# Ratings, adversity and EM policy responses

By Jan Dehn

Russia is investment grade again. The roundtrip in Russian sovereign ratings is testimony to the fact that ratings agencies pay more attention to the sources of adversity rather than the policy response to adversity when it comes to Emerging Markets (EM) countries. This is bad practice, because it makes ratings agencies little better than momentum jockeys with official regulatory recognition. It is time that ratings agencies start to use their privileged access to EM policy-makers to make judgements about the likely quality of policy responses rather than merely seeking to be on the right side of the momentum all the time.

| Emerging Markets | Next year forward PE/Yield | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| MSCI EM | 11.7 | – | 1.42% |
| MSCI EM Small Cap | 11.6 | – | 1.55% |
| MSCI Frontier | 11.4 | – | 0.51% |
| MSCI Asia | 12.1 | – | 1.49% |
| Shanghai Composite | 11.2 | – | 5.09% |
| Hong Kong Hang Seng | 7.3 | – | 3.87% |
| MSCI EMEA | 10.5 | – | 0.65% |
| MSCI Latam | 13.1 | – | 1.81% |
| GBI-EM-GD | 6.05% | – | -0.34% |
| ELMI+ | 3.70% | – | -0.44% |
| EM FX spot | – | – | -0.60% |
| EMBI GD | 5.72% | 284 bps | -0.14% |
| EMBI GD IG | 4.48% | 159 bps | -0.16% |
| EMBI GD HY | 6.99% | 413 bps | -0.11% |
| CEMBI BD | 5.43% | 261 bps | -0.06% |
| CEMBI BD IG | 4.50% | 169 bps | -0.02% |
| CEMBI BD Non-IG | 6.56% | 374 bps | -0.11% |

| Global Backdrop | Next year forward PE/Yield/Price | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| S&P 500 | 16.0 | – | 0.62% |
| 1-3yr UST | 2.23% | – | 0.04% |
| 3-5yr UST | 2.60% | – | 0.14% |
| 7-10yr UST | 2.85% | – | 0.28% |
| 10yr+ UST | 3.13% | – | -0.14% |
| 10yr+ Germany | 0.65% | – | 0.83% |
| 10yr+ Japan | 0.05% | – | 0.24% |
| US HY | 6.18% | 344 bps | 0.25% |
| European HY | 2.89% | 364 bps | -0.19% |
| Barclays Ag | – | 249 bps | 0.01% |
| VIX Index* | 16.51 | – | -2.95% |
| DXY Index* | 89.74 | – | 0.64% |
| EURUSD | 1.2322 | – | -0.69% |
| USDJPY | 106.81 | – | 0.21% |
| CRY Index* | 196.47 | – | 2.89% |
| Brent | 67.0 | – | 1.98% |
| Gold spot | 1338 | – | -0.66% |

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

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- **Russia:** Should ratings agencies change their EM sovereign ratings in response to adversity or should their ratings decisions pay more attention to the policy response to the adversity? This question is worth thinking about as ratings agency S&P last week returned Russia´s sovereign debt credit rating to investment grade. S&P upgraded Russia to BBB- with stable outlook, which concludes a round trip which saw the agency downgrade Russia in response to a plethora of external shocks starting in 2014. There is no doubt that S&P downgraded Russia in response to the external shocks it faced; namely the severe deterioration in market sentiment towards the credit due to the decline in oil prices, the sanctions which were imposed on a number of Russian institutions and Russia´s dispute with the West over Crimea and Eastern Ukraine. Surely the job of ratings agencies should not be simply to change sovereign ratings in line with market sentiment, which, frankly, is obvious to everyone? Rather, if they wish to add real value, the ratings agencies should look deeper with a view to making a forward-looking call on the quality of the policy response to those changes in external sentiment and conditions. S&P and other ratings agencies failed to do so in this case. Russian policy makers, like policy makers in most other EM countries, were never given the benefit of the doubt by ratings agencies. In our opinion, they were downgraded without due regard to all of the facts. Russia´s fundamentals were extremely strong at the time, and continue to remain strong. Russia´s debt burden was and remains small while central bank reserves were, and continue to remain high.

We believe that the ratings agencies really failed in not recognising that the quality of the policy response from the Government and Russian central bank was 'top-notch' and so well recognised that the Chairwoman of the Bank of Russia, Elvira Nabiullina, won the coveted Central Banker of the Year Award in 2015. The ratings agencies also appear to have completely ignored that President Vladimir Putin´s political capital was sky-high and that he was willing to put this capital at risk by fully backing Nabiullina´s tough response to the plethora of shocks. The ratings agencies also appear to have chosen to ignore completely the very significant changes to Russia´s financial and macroeconomic infrastructure in the preceding years, including the adoption of a flexible

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exchange rate regime and a rock solid commitment to keeping the capital account open. Russia´s government should have been given the benefit of the doubt in the same way in which ratings agencies invariably give Western governments the benefit of the doubt, even when policies actually deteriorate outright. For example, where is the ratings agency's response to the massive deterioration in the US fiscal outlook following the Trump tax cut? Surely after literally a quarter of a century of fundamental improvements, which have rendered most established EM countries unrecognisably stronger, it is time that ratings agencies also let go of their long-outdated prejudices? The shocks faced by Russia did not adversely impact Russia´s ability and willingness to pay. Rather, they demonstrated viscerally that Russia´s commitment to sound financial management was far stronger than anyone had imagined, especially the ratings agencies.

S&P was therefore wrong on two specific counts. First, S&P should have looked through the volatility, much like a value investor would. Second, S&P should have used its privileged access to the Russian government to make a call on the quality of the Russian policy response. S&P did neither. Instead, it just went with sentiment, thereby offering no value added at all, in fact arguably contributing to the severe mispricing of Russian assets, which took place during late 2014 and early 2015. S&P is now U-turning on Russia because it was wrong. It would probably be naive to expect S&P or any of the other ratings agencies to take this lesson to heart. However, until they do, the ratings agencies offer no real value added and investors should ignore them, in our opinion. The best investors can do is to entrust their money to managers, who judge countries on the quality of the response to adversity, rather than on adversity itself, because to do otherwise is to pander to prejudice. In other news, economic activity indicators surprised to the upside in January.

Brazil: In another borderline farcical example of ratings agency theatrics, Fitch downgraded Brazil´s sovereign credit rating to BB- with a stable outlook (from BB with negative outlook) following the government´s formal acknowledgement last week that the long-suffering pension reform proposal will not be put to a vote. The death of the pension fund was 100% discounted by the market, so the downgrade was a classic case of closing the stable doors after the horses had bolted. Indeed, Brazilian markets rallied moderately on the day of the news. The government also said that it expects a downgrade from Moody´s, so this future downgrade is now also 'in the market'. S&P downgraded Brazil in January. The markets could not care less because apart from the fact that the failure to pass the pension reform is already fully priced, the market is currently far more focused on the upturn in the business cycle, which is likely to be sustained for a long time, given the starting point. The market is also focused on the election in H2 2018, which is likely to see a market-friendly candidate win and thus breathe new life into the pension reform. Besides, there will be other lesser but nevertheless credit-positive developments taking place between now and the election, including the likely privatisation of Electrobras, the expiry of tax breaks and regulatory improvements. In other news, inflation was benign in the first half of February, coming at 0.38% mom compared to 0.39% mom in January. On a yoy basis, this meant that the inflation rate declined to 2.86% from 3.02% yoy in January, keeping alive the possibility of further (very modest) rate cuts from the central bank.

Colombia: In a third ratings-related action, Moody´s last week cut the outlook for Colombia´s sovereign debt rating to negative from stable, citing weaker growth as the reason. Yet, this is hardly news. Colombia delayed adjustment to lower oil prices significantly in order to secure support for a peace accord with FARC rebels and has been paying the price for some time. One must also suspect, based on the record of ratings agencies, that they are finding it difficult to resist the temptation to jump on the sentiment band wagon ahead of the 27 May 2018 presidential election, where polls currently point to former Bogota Mayor Gustavo Petro, a former left-wing rebel, as the next president of the country. The poll by National Consulting Center showed Petro with 22% support, independent leftist Sergio Fajardo with 16% support, Uribe protégé Iván Duque with 15% support and Germán Vargas Lleras, a right-wing former vice-president with 8% support.

Mexico: Mexico´s current account deficit narrowed to USD 18.8bn in 2017, or 1.6% of GDP, which compares favourably to the deficit of 2.1% of GDP in 2016. Moreover, the current account deficit was more than fully financed by net foreign direct investment flows alone, which totalled USD 29.7bn in 2017. This fortunate set of circumstances also looks likely to occur in 2018, which is comforting, since 2018 is an election year in Mexico and Andrés Manuel López Obrador (AMLO), a left-leaning populist, currently looks most likely to become Mexico´s next president. Markets are unlikely to take kindly to an AMLO presidency. Locals are already taking money out of Mexico, but these outflows are taking place against a backdrop of broad inflows into EM local markets, including Mexican markets. This counter-flow has helped USDMXN to maintain an 18 handle (recall that Mexico is a large percentage of most EM indices and most investors are index huggers, so when they allocate to EM they also buy Mexico by virtue of their insistence on remaining close to benchmarks). AMLO is doing better than any other candidate in the polls and if this continues (which seems likely as long as the candidates from the market-friendly PRI and PAN parties continue to split the center-right vote) then investment banks can be expected to draw up massively exaggerated binary portraits of Mexico under AMLO versus the others.

Many investors will pay attention to this and the currency, as spreads and to a lesser extent, local bond yields could get hit in the months leading up to the July election. This is therefore important to watch carefully. If and when valuations fall below what is justified by Mexico's solid fundamentals then Mexican assets could

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become a very strong ´buy´ just ahead of the election, regardless of who wins. Obviously, if a PAN or PRI candidate wins, the market will stage a material relief rally, but even if AMLO wins the market is still likely to rally, because AMLO-related downside risks are likely to have been seriously overpriced by then. In fact, only last week AMLO indicated that he will respect contracts in the oil sector. He is also being linked with sensible economists for the post of Finance Minister. Rationally, the last thing AMLO is likely to want is to see his limited political capital eroded rapidly by a currency and confidence crisis at the very start of his presidency. He is not likely even to obtain command of a majority in parliament to begin with. Get ready to make some alpha! In other news, Mexican core inflation declined to 4.32% yoy in H1 February from 4.83% yoy in December.

- South Africa: Newly appointed President Cyril Ramaphosa wasted no time in presenting a Budget, which was well received due to its orthodoxy. The deficit projections were narrowed meaningfully due to a 1% VAT hike and cuts in expenditure, which should lead to South Africa´s debt profile stabilising. Clearly, change is afoot and there will be more positive news in the future as Ramaphosa continues to implement his programme of government. All these changes have in turn led to speculation that there could be demonstration effects in the rest of Africa. Are such demonstration effects likely? We doubt it. Intuitively, to argue that political events in South Africa should somehow lead to meaningful change in, say, Senegal is the equivalent to arguing that Sweden will materially change policies because the US has elected Trump to the presidency. At best, this would be a weak effect. Still, it may help to spell out the specific reasons why demonstration effects are likely to be minor, if there at all.

There are two potential channels of demonstration effects. The first is via markets in the sense that investor behaviour somehow changes, such that other African countries are ´rewarded´ for doing what South Africa just did. We do not think this is very likely, because in our view most experienced EM investors recognise that South Africa is a very different country from other Sub-Saharan African countries. For example, South Africa has very deep capital markets and has far more developed institutions, including a large savings industry, while the rest of Africa is far more ´frontier´, i.e. has shallower financial markets, more rudimentary institutions and lower per capita GDP. In fact, no other Sub-Saharan African country really looks like South Africa at all and investors know this. Just consider one little detail in the political system: Zuma was forced out by a party, the ANC, not by the electorate. Indeed, the entire notion of fundamental contagion, political as well as economic, positive as well as negative, has been discredited. Not to be confused with market contagion, which still happens because it is down to investor behaviour rather than fundamentals. EM countries have not shown signs of serious fundamental contagion for a long time. Each country is obviously unique and increasingly recognised as such. But even if investors were to see some political spillovers from events in South Africa to other African countries, the fact remains that South Africa is the only African country to feature in the JP Morgan GBI EM GD index of local currency government bonds. Since investors are benchmark huggers, meaning they rarely venture outside the index names, there is not a powerful avenue for expressing financial ´rewards´ within the typical EM portfolio.

The other mechanism, whereby demonstration effects might conceivably come about is that the removal of a populist from power in South Africa somehow sends a direct ´signal´ to other African leaders. But how would such a signal bring about actual change in other countries? Most African governments are not populist to begin with, and when they are, it is typically not because they are copying the Zuma model of bad government. The political dynamics, which deliver a particular quality of governance within each country, are overwhelmingly determined by domestic factors, not external ones. It is also worth bearing in mind that post-Apartheid South Africa does not have a record of using its economic or political clout to influence other Sub-Saharan African countries. This is for good historical reasons. During the Apartheid era the Botha-led South African government operated a massive and ruthless programme of active destabilisation of the so-called ´Frontline States´. This programme involved frequent military and other operations in neighbouring countries as far north as Tanzania in East Africa. Going down the road of intervention in neighbouring countries would therefore quickly bring back some very painful memories, which would leave a really bad taste in the mouth. Finally, one should not forget that Ramaphosa inherits a party in decline and he will undoubtedly have his hands far too full managing the domestic South African political agenda to concern himself too much with the politics in Africa´s more than 50 other sovereign countries. In other news, the rate of CPI inflation declined to 4.4% yoy in January from 4.7% yoy in December.

- Venezuela: The opposition MUD coalition called for a boycott of the presidential election scheduled for April of this year, because they could not agree on a candidate. President Maduro immediately announced there will also be elections for the Legislature. This election will also likely be boycotted by the Opposition, wherefore parliament now looks set to fall into the hands of Maduro again. In other news, Euroclear is said to have received the coupon payment for the 2022 6% PDVSA bond, suggesting that Venezuela is still trying to service PDVSA debt in spite of US financial sanctions.

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Snippets:

- **Argentina:** The trade balance continues to deteriorate. The deficit was USD 986m in January versus USD 557m expected. Like the US, Argentina is running a major twin-deficit operation against a backdrop of low productivity and still inadequate reforms.
- **India:** The minutes of the monetary policy committee of the Reserve Bank of India were more hawkish than expected.
- **Peru:** Real GDP sequential growth accelerated in Q4 2017 to 0.9% qoq from 0.3% qoq in Q3 2017.
- **Singapore:** The rate of CPI inflation was 0% yoy in January versus 0.4% yoy expected. The government postponed an expected hike in GST of 2% to 9% to the 2021-2025 without loss of fiscal credibility against a backdrop of gently rising growth.
- **South Korea:** Exports were 8.6% higher in the first 20 days of February than in the same period the year before.
- **Thailand:** Both exports and imports were far stronger than expected in January, pointing to healthy economic activity, but also generating a small trade deficit of USD 119m.

## Global backdrop

The US stock market is showing considerable sensitivity to movements in the US Treasury curve. This is hardly surprising, because stock market valuations are inflated by easy money and investors have not priced in any macroeconomic risks. Besides, the supply of bonds is rising due to bad fiscal policies and is pushing up borrowing costs in the US economy. One wonders how the stock market will perform once inflation actually shows up and Americans actually have to pay interest on their borrowing.

## Benchmark performance

| Emerging Markets | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| MSCI EM | -2.96% | 5.12% | 31.04% | 10.30% | 5.80% |
| MSCI EM Small Cap | -3.38% | 2.23% | 23.92% | 8.62% | 5.42% |
| MSCI Frontier | -1.63% | 4.00% | 27.67% | 6.55% | 8.38% |
| MSCI Asia | -3.94% | 3.31% | 32.53% | 10.96% | 8.68% |
| Shanghai Composite | -5.51% | -0.54% | 3.25% | 2.33% | 9.87% |
| Hong Kong Hang Seng | -6.10% | 8.76% | 25.88% | 5.75% | 6.45% |
| MSCI EMEA | 0.55% | 6.73% | 25.68% | 6.85% | 1.72% |
| MSCI Latam | -0.62% | 12.46% | 22.04% | 9.32% | -0.73% |
| GBI EM GD | -0.23% | 4.24% | 14.16% | 4.33% | -0.85% |
| ELMI+ | -0.65% | 2.22% | 9.91% | 3.63% | -0.19% |
| EM FX Spot | -0.76% | 2.75% | 5.38% | -2.28% | -6.39% |
| EMBI GD | -2.20% | -2.24% | 4.41% | 6.01% | 4.50% |
| EMBI GD IG | -2.11% | -2.76% | 3.18% | 3.48% | 3.18% |
| EMBI GD HY | -2.28% | -1.76% | 5.62% | 9.10% | 6.01% |
| CEMBI BD | -1.05% | -0.98% | 4.26% | 5.40% | 4.26% |
| CEMBI BD IG | -1.15% | -1.35% | 2.84% | 3.45% | 3.49% |
| CEMBI BD Non-IG | -0.94% | -0.49% | 6.26% | 8.51% | 5.25% |

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## Benchmark performance

| Global Backdrop | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| S&P 500 | -2.53% | 3.04% | 18.53% | 11.49% | 14.97% |
| 1-3yr UST | -0.03% | -0.35% | -0.21% | 0.41% | 0.49% |
| 3-5yr UST | -0.18% | -1.16% | -0.76% | 0.68% | 0.80% |
| 7-10yr UST | -0.96% | -3.10% | -1.49% | 0.26% | 1.05% |
| 10yr+ UST | -3.51% | -6.62% | 0.01% | -0.02% | 2.72% |
| 10yr+ Germany | 0.06% | -1.47% | -3.69% | 0.11% | 5.26% |
| 10yr+ Japan | 0.73% | 0.53% | 2.45% | 4.50% | 5.10% |
| US HY | -1.14% | -0.55% | 4.12% | 5.32% | 5.34% |
| European HY | -0.84% | -0.65% | 3.75% | 4.52% | 6.59% |
| Barclays Ag | -1.04% | -1.70% | 2.86% | 2.76% | 3.53% |
| VIX Index* | 21.94% | 49.55% | 43.94% | 18.69% | -2.13% |
| DXY Index* | 0.68% | -2.59% | -11.23% | -5.83% | 9.61% |
| CRY Index* | -0.46% | 1.35% | 2.90% | -11.08% | -33.00% |
| EURUSD | -0.74% | 2.64% | 16.39% | 10.04% | -5.66% |
| USDJPY | -2.18% | -5.22% | -5.23% | -10.55% | 16.12% |
| Brent | -3.01% | 0.15% | 19.61% | 11.52% | -40.58% |
| Gold spot | -0.56% | 2.67% | 6.77% | 10.59% | -17.11% |

*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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