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WEEKLY INVESTOR RESEARCH

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RMB in the SDR this month

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China's RMB is set for inclusion in the SDR, the IMF's reserve currency basket, this month. India responds to election defeat in Bihar by liberalising the regime for Foreign Direct Investment. The market reaction to rumours that Henrique Meirelles could replace Finance Minister Joaquim Levy shows that President Dilma Rousseff still has options. Indonesia prepares to increase bond holdings by pension funds and insurance companies and Turkey's current account balance turns positive in the latest sign of the dramatic adjustment of external balances in Emerging Markets (EM). In the global backdrop it is déjà vu time; the market is testing the Fed's commitment to its declared intention of hiking rates in December by pushing down stocks and pushing up the US dollar. Japan enters recession.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.7	–	-3.66%
MSCI EM Small Cap	11.7	–	-3.42%
MSCI Frontier	9.2	–	0.09%
MSCI Asia	11.2	–	-3.44%
Shanghai Composite	13.9	–	-0.25%
Hong Kong Hang Seng	7.1	–	-3.55%
MSCI EMEA	9.3	–	-4.48%
MSCI Latam	12.9	–	-2.11%
GBI-EM-GD	6.88%	–	-0.49%
ELMI+	4.73%	–	-0.56%
EM FX spot	–	–	-0.51%
EMBI GD	6.12%	382 bps	-0.72%
EMBI GD IG	4.88%	251 bps	-0.66%
EMBI GD HY	8.12%	595 bps	-0.79%
CEMBI BD	6.05%	395 bps	-0.55%
CEMBI BD HG	4.61%	251 bps	-0.38%
CEMBI BD HY	8.56%	645 bps	-0.82%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	-3.56%
1-3 year UST	0.86%	–	0.19%
3-5 year UST	1.65%	–	0.38%
7-10 year UST	2.26%	–	0.44%
10+ years UST	3.04%	–	0.51%
US HY	8.34%	678 bps	-1.52%
European HY	4.96%	510 bps	-0.14%
Barclays Ag	–	226 bps	0.28%
VIX Index*	20.08	–	5.03%
DXY Index*	99.15	–	0.17%
EURUSD	1.0724	–	-0.32%
USDJPY	122.94	–	-0.16%
CRY Index*	184.77	–	-7.67%
Brent	44.8	–	-5.11%
Gold spot	1093	–	0.28%

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

Emerging Markets

- **China:** Never underestimate the pace of reform in China. IMF ('Fund') chief Christine Lagarde and her staff last week declared that they have approved the Renminbi (RMB) for inclusion in the Fund's basket of reserve currencies, the Special Drawing Right (SDR). Formal inclusion will likely take place at a meeting on 30 November 2015. In our view, the RMB is expected to be given a weight of approximately 13% in the basket. China has moved quickly to address the remaining technical issues identified by the IMF in July of this year, including adjusting the overnight fixing of the currency to the spot rate (a move that was wrongly interpreted as a deliberate devaluation by many analysts).

The RMB's ascent will likely be far more rapid than the speed at which China will catch up with per capita GDP in the Western world. Some 97% of the world's FX reserves are presently invested in just four currencies (USD, EUR, JPY and GBP). All four central banks that issue these currencies are currently abusing their reserve currency status by printing money through Quantitative Easing (QE) programs, with much of the printing happening because governments cannot pass the reforms required to achieve supply-side led growth. QE policies will eventually lead to inflation and/or currency debasement, which in turn will result in an acute shortage of global reserve currencies with integrity. This bodes well for the rapid adoption of the RMB by central banks.

In our view, all investors should have a China strategy, in the way most institutional investors have a US strategy. China's RMB is ultimately destined to replace the US dollar as the world's primary reserve currency, while China's central government bond market will become the world's primary reference market for fixed income. This prediction is simply the inevitable consequence of China's size – China's population is more than 4 times larger than that of the United States. If per capita GDP grows at the average pace sustained between 2011 and 2015 in both the US and China it will expand at the pace that both countries have averaged between 2011 and 2015 – i.e. since US QE policies began – then China's per capita GDP will overtake that of the United States by 2043. Or to put it differently, anyone 40 years of age or younger today is likely to see the day when China's per capita GDP overtakes that of the United States in their lifetimes.

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Emerging Markets

The establishment of the RMB as a global reserve currency will further accelerate the opening of China's capital account, because the adoption of the RMB by central banks will make the currency more stable. The latest balance sheet information shows that PBOC may have turned into a net buyer of US dollars in October after selling substantial volumes in previous months. This is significant, because it would be consistent with our view that most FX imbalances on corporate balance sheets have been neutralised by now with the help of official currency sales.

China is also reported to have increased the volume of local government loans set to be formally swapped into tradable bonds. The current amount of RMB 3.2trn is set to rise to somewhere between RMB 3.8trn to RMB 4.0trn this year, according to media reports. China had about RMB 11trn (USD 1.7trn) of local government loans prior to the swap program. We think most of these loans will be swapped into tradable bonds with maturities of 1, 3, 5 and 7 years. These bonds will be sold to mutual funds and local pension funds, thus creating the world's second largest muni bond market. Note that this market will exceed the entire USD denominated corporate debt market in the whole of EM by some USD 400bn. Why these swaps? Because when China becomes consumption-led the macro economy will primarily be controlled using interest rates. Muni bonds will constitute an important part of the monetary transmission mechanism. The latest retail spending numbers in China were stronger than expected: 11% yoy in September versus 10.9% yoy expected. The supply-side of the economy is understandably slowing.

One consequence of the local government loan swaps is that China's 'total social funding' (TSF) numbers will decline, because as local government loans are swapped into local government bonds they automatically drop out of the TSF numbers. Money supply numbers therefore become better indicators of the stance of monetary policy. M2 growth was stronger than expected in October (13.5% yoy versus 13.2% expected). Fiscal spending is also rising in China (from a low base) as the government actively supports the economy during the current phase of rapid and deep reforms.

Finally, we note that inflation in China dropped to just 1.3% yoy in October, ensuring that central government bonds still pay by far the highest real yields in any of the existing reserve currency nations. The government announced that all remaining price controls for goods and services will be completely removed by 2017 for all competitive sectors. This means the entire economy except for key utility services, public-services programmes and industries with natural monopolies, such as electricity and water supply.

- India: The Modi administration responded to its defeat in the Bihar election by launching a set of deep reforms that will encourage further Foreign Direct Investment (FDI) into the country. The reform increases the quota for FDI by 60% from INR 30bn to INR 50bn per year and eases red tape, including eliminating lock-in periods, relaxing sourcing norms and opening whole sectors to foreign investment, including entertainment. Meanwhile, industrial production slowed to 3.6% yoy in September from 6.3% yoy in August. October inflation rose to 5.0% yoy from 4.4% yoy in September. Core inflation remained around 4.1%.

- Brazil: Rumours are swirling that Finance Minister Joaquim Levy may be replaced by former central bank president Henrique Meirelles. The rumours were denied by President Dilma Rousseff. However, the market reaction was telling. Brazilian markets rallied strongly intra-week in response to the news. This information is valuable; it shows that (a) Levy's effectiveness has declined to the point where his departure would not adversely affect the outlook for reforms and (b) Meirelles may be more effective in moving the reform agenda forward. Meanwhile, retail sales declined 0.5% in September from the previous month. This was not as bad as expected (-0.9% mom). Retail sales are now 11.5% lower than in the same month last year.

- Indonesia: Bloomberg reports that the financial services regulator is considering increasing minimum holding limits for pension funds and insurance companies of government bonds to 20%-30%. Pension funds currently hold 3%-4% in government bonds, while insurance companies hold about 10%-11% in government bonds. So far, the news has not been officially confirmed, but increasing the share of government bonds held by local institutional investors is usually highly effective in stabilising the behaviour of bond markets. In other news, the trade surplus of USD 1bn in October was 30% larger than expected and unchanged from September.

- Turkey: The current account balance has now improved so much that it has become a surplus. According to official data, Turkey's current account surplus was USD 0.1bn in September. The improvement in external balances across EM due to USD strength has been dramatic – a current account surplus in Turkey is perhaps the strongest manifestation yet. For more details see *"Nothing stays the same: EM's dramatic external rebalancing"*, The Emerging View, November 2015. In other news, it was reported this morning that China and Turkey will extend for another three years and upsize their mutual currency swap by 20% (the swap will be RMB 12bn after upsizing).

Snippets:

- Argentina: The latest polls put opposition candidate Mauricio Macri between 3.8% and 8.5% ahead of government candidate Daniel Scioli with 10% of the electorate declaring that they are undecided. A second round presidential election is due to be held on 22 November.
- Chile: The central bank left rates unchanged at 3.25% with a hawkish bias.

Emerging Markets

- **Hungary:** Core inflation rose to 1.5% in October from 1.3% yoy in September.
- **Malaysia:** The balance of payments surplus rose sharply to USD 4.2bn in Q3 2015 from USD 2.3bn in Q2 2015. The current account was also in surplus to the tune of USD 1.2bn. Malaysian GDP expanded at a rate of 4.7% yoy in Q3 2015 compared to 4.9% yoy in the previous quarter.
- **Mexico:** Industrial production rose 1.7% yoy in September versus 1.2% yoy expected. Inflation was 0.51% in the month of October versus 0.52% mom expected. This took the yoy inflation down 4bps to 2.48% yoy.
- **Peru:** The central bank left rates unchanged at 3.5%.
- **Russia:** GDP was stronger than expected in Q3 2015, rising 0.7% qoq saar. On a yoy basis, Russian GDP was 4.1% lower versus -4.4% yoy expected. The goods trade surplus was USD 9.6bn in September versus USD 8.9bn expected.
- **South Africa:** Manufacturing activity rose 0.9% yoy in September. Consensus expectations had predicted a decline of 2.5% yoy.
- **South Korea:** The Bank of Korea left rates unchanged at 1.5%.
- **Taiwan:** The Taiwanese economy racked up a record USD 6.1bn trade surplus in October. This was well above expectations of USD 5.2bn.
- **Thailand:** The economy grew far more strongly than expected, expanding at a rate of 4.0% qoq saar in Q3 versus 2.5% expected.

Global backdrop

Déjà vu. November is beginning to look like August. The Treasury market has priced in a 70% probability of a Fed hike next month, but FX and stock markets seem bent on allowing their current momentum to carry further, perhaps in a bid to test the conviction of the Fed behind its stated objective of raising rates in December. Risk aversion – some of it in the form of lower US stock prices – certainly took hold last week, while the US dollar has staged a recovery. The latter in turn pushed down oil prices (aided by higher than expected inventories). This means that the euphoria following the recent strong payroll number has already given way to gloom following weak retail sales data. But the data may ultimately be of secondary importance right now; the stock market is well aware that the Fed is bound to honour a de facto third mandate to keep asset prices high after years of QE. If so, it is conceivable that concerted pressure on the Fed via a higher US dollar and lower stock prices could potentially force the Fed to U-turn on hikes in December, just like what happened in September. All in all, this fact provides a bearish global backdrop for EM asset prices as we enter the last month before the scheduled 16 December Fed meeting. In other global news, Japan re-entered recession as Q3 GDP contracted 0.2% qoq following a 0.7% qoq contraction in Q1. This illustrates the difficulties developed economies are having in sustaining economic performance despite hyper-easy monetary policies. Euro-area GDP was marginally softer than expected in Q3 2015.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.12%	-12.05%	-14.98%	-3.17%	-3.36%
MSCI EM Small Cap	-3.06%	-7.23%	-10.07%	0.39%	-2.57%
MSCI Frontier	-0.25%	-10.67%	-15.40%	7.58%	1.93%
MSCI Asia	-2.61%	-7.84%	-8.87%	2.34%	0.69%
Shanghai Composite	5.87%	12.45%	46.34%	23.68%	6.27%
Hong Kong Hang Seng	-2.07%	-12.43%	-2.81%	3.69%	-2.27%
MSCI EMEA	-5.97%	-13.30%	-21.27%	-8.31%	-6.38%
MSCI Latam	-1.29%	-25.64%	-31.03%	-15.43%	-12.36%
GBI EM GD	-1.74%	-12.61%	-17.42%	-7.97%	-3.12%
ELMI+	-1.45%	-6.64%	-9.94%	-4.73%	-2.93%
EM FX Spot	-1.71%	-15.80%	-20.39%	-11.92%	-9.12%
EMBI GD	-0.68%	1.97%	0.30%	1.78%	4.92%
EMBI GD IG	-0.72%	-0.29%	-0.55%	0.61%	4.24%
EMBI GD HY	-0.63%	5.05%	0.74%	3.50%	5.95%
CEMBI BD	-0.40%	2.68%	0.67%	2.82%	4.57%
CEMBI BD HG	-0.50%	2.03%	1.32%	2.81%	4.77%
CEMBI BD HY	-0.23%	3.71%	-1.02%	2.95%	4.28%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-2.58%	0.06%	1.28%	16.17%	13.38%
1-3 year UST	-0.25%	0.53%	0.43%	0.40%	0.64%
3-5 year UST	-0.50%	1.64%	1.79%	1.16%	1.61%
7-10 year UST	-0.92%	1.85%	3.27%	1.15%	4.06%
10+ years UST	-2.31%	-2.37%	3.49%	1.07%	8.13%
US HY	-1.76%	-1.58%	-3.88%	3.72%	6.14%
European HY	0.38%	3.44%	3.27%	8.50%	9.87%
Barclays Ag	-0.41%	-0.08%	0.87%	2.55%	4.35%
VIX Index*	33.24%	4.58%	50.86%	22.36%	-11.07%
DXY Index*	2.27%	9.84%	13.28%	22.02%	25.17%
CRY Index*	-5.54%	-19.65%	-30.75%	-37.06%	-37.63%
EURUSD	-2.56%	-11.37%	-13.85%	-15.84%	-20.48%
USDJPY	1.92%	2.59%	5.54%	51.18%	47.29%
Brent	-9.64%	-21.89%	-43.61%	-58.90%	-47.15%
Gold spot	-4.28%	-7.97%	-7.64%	-36.20%	-18.26%

*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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