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Update on Venezuela and other EM events

By Jan Dehn

And the winner is…well, investors it would seem when it comes to Venezuela. Bond holders have so far been paid their dues, albeit late, and owners of default protection can also look forward to a payday. If Venezuela continues to pay, the biggest winners may yet be those who bought the dip during the 'market swoon' of the last couple of weeks. This Weekly also discusses India's sovereign upgrade, Zimbabwe's coup, yet more financial reforms in China; a market-friendly candidate emerges as front-runner after the first round of Chile's presidential election and President Mauricio Macri's fiscal deal with provincial governments in Argentina. In the global backdrop we discuss the frightening possibility investors are wrongly looking for bubbles in specific sectors of the economy, when in fact the problem is macroeconomic in nature, i.e. all sectors are mispriced.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	-0.73%
MSCI EM Small Cap	12.9	–	0.04%
MSCI Frontier	11.8	–	0.89%
MSCI Asia	12.4	–	-0.51%
Shanghai Composite	13.1	–	-0.83%
Hong Kong Hang Seng	8.1	–	-1.79%
MSCI EMEA	10.4	–	-0.90%
MSCI Latam	13.6	–	-1.67%
GBI-EM-GD	6.26%	–	0.00%
ELMI+	3.79%	–	0.32%
EM FX spot	–	–	0.13%
EMBI GD	5.35%	297 bps	0.30%
EMBI GD IG	4.10%	169 bps	-0.11%
EMBI GD HY	6.70%	435 bps	0.69%
CEMBI BD	5.10%	281 bps	-0.12%
CEMBI BD IG	4.17%	189 bps	-0.13%
CEMBI BD Non-IG	6.37%	407 bps	-0.09%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.6	–	0.15%
1-3yr UST	1.72%	–	-0.10%
3-5yr UST	2.07%	–	-0.20%
7-10yr UST	2.36%	–	-0.24%
10yr+ UST	2.81%	–	-0.10%
10yr+ Germany	0.37%	–	0.12%
10yr+ Japan	0.04%	–	-0.26%
US HY	5.82%	363 bps	-0.06%
European HY	2.78%	344 bps	-0.46%
Barclays Ag	–	251 bps	-0.26%
VIX Index*	11.68	–	0.39%
DXY Index*	93.73	–	-0.66%
EURUSD	1.1796	–	1.13%
USDJPY	112.61	–	-0.81%
CRY Index*	188.25	–	-3.62%
Brent	62.1	–	-2.28%
Gold spot	1282	–	0.54%

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

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- **Venezuela:** Provided Venezuela continues to pay principal and coupons, even if the payments are late, as Venezuela has been doing so far, then it would seem that everyone could yet emerge a winner from the last two weeks of extreme volatility in that country's bond markets. The most recent bout of volatility was triggered, when market participants, rating agencies and much of the financial media interpreted President Nicholas Maduro's statement that he would "refinance and restructure" Venezuela's external debt to mean that he would default immediately. Bond prices tumbled right away, at one point touching 20 cents on the Dollar, and the weighted spread over US Treasuries on the 21 Venezuelan bonds in the JP Morgan EMBI benchmark fluctuated wildly between 3000bps and 4884bps. Yet, the death of Venezuelan bonds may as yet prove premature. Last week officials repeatedly stated that all due payments on bonds issued by government, PDVSA (the national oil company) and even Electricidad de Caracas (EDC), a PDVSA owned utility, whose bond does not cross-default with other bonds, would be paid in full. Some of payments arrived and others appear to be en route to investors' portfolios. If these payments do indeed arrive then it would seem that bond holders will not lose money, while active buyers of the dip could make very attractive returns over the coming months. Indeed, if spreads stay where they are today and Venezuela continues to service, debt investors can reasonably expect to make more than 30% in Dollar terms between now and the next principal repayment in August 2018.

The volatility of the past couple of weeks was to some extent justified. After all, payments were indisputably late. However, there is arguably a difference between inability and unwillingness to pay on one hand and paying late on the other. Moreover, there is a good explanation for the late payments. Sanctions recently imposed on Venezuela by US President Donald Trump continue to severely interrupt the normal payment mechanisms. A situation where government ability and willingness to pay were both intact, but payments were held up by actions taken by third parties is not without precedent: a few years ago a judge in New York

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issued an injunction barring financial intermediaries from processing payments on Argentinian debt. Argentina paid in full once the injunction was lifted. CDS was triggered, but bonds holders never accelerated and investors were eventually paid in full.

Last week the International Swaps and Derivatives Association (ISDA) similarly ruled that a credit event had taken place, which means that owners of Venezuelan default protection (credit default swaps, or CDS) will also have a pay day. This is akin to being paid on your car insurance, when your car is, so far at least, intact. This is possible because the payments delays constitute a credit event under the rules governing CDS. However, CDS and bonds are completely different contracts, so the declaration of a credit event in CDS has no impact on the status of the bonds, where de facto a default only occurs if a sufficient number of bond holders chose to accelerate one or more bonds.

So has Venezuela defaulted? The financial press wasted no time confirming whether the bond cash flows will be paid or not. They leapt to the conclusion that a default had happened ("Venezuela goes bust" screamed the Wall Street Journal's Editorial Board, while the Financial Times claimed that "Venezuela slips deeper into crisis after default"). Ratings agencies were also quick to the trough, downgrading both the sovereign and PDVSA, though, as usual, the downgrades happened after bonds had already tumbled. It was noticeable that there was no consistency across ratings agencies as to which bonds – sovereign or PDVSA – were downgraded and as to whether the trigger for downgrades were missed deadlines on coupons or missed deadlines on principal payments. The lack of consistency here is clearly a source of risk for investors, who pin their faith on the opinions of these institutions.

In retrospect, the events in the Venezuelan bond market of the past couple of weeks are far from unique. Many similar events have taken place in the past. Four general observations can be made about such events. First, the volatility of asset prices during the event often turns out to be far greater than actual riskiness, that is, permanent losses (of which there have so far been none in this case). Second, banks, the media and even ratings agencies waste no time in getting on the side of the market momentum and thus typically end up reinforcing herd dynamics rather than throwing genuine light on proceedings. Third, the true nature of what went on is often obscured until long afterwards and then rarely explained as attention has shifted elsewhere. It is noticeable that in this case there has been precious little attention paid to the fact that President Maduro repeatedly stated that he had no intention to default. Nor did the media show much interest in the possibility that Maduro's comments may have been intended for domestic consumption, which would have made them far less alarming. After all, it is almost certain that it was claims made by the opposition in Venezuela that Maduro was hurting Venezuelans by not refinancing the debt, which prompted Maduro to raise the whole issue of refinancing. Maduro's public display of trying to refinance may have been done to demonstrate that it is precisely impossible to do so because of US sanctions, which have been publicly supported by members of the opposition.[1] In other words, there may not have been an intention to default at all, merely an elaborate political scheme to deflect criticism back upon the opposition. If so, we should know in the coming days and weeks. If the payments do indeed come in, then Venezuelan bonds have been severely mispriced in recent weeks and now constitute an excellent buying opportunity.

- India: Moody's upgraded India's sovereign credit rating from Baa3 to Baa2. This is good and unexpected news. This is not just late ratings action long after India's recent efforts at structural reform. Rather, Moody's appears to have taken a genuinely forward-looking stance. First, Moody's has upgraded India one step further than the other two global ratings agencies. Second, the timing is quite bold as the upgrade comes after a bout of poor market price action and negative data surprises, including this week a wider than expected current account deficit and higher than anticipated inflation. We think Moody's is right to look through the short term noise. The data misses are moderate and from a low base. They can also partly be attributed to higher oil prices and recent negative global sentiment towards EM as well as profit-taking after a long sustained rally. There is no reason to suspect that India's macro story is coming off the rails. Instead, India stands to gain significantly going forward from the reforms it has already undertaken, but which have barely had time to bear fruit. Prime Minister Modi's demonetisation, initially slated as a failure, has forced many people into the formal sector. The adoption of unique electronic identification cards ('aadhaar') for recipients of subsidies has reduced informality by inducing more than 110 million people to open bank accounts, the benefits of which will play out over years, even decades as business potential grows and the tax base widens. Tax reform (GST) has laid the foundations for greater trade between states within India and hence opened up for greater economies of scale in business. The recent announcement of bank recapitalisation is also hugely significant and may ultimately pave the way for greater economic openness. In addition, the government has improved conditions for doing business by cutting red tape. India has begun to move higher in the ease of doing business rankings. The credibility of monetary policy has been greatly improved. Most importantly, there are no obvious and serious imbalances in the Indian economy. Hence, short term jitters are not justified. Moody's is right to look through the fog to the clearer skies beyond.

[1] We highlighted this interpretation of Maduro's actions in *'Playing for time in Venezuela'*, Weekly Investor Research, 6 November 2017.

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- **Zimbabwe:** President Robert Mugabe's long spell in charge appears to be over following a coup, though it may take some time before his long and strong grip on power is finally fully relinquished. Like many other African first-generation presidents Mugabe oversaw a catastrophic economic collapse as he concentrated power into his own hands, often at enormous human cost. Unlike other first-generation African presidents, however, Mugabe can make no excuses for his misrule. Zimbabwe obtained independence more than a decade after most other African countries, so Mugabe was in a position to learn from the lessons of others, yet chose not to do so. Mugabe will go down in history as a failure and his only contribution will be the lesson his misrule can offer others. The majority of African countries became far more politically and economically accountable since the end of the Cold War. Second and third generation post-independence leaders have generally been far better leaders than their predecessors.

- **China:** The government continues to move to rapidly reform capital markets following the recently concluded Party Conference (last week we reported on the lifting of foreign ownership rules). In the past week the People's Bank of China took yet another meaningful step forward by issuing new rules for the asset management industry. The importance of this announcement lies in the fact that the asset management industry is going to be a critical part of the shift to consumption-led growth in China. Savers need access to better and more diverse investment opportunities in order to stabilise savings and thus erode precautionary motives for high savings rates. The measures announced by PBOC last week included defining leverage ratios for open and close ended funds, setting rules for maximum single investments and introducing parameters for various risk management operations. The overall objective is to move towards a single set of regulations for all asset management in China with proper supervision. In other developments, fixed asset investment, retail sales and industrial production all slowed marginally in October, though mainly due to fewer working days in the month. Monetary indicators were correspondingly lower too.

- **Argentina:** Last week president Mauricio Macri reached an agreement on fiscal policy for next year with all but one of 24 provincial governors. As is usually the case, provinces won out at the expense of the central government. Taxation in provinces will now decline over the next five years in exchange for a promise to keep spending stable as provinces will receive a share of central government tax revenues. Solvency at central government level is no issue at all in Argentina at this point, but it is important to understand that the extraction of fiscal rents by provinces is the fundamental reason why Argentina has been a serial defaulter for so many years. The extraction of rents from the central government is ultimately rooted in an imbalance of power between the central government and provinces enshrined in the Constitution. No central government so far has been able to alter this imbalance. Macri's government is no exception, but at least it has a lot of time until it goes bust again. In other news, CPI inflation was 1.5% mom in October and core inflation ran at 1.3% mom. It was positive relative to expectations that core inflation declined by 0.3% from last month.

- **Chile:** In Chile's presidential election first round ballot on Sunday, former President Sebastian Piñera of the 'Vamos Chile' centre-right coalition came first with 36.6% of the votes. He achieved a significant lead over second place Senator Alejandro Guillier of the incumbent 'Nueva Mayoria' (centre-left) coalition, who garnered 22.7% of the votes. Although there was little doubt that Piñera would lead after the first round, he fell well short of the expected 40% of the votes, while the traditional leftist candidate Beatriz Sanchez of 'Frente Amplio' surpassed her expected tally by some 5% to reach 20.3% of the votes. The overall message is that Chile seems to echo the changes seen in many European countries, where the left wing is splitting and its more extreme fringe is gaining in popularity at the expense of incumbent centre left parties. The move should not prevent Piñera from winning in the run-off on December 17th, but his margin for error is a lot smaller than was anticipated.

Snippets:

- **Brazil:** Retail sales picked up strongly in September. The broad measure of retail sales was 9.3% higher than in the same month last year, while core retail sales were 6.4% higher than last year.
- **Colombia:** The rate of real GDP growth was 2.0% yoy in Q3 2017 compared to 1.2% yoy in Q2 2017. The trade deficit narrowed to 2.7% of GDP in September from 3.0% of GDP in the month of August.
- **Czech Republic:** Q3 GDP growth was strong at 5.0% yoy versus 4.7% yoy expected.
- **Indonesia:** The central bank left the policy rate unchanged at 4.25% with neutral bias. Exports increased at a rate of 18.4% yoy in October versus 15.4% yoy expected.
- **Malaysia:** The real GDP growth rate was 6.2% yoy in Q3 2017 versus 5.8% yoy in Q2 and 5.7% yoy expected.
- **Mongolia:** Fitch revised the outlook on Mongolian sovereign debt to positive from stable. The rating was kept at B-.
- **Peru:** September delivered a better than expected growth rate of 3.2% yoy compared to 2.5% yoy in August, according to the monthly activity indicator.
- **Philippines:** The economy expanded at rate of 6.9% yoy in Q3 2017 versus 6.6% yoy expected. Remittances declined in September.

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- **Poland:** The real GDP growth rate was 4.7% yoy in Q3 versus 4.5% yoy expected and 3.9% yoy in the previous quarter. The rate of headline inflation moderated to 2.1% yoy in October from 2.2% in September. Core inflation remained low and stable at 1.0% yoy.
- **Romania:** Romanian GDP growth in Q3 was a very strong 8.8% yoy versus 6.2% yoy expected.
- **Russia:** The rate of real GDP growth slowed to 1.8% yoy in Q3 2017 from 2.5% yoy in Q2 2017.

Global backdrop

Everyone knows that the next crisis will not look like the last one. Everyone knows investors will miss the warning signs because they will be looking in the wrong place. We do not claim to see what others cannot see, but there is at least one glaring lacuna in investors' current efforts at spotting the next crash, namely that most still seem to be looking for sector problems when the real issue may be macroeconomic in nature. The fact is that over the past thirty years investors have become accustomed to looking for bubbles within particular sectors of the economy, because every major upheaval over this period has, without exception, been sector specific in nature. Famous examples include savings & loans, telecoms, dotcom, banks or subprime housing. By contrast, conventional macroeconomic problems, such as inflation, declining productivity, overvalued exchange rates and generalised mispricing of assets – economy wide bubbles – have not been in evidence since the 1970s. The market regularly gets jitters about particular sectors; last week's US high yield jitters being a perfect case in point. However, so far no single sector has been identified as vulnerable enough compared to other sectors to warrant specific concern. Yet, we would argue that the mere fact that investors fail to spot trouble in a single sector should not be grounds for comfort: the reason why no single sector stands out may be that all the sectors are mispriced.

Statisticians are fond of using the term 'fallacy of composition' to describe the practice of wrongly inferring to the whole what is true for a single part. However, it is also possible to have the opposite of fallacy of composition, call it fallacy of disaggregation, which means a failure to infer to the group level what is true at the level of the individual parts. We think fallacy of disaggregation may well be pervasive at this moment in time. Mispricing of assets is pervasive across the entire financial space within developed markets after years of direct stimulus into financial markets via Quantitative Easing (QE). Neglect of economic reforms has only worsened the problem of mispricing. If investors mainly evaluate risks in one sector by comparing pricing to that in another sector they are likely to miss the generalised mispricing problem caused by QE, because all the sectors are mispriced. QE has pushed all asset prices deeply into overvalued territory, be they bonds, stocks, currencies, credit.

If you feel sceptical about this, stop for one second and consider the following statistics: In 2007 a German 30 year bond yielded 3.5%, today the yield is 1.3%. Real yields are negative across trillions of dollars of developed market bonds. In fact, yields are so low that should yield curves return to their 1990-2007 average it would wipe out 11 years of carry in US 10 year bonds, 71 years of carry in German 10 year bonds and 766 years of carry in Japanese 10 year bonds. The problem is not just confined to government bonds. In 2007 US junk bonds yielded 8.3%, today they yield 5.6%, but with twice the default rate. In 2007 the S&P 500 was 1525, today stocks trade at 2585 at a P/E just shy of 22. In 2007, the broad Dollar index was 80 today it is 94, yet the US debt stock has now hit 107% of GDP compared to just 60% at the turn of the century. Average growth rates have also declined by nearly 40% in real terms as productivity growth has declined sharply. As if that was not enough, central banks have almost no room to cut rates, certainly not enough room to cure a recession, and politics has become far more populistic with negative consequences for the quality of economic policies. If the value proposition currently on offer in developed markets had been offered to a rational investor in 2007 he or she would have run screaming to the hills. Yet, today everyone acquiesces in these valuations.

There is still a failure to recognise that QE was the largest and most distortionary intervention ever made by governments in financial markets. The four central banks bought 15% of all outstanding bonds in the entire world, but they did not buy pro-rata across all the world's bond markets. Rather, they only bought their own government bonds. This triggered a highly selective rally in a subset of global financial markets, notably in US stock markets, in the Dollar and in European bonds. As QE is now slowly being reversed the most overvalued assets offer far less scope for capital gain and many offer no yield at all. Hence, the best way to trade the unwinding of QE is to simply reverse the QE trades. The only markets in the world, which did not benefit from QE – in fact suffered outflows under QE – were Emerging Markets. In direct contrast to the QE sponsored markets in the developed world, EM markets today offer the best technicals, stronger growth, higher yields and more currency upside. Ultimately, they are less risky. This is why we continue to expect EM asset classes broadly to outperform the QE markets over the next few years, as indeed they have done this year and in most of 2016 too.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.59%	33.38%	36.31%	7.14%	5.84%
MSCI EM Small Cap	0.36%	27.46%	27.44%	5.76%	6.10%
MSCI Frontier	-0.37%	25.88%	27.58%	1.47%	9.01%
MSCI Asia	1.29%	39.15%	39.22%	9.86%	9.49%
Shanghai Composite	0.17%	11.78%	8.25%	13.18%	13.71%
Hong Kong Hang Seng	0.23%	27.68%	28.13%	6.21%	6.47%
MSCI EMEA	0.24%	13.40%	23.98%	-0.37%	-0.24%
MSCI Latam	-2.42%	19.48%	22.89%	0.55%	-2.03%
GBI EM GD	-0.13%	10.91%	12.47%	-0.59%	-1.51%
ELMI+	0.37%	9.14%	9.37%	0.33%	-0.63%
EM FX Spot	0.07%	3.52%	3.98%	-6.67%	-6.95%
EMBI GD	-0.58%	8.76%	9.77%	6.04%	4.67%
EMBI GD IG	-0.09%	8.22%	8.32%	4.54%	3.23%
EMBI GD HY	-1.03%	9.39%	11.41%	7.52%	6.52%
CEMBI BD	-0.33%	7.24%	8.11%	5.34%	4.79%
CEMBI BD IG	-0.30%	5.74%	5.83%	4.07%	3.89%
CEMBI BD Non-IG	-0.37%	9.46%	11.59%	7.11%	6.26%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.57%	17.57%	21.20%	10.50%	16.12%
1-3yr UST	-0.13%	0.49%	0.41%	0.60%	0.59%
3-5yr UST	-0.17%	1.25%	0.79%	1.37%	1.03%
7-10yr UST	0.06%	2.73%	1.39%	2.14%	1.32%
10yr+ UST	1.15%	7.27%	4.70%	4.14%	2.64%
10yr+ Germany	-0.45%	-2.45%	-2.42%	3.92%	5.25%
10yr+ Japan	0.47%	0.05%	-1.56%	4.57%	5.03%
US HY	-0.82%	6.58%	9.41%	5.41%	6.25%
European HY	-0.65%	5.79%	8.05%	5.64%	7.74%
Barclays Ag	-0.24%	4.87%	5.20%	3.87%	3.73%
VIX Index*	14.73%	-16.81%	-12.51%	-16.51%	-28.82%
DXY Index*	-0.87%	-8.29%	-7.09%	6.61%	15.35%
CRY Index*	0.37%	-2.22%	3.18%	-29.61%	-35.87%
EURUSD	1.29%	12.13%	11.01%	-5.25%	-7.43%
USDJPY	-0.91%	-3.75%	2.26%	-3.46%	38.48%
Brent	1.14%	9.24%	33.51%	-21.74%	-43.03%
Gold spot	0.89%	11.30%	5.42%	8.08%	-25.17%

*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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