The worm turns

By Jan Dehn

The central banks in UK and US surprised on the hawkish side, but underlying fundamentals in both countries suggest the fears of draconian tightening are grossly misplaced. New US sanctions against Russia will mainly hurt President Trump and the European Union. The rise in unemployment in Argentina is symptomatic of a wrong policy mix. The Indian balance of payments was extremely strong in Q2 2017 as inflation hits a record low. Uruguay signals a clear intention to join the JP Morgan GBI EM GD benchmark index with its latest bond issue.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	-1.41%
MSCI EM Small Cap	11.7	–	-0.77%
MSCI Frontier	10.5	–	-0.33%
MSCI Asia	12.1	–	-1.46%
Shanghai Composite	12.3	–	-0.83%
Hong Kong Hang Seng	7.7	–	-1.83%
MSCI EMEA	9.0	–	-2.14%
MSCI Latam	12.4	–	-0.05%
GBI-EM-GD	6.21%	–	0.15%
ELMI+	4.00%	–	-0.14%
EM FX spot	–	–	-0.03%
EMBI GD	5.21%	306 bps	0.05%
EMBI GD IG	4.02%	182 bps	0.17%
EMBI GD HY	6.57%	449 bps	-0.07%
CEMBI BD	5.03%	300 bps	0.21%
CEMBI BD IG	4.08%	206 bps	0.30%
CEMBI BD Non-IG	6.45%	443 bps	0.08%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.7	–	0.12%
1-3yr UST	1.34%	–	0.05%
3-5yr UST	1.76%	–	0.10%
7-10yr UST	2.17%	–	0.43%
10yr+ UST	2.78%	–	1.35%
US HY	5.50%	365 bps	0.10%
European HY	3.00%	345 bps	0.15%
Barclays Ag	–	248 bps	0.31%
VIX Index*	10.46	–	-1.00%
DXY Index*	97.28	–	0.14%
EURUSD	1.1182	–	-0.19%
USDJPY	111.23	–	-1.15%
CRY Index*	172.18	–	-3.75%
Brent	47.5	–	-1.72%
Gold spot	1250	–	-1.26%

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

Emerging Markets

The worm turned last week. A little bit. By committing the Fed to scaling back bond purchases starting as early as this year, Fed Chairwoman Janet Yellen effectively tied the hands of her successor. At the same time, the MPC at the Bank of England only narrowly voted against a rate hike. Against a backdrop of recent lower US inflation prints and considerable political uncertainty in the UK, the expectation has been for the Fed and the BOE both to want to err on the side of dovishness. In the end, they did not. What, then, should EM investors make of their hawkish tilt?

Firstly, EM investors should welcome that the Fed is on the ball. Close to full employment yet with a real policy rate still about nearly 100bps in negative territory and the risk of greater fiscal stimulus clearly on the rise, the Fed is right to try to roll back some of the stimulus. The loss of macroeconomic stability due to excessively easy monetary policies for too long, clearly poses a far greater threat to global growth than a US economy which grows more slowly but maintains stability under responsible monetary policies.

Second, EM markets should not be very affected. EM local currency bond yields are already in excess of 200bps in real terms, while government bonds with similar duration in developed markets trade with yields well below zero in real terms. Thirdly, EM currencies are extremely competitive, while the USD in particular is overvalued. This means that EM economies have far more room to grow even if global rates increase in real terms. Indeed, the tightening of monetary policies in the US and other developed economies primarily poses risks at home, not in EM. Tighter monetary policies could incur larger than normal costs given the conditions of very low productivity growth, excessive debt levels and bloated asset prices, which prevail in developed economies. Clearly, low trend growth is not the Fed's problem, so the Fed should keep its focus firmly on managing the cycle. It is up to the Executive and Congress to ensure that debt levels come down and reforms are implemented in a timely manner to ensure that productivity growth recovers.

Sadly, the Trump Administration appears to be contemplating more fiscal stimulus and protectionism rather than deleveraging and reforms. Against this backdrop, we maintain a strong conviction that the Fed will ultimately be quite constrained in terms of how far it can maintain its newly discovered hawkishness. Because

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of the lack of responsible governance in the Executive and Legislative branches of government, the Fed has no choice but to be far more mindful about matters that ought not to feature in its remit than normal. Hence, it will still err on the side of dovishness for the foreseeable investment horizon. Excessive market reactions should therefore be ruthlessly exploited to add to positions in EM fixed income.

- New US sanctions on Russia: The US Senate has approved new sanctions on Russia. They are likely to be approved in the House of Representatives as well. To become law, President Donald Trump will also have to approve them. Failing to do so will pitch him against Congress at a time when Trump claims that he is under formal investigation for firing the former director of FBI, who was conducting an investigation into Russian influence in last year's election. Trump's own lawyer denies the allegations, however. Regardless, this move by the Senate puts the squeeze on Trump. The other party which was left to hang out to dry was the European Union. The sanctions appear to target the North Stream 2 pipeline projects, which is explicitly designed to reduce uncertainty of supply of energy from Russian gas fields, given the risks associated with piping gas through two other pipelines via Ukraine and Turkey. Russia, on the other hand, has survived a triple whammy of shocks in recent years including serious financial sanctions over Crimea, lower oil prices and a severe bout of market pessimism about anything Russian. The brutal truth is that Europe is completely dependent on Russian energy supplies. The sanctions will drive a wedge between the US and Europe, which may actually make it harder for US shale gas producers to export to Europe, which in turn means that Europe may have to make concessions to Putin. In short, the new US sanctions improve the odds at the margin that Europe will ease its sanctions against Russia. In other Russian news, the Russian Central Bank cut the benchmark policy rate from 9.25% to 9.00%, while industrial production surged at a rate of 5.6% yoy in May versus 2.4% yoy expected.

- Argentina: Unemployment rose to 9.2% in Q1 2017 from 7.6% in Q4. This is not good news. The Macri Administration has favoured a combination of loose fiscal policy and tight monetary policy in order to smooth the adjustment of the economy following grotesque mismanagement and excess demand stimulus under the Kirchner Administration. However, this constellation of loose fiscal/tight monetary policies leads to crowding out of private sector investment and hot money inflows (i.e. bubbles in both financial and currency markets) not the investment Argentina needs to improve the supply side of the economy. The poor employment performance seems to support this interpretation. Mid-term elections are due to be held on 22 October 2017. It is important for prospects of further reforms that the coalition supporting President Mauricio Macri does well in this election. The central bank left the policy rate unchanged at 26.25% in last week's MPC meeting.

- India: The balance of payments surplus was USD 7.3bn in surplus in Q2 2017, a marked improvement from a deficit of USD 1.2bn in the previous quarter. The current account deficit narrowed to 0.6% of GDP from 1.5% of GDP in the previous quarter. Exports led the improvement after rising at a rate of 17% yoy in Q2 2017. This is the strongest current account position India has recorded since 2005. In other goods news, CPI inflation dropped to just 2.18% yoy in May. This is the lowest yoy inflation rate in the history of the index. At 3.1% yoy, industrial production was stronger than expected in April (2.7% yoy).

- Uruguay: The government finally took the plunge of issuing a benchmark size Euroclearable non-inflation-linked nominal bond in local currency. The bond was equivalent to USD 1.25bn in size with duration of 4 years. It was issued at a yield of 10% and rallied to a 9.2% yield. This is an important development for Uruguay, which is now aiming at index inclusion, like neighbouring countries Argentina and Chile. Good news for those who want to see JP Morgan's local currency bond indices become more representative.

Snippets:

- Brazil: Real economic activity increase 0.3% in April in line with expectations. Retail sales rose strongly in April (1.5% mom versus 0.2% mom expected).
- Chile: The central bank in Chile kept the policy rate unchanged at 2.5%.
- China: New loan growth was stronger than expected in May (RMB 1110bn versus RMB 1000bn expected). Industrial production, retail sales and fixed asset investment were broadly in line with expectations suggesting that the current pace of growth is holding up.
- GCC: The five Gulf Cooperation Council (GCC) nations of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates hiked interest rates by 25bps as required on account of their currencies being pegged to the US dollar. The Fed hiked the Fed funds rate by 25bps to 1.0% last week.
- Indonesia: The central bank left the policy rate unchanged at 4.75%. Exports rose a rate of 24.1% yoy in May versus 15.7% yoy expected.
- Panama: The government switched allegiance from Taiwan to China. China is pushing to get smaller countries to support its position versus Taiwan in the UN. Turning Panama is a small victory for China over the US, a staunch ally of Taiwan.
- Peru: Real GDP expanded by a more modest than expected 0.2% yoy rate in April, mainly due to a powerful Easter calendar effect, which has also impacted Colombian and Chilean data from April.
- Romania: Inflation was unchanged at 0.6% yoy amidst considerable political noise.

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- **Singapore:** Non-oil domestic exports rose 8.1% in the month of May versus 4.2% mom expected. Unemployment declined to 2.2% in Q1 2017.
- **South Africa:** The Ministry of Mines announced that black ownership of mines must be increased to 30% over the next 12 months from 26% today. Mining stocks reacted negatively. Business confidence fell sharply in Q2, reflecting the dismissal of Pravin Gordhan as Finance Minister.
- **South Korea:** Unemployment dropped sharply in May to 3.6% from 4.0% in April.
- **Tanzania:** The government announced that capital requirements for banks will be raised after a sharp rise in non-performing loans
- **Turkey:** The central bank left the policy instruments unchanged at the June MPC meeting. The policy bias was hawkish.
- **Venezuela:** The government announced new investments by China worth USD 4.3bn intended to jack up production of oil.

Global backdrop

The Fed raised the funds rate by 25bps as expected in the face of weakness continuing in most economic indicators in the US, including industrial production, inflation and housing data, consumer sentiment and retail sales. Tech stocks have also been under the cuff recently. Q2 growth expectations are steadily being revised lower following the very weak growth performance in Q1. Consensus now expects balance sheet normalisation to begin in September and for the next Fed hike to happen in December. Our view is that the risks are skewed to the downside.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.05%	17.26%	28.72%	1.26%	4.36%
MSCI EM Small Cap	0.95%	16.22%	21.01%	1.32%	5.91%
MSCI Frontier	0.36%	15.17%	13.35%	-3.38%	8.78%
MSCI Asia	0.42%	21.42%	30.33%	5.24%	8.25%
Shanghai Composite	0.58%	1.21%	11.16%	17.06%	8.75%
Hong Kong Hang Seng	-1.69%	11.17%	27.87%	3.07%	4.76%
MSCI EMEA	-2.41%	4.96%	19.54%	-5.50%	-0.63%
MSCI Latam	0.10%	9.70%	25.71%	-6.69%	-3.18%
GBI EM GD	1.02%	10.98%	11.80%	-2.30%	-0.10%
ELMI+	0.21%	7.38%	6.95%	-2.04%	-0.28%
EM FX Spot	0.35%	5.01%	3.20%	-8.80%	-6.52%
EMBI GD	0.54%	6.92%	9.16%	5.88%	5.99%
EMBI GD IG	0.92%	6.51%	5.74%	4.77%	4.33%
EMBI GD HY	0.18%	7.41%	13.16%	6.65%	8.25%
CEMBI BD	0.35%	5.17%	8.06%	5.04%	5.78%
CEMBI BD IG	0.36%	4.47%	4.93%	4.31%	4.89%
CEMBI BD Non-IG	0.34%	6.24%	13.17%	5.84%	7.41%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.99%	9.74%	19.56%	10.17%	15.03%
1-3yr UST	-0.06%	0.70%	0.35%	0.77%	0.62%
3-5yr UST	0.00%	1.60%	-0.37%	1.94%	1.37%
7-10yr UST	0.56%	3.67%	-1.86%	3.70%	1.88%
10yr+ UST	1.58%	6.99%	-4.82%	6.61%	2.68%
10yr+ Germany	0.22%	5.02%	13.82%	4.60%	7.25%
10yr+ Japan	0.31%	3.60%	9.63%	4.79%	9.65%
US HY	0.43%	3.57%	3.87%	4.12%	4.61%
European HY	0.48%	-25.50%	-46.11%	-1.51%	-43.09%
Barclays Ag	0.37%	-4.82%	3.27%	21.12%	19.54%
VIX Index*	-4.22%	-10.56%	-10.50%	-44.77%	-37.89%
DXY Index*	-0.55%	6.32%	-1.17%	-17.83%	-11.85%
CRY Index*	-0.40%	5.15%	-6.55%	-8.35%	-29.02%
EURUSD	-5.66%	-16.47%	-3.48%	-58.75%	-50.44%
USDJPY	-1.47%	8.96%	-3.07%	-5.31%	-22.74%
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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