Brazilian inflation drops significantly in May

By Jan Dehn

Two good pieces of news in Brazil, one economic, the other political. The rift between Qatar and its neighbours is likely to be contained. Asian FX reserves rise across the board. Mexico State's electorate sends Morena into second place. Thailand liberalises its FX regime. Venezuela enters into talks to restructure a Russian bond. The global backdrop analyses the rise of populism in the US and UK in terms of what it means for investors.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.4	–	0.36%
MSCI EM Small Cap	11.9	–	1.00%
MSCI Frontier	10.7	–	-0.66%
MSCI Asia	12.3	–	0.87%
Shanghai Composite	12.3	–	1.80%
Hong Kong Hang Seng	7.7	–	-0.48%
MSCI EMEA	9.2	–	-1.64%
MSCI Latam	12.4	–	-0.39%
GBI-EM-GD	6.22%	–	0.03%
ELMI+	3.69%	–	0.12%
EM FX spot	–	–	-0.16%
EMBI GD	5.21%	301 bps	0.17%
EMBI GD IG	4.03%	178 bps	0.40%
EMBI GD HY	6.53%	441 bps	-0.05%
CEMBI BD	5.05%	299 bps	0.00%
CEMBI BD IG	4.12%	205 bps	-0.07%
CEMBI BD Non-IG	6.46%	439 bps	0.08%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.7	–	-0.27%
1-3yr UST	1.35%	–	-0.12%
3-5yr UST	1.78%	–	-0.16%
7-10yr UST	2.21%	–	-0.25%
10yr+ UST	2.87%	–	-0.70%
10yr+ Germany	0.26%	–	0.00%
10yr+ Japan	0.06%	–	0.04%
US HY	5.52%	365 bps	-0.09%
European HY	3.01%	352 bps	0.00%
Barclays Ag	–	247 bps	-0.09%
VIX Index*	11.24	–	1.17%
DXY Index*	97.19	–	0.39%
EURUSD	1.1215	–	-0.35%
USDJPY	110.20	–	-0.23%
CRY Index*	176.76	–	-1.20%
Brent	48.1	–	-2.75%
Gold spot	1267	–	-0.95%

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

Emerging Markets

- Brazil: There were two important developments in Brazil in the past week, both positive. First, IPCA inflation declined sharply to just 3.6% yoy in May from 4.1% in April. The decline in inflation was much greater than expected, which underlines there are still significant rate cuts to come in Brazil, where the central bank currently maintains a policy rate of 10.25%. There is considerable slack in Brazil's economy despite the return to positive growth, so inflation should continue to fall for the foreseeable future, in our view. The combination of moderately rising growth amidst falling inflation rates, also known as 'goldilocks', is obviously very benign for fixed income markets. The other important development was that a huge piece of uncertainty was lifted from the political outlook as the Electoral Court acquitted President Michel Temer of charges of campaign finance abuse in the 2014 election. If the Court had ruled the other way President Temer would have had to leave office with all the accompanying uncertainty. The acquittal does not mean that the political outlook is entirely clear, however. There is still an important decision pending from the Supreme Court regarding the integrity of evidence, which allegedly shows Temer failing to object to illicit payments made to former speaker of parliament, Eduardo Cunha. Why does all this matter? Because the prospect of passage of an important pension reform very much hinges on Temer's political capital. The market has priced out passage of the reform under Temer's term, but if the president's political fortunes continue to recover there could be additional upside for investors over and above what accruing from the 'goldilocks' economic situation.
- Middle East: Having recently sparked tensions between Sunni and Shia majority countries in the Middle East, US President Donald Trump has now been forced to let his top emissary, State Department Head Rex Tillerson intervene diplomatically in order to ease tensions. A sharp division erupted between Qatar on the one hand and Saudi Arabia, UAE, Egypt and Bahrain on the other following Trump's recent visit. The latter four countries blame Qatar for supporting Iran and financing terrorist groups opposed to Saudi Arabia and others in the region. Tensions between Sunni and Shia supported governments in the region are by no means unprecedented. In 2011, for example, Saudi Arabia sent tanks to put down an uprising among the Shia segment of Bahrain's population. The potential fallout from all-out war between the Shia and Sunni dominated

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Emerging Markets

countries in the region is enormous, because such a conflict would potentially extend far beyond the borders of the Arab Peninsula to include countries such as Iran, Iraq, Syria and Turkey. Russia and Western countries would likely also be drawn into the conflict due to strong vested interests in the region. It is precisely this prospect of mutual assured destruction, which, in our view, should ensure that all sides in this crisis opt eventually to de-escalate. Indeed, there are signs that Saudi Arabia and her allies are softening their stance on expulsion of Qatari nationals. As for Qatar's ability to ride out the storm, we note that Qatar has reserves equivalent to more than 250% of GDP.

- FX reserves: Asian central bank reserves increased in May, including in China, Malaysia, India, Indonesia, Taiwan, Philippines, South Korea, Thailand and Singapore. The increases are due to improvements in external balances (net exports) due to highly competitive currencies plus positive valuation effects as the Dollar continues to fall (many Asian central banks have diversified their FX reserves into other G7 and Emerging Markets (EM) currencies, which are now appreciating versus the Dollar). In some countries, such as Philippines, remittances are also an important driver of reserves.

- Mexico: The governing PRI party won the gubernatorial election in the State of Mexico, Mexico's largest state. The populist Morena Party of Andres Manuel Lopez Obrador was pushed into second place. Given the low popularity of PRI President Pena Nieto the election was thus an important test of Morena's strength, which Morena failed. The outcome should be regarded as positive, in our view. In other news, industrial production declined 0.3% mom in April, mainly due to Easter calendar effects. Inflation also declined 0.12% in the month of May, in line with expectations.

- Thailand: The government last week announced a major liberalisation to the FX regime, whereby domestic companies will now be given greater access to FX markets. This should increase economic efficiency and reduce some of the pressure for the Thai Baht to appreciate.

- Venezuela: Venezuela missed a payment on a bond owed to Russia. ISDA determined over the weekend that the missed payment does not constitute a CDS credit event. According to press reports Russia is in talks with Venezuela to renegotiate the terms of the bond. President Nicholas Maduro said that Venezuela has funds to service all 2017 and 2018 debt obligations.

Snippets:

- Argentina: The monthly rate of inflation dropped sharply in May. The CPI index recorded 1.3% inflation in May compared to 1.7% mom expected and 2.6% mom in April.
- Chile: Inflation rose at a 2.6% yoy rate in May, down from 2.7% yoy in April.
- China: CPI inflation increased to a still very modest 1.5% yoy in May from a very low print of 1.2% yoy in April. PPI was also lower at 5.5% yoy. Exports expanded at an 8.7% yoy rate in May versus 7.2% yoy expected, while imports rose at a pace of 14.8% yoy compared to 8.3% yoy expected.
- Dominican Republic: The central government's fiscal deficit narrowed by half to 0.5% of GDP in January-April versus 1.0% of GDP in the same period last year.
- Egypt: Inflation appears to have turned a corner following the government's decision in November last year to set the currency free. Mom inflation was 1.7% in May, unchanged from April.
- Hungary: The rate of inflation in May fell to 2.1% yoy from 2.2% yoy in April.
- India: The Reserve Bank of India left the policy rate unchanged at 6.25%, but lowered its expected inflation trajectory meaningfully with a strong hint that further cuts could be made if the new trajectory for inflation materialises.
- Malaysia: Industrial production rose at a 4.2% yoy rate in April versus 4.6% yoy expected.
- Peru: The central bank kept the policy rate unchanged at 4.0% in June.
- Philippines: The trade deficit narrowed to USD 2.1bn in April from USD 2.3bn in March.
- Russia: Central bank governor Elvira Nabiullina pointed to a possible rate cut of 25-50bps at the upcoming policy meeting on 16 June.
- South Africa: Industrial production rose 0.9% in April following a similar monthly increase in March. The rise in April meant that the 3-month rolling volume of industrial output increased at a yoy rate of 1.4% in April. Moody's downgraded South Africa's sovereign credit rating by one notch (Baa2 to Baa3) with negative outlook, thus maintaining the country's investment grade rating.
- Taiwan: Exports were 8.4% higher than a year ago in May (versus an expectation of 7.0% yoy).
- Turkey: Real GDP expanded at a rate of 5.0% yoy in Q1. This was better than expected (3.5% yoy). The current account deficit of USD 3.6bn in April was in line with expectations. Inflation ticked marginally lower from 11.87% yoy in April to 11.72% yoy in March.

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Global backdrop

As the name suggests populism is a type of politics, which aims to tailor policies in accordance with what is popular with voters right here, right now. Populism is not confined to any one particular political persuasion. Rather, it finds expression across the full political spectrum, where the main difference between, say, left and right wing parties mainly pertains to which interest groups they tend to favour and which ones they tend to vilify.

Populism has re-emerged in the Developed Countries following the crisis in 2008/2009 and has been accelerating recently. This reflects the fact that the easy solutions, such as printing money to stimulate growth, have largely been exhausted, while discontentment with mediocre growth and rising inequality continues to grow in Western societies. Populists are experts at exploiting precisely such sentiments. As mainstream politicians continue to shy away from dealing with these intractable and largely self-inflicted economic problems the populists present easy-to-sell but ultimately false solutions, which often revolve around blaming foreigners for the domestic malaise.

For example, both the current US and UK governments have opted to place the blame for their domestic problems overseas. Donald Trump blames America's problems on China, Mexicans and Muslims, while Theresa May has sought to place the blame for UK's problems at the door of the European Union.

It is important to resist the temptation to conclude that right wing governments, such as the Trump and May administrations, are somehow more beholden to populism that the Left. The fact that it happens to be right wing governments, which are currently leading the populist charge in these two countries is more historical accident than anything intrinsic to right wing politics per se. Indeed, the strong surge in popularity in last week's UK parliamentary election for Jeremy Corbyn, a left-wing firebrand, and the impressive showing of Bernie Sanders in last year's US election illustrate that left-wing voters are just as prone to the lure of populist messages as right-wing voters.

Rather than taking sides in the sordid populist politics in UK and the US, investors would be well advised to take a broader perspective. They should recognise that populism has already rendered the governments ineffectual in both countries. This ought to be a major source of concern, because the US and the UK both face major structural and economic challenges, which can only be solved with strong governments that are willing and able to pursue policies based on evidence, that is, policies that are efficient, sustainable and effective. Sadly, such policies are precisely the ones that get jettisoned by weak and populist administrations.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.38%	18.94%	24.90%	1.71%	5.15%
MSCI EM Small Cap	1.74%	17.12%	17.39%	1.51%	6.49%
MSCI Frontier	0.68%	15.55%	13.46%	-3.66%	8.67%
MSCI Asia	1.90%	23.21%	27.16%	5.79%	9.16%
Shanghai Composite	1.43%	2.06%	10.08%	18.47%	9.34%
Hong Kong Hang Seng	0.14%	13.25%	22.32%	4.34%	6.18%
MSCI EMEA	-0.28%	7.26%	14.32%	-5.10%	0.32%
MSCI Latam	0.15%	9.75%	19.32%	-6.69%	-2.90%
GBI EM GD	0.86%	10.81%	8.46%	-2.66%	0.08%
ELMI+	0.35%	7.53%	5.43%	-2.15%	-0.12%
EM FX Spot	0.38%	5.04%	0.67%	-9.03%	-6.39%
EMBI GD	0.49%	6.87%	8.35%	5.52%	6.26%
EMBI GD IG	0.75%	6.33%	4.98%	4.42%	4.58%
EMBI GD HY	0.26%	7.49%	12.27%	6.26%	8.52%
CEMBI BD	0.15%	4.95%	7.58%	4.92%	5.83%
CEMBI BD IG	0.07%	4.16%	4.61%	4.14%	4.92%
CEMBI BD Non-IG	0.27%	6.16%	12.37%	5.82%	7.50%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.87%	9.61%	17.38%	9.89%	15.31%
1-3yr UST	-0.11%	0.65%	0.49%	0.74%	0.61%
3-5yr UST	-0.09%	1.50%	0.08%	1.89%	1.36%
7-10yr UST	0.12%	3.23%	-1.40%	3.59%	1.90%
10yr+ UST	0.23%	5.57%	-4.47%	6.42%	2.65%
10yr+ Germany	0.43%	-1.57%	-5.25%	7.96%	5.11%
10yr+ Japan	-0.02%	-0.31%	-5.36%	5.77%	5.17%
US HY	0.12%	4.92%	12.43%	4.64%	7.31%
European HY	0.16%	3.44%	8.05%	4.77%	9.67%
Barclays Ag	0.11%	3.24%	3.75%	4.06%	4.59%
VIX Index*	7.97%	-19.94%	-34.00%	-10.51%	-49.12%
DXY Index*	0.27%	-4.92%	2.77%	20.61%	17.91%
CRY Index*	-1.67%	-8.18%	-8.36%	-42.72%	-34.74%
EURUSD	-0.26%	6.61%	-0.68%	-17.24%	-10.31%
USDJPY	-0.52%	-5.81%	3.69%	8.36%	38.56%
Brent	-4.37%	-15.33%	-4.81%	-57.43%	-50.47%
Gold spot	-0.13%	9.99%	-1.29%	-0.48%	-21.27%

*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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