Positive but still moderate inflows

By Jan Dehn

New data from EMTA shows that trading volumes are rising at a speed consistent with still only moderate inflows to the EM asset class: we see scope for considerably larger flows back to Emerging Markets (EM) after the QE-induced outflows between 2010 and 2015. Brazil's central bank points to the macroeconomic data, which remains very solid for fixed income investors. It was a big week for Argentina with both positive and negative news. Peru's finance minister is forced to step down. Mexico signals a turning point for the interest rate cycle. There are signs of movement in the conflict engulfing Qatar and her neighbours. Russian data looks strong despite sanctions. India recognises bad loans and Chinese A-shares join the MSCI EM index. The global backdrop kept EM performance choppy.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	0.99%
MSCI EM Small Cap	11.8	–	-0.35%
MSCI Frontier	10.5	–	-0.34%
MSCI Asia	12.2	–	1.30%
Shanghai Composite	12.5	–	1.18%
Hong Kong Hang Seng	7.7	–	1.13%
MSCI EMEA	9.6	–	0.52%
MSCI Latam	12.3	–	-1.61%
GBI-EM-GD	6.19%	–	-0.37%
ELMI+	3.92%	–	-0.46%
EM FX spot	–	–	-0.60%
EMBI GD	5.27%	313 bps	-0.29%
EMBI GD IG	4.05%	187 bps	-0.20%
EMBI GD HY	6.66%	459 bps	-0.38%
CEMBI BD	5.05%	303 bps	-0.09%
CEMBI BD IG	4.08%	206 bps	0.03%
CEMBI BD Non-IG	6.51%	449 bps	-0.27%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.8	–	0.22%
1-3yr UST	1.34%	–	–
3-5yr UST	1.75%	–	–
7-10yr UST	2.12%	–	–
10yr+ UST	2.68%	–	–
10yr+ Germany	0.25%	–	–
10yr+ Japan	0.05%	–	–
US HY	5.65%	378 bps	-0.37%
European HY	3.04%	347 bps	-0.04%
Barclays Ag	–	249 bps	0.25%
VIX Index*	10.20	–	-0.17%
DXY Index*	97.29	–	-0.26%
EURUSD	1.1193	–	0.39%
USDJPY	111.50	–	-0.03%
CRY Index*	167.83	–	-3.45%
Brent	45.6	–	-2.79%
Gold spot	1243	–	-0.06%

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

Emerging Markets

- **EM trading volumes:** The Emerging Markets Traders Association (EMTA) reported a 2% yoy increase in trading volumes in Q1 2017. This is consistent with positive, but so far still modest inflows to the asset class. While trade volumes were 17% higher than in Q4 2016 this reflects mainly familiar seasonal patterns, wherein new risk budgets and fresh issuance push up trading volumes in the first quarter of each year, while investors typically reduce trading volumes towards year end. We would similarly expect to see trade volumes and risk appetite dip in Q2 2017 and then pick up again in Q3 2017. The broader picture is this: a wave of liquidity washed up on the shores of developed markets in the wake of QE policies, sucking with it considerable liquidity from markets that were not sponsored by QE policies, including EM. We expect much of this capital to flow back towards the non-QE universe over the coming years with positive implications for returns in EM.

Many analysts expected that QE would induce massive inflows to EM on the argument that investors would search for yield. The reality, however, has been far more sordid: investors chose instead to chase bubbles in in the QE-sponsored markets. The motivation was short-term returns: for example investors could buy German 30 year bonds a few years ago at 4% yield and then see the yield decline to 1% for a +60% return against a backdrop of low and falling inflation. Nothing in EM's markets could beat such returns. With European bonds, US stocks and the Dollar all benefitting strongly from QE-related easing investors therefore liquidated many of their EM positions in favour of chasing the rally in the QE markets. Now, however, valuations, positioning, performance and flows all favour the non-QE markets. We believe that the flows back to EM are in their early stages and that they will progress at moderate speed. In particular, we dismiss the flow picture painted by the usual published weekly flow indicators. These indicators tend to cover only publicly traded funds and therefore miss the bulk of the market, which is owned by big institutional asset owners, including large insurance and pension mandates with segregated accounts, sovereign wealth funds, central banks and others. These large investors are slower movers and remain very underweight and have barely begun to allocate.

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Emerging Markets

- Brazil: In its quarter inflation report the central bank shifted its outlook marginally in a dovish direction by placing greater emphasis on the data than on politics. Brazilian macroeconomic data is likely to continue to be extremely favourable for fixed income markets due to declining inflation and moderately improving growth against a backdrop of still considerable spare capacity. The IPCA-15 inflation rate last week dropped to 3.52% yoy in June from 3.77% in May. The economy added 34.3k jobs in May versus 15.5k jobs expected. As far as politics is concerned there have been no major changes. Markets fretted over the rejection of labour market reform in a parliamentary committee, but the truth is that the committee in question is irrelevant and hence it would have been silly for the government to waste political capital in changing the committee's verdict. We expect the labour reform to pass the constitutional committee next week and then to be approved in the Senate within the first two weeks of July. The fate of the pension reform will become clearer after the parliamentary recess. If the Temer Administration fails to obtain approval we expect the reform will be approved in the next government. In our view, investors should already now be positioning for the 'Joao Doria Trade'. The mayor of Sao Paulo, Doria is a young Macron-type PSDB politician, who is not afflicted by the air of corruption, which clings to other members of the party. We expect Doria to become president in 2018.

- Argentina: It was a big week of good and not so good news for Argentina. Many will rejoice at the stronger than expected growth rate in Q1 2017, which saw the real economy expand by 1.1% compared to 0.7% in Q4 2016. The acceleration in the growth rate improves the odds that the Macri Administration will do well in October's mid-term election. This is absolutely crucial, because we believe that the pace of reform can resume only if Macri's hand is strengthened by the electorate. Argentina also successfully issued a 100-year bond. This is the first time in EM history that a sub-investment grade sovereign issuer has issued such a long bond. As expected, eyebrows were raised. After all, Argentina is a serial defaulter. However, Argentina likes to make headlines and did so very effectively. As for the length of the bond it does not really matter if it is a 30-year bond or a 100-year bond, in our view. The duration is similar and the really important point is surely that the bond is liquid, so that investors can trade it – no one is going to have to take a 100 year view on Argentina in order to get involved. Sceptics about Argentina will be concerned, however, that the trade balance deteriorated to a deficit of USD 642m in May versus USD 100m expected. Argentina really ought not to be running up deficits this early in the expansion. The fact that it does reflects real exchange rate overvaluation, which in turn is directly attributable to the macroeconomic policy mix of tight monetary policies and loose fiscal policies. Hot money is flowing into Argentina, but it is not invested productively, because excessive borrowing by the government is crowding out private sector investment. The strong currency is clearly also hurting exports as the trade deficit shows. Finally, equity investors in Argentina were dealt a blow when MSCI failed to upgrade Argentina from frontier to emerging market status. The rationale offered by MSCI is that Argentina has not yet convinced enough investors that the gains made under Macri are irreversible. This is, in our view, an entirely fair assessment. The macroeconomic policy mix has to change and greater emphasis must be placed on trade liberalisation. Key to making progress in these areas is the outcome of the mid-term election: all eyes on October.

- Peru: The corruption scandal that began in Brazil and spread to Peru has now claimed another victim, namely Alfredo Thorne, Peru's finance minister. Thorne resigned last week after losing a confidence motion in parliament, which was upset by a recording showing Thorne offering the Comptroller General's office a larger budget in exchange for approving an infrastructure project. Thorne's objective, in our view, was not personal gain, but rather to kick-start the projects, which have been halted due to contract irregularities dating back to the time of the Humala Administration. President Kuczynski does not command a majority in Peru's parliament. The main implication of the Thorne resignation is that Kuczynski's political capital is further eroded and investment projects will be further delayed. The silver-lining is that tolerance for corruption is crashing in the region, which will eventually be good for growth.

- Mexico: 400bps. It is tempting to say that this was the price Mexico had to pay as a result of American voters putting Donald Trump into office. However, the 400bps of interest rate hikes implemented by Banxico, Mexico's central bank, was also the adjustment required to cope with falling oil prices, minimum wage hikes and a cyclical upswing in the economy. The economy expanded at a rate of 2.8% yoy in Q1 2017 versus 2.3% yoy in Q4 2016. This was the highest rate of growth since Q3 2015. Retail sales and activity in the services sector were solid in April. After hiking 25bps last week, Banxico's policy rate is now 7% and investors can look forward to rate cuts at some point in the future as inflation begins to respond. This was the message from the dovish statement released by Banxico, which heralded the end of the hiking cycle as one board member dissented and further hikes were excluded.

- Saudi Arabia: Deputy Crown Prince Mohammed Bin Salman was promoted to heir to the throne. His appointment suggests continuity in economic reforms, since MBS, as he is known, has designed the current economic strategy. MBS is also known as a hardliner on foreign policy. This may already have found a manifestation in the real world after a group of Arab countries led by Saudi Arabia last week issued a list of conditions to the government of Qatar , which, if satisfied could lead to the removal of recently imposed sanctions against Qatar. The conditions are aggressive, so unlikely to be acceptable to Qatar in their current format.

  MSCI also placed the USD 435bn Saudi Arabian stock market on its watch list for inclusion in the MSCI EM index, which means inclusion may take place in the next 12-24 months.

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Emerging Markets

- **Russia:** The economy is now performing very strongly. Industrial production and manufacturing both surprised to the upside May with rates of expansion of 5.6% yoy and 5.7% yoy, respectively. This was more than twice as strong as expected. Real wages also rose strongly in May (3.7% yoy versus 2.4% yoy expected) and retail sales were up at a rate of 0.7% yoy versus 0.5% yoy expected. The US Treasury added 38 individuals and organisations to a sanctions list. The list mainly relates to Russian entities with direct involvement in Crimea and will have no major macroeconomic implications for Russia, in our view. The European Union also extended the current sanctions regime for a year.

- **India:** The Reserve Bank of India has forced the recognition of USD 38bn bad loans in 12 separate cases. This is good news. One of the remaining macroeconomic problems in India is that public sector banks remain saddled with unrecognised bad loans. Until these issues are resolved it will be difficult to open the capital account further.

- **China:** The MSCI included Chinese stocks in its main EM fixed income benchmark. For more details see 'China's MSCI index inclusion: the sound of inevitability', Market Commentary, 21 June 2017.

Snippets:

- **Colombia:** The trade deficit widened to USD 1.2bn in April from USD 0.7bn in March. The market expectation was a deficit of USD 1.0bn.
- **Malaysia:** The rate of CPI inflation declined to 3.9% yoy in May versus 4.1% yoy expected.
- **Philippines:** The central bank left the policy rate unchanged at 3.00%.
- **Hungary:** The central bank's policy rate was unchanged at 0.9%.
- **Oman:** Fitch revised Oman's sovereign credit outlook to negative on fiscal concerns, but maintained the rating at 'BBB'.
- **Poland:** Economic activity picked up in May. Industrial output was up 9.1% yoy, while construction output rose 8.4% yoy. Retail sales volumes grew 7.4% yoy.
- **Romania:** The ruling government coalition has removed its own prime minister following a falling out with the head of the largest party in the coalition.
- **Singapore:** May CPI inflation was 1.6% yoy versus 1.7% yoy expected.
- **South Africa:** May's core CPI inflation was unchanged at 4.8% yoy, while headline inflation rose to 5.4% yoy from 5.3% yoy in April. The current account deficit was 2.1% of GDP in Q1 2017 versus 1.9% of GDP expected.
- **South Korea:** Exports rose at a rapid pace of 24.4% yoy in the first 20 days of June compared to a rate of expansion of 3.4% yoy in the first twenty days of May.
- **Sri Lanka:** The central bank left the policy rates unchanged at 7.25-8.25%.
- **Taiwan:** Industrial production rose at a rate of 0.78% yoy in May versus 0.5% yoy expected. The central bank left the policy rate unchanged at 1.375%. Export order rose at a rate of 9.1% yoy in May versus 7.5% yoy expected.

Global backdrop

EM sentiment remains choppy, partly due to the summer lull and strong performance in H1 2017and signs of progress towards tax reform in the US, which re-injects some hope for returns in US assets. Specifically, the Senate last week issued a draft healthcare reform proposal, which removes some of the more onerous elements, which made an earlier version of the reform untenable. Still, the bill is likely to be very controversial even among Republicans and the odds that it passes in the Senate before recess starts on 4th July remain low. Due to the fiscal implications of the healthcare reform it is not possible to pass a tax reform until the healthcare reform is completed. Beyond the recess looms a potential government shutdown as the debt limit approaches.

The US current account deficit widened to 2.5% of GDP in Q1 2017 despite sluggish domestic demand. Wage inflation remains low despite low unemployment. This reflects that labour has very little bargaining power due to a number of changes in recent years, including less union power, more immigration, outsourcing, automation, etc. However, the low profile of wages does not mean that the economy is safe from overheating. QE policies have pushed the prices of capital and currencies far beyond healthy levels. Inflation is already excessive in these areas and with the Fed still maintaining extremely stimulatory policies the US real exchange rate remains seriously overvalued given low productivity, while the bubble in the equity market continues to pose a serious threat to the expansion.

Meanwhile, in Europe the positive sentiment continues due to declining political risk and improving economic indicators, including manufacturing and consumer confidence surveys. German Chancellor Angela Merkel

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Global backdrop

even agreed to consider the possibility of a European Union finance minister, an important step that could signal the centralisation of some fiscal functions within the EU.

The EU and the UK government have not yet made any breakthrough in the talks over the rights of EU citizens in the UK and UK citizens in Europe, which must be resolved even before proper Brexit talks can begin. Prime Minister Theresa May depends so much on hard-line Brexiteers that if she makes concessions to the EU she could quickly be unseated. The political and economic uncertainty facing investors in UK assets therefore remains considerable, in our view. Nomura, a large bank, was reported to be planning to move its European headquarters from London to Frankfurt.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.93%	18.42%	24.23%	1.68%	4.74%
MSCI EM Small Cap	0.60%	15.81%	17.27%	1.46%	5.69%
MSCI Frontier	0.01%	14.78%	16.10%	-3.43%	8.53%
MSCI Asia	1.73%	23.00%	27.84%	6.03%	8.70%
Shanghai Composite	1.78%	2.42%	11.53%	18.44%	9.38%
Hong Kong Hang Seng	-0.59%	12.43%	22.64%	4.29%	5.49%
MSCI EMEA	-1.90%	5.51%	10.72%	-5.67%	-0.25%
MSCI Latam	-1.51%	7.93%	15.56%	-7.27%	-3.48%
GBI EM GD	0.65%	10.57%	7.41%	-2.54%	-0.23%
ELMI+	-0.25%	6.89%	4.46%	-2.27%	-0.29%
EM FX Spot	-0.26%	4.38%	-0.41%	-9.06%	-6.55%
EMBI GD	0.25%	6.61%	7.72%	5.66%	5.91%
EMBI GD IG	0.72%	6.30%	4.83%	4.74%	4.28%
EMBI GD HY	-0.20%	7.00%	11.12%	6.11%	8.13%
CEMBI BD	0.26%	5.07%	7.44%	4.92%	5.67%
CEMBI BD IG	0.40%	4.50%	4.79%	4.25%	4.84%
CEMBI BD Non-IG	0.07%	5.95%	11.71%	5.62%	7.19%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.21%	9.98%	17.81%	9.78%	15.21%
US HY	-0.15%	4.63%	11.96%	4.36%	6.95%
European HY	0.28%	3.57%	8.53%	4.68%	9.40%
Barclays Agg	0.68%	3.83%	4.56%	4.20%	4.64%
VIX Index*	-2.02%	-27.35%	-60.40%	-12.30%	-48.28%
DXY Index*	0.38%	-4.82%	1.93%	21.27%	18.11%
CRY Index*	-6.64%	-12.82%	-11.05%	-46.21%	-38.47%
EURUSD	-0.45%	6.43%	1.52%	-17.77%	-10.39%
USDJPY	0.65%	-4.67%	9.31%	9.60%	40.22%
Brent	-9.36%	-19.75%	-5.80%	-59.72%	-50.98%
Gold spot	-2.04%	8.33%	-6.15%	-5.58%	-20.97%

*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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