Nearly there

By Jan Dehn

A bunch of 'nearly there' events currently dominate the EM investment environment. Within EM itself, Nigeria is now nearly there in terms of getting its FX policy right. Brazil's new fiscal framework is nearly ready for approval and the rate cutting cycle is nearly about to begin. In China, MSCI is nearly ready to admit A-shares into the EM indices and India's current account is nearly in surplus. The Indian government is also nearly ready to attempt to pass GST. In Venezuela, a new poll shows that Maduro's reign may now nearly be over. In Argentina, the government has nearly restored the state of national statistics to a normal footing and Papua New Guinea's government is nearly ready to join the global capital markets. In the global backdrop, the big 'nearly there' event is clearly the UK Brexit vote on 23 June. All government bonds in developed markets are also nearly trading with negative yields by now and policy makers have nearly almost all run out of effective monetary policy stimulus measures. Most 'nearly there' events in EM are upside risks, while most of the 'nearly there' events in developed markets are taking them in the wrong direction.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	-2.05%
MSCI EM Small Cap	11.3	–	-2.15%
MSCI Frontier	9.4	–	1.21%
MSCI Asia	11.3	–	-2.40%
Shanghai Composite	11.7	–	-1.31%
Hong Kong Hang Seng	6.6	–	-3.19%
MSCI EMEA	9.6	–	-2.71%
MSCI Latam	12.3	–	-0.30%
GBI-EM-GD	6.51%	–	-0.84%
ELMI+	3.90%	–	-0.48%
EM FX spot	–	–	-0.82%
EMBI GD	5.67%	404 bps	-0.45%
EMBI GD IG	4.27%	257 bps	-0.35%
EMBI GD HY	7.63%	611 bps	-0.56%
CEMBI BD	5.48%	402 bps	-0.12%
CEMBI BD IG	4.19%	274 bps	-0.02%
CEMBI BD Non-IG	7.64%	616 bps	-0.29%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.5	–	-1.12%
1-3yr UST	0.72%	–	0.10%
3-5yr UST	1.15%	–	0.27%
7-10yr UST	1.65%	–	0.26%
10yr+ UST	2.47%	–	0.68%
10yr+ Germany	0.05%	–	0.27%
10yr+ Japan	-0.14%	–	0.19%
US HY	7.35%	590 bps	-0.79%
European HY	5.05%	541 bps	-1.03%
Barclays Ag	–	238 bps	-0.15%
VIX Index*	17.49	–	-3.48%
DXY Index*	93.64	–	-0.73%
EURUSD	1.1340	–	0.43%
USDJPY	104.54	–	-1.64%
CRY Index*	192.38	–	-0.51%
Brent	50.0	–	-0.77%
Gold spot	1287	–	0.26%

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

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- **Venezuela:** A new poll from Datanalisis, a credible pollster, showed that 94.6% of the Venezuelan population now deems the economic situation in the country to be bad. The poll also showed that more than three quarters of voters favour a referendum to recall President Maduro, whose personal approval rating dropped 3.5% to 23.3%. The process of verifying signatures collected in favour of a recall referendum is progressing, and puts Venezuela on track for a change of president within the next 12 months, in our view. Meanwhile, Oil Minister Eulogio Del Pino said that Venezuela is able to service debts falling due this year, and confirmed that the government is in talks with China over possible easing of its refinancing conditions. This is important. China is Venezuela's most important source of external financing. The People's Daily, a newspaper that reflects the views of the Chinese Communist Party, published a front page article on June 11th titled *'Will Venezuela Default?'* The article made three points, namely: (a) that Venezuela has strong willingness to pay and will keep servicing external debt, including debt to China; (b) Venezuela's economy has difficulties, but given its large oil reserves no solvency problem, wherefore it is right for China to take a long-term view and provide help to Venezuela in this difficult situation; and (c) that China is not worried about the opposition taking power, because a cross-party consensus exists in Venezuela that the relationship to China is crucial for the country. The author of the article is pen-name called "Lu Da Xin", which, if pronounced in reverse, is Chinese "New Continent", the nickname used in China for South America. Our view is that this article is the closest you are going to get to a policy statement. China takes a long-term view on Venezuela, one that transcends governments. Venezuela's sovereign bonds returned more than 17% in Dollar terms last year and have returned more than 11% in Dollar terms year to date in 2016.

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- **India:** In line with dramatic improvements in external balances elsewhere in Emerging Markets (EM), India's current account deficit shrank to just USD 300m (0.1% of GDP) in Q1 2016. By contrast, as recently as early 2013 India's current account deficit exceeded USD 30bn (5% of GDP). As a result of the stronger current account balance plus capital inflows, India's FX reserves reached a new all-time high of USD 363bn in early June, the highest ever level of FX reserves. In other good news, the government has now published a draft version of the Goods & Services Tax (GST) bill. This suggests that the government will seek to obtain approval for the bill in the next parliamentary session that begins in July. India also recently passed reforms of the solvency and bankruptcy laws. On the other hand, some uncertainty had been created by the announcement at the weekend that the term of Raghuram Rajan, governor of the Reserve Bank of India (RBI), is nearly over. Rajan is stepping down in September. There will be a period of uncertainty until the government announces his replacement, but we are not too concerned about his departure. Rajan was formidable, but he is not indispensable. India is a huge country with many highly qualified professionals who can replace him. Besides, Rajan was brought in to help restore confidence at a very difficult point in India's recent macroeconomic history, a job executed extremely well and today India's economy is far stronger. Besides, Rajan never severed his ties with the Chicago Booth School of Business, where he was professor prior to his appointment in India. The key going forward is going to be the RBI's policies, not personalities. This is not least because the government looks set to preserve the new CPI target (1.5%-2% range for real rates) and the same policy tool (the repo rate) as well as the same committee structure that Rajan designed. This committee structure becomes effective in September and involves a six-member MPC, including three representatives from the RBI. Even so, the market will want to see a technically competent and credible replacement for Rajan, who is in good standing with Modi, and also someone who can hold his own vis-a-vis Jaitley. This is particularly important as the Indian government seeks to pass GST, the most politically challenging reform in the Modi era. The market will soon move on from the Rajan news and focus on other drivers, including GST itself, inflation and growth plus all global factors, such as Brexit, the Fed's hiking cycle and the US election. Inflation was 5.76% yoy in May, marginally higher than expected (5.60%). This was due to higher agricultural prices. Core inflation was well-behaved.

- **Brazil:** Brazil's upcoming fiscal reform promises to be a game changer. In a note published last week, the Finance Ministry led by Henrique Meirelles explained that the fiscal reforms will be enshrined into Brazil's Constitution. Under the proposal, a cap will be applied to total spending that prohibits primary spending from growing from 2017 onwards (except for expenditures to recapitalise state-owned enterprises, but including arrears) with penalties for non-compliance. The Constitutional Amendment will remain on the books for 20 years. The challenge will be getting the reform approved and some dilution of the original bill should be expected, in our view. Constitutional Amendments required passage in both houses of congress twice with majorities of three-fifths of the votes of the respective members of each house. The current political climate is therefore very important. Last week, yet another minister in the government of acting President Michel Temer had to resign over allegations of financial impropriety. Tourism Minister Henrique Eduardo Alves was the third minister to fall on his sword. Temer has maintained a tough line with respect to corruption allegations, sacking or encouraging resignation of ministers who become tainted by a widening campaign by lawyers to punish illegal campaign financing and bribery. Meanwhile, Temer himself sought illegal campaign contributions, according to a key witness for the prosecutors. Illegal campaign financing was widespread in Brazil, not just confined to the PT party of suspended President Dilma Rousseff. The main risk to our bullish view on Brazil is that governance becomes impossible should the Temer administration also be forced to relinquish power over impropriety. Meanwhile, two inflation indicators published last week came lower than expected in a boost to the expectations that the central bank will commence the rate cutting cycle in the second half of 2016.

- **Nigeria:** Get ready for fireworks! The government announced last week that it will abandon its fixed exchange rate in favour of a single flexible exchange rate today. This morning USD:NGN rallied from 197 to 257. There is considerable pent-up demand for Dollars following Nigeria's reluctance until now to devalue the currency following the fall in oil prices that began in the summer of 2014, so NGN has the potential to move sharply until it finds a new equilibrium. The abandonment of the peg is good news. Until now, the government of President Buhari has been in denial about the fall in oil prices, failing to see the need to adjust the economy early and decisively to the new external circumstances. The simple insight that seems to have eluded President Buhari's economic advisers is that Nigeria is a completely oil dependent economy and that lower oil prices mean that national income is lower. This means that consumption must also be adjusted to bring it into line with lower national income, which is usually done through adjustment of both domestic and external balances. Domestically, spending must be reduced through rate hikes and/or fiscal spending cuts, while the external accounts are brought into balance through a devaluation of the currency. In our view, Nigeria has caused serious long-term damage to its economy through its botched and much delayed policy response. One permanent cost, for example, is that Nigeria's domestic bond market has been kicked out of the JP Morgan local currency bond index. Still, the decision to devalue is very positive, because it shows that the government is finally realising the need to adjust. This process will put Nigeria back on a sustainable path, but only after a long and tough adjustment to the new exchange rate regime.

- **Argentina:** The government has taken a major step forward towards statistical normality by launching a fully revamped CPI index that is based on internationally acceptable standards. This should pave the way for the first Article IV mission to Argentina since 2006. The IMF's Article IV missions carry out detailed assessments

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of both policies and the state of the economy and typically result in the publication of a so-called Article IV report, which usually provides an excellent overview of all major economic issues in the country in question. The only country in the world with a longer delay in Article IV missions than Argentina is Venezuela (the last one was in 2004). The new CPI index showed that monthly inflation is running at 4.2% mom, but core inflation was substantially lower at 2.7% mom. The central bank maintains a tightening stance, albeit with rapidly declining nominal rates, while the ARS is appreciating both of which should cause inflation to continue to decline. Last week the rate on the 35-day Lebac – a key policy instrument – declined by another 100bps to 32.25%.

- Index news: China's A-share market has moved several steps closer to qualifying for inclusion in the MSCI EM benchmark equity index. The two remaining constraints pertain to trading suspension policies and limits on monthly repatriation of funds. We think China will continue to liberalise the capital account and that these outstanding issues will be addressed, paving the way for China's formal inclusion in the MSCI EM index by next year with the main risk being an earlier inclusion. The market reacted positively to the news suggesting that there was no expectation that inclusion would take place at this time. Besides, China's index inclusion is clearly not critical for creating liquidity. Between them, the Shanghai and Shenzhen exchanges trade USD 43bn of A-shares every single day compared to just USD 29bn of average daily trading on the New York Stock Exchange (NYSE). In addition, the Hong Kong exchange averages USD 71bn in daily trading, so between Hong Kong and the onshore exchanges China's market is nearly four times as large as the NYSE. As for bonds, our view is that the Chinese bond market will achieve index inclusion over the next 18 months, though this remains up to JP Morgan, the index provider. China's bond market has broader institutional involvement and behaves in a more orderly fashion as a result. In addition to the progress report on the inclusion of A-shares into the MSCI EM index, MSCI announced that South Korea will remain within the MSCI EM index. Other index providers, including FTSE and S&P, already classify South Korea as a developed market, but MSCI deems that restrictions on convertibility of the KRW preclude South Korea from qualifying as a developed market. MSCI also put Argentina on review for reclassification from Frontier to Emerging Markets status. Nigeria was put on review for possible exclusion from MSCI's suite of indices.

- China: Total Social Financing – a catch-all indicator of China's overall credit markets – expanded by less than expected in May (RMB 695bn vs RMB 1000bn expected). The short-fall was mainly due to lower than anticipated corporate bond issuance (RMB 40bn, down from RMB 201bn in April). This decline in corporate RMB issuance suggests that the refinancing by Chinese corporates of their USD bonds into RBM bonds following the adoption of a more flexible currency regime last year may now be slowing. Meanwhile, mortgage lending picked up sharply in the household sector resulting in higher than anticipated bank lending (RMB 986bn versus RMB 750bn expected). The overall stance of monetary policy remains accommodative amidst somewhat tighter financial conditions within the banking sectors. For example, narrow money (M1) was up 23.7% yoy in May, but broader money (M2) only expanded at 11.8% yoy.

- Papua New Guinea: The Independent State of Papua New Guinea (PNG) is conducting a roadshow with a view to entering the global financing markets. PNG is rated B2 with a stable outlook by Moody's and B+ (Negative) by S&P. We expect the bond to be eligible for inclusion in the JP Morgan EMBI GD index, thus taking the number of countries in the index to 67. In recent research, we showed that the sharp rise in the number of countries in the index has sharply reduced the volatility of the index without reducing the yield. This implies, in our estimation, that investors are being paid 100bps more than is necessary to compensate for the risk, a clear arbitrage opportunity. PNG's inclusion in the index will further enhance this arbitrage opportunity.[1] Of course, EM investors already have opportunities to invest in corporate bonds in PNG.

- Colombia: Retail sales and industrial production both beat expectations in April. Retail sales rose at a yoy pace of 5.4% versus 3.9% yoy expected, while industrial production surged 8.4% yoy, up from 1.4% yoy in March. This is encouraging after domestic demand slowed in the first three months of 2016. Specifically, real GDP slowed to 2.5% yoy in Q1 2016 from 3.4% yoy in Q4 2015.

- Indonesia: Bank Indonesia cut interest rates by 25bps to 5.25%. Last week South Korea also cut rates. The timing of these rate cuts is noteworthy, because they are taking place during a period of heightened risk aversion due to the looming Brexit vote. This is a big change from recent years, where it would have been very difficult for EM central banks to cut rates during bouts of risk aversion. As such, these rate cuts are a good indication of the changing fortunes for EM local markets in particular, where returns year to date are close to 10%. Indonesia also eased LTV limits for mortgage financing to 80%. Indonesia racked up yet another trade surplus, the fifth so far this year.

- Bulgaria: The International Court of Arbitration has ruled that the government must pay EUR 550m (more than 1% of GDP) to Rosatom Corp, a producer of nuclear reactors, after failing to honour the contract with the company. The government budget is in surplus to the tune of approximately 3% of GDP, while overall government debt is less than 30% of GDP. Still, this ruling is a serious blow, in our view.

- Croatia: Parliament, led by the senior party in the ruling coalition, HDZ, has passed a no-confidence vote against the government of Prime Minister Tihomir Oreskovic . This follows a verdict by an ethics committee that the business ties of a senior HDZ politician with Hungarian oil company MOL constituted a conflict of

[1] *"Free Money: Arbitrage opportunities in EM external debt"*, Market Commentary, 14 June 2016.

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interest. HDZ will now try to form a new government, which must survive a vote of confidence within 30 days, or Croatia has to have fresh elections. An election by September seems likely given that HDZ controls less than 1/3 of the seats in parliament. It is likely that reforms and large infrastructure investment projects will now be put on hold until the political landscape settles down.

Snippets:

- **Malaysia:** Inflation in June slowed to 2.0% yoy from 2.1% yoy in May. Prime Minister Najib Razak boosted his political capital by increasing his majority in by-elections on Saturday.
- **Peru:** The economy expanded at a pace of 2.4% yoy in May.
- **Philippines:** Remittances grew 4.1% yoy in April.
- **Serbia:** China and Serbia have signed a local currency swap deal worth RMB 1.5bn.
- **Singapore:** Non-oil domestic exports surged 16.8% mom in May, much faster than the 2.0% mom increase expected by the market.
- **South Korea:** Unemployment was unchanged in May at 3.7%, slightly better than anticipated (3.8%).
- **Turkey:** Unemployment drops to 10.1% in May from 10.9% in April.

Global backdrop

Global markets will be completely focused on Brexit this week. This is, of course, a little bit of out proportion. After all, the policy decisions of a small European country, such as the UK, will not have much fundamental impact beyond its own borders, let alone in EM. But global markets like to trade themes and here is one, so to the extent that the Brexit vote causes temporary volatility in EM asset prices we think investors should take the opportunity to buy into weakness, if any. However, it is far from obvious that there will be much impact on EM asset prices, which have been very resilient both to Brexit sentiment and to recent shifting expectations of Fed hikes. Also, regardless of the outcome of the Brexit vote the mere fact that the uncertainty caused by the Brexit vote will be out of the way by Friday of this week may itself give rise to a relief rally. If so, investors may find that EM assets perform very strongly post the Brexit vote, while some weakness can be expected in developed market bonds that appear to have priced in an extraordinary amount of bearishness, in our view.

As for US monetary policy, the Fed left rates unchanged at the June FOMC. Following weak payrolls, this was largely expected. The FOMC also cut terminal rate expectations, however, reflecting a more bearish longer-term growth outlook for the US economy. This is clearly a concession to reality. Even so, a strong collective schizophrenia still exists among market participants about the direction of travel. For example, the Overnight Index Swap market last week priced Fed funds three years from now at just 64bps, while most analysts still believe that the Fed will hike about five times over the same period. The Fed itself is a total outlier with a prediction that rates will rise to 3% by 2018. Obviously, they cannot all be right. Overnight Index Swaps imply an 80% probability that the Fed is wrong. Analysist expectations imply at least a 50% probability of a Fed policy mistake.

There are reasons to believe both the traders and the Fed may be wrong. For example, it is obvious from past revisions of forecasts that the Fed deliberately biases its projections to the upside. After all, the Fed has to err on the side of optimism, since current economic policies rely on keeping asset prices elevated far above levels that are justified by weak economic fundamentals. This means that the rubber is rarely allowed to meet the road, so the Fed continuously revises its forecasts lower as the future creeps ever closer. Traders, on the other hand, are so myopic that they are unable to look beyond the risk associated with the next risk event, in this case the Brexit vote on 23 June. As for the analysts, they are by no means any better. Most have no clearly defined notion of what is going to happen in the current unprecedented environment of unconventional policies. Hence, they just assume that rates must go up slowly, because, well, that is usually what rates do when they are low.

We think investors should take a step back to look at the market from a slightly greater height. The key development in the first half of 2016 has been the collapse of the Fed's plans to continue the hiking cycle. Plans to execute a slow but steady return to normal monetary policy were scuppered. Markets are now pricing just a 37% probability of a single hike this year. Why does the economy continue to be so weak that even the Fed's very gentle hiking cycle cannot be sustained? The reason why developed economies are not responding to eye-watering quantities of monetary stimulus is that the problems are not monetary in nature. Hence, the blame should not be placed at the door of the central banks, though one could argue that should have been a bit more vocal about their impotence (in truth, of course, no one likes to advertise their own impotence). The core problems in developed economies are related to productivity and debt. The longer ineffective monetary medicine is dispensed the longer the underlying ailment is left untreated. What is frightening is that fiscal policy is not the solution either, because it will only add further to the debt stock. Today, recovery requires less debt and much higher rates of productivity growth, but neither politicians nor the majority of economic pundits are yet willing to face up to this fact, probably because the ramifications are too horrible to contemplate.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.09%	2.44%	-14.47%	-3.04%	-3.45%
MSCI EM Small Cap	0.20%	-0.91%	-15.13%	-1.75%	-1.98%
MSCI Frontier	2.28%	5.40%	-6.47%	1.71%	2.35%
MSCI Asia	-0.61%	-1.11%	-14.41%	0.80%	0.48%
Shanghai Composite	-0.81%	-18.11%	-40.93%	13.03%	4.14%
Hong Kong Hang Seng	-1.51%	-11.00%	-34.33%	-1.34%	-3.54%
MSCI EMEA	0.07%	8.09%	-14.20%	-7.37%	-7.16%
MSCI Latam	3.23%	16.38%	-14.67%	-11.28%	-10.40%
GBI EM GD	2.44%	10.31%	-0.97%	-5.89%	-2.70%
ELMI+	1.28%	4.52%	-2.41%	-3.96%	-3.01%
EM FX Spot	1.46%	3.22%	-8.89%	-11.15%	-9.37%
EMBI GD	1.21%	8.00%	8.17%	5.15%	6.12%
EMBI GD IG	1.34%	7.86%	6.73%	4.40%	5.21%
EMBI GD HY	1.06%	8.00%	9.97%	6.19%	7.42%
CEMBI BD	0.85%	6.81%	4.45%	4.52%	5.15%
CEMBI BD IG	0.87%	5.40%	4.61%	4.66%	5.33%
CEMBI BD Non-IG	0.82%	9.24%	3.85%	4.02%	4.83%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.11%	2.42%	0.81%	10.40%	12.63%
1-3yr UST	0.42%	1.38%	1.33%	0.73%	0.68%
3-5yr UST	1.12%	3.24%	3.71%	2.32%	1.95%
7-10yr UST	2.01%	6.47%	8.27%	4.25%	5.12%
10yr+ UST	4.45%	13.02%	17.54%	9.26%	10.19%
10yr+ Germany	3.89%	14.61%	17.40%	11.57%	12.06%
10yr+ Japan	1.12%	14.61%	20.36%	9.94%	7.80%
US HY	0.21%	8.29%	0.52%	3.37%	5.79%
European HY	-0.44%	3.87%	2.96%	6.47%	9.09%
Barclays Ag	1.01%	5.67%	5.94%	4.43%	5.11%
VIX Index*	23.26%	-3.95%	25.29%	-14.64%	-12.51%
DXY Index*	-2.35%	-5.06%	-0.48%	14.31%	24.80%
CRY Index*	3.34%	9.21%	-13.39%	-31.19%	-42.74%
EURUSD	1.98%	4.46%	-0.01%	-14.22%	-20.72%
USDJPY	-5.58%	-12.93%	-15.27%	7.44%	30.25%
Brent	0.54%	34.01%	-20.72%	-51.09%	-55.27%
Gold spot	5.92%	21.28%	8.55%	0.17%	-16.45%

*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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