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Ashmore

Brazil – the gift that keeps on giving

By Jan Dehn

Brazilian fixed income returned 66% in Dollar terms as the country embarks on 'super goldilocks'. The recent fortunes of Mexico and Turkey are less spectacular – for very different reasons. Argentina strikes a deal with energy companies and unions to develop the country's vast shale fields. The consumption boom, which will unfold in China over the next couple of decades, will dwarf any other consumption boom in human history – and the US risks cutting itself off from this goldmine if it chooses to enter into a trade war with China. Is India the next goldilocks market in EM? Finally, South Africa's Zuma hints at succession.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	1.69%
MSCI EM Small Cap	10.8	–	1.31%
MSCI Frontier	9.7	–	1.75%
MSCI Asia	11.6	–	1.88%
Shanghai Composite	11.6	–	-1.32%
Hong Kong Hang Seng	7.3	–	1.83%
MSCI EMEA	9.3	–	1.33%
MSCI Latam	12.1	–	1.74%
GBI-EM-GD	6.70%	–	0.22%
ELMI+	3.92%	–	0.16%
EM FX spot	–	–	-0.20%
EMBI GD	5.59%	319 bps	0.27%
EMBI GD IG	4.36%	193 bps	0.46%
EMBI GD HY	7.16%	485 bps	0.07%
CEMBI BD	5.30%	306 bps	0.22%
CEMBI BD IG	4.37%	212 bps	0.16%
CEMBI BD Non-IG	6.82%	457 bps	0.31%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.6	–	-0.09%
1-3yr UST	1.20%	–	0.06%
3-5yr UST	1.90%	–	0.16%
7-10yr UST	2.40%	–	0.24%
10yr+ UST	2.99%	–	0.34%
10yr+ Germany	0.32%	–	-0.23%
10yr+ Japan	0.05%	–	0.07%
US HY	5.84%	389 bps	0.20%
European HY	3.41%	392 bps	0.03%
Barclays Ag	–	240 bps	0.20%
VIX Index*	11.23	–	-0.09%
DXY Index*	101.70	–	-0.23%
EURUSD	1.0590	–	0.15%
USDJPY	114.27	–	1.54%
CRY Index*	194.54	–	1.00%
Brent	55.4	–	0.78%
Gold spot	1202	–	1.78%

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

Emerging Markets

- **Brazil:** The Brazilian super-goldilocks scenario is rapidly unfolding as inflation moved within the central bank's target range and growth picked up amid rate cuts and currency appreciation. Inflation fell to 6.29% yoy in December versus the central bank's year-end target of 6.5% yoy target. This allowed the conservative central bank to up the pace of rate cuts to 75bps with plenty of room for further cuts as the policy rate still sits at a very elevated 13%. EM's USD 20trn bond market is unambiguously the most attractive of all bond markets in the world and Brazilian bonds are among the most attractive within EM. In the past 12 months, Brazil's local currency bond market returned 66% in Dollar terms with roughly even contributions from (a) carry + duration and (b) FX. However, we continue to see considerable upside since inflation has had more room to decline. The Central Bank's inflation target for 2017 is 4.5% as speculation mounts that the central bank will lower the target for 2018 to just 4%. We also expect BRL to appreciate amidst further rate cuts and a gradual return to positive growth (the four ingredients in 'super-goldilocks'). Indeed, there are already tentative signs of a stabilisation in economic activity as retail sales rose significantly in November, beating very bearish expectations.

  The central bank's monthly GDP indicator also rose 0.2% mom sa in November with a positive revision to October's data, beating expectations as well. Finally, technicals are supportive as foreign holdings of index-eligible bonds have declined from around USD 170bn (about 19% of bonds) in November 2015 to about USD 120bn (14.4% of index bonds) in November 2016. The chart below shows inflation and nominal 1 yr bond yields in Brazil.

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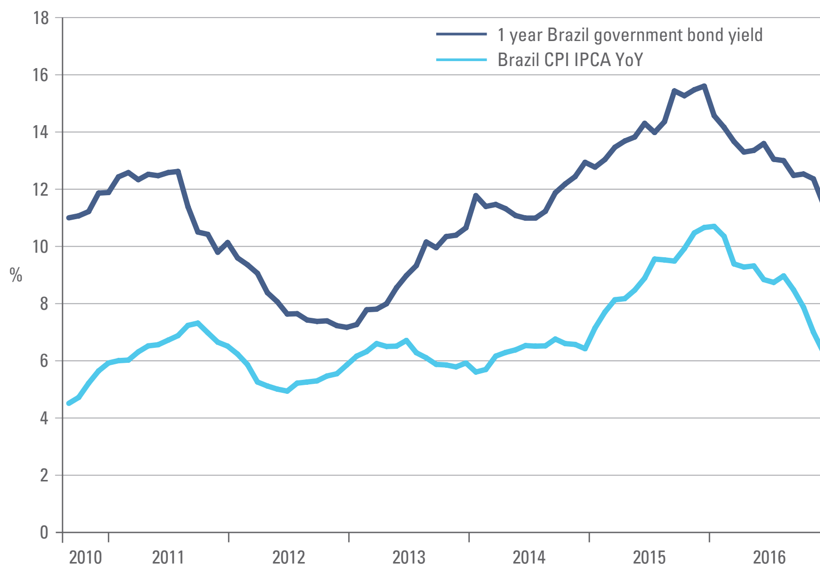
Emerging Markets

Fig 1: **Brazil: Inflation and nominal 1yr bond yield**



Source: Ashmore, Bloomberg.

- **Mexico and Turkey:** Mexico and Turkey's currencies have been under severe pressure lately, but they are not typical of broader EM currency performance. Rather, EM currencies ex-Mexico and Turkey are appreciating versus the Dollar. Specifically, TRY and MXN are down by 5.4% and 3.5% respectively. This has pushed EM currencies as a whole (in the GBI index) down by -0.1% ytd. Excluding TRY and MXN, however, EM FX is up 1.0% ytd versus USD. In other words, the overall environment remains benign for EM FX and particularly for active managers if they can successfully distinguish between bulk of EM currencies, which are doing well and the few negative stories, such as MXN and TRY. So what is weighing so much on the MXN and TRY? They are in fact two completely unrelated stories.

The plight of MXN can be directly attributed to the US President-elect's vitriolic rhetoric and apparent dislike for everything Mexican. As such, the MXN may well experience bouts of pressure until Trump's intentions regarding NAFTA and his policies towards US and foreign companies which invest in Mexico become clearer. However, Mexican fundamentals are sound and the economic team in Mexico is likely to manage US hostility in a constructive and prudent manner. Moreover, relations with Mexico are likely to be decided within the context of a re-negotiation of NAFTA, not via Twitter. NAFTA re-negotiation will likely also include Canada. As such, we think the eventual outcome for Mexican fundamentals will be less onerous to both the recent price action and the implications of Trump's Tweets. Mexico's real exchange rate is back to levels last seen in the immediate aftermath of the Tesobono Crisis of 1994. This is extreme, given the enormous progress made in all areas of Mexican economic and political fundamentals since those days. For that reason, we see the current weakness in the MXN as the making of an opportunity to build positions in Mexican securities.

Turkey is a different story altogether and the TRY is being beaten up for entirely different reasons. Unlike Mexico, Turkey's problems are largely self-inflicted. Years of excessive monetary stimulus, a confrontational style of politics and the misfortune of being located in a particularly bad neighbourhood are now taking their toll on the TRY. The latest concern is grounded in the fact that the economy now seems to be taking a dive. Weaker growth raises important questions about the economic health of the corporate sector and ultimately Turkish banks. In addition to these cyclical concerns, we also see two deeper fundamental problems in Turkey. President's Erdogan's laudable ambition to implement an Asian-style growth miracle in Turkey, is not consistent with Turkey's very low savings rates. Remember that Asia's successful 'tiger economies' achieved rapid growth on the back of high domestic savings rates, which enabled them to sustain elevated levels of high quality investment for many years. Turkey does not have a high domestic savings rate nor does the quality of macroeconomic policy inspire confidence that savings rates will rise. There are also questions about the quality of investments, particularly in the real estate sector. This has led President Erdogan to explicitly apply pressure on the central bank to keep rates below levels that would be consistent with macroeconomic stability. Finally, political risk is increasing ahead of yet another attempt by Erdogan to change the Turkish constitution to give him greater executive powers. In light of all these challenges we see little chance that the central bank's attempts to halt outflows will have anything other than a transitory effect. Indeed, a material tightening of monetary policy is required in order to restore equilibrium, but even before tightening were implemented Turkey would clearly have to go through a recession or at least a marked cyclical downturn prior to the economy once again becoming a very attractive destination for anything other than very tactical plays, in our view.

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Emerging Markets

- **Argentina:** Argentina has reached an important accord with energy companies, local governments and unions to develop the vast Vaca Muerta oil field. Vaca Muerta, in Neuquen province, is estimated by YPF Repsol to be 22.5bn barrels. The agreement defines labour relations in exchange for investment commitments by energy companies. In other news, inflation is finally showing signs of bending to the will of the central bank as CPI inflation in Greater Buenos Aires decelerates to 1.2% mom from 1.6% mom in November. This was also better than expected (1.4% mom). In other news, the government is preparing to come to market after securing authorisation to issue new debt. According to Finance Minister Luis Caputo, Argentina will issue USD 10bn externally of which USD 7bn will be in Dollars and hence index eligible. Another USD 14bn will be issued locally and presumably enter the GBI EM GD index, which Argentina will join by end of February this year. This signals the emergence of what will eventually become a very large new player in EM's local bond markets.

- **China:** US President-elect continues to signal an imminent trade war with China. We discussed at some length the potential near-term implications in a recent publication.[1] However, it is also worth emphasising the long-term implications of picking a fight with China. We estimate conservatively that the Chinese economy will be some 4.5 times larger than the US economy by 2050. China's GDP will overtake US GDP long before that. More importantly, China is (wisely) rotating its economy from export to consumption-led growth. This means that China will experience the largest consumption boom in world history, because Chinese savings rates will decline from 49% today towards single digits. Chinese consumption will therefore outpace even Chinese GDP growth. In short, China's consumer market is a market you definitely should NOT exclude yourself from. In other news, the economic data out of China continues to improve. Producer prices rose at a rate of 5.5% yoy in December versus 4.6% yoy expected. CPI inflation was well-behaved at 2.1% yoy versus 2.2% yoy expected. Rising producer prices mean more profits for firms, but stable consumer prices imply no immediate change in monetary policies. Imports were also stronger than expected and exports rose sequentially (though they were down yoy due to base effects). The schizophrenic market sentiment towards China means that if the good data continues for much longer, the market comments will likely switch from being concerned about imminent hard landings to fears of imminent inflation. By that logic China is either battling landings or having massive inflation problems with nothing in between. Of course, the reality is exactly the opposite: China has in the main avoided extreme economic outcomes and remains firmly committed to reforms which should guarantee continued growth outperformance versus developed economies.

- **India:** Maybe sentiment has become a little bit too negative about India following the recent de-monetisation process? Certainly, it was a big surprise when industrial production in November clocked in at 5.7% yoy compared to 1.5% yoy expected. Inflation also dropped to the lowest yoy rate since 2014 (3.41%) and there is now a very good chance that inflation could break to an all-time low, even as India's economy slowly recovers from the temporary impact of the de-monetisation exercise. Is India another EM goldilocks economy in the making? Most likely.

- **South Africa:** President Zuma says he will not seek re-election and would welcome a woman candidate for ANC president, a reference to Nkosazana Dlamini-Zuma, his ex-wife. Other candidates for the ANC presidency include ANC Deputy President Cyril Ramaphosa and ANC Treasurer General Zwile Mkhize. The presidency of the ANC holds the key to Zuma's future as President of South Africa. In 2008, Zuma was able to depose then South African President Thabo Mbeki less than a year after Zuma had defeated Mbeki in the race for the ANC presidency. Although the next national election is not until 2019 the real battle will be the ANC presidential election next year. Zuma's comments imply that the succession issue is now very much live.

- **EM growth premium:** The World Bank expects a sustained increase in the EM growth premium over the next couple of years and even faster improvement than the IMF.[2] In its latest forecast revision, which was published last week the World Bank expects the EM growth premium to rise to a full 3% by 2019 from 2.4% in 2017. The World Bank is forecasting an outright decline in growth rates for all the major developed economies over this period, from 1.8% in 2017 and 2018 to 1.7% in 2019. By contrast, the World Bank sees EM growth rates steadily rising each of the next three years from 4.2% in 2017 to 4.6% in 2018 and 4.7% by 2019. Within EM, in 2017 the World Bank sees the biggest improvements in absolute growth rates in Latin America (+2.6%) followed by commodity-exporting countries (+2.0%) and Sub-Saharan Africa (+1.4%). The World Bank expects a moderate decline in Asian growth rates of 0.1%, while Eastern Europe and the Middle East are expected to grow 1.2% and 0.4% faster in 2017 compared to last year. The EM growth premium versus the United States has particular significance, because of the existence of a strong historical positive correlation with EM currencies (see chart overleaf). It is therefore an encouraging outlook for EM currencies that the World Bank and the IMF both expect the EM-US growth premium to rise continuously the next few years. The World Bank sees the EM-US growth premium rise to 3% by 2019, while the IMF's is forecasting a rise to 2.8%.

[1] *"Trump and EM"*, The Emerging View, January 2017.

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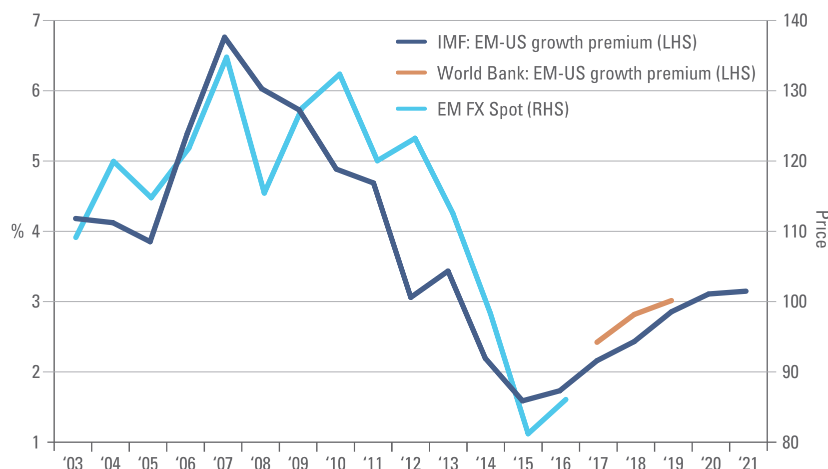
Emerging Markets

Fig 2: **EM growth premium and EM FX**



Source: Ashmore, World Bank, IMF.

Snippets:

- **Belarus:** The government now offers visa-free entry to US and EU citizens.
- **Chile:** The trade surplus surged by 30.4% to USD 4.6bn last year from USD 3.5bn in 2015.
- **Dominican Republic:** Inflation decelerated to 1.7% yoy in December compared to 2.3% yoy in December 2015.
- **Hungary:** Inflation was 1.8% yoy in December versus 1.1% yoy in November. Core inflation rose 0.2% to 1.5% yoy.
- **Malaysia:** Industrial production defied expectations of a 5.5% yoy increase by accelerating to 6.2% yoy.
- **Peru:** The trade surplus reached 0.4% of GDP in November compared to 0.1% of GDP in the same month of 2015. The central bank left the policy rate unchanged at 4.25%. The 2016 fiscal deficit declined to 2.6% of GDP versus the government's own target of 3.0% of GDP.
- **Philippines:** The trade deficit widened to USD 2.6bn in November 2016, up from USD 2.0bn in October.
- **Russia:** Inflation declined to 5.4% in December. Inflation peaked at 13.9% in March 2015. The Russian central bank will most likely cut rates this year, in our view.
- **South Korea:** Unemployment declined to 3.4% in December from 3.6% in November. The Bank of Korea left the policy rate unchanged at 1.25%.
- **Venezuela:** FX reserves dropped to USD 10.6bn, the lowest level in 15 years.

Global backdrop

Trump's first press conference was very entertaining.

[2] We define the EM growth premium quite simply as the difference between the average growth rate in EM countries and the average growth rate in developed countries.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.93%	3.93%	25.85%	-0.24%	1.53%
MSCI EM Small Cap	3.00%	3.00%	13.39%	-0.27%	3.59%
MSCI Frontier	3.88%	3.88%	12.92%	-1.41%	6.07%
MSCI Asia	4.46%	4.46%	19.32%	2.45%	5.10%
Shanghai Composite	0.29%	0.29%	7.71%	18.37%	9.44%
Hong Kong Hang Seng	4.18%	4.18%	20.19%	2.51%	2.26%
MSCI EMEA	2.65%	2.65%	35.56%	-4.52%	-0.59%
MSCI Latam	3.63%	3.63%	49.53%	-5.13%	-5.76%
GBI EM GD	0.70%	0.70%	12.48%	-3.85%	-1.36%
ELMI+	0.49%	0.49%	5.93%	-3.66%	-1.28%
EM FX Spot	-0.06%	-0.06%	2.55%	-10.15%	-7.66%
EMBI GD	1.67%	1.67%	13.04%	6.57%	6.37%
EMBI GD IG	1.71%	1.71%	9.17%	5.48%	4.73%
EMBI GD HY	1.63%	1.63%	17.51%	7.45%	8.54%
CEMBI BD	0.96%	0.96%	11.01%	5.36%	5.94%
CEMBI BD IG	0.80%	0.80%	6.64%	4.78%	5.11%
CEMBI BD Non-IG	1.22%	1.22%	18.52%	5.94%	7.50%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.67%	1.67%	22.98%	10.02%	14.43%
1-3yr UST	0.01%	0.01%	0.75%	0.57%	0.53%
3-5yr UST	0.19%	0.19%	0.60%	1.70%	1.16%
7-10yr UST	0.46%	0.46%	-0.12%	3.54%	1.99%
10yr+ UST	1.62%	1.62%	-0.04%	7.72%	2.89%
10yr+ Germany	-1.79%	-1.79%	4.98%	10.54%	6.64%
10yr+ Japan	-0.23%	-0.23%	6.42%	6.37%	5.67%
US HY	1.17%	1.17%	19.90%	4.80%	7.37%
European HY	0.58%	0.58%	11.08%	5.65%	10.70%
Barclays Ag	0.33%	0.33%	5.91%	4.22%	4.71%
VIX Index*	-20.01%	-20.01%	-58.44%	-10.38%	-46.29%
DXY Index*	-0.50%	-0.50%	2.77%	25.70%	24.76%
CRY Index*	1.05%	1.05%	21.64%	-30.13%	-36.78%
EURUSD	0.69%	0.69%	-2.77%	-22.25%	-16.40%
USDJPY	2.35%	2.35%	2.67%	-8.68%	-32.81%
Brent	-2.55%	-2.55%	91.33%	-48.30%	-50.21%
Gold spot	4.76%	4.76%	10.32%	-3.24%	-26.87%

*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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