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The Fed remains cornered while EM fundamentals continue to improve

By Gustavo Medeiros

- In Brazil, Rousseff is impeached as Michel Temer rolls out the red carpet for investors at the G-20 meeting.
- Hundreds of thousands of people take to the streets in Caracas, protesting against the postponement of the referendum to recall president Maduro.
- Flows to EM debt remained positive as data continues to improve sequentially.
- Labour market data in the US should support more hawkish members of the FOMC, but the Fed remains stuck between too many objectives.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	-0.10%
MSCI EM Small Cap	11.8	–	-0.06%
MSCI Frontier	10.1	–	-0.40%
MSCI Asia	12.5	–	0.26%
Shanghai Composite	12.8	–	-0.09%
Hong Kong Hang Seng	7.7	–	1.43%
MSCI EMEA	9.8	–	-2.13%
MSCI Latam	14.0	–	0.51%
GBI-EM-GD	6.25%	–	-1.51%
ELMI+	3.53%	–	-0.85%
EM FX spot	–	–	-1.58%
EMBI GD	5.00%	338 bps	-0.18%
EMBI GD IG	3.81%	214 bps	-0.39%
EMBI GD HY	6.67%	514 bps	0.05%
CEMBI BD	4.89%	338 bps	-0.03%
CEMBI BD IG	3.78%	228 bps	-0.07%
CEMBI BD Non-IG	6.83%	532 bps	0.04%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	0.56%
1-3yr UST	0.79%	–	0.10%
3-5yr UST	1.19%	–	0.16%
7-10yr UST	1.60%	–	0.19%
10yr+ UST	2.28%	–	0.19%
10yr+ Germany	-0.05%	–	-1.00%
10yr+ Japan	-0.01%	–	-1.96%
US HY	6.29%	488 bps	0.08%
European HY	3.90%	435 bps	0.21%
Barclays Ag	–	245 bps	0.06%
VIX Index*	11.98	–	-1.67%
DXY Index*	95.64	–	0.06%
EURUSD	1.1163	–	-0.23%
USDJPY	103.20	–	-1.24%
CRY Index*	179.99	–	-6.12%
Brent	48.5	–	-1.56%
Gold spot	1327	–	0.30%

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

Emerging Markets

- **Brazil:** Wednesday was a big day for Brazil watchers as the final vote for the impeachment of Dilma Rousseff passed the Senate and the monetary policy committee meeting (COPOM). Both delivered in line with expectations, but there were some nuances. On the political front, the President was impeached with 61 votes for (75.3% senate) vs. 20 votes against (24.7%). According to the constitution, in addition to losing office, this also means that Dilma Rousseff is ineligible for any political position for the next eight years. The nuance was a last minute behind the scenes deal orchestrated by the Head of the Senate, Renan Calheiros, which called for a separate voting on whether Dilma should lose political rights. On that ballot, Dilma was absolved as only a simple majority (42 out of 81) of the senators voted for her to lose political rights, short of the required two-thirds majority. This is a clear political manoeuvre which could benefit other politicians removed from their position (like the former leader of Congress Eduardo Cunha). It increases uncertainties at the margin since the Supreme Court is likely to review the unconstitutional decision of slicing the impeachment vote and could demand a re-run of the vote on the Senate. But in practical terms doesn't change much. At this current juncture, Dilma Rousseff is so unpopular that not even her own political party wants her back as she would be a liability for the municipal elections at the end of October. Last week Michel Temer officially assumed the presidency until December 2018, mentioning the commitment to structural fiscal reforms in his inaugural speech. The President then attended the G-20 meeting in China, rolling out the red carpet for investors.

While the COPOM met and kept policy rates unchanged at 14.25%, the news was in the statement which followed the meeting. The committee dropped the sentence "no room for monetary easing/flexibility" and added three goal posts to start the easing cycle: the approval of the constitutional budget amendment, the

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Emerging Markets

softening of the portion of inflation affected by monetary policy (mainly service inflation) and lower inflation expectations for 2017/18. This could open the door for a cut as soon as October depending on the political/economic environment.

- Venezuela: A solid show of strength was displayed by opposition on September 1st when hundreds of thousands of people occupied the three main avenues in Caracas, protesting against the National Electoral Council's (NEC) continuous delay on the process leading to a referendum. Ahead of the planned demonstrations, the government used the typical intimidation tactics to discourage protesters from coming to the street, e.g. by arresting radical members of the opposition and heavily policing the streets – a threat of violence against the protestors which was used in small demonstrations in the past. Most importantly, the protest was peaceful, which shows that the radicalisation strategy of the government has a limit. It's been crystal clear for months that the Maduro government will not last until the end of its term. The population has been overwhelmingly supporting a recall referendum and thus a political transition. The government's strategy is to play for time because if the recall referendum is held before the 10th of January 2017, new elections would be held, which means a transition of power from Chavismo (in the guise of the ruling PSUV party) to the opposition coalition – the MUD (Democratic Unity Roundtable). The NEC, controlled by Chavistas, has been trying to postpone the date of the referendum to after the 10th January. Should Maduro be recalled after this day, his vice-president would assume his duties, which presents a much better outcome for Chavistas and rent seekers in the country. The strong demonstration adds pressure on the NEC to hold an early referendum.

- South Africa: The stand-off between Finance Minister Gordhan and the Hawks, a unit of the South African police focusing on economic crime and corruption, continued. In lieu of appearing before the Hawks for a summons, his lawyers addressed what for many are baseless and politically driven accusations dating back to his time at the South African Revenue Service. While a potential arrest of Gordhan by the Hawks continued to dominate headlines throughout the week, the wider battle between the patronage network of President Zuma and the technocratic faction of the ANC embroiled the SOEs, such as Eskom which was accused by the Treasury of withholding information regarding coal supply contracts it has with a Gupta-owned company. For another SOE, South African Airways, Zuma and Gordhan seemed to agree on the composition of the new SAA board, which would clear the way for the Treasury to issue a R5bn load guarantee needed ensure the company's ongoing operations. The re-appointment of Dudu Myeni, a close friend of President Zuma, to the chair of the SAA board is potentially negative for the country's efforts to rationalise state-owned enterprises as, in effect, does the recent establishment of a presidential coordinating committee to oversee strategy for all state-owned enterprises chaired by President Zuma.

Snippets:

- China: China PMI surprised on the upside at 50.4 above consensus estimates of of 49.8 and the largest number since October 2014. The private Caixin services PMI was reported as increasing 0.4pts last month to 52.1. PBOC Vice Governor Yi Gang said China will stabilise the leverage situation in the short term by slowing down its expansion.
- Colombia: The Central Bank left the policy rate unchanged at 7.75% in line with consensus expectations, pausing a long hiking cycle which started in August2015 when its policy rate was at 4.5% in order to rein in inflationary pressures.
- India: The RBI announced measures for the development of the corporate bond market, allowing repost for short term borrowing from the RBI which should increase the liquidity and depth in the bond markets.
- Indonesia: Inflation declined to the lowest level since 2009 at 2.8% yoy in August. The Bank of Indonesia is likely to start cutting its benchmark from 6.5% after pausing over the last two meetings
- Mexico: Business sentiment indicators improved with the government's measure of the PMI rising from 51.3 in July to 52.7 in August. The Mexican Central Bank lowered its 2016 GDP growth forecast to between 1.7% and 2.5% from between 2.0% and 3.0%.The Mexican Ministry of Finance announced the conclusion of the 2017 oil hedging programme which will guarantee a minimum price of USD 42 per barrel of Mexico's net energy exposure via put options.
- Russia: Manufacturing PMI improved in Russia, bouncing back to 50.80 in August, from 49.5
- South Korea: Exports surprised on the upside, rising 2.6% yoy on the month on the back of better tech shipments. Imports were up 0.1% yoy.
- Turkey: Turkey will exit the GBI-EM IG-only sub-indices at the 30 September 2016 rebalance following the recent S&P local currency rating downgrade to BB+ from BBB-. In the GBI-EM IG sub-indices, all three ratings from Moody's, S&P, and Fitch are required to be IG for continued inclusion. We don't anticipate flows to be large in magnitude due to the relatively small investment base of the GBI-EM IG. Turkey will remain in the EMBI IG-only sub-indices; however, a one notch downgrade by Moody's or Fitch would result in Turkey's removal from the EMBI IG-only sub-indices and the Barclays Global Aggregate.

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Global backdrop

US non-farm payrolls increased by 151k in August, unemployment was stable at 4.9% and average hourly earnings at 2.4% yoy. The previous month's data was revised upwards, posting a solid labour market picture in the US. Overall the data should be consistent with the targets of the Fed and justify a September hike after the more hawkish tone in Jackson Hole speeches and interviews. Fed members seems to be increasingly concerned with financial stability risks caused by rising asset prices and want to normalise rates in order to gain room to manoeuvre in a future recession. A move in September, however, just a few months ahead of a controversial presidential election would be too risky, especially given the market reaction after the hike in December 2015 led to a small bounce in the USD and commodity prices sold off which took equity markets to its second 10% correction in less than six months. If the Fed does raise rates in September, the hike would likely be accompanied by a strong dovish message that another hike in December is all but ruled out in order to keep volatility low. The other problem with an early hike is a likely flattening of the US yield curve when the Fed should actually be targeting a steeper curve via higher inflation expectations, which would improve the incentives for credit creation by the banking sector. The fact that the 5y5y inflation swap has remained below the 2.0% target since mid-June doesn't support the view of the more hawkish members that all is fine and that the base rate should be at higher levels. Overall, the Fed remains on its self-inflicted cornered position, as it pursues too many conflicting objectives (asset price stability, inflation, growth and financial stability). Fed inaction will eventually lead to excessive risk-taking at expensive levels in some markets (the equity markets are a strong candidate this time), but it's hard to fight it while it lasts.

But what would happen if the Fed hikes? Will Emerging Markets (EM) suffer? We don't believe EM is anywhere near as vulnerable to a rate hike as some fear.

Firstly, macro conditions in EM are much more resilient. When Bernanke's "tapering" announcement caused the "taper tantrum" in 2013, the average current account in EM was at a deficit of 2.1% (GBI-EM GD weighted CAD); today external accounts in EM are close to being balanced over the last 12 months, or in a surplus when one annualises the latest figures (see figure 1). This means that coming from a net debtor position three years ago, EM is now becoming a net creditor to the rest of the world. This makes these countries much more resilient to an increased cost of funding in the USD system.

Fig 1: **EM current account balances weighted by JP Morgan GBI EM GD**

Source: JP Morgan and Bloomberg.

Secondly, as stated above, we believe that the Fed will continue to be biased towards the dovish side. Previous FOMC meetings explicitly mentioned the intention of avoiding another taper tantrum. Hence, the FED will try to avoid excessive volatility on the long end of the curve since such an event would lead to further weakness on the US housing market, which is far from regaining its pre-crisis levels. Note the long end is also where Emerging Markets borrow, hence subdued long end rates should keep EM bid.

Lastly, the technical position in EM is much more benign today. Contrary to the taper tantrum in 2013 when billions of US dollars chased expensive local currency bonds, positions are extremely clean after almost three years of relentless outflows and valuations remains attractive even after the current year rally. Granted, inflows over the last two months were strong, but we're just seeing the beginning of a long term rebalancing from expensive momentum assets in developed markets to attractively valued assets in EM, so buying EM in dips should remain the preferred strategy for global investors.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.75%	15.63%	16.19%	1.38%	0.28%
MSCI EM Small Cap	0.32%	8.13%	13.52%	2.99%	1.29%
MSCI Frontier	0.45%	0.08%	-2.89%	0.11%	3.09%
MSCI Asia	0.35%	11.29%	16.53%	4.80%	4.01%
Shanghai Composite	-0.59%	-11.62%	-0.89%	16.18%	6.59%
Hong Kong Hang Seng	1.52%	4.38%	8.67%	2.65%	2.02%
MSCI EMEA	1.92%	17.12%	5.67%	-4.54%	-3.74%
MSCI Latam	2.12%	36.37%	26.33%	-4.64%	-6.39%
GBI EM GD	0.42%	15.23%	13.25%	-1.76%	-2.17%
ELMI+	0.16%	6.61%	6.22%	-2.25%	-2.32%
EM FX Spot	0.16%	4.80%	1.40%	-9.04%	-8.63%
EMBI GD	-0.08%	14.21%	14.60%	8.92%	6.66%
EMBI GD IG	-0.29%	13.00%	12.82%	8.22%	5.49%
EMBI GD HY	0.16%	15.44%	16.62%	9.56%	8.28%
CEMBI BD	-0.02%	10.93%	10.27%	6.84%	5.82%
CEMBI BD IG	-0.04%	8.73%	8.44%	6.74%	5.53%
CEMBI BD Non-IG	0.03%	14.73%	13.26%	6.72%	6.44%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.42%	8.27%	14.35%	12.40%	15.62%
1-3yr UST	0.03%	1.38%	1.14%	0.73%	0.64%
3-5yr UST	0.04%	3.15%	2.91%	2.66%	1.54%
7-10yr UST	-0.13%	6.62%	6.68%	5.77%	3.43%
10yr+ UST	-0.84%	15.33%	16.18%	12.14%	7.10%
10yr+ Germany	-0.95%	15.73%	16.78%	13.60%	9.97%
10yr+ Japan	-1.10%	10.71%	14.27%	8.31%	6.79%
US HY	0.01%	14.36%	9.13%	5.38%	7.40%
European HY	0.09%	8.18%	7.02%	7.27%	11.05%
Barclays Ag	-0.21%	8.50%	8.88%	5.83%	5.35%
VIX Index*	-10.73%	-34.21%	-56.91%	-24.03%	-64.68%
DXY Index*	-0.39%	-3.03%	-0.61%	15.75%	27.34%
CRY Index*	-0.12%	2.19%	-8.49%	-38.08%	-46.76%
EURUSD	0.04%	2.77%	-0.06%	-14.92%	-20.82%
USDJPY	0.22%	16.49%	15.58%	-2.99%	-25.49%
Brent	3.08%	30.07%	-2.26%	-57.93%	-55.95%
Gold spot	1.41%	25.10%	18.59%	-2.93%	-30.14%

*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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