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WEEKLY INVESTOR RESEARCH

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Thailand's plebiscite

By Jan Dehn

Thailand's voters are heading to the polls next week in order to give their verdict on the military's new constitution. If approved, Thailand will have general elections in the middle of 2017 to pave the way for a return to a civilian government. Prospects for reforms in Indonesia were given a big shot in the arm last week with the re-appointment to the post of finance minister of Sri Mulyani Indrawati, a former World Bank Managing Director. India's GST bill has now made it to the floor of the Senate and should be voted upon in the coming days. Euroclear approves Russia's 2026 sovereign bonds for approval. China announces new regulation for wealth management companies. Venezuelan bonds rallied sharply last week despite lower oil prices due to expectations of liability management on the part of PDVSA, the national oil company. Petrobras has begun to sell assets. In the US, the FOMC must have let out a collective sigh of relief that it did not raise rates in July as the weakness of the Q2 GDP number became apparent, while Europe's bank stress tests failed to reassure Germany's Bundesbank.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.6	–	0.52%
MSCI EM Small Cap	12.1	–	0.55%
MSCI Frontier	9.4	–	0.80%
MSCI Asia	12.1	–	0.29%
Shanghai Composite	12.1	–	-1.06%
Hong Kong Hang Seng	7.2	–	-0.81%
MSCI EMEA	9.9	–	1.58%
MSCI Latam	13.6	–	-0.03%
GBI-EM-GD	6.25%	–	0.93%
ELMI+	3.72%	–	0.50%
EM FX spot	–	–	0.51%
EMBI GD	5.17%	370 bps	-0.22%
EMBI GD IG	3.92%	239 bps	-0.23%
EMBI GD HY	6.95%	557 bps	-0.21%
CEMBI BD	5.06%	372 bps	0.18%
CEMBI BD IG	3.89%	256 bps	0.23%
CEMBI BD Non-IG	7.01%	566 bps	0.11%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	-0.05%
1-3yr UST	0.67%	–	0.15%
3-5yr UST	1.05%	–	0.36%
7-10yr UST	1.48%	–	0.88%
10yr+ UST	2.20%	–	1.83%
10yr+ Germany	-0.11%	–	2.04%
10yr+ Japan	-0.13%	–	-0.22%
US HY	6.71%	540 bps	-0.34%
European HY	4.42%	489 bps	0.14%
Barclays Ag	–	244 bps	0.49%
VIX Index*	11.88	–	-0.99%
DXY Index*	95.65	–	-1.64%
EURUSD	1.1168	–	1.57%
USDJPY	102.40	–	-3.22%
CRY Index*	181.01	–	-1.89%
Brent	43.6	–	-2.62%
Gold spot	1349	–	2.54%

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

Emerging Markets

- **Thailand:** Voters will be asked to vote in a plebiscite on a new constitution on 7 August, which has the potential to break Thailand's cycle of populism and military dictatorships. The new constitution introduces a transition period for the handover to full civilian control, including a five year period during which Senators will be appointed with input from the military. The plebiscite will also ask voters to approve a new method for selecting the prime minister that involves the Senate, in addition to the Lower House, thus reducing the risk that a populist takes power. Finally, the new constitution also bans for life politicians convicted of corruption or election fraud from taking public office.

Polls suggest that the majority of voters are in favour of the new constitution, but there are still many undecided voters (a recent poll showed 44% in favour, 37% undecided, 13% abstaining and 7% against).

If the plebiscite is approved a general election will take place around July 2017. If it fails, the military government will remain in power and seek to draft another version of the constitution that can be put before the people later in 2017. Political pressure from the US would likely increase in that scenario, but would not alter the direction of travel, in our view.

The odds of an orderly transition to democracy will be aided if the economy improves. Despite weaker economic data this week, a mild economic upswing appears to be underway in Thailand led by domestic demand, particularly consumption. Agriculture is also picking up as El Nino weakens. Importantly, major infrastructure investments in highways, mass transit and high speed rail worth more than 4% of GDP are due to take off in H2 2016.

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Emerging Markets

The broader economic picture is sound – government debt to GDP ratio is about 50%, exports make up nearly 70% of GDP with tourism, petrochemicals, autos, agriculture and seafood the most important sectors. Thailand is running a current account surplus of 10% of GDP and has some USD 179bn in central bank reserves. The yoy rate of exports increased from -3.7% in May to 1.9% yoy in June. Growth is likely to be about 3% this year and next. Inflation is running at just 0.1% yoy (July), but should creep higher in coming months on the back of the pick-up in economic activity.

Thailand has been under military rule since 2014. The real power lies with General Prayut Chan-o-cha. The military took power following political paralysis due to tension between the rural-based, populist government led by Yingluck Srinawatra and the urban-based, educated, minority elite. Unlike dictatorships in other countries, in Thailand the military has become an almost steady feature of the political business cycle. Democratic elections tend to usher in populists, whose administrations get bogged down in corruption and conflicts with the urban elites. The resulting paralysis eventually triggers military intervention. After some time, the constitution is then changed in a bid to find a more workable solution followed by fresh elections. Then the pattern repeats.

Meanwhile, hovering far above the occasionally sordid reality of daily politics the ageing King Bhumibol remains an anchor of stability and grace to most Thais. Succession remains a source of uncertainty going forward, but we think the real risks in Thailand are rooted in the deeper social divisions within Thai society and the balance of power between the people and the military.

- Indonesia: Prospects for reforms were given a big shot in the arm last week, when former finance minister and World Bank Managing Director, Sri Mulyani Indrawati, was re-appointed as Finance Minister following a cabinet reshuffle. The reshuffle also saw other reformers and technocrats rise to key positions within the Jokowi Administration. Sri Mulyani will give more direction to the policy agenda and build credibility among investors. The technocratic appointments were politically challenging, so the fact that they were supported by the main coalition partner (Golkar) suggests that President Jokowi is very strong at this juncture. This is good for Indonesia. A tax amnesty should boost fiscal coffers in the coming year and Bank Indonesia is accumulating significant reserves on the back of inflows to local bond and equity markets. Inflation continues to be contained below the central bank's 4% target. Indeed, in July the rate of inflation dropped to just 3.21% yoy, the lowest rate for several years.

- India: Following its passage in the Lower House in 2015 the GST (Goods & Services Tax) bill has now made it onto the list of items to be voted upon in the current session of the Senate, which runs through 12 August. The ruling BJP party will have to rely on a coalition of parties to pass the bill which will then have to be approved by at least half of India's states. If passed, the reform will change the economic landscape of India dramatically by reducing costs to trade, though implementation will likely not happen until 2017 or 2018. The latest fiscal data shows that the deficit is higher than projected for this stage of the budget year, mainly due to disbursement of subsidies and rural development spending. It is normal for intra-year cash flows to be highly uneven, so this is not necessarily a concern as long as tax revenues pick up later in the year as expected. Manufacturing PMI rose to 51.8 in July from 51.7 in June.

- Russia: Euroclear has admitted a controversial 2026 Russian sovereign Eurobond for settlement. Russia issued the bond earlier this year, but investors and clearing houses were reluctant to get involved due to uncertainty about the reaction of governments in Europe and the US. Issuance by the Russian sovereign has been subject to sanctions, but market participants, including Euroclear, fear legal drift, i.e. ex-post re-interpretation of the sanctions regime by policy makers. The inclusion of the bond for Euroclear settlement is clearly good news for Russia. The sovereign should now be able to issue similar structures without the delay, provided Euroclear's exemption is not a one-off. Whether Russia will issue, however, remains to be seen. It is still not clear if 'Euroclearability' will pave the way for inclusion of the bond in the EMBI GD index. JP Morgan will have to assess the bond's liquidity and other considerations before deciding on this question. In other news, Moody's, the rating agency, said that the sanctions imposed by the US and Europe on Russian banks only had a 'negligible' impact. Russian banks are comfortably repaying debt and do not need to borrow abroad, according to the agency.

- China: Amidst signs that the Chinese economy is stabilising the authorities have stepped up the pace of reforms again. In addition to launching a number of pilot projects to kick start reform of China's state-owned enterprises (SOEs) the China Banking Regulatory Commission (CBRC) announced last week that the wealth management industry will also be placed under tighter regulation. Wealth management products have emerged as investors have sought access to fixed income-like instruments in the absence of readily available bonds. The availability of liquid fixed income instruments is now rapidly improving due to the growth of the municipal bond market. We also expect strong growth in the mutual fund industry in China as bank balance sheets are relieved of non-tradable local government loans and banks get into the business of providing better retail savings products. Local analysts expect the reform of wealth products in China to be initially negative for Chinese equities and positive for bonds. Our view remains that the ongoing reforms in China support the fixed income markets, at least until the bulk of the reforms have been carried out. The latest activity data shows that large scale manufacturing – including SOEs – weakened from 50 in June to 49.9 in July, while the index for small and medium sized industries, the Caixin index, picked up from 48.6 to 50.6. Services remained strong at 53.9 (53.7 in June).

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Emerging Markets

- **Venezuela:** Venezuelan bonds rallied sharply last week despite lower oil prices due to expectations of liability management on the part of PDVSA, the national oil company. Eulogio Del Pino, Oil Minister, stated that PDVSA is in talks with investors about re-profiling the company's debts with a view to removing near-term maturities. A successful liability management exercise could significantly improve the near-term debt service profile for Venezuela and therefore reduce default risk, in our view. Del Pino also said that it had been a mistake to nationalise oil service companies. In other news, FLAR, the Latin American reserve fund, approved a USD 482m loan to the Venezuelan central bank.

- **Brazil:** Petrobras has begun to sell assets. The state-owned oil company announced on Friday last week that the company has agreed to sell its 66% stake in the BM-S-8 license, which includes the significant Carcará field, to Statoil, the Norwegian oil giant. The sale is worth USD 2.5bn to Petrobras. In another deal, Mexico's Alpek SA is expected to offer to buy Petrobras' petrochemical unit in Pernambuco, according to Reuters. These deals illustrate an enormous revenue potential for Brazil and hold up the prospect of more efficient exploitation of the country's enormous potential as an energy producer and exporter. Meanwhile, economic indicators weakened last week including further credit contraction and weak labour market numbers. If the fiscal reform is implemented there will be further drags on the economy coming from the public sector, though we expect private sector investment to pick up. The current account deficit widened to USD 2.5bn in June versus USD 1.4bn expected against a backdrop of strong FDI inflows. The monetary policy committee (COPOM) issues its first set of minutes following Ilan Goldfajn's ascent to the position as president of the central bank – the message was broadly hawkish as the central bank starts to claw back the credibility lost under previous president, Alexandre Tombini. Net net, Brazil remains a solid fixed income story, in our view. In other news, Brazil's former president Luis Inacio Lula da Silva is facing trial for obstruction of justice in the ongoing Petrobras scandal. This is not altogether unexpected, but is marginally positive, because it reduces the odds that he – and the PT party – will stage a comeback in 2018.

Snippets:

- **Argentina:** The central bank left the 35-day LEBAC interest rates unchanged at 30.25% for the third week in a row. The trade surplus narrowed to USD 126m in June from USD 443m in May.
- **Chile:** Retail sales and manufacturing production were softer than expected and Q2 unemployment increased to 6.9% (6.5% in the same quarter last year). Growth looks set to be between 1% and 2% this year.
- **Colombia:** The central bank hiked rates by 25bps to 7.75%. Inflation is running at 8.6% yoy, however. The silver-lining is that the economy is showing signs of adjusting. Unemployment rose to 10.2% in June versus 9.5% expected and 9.0% in May.
- **Ecuador:** The government successfully issued USD 1bn in international bond markets.
- **Ghana:** The government has announced a tender offer to buy back its 2017 bonds. The government is expected to come to market to raise new money.
- **Mexico:** May retail sales rose 8.6% yoy (+1.2% mom sa), which was much stronger than expected 6.0% yoy (0.4% mom sa). The unemployment rate dropped to 3.9% in June from 4.0% in May. The yoy GDP growth rate slowed to 2.4% in Q2 from 2.6% in Q1.
- **Peru:** Pedro Paul Kuczynski was sworn in as president of Peru. Now the difficult task begins of finding common ground with opposition leader Keiko Fujimori in order to pass legislation. Fujimori controls the congress.
- **Philippines:** The trade deficit widened to USD 2.0bn in May from USD 1.7bn in April on the back of strong imports. Imports were dominated by capital goods, which bodes well for growth going forward.
- **Singapore:** Industrial production declined at a rate of 0.3% yoy, which was softer than expected.
- **South Korea:** Exports declined at a rate of 10.2% yoy in July, weaker than expected. This is likely to be due to bulky items – ships – that boosted exports in June. Despite weak exports, the advance estimate of Q2 2016 GDP was higher than expected at 3.2% yoy.
- **Taiwan:** The recession is over. The economy returned to positive growth after three quarters of negative growth. Q2 2016 GDP was up 0.69% yoy. Taiwanese manufacturing also picked up to 51 in July from 50.5 in June.

Global backdrop

The members of FOMC must have let out a collective sigh of relief that they did not raise rates in July when they saw the weak Q2 growth number. The market had clearly gotten ahead of itself, because the FOMC's decision to leave rates unchanged triggered a broad rally in stocks and bonds, while the USD sold off, credit spreads tightened and the market went on to price in a lower probability of future rate hikes. But the extent of over-exuberance only became clear a few days later, when the advance estimate of US GDP growth in Q2 turned out to be much lower expected (1.2% versus 2.5% qoq annualised expected). To make matters worse, Q1 was also revised down to 0.8% from 1.1% qoq. The trade deficit was wider than expected and inventories lower than expected, but the real kick in the teeth came from investment, which practically collapsed. Was this the effect on Brexit on the US economy? Or US election risk? Or just the gradual realisation that asset

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Global backdrop

prices are very elevated, things are not great and policy-makers are running out of ammo? While some of the higher frequency indicators, notably manufacturing, were ok as well as housing and employment numbers none of this seems to translate into growth. Are companies and households investing in stocks instead of doing normal business, one wonders? After all, as everyone knows by now bad news leads to more stimulus, which in turn blows yet more hot air into the bubbles in developed financial markets.

It is easy to make a meal of some bad numbers. The big picture, however, remains broadly unchanged: there is neither a prospect of imminent inflation nor of recession. But if the economy veers off course, particularly into a downturn, only fiscal policy and a much weaker USD stand between the US and recession.

Fiscal policy, in any case, looks set to make a major renaissance. The signs are everywhere. The Bank of Japan held back from significant further monetary easing; it knows that it is running out of bullets. In the UK, the fall in GBPUSD as a result of Brexit may not prove nearly as beneficial for exporters as many are hoping, because the enormous residual uncertainty that surrounds the country's relationship with its largest trade partner, the EU, will weigh on investment in the sector. Hence, domestic demand will have to do the hard work – and that in turn will require much more fiscal spending. The US too looks set to do more fiscal spending, in our view.

All of this additional fiscal stimulus should worry investors. As populations age and get sicker, the cost of health care and caring for the elderly will rise. If interest rates go up the cost of debt service will rise. Superimpose upon this already somewhat worrisome fiscal situation the prospect of much more fiscal stimulus starting next year. The US Office of Management and Budget last week revised up the US fiscal deficit by 35% to USD 600bn for this year relative to last year, while the Congressional Budget Office revised its projections for the debt of the Federal Government up by 11% of GDP over the next decade. The long end of the yield curve looks vulnerable. Thankfully markets are still clinging to the religion that US debt is risk free. And if they lose faith there is financial repression.

Finally, we note that European banks passed stress tests that showed that only one bank, Monte Dei Paschi di Siena SpA, required further capital. A private sector-led deal may now be underway, removing immediate concerns about this bank and Italian banks in general. Cynics, though, would argue that the stress tests were not designed to test, but to reassure. After all, the tests did not examine the impact of negative rates or Brexit. They also excluded all Greek and Portuguese banks. The German Bundesbank was certainly not fooled. Last week it issued a proposal that European sovereign bonds be equipped with clauses that would automatically trigger payment delays if countries get into financial difficulties. Yet, most European sovereign bonds now pay negative yields, even many corporate bonds. Debt levels are sky high and Europe's banks are fragile. Euro-area GDP growth slowed to 0.3% qoq in Q2 from 0.6% qoq in Q1. The risk-reward on European bonds has never been worse.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	5.09%	11.95%	-0.39%	0.05%	-2.42%
MSCI EM Small Cap	4.34%	5.82%	-1.16%	1.46%	-1.54%
MSCI Frontier	1.27%	0.77%	-8.23%	-0.40%	2.07%
MSCI Asia	4.89%	7.24%	-1.20%	3.35%	1.04%
Shanghai Composite	2.70%	-14.25%	-17.02%	17.06%	4.56%
Hong Kong Hang Seng	3.19%	-3.48%	-16.03%	1.38%	-2.49%
MSCI EMEA	5.61%	18.00%	-4.47%	-4.65%	-5.81%
MSCI Latam	5.53%	32.61%	6.69%	-6.09%	-8.31%
GBI EM GD	0.60%	14.71%	5.30%	-3.20%	-2.38%
ELMI+	0.37%	6.21%	1.88%	-2.91%	-2.85%
EM FX Spot	-0.30%	4.93%	-3.92%	-9.87%	-9.21%
EMBI GD	1.80%	12.30%	11.22%	7.41%	6.44%
EMBI GD IG	1.22%	11.57%	9.28%	6.76%	5.53%
EMBI GD HY	2.47%	12.97%	13.57%	8.10%	7.73%
CEMBI BD	1.59%	9.51%	7.01%	5.98%	5.36%
CEMBI BD IG	1.22%	7.66%	6.38%	5.98%	5.45%
CEMBI BD Non-IG	2.18%	12.69%	7.78%	5.71%	5.19%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	3.69%	7.66%	5.60%	11.16%	13.35%
1-3yr UST	-0.08%	1.57%	1.36%	0.78%	0.71%
3-5yr UST	-0.07%	3.72%	3.52%	2.65%	1.87%
7-10yr UST	0.14%	7.86%	8.24%	5.61%	5.07%
10yr+ UST	1.79%	17.68%	17.70%	12.45%	10.65%
10yr+ Germany	0.65%	18.72%	17.40%	13.48%	11.80%
10yr+ Japan	-1.82%	14.60%	18.72%	9.89%	7.63%
US HY	2.70%	12.01%	4.98%	4.46%	6.16%
European HY	2.38%	6.20%	3.97%	6.83%	9.48%
Barclays Ag	1.63%	8.27%	7.91%	5.55%	5.38%
VIX Index*	0.08%	-34.76%	-1.98%	-8.19%	-49.79%
DXY Index*	0.12%	-3.03%	-1.74%	16.17%	28.80%
CRY Index*	0.00%	2.76%	-10.64%	-36.50%	-46.98%
EURUSD	-0.07%	2.87%	1.99%	-15.44%	-21.63%
USDJPY	0.32%	-14.71%	-17.45%	2.87%	32.63%
Brent	2.57%	16.82%	-16.59%	-60.24%	-62.72%
Gold spot	-0.14%	27.10%	24.13%	2.98%	-16.67%

*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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