickly neutralise better data due to low productivity, an already strong USD, a challenging earnings picture, high levels of debt and the drag from the energy sector. Net net, this suggests a more balanced outlook for the USD compared to the last few years, though additional ECB easing this week could provide some downwards momentum for EURUSD if President Draghi wants to go down that road.[2]

Energy prices have rallied strongly in the last week. A more stable USD, receding recession fears in the US and the view expressed in some quarters that supply destruction is now well-advanced in the US shale sector all contributed.

Finally, we note that Japan last week managed to auction a 10-year bond at negative yields.

[1] David Hendry (1980), *"Econometrics – Alchemy or Science?"* Economica, 47, pp. 387-406.
[2] For a more detailed discussion of the USD outlook see *"The View from Kilimanjaro – EM FX in a QE world"*, The Emerging View, September 2015.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	6.85%	-0.26%	-16.71%	-6.16%	-4.35%
MSCI EM Small Cap	5.18%	-3.46%	-12.57%	-3.55%	-2.73%
MSCI Frontier	1.92%	-1.73%	-14.92%	1.65%	1.77%
MSCI Asia	5.88%	-3.14%	-15.22%	-1.43%	-0.17%
Shanghai Composite	6.93%	-18.78%	-10.96%	11.00%	2.00%
Hong Kong Hang Seng	8.10%	-11.40%	-24.84%	-4.77%	-4.44%
MSCI EMEA	6.59%	4.16%	-18.50%	-10.51%	-8.05%
MSCI Latam	13.11%	12.00%	-17.05%	-16.06%	-12.02%
GBI EM GD	3.47%	5.33%	-7.66%	-8.39%	-2.61%
ELMI+	2.29%	1.69%	-3.59%	-5.01%	-3.09%
EM FX Spot	2.58%	1.94%	-11.51%	-12.30%	-9.32%
EMBI GD	1.13%	2.87%	2.43%	2.44%	5.93%
EMBI GD IG	0.97%	3.55%	0.75%	2.01%	5.17%
EMBI GD HY	1.33%	1.94%	4.69%	3.00%	7.06%
CEMBI BD	1.05%	1.73%	1.09%	2.13%	4.65%
CEMBI BD IG	0.57%	1.47%	0.89%	2.63%	5.21%
CEMBI BD Non-IG	1.90%	2.18%	1.34%	1.03%	3.66%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	3.54%	-1.73%	-2.63%	11.76%	10.98%
1-3yr UST	-0.23%	0.75%	1.01%	0.55%	0.70%
3-5yr UST	-0.62%	1.55%	2.56%	1.59%	2.21%
7-10yr UST	-1.13%	3.50%	4.70%	2.72%	5.75%
10yr+ UST	-1.53%	6.70%	4.74%	5.80%	10.64%
10yr+ Germany	-2.25%	7.57%	2.36%	9.13%	11.39%
10yr+ Japan	1.57%	8.52%	13.99%	7.55%	7.18%
US HY	2.40%	0.96%	-6.72%	1.31%	4.72%
European HY	1.33%	0.05%	-2.00%	5.93%	8.48%
Barclays Ag	-0.03%	0.99%	-0.51%	2.70%	4.66%
VIX Index*	-17.96%	-7.41%	10.92%	29.10%	-18.39%
DXY Index*	-0.69%	-1.12%	-0.09%	18.82%	27.50%
CRY Index*	3.27%	-4.31%	-23.43%	-42.42%	-53.55%
EURUSD	0.88%	0.99%	1.08%	-16.31%	-21.47%
USDJPY	0.78%	-5.53%	-6.26%	19.77%	38.10%
Brent	9.40%	5.55%	-34.12%	-64.60%	-65.79%
Gold spot	2.57%	19.73%	8.85%	-19.54%	-11.28%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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