

Signal versus noise: the case of Brazil

By Jan Dehn

Brazil offers a good example which illustrates the difference between signal and noise in investing. A complete mess from a journalistic perspective, Brazil has been one of the best investments in global fixed income markets and continues to offer an attractive investment proposition. We examine why countries with so much bad news can be such excellent investments. We also provide an update on EM corporate high yield bonds, whose default rates are now falling faster than any other region on earth.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)	Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	4.60%	S&P 500	16.8	–	1.42%
MSCI EM Small Cap	12.2	–	2.22%	1-3yr UST	1.36%	–	0.13%
MSCI Frontier	10.5	–	1.08%	3-5yr UST	1.86%	–	0.37%
MSCI Asia	12.6	–	3.70%	7-10yr UST	2.32%	–	0.68%
Shanghai Composite	12.4	–	0.93%	10yr+ UST	2.91%	–	0.58%
Hong Kong Hang Seng	7.9	–	4.99%	10yr+ Germany	0.59%	–	0.55%
MSCI EMEA	10.0	–	6.24%	10yr+ Japan	0.08%	–	0.30%
MSCI Latam	13.0	–	6.82%	US HY	5.61%	365 bps	0.53%
GBI-EM-GD	6.17%	–	2.55%	European HY	3.25%	352 bps	0.35%
ELMI+	3.88%	–	1.41%	Barclays Ag	–	248 bps	0.47%
EM FX spot	–	–	1.79%	VIX Index*	9.51	–	-1.68%
EMBI GD	5.38%	306 bps	1.06%	DXI Index*	95.26	–	-0.76%
EMBI GD IG	4.17%	180 bps	0.76%	EURUSD	1.1457	–	0.51%
EMBI GD HY	6.73%	449 bps	1.35%	USDJPY	112.58	–	-1.28%
CEMBI BD	5.10%	293 bps	0.50%	CRY Index*	176.28	–	3.72%
CEMBI BD IG	4.12%	195 bps	0.45%	Brent	49.0	–	4.56%
CEMBI BD Non-IG	6.51%	432 bps	0.56%	Gold spot	1231	–	1.36%

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

Emerging Markets

There is nothing quite like an Emerging Markets (EM) country in crisis to illustrate the difference between signal and noise. Brazil is a good case in point. Headlines suggest that the country is a complete mess! Brazil is mired in the worst economic downturn in its modern history and almost the entire political class has been exposed as utterly corrupt by Judge Sergio Moro, whose relentless campaign to uproot corruption has already seen one president impeached, another sentenced to 9.5 years in jail for corruption and a third teetering on the precipice of political demise.

Yet, from an investment perspective Brazil has been one of the most attractive opportunities in global fixed income and the country arguably continues to offer a compelling investment case. For example, in 2016 Brazilian local currency government bonds returned 58% in USD terms and year to date they are up 12%. If the year ends as it started, investors can expect to make about 25% in USD terms in Brazilian fixed income in 2017. For simple government bonds with a modest 3 years of duration that is hard to beat.

But how can returns be so stellar when the news is so bad? The answer is that investment returns depend on key signals about the likely evolution of deeper economic and political parameters, whereas news headlines often focus on events, which, though colourful, often have no bearing on the key parameters, which impact investment returns. In other words, a lot of news is quite simply noise, at least from the narrow perspective of the investor.

The reason for this distinction is that the act of investing is about making forward-looking calls on what is about to happen to the key underlying risk parameters, such as growth, inflation, reforms, policy interest rates and the ability and willingness to pay. The investor then compares these parameters with the current level of asset prices in order to assess if they are consistent with each other. Investing is a forward-looking exercise in signal extraction, which is obviously a very different exercise from noise reporting, which is not only imprecise (from a narrow investment perspective) but also mostly backward-looking in nature.

So what were the Brazilian investment signals in late 2015 ahead of the monster rally of the last eighteen months? First, the central bank policy rate in Brazil was 14.25%, while inflation was showing signs of peaking

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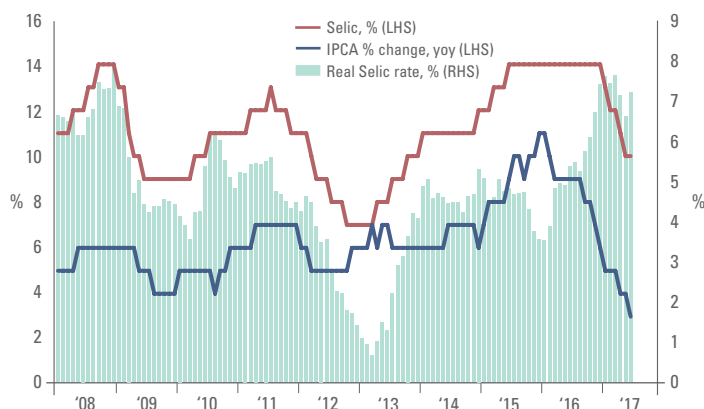
around 10.7%. This meant that the policy rate was a positive 355bps, which is extremely high. At the same time, GDP was contracting sharply. Hence, it seemed very likely that this combination of high real rates and very weak growth would usher in a period of falling inflation.

Second, the real exchange rate was beginning to get seriously cheap by late 2015 following a 41% decline over the previous four years. The very competitive real exchange rate was already beginning to improve Brazil's trade balance, which in turn could be expected to begin to stabilise economic growth, though with no serious risk of inflation since the enormous slack in the Brazilian economy meant it would probably take years before wage costs would threaten to push up inflation. In short, Brazil looked very likely to enter what some people call a 'goldilocks' scenario, that is, coincident positive growth and declining inflation. In Brazil's case, of course, the story was even more compelling because in addition to rising growth and falling inflation, investors could also expect reasonable currency appreciation and a central bank poised to cut rates aggressively (a quadruple fixed income tailwind known as 'super goldilocks').

Thirdly, the political crisis in Brazil was doing wonders for the willingness to reform. The PSDB and PMDB political parties recognised early that the collapse of the PT party presented an opportunity to implement tough reforms, since voters would, for some time at least, attribute blame for the associated pain on Lula and Dilma's administrations. PSDB in particular is supportive of reforms, because the idea that the most challenging reforms could be undertaken before the 2018 elections seems very appealing. A team of highly credible technocrats led by Ilan Goldfajn at the central bank and Henrique Meirelles at the Finance Ministry was therefore put in place to assist the Temer Administration in designing and executing deep reforms. Anchored in an amendment to Brazil's constitution, which freezes public spending in real terms for the next 20 years, the draconian commitment to fiscal probity immediately broke inflation expectations and enabled the central bank to start cutting rates as inflation tumbled.

Looking forward, the economic case for Brazilian fixed income remains solid. Inflation is still falling rapidly. Only last week the inflation rate declined to just 3.0% yoy for the month of June from 3.6% yoy in May and 8.84% a year ago. However, the central bank's policy rate is still very high in both nominal (10.25%) and real terms (7.25%) – see Figure 1. Finally, positioning remains light as foreigners hold only 13.4% of Brazilian bonds compared to more than 20% in 2014.¹

Fig 1: Brazil policy rate and inflation



Source: Ashmore, Bloomberg

What about the political outlook? Actually, the political front continues to deliver positive news despite the vulnerability of the Temer Administration. Importantly, the political logic underpinning reforms still holds sway. This was illustrated clearly last week, when the Senate approved important changes to Brazil's labour code aimed at making the labour market far more flexible. The reform will make Brazil more productive, allow the economy to return to full employment quicker and place the country on a faster non-inflationary trend growth rate once the recovery is complete. In another positive piece of political news Judge Moro last week gave former president Lula a 9.5 year prison sentence for corruption, which deals a serious blow to Lula's hopes of returning to frontline politics in the 2018, thus reducing an important potential downside risk to the medium political outlook. Lula has the right to appeal, but nevertheless this is a clear setback for his political ambitions.

In the next 18 months the economy is likely to contribute most of the positive news, while the main source of volatility will still come from politics. Temer may yet be forced from office, but with Lula's return now less likely the downside risks associated with Temer's removal from office are much reduced. The reform of the pension system, still outstanding, is not overly time sensitive and can be postponed to early in the first term of a future PSDB Administration, that is, early 2019. There is still a chance that the pension reform is passed before next year's election if Temer is replaced by a technocrat appointed by parliament. Hence, Temer leaving is not necessarily bad news.

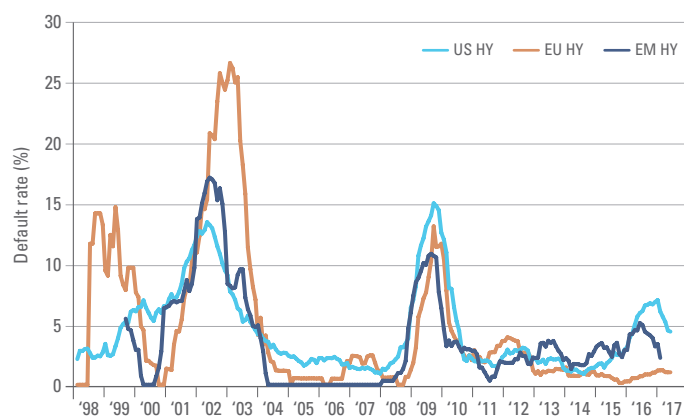
¹ Credit Suisse EM Strategy, 'Non-resident holdings in local currency government bonds: May 2017', 7 July 2017. <https://plus.credit-suisse.com/researchplus/ravDocView?docid=V7f35T2AC-WEIQJP>

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The lesson from Brazil, when it comes to investing, is that crises can be tremendous investment opportunities. This is because the price action during crises tends to be extreme as many investors confuse noise and signal. The headlines are almost always bad, but it is often precisely during such times that the underlying economic and political dynamics begin change in a favourable direction. This insight generalises across EM. The vast majority of EM country-specific crises have turned out to be buying opportunities. Even so, it should never be assumed that crises give way to recoveries. Investment managers must make judgements in each specific case as to whether the crisis in question will end well or not. Serious and well-informed journalistic insight into local political and economic dynamics can clearly be extremely valuable in this context, but frantic overly headline-driven journalistic over-reactions aimed at exploiting investor fears can be directly counter-productive to making sound investment decisions. Investors who focus too much on the noise risk missing important investment signals. The signals can only be extracted from the noise through forward-looking and rational analysis of the deeper economic and political dynamics.

Corporate defaults: Corporate high yield (HY) default rates are now falling faster in EM than in all other regions of the world. The chart below shows corporate HY bond default rates in the US, EU and EM for the period from 1999 thru June 2017 based on data compiled by Bank of America Merrill Lynch. EM corporate HY default rates have declined from a local peak of about 5% in 2016 to just 2.2% as of June 2017.² This compares to an average long-term default rate for EM corporate HY bonds of 3.69%, including restructurings some of which did not involve haircuts. By contrast, US default rates, while also declining, are nearly twice as high at 4.43% and European corporate HY default rates are now rising outright after a long low spell due to extraordinarily low European interest rates.

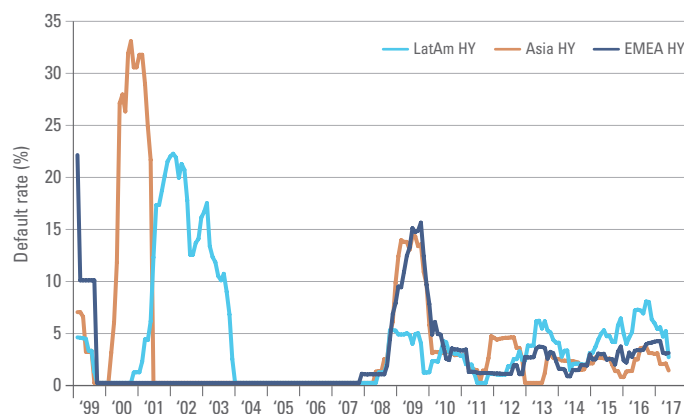
Fig 2: Default rates for HY issuers: US, EU and EM



Source: BAML. As at 30 June 2017

Looking closer within the EM space the chart below shows default rates by EM region. The main observation from this chart is that default rates are falling fastest in Latin America. This makes sense. Over the last few years Latin America was hit more severely than other regions by capital flight (due to lower domestic savings in Latin America), falling commodity prices (Latin America exports more commodities than other regions) and populism (Latin American governments have had more pro-cyclical policies) than other regions. However, Latin America is on the mend. The region is the fastest improving region in terms of GDP and this is beginning to show in sharply declining default rates. EMEA default rates went up a little bit after 2014 due to the problems in Ukraine and the slowdown in the Russian economy, while Asian default rates have been relatively stable. In general neither EMEA nor Asia show serious signs of distress.

Fig 3: Intra-EM regional default rates



Source: BAML

² A similar pattern is evident in JP Morgan's corporate indices, where default rates have fallen to 1.2% annualised June ytd compared to 2.6% for the full year in 2016 and 2.2% for the year 2015.

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Investors would be right to ask how EM default rates stayed so low given what have, after all, been quite serious external shocks in recent years, including the Taper Tantrum, falling commodity prices, Fed hikes and the rising Dollar. There has been no shortage of doomsday merchants either.³ The reasons for EM corporate resilience are many and they include the generally healthy macroeconomic conditions in most EM economies due to lower debt levels, plenty of FX reserves, room to change policies, better demographics, etc. However, there have also been a number of corporate-specific reasons for EM resilience of which the following are the most important:

1. **FX hedging:** Most EM corporates hedge their FX exposures when they borrow overseas unless they have strong revenue streams in Dollars. Hence, the Dollar rally against EM currencies from 2010 to 2015 did not overly rattle them.
2. **Liability matching:** Many EM corporate issuers are exporters with revenue streams in Dollars, so they actually reduce FX mismatches by borrowing in Dollars (since Dollar borrowing creates a Dollar liability stream to match their pre-existing Dollar revenue stream).
3. **Central banks:** Some EM central banks have actively provided Dollars when and where needed. For example, China's authorities were active in making Dollars available to Chinese homebuilders to enable them to refinance Dollar debt in local currency after China's CNY de-pegged from the Dollar.
4. **Local financing:** Foreign financing is actually not very important to most EM corporates. The EM corporate debt universe is USD 10.2trn⁴, but only 18% is in foreign currency. In other words, EM corporates have other financing options.
5. **Leverage:** EM corporates are less leveraged than US companies.
6. **Growth:** EM growth rates have been and remain substantially higher than growth rates in the US and other developed economies.
7. **State-owned oil companies:** Many EM oil companies are state-owned companies, which receive state support when oil prices decline. By contrast, US shale companies go to the wall and default.
8. **Currencies:** The weaker EM currencies in recent years are now helping EM corporates to gain market share, while the strong Dollar has hurt US competitiveness.

- **China:** Stronger than expected real GDP growth in Q2 (6.9% yoy versus 6.8% yoy) this morning is prompting some analysts to upgrade their growth forecasts for China for 2017 and 2018. Despite clear evidence of concerted deleveraging in H1 2017 the economy is holding up well. In other news, the State Council's Finance Work Conference assigned greater powers to the PBOC over macroprudential policy and systemic risk prevention. This is very good news and points to continuation of the ongoing financial sector reforms sponsored by Xi Jinping. The Conference also emphasised continued deleveraging of state-owned enterprises and reiterated the fundamental role of the financial system in the functioning of the overall economy. In other news, industrial production, retail sales, fixed asset investment and the trade balance also beat expectations.

Snippets:

- **Argentina:** The central bank left the policy rate unchanged at 26.25%. Inflation declined to 21.9% in June from 24% in May.
- **Chile:** The central bank kept the policy rate unchanged at 2.5%.
- **Hungary:** Inflation was just 1.7% yoy in June, a new low for the year.
- **India:** Inflation in June was just 1.5% versus 1.7% expected. This is the lowest inflation rate since 2012. Industrial production was 1.7% higher than a year ago versus 2.0% yoy expected.
- **Indonesia:** The trade surplus was USD 1.6bn in June versus USD 0.6bn expected, though mainly due to a seasonal slowdown in imports.
- **Malaysia:** Bank Negara Malaysia kept the policy rate unchanged at 3.0%. Industrial production was stronger than expected (4.6% yoy versus 4.1% yoy expected).
- **Mexico:** Industrial production increased at a rate of 1.0% yoy in May versus 0.3% yoy expected. A consortium of international oil companies announced last week that they had discovered significant new oil fields. We think that this is a direct consequence of Mexico's recent reform of the oil sector.
- **Philippines:** Government infrastructure spending increased at a rate of 31% yoy in May, which indicates that long-awaited investments are now underway. Capital goods imports were also the strongest component of the May import data.
- **Poland:** Inflation was low at 1.5% yoy in June.
- **Russia:** The trade surplus increased to USD 8.5bn in May from USD 8.0bn in April. FX reserves increased to USD 412.2bn in June from USD 405.7bn in May.

³ See for example Martin Wolf's 'The emerging risks of ticking time bombs', Financial Times, 10 December 2013.

⁴ Source: BIS, as at December 2016.

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- **Singapore:** Non-oil domestic exports declined 3.2% in June following a very strong 8.8% growth rate in the month of May.
- **South Korea:** The Bank of Korea left the policy rate unchanged at 1.25%, but increased the growth forecast for this year to 2.8% from 2.6%.
- **Venezuela:** Ratings agency S&P lowered Venezuela's sovereign credit rating to CCC- from CCC, while maintaining a negative outlook. At the weekend, a mock referendum rejected President Maduro's plans to reshape Venezuela's constitution. The mock referendum allegedly attracted a turnout of more than 7 million Venezuelans of which more than 98% rejected Maduro's plans.

Global backdrop

Fed Chairwoman Janet Yellen struck a dovish tone in testimony to the two houses of the US Congress. The change in tone was notable because only a couple of months ago Fed officials were issuing hawkish rhetoric. Now they are dovish again although very little else has changed. Why do Fed officials feel this compulsion to create volatility? The Trump Administration by itself is perfectly capable of generating headlines. Case in point, last week Donald Trump Jr.'s emails raised renewed concerns about illicit links with Russia during the 2016 election campaign. Unfortunately, reforms continue to be neglected. The Trump Administration has so far prioritised the undoing of existing US policy commitments, including the TPP, NAFTA, Obamacare, the Iran deal and the Paris Climate Agreement, without trying to build anything to replace them apart from trade barriers and a wall along the border with Mexico. We think that this policy backdrop should keep growth tepid and monetary policy easy.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.99%	23.29%	24.12%	2.20%	5.31%
MSCI EM Small Cap	1.87%	18.20%	15.85%	1.28%	5.76%
MSCI Frontier	1.17%	16.85%	18.52%	-3.79%	8.54%
MSCI Asia	3.06%	26.62%	26.38%	5.97%	9.13%
Shanghai Composite	1.87%	5.55%	7.64%	18.29%	10.71%
Hong Kong Hang Seng	5.21%	18.34%	23.66%	4.68%	7.14%
MSCI EMEA	4.82%	10.27%	13.54%	-4.31%	0.04%
MSCI Latam	6.80%	17.83%	17.63%	-5.34%	-2.31%
GBI EM GD	1.14%	11.62%	6.02%	-2.58%	-0.57%
ELMI+	0.84%	8.11%	5.00%	-2.08%	-0.26%
EM FX Spot	0.96%	5.43%	0.05%	-8.93%	-6.51%
EMBI GD	0.16%	6.36%	4.03%	5.29%	5.28%
EMBI GD IG	0.02%	5.74%	0.78%	4.31%	3.63%
EMBI GD HY	0.29%	7.07%	7.79%	5.76%	7.48%
CEMBI BD	0.20%	5.21%	5.64%	4.76%	5.30%
CEMBI BD IG	0.11%	4.48%	2.86%	4.07%	4.46%
CEMBI BD Non-IG	0.32%	6.34%	10.11%	5.48%	6.81%

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.56%	11.05%	16.04%	9.82%	15.03%
1-3yr UST	0.10%	0.55%	0.14%	0.74%	0.63%
3-5yr UST	0.15%	1.38%	-0.66%	1.74%	1.16%
7-10yr UST	0.04%	2.43%	-3.49%	2.86%	1.37%
10yr+ UST	-1.01%	4.46%	-8.70%	5.30%	1.91%
10yr+ Germany	-1.05%	-4.86%	-10.60%	5.80%	4.58%
10yr+ Japan	-0.15%	-0.78%	-7.98%	5.29%	4.83%
US HY	0.29%	5.23%	10.03%	4.60%	6.78%
European HY	0.07%	3.42%	7.55%	4.89%	8.92%
Barclays Ag	0.19%	3.34%	1.92%	3.89%	4.19%
VIX Index*	-14.94%	-32.26%	-24.94%	-34.59%	-42.29%
DXY Index*	-0.39%	-6.80%	-1.37%	18.33%	14.73%
CRY Index*	0.86%	-8.43%	-6.66%	-40.83%	-40.37%
EURUSD	0.27%	8.91%	3.44%	-15.30%	-6.81%
USDJPY	0.19%	-3.78%	6.06%	11.28%	42.40%
Brent	2.30%	-13.73%	2.96%	-54.56%	-52.87%
Gold spot	-0.86%	6.82%	-7.37%	-6.70%	-22.26%

*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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