PDVSA prepares to pay… again

By Jan Dehn

PDVSA prepares to pay its upcoming obligations on Wednesday of this week. South Africa drops out of JP Morgan's investment grade indices following former Finance Minister Pravin Gordhan's dismissal. Brazil's 12-month rolling trade surplus swells to more than USD 53bn. The Czech National Bank abandons the peg in favour of a stronger Koruna versus the EUR. The tax amnesty in Argentina has now more than doubled the wealth tax base. India relaxes quotas for foreign participation in the domestic bond market. Duterte loses some support in the Philippines. Turkey delivers another inflation shocker. Russia's outrage at the US bombing raid of Syria challenges the Putin-Trump 'bromance' and Egypt declares a state of emergency. Meanwhile, in the rest of the world we see the gradual normalisation of the Trump presidency as a positive for EM, though we hope for the sake of the US that Trump will be able to pass more reforms than his impotent predecessors.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	0.38%
MSCI EM Small Cap	11.7	–	0.46%
MSCI Frontier	10.1	–	1.42%
MSCI Asia	11.9	–	0.41%
Shanghai Composite	12.3	–	1.40%
Hong Kong Hang Seng	7.5	–	-0.79%
MSCI EMEA	9.1	–	-0.20%
MSCI Latam	12.5	–	1.45%
GBI-EM-GD	6.56%	–	-0.30%
ELMI+	3.96%	–	-0.26%
EM FX spot	–	–	-0.37%
EMBI GD	5.42%	304 bps	0.45%
EMBI GD IG	4.27%	185 bps	0.15%
EMBI GD HY	6.87%	458 bps	0.78%
CEMBI BD	5.17%	292 bps	0.37%
CEMBI BD IG	4.27%	201 bps	0.35%
CEMBI BD Non-IG	6.60%	435 bps	0.39%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	-0.24%
1-3yr UST	1.28%	–	-0.08%
3-5yr UST	1.91%	–	0.02%
7-10yr UST	2.37%	–	0.09%
10yr+ UST	3.00%	–	0.12%
10yr+ Germany	0.22%	–	1.60%
10yr+ Japan	0.06%	–	0.16%
US HY	5.78%	377 bps	0.33%
European HY	3.45%	397 bps	0.17%
Barclays Ag	–	243 bps	0.29%
VIX Index*	13.26	–	0.88%
DXY Index*	101.18	–	0.64%
EURUSD	1.0586	–	-0.79%
USDJPY	111.28	–	0.35%
CRY Index*	187.11	–	1.22%
Brent	55.6	–	4.63%
Gold spot	1253	–	-0.02%

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

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- **Venezuela:** Bondholders should have been delighted to learn last week that PDVSA, the national oil company, is making preparations to pay the maturing 2017 PDVSA bond on Wednesday of this week plus make coupon payments on the 2027 and 2037 bonds. Meanwhile, the political situation continues to deteriorate: Henrique Capriles, a leading opposition politician, has been banned from participating in political life for 15 years, according to his own Twitter feed. Leopoldo Lopez, another promising opposition politician, is languishing in jail. Repression of political opponents commenced under former president Hugo Chavez, so Capriles' ban from politics is not a departure from the pattern of recent years. Even so, under the current dire economic circumstances each discrete step taken by the government to quell opposition is like a lightning rod for the opposition. Hence, there have been demonstrations against the government in Caracas and other Venezuelan cities in recent days.

- **South Africa:** Fitch, a ratings agency, has downgraded South African sovereign debt to sub-investment grade status. With two of the three main ratings agencies now rating South Africa at junk South African bonds will be excluded from JP Morgan's investment grade (IG) bond indices, both for local currency and for Dollar-denominated bonds. South Africa will leave the EMBI GD index at the end of this month and the GBI EM GD IG by the end of May. The downgrades follow President Zuma's dismissal of Pravin Gordhan as finance minister. See recent Weeklies for further discussion of the developments leading up to the current situation.

- **Brazil:** Brazil's trade surplus rose to USD 7.1bn in March compared to USD 4.4bn in the same month last year. On a 12-month rolling basis Brazil's trade surplus reached a new high of USD 53.7bn, which is equivalent to slightly less than 3% of GDP. This compares favourably to trade surpluses of USD 47.7bn in 2016, USD 19.7bn in 2015 and an actual deficit of USD 4.1bn in 2014. In other news, the government bowed to the

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inevitable by adjusting the primary fiscal deficit target higher for 2018 in recognition of continuing weak domestic demand. The original primary fiscal target of BRL 79bn was revised to BRL 129bn, or roughly 1.8% of GDP. Compared to this year's expected deficit of BRL 139bn the deficit should therefore still narrow next year albeit marginally. Pending an upturn in the economy, which should augment the fiscal accounts, the Brazilian inflation rate continues to fall. This bodes well for further cuts in the monetary policy rate. The yoy rate for IPCA inflation in March declined to 4.57% from the 4.76% yoy in February. At the current pace of decline, Brazilian inflation may even drop below 4% this year. Meanwhile, there are patchy signs of improvement in the economy. For example, vehicle production rose sharply due to a pick-up in exports as well as domestic demand. On the reform front, negotiations about the upcoming pension reform are now well underway. The central element in the government's reform is the introduction of a retirement age of 65. In order not to dilute this important objective the government has built in room within its reform proposal to bargain with other components for particular groups. We expect the pension reform to pass over the course of the summer.

- Czech Republic: The Czech National Bank (CNB) abandoned its exchange rate peg with the EUR in favour of a floating exchange rate. For some years, the CNB has been protecting the floor for EURCZK in a bid to stem excessive appreciation of the Czech Koruna against the EUR. However, the resulting rapid accumulation of FX reserves (to more than USD 112bn) and sharp recent rises in inflation (CPI was 2.5% yoy in February versus the CNB's target of 2%) prompted the abandonment of the peg. The CZK is now expected to appreciate gradually. There is also speculation that the CNB's decision to let go of the CZK peg is based on insights about future European Central Bank (ECB) monetary policy decisions, i.e. a more hawkish tilt at the ECB. Both industrial production and PMIs have been strong in the Czech Republic lately.

- Argentina: The government announced that USD 117bn of previously undeclared wealth has now been declared to the tax authorities as part of a tax amnesty. The declarations therefore almost double the wealth tax base from USD 116 to USD 226bn. Actual tax revenues arising from the amnesty have so far amounted to about 1.7% of GDP. Based on this revenue boost, the government now believes that it will beat its Q1 fiscal targets. Ratings agency S&P upgraded Argentina's long-term sovereign credit rating to 'B' from B-, with a stable outlook.

- India: India relaxed quotas for foreign institutions to invest in the domestic bond market by USD 700m for pension funds and USD 1.0bn for sovereign wealth funds and central banks. The quotas now total USD 4.2bn and USD 5.4bn, respectively. The Reserve Bank of India left the policy rate unchanged at 6.25%, but raised the reverse repo rate by 25bps, which narrows the short-end of the policy rate corridor and should therefore be construed as tightening at the margin. In other news, the services PMI index hit 51.5 in March, up from 50.3 in February.

- Philippines: President Rodrigo Duterte remains popular, though his ratings have slipped recently among the poorest sections of the population, which have borne the brunt of his hard-line tactics against drug takers. Duterte's approval rating was 78% in March compared to 83% in December. The rate of headline inflation rose to 3.4% yoy in March from 3.3% yoy in February. Overnight, Finance Secretary Carlos Dominguez said that Philippines will copy the examples of Brazil, Argentina and Indonesia of rolling out tax amnesty plans in a bid to increase the wealth tax base.

- Turkey: Another inflation shocker in Turkey as the yoy rate of inflation hit a high of 11.3% in March from 10.1% yoy in February. As if the nasty inflation surprise was not enough, credit growth also rebounded strongly after a weak spell during 2016 when Turkey experienced a serious attempted coup. Public sector banks are leading the expansion of credit. Unfortunately, outstanding credit is already excessive in Turkey. In our opinion, the already too high rate of inflation combined with over-easy monetary policies and now a government-led resumption of credit creation are bad omens for long-term macroeconomic stability in Turkey.

- Russia: Russia's Prime Minister Dmitry Medvedev used strong words to condemn the US bombing of a Syrian airbase in response to the Syrian government's alleged use of poison gas against civilians. However, the fact that Medvedev rather than Putin lead the Russian objections suggests that the Russians are not quite as outraged as Medvedev's reaction would imply. Even so, relations between the US and Russia are clearly deteriorating as vested interests in both countries begin to assert themselves and undermine the early 'bromance' between Vladimir Putin and Donald Trump.

- Egypt: The military government of President Abdel-Fattah El-Sisi declared a state of emergency following Islamic State bombings over the last few days. The declaration of emergency follows meetings between El-Sisi and US President Donald Trump. Egyptian PMI dropped 0.8 points to 45.9 in March.

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Snippets:

- **Chile:** Real GDP contracted -1.3% yoy in February. The market had expected worse (-1.4% yoy). Even so, the print is weak, which reflects a long-standing strike at the Escondida copper mine, which accounts for 20% of mining GDP.
- **China:** FX reserves increased marginally in March. Official FX reserves increased to USD 3.009trn compared to USD 3.005trn in February.
- **Colombia:** The rate of CPI inflation dropped to 4.69% yoy in March from 5.18% yoy in February.
- **Costa Rica:** The central government's fiscal deficit was at 5.2% of GDP (USD 2.91bn) in 2016, which was a slight improvement on the deficit of 5.7% of GDP (USD 3.06bn) in 2015.
- **Dominican Republic:** Foreign direct investment was 16.7% higher in 2016 at USD 2.59bn (3.6% of GDP) compared to USD 2.22bn (3.3% of GDP) in 2015.
- **Ecuador:** Lenin Moreno was confirmed the winner of the Ecuadorian presidential election. His victory signals continuity of policies in Ecuador.
- **Malaysia:** At 27% yoy the yoy rate of export growth was much better than expected in February. The market had expected a rate of growth of 15% yoy. The rate was 14% yoy in January. Imports also rose at a healthy 28% yoy clip in February versus 16% yoy in January. As a result, the trade surplus was higher than expected (USD 2.0bn versus USD 1.6bn expected).
- **Mexico:** March CPI inflation was 0.61% mom compared to 0.58% mom expected. Business and consumer confidence indicators are rebounding from the low levels reached in the immediate aftermath of Donald Trump's election victory in the US. Investment, however, remains weak.
- **Panama:** Cargo volumes through the Panama Canal in the month of January were just shy of 30% higher than in same month of last year.
- **Peru:** The central bank left the policy rate unchanged at 4.25%, but the accompanying statement was dovish. Inflation was 1.3% yoy in March compared to 0.8% yoy expected.
- **Poland:** The National Bank of Poland left the policy rate unchanged at 1.5%
- **Romania:** The National Bank of Romania left the policy rate unchanged at 1.75%
- **Russia:** Inflation continues to fall. The headline CPI inflation rate dropped to 4.3% in March from 4.6% in February. The central bank continues to buy Dollars in the FX markets to limit the pace of currency appreciation versus the US dollar. Reserves now stand at USD 398bn.
- **South Korea:** Official forex reserves increased to USD 375bn, up USD 1.4bn from the month before. The rate of core inflation dropped to 1.4% yoy in March from 1.5% in February despite higher headline CPI inflation on the back of higher energy prices.
- **Taiwan:** PMI rose to 56.2 in March from 54.5 in February.
- **Ukraine:** IMF approved disbursement of USD 1.0bn to Ukraine under the ongoing adjustment programme.

Global backdrop

The more things change the more they stay the same. Following last week's US airstrike on Syria, Stephen Bannon's sacking from the National Security Council and the amicable meeting between US President Donald Trump and his Chinese counterpart President Xi Jinping, it is difficult to escape the conclusion that US foreign policy is beginning to look rather conventional.

Trump threatened 45% blanket trade tariffs against China during the election campaign, but now, it seems, the two countries will work on a joint project over the next 100 days, which may end up deepening trade ties. Moreover, China's so-called 'concessions' – to quote the Financial Times – include liberalisation of China's financial markets, which is already high on China's own reform agenda.

In addition to pulling back from his erstwhile hostile rhetoric towards China, Trump has also changed his antagonistic tone against Mexico, while seemingly distancing himself from his campaign promise to withdraw from NATO as well. Over the weekend Secretary of State Rex Tillerson said that the US is not seeking regime change in North Korea. Even Trump's friendly stance towards Russia is in rapid retreat towards what one might call the 'traditional' US stance i.e. deep mistrust.

Trump's retreat towards the centre in the foreign policy area is consistent with the view we expressed in the conclusion of our January Emerging View, 'Trump and EM'.[1] The main reason why Trump is pulling back from his once radical proposals is simply that America's many institutional constraints and vested interests – which

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

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jointly define the US national interest – are slowly but surely neutering him. Change is not easy to bring about, especially for a protest vote president without broad backing in the Republican Party.

Is Trump's retreat towards the centre good or bad for EM? We think it is good news. Certainly, the return to conventional foreign policy reduces uncertainty, including the probability of serious tail risks, such as major trade wars and associated disruptive currency movements. The bigger issue, however, is whether Trump's regression to convention in foreign policy also carries over to domestic policy. We hope not, although the experience with Obamacare and the delay to tax reform give plenty of grounds for concern. In our view, the US economy is in dire need of new growth drivers. The economy is close to full employment and inflation is rising, so monetary policies are slowly being tightened, but this cyclical upswing is taking place against a dismally low trend growth rate. Indeed, as of 7 April the Atlanta Fed's GDP Now estimate of Q1 real GDP growth stood at just 0.6% qoq annualised. However the Fed will have little choice but to gradually tighten. Last week, for example, the March FOMC minutes surprised markets by hinting at Quantitative Tightening (QT) starting as early as this year. In any other business cycle the Fed's tighter monetary policy would be considered a bullish sign by the market, but in the present business cycle, where 'exit velocity' is still sorely missing, the prospect of tighter money poses a direct threat to growth, asset prices and even the Dollar. Sadly, there appears to be no appetite in policy cycles to pursue policies to bring down the excessive debt load and to reverse the trend of declining productivity. Rather, the most likely response to tepid growth is yet more fiscal stimulus, such as tax cuts. This may provide a temporary boost to activity but only by adding further to the already large debt overhang and crowding out of the private sector.

Meanwhile, US payroll data was ambiguous last week. The lower than expected headline payroll print of 98K jobs (versus 180K expected) coincided with a sharp drop in the unemployment rate to 4.5% from 4.7%. This leaves sufficient ambiguity for the Fed to take any path that it wishes – likely dovish. The Fed will nevertheless conclude that the cyclical recovery remains on track even if the underlying structural growth story is not.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.38%	11.88%	22.02%	1.29%	1.31%
MSCI EM Small Cap	0.46%	13.54%	16.30%	1.68%	3.36%
MSCI Frontier	1.42%	10.33%	15.12%	-2.33%	6.37%
MSCI Asia	0.41%	13.83%	21.04%	4.66%	5.07%
Shanghai Composite	1.99%	5.92%	11.51%	19.52%	10.04%
Hong Kong Hang Seng	0.00%	9.36%	23.90%	4.27%	3.05%
MSCI EMEA	-0.20%	2.62%	14.36%	-4.54%	-2.69%
MSCI Latam	1.45%	13.74%	33.62%	-4.22%	-5.36%
GBI EM GD	-0.30%	6.19%	7.09%	-2.91%	-1.59%
ELMI+	-0.26%	4.91%	4.21%	-2.48%	-1.38%
EM FX Spot	-0.37%	2.78%	-0.53%	-9.54%	-7.87%
EMBI GD	0.45%	4.33%	9.33%	6.22%	5.91%
EMBI GD IG	0.15%	3.82%	4.92%	5.00%	4.34%
EMBI GD HY	0.78%	4.90%	14.52%	7.16%	7.99%
CEMBI BD	0.37%	3.35%	8.91%	5.31%	5.56%
CEMBI BD IG	0.35%	2.75%	5.08%	4.53%	4.86%
CEMBI BD Non-IG	0.39%	4.28%	15.31%	6.21%	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	-0.24%	5.81%	17.83%	10.79%	13.37%
1-3yr UST	-0.08%	0.32%	0.18%	0.64%	0.61%
3-5yr UST	0.02%	0.69%	-0.79%	1.78%	1.28%
7-10yr UST	0.09%	1.22%	-3.04%	3.36%	2.25%
10yr+ UST	0.12%	2.01%	-6.62%	6.23%	3.87%
10yr+ Germany	1.60%	-0.12%	-2.32%	9.48%	7.11%
10yr+ Japan	0.16%	-0.93%	-3.94%	5.65%	5.48%
US HY	0.33%	3.04%	16.57%	4.59%	6.88%
European HY	0.17%	1.61%	8.83%	4.97%	9.23%
Barclays Ag	0.29%	1.50%	3.61%	3.97%	4.39%
VIX Index*	7.19%	-5.56%	-13.67%	-16.55%	-34.97%
DXY Index*	0.83%	-1.01%	7.37%	27.46%	26.65%
CRY Index*	0.66%	-2.81%	9.39%	-39.68%	-37.73%
EURUSD	-0.63%	0.63%	-7.20%	-23.76%	-19.08%
USDJPY	-0.10%	-4.89%	3.08%	9.59%	37.94%
Brent	5.21%	-2.18%	32.52%	-48.28%	-53.64%
Gold spot	0.30%	8.75%	-0.39%	-4.99%	-24.51%

*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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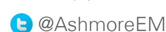
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