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WEEKLY INVESTOR RESEARCH

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EM holding on to its gains in a quiet week

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In a quiet, slightly weaker week for global markets and global macroeconomic news, Emerging Markets (EM) managed to hold onto their gains after a very strong start of the month. The market was always due to consolidate ahead of important US data and Fedspeak this week, but our relatively dovish views on the US and the Fed have been vindicated and investors have not wavered. The global policy environment remains biased towards easy monetary conditions and some EM central banks such as Turkey and Hungary have cut rates. Technicals have been very supportive, with strong inflows into EM debt and equity funds and modest issuance. This week we also cover developments in Brazil and South Africa.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	-1.83%
MSCI EM Small Cap	7.6	–	-1.57%
MSCI Frontier	8.8	–	-0.88%
MSCI Asia	11.1	–	-1.52%
Shanghai Composite	11.5	–	-2.65%
Hong Kong Hang Seng	6.6	–	-1.76%
MSCI EMEA	8.9	–	-3.46%
MSCI Latam	12.5	–	-1.30%
GBI-EM-GD	6.54%	–	-0.86%
ELMI+	3.78%	–	-0.71%
EM FX spot	–	–	-0.90%
EMBI GD	5.96%	414 bps	-0.40%
EMBI GD IG	4.47%	258 bps	-0.19%
EMBI GD HY	8.02%	631 bps	-0.63%
CEMBI BD	5.89%	424 bps	0.07%
CEMBI BD IG	4.45%	282 bps	0.13%
CEMBI BD Non-IG	8.37%	671 bps	-0.05%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.3	–	0.20%
1-3yr UST	0.78%	–	0.25%
3-5yr UST	1.28%	–	0.62%
7-10yr UST	1.81%	–	1.15%
10yr+ UST	2.61%	–	2.16%
10yr+ Germany	0.14%	–	1.42%
10yr+ Japan	-0.09%	–	-1.20%
US HY	8.98%	767 bps	-1.03%
European HY	5.68%	576 bps	0.05%
Barclays Ag	–	233 bps	0.60%
VIX Index*	13.82	–	0.03%
DXY Index*	94.86	–	-0.79%
EURUSD	1.1331	–	1.34%
USDJPY	112.15	–	0.21%
CRY Index*	171.47	–	-4.90%
Brent	39.7	–	-5.00%
Gold spot	1241	–	1.72%

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

Emerging Markets

Thanks to the stalemate in policy divergence between the Fed and other G4 central banks, Emerging Markets currencies have been rebounding from their lows, leading to lower pressure on corporate balance sheets and inflation expectations. These conditions have allowed EM central bankers to either get away from crisis control mode and move towards a more neutral monetary policy stance, or to ease policy where disinflation and currency strengths are the most immediate concerns, a welcome development in a growth-starved and imbalanced global economy. This week it was the turn of Hungary, Turkey and Taiwan to take on the dovish baton, each of them for their own particular reasons.

Hungary surprised the market by cutting all benchmark rates by 15bps, cutting the main policy rate to 1.20% and the lower boundary of its interest rates corridor to a negative -0.05%, thereby becoming the first EM central bank to go negative. The policy move was motivated by the downward revision in projected inflation and ongoing disinflation risks. Contrary to many EM central banks, the National Bank of Hungary is not faced with excessive currency weakness and is comfortable in pushing the HUF weaker if it can help stimulate inflation and economic activity. Hungary has been running large current account surplus for some time and is a serious candidate for a re-rating to Investment Grade in 2016, so the risks to this adjustment in monetary policy are limited, in our view.

The situation is vastly different in Turkey, which has long posted a sizeable, structural current account deficit and where weaker FX and higher inflation have been the main macro challenges. Last week, Central Bank of Turkey (CBRT) Governor Basci led his final monetary policy committee (MPC) before the end of term on 19 April. The MPC kept the main 1-week repo policy and deposit rates unchanged at 7.5% and 7.25% respectively, but cut the overnight lending rate (the upper-end of the corridor) by 25 basis points to 10.5%. This was a modest move, and it is too early to assume that the next governor will continue down an easing path, but external conditions have improved in recent weeks and it has not been uncommon for the CBRT to take advantage of these periods to cut interest rates, even with inflation printing above target. In the four weeks to

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Emerging Markets

the middle of March, the cumulative portfolio inflows into the domestic bond and equity markets have totalled c. USD 2bn, half of which went into local government bonds, helping the TRY trade 10 cents stronger vs USD to 2.86 and providing the CBRT with a favourable environment against which to act.

Finally, Taiwan's Central Bank, the Central Bank of China (CBC), cut its policy rate by another 0.125% to 1.5%, in line with expectations, and its third cut in as many quarters, citing external conditions and a steady rise on the unemployment rate to 3.94%. As a small, export-orientated economy, Taiwan has long sought to shield its domestic exporters from excessive currency movements. Last week's policy move was no exception and Governor Perng mentioned how a lower interest rate would help limit so-called hot money flows.

Conversely, the central banks of Russia and Mexico kept rates unchanged last week. The decision by Banxico was expected. In Russia, the CBR kept its policy rate at 11% despite the rapid decline in inflation on YoY terms. Governor Nabiulina has been steadfast in the fight against inflation, taking note of the risk of a second bounce if the RUB doesn't stabilize. Away from the consumer sector, which remains depressed, economic data out of Russia has been a little bit better than expected.

Brazil remained in the spotlight last week. Domestic economic data continued to weaken but political developments are really driving markets at the moments. Another 110,000 jobs were lost in February, taking the unemployment rate to 9.5% from 6.8% at the same time last year, and retail sales surprised on the downside. However, external accounts remained solid with a current account deficit of USD 1.8bn in February, down from USD 11bn one year ago, talking the YoY deficit down to 2.7% of GDP from 4% of GDP in 2014. At this pace, the current account will be balanced by year-end due to a rather painful recessionary adjustment via lower imports. Foreign Direct Investment continues to be strong at USD 5.9bn in February and the last twelve month at USD 77bn or 4.5% GDP – a sign foreign investors have been taking advantage of the weak BRL.

On the political side, the 'Car Wash' investigators issued another 110 search and arrest warrants mainly involving directors of Odebrecht. After nine months in jail, the company's CEO Marcelo Odebrecht has agreed to a guilty plea with prosecutor general Sergio Moro, bringing new evidence to light against the government, but also against other political parties. Meanwhile, on March 29 the PMDB national convention decided to leave the government coalition. The party controls 65 seats out of 513 in Congress and 18 seats out of 81 in the Senate. The decision increases the likelihood of President Roussef's eventual impeachment and this is generally viewed as a good thing by the market, who is eager to see a new leader with political capital at the helm. However this may make the situation of Vice President Michel Temer, himself a PMDB party member, a little awkward if he is to take over for a few months (until the final Senate vote) with many of his political allies out of office.

A website supporting the impeachment (vemprarua.net) has organized a public vote asking parliamentarians to state their view. On March 29, 257 members of the lower house supported impeachment, with 118 against and 138 undecided. While this seems far from the minimum 342 votes necessary for impeachment, the number of representatives voting 'for' has been growing fast. Splitting the undecided according to the proportion 'for' and 'against' from each party would suggest the lower house would get to the minimum needed if the vote (expected mid-April) was held today.

Petrobras' Q4 results were worse than expected with the weak BRL, a clear negative, but the details were better. The company expects its cash position to decline from USD 22bn to USD 20bn at the end of 2016 after USD 14bn of divestments and little debt rollover. Further operational gains are expected to reduce the break-even of the pre-salt basin further (from current estimated USD 30-35) and cash generation is likely to provide most funding for OPEX. A political transition would make the company's ability to implement its divestment plan easier not to mention an improvement in the regulatory regime.

In contrast, in South Africa political risk subsided since the ANC's executive committee meeting last week. There was no direct challenge against President Zuma at the committee despite recent allegations of influence peddling involving the Gupta brothers, and the committee's statement read like a whitewash for Zuma. However, an investigation into these allegations was decided, to be conducted by Secretary General Mantashe, and it may simply be a matter of time before political risk resurfaces.

Market sentiment about China continued to improve. Profits of industrial companies improving in January-February by 4.8% YoY (the fastest expansion since 2014) led by sectors like automobile, machinery and computer manufacturing. This contrasts with worse than expected IP numbers, for the same period, suggesting activity is likely to bounce up in Q2 following strong credit expansion in Q1. Whilst more leverage is not necessarily what China needs, there are indications that the Government understands the importance of dealing with non-performing loans and bank capital as the end of the credit cycle approaches.

Snippets:

- Thailand: Reported a very high trade surplus for February, with exports jumping by 10% YoY after a 9% contraction in January. The large USD 5bn trade surplus contrasted with the USD 0.7bn consensus expectations and was due to a spike in gold exports, while other exports sectors were soft. Nevertheless, it seems to have convinced the Bank of Thailand to hold off on an expected rate cut, and to leave the policy rate at 1.5% for the time being.

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Emerging Markets

- **Nigeria:** The Central Bank hiked interest rates by 1% to 12% in order to bring down inflation expectations.
- **Belarus:** Received a USD 2bn loan from the Eurasian Bank, in a 10-year facility with a 5-year grace period. This credit line could make it unnecessary for Belarus to issue in external markets this year and should support the price of the current bonds.
- **Strong Portfolio Flows:** For the week ending 23 March, EPFR fund flow data showed that EM-dedicated bond funds received USD 1.4bn in inflows, the largest weekly inflow since June 2014 and the fifth positive number in succession. Hard-currency bond funds received USD 830m, the largest inflow in well over a year, with strong interest from institutional investors. Inflows into local-currency bond funds accelerated to USD 402m. Retail investors have remained on the side lines and may be tempted to chase the rally. EM bond funds data still shows a net outflow year-to-date, but it has fallen to just USD 1.6bn on aggregate. Within this data, flows to local-currency bond funds are now a positive USD 425m year-to-date.

Global backdrop

US macro data has been generally weak over the last week, especially the February personal income and spending data: February real personal consumer expenditures came in at just 0.2%, while January was revised down sharply to zero, implying an increase in the average American's savings ratio. This led the Atlanta Fed nowcast estimate for Q1 GDP to drop significantly to 0.6% from 1.4% just last week. A number of private sector economist have also revised their Q1 GDP forecast to 1% or below, which would come as a large negative surprise after the disappointing outturn of the previous quarter.

In contrast, US manufacturing survey data has thawed a bit, with the regional manufacturing surveys for March rebounding nicely and the Flash Markit PMI number up a tick to 51.4 from 51.3.

What mattered more, however, was the tone of some of the Fed speakers who spoke last week and how the market reacted to their comments. Both President Lacker and Bullard made hawkish remarks, to the effect that the April FOMC was a 'live' meeting when the Fed could hike rates. However the market impact of their comments was limited and front-end yields were little changed until Chair of the Board, Janet Yellen spoke in a dovish tone at the Economic Club of New York on March 29. In her prepared remarks, Yellen minimized the risk that the Fed would overreact to the temporary rise in inflation data, and reiterated the risks to the outlook coming from international factors and the Dollar. Markets loved it and she drove the 2-year yield 8 basis points lower, the Dollar weaker and stocks higher.

In Europe, the March flash PMI surprised on the upside. The composite PMI came in at 53.7 vs 53.0 expected, helped by a jump in Services. The manufacturing survey was 51.4, as expected. These numbers are in line with annualised growth of c. 2.0% in the Euro area.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	10.23%	2.90%	-12.55%	-5.03%	-3.85%
MSCI EM Small Cap	7.26%	-1.55%	-10.11%	-3.25%	-2.36%
MSCI Frontier	1.68%	-1.96%	-12.76%	1.33%	1.00%
MSCI Asia	8.67%	-0.59%	-12.34%	-0.41%	0.24%
Shanghai Composite	8.63%	-17.49%	-19.63%	12.19%	2.22%
Hong Kong Hang Seng	10.24%	-9.65%	-24.38%	-3.54%	-4.17%
MSCI EMEA	10.05%	7.54%	-14.05%	-9.36%	-7.75%
MSCI Latam	18.38%	17.22%	-8.71%	-15.02%	-10.99%
GBI EM GD	6.27%	8.18%	-4.34%	-7.52%	-2.34%
ELMI+	4.14%	3.53%	-2.16%	-4.50%	-2.86%
EM FX Spot	4.05%	3.40%	-9.36%	-11.78%	-9.14%
EMBI GD	2.60%	4.36%	3.63%	3.21%	6.11%
EMBI GD IG	2.38%	5.01%	1.37%	2.63%	5.41%
EMBI GD HY	2.84%	3.46%	6.93%	3.99%	7.17%
CEMBI BD	2.66%	3.34%	2.42%	2.66%	4.84%
CEMBI BD IG	1.94%	2.85%	1.97%	3.11%	5.36%
CEMBI BD Non-IG	3.91%	4.19%	3.10%	1.63%	3.91%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	6.53%	1.10%	1.89%	11.70%	11.61%
1-3yr UST	0.02%	0.99%	1.08%	0.64%	0.76%
3-5yr UST	0.01%	2.19%	2.41%	1.78%	2.36%
7-10yr UST	-0.31%	4.37%	4.07%	2.88%	5.88%
10yr+ UST	0.12%	8.49%	3.06%	6.46%	10.75%
10yr+ Germany	0.36%	10.44%	0.01%	9.61%	12.19%
10yr+ Japan	3.39%	10.46%	14.51%	7.15%	7.55%
US HY	3.87%	2.41%	-4.87%	1.44%	5.01%
European HY	3.36%	2.05%	0.12%	6.40%	9.02%
Barclays Ag	2.13%	3.17%	0.92%	3.36%	5.09%
VIX Index*	-32.75%	-24.11%	-4.76%	8.82%	-21.96%
DXY Index*	-3.41%	-3.82%	-3.18%	14.29%	24.62%
CRY Index*	5.06%	-2.65%	-19.97%	-42.15%	-51.53%
EURUSD	4.21%	4.32%	4.60%	-11.61%	-19.79%
USDJPY	0.48%	7.20%	7.06%	-15.99%	-26.09%
Brent	10.37%	6.49%	-29.47%	-63.92%	-65.52%
Gold spot	0.20%	16.96%	4.64%	-22.31%	-12.78%

*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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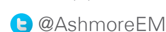
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