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WEEKLY INVESTOR RESEARCH

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The RCEP trade deal advances at the expense of TPP

By Jan Dehn

Sixteen nations in the Pacific region are advancing towards a trade deal, which includes China and excludes the US. While domestic political pressures are forcing the US away from its traditional commitment to freer trade, the majority of countries in the Pacific region continue to recognise that free trade is good for growth. China in particular stands to gain from US introversion, in our view. In other news, inflation is falling in both Brazil and Russia, which bodes well for local currency bonds in 2017. In Argentina, Macri's honeymoon is well and truly over as Peronists impose a deeply myopic and ultimately economically destructive fiscal reform upon his administration. Ecuador assuages near-term payment concerns with an attractively priced bond. In China, more signs that the economic upswing is taking root with better trade data and higher inflation. Colombia's fiscal reform advances, consumer sentiment soars in Philippines and Park is impeached in Seoul. India's RBI keeps cool in the face of a mini-storm over de-monetisation and Mexico successfully auctions more oil fields. In the global backdrop, attention shifts from the ECB to the Fed as oil prices rise.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.0	–	2.92%
MSCI EM Small Cap	12.1	–	1.98%
MSCI Frontier	10.3	–	0.94%
MSCI Asia	12.5	–	1.81%
Shanghai Composite	13.3	–	-0.34%
Hong Kong Hang Seng	7.9	–	0.89%
MSCI EMEA	9.9	–	5.11%
MSCI Latam	14.1	–	4.34%
GBI-EM-GD	6.75%	–	1.86%
ELMI+	3.87%	–	0.69%
EM FX spot	–	–	0.95%
EMBI GD	5.84%	337 bps	1.10%
EMBI GD IG	4.54%	202 bps	0.78%
EMBI GD HY	7.51%	512 bps	1.47%
CEMBI BD	5.47%	316 bps	0.54%
CEMBI BD IG	4.47%	216 bps	0.35%
CEMBI BD Non-IG	7.07%	476 bps	0.84%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.0	–	3.13%
1-3yr UST	1.15%	–	-0.06%
3-5yr UST	1.92%	–	-0.19%
7-10yr UST	2.51%	–	-0.59%
10yr+ UST	3.20%	–	-1.54%
10yr+ Germany	0.41%	–	-2.67%
10yr+ Japan	0.09%	–	-1.39%
US HY	6.19%	417 bps	1.21%
European HY	3.75%	426 bps	0.84%
Barclays Ag	–	237 bps	-0.15%
VIX Index*	12.21	–	0.07%
DXY Index*	101.54	–	1.45%
EURUSD	1.0575	–	-1.76%
USDJPY	115.95	–	1.84%
CRY Index*	191.98	–	0.29%
Brent	57.1	–	3.93%
Gold spot	1153	–	-1.48%

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

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- **Trade:** China and 15 other nations in the Pacific region are pushing ahead to reach agreement on the Regional Comprehensive Economic Partnership (RCEP), a trade deal that may eventually result in the world's largest trade block. RCEP does not include the US. President-elect Donald Trump's recent announcement that the US will pull back from TPP, a US initiative designed to preserve the US's economic influence in the Pacific region in the face of rising Chinese dominance, has given renewed impetus to RCEP. Most Emerging Markets (EM) countries in the Pacific region recognise that free trade plays a key role in sustaining high growth rates and most are increasingly aware that their interests may be better served by deepening ties with China. This is not just a tactical consideration triggered by the US lurch towards protectionism and the realisation that US consumption may not be what it once was as debt service costs rise. Rather, there are important strategic reasons for turning towards China. China's economy will be more than four times larger than the US economy by the middle of this century and Chinese consumption will significantly outpace Chinese GDP growth over this period given China's starting with a saving rate of 49%. In short, China will quite simply – and by some margin – deliver the largest boom in consumption the world has ever seen over the next three decades.
- **Brazil:** The outlook for fixed income investors in Brazil improved further last week, when inflation in November dropped to just 0.18% mom, which is equivalent to 7.0% yoy. This was lower than expected and has to be viewed in the context of a policy rate of 13.75%. Brazil has one of the world's highest real rates, which means that the odds strongly favour significant rate cuts in the coming year as inflation continues to tumble. In other positive news, the Supreme Court ruled that Senate President Renan Calheiros can serve out his term in spite of facing embezzlement charges. This is a clear sign of growing pragmatism on the part

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Emerging Markets

of the Judiciary, which, despite persecuting rampant and widespread corruption among Brazil's political elite, appears to recognise the need for a functioning government. The decision to allow Calheiros to serve out his term means that an all-important fiscal reform will likely be passed and that the next major reform – a pension bill, which was submitted to parliament last week – also faces good odds of passage. The pension bill is critical to the overall fiscal outlook, because by limiting statutory payments it will ensure spending for other purposes will not be cannibalised by pension payments as the new constitutional limit on overall spending kicks in. The twin fiscal and pension reforms should transform Brazil's fiscal outlook and return the country to a sustainable fiscal path. This will, in turn, enable the central bank to speed up the pace of rate cuts, a possibility hinted at in comments by central bank president Ilan Goldfajn in the past week. Taken all together, the falling inflation and fiscal reforms are paving the way for 'super-goldilocks' next year, in our humble opinion.

- Russia: Inflation fell much more than expected in November. Consumer price inflation was just 5.8% yoy compared to 6.1% yoy in October. Core inflation dropped at an even faster pace (-0.4% in one month). The significance of the continuing rapid fall in inflation is that the hawkish Russian central bank may soon inch closer to resuming rate cuts. Given that Brazil is also likely to cut rates next year, these two countries alone should ensure that the yield on the JP Morgan GBI EM GD index declines materially next year.

- Argentina: The honeymoon is over for the Macri Administration. The government was put on the back foot last week, when a coalition of (opposition) Peronists passed an income tax bill, which undermines the government's income tax revenue projections. The Macri Administration will now be forced to attempt to mobilise support among provincial governors to overturn the bill in the Senate, or, if required, veto the bill. Alternatively, the government may simply live with worse fiscal numbers given the approaching mid-term elections. Either way, this takes chunks out of Macri's political capital, which is clearly negative. The Peronist attack illustrates several depressing aspects of the political reality in Argentina. First, as mid-term elections draw closer all long-term economic commitments are ditched. Second, Peronists in particular are showing that they are happy to lead this destructive trade-off. These features of Argentine politics are what have turned the country into a serial defaulter and relegated it to outlier status among EM's underclass of nations, while most other EM countries have been able to move onward and upwards.

- Ecuador: The government issued a USD 750mn 10 year Dollar-denominated bond at a yield of 9.65%. The successful bond placement significantly reduces near-term refinancing concerns, which have been further reduced by a recent rise in oil prices. Seen in this light, the high yield on Ecuadorian sovereign bonds is attractive, in our view.

- China: The macroeconomic indicators continue to point to a moderate economic upswing. CPI inflation increased to 2.3% yoy in November from 2.1% in October, while core inflation rose 0.1% to 1.9% yoy. Producer prices also rose due to higher coal prices. The pickup in price pressures is consistent with other economic data, which also points to a strengthening economy. November's trade data was also a great deal stronger than expected with exports rising 5.9% yoy in November and imports up 13.0% yoy, in both cases far quicker than expected. The trade surplus narrowed to USD 45bn from USD 49bn in October as a result and China's FX reserves declined by USD 69bn to USD 3.05trn. However, more than half of the decline was due to FX valuation effects. China's central bank has been tightening liquidity conditions since August and the Shanghai composite index is up more than 21% since February.

- Colombia: Colombia's government appears to be weathering the set-back of losing the referendum on the FARC peace accord far better than expected. Not only has Congress quickly approved a revised peace deal, but there have also been swift advances on a fiscal reform intended to make up for lost oil revenues. The fiscal reform passed the committee stage in Congress last week and may now enter the main plenum of parliament to be voted on before the end of the year. This reduces the chances of a ratings downgrade and should be positive for business confidence. Meanwhile, minutes from the central bank's last meeting in November hinted that rate cuts may be in the pipeline as inflation continues to decline. All of these ingredients add up to a potentially interesting constellation of better economic fortunes and easier monetary policies next year.

- Philippines: President Duterte's methods for dealing with drug criminals may not be to everyone's liking, but this has not dented business confidence in the Philippines at all. In fact, the Q4 2016 consumer sentiment survey showed consumer confidence surging 9.2% in the quarter on the back of improvements in law and order, better availability of jobs, more effective governance and expectations of increased incomes. Capital imports also rose 0.8% mom sa, or 13.1% yoy, which bodes well for growth going forward. The trade deficit of USD 2.2bn in October was unchanged from October 2015. Finally, inflation was benign at 2.5% yoy.

- South Korea: The National Assembly (NA) last week accepted President Park's invitation to impeach her. This is a positive development. Park had become a lame duck. There were also concerns in some quarters that parliament could become bogged down in protracted deliberations about the timing of her impeachment. The fact that the process is now underway will clear the air and enable Korea to move on from Park's tragic circumstances. The Constitutional Court must now rule on the validity of the NA's decision – we expect this to be relatively swift – followed by a fresh presidential election within 60 days. One very interesting aspect of Korea's political crisis is that fresh elections could propel Korea to form closer ties with China at a time when the US is pulling back from its economic sphere of influence in Asia and Latin America.

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India: The Reserve Bank of India (RBI) did not flinch in the face of the mini-storm caused by the ongoing de-monetisation process in the country. All MPC members voted to keep the policy rate at 6.25% on the view – with which we agree – that the economic costs of implementing de-monetisation will be transitory. RBI prudently takes the view that rate cuts can only be justified on the basis of compelling evidence that inflation is falling.

Mexico: November inflation was 0.22% versus 0.29% mom expected. Headline inflation was also better than expected at 0.78% mom (the consensus expectation was 0.82% mom). This means that core and headline inflation are both running at roughly 3.3% yoy despite heavy pressure on MXN due to Donald Trump's well known views on Mexicans. In other news, Mexico auctioned eight of ten planned oil fields to private contractors last week. The fields in question are expected to generate as much as USD 11bn in FDI with a further USD 30bn in the pipeline from other fields. Gross fixed investment also picked up pace in September, rising to 0.3% yoy from -0.6% yoy in August.

Romania: Romania's left-leaning Social Democrats have been put back into power by voters after winning 46% of the cast votes in Sunday's election. Party leader Liviu Dragnea has a conviction for voter fraud in the past and has supported populist policies. Indeed, the last Social Democrat government was brought down by protests over corruption, wherefore Romania was ruled by a technocratic administration in the past year. Swings and roundabouts, except for the fact that Romania's economic circumstances are materially stronger today than in the past precisely due to the reforms undertaken during the technocratic administration.

Snippets:

- **Chile:** The twelve-months rolling trade surplus was USD 3.4bn in November, which is broadly unchanged from a year ago (USD 3.5bn). Inflation was 0.05% mom in November, i.e. broadly in line with expectations. Forward-looking business sentiment in November improved to the highest level so far this year.
- **Costa Rica:** Inflation was unchanged at 0.6% yoy in November.
- **Czech Republic:** CPI inflation was 1.5% yoy in November, which remains well below the central bank's target of 2.0%.
- **El Salvador:** The fiscal deficit narrowed to 1.2% of GDP in the first ten months of 2016 compared to 2.3% of GDP over the same period last year. The improvement was mainly due to higher revenues as well as some moderation in spending.
- **India:** Industrial production declined at a rate of 1.9% yoy in October, which was lower than expected. However, calendar effects, which reduced the number of working days in the month, may have played a part.
- **Malaysia:** Industrial production was stronger than expected in October, rising at a rate of 4.2% yoy compared to a consensus expectation of 3.4% yoy. The surprise was caused by stronger than anticipated activity in both the mining and energy sectors. The trade surplus increased to MYR 9.8bn in October versus MYR 7.9bn expected.
- **Nigeria:** The government plans to return to external debt markets in January, according to the finance ministry. Bad economic policies have seen Nigeria ousted from the JP Morgan GBI EM GD index, so the attempt to tap external markets is a sign of financial weakness rather than strength, in our view.
- **Paraguay:** Real GDP growth accelerated to 4.2% yoy in the first three quarters of 2016 compared to 3.8% yoy in the same period last year.
- **Peru:** The current account deficit narrowed to 2.7% of GDP in Q1-Q3 2016 from 3.9% of GDP in the same period last year.
- **Poland:** The National Bank of Poland left rates unchanged at 1.5%.
- **Russia:** The government is selling a 20% stake in state oil giant Rosneft to Glencore and Qatar Investment Authority, according to media reports. Rosneft is the world's largest publicly traded oil company.
- **South Africa:** Manufacturing contracted at a pace of 2.7% yoy in October, which was worse than expected (-0.6% yoy). Manufacturing and business investment in general remains subdued due to an ongoing power struggle within the ruling ANC party, which is unlikely to find resolution in the near term. GDP growth was flat versus Q2 2016 at 0.7% yoy in Q3 2016.
- **Taiwan:** The economic upswing continued with a strong bounce in exports, which increased 12.1% yoy in November compared to 9.3% yoy expected. Inflation was higher than expected in November (1.97% yoy versus 1.50% expected).
- **Tanzania:** The Finance Ministry says it aims to issue a sovereign external bond in 2017 as part of its strategy for raising some USD 900m in non-concessional financing next year.

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Global backdrop

Much attention was paid to the ECB meeting last week, not least following Italy's bungled referendum and change of government. In the end, however, none of these events changed the basic consensus among investors that the EUR must fall and the Dollar must rise. The ECB issued three messages to the market: First, the overall volume of bond purchases will be increased via an extension of the length of the ECB's QE programme. Second, the marginal pace of purchases will be reduced by EUR 20bn per month to EUR 60bn per month starting in March 2017. Thirdly, ECB President Draghi was unambiguously dovish in his press conference as he admitted that the volume of bond purchases is not consistent with the ECB's own objective of reaching its 2% inflation target. The first two points can obviously be interpreted as either bullish or bearish for EUR depending on whether you think the overall stock or the marginal rate of purchases is more important. Faced with this rather complex and ambiguous conundrum the market chose instead to take its guidance from Draghi's dovish comments, so EUR ended up trading lower. In a market obsessed with extending any prevailing momentum this conclusion should perhaps not have surprised very much. Beneath the bonnet, however, the ECB is obviously trying to balance conflicting interests among its members as the limits to bond purchases imposed by current rules are drawing closer.

In addition to the impact on the EUR, the ECB also removed the rate floor on bond purchases and opened up for purchases of bonds between 1 and 2 years tenor. This resulted in steeper yield curves in the Eurozone. Arguably, the tendency towards steeper curves is more important that the currency impact, because the really big unresolved question facing the ECB – and Europe – is how to prevent another blow-up in European periphery bond markets if US inflation continues to rise and pushes term yields higher. The US should be able to stomach modestly higher nominal bond yields as long as inflation is also going up, since this would keep real yields contained. However, the Eurozone will struggle to generate inflation due to its failure to recapitalise its banks, so rising real bond yields here could ultimately put bond markets in Europe's over-indebted and unproductive periphery economies under renewed pressure (quite aside from pushing the EUR higher versus the Dollar since currencies move with real rates).

This week the focus will shift to the Fed, whose second rate hike is already fully priced in, wherefore the forward guidance is more important than the hike itself. Core CPI inflation is already above the Fed's 2% target, oil prices are surging and unit labour costs are rising. Never before has the Fed allowed the US economy to approach full employment with only one hike on its books and the Fed would currently have to hike more than eight times just to get the policy rate to neutral. Inflation risks are also rising due to Trump's promise to pursue Reagan-type policies of fiscal stimulus and deregulation. Ordinarily the Fed would simply hike rates by whatever amount required in order to crush inflation, but in today's economy the Fed could trigger important economic headwinds if it gets too hawkish. For example, the US carries twice as much debt today as it did when Reagan took office and while interest rates declined sharply during Reagan's eight years in office, which freed up room to spend more as debt service costs declined this is not the case today. Under Trump rates will likely go up and debt service costs increase. Debt service costs for the US economy are currently just shy of 7% of GDP, but they will rise by 3.3% of GDP for every 100bps rise in yields due to the enormous US debt stock. Mortgage applications have already started to fall sharply in response to what has so far been modest bear market steepening, in fact pro-rata with the fall in mortgage applications in 2013, which ultimately prompted a U-turn on the policy of Tapering by the Fed. In addition to the large debt stocks, the Dollar could pose a threat to the US economic expansion, since the Greenback is already so strong that net exports are struggling (real exports declined 2.9% in October). Finally, years of not investing has pushed productivity growth rates to historical lows, which means there is not much downside tolerance for growth before the economy enters a recession.

It has not escaped anyone's attention that oil prices are going up. Since most EM countries are net importers of oil, will this not hurt their economies? The answer is "Yes, but..." Asian and Eastern European economies are net oil importers (with important exceptions in Russia and Malaysia), so they will be impacted adversely by rising prices. However, they are only likely to get hurt a lot if oil prices go up a lot. The marginal cost is small at current low prices. On the other hand, the marginal benefit of the recent increases in oil prices to struggling oil exporters is enormous, even at current low prices. We therefore think the increase in oil prices around current levels is positive for EM as a whole, since the marginal benefit to the oil exporters is significantly larger than the marginal cost to importers.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.76%	13.17%	13.40%	-2.03%	1.55%
MSCI EM Small Cap	0.67%	3.28%	5.65%	-0.83%	3.54%
MSCI Frontier	1.34%	1.35%	1.87%	-2.09%	4.33%
MSCI Asia	0.88%	8.78%	10.27%	1.03%	5.53%
Shanghai Composite	-0.53%	-6.77%	-4.97%	15.65%	9.59%
Hong Kong Hang Seng	0.30%	6.55%	7.69%	-1.10%	3.56%
MSCI EMEA	4.63%	17.61%	15.43%	-6.76%	-1.61%
MSCI Latam	0.73%	31.14%	24.45%	-7.51%	-6.14%
GBI EM GD	1.20%	9.22%	7.08%	-4.64%	-1.73%
ELMI+	0.69%	3.75%	2.92%	-3.98%	-1.53%
EM FX Spot	0.56%	0.19%	-1.32%	-10.77%	-7.87%
EMBI GD	0.64%	9.40%	8.52%	6.27%	5.84%
EMBI GD IG	0.28%	6.70%	6.00%	5.15%	4.28%
EMBI GD HY	1.03%	12.36%	11.25%	7.31%	7.93%
CEMBI BD	0.39%	9.23%	8.68%	5.23%	5.92%
CEMBI BD IG	0.17%	5.57%	5.26%	4.70%	5.15%
CEMBI BD Non-IG	0.74%	15.46%	14.47%	5.75%	7.42%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.81%	12.87%	12.80%	9.99%	14.89%
1-3yr UST	-0.02%	0.96%	0.87%	0.55%	0.53%
3-5yr UST	-0.10%	1.23%	0.93%	1.52%	1.14%
7-10yr UST	-0.54%	0.62%	0.21%	3.34%	2.17%
10yr+ UST	-1.87%	-0.49%	-1.01%	7.39%	3.04%
10yr+ Germany	-2.70%	6.04%	5.28%	10.13%	7.54%
10yr+ Japan	-1.72%	7.97%	9.28%	6.44%	5.82%
US HY	1.31%	16.51%	15.15%	4.61%	7.49%
European HY	0.89%	8.76%	7.21%	5.74%	10.97%
Barclays Ag	-0.22%	5.22%	4.65%	4.19%	4.86%
VIX Index*	-8.40%	-32.95%	-49.94%	-21.43%	-52.43%
DXY Index*	0.04%	2.95%	4.07%	26.60%	27.67%
CRY Index*	1.41%	8.99%	9.79%	-31.47%	-36.61%
EURUSD	-0.12%	-2.59%	-3.79%	-23.11%	-19.81%
USDJPY	1.30%	-3.42%	-4.19%	12.16%	48.81%
Brent	13.14%	53.17%	50.54%	-47.46%	-46.76%
Gold spot	-1.72%	8.64%	8.80%	-5.91%	-30.81%

*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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