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A US recession draws nearer

By Jan Dehn

Why are Chinese stock markets and CNH under so much pressure when China's fundamentals are so healthy? We suggest global factors are to blame along with impediments to trading that distort valuations materially. Iran joins the family of nations. Poland is downgraded for political rather than economic reasons. Russia delivers a fiscal response to a narrowing trade surplus. Venezuela's opposition blinks. Petrobras cuts its capex program. Argentina prepares for negotiations with holdout investors. In the global backdrop section we discuss the implications of the US hurtling towards recession.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.1	–	-4.17%
MSCI EM Small Cap	9.9	–	-5.34%
MSCI Frontier	7.7	–	-4.85%
MSCI Asia	9.8	–	-3.84%
Shanghai Composite	10.4	–	-8.96%
Hong Kong Hang Seng	5.7	–	-6.89%
MSCI EMEA	7.3	–	-6.64%
MSCI Latam	9.5	–	-2.91%
GBI-EM-GD	7.13%	–	-0.80%
ELMI+	5.80%	–	-0.87%
EM FX spot	–	–	-0.87%
EMBI GD	6.71%	466 bps	-1.53%
EMBI GD IG	5.22%	310 bps	-0.99%
EMBI GD HY	9.09%	718 bps	-2.23%
CEMBI BD	6.59%	474 bps	-0.81%
CEMBI BD IG	4.88%	303 bps	-0.34%
CEMBI BD Non-IG	9.70%	785 bps	-1.61%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	13.6	–	-2.15%
1-3yr UST	0.85%	–	0.25%
3-5yr UST	1.45%	–	0.45%
7-10yr UST	2.04%	–	0.73%
10yr+ UST	2.81%	–	1.72%
10yr+ Germany	0.54%	–	0.94%
10yr+ Japan	0.21%	–	-0.26%
US HY	10.00%	850 bps	-2.63%
European HY	6.40%	642 bps	-1.13%
Barclays Ag	–	226 bps	-0.16%
VIX Index*	27.02	–	0.01%
DXY Index*	99.04	–	0.31%
EURUSD	1.0891	–	0.29%
USDJPY	117.38	–	-0.32%
CRY Index*	159.93	–	-8.64%
Brent	29.3	–	-7.29%
Gold spot	1090	–	-0.35%

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

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- **China:** Banks and sections of the media continue to bleat about China's role in the global equity market sell-off. From a fundamental perspective, this fascination with China as a driver of global weakness borders on the surreal. After all, few investors in the developed markets have any exposure in China at all, while they are loaded up on US stocks. There is a similarly negative entrenched view about China's currency, that China needs a materially weaker RMB.

Clearly, the fundamentals do not justify such pessimism. China is running a current account surplus of USD 60bn per month, has USD 3.3trn of reserves and real rates that are far higher than in developed markets. Most FX mismatches on corporate balance sheets in China were neutralised last year. Chinese growth is far stronger than in most developed economies and inflation is roughly the same. Lastly, the property market is very healthy with sales up 63% yoy in 2015 in Tier 1 cities and 34% higher yoy in Tier 2 cities. Only 2 developers out of 38 had negative sales in 2015 and 27 met or exceeded sales targets. Loans to the real economy rose strongly to RMB 1820bn in December from RMB 1018bn in November.

Still, there is no denying the pressures in both the stock and Renminbi (RMB) markets. So what accounts for this weakness? Consider first the currency. FX has now become the dominant global asset class, in a sense that what happens in FX markets largely drives sentiment in other financial markets. This did not use to be the case, but repeated doses of QE have pushed yields to zero and at this threshold the marginal unit of capital will flow into the FX markets rather than bond markets. After all, at zero yield bonds and currencies pay the same (i.e. nothing), but currencies are more liquid and have no credit risk. Hence, the focus in general is on currencies. Next, consider that RMB is now a global reserve currency, but so far the only Emerging Markets (EM) currency in this elite group of currencies. Thus, whenever global sentiment turns negative RMB becomes a target in a market that still trades according to simplistic rules of thumb.

China itself is also partly to blame. It is still far too difficult for foreign investors to enter China's domestic markets. For many, staying offshore and simply expressing a risk on/risk off sentiment in the CNH market is

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still by far the easiest choice. The RMB also takes its cue from the performance of the domestic stock market in China. This market too is excessively volatile relative to fundamentals, because Chinese retail investors do not have good access to bonds, a market that absorbs capital in bear market conditions for stocks. The result is that onshore investors either seek to short stocks outright or short the RMB.

The fact that RMB has become a popular way in the world to express negative risk appetite, regardless of China's fundamentals, is not a comfortable situation for China. China's fundamentals are good, but markets are trading anything but Chinese fundamentals. This poses a challenge: China wants to make its currency more market determined as part of the qualification for RMB inclusion in the SDR, but when currency markets trade so irrationally then China's authorities have no choice but to intervene. At this point, they are immediately accused of backpedalling on their commitment to a more flexible currency.

China can take comfort in the fact that this is only a temporary problem. As China accelerates its liberalisation efforts and institutional participation becomes more important in all China's markets then the current inefficiencies will gradually wane. The real risk facing China is excessive currency appreciation. QE will eventually trigger inflation and currency weakness in the countries pursuing such policies. When this happens, the RMB will come under constant pressure to appreciate against the QE currencies. It is important that investors and the Chinese authorities alike continue to keep their eyes firmly on this particular risk. This is why China must continue to reform, even in the face of short-term speculative pressures. China is travelling in the right direction and those investors that buy a business ticket for the whole journey are more likely to end up richly rewarded than those cling to the handrails for a short ride.

- Iran: Iran has satisfied the conditions for sanctions to be lifted, according to the UN. For international investors, this presents opportunities and poses some new risks. Iran's return to the family of nations means that the EM universe is continuing to grow. Iran's journey out of international isolation will take some time, but the prospect is exciting. Iran has a population greater than that of France and a very well diversified economy after years of self-reliance under sanctions. Iranian businesses will now be seeking external financing and international investors are likely to respond. On the other hand, Iran will be facing challenges due to very low prices globally and tensions within the wider region remain high. Saudi Arabia and other powers in the region will not be comfortable with Iran's return to the mainstream. The new US Middle East policy of dividing the region along Sunni-Shia lines instead of along Arab-Israeli lines will benefit Iran for now, but poses a threat to Saudi Arabia and others. The risk associated with dividing a region along politically sensitive lines is that countries try to force a show of allegiance, which could well increase tensions regionally.

- Poland: S&P, a ratings agency, downgraded Poland's sovereign debt rating from A- to BBB+ with negative outlook. The reason for the downgrade is difficult to understand from the perspective of Poland's ability and willingness to service debt. Rather than focusing on those, S&P cited Poland's weaker institutions in the aftermath of the election of the nationalist Law and Justice Party (PiS). PiS has appointed new Supreme Court judges, changed the rules governing the appointment of senior officials on the board of public broadcasters and altered the structure of the civil service. It is difficult to see how this will materially impact bond holders, however. EU has initiated Rule of Law Framework, a review of institutions in Poland, but the framework is not binding. S&P expects Poland's growth rate to remain strong at an average of 3.3% between now and 2018 and for the public debt to remain stable at 51% of GDP through 2018. Net external debt is likely to fall to just over 50% of current account receipts, according to the ratings agency.

- Russia: The trade surplus in H2 2015 declined to USD 9.5bn from USD 14.6bn in H1 2015. The erosion in the trade balance suggests that a further spending restraint may be required following the continuation of the fall in oil prices. In response, the economy issued revised forecasts for the public finances. The government is now working with a forecast based on oil prices at USD 40 per barrel and a mild contraction of the economy in 2016. The Central Bank of Russia expected inflation to fall to 7% in 2016, based on a view that oil prices will average USD 35 per barrel. Inflation was 12.9% yoy in December, down from 15% yoy in November.

- Venezuela: The opposition blinked last week, accepting a Supreme Court ruling to disallow three National Assembly deputies from taking their seats. The ruling in effect reduces the opposition majority to just below two-thirds of the parliament. Venezuela's Supreme Court has been stuffed with allies of President Maduro, while the National Assembly is controlled by the opposition. The two institutions effectively define the battleground in Venezuelan politics. This is better than fighting on the streets, but it is not a stable situation. The leader of the opposition has stated that his objective is to remove Maduro from power.

- Brazil: Petrobras, the state-owned oil company, will cut spending by 36% in the 2017-2019 period, according to the company. The resulting saving will be around USD 10bn. Petrobras has USD 24bn falling due in debt repayments over the next two years. Moody's, a ratings agency, commended Petrobras for the spending cuts, which helps to preserve cash in a time of elevated refinancing risks.

- Argentina: The government will submit a proposal to settle the dispute with holdout investors this month, according to Finance Secretary Luis Caputo. Holdout investors are also expected to submit a proposal. Negotiations to find a proposal acceptable to both sides can then begin. Finance Minister Alfonso Prat Gay presented the government's fiscal and inflation targets for 2016-2019. The government aims to bring inflation down gradually from just below 30% today to a range between 3.5% and 6.5% by 2019. The primary deficit

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will be reduced at a gradual pace of 1.5% of GDP per year to reach 0.3% of GDP by 2019. We expect the overall deficit – which includes interest payments – to decline more slowly than the primary deficit as Argentina begins to tap international debt markets following an agreement with holdout investors.

- Taiwan: The Democratic Progressive Party (DPP) won a landslide victory in presidential and parliamentary elections held at the weekend. DPP's absolute parliamentary majority under the leadership of President-elect Tsai Ing-wen bodes well for the reform outlook. Initial statements suggest that policies towards China will remain cordial, if more pragmatic than under the former KMT administration.

Snippets:

- Brazil: Retail sales rose 1.5% mom in November versus -0.8% mom expected.
- Chile: The central bank left rates unchanged at 3.5% in line with expectations.
- Guatemala: The economy expanded at a pace of 4.1% yoy in November, unchanged from the previous three months.
- Hungary: Inflation rose to 0.9% yoy in December from 0.5% yoy in November due to changing fuel prices. Core inflation was unchanged at 1.4% yoy.
- India: Core inflation rose marginally from 4.6% yoy in November to 4.7% yoy in December. The new inflation targeting system starts this month. The Reserve Bank must explain itself to the government if inflation breaches a 4% +/-2% target range for more than 3 consecutive quarters.
- Indonesia: The trade balance was marginally in the red in December. The USD 230m deficit occurred, because capital goods imports rose more than expected in response to a pick-up in public works. Capital goods imports are a leading indicator of growth. Bank Indonesia cut policy interest rates by 25bps, which took the three policy rates to 7.25%, 5.25% and 7.75%, respectively.
- Peru: The central bank hiked the policy rate by 25bps to 4%.
- Philippines: Exports surged at a 15.5% mom pace in November. The pick-up in exports was broad-based.
- South Africa: Manufacturing was stronger than expected, but still in contractionary territory in December. PMI was 45.5 vs 45 expected. South African mining output was higher than anticipated.
- South Korea: The Bank of Korea left rates unchanged at 1.5%.

Global backdrop

The US appears to be hurtling towards recession. Atlanta Fed has now revised Q4 growth to just 0.6% qoq annualised, a hair's breadth away from negative growth. The data published so far in 2016 does not provide grounds for optimism, especially following a shockingly soft retail sales print and poor inventory data.

A lot of global capital is now tied up in long US dollar and long US stock market positions. These positions have been put on in anticipation of stronger US growth and Fed hikes; but if, in response to a weakening economy, the Fed must reverse its December hike and perhaps even go to negative rates instead of hiking four times in 2016 then the outlook for the US dollar is not good. It is, after all, the only remaining policy instrument available to US authorities. New York Fed Chairman William Dudley said last week that the Fed would consider negative rates if the economy weakened.

The US needs more than monetary stimulus. It needs supply-side reforms, higher productivity, less debt and external rebalancing. Sadly only a weaker Dollar looks remotely possible, given the Administration's complete lame duck status vis-à-vis Congress. The silver-lining is that the US government no longer runs 10% of GDP fiscal deficits, so foreign demand is no longer essential to financing the deficit, at least as long as rates remain very low. In turn, this means that the Dollar can be weakened without affecting refinancing operations.

The advantage of letting the Dollar go would be that it would push up oil prices and therefore help the beleaguered US energy sector, while also stimulating manufacturing (which is already in recession).

Foreign savers with investments in Dollar beware. A weaker Dollar would pass the cost of US economic adjustment to foreign central banks, thus highlighting the importance of diversifying foreign exchange reserves away from the Dollar.

A weaker USD would be very good for growth and the efficiency of global asset allocation. Capital flows have blindly followed the Dollar, in spite of fundamentals. The result has been a very counter-productive redistribution of global capital towards the already over-indebted and very expensive growth challenged developed countries from EM economies with far more potential to drive global growth. No wonder global growth has weakened. Neither the US nor Europe have achieved anything near 'exit velocity' despite sucking in enormous volumes of capital. US stocks are now struggling to perform, while nearly half of European

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Global backdrop

government bonds pay negative yields. Where is the growth dividend? The US economy has only managed to grow at a very disappointing 2% pace for more than half a decade, despite massive stimulus. Controlling for population growth differences, Europe's growth rate has been very similar. Neither region shows signs that things will look up anytime soon.

The policy of throwing good money after bad has obviously caused growth to slow in EM countries, not least because their economies have been forced to adjust to big changes in exchange rates and cope with tighter financing conditions. The good news is that EM economies have held up well in spite of these challenges, avoiding large numbers of defaults, balance of payments crises, and IMF emergency support programs. The rebalancing which has taken place now makes them much more competitive and gives them room to grow.

The way to get global growth back is to allocate the marginal unit of capital to those countries that can produce the largest growth dividend. This would weaken QE currencies, notably the Dollar, but that would be good for US energy and US manufacturing. Capital would flow back to EM countries, where it is needed and pays far better yields (bond yields in EM are now higher than when the Fed had interest rates at 5.375%). For more details on this see *"How to get global growth back"*, Market Commentary, October 2015.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-10.68%	-10.68%	-24.24%	-10.52%	-6.82%
MSCI EM Small Cap	-9.76%	-9.76%	-16.66%	-5.95%	-5.09%
MSCI Frontier	-7.83%	-7.83%	-18.55%	0.38%	-1.68%
MSCI Asia	-9.90%	-9.90%	-19.37%	-4.56%	-2.33%
Shanghai Composite	-18.03%	-18.03%	-11.68%	10.51%	3.27%
Hong Kong Hang Seng	-14.75%	-14.75%	-30.36%	-8.41%	-5.61%
MSCI EMEA	-13.40%	-13.40%	-30.29%	-17.18%	-11.19%
MSCI Latam	-11.07%	-11.07%	-36.38%	-22.97%	-16.18%
GBI EM GD	-2.56%	-2.56%	-17.71%	-10.88%	-3.83%
ELMI+	-2.56%	-2.56%	-8.94%	-6.59%	-3.59%
EM FX Spot	-2.86%	-2.86%	-19.14%	-14.10%	-9.92%
EMBI GD	-1.77%	-1.77%	-0.71%	0.42%	4.82%
EMBI GD IG	-0.90%	-0.90%	-2.69%	-0.10%	4.26%
EMBI GD HY	-2.89%	-2.89%	2.31%	1.15%	5.68%
CEMBI BD	-0.73%	-0.73%	0.47%	1.34%	4.11%
CEMBI BD IG	-0.21%	-0.21%	0.21%	2.05%	4.76%
CEMBI BD Non-IG	-1.64%	-1.64%	1.20%	-0.09%	3.00%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	-7.93%	-7.93%	-3.63%	10.78%	10.07%
1-3yr UST	0.47%	0.47%	0.62%	0.48%	0.69%
3-5yr UST	1.18%	1.18%	0.70%	1.52%	2.05%
7-10yr UST	2.09%	2.09%	0.38%	2.37%	5.32%
10yr+ UST	3.76%	3.76%	-4.30%	4.47%	9.92%
10yr+ Germany	2.51%	2.51%	-0.56%	7.99%	9.75%
10yr+ Japan	0.67%	0.67%	1.27%	6.16%	5.51%
US HY	-2.97%	-2.97%	-7.77%	0.27%	4.39%
European HY	-1.36%	-1.36%	-0.46%	5.37%	8.57%
Barclays Ag	0.36%	0.36%	-1.42%	2.53%	4.63%
VIX Index*	48.38%	48.38%	28.97%	116.85%	70.26%
DXY Index*	0.41%	0.41%	7.05%	23.74%	25.43%
CRY Index*	-9.20%	-9.20%	-28.68%	-46.90%	-52.08%
EURUSD	0.27%	0.27%	-6.16%	-18.24%	-18.65%
USDJPY	-2.36%	-2.36%	-0.15%	30.28%	42.18%
Brent	-21.54%	-21.54%	-41.70%	-73.86%	-70.09%
Gold spot	2.76%	2.76%	-14.52%	-35.26%	-20.31%

*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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