EM manufacturing upswing

By Jan Dehn

EM manufacturing is rising even as manufacturing in developed markets slumps – which is likely due to the effects of financial policies in developed economies. The outlook for EM FX reserves is brightening – we explain why and how. Oman looks set to be the 66th country in the JP Morgan EMBI GD index, which is now an extremely diversified index, and therefore a great deal safer than just a few years ago. Petrobras makes progress. Peru has gone to the polls. Mexico's fiscal outlook is benign and Saudi considers a big bond issue and clamps down on speculators. The global market backdrop is changing – one way to think of it is that markets are shifting from a giant momentum trade to value investing; EM should be well-placed to perform well in this environment.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	1.06%
MSCI EM Small Cap	11.3	–	1.05%
MSCI Frontier	9.3	–	0.04%
MSCI Asia	11.5	–	0.99%
Shanghai Composite	11.8	–	4.22%
Hong Kong Hang Seng	6.7	–	2.72%
MSCI EMEA	9.9	–	1.44%
MSCI Latam	12.5	–	2.22%
GBI-EM-GD	6.53%	–	1.46%
ELMI+	4.08%	–	0.48%
EM FX spot	–	–	0.89%
EMBI GD	5.69%	396 bps	0.90%
EMBI GD IG	4.30%	251 bps	0.81%
EMBI GD HY	7.60%	599 bps	1.01%
CEMBI BD	5.53%	397 bps	0.41%
CEMBI BD IG	4.25%	270 bps	0.32%
CEMBI BD Non-IG	7.66%	608 bps	0.57%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	0.49%
1-3yr UST	0.79%	–	0.29%
3-5yr UST	1.24%	–	0.65%
7-10yr UST	1.71%	–	1.26%
10yr+ UST	2.52%	–	2.65%
10yr+ Germany	0.07%	–	1.58%
10yr+ Japan	-0.12%	–	-0.21%
US HY	7.31%	578 bps	0.17%
European HY	4.69%	500 bps	0.27%
Barclays Ag	–	237 bps	0.70%
VIX Index*	13.47	–	0.04%
DXY Index*	94.21	–	-1.31%
EURUSD	1.1340	–	1.81%
USDJPY	106.99	–	-3.73%
CRY Index*	188.67	–	3.08%
Brent	50.0	–	0.44%
Gold spot	1241	–	2.95%

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

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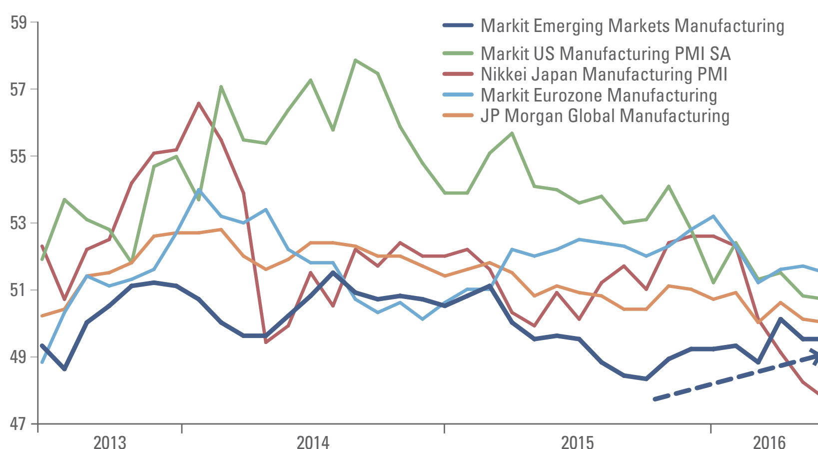
Fig 1: **Markit PMI Manufacturing**



Source: Ashmore, Bloomberg, Markit.

- **Manufacturing:** The global manufacturing cycle is in decline with one notable exception, Emerging Markets (EM). EM manufacturing bottomed out in late summer 2015 and has since been on an upwards trend, while manufacturing in the US, the Eurozone and especially in Japan has been in decline over the same period. The net effect of rising EM PMIs and falling developed market PMIs has been to push down global manufacturing

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overall. Why are EM manufacturers bucking the trend in manufacturing in developed markets? The answer probably has something to do with global financial policies. As investors have pulled money from local markets to chase QE-sponsored markets in the developed world, EM currencies have cheapened which has rendered EM producers more competitive (this is also supported by strong evidence of sharply improving EM external balances). At the same time, policies have strongly favoured financial markets, while the neglect of fundamental reforms has gradually rendered the real economy more sluggish. In this environment, capital has been lured away from the real economy within developed markets towards financial investments. Re-investment rates of profits in companies in developed markets have been extremely low as companies have favoured buying back their own stock, even to the point of issuing debt in order to do so.

- EM Reserves: EM reserves are up 2.1% year to date (5.0% annualised), excluding China and Saudi Arabia. FX reserves in China and Saudi Arabia, while down year to date, are also declining at much reduced rates compared to last year. In fact, China's reserves have risen slightly in the last two months. EM reserves have held up remarkably well in recent years. At USD 8.6trn, EM reserves are down a mere 2.3%, or USD 198bn, since the end of 2012. This means that EM central banks still control 78% of the world's FX reserves, despite the near-perfect constellation of anti-EM shocks in recent years, including outflows caused by the Taper Tantrum, the start of the Fed hiking cycle, the Dollar rally and the commodity price crash. The resilience of EM reserves offers an important insight: there is very little risk that EM reserves will decline to levels that warrant serious concern. In fact, the risk is now that EM reserves go up rather than down. The pace of decline in EM reserves (including China and Saudi Arabia) is moderating sharply. EM reserves are down just 1.2% annualised year to date compared to -8% in 2015. Out of a sample of 24 of the most important EM countries – comprising all the countries in the JP Morgan GBI EM GD local currency bond index plus nine large EM reserve countries, including China, Saudi Arabia, India, Taiwan, Singapore and Algeria – only four countries have had falling reserves this year.[1] This compares to 18 countries last year, 15 in 2014 and 10 in 2013. Among the countries whose reserves have declined, there are good reasons to expect further moderation. China's domestic markets are about to enter important global benchmark indices as well as the SDR basket, while the programmes of corporate refinancing in RMB from USD are drawing to a close. FX valuation effects are also diminishing as the Dollar rally has lost much of its impetus after the strong Dollar started to meaningfully hurt the American economy. Saudi Arabia is also gradually adjusting to lower oil prices and shifting emphasis to bond issuance instead of reserve drawdowns. As for the rest of EM, the massive currency depreciation of recent years and tighter domestic financial conditions have helped to improve their external balances, which should now begin to translate into improving reserves via stronger external balances.

Following its inaugural bond issue last week, the Sultanate of Oman looks set to become the 66th EM country to join JP Morgan's EMBI GD benchmark index. This index is the main market benchmark and comprises EM sovereign and quasi-sovereign issuers of Dollar-denominated bonds. The index is therefore on track to have 80 members by the end of the decade. The rapid rise in the number of countries issuing Dollar bonds compared to a decade ago when there were just 26 EM countries in the index is very important. The increase in the number of index members reflects the broad-based macroeconomic resilience, stronger growth, rapid financial deepening and broadening and more stable political conditions that have prevailed in EM since the mismanagement of the Cold War period. Yet, we think many investors have not yet fully recognised the significance of the growing diversification within the external debt asset class. The index is now far less risky than before. It has no fewer than 132 independent issuers and more than 510 individual securities. The largest weight of any single country in the index is now just 5.49% (Mexico) with 78% of the countries in the index having 3.0% or less in weighting. The diverse nature of the index is a far cry from the early 2000s, when a single country like Argentina could command a 20% index weight. This will never happen again. The blended spread of the EMBI GD index is 394bps for a yield of 5.8%, duration of 6.71 years and an average rating of Ba1/BB+/BB+ (Moody's/S&P/Fitch), i.e. one notch below investment grade. The lowest spread for the index was 166bps in 2007, when the Fed funds rate was 5.375%. In 2008, the EMBI GD spread briefly blew out to 768bps due to panic selling of EM assets in response to the US subprime collapse. Investors quickly returned, however, and by March 2010 the spread set a post-Subprime low of 255bps. Since then EMBI GD spreads have traded in a range between 255bps and 464bps, though the market has traded at current spreads or tighter 85% of this time. We think EM external debt offers excellent value, both relative to actual risks in EM, relative to previous spread levels and especially relative to developed market bonds. Indeed, most developed market bonds now trade at negative yields so they should be thought of as taxes rather than investments.

- Brazil: Following its bond issue a fortnight ago Petrobras last week went shopping, buying back nearly USD 6bn of its own bonds. The buybacks targeted near-term maturities, reducing principal repayments by USD 3.4bn in 2017 and USD 2.5bn in 2018 and USD 65m in 2019. This means that overall amortisations have been reduced by more than one quarter in 2017 and 2018, significantly easing Petrobras's refinancing challenges for the foreseeable future. Remaining amortisations are mainly bank loans, which are likely to be easier to roll. Comments from Petrobras' new CEO Pedro Parente about reforms at Petrobras, the state-owned oil giant, are highly encouraging. Parente says that the company will set fuel prices, sell assets and will operate independently of central government. Parente himself has a strong reform record, having overseen

[1] The four with declining reserves are Hungary, Peru, China and Saudi Arabia.

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Petrobras' original conversion from a conventional state-owned enterprise into a public-private partnership. The Lower House may soon consider a bill that removes Petrobras' obligation to co-participate in off-shore oil projects, i.e. the bill could open Brazil's deep-water fields to foreign investment without placing a large investment burden on Petrobras, which under current rules must contribute 30% to each project. In other news, the economic data is now regularly outperforming expectations. Q1 growth, while weak, was far better than expected. The economy contracted 0.3% qoq compared to -0.8% qoq expected and -1.3% qoq in the previous quarter. Inflation also moderated to 0.64% mom from 0.68% mom and industrial production rose 0.1% percent mom compared to expectations of a contraction of 0.9% mom. The trade balance, however, stole the show with a massive beat of USD 6.4bn vs USD 5.6bn expected. The beat was mainly on the export side. Exports increased to USD 17.5bn in May versus USD 16.7bn expected and USD 15.4bn in April.

- Peru: At the time of writing, Pedro Pablo Kuczynski (aka PPK) leads Keiko Fujimori by 50.8% to 49.2% in the run-off election for president. A win for PPK, a former finance minister, would be positive at the margin, in our view. We believe both candidates, however, would pursue market friendly policies. Advisers close to Keiko indicated last week that her government would significantly boost infrastructure spending. Inflation was lower than expected in May (0.21% mom versus 0.24% expected and 0.56% mom in the same month last year).

- Mexico: The Mexican government is on track to meet the 3% fiscal deficit target for 2016. This shows that the government has successfully adjusted to lower oil prices. The government ran a surplus in April and the total debt stock of the government including the debt of state-owned oil company PEMEX stands at 46% of GDP. Macroeconomic management in Mexico is generally excellent.

- Saudi Arabia: The Saudi Arabia Monetary Agency has banned speculation against the Saudi riyal in the forward markets. Forward contracts can still be used to back trade in goods and services. The decision is a strong indication that Saudi Arabia has no intention to devalue its currency, nor that Saudi Arabia wants to expend reserves fighting off currency speculators. In our opinion, there is no desire whatsoever for Saudi Arabia to de-peg. In fact, having drawn on reserves in the early phases of its adjustment to lower oil prices the Kingdom is now gradually turning to bond issuance instead. Saudi Arabia is widely expected to bring a USD 15bn bond issue to market in the near-term.

- China: HSBC, an investment bank, estimates the combined offshore demand for Chinese government bonds arising from index inclusion will be between USD 100bn to USD 150bn. This will have negative implications for index weights in countries with smaller weightings, because such countries are currently better represented in the (diversified, that is capped) benchmark indices. Inclusion of A Shares in the MSCI suite of indices would induce further demand. The Strategic and Economic Dialogue between the US and China starts this week against low expectations on account of the proximity of a change of government in the US.

Snippets:

- Chile: Retail sales rebounded strongly at a rate of 7.9% yoy versus a consensus expectation of 4.5% yoy in April, up from 2.7% yoy in March.
- Indonesia: S&P left Indonesia's sovereign debt rating unchanged at BB+ with a positive outlook. The 2016 budget deficit was increased marginally from 2.2% of GDP to 2.5% of GDP due to lower commodity-related royalties.
- Malaysia: The trade surplus was USD 2.3bn in April following a USD 2.8bn surplus in March.
- Russia: FX reserves rose marginally to USD 389bn.
- South Korea: CPI inflation slowed to 0.8% yoy in May from 1.0% yoy in April, while exports disappointed. Exports were down 6% yoy versus -0.4% yoy expected. Imports were down 9.3% yoy versus -9.7% yoy expected, so the trade surplus narrowed from USD 8.8bn to USD 7.1bn.
- Sri Lanka: The government and the IMF have reached agreement on a USD 1.5bn credit facility that involves raising tax revenues, stabilising reserves, reducing debt levels and improving efficiency in state-owned enterprises.
- Thailand: Core inflation was unchanged in May and lower than expected (0.78% yoy versus 0.81% yoy expected). Headline inflation rose to 0.46% yoy from 0.07% yoy
- Turkey: CPI inflation was lower than expected in May. CPI inflation was 6.58% yoy versus 6.70% yoy expected.
- Ukraine: The government signed yet another US-backed USD 1.0bn loan guarantee agreement.
- Zambia: IMF has indicated that talks with the government over a program have stalled pending the conclusion of the next election scheduled for August.

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Global backdrop

Global financial markets have engaged in a giant portfolio shift on the back of QE policies since around 2010. Investors jumped onto the QE markets to ride the momentum created by central bank sponsorship, financing their purchases in these markets by reducing exposure to non-QE markets, including EM. One can think of this as a momentum trade, meaning that the direction of asset prices mattered far more than fundamentals. However, momentum trades always end. Firstly, investors get too long. Returns begin to wane. Secondly, value opportunities elsewhere begin to appear. Value investments differ from momentum trades in that fundamental are also given consideration. This is healthy and bodes well for EM. After all, EM economies have maintained solid fundamentals despite severe shocks in recent years, while valuations have been pushed to extremely attractive levels. By contrast, developed markets look overbought. It is time to rotate those QE trades into the non-QE investment universe, including EM.

Fitch ratings noted that more than USD 10trn of sovereign debt now trades with negative yield. This is roughly 1/3 of all government debt in developed markets, though some countries are more afflicted than others. QE money has sought government bonds in Europe and Japan resulting in lower yields in those countries than in the US, though real 5 year yields are negative in all three regions. Some 70% of German government debt now trades with negative yield, which means that investors will have to hold the bonds for far longer in order for any carry to offset losses in the event of a fall in bond prices. By contrast, as noted above, EM bonds – which have largely been sold in the giant portfolio shift caused by QE programs – now pays a high real yield.

Market speculation about a cap on oil production proved groundless. Even so, oil prices were strong and oil credits performed well last week. OPEC's inability to agree on anything is not surprising. With Iran desperate for money and hence exporting as much oil as possible the odds that Saudi Arabia supports a production cut is very low. Hence, everyone is effectively pumping at full tilt. Yet, the oil market is currently clearing at around USD 50 per barrel. This can easily be interpreted as a bullish sign for oil prices.

In the US, Donald Trump won the all-important endorsement of Paul Ryan, House Speaker. Realpolitik demands the "Trump and Ryan Show" – both men are likely to agree on downsizing the government bureaucracy, while we expect the next US government will want to spend more on infrastructure.[2]

A significant camp within the FOMC has been making the argument that the Fed should not hike just because unemployment is falling and growth has improved a bit in Q2. There is no inflationary pressure, they argue. Another camp argues in favour of hikes, because they would give the Fed room to cut rates when the next recession strikes. The former camp received a strong boost following last week's collapse in payrolls and the slump in the US services sector, neither of which can be explained by a strike at Verizon, by the way.

Clearly, as far as US monetary policies are concerned one swallow does not a summer make. However, the 38K payroll number should take a hike off the table this summer. And if the recent weakness in the services sector foretells of a recession – which cannot be ruled out – then expect stimulus rather than tightening. Fed Chairwoman Janet Yellen may provide some more colour.

In any case, EM investors should not worry about hikes, given the shallower pullbacks and stronger recoveries already evident in the data.[3] The real risk, in our view, is that a recession in the US is inevitable at some point and there are no conventional easing options left. A 25bps rate cut will not pull the economy out of a recession, so Helicopter Money or negative rates would become reality. Both would be bad for the Dollar and could cause the US yield curve to steepen. Markets are not prepared for this at all.

The ECB left policy rates unchanged and failed to improve on its forecasts for 2017 and 2018. The ECB's inaction is another good indication that the Fed will not hike in June, in our view. In Japan, Prime Minister Shinzo Abe confirmed that sales taxes will be postponed, but clarified that a new stimulus package may not be ready until autumn, raising fresh concerns about the economy. Developed economies look poorly prepared for any kind of withdrawal of stimulus. That particular predicament has a name – addiction.

[2] For more thoughts about how the Trump campaign may unfold see *"The Coming Trump Pitch"*, Weekly Investor Research, 16 May 2016.
[3] See *"EM and the Fed: Smaller pullbacks and greater recoveries"*, The Emerging View, June 2016.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.13%	3.50%	-15.74%	-3.96%	-4.11%
MSCI EM Small Cap	0.89%	-0.22%	-17.15%	-2.91%	-2.65%
MSCI Frontier	1.15%	4.23%	-9.73%	0.48%	2.19%
MSCI Asia	0.58%	0.07%	-16.05%	-0.11%	-0.31%
Shanghai Composite	0.78%	-16.80%	-39.21%	11.37%	3.99%
Hong Kong Hang Seng	1.23%	-8.53%	-35.68%	-2.21%	-3.93%
MSCI EMEA	2.48%	10.69%	-13.23%	-6.79%	-7.12%
MSCI Latam	3.24%	16.40%	-14.75%	-12.95%	-11.23%
GBI EM GD	1.64%	9.45%	-2.93%	-6.21%	-3.11%
ELMI+	0.65%	3.88%	-3.30%	-4.02%	-3.36%
EM FX Spot	1.06%	2.81%	-9.77%	-11.10%	-9.67%
EMBI GD	0.92%	7.69%	6.22%	4.70%	6.04%
EMBI GD IG	0.93%	7.42%	4.70%	4.11%	5.16%
EMBI GD HY	0.91%	7.84%	8.10%	5.44%	7.31%
CEMBI BD	0.42%	6.35%	3.30%	4.03%	4.98%
CEMBI BD IG	0.37%	4.88%	3.47%	4.19%	5.24%
CEMBI BD Non-IG	0.49%	8.89%	2.69%	3.49%	4.52%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.13%	3.71%	1.49%	10.86%	12.43%
1-3yr UST	0.23%	1.18%	1.22%	0.68%	0.66%
3-5yr UST	0.57%	2.68%	3.48%	2.12%	1.89%
7-10yr UST	1.21%	5.63%	7.97%	3.89%	5.04%
10yr+ UST	2.56%	10.97%	15.92%	8.08%	9.89%
10yr+ Germany	1.57%	12.06%	14.79%	10.74%	11.66%
10yr+ Japan	-0.12%	13.21%	18.98%	9.15%	7.55%
US HY	0.03%	8.09%	-0.51%	3.08%	5.50%
European HY	0.24%	4.57%	2.09%	6.43%	8.99%
Barclays Ag	0.66%	5.30%	5.50%	4.04%	5.04%
VIX Index*	-5.07%	-26.03%	-5.21%	-19.00%	-27.15%
DXY Index*	-1.75%	-4.48%	-2.17%	15.55%	27.40%
CRY Index*	1.35%	7.11%	-15.22%	-34.27%	-45.38%
EURUSD	1.98%	4.46%	0.43%	-14.39%	-22.20%
USDJPY	-3.37%	-10.89%	-14.06%	10.33%	33.57%
Brent	0.58%	34.07%	-21.06%	-51.76%	-56.34%
Gold spot	2.12%	16.93%	5.71%	-12.22%	-19.65%

*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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