Growth of local bond indices

By Jan Dehn

Global markets are torn between fears of Eurozone break up, which is driving down German bond yields and hopes for major tax cuts in the US, which is driving up stocks. This makes the global backdrop appear superficially reminiscent of the good old QE days, where stocks and bonds also rallied simultaneously. However, do not be deceived. Le Pen is unlikely to become president of France and Trump's tax plans are unlikely to usher in a sustained American economic renaissance and valuations look extremely stretched. Meanwhile, the year has been good for EM so far with outperformance in all asset classes versus the major US markets. In terms of new developments, the main EM local currency government bond index is likely to welcome three new members this year: Argentina, Czech Republic and, possibly, China. In country-specific news, the fiscal numbers are turning positive in Brazil after years of deterioration on the back of a gradually stabilising economy, while the Mexican peso staged a strong rally last week as the central bank launched a new programme of intervention and Mexican real GDP growth beats expectations. We also cover news in Ecuador and Argentina.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	0.51%
MSCI EM Small Cap	11.8	–	0.79%
MSCI Frontier	9.9	–	-0.42%
MSCI Asia	12.0	–	0.78%
Shanghai Composite	12.0	–	1.60%
Hong Kong Hang Seng	7.7	–	0.56%
MSCI EMEA	9.4	–	-0.03%
MSCI Latam	12.4	–	-0.06%
GBI-EM-GD	6.60%	–	1.02%
ELMI+	3.68%	–	0.66%
EM FX spot	–	–	0.63%
EMBI GD	5.43%	311 bps	0.72%
EMBI GD IG	4.26%	190 bps	0.64%
EMBI GD HY	6.94%	471 bps	0.81%
CEMBI BD	5.14%	297 bps	0.43%
CEMBI BD IG	4.27%	209 bps	0.42%
CEMBI BD Non-IG	6.56%	439 bps	0.44%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	0.90%
1-3yr UST	1.16%	–	0.17%
3-5yr UST	1.83%	–	0.35%
7-10yr UST	2.34%	–	0.87%
10yr+ UST	2.97%	–	1.33%
10yr+ Germany	0.20%	–	2.11%
10yr+ Japan	0.05%	–	0.85%
US HY	5.62%	375 bps	0.52%
European HY	3.29%	390 bps	0.19%
Barclays Ag	–	243 bps	0.73%
VIX Index*	11.47	–	-0.29%
DXY Index*	101.14	–	0.19%
EURUSD	1.0565	–	-0.45%
USDJPY	112.17	–	-0.82%
CRY Index*	190.93	–	-1.83%
Brent	56.4	–	0.36%
Gold spot	1257	–	1.48%

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

Emerging Markets

- **Trump and EM:** It is tempting to say that Trump has been good for Emerging Markets (EM) so far this year, but the reality is that EM has racked up strong performance in spite of Trump. EM is extremely cheap after years in the cold during the height of the QE bond and equity market frenzies in developed economies in recent years. Meanwhile, the return of inflation and the gradual rotation out of QE and into fiscal stimulus poses major challenges for developed market bonds. EM markets already began to outperform last year and the pace of outperformance has accelerated compared to last year. Thus, EM stocks are up just shy of 10% year to date compared to 6% for US stocks. EM small cap stocks are up more than 10% year to date. Even EM frontier equities are beating the S&P 500. EM currencies have also continued their outperformance from 2016 against the Dollar, so far rising by 2.6% year to date versus the Greenback. EM corporate high yield bonds are beating US high yield bonds 3.5% versus 2.7% and also beating the 1.4% return racked up by the Bloomberg Barclays Aggregate Bond Index. However, the best performing asset class in relative terms is local currency government bonds, which are up 4.6% year to date compared to just 80bps for US government bonds with comparable duration. EM external debt is up 3.4% year to date versus 1.4% for US 10-year bonds. All EM returns stated here are in Dollar terms. For more details see the table at the back of this report.
- **Index developments:** EM local currency bond markets can now look forward to becoming better represented by the main benchmark index in the near future. JP Morgan announced last week that the Czech Republic will enter the GBI EM GD index starting on 28 April 2017, while Argentina's local currency government bonds are set for index inclusion as early as tomorrow. There is also a growing likelihood that

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Emerging Markets

China's government bonds will be included in the index sometime later this year, though so far no announcement has been made. In addition to supportive statements to that effect from some of the main index providers the People's Bank of China (PBOC) Chief Economist Jun Ma confirmed last week that China is working hard to become eligible for index inclusion. Index inclusion could result in inflows of up to USD 250bn into Chinese fixed income markets, provided China joins all three main benchmarks, which are provided by Bloomberg Barclays, JP Morgan and Citibank. If all three countries are included in the JP Morgan GBI EM GD index it will then have 18 members. This constitutes important progress, but there is still much work to do given that there are some ten times more EM countries and most of them issue government bonds in some form or other.

- Brazil: It has been a while since Brazil delivered positive fiscal news. After all, fiscal numbers in Brazil are highly sensitive to the underlying economic cycle, which has been lacklustre of late. It is therefore noteworthy that the fiscal numbers now appear to be improving. Specifically, January saw Brazil's primary surplus reach BRL 36.7bn, which was far better than expected (BRL 18.8bn). This was due to lower than expected discretionary spending, although central government tax revenues also increased in real terms (0.8% yoy in January). The stabilisation of fiscal numbers is important, because the single largest threat facing investors in the Brazilian debt market is fiscal profligacy. Fortunately, the outlook for Brazil's public finances is now brightening due to the recent passage of a constitutional amendment, which caps public spending. The government is also in the process of passing an important pension reform, which will complement the spending cap. Between them, these two reforms will dramatically transform the Brazilian government's debt profile over the next two decades. In other news, the central bank cut the policy rate by 75bps to 12.25% and maintained a dovish bias. The rate of inflation declined to 5.0% yoy in February from 5.9% yoy in January and the external balances continue to improve as the trade surplus reached USD 3.3bn in the first three weeks of February compared to USD 2.7bn for the whole of January.

- Mexico: The Mexican peso rallied strongly last week following the launch of a new central bank facility designed to enable corporates in Mexico to hedge out currency risk. The central bank launched the new facility, because it is worried that prolonged currency volatility could ultimately hurt the real economy, though so far this has not happened. Indeed, real GDP growth in Q4 2016 surprised to the upside (2.4% yoy compared to 2.2% yoy expected) and economic growth actually accelerated relative to Q3 2016 (2.2% yoy). Retail sales were up at a rate of 9.0% yoy in December. The stronger than expected domestic economy pushed inflation a bit higher than anticipated (4.71% yoy versus 4.68% yoy expected), which in turn prompted the central bank to maintain a hawkish bias. Meanwhile, the current account deficit in Q4 2016 narrowed to USD 3.4bn from USD 7.5bn in Q4 2015 and a wide of USD 9.1bn in Q1 2015. In terms of US relations, we note that US Treasury Secretary Steve Mnuchin stated that the US will not engage in any hostile trade action against Mexico in the short term, increasing odds that trade relations will be managed within the relatively rational setting of a formal NAFTA renegotiation, which is our base case.

- Ecuador: The National Electoral Council confirmed that government presidential candidate Lenin Moreno and the challenger, former banker Guillermo Lasso, will face each other in a second-round runoff on 2 April. The latest poll shows that Lasso would beat Moreno by 44.8% to 41.2%. The poll by Cedatos shows that 81% of voters have made up their minds about who they want to vote for.

- Argentina: The central bank left the policy rate unchanged at 24.75% and indicated that there is no room for further cuts in the immediate future. Argentina's FX reserves rose above USD 50bn for the first time since 2011; when the Macri Administration took office last year reserves were a mere USD 26bn.

Snippets:

- China: The National People's Congress opens on 5th March and will, as per usual practice, start by defining the Administration's key policy objectives.
- Colombia: Real GDP growth accelerated in Q4, when the economy was 1.6% larger than in the same quarter the previous year. The market has only expected the economy to be 1.4% larger. The central bank surprised the market by cutting the policy rate by 25bps to 7.25%.
- Hong Kong: Real GDP expanded at a higher than anticipated rate of 3.1% yoy in Q4.
- Malaysia: Core CPI inflation increased to 2.3% yoy in January from 2.1% in December.
- Romania: The parliament approved a government order to dissolve a decree that had seriously weakened safeguards against corruption. This follows successful protests by large numbers of ordinary Romanians.
- Singapore: Industrial production increased at a rate of 2.2% yoy in January. The lower than expected result may be due to calendar effects (Lunar Year holiday was in January).
- South Africa: Finance Minister Pravin Gordhan raised taxes and cut spending in the 2017/2018 Budget, which was passed last week. The Budget keeps South Africa's public finances on a path of consolidation.
- Thailand: Thailand's exports beat expectations and the trade surplus increased to USD 826m in January. This is nearly four times larger than the surplus in the same month last year (USD 237m).

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Global backdrop

A pronounced outbreak of schizophrenia is afflicting the global backdrop and led to a modest pullback in EM asset prices towards the end of last week, although most EM markets recorded solid returns for the week as a whole. US stocks have been on a tear in anticipation of President Donald Trump's tax plans, which he may disclose in tomorrow's speech to Congress. Yet, at the same time German bonds have been rallying strongly on concerns about a possible Eurozone breakup triggered by a victory by Marine Le Pen in the upcoming presidential election in France. The rally in German bonds has in turn put strong downwards pressure on yields in the US. The simultaneous rally in stocks and bonds is thus reminiscent of the good old QE days, but investors should not let themselves be fooled: Le Pen is unlikely to become France's next president even if she wins the first round and Trump's tax plans are unlikely to usher in a sustained period of American economic renaissance. Beware of whiplash!

US Treasury Secretary Steve Mnuchin signalled yet another Trump Administration policy U-turn as he failed to label China a currency manipulator. Mnuchin's conciliatory stance towards China contrasts sharply with the public statements of his boss, President Donald Trump, who said that China is the "grand champion" of currency manipulation. Similar U-turns have become common-place, including over One-China policy, NATO, EU-relations and payment for the Mexican Wall. While the Trump Administration's policy U-turns are positive from a global political and economic perspective they of course do raise questions about where the US is heading. Is Trump in charge or are his officials running the show? Is Trump just a court jester, while serious policy is being undertaken by the adults in the Administration? Time will tell. To us, however, the many U-turns signal a growing recognition that although the US is still the largest economy in the world and clearly its most formidable military power the reality is that the US cannot thrive without cooperating closely with other nations in areas ranging from trade through finance and security. And Trump's senior officials certainly appear to be aware of this fact.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.83%	9.52%	31.53%	2.23%	0.33%
MSCI EM Small Cap	5.31%	10.25%	23.35%	2.04%	2.11%
MSCI Frontier	0.19%	6.87%	13.80%	-1.05%	5.78%
MSCI Asia	3.79%	10.21%	27.27%	4.91%	4.09%
Shanghai Composite	2.98%	4.83%	13.37%	18.82%	8.59%
Hong Kong Hang Seng	6.27%	10.90%	34.78%	6.02%	1.61%
MSCI EMEA	2.38%	4.54%	32.10%	-3.42%	-3.25%
MSCI Latam	4.31%	12.27%	51.80%	-1.26%	-6.46%
GBI EM GD	2.31%	4.62%	13.23%	-2.29%	-2.24%
ELMI+	1.66%	3.53%	8.14%	-2.49%	-1.82%
EM FX Spot	1.46%	2.61%	3.90%	-9.07%	-8.30%
EMBI GD	1.91%	3.38%	12.88%	6.85%	5.84%
EMBI GD IG	1.78%	3.11%	8.07%	5.41%	4.38%
EMBI GD HY	2.04%	3.67%	18.58%	8.31%	7.76%
CEMBI BD	1.38%	2.63%	12.03%	5.55%	5.58%
CEMBI BD IG	1.30%	2.09%	7.23%	4.76%	4.89%
CEMBI BD Non-IG	1.49%	3.45%	20.27%	6.49%	6.75%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	4.12%	6.09%	25.35%	10.92%	14.02%
1-3yr UST	0.24%	0.36%	0.41%	0.66%	0.63%
3-5yr UST	0.49%	0.80%	-0.07%	1.73%	1.32%
7-10yr UST	1.19%	1.41%	-2.07%	3.49%	2.24%
10yr+ UST	1.98%	2.47%	-4.84%	7.40%	3.60%
10yr+ Germany	3.48%	0.59%	-0.02%	10.44%	7.50%
10yr+ Japan	-0.01%	-1.34%	0.58%	5.57%	5.47%
US HY	1.26%	2.73%	23.89%	4.84%	6.88%
European HY	0.85%	1.51%	13.32%	5.55%	9.58%
Barclays Ag	1.27%	1.40%	6.97%	4.31%	4.51%
VIX Index*	-4.34%	-18.30%	-42.10%	-18.30%	-36.94%
DXY Index*	1.64%	-1.05%	3.05%	25.98%	28.73%
CRY Index*	-0.57%	-0.82%	18.10%	-36.69%	-41.27%
EURUSD	-2.15%	0.43%	-2.83%	-22.94%	-21.14%
USDJPY	-0.56%	-4.13%	-0.46%	9.84%	39.17%
Brent	1.22%	-0.77%	60.63%	-48.26%	-54.59%
Gold spot	3.82%	9.08%	1.46%	-5.59%	-28.90%

*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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