Inflation continues to tumble in key EM countries

By Jan Dehn

Inflation remains very benign in several large EM countries and with spare capacity inflation will only resurface slowly. China strikes a trade deal with the US, which should advance China's inclusion in the global financial market. Saudi Arabia's fiscal deficit has collapsed over the past year. Argentina's central bank formally seeks to add to its already sizeable pile of FX reserves. Foreign holdings of EM local currency bonds remain very low. Europe continues to outperform the US. If this is surprising to you then maybe you are paying too little attention to exchange rate and political risks in developed economies.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	2.49%
MSCI EM Small Cap	12.0	–	0.80%
MSCI Frontier	10.3	–	1.77%
MSCI Asia	12.1	–	2.18%
Shanghai Composite	12.0	–	-0.60%
Hong Kong Hang Seng	7.7	–	3.61%
MSCI EMEA	9.9	–	1.98%
MSCI Latam	13.1	–	3.82%
GBI-EM-GD	6.39%	–	0.55%
ELMI+	3.87%	–	0.43%
EM FX spot	–	–	0.40%
EMBI GD	5.31%	298 bps	0.37%
EMBI GD IG	4.18%	180 bps	0.27%
EMBI GD HY	6.59%	435 bps	0.47%
CEMBI BD	5.07%	288 bps	0.21%
CEMBI BD IG	4.18%	199 bps	0.28%
CEMBI BD Non-IG	6.43%	424 bps	0.11%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.5	–	-0.26%
1-3yr UST	1.29%	–	0.10%
3-5yr UST	1.85%	–	0.15%
7-10yr UST	2.33%	–	0.21%
10yr+ UST	3.00%	–	-0.01%
10yr+ Germany	0.41%	–	0.14%
10yr+ Japan	0.04%	–	-0.67%
US HY	5.63%	369 bps	0.30%
European HY	3.24%	367 bps	0.25%
Barclays Ag	–	245 bps	0.33%
VIX Index*	10.81	–	1.04%
DXY Index*	98.91	–	-0.16%
EURUSD	1.0968	–	0.40%
USDJPY	113.50	–	-0.21%
CRY Index*	181.69	–	3.77%
Brent	52.2	–	5.84%
Gold spot	1231	–	0.39%

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

Emerging Markets

- **Benign inflation:** Inflation continues to fall in three large important Emerging Markets (EM) countries, Russia, India and Brazil. This bodes well for prospects of rate cuts and further returns to holders of local currency bonds. Most EM countries are now experiencing cyclical upswings, but many have spare capacity due to the financial tightening of recent years, which means that it will take some time for inflation to become a problem. Inflation will ultimately resurface from non-tradable goods as money flows back to EM countries. As this happens, we expect prices for tradables to decline as EM currencies appreciate and imports cheapen in local currency terms.

Russian CPI inflation in April declined to 4.1% from 4.3% yoy in March, while core inflation dropped to 4.1% yoy as well. The Central Bank of Russia's target for inflation is 4%, which now looks extremely likely to be reached this year. Russia has now fully returned to the inflation rates that prevailed prior to the 2014 collapse in commodity prices. This is clear evidence of the disciplined approach adopted by the CBR in the face of a material decline in national income.

In India, inflation also surprised to the downside in April. CPI inflation was just 2.99% versus 3.3% yoy expected, while core inflation moderated to 4.5% yoy from 4.9% in March. This leaves room for the Reserve Bank of India to cut rates later this year. India's inflation outlook is supported by a combination of factors, including lower imported inflation due to a rising currency, lower oil prices and supply-side reforms, which contribute to lower cost push.

Meanwhile, in Brazil April IPCA inflation (Amplified Consumer Prices Index as calculated by IGBE) was just 14bps in the month, or 4.08% yoy. This annual rate compares to 4.76% in March. The rapid pace of disinflation is therefore continuing. The conditions are in place for the Central Bank to further increase the pace of rate cuts, provided that the government passes the pension reform this month or next.

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Emerging Markets

- China: China further cemented its position as undisputed leader of globalisation with President Xi Jinping's commitment to spending USD 124bn on the so-called Belt & Road initiative, a scheme to promote trade across the Asian continent all the way to Europe by means of massive Chinese investments in infrastructure. To put Belt & Road commitment into perspective, the initiative is roughly equivalent in size to the US Marshall Plan investments in Europe following World War II. In addition to taking the lead in promoting trade, China is also nimbly defusing protectionist threats elsewhere. Contrary to his election promise of 45% tariffs on Chinese imports and other anti-Chinese rhetoric, last week Donald Trump entered into a benign trade agreement with China encompassing ten areas including agriculture, energy and financial services. China will grant more access to its domestic market for US financial sector institutions, including ratings agencies. We think this should further aid China's inclusion into the main global benchmark indices, a key part of China's overall objective of joining the global financial system. In exchange for this clear benefit, China's banks will also be given greater access to the US market. This too is favourable for China. We think China's financial sector liberalisation will eventually result in a much more visible presence of Chinese banks on the global stage. As such, the trade deal plays right into China's hands. Meanwhile, on the domestic policy front the monetary policy report of the PBOC pointed to a gradual moderation of the hawkish tone adopted in Q4 2016, which preceded last quarter's meaningful financial tightening episode. The volume of bank lending in April was higher than expected. The State Council also issued new guidelines for reform of state-owned enterprises, including measures for improving performance and efficiency. The rate of inflation in April was 1.2% yoy, which was well below the average rate of 1.4% in Q1 2017.

- Saudi Arabia: The fiscal deficit narrowed from USD 24bn in Q1 2016 to just USD 7bn in Q1 2017 mainly due to an improvement in oil prices over the period, although expenditures were meaningfully lower by 3% of GDP over the period. The fiscal deficit – roughly 4% of GDP – is financed mainly by drawing down FX reserves, but also by an increase in external borrowing

- Argentina: The central bank formally announced that it will seek to accumulate more FX reserves. The objective is that FX reserves reach the equivalent to 15% of GDP versus a current stock of 9% of GDP (approximately USD 50bn, up from USD 25bn in October 2015). Debt issuance in foreign currency will help to increase reserves, but direct FX purchases can also contribute, though FX purchases will be limited by inflationary pressures. This is because each time the central bank buys a Dollar it will have to print pesos to do so. This may be challenging in the current environment, where inflation is still very high (inflation picked up in April). Buenos Aires CPI monthly inflation was 2.6% compared to 2.4% in March and 2.5% in February. The government has announced that a new CPI index covering the whole of the country – as opposed to just Buenos Aires – will be published starting in July. It remains to be seen how inflation outside of the capital is evolving, though we would expect it to be lower. The central bank left the key policy rate unchanged at 26.25%.

- Local currency bonds: A new report from Credit Suisse estimates that foreign holdings of local currency bonds in the ten most traded EM local markets has dropped to 28.1% in March from 28.3% in February. Foreign holdings in the ten countries peaked at 31.6% in January 2015. While surveys of this kind are notoriously incomplete we believe that foreign holdings are indeed very low based on the downside resilience of EM local markets to negative global events.

Snippets:

- Azerbaijan: The International Bank of Azerbaijan said it has suspended payments on some bonds and asked creditors for support in restructuring bad loans.
- Chile: The government has scaled back its plans for debt issuance in response to higher than expected copper revenues. Inflation was 0.2% mom in April, down from 0.4% mom in March.
- Colombia: Industrial production and retail sales both beat expectations in March, aided in part by calendar effects.
- Czech Republic: Inflation in April declined significantly from 2.6% yoy in March to just 2.0% yoy.
- Dominican Republic: Tourism receipts surged 10% in Q1 2017 to USD 2.0bn or roughly 2.6% of GDP. Real GDP expanded at a rate of 5.2% yoy in Q1 2017.
- India: Auto sales were up 14.7% yoy in April from 10% yoy in March.
- Hong Kong: Q1 2017 real GDP was 4.3% higher compared to Q1 2016, handsomely beating the expectation of 3.7% yoy growth.
- Hungary: Inflation reached 2.2% yoy in April versus 2.3% yoy expected. Inflation in March was 2.7% yoy. Construction growth was red hot in Q1 2017, rising at a rate of 22% yoy.
- Malaysia: Bank Negara Malaysia maintained the policy rate at 3.00% as industrial production rose at a pace of 4.6% yoy versus 4.8% yoy expected.
- Mexico: Industrial production powered ahead at a pace of 4.3% yoy in March versus 2.2% yoy expected.

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Emerging Markets

- **Oman:** S&P cut the sovereign debt rating of Oman to junk
- **Peru:** The central bank cut the policy rate from 4.25% to 4.00% contrary to expectations of no change.
- **Philippines:** The central bank kept the policy rate unchanged at 3% in line with expectations although the statement maintained a hawkish bias. The trade deficit was USD 2.3bn in March compared to USD 1.8bn in February. Both imports and exports are rising strongly (24% and 21% yoy, respectively).
- **Romania:** Core inflation was low and unchanged at 0.6% yoy in April.
- **South Korea:** Unemployment ticked up to 4% of the labour force in April compared to 3.7% in March.
- **Turkey:** The March current account deficit narrowed to USD 33bn or just below 4% of GDP, aided by low oil prices.
- **Vietnam:** Moody's lifted the outlook for Vietnam's sovereign credit rating to positive from stable.

Global backdrop

Too little attention is being paid to the role of exchange rates in today's economic landscape. Europe's economy and EM economies are both picking up aided by highly competitive currencies following an extended period of nominal depreciation. Meanwhile the US economy is struggling to perform precisely because the Dollar has appreciated so much in nominal terms that it is now meaningfully overvalued in real terms. Of course, the strong Dollar would not matter so much if the US economy was productive, but investment levels have been low for a long time and the debt burden is high, because no US government since the Developed Market Crisis of 2008/2009 has bothered to pursue serious deleveraging or reforms. Of course, Europe has not reformed either, so the mere fact that Europe's economy is picking up on the back of a competitive currency should not provide grounds for excessive optimism. Like their American counterparts, Europe's leaders have spectacularly failed to undertake reforms or even bank recapitalisation since 2008/2009, barring a few periphery economies. Investors should not confuse an upturn in the business cycle with stronger trend growth. All business cycles will have their ups and downs regardless of the underlying trend growth. The cyclical upturn now underway in Europe will not turn into sustained higher trend growth rates unless it is accompanied by a serious commitment to, and full implementation of, reforms. In this respect, the news out of Europe has mainly been positive of late. The market will certainly welcome Germany Chancellor Angela Merkel's victory in the state election in North Rhine Westphalia, which, alongside Emmanuel Macron's commitment to reforming France, suggests that Europe is moving decisively away from populism. But will this translate into much-needed institutional reforms in Europe, particularly now that Britain is exiting stage right? Time will tell.

Meanwhile, the news out of the United States is more ambiguous. Lower than expected inflation and retail sales prints in the past week should keep market expectations of Fed hikes well contained. Long-term inflation expectations in the University of Michigan survey of consumer expectations dropped to a new low. In the past, this was clearly due to spare capacity in the economy, but by now, where the US economy is already at full employment, does the decline in inflation expectations signal rising expectations of recession? The Trump Administration was hit by yet another political scandal – this time the dismissal of FBI Chief James Comey. Political risk is clearly on the rise in the United States. In essence, political risk refers to sudden shifts in the political capital of the Executive relative to his or her competitors. Political risk can thus be either positive or negative depending on the direction of change. In Trump's case, his inability to deliver anything substantial more than 100 days into his presidency has generally been a positive development in political risks terms in the sense that his promises of severe protectionism have been thwarted, for now at least. On the other hand, the daily erosion of his political capital through Comey-type events means that he will soon be rendered a lame duck. If this happens then America has to go through yet another four years without much-needed reforms. This is now a very real possibility, which, if materialises, will ultimately extend Trump's misfortunes to others, not least Republican members of Congress. As the mid-term elections draw closer, their willingness to continue to countenance Trump's political impotence may wear thin.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.57%	16.86%	27.65%	2.29%	3.45%
MSCI EM Small Cap	0.56%	14.96%	18.73%	2.09%	4.46%
MSCI Frontier	2.62%	12.88%	12.10%	-2.60%	6.89%
MSCI Asia	2.38%	18.63%	28.83%	5.96%	7.05%
Shanghai Composite	-2.22%	-0.56%	11.01%	17.18%	7.83%
Hong Kong Hang Seng	0.64%	9.48%	27.48%	5.45%	4.27%
MSCI EMEA	0.97%	8.38%	19.46%	-3.69%	-0.70%
MSCI Latam	4.68%	17.43%	26.27%	-4.45%	-3.15%
GBI EM GD	0.69%	8.48%	7.65%	-2.83%	-1.01%
ELMI+	0.43%	5.98%	4.78%	-2.44%	-0.94%
EM FX Spot	0.43%	3.84%	0.17%	-9.41%	-7.32%
EMBI GD	0.23%	5.65%	8.56%	5.92%	5.86%
EMBI GD IG	0.16%	4.76%	4.44%	4.52%	4.18%
EMBI GD HY	0.29%	6.62%	13.34%	7.13%	8.07%
CEMBI BD	0.27%	4.41%	8.09%	5.29%	5.55%
CEMBI BD IG	0.27%	3.49%	4.59%	4.37%	4.75%
CEMBI BD Non-IG	0.27%	5.82%	13.80%	6.44%	6.94%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.40%	7.58%	18.29%	10.32%	14.45%
1-3yr UST	-0.01%	0.58%	0.47%	0.70%	0.61%
3-5yr UST	-0.02%	1.29%	0.02%	1.85%	1.33%
7-10yr UST	-0.32%	1.89%	-2.05%	3.30%	1.98%
10yr+ UST	-0.64%	2.68%	-5.02%	5.84%	3.12%
10yr+ Germany	-1.20%	-2.66%	-3.11%	8.05%	5.76%
10yr+ Japan	-0.83%	-0.83%	-5.31%	5.74%	5.10%
US HY	0.20%	4.09%	13.99%	4.66%	6.78%
European HY	0.64%	2.97%	9.37%	4.96%	9.30%
Barclays Ag	0.15%	2.30%	3.89%	3.93%	4.38%
VIX Index*	-0.09%	-23.01%	-28.13%	-17.92%	-50.80%
DXY Index*	-0.15%	-3.23%	4.54%	23.63%	21.77%
CRY Index*	-0.02%	-5.62%	-0.47%	-40.83%	-37.16%
EURUSD	0.67%	4.29%	-3.12%	-20.00%	-13.83%
USDJPY	-1.77%	3.05%	-3.94%	-10.50%	-29.36%
Brent	0.95%	-8.10%	9.18%	-52.72%	-53.47%
Gold spot	-2.94%	7.27%	-3.39%	-5.03%	-20.28%

*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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