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Things are looking up in Colombia

By Jan Dehn

Market-friendly candidate Ivan Duque has taken a clear lead in the Colombian race for the presidency which is scheduled for 27 May after logging a convincing win in the primaries with far more votes than left-wing candidate Gustavo Petro. A market-friendly government may unleash pent-up investment demand at the same time as Colombia receives inflows, recovers from a protracted cyclical downturn and gets additional tail winds from stabilising to rising oil prices. In short, Colombia looks set to beat expectations in the next couple of years. In other notable Emerging Markets (EM) developments, the EM external sovereign debt asset class has now grown to more than USD 1 trn for the first time, and China reforms its regulatory institutions and appoints reformers to key positions. In Russia, as Putin heads for another six years in office, the escalation of a diplomatic spat over the poisoning of a Russian spy in London currently serves the interests of both Putin and British Prime Minister Theresa May. The global backdrop section discusses global inflation dynamics and draws attention to the link between slower US growth, the reshuffle of members of the Trump Administration and the upcoming US mid-term elections. The outcome: trade tensions may escalate further.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.6	–	0.52%
MSCI EM Small Cap	11.7	–	0.70%
MSCI Frontier	11.4	–	-0.11%
MSCI Asia	12.2	–	1.65%
Shanghai Composite	11.1	–	-1.13%
Hong Kong Hang Seng	7.5	–	1.95%
MSCI EMEA	10.0	–	-2.94%
MSCI Latam	12.4	–	-2.88%
GBI-EM-GD	6.11%	–	-0.55%
ELMI+	3.60%	–	-0.22%
EM FX spot	–	–	-0.70%
EMBI GD	5.75%	290 bps	0.08%
EMBI GD IG	4.54%	167 bps	0.17%
EMBI GD HY	7.03%	419 bps	-0.01%
CEMBI BD	5.47%	267 bps	-0.01%
CEMBI BD IG	4.52%	173 bps	0.03%
CEMBI BD Non-IG	6.66%	385 bps	-0.06%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	-1.20%
1-3yr UST	2.31%	–	0.01%
3-5yr UST	2.65%	–	0.07%
7-10yr UST	2.85%	–	0.37%
10yr+ UST	3.08%	–	1.40%
10yr+ Germany	0.58%	–	1.25%
10yr+ Japan	0.04%	–	0.17%
US HY	6.19%	339 bps	-0.19%
European HY	2.91%	365 bps	0.03%
Barclays Ag	–	249 bps	0.14%
VIX Index*	18.01	–	2.23%
DXY Index*	90.01	–	0.11%
EURUSD	1.2321	–	-0.11%
USDJPY	106.11	–	0.29%
CRY Index*	193.41	–	-1.11%
Brent	65.5	–	0.82%
Gold spot	1313	–	-0.80%

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

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- **Colombia:** Colombia's economy is now clearly showing signs of a cyclical upswing. This follows a long slump caused by a combination of lower oil prices, delayed macroeconomic adjustment to lower prices, political uncertainty associated with approval of a peace accord with FARC rebels, election related uncertainty and the natural consequences of a lame duck administration. Most of the headwinds are now turning into tail winds and the economy is beginning to respond positively. In particular, retail sales, a classic cyclical indicator, rose much more than expected in January, when demand for goods rose at a more than solid pace of 6.2% yoy (versus 1.2% yoy expected). A cyclical upswing at this point is likely to be sustainable for a number of reasons. First, the improving growth outlook in Europe and Emerging Markets should ensure that global GDP growth rises as well, which in turn provides support for oil prices, which still matters a great deal at the margin to the performance of the Colombian economy. Second, inflows are returning to EM local markets of which Colombia will receive a share, thus, helping to ease domestic financial conditions and reigniting demand. Third, inflation has been slowing and the Colombian peso is cheap, so Colombia's real effective exchange rate is competitive. This should help net exports and therefore growth. Finally, Colombia looks set to elect a business friendly president later this year, which is likely to unleash a great deal of pent up investment. Investment has been sluggish because of the lame duck status of the Santos Administration and more recent concerns that Gustavo Petro, a left-wing former mayor of Bogota, could win the upcoming presidential election. However, Petro-related fears were allayed somewhat last week following parliamentary elections, which saw the business friendly centre-right parties gain greater influence in the Legislature. More importantly, both the Left and the Right in Colombian politics held primaries last week and the clear winner in

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the centre-right presidential primary was Ivan Duque, a protégé of former President Alvaro Uribe. Duque's policies are likely to be market friendly. The Left also held primaries, which saw Gustavo Petro clock up a convincing win, but crucially Duque received almost twice as many votes as Petro, which makes Duque the clear favourite to win the first round of the presidential election scheduled for 27 May 2018. The main uncertainty surrounding Duque is his close affiliation with Uribe, who has expressly stated his desire to dissolve the FARC peace accord. If Duque wins and if he decides to challenge the peace process then foreign investors will likely react badly, because they will see a dissolution of the peace accord as a regressive move, motivated more by personal grievances rather than the national interest.

- Index news: JP Morgan announced last week that EM external sovereign debt asset class now exceeds USD 1trn for the first time. EM external debt has grown from a small asset class with just handful of issuers a quarter of a century ago to well diversified asset class where the index alone has 67 countries. JP Morgan's EMBI GD benchmark index has delivered about 20% more return in Dollar terms than the S&P 500 index since inception, with lower volatility. Today the average index weight per country is less than 1.5% and the diversified nature of the index means that no single country can have more than a 10% weight in the index. Most countries, of course, have very small weights so the index is extremely diverse. This greater diversification of this index implies that external debt should trade closer to 200bps over UST than the current spread of just below 300bps, in our view. In other words, we see value. Besides, most EM countries no longer rely on external Dollar funding very much as they now get the bulk of their funding from local markets. In other words, there is little benefit to defaulting in terms of fiscal savings and a terrible price to pay in terms of reputation.

- China: President Xi Jinping's recent acquisition of greater political control was immediately put to good work when China's Banking and Insurance regulators were merged and placed under control of the People's Bank of China (PBOC). PBOC is the strongest and the most prudent of China's regulators. With its newfound powers, PBOC is likely to push to reduce financial risks in China, while at the same time advance the sophistication of China's financial infrastructure. In related news, Yi Gang is widely expected to replace PBOC Governor Zhou Xiaochuan. Yi Gang is market-oriented financial reformer. The pro-reform camp is also being strengthened by the appointment of Liu He, another reformer, to the influential role of vice premier in charge of the economy. In short, all the indications are that President Xi Jinping will use his new powers to speed up economic reform in China. The reform of China's regulatory structure could soon have direct implications for investors. One of the obstacles to China's further integration into global financial markets, including entry to the main global and EM bond market indices, has been the confusing state of the Chinese regulatory system, where multiple agencies have often had overlapping and, sometimes, contradictory rules. This situation may now begin to improve. For further discussion on how improved access to China's onshore bond market may impact EM and global investors please see *The Emerging View* for March 2018, which specifically examines the role of Chinese government bonds in EM and global bond portfolios going forward.[1] This year foreign investors have increased their holdings of Chinese government bonds at the fastest rate since September 2016 and now hold more than 5% of Chinese government bonds for the first time in history. The Chinese economy is also performing better than expected with industrial production rising at a yoy rate 7.2% in January-February versus 6.2% yoy expected, while fixed asset investment also beat expectations (7.9% yoy versus 7.0% yoy expected). Retail sales growth was solid at 9.7% yoy.

- Russia: At the time of writing on Sunday night President Vladimir Putin looked set to win a landslide victory in the Russian presidential election, thus securing another six years in office. This outcome is unlikely to be a surprise to markets. Meanwhile, both Russia and the UK appear to want to escalate tensions arising from Russia's alleged involvement in the poisoning of a spy in London. President Vladimir Putin's standing among voters in Russia is enhanced by the perception that Russia is once again under threat from the West and that Putin is standing up for Russia. Meanwhile, tensions with Russia also constitute a welcome distraction from the Brexit malaise for British Prime Minister Theresa May. Whether this conflict impacts Russia's ability and willingness to pay will boil down to the nature of sanctions, if any. If they prevent access to financing and block Russian energy exports they may matter, otherwise not. Europe depends on imports of Russian gas, so we expect sanctions, if any, to target individuals and not materially impede Russia's ability and willingness to pay. Russia successfully issued a bond last week. The bond issue was oversubscribed. Russian public finances are currently improving sharply. The federal budget deficit narrowed to 1.1% of GDP in February from 1.3% in January. A year ago, the deficit was 3.9% of GDP (all deficits on a 12-month rolling basis).

- Argentina: Inflation rose in February due to well-anticipated changes in regulated prices and temporary pass-through to import prices from a weaker ARS. Specifically, the yoy rate of inflation increased to 25.4% in February from 25.0% in January. This is equivalent to a monthly increase in inflation of 2.40%, which was actually below the market consensus expectation of inflation of 2.45% mom. The central bank left the policy rate unchanged at 27.25% with a hawkish bias. Positive real rates should gradually bring Argentina's atypically high (from a broader EM perspective) inflation rate down over time, though breaking deeply entrenched high inflation expectations in Argentina will be tough, in our view.

[1] See *'How Chinese bonds can enhance your portfolio'*, Weekly Research, 15 January 2018.

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- **Brazil:** The broader EM story of improving domestic demand is clearly in evidence in Brazil, where retail sales accelerated to 6.5% yoy in January. Retails sales were 4.9% higher in the three months to January than in the previous three-month period, so retail sales growth is clearly accelerating.

- **Chile:** Without giving further details, Finance Minister Felipe Larrain announced that the upcoming tax reform of newly elected government of Sebastian Pinera is likely to be revenue neutral. Chile runs very prudent fiscal policy. The Chilean economy has begun to perk up with industrial production and fixed asset investment both picking up in the first couple of months of the year.

- **India:** The rate of wholesale prices inflation was 2.48% yoy in February, below the market expectation of 2.50% yoy. More importantly, headline CPI inflation declined to a rate of 4.4% yoy in February from 5.1% yoy in January. The February inflation print was lower than expected (4.7% yoy). The current account deficit in Q4 2017 was significantly lower than expected (USD 13.5bn versus the USD 15.9bn Bloomberg consensus expectation).

- **Kazakhstan:** Ratings agency Moody's said that the government has successfully stabilised the banking system, thus eliminating an important lingering risk from the decline in oil prices in 2014. Most oil producers – and now Kazakhstan – have completed adjustment to lower prices, but in many cases their bonds still trade at distressed spreads.

- **Peru:** The rate of real GDP accelerated to 2.8% yoy in January versus 2.3% yoy expected and 1.3% yoy in December. President Pedro Pablo Kuczynski will face a de facto impeachment vote on Thursday 22 March. We do not expect major changes in economic policy.

Snippets:

- **Indonesia:** Imports of capital goods rose at a strong 32.2% yoy rate in February, which suggests that investment demand is picking up.
- **Mexico:** Industrial production was up 0.9% on a yoy basis in January, which was marginally stronger in than expected.
- **Nigeria:** CPI inflation eased to a rate of 14.3% yoy in February from 15.1% yoy in January.
- **Poland:** The yoy rate of CPI inflation declined 1.4% in February from 1.9% in January.
- **Romania:** Industrial production growth slowed to a still solid 8.7% yoy rate in January from and upwards revised print of 13.8% yoy in December.
- **Singapore:** Non-oil domestic exports slowed to a yoy rate of 6% in February from 18% yoy in January. Imports slowed by less as domestic demand picked up.
- **South Africa:** Former President Jacob Zuma is to be charged with corruption offences.
- **South Korea:** The rate of unemployment was lower than expected in February (3.6% versus the 3.7% consensus expectation).
- **Tunisia:** Moody's downgraded Tunisia's sovereign credit rating one notch to B2 over fiscal concerns.
- **Turkey:** The 12-month cumulative budget deficit increased marginally to 1.7% of GDP in February from 1.6% in December 2017.

Global backdrop

Financial markets fret a great deal about inflation. Will it come or will it not come? If so, when? How important are cyclical factors versus structural factors, such as innovation, online retail, blockchain, etc.? What is the impact on inflation of outsourcing and free trade and what impact will protectionism have on the inflation outlook? Our view on inflation can be summarised as follows: inflation is going to drift higher slowly and the greatest risk of higher inflation comes from protectionism and other policies, which impede the smooth operation of global markets.

The clearest way to think about inflation is that most markets for goods, services and labour are now global markets. Prices are therefore determined in the global markets place rather than in individual countries. Despite recent setbacks in free trade, such as the Trump Administration's tariffs on steel and aluminium, most goods, services, capital and to a lesser extent labour can still move relatively freely across borders. This means that if, say, the labour market in any one country reaches full employment, which in turn begins to put upwards pressure on wages, then it does not take very much time until the industry in question loses orders and/or production gets outsourced to other countries, where labour markets are more competitive. In other words, labour markets in individual countries do not determine inflation rates, the global labour market does. The key to understanding inflation is therefore to examine the state of the global labour market. We shall do so in an upcoming report. Suffice to say at this point, however, that most of the world's economies currently operate with excess capacity. EM countries, which make up between 40% and 60% of global GDP, are only just

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Global backdrop

emerging from several years of cyclical downturn, while Europe is also in the early stages of recovery. The US is at or close to full employment, but if wages rise in the US then business will quickly go overseas.

That is, unless governments get in the way. If, as we suspect, inflation rates are determined in global rather than national labour markets, then barriers to trade, capital flows and migration could pose a serious threat of higher inflation. Barriers cut markets off from one another, forcing countries into autarchy. In the extreme, protectionism forces each country to produce everything at high cost within its own borders, even if costs are lower elsewhere. Undoubtedly it is possible to make Swiss-style cheese from milk of Oklahoman cows, but probably at a much higher cost and inferior quality to the cheese made from the rich milk coming straight from the bountiful Swiss cows munching on lush alpine grass all day long.

Moreover, protectionism will cause more inflation in closed economies and economies with larger non-tradable sectors, such as the US, than in open economies with large tradable sectors. To see why, consider what happens if an open economy with a large tradable sector imposes a tariff on, say, steel. The moment the tariff is imposed all the other exporting sectors, which use steel as an input for production, will immediately lose business to competitors in other countries. This puts downwards pressure on labour costs, which eventually offsets the effect of the tariff. On the other hand, the closed economy with a large non-tradable sector does not face competition from abroad so the cost of the tariff is passed on to consumers in the form of higher inflation. The deflationary impact coming through via the tradable sector is smaller in the closed economy due to the lower share of the tradable sector in GDP compared to the open economy.

What about the role of technology in inflation dynamics? We believe that supply and demand dynamics determine prices. Technological progress is part of this framework, since technological progress is a supply shock. However, the fact that unemployment rates are low in the US right now points to relative efficient labour markets, that is, people who are laid off in, say, retail, appear to be able to find jobs elsewhere, say, in transportation. Hence, the death of high street retail at the hand of Amazon may not be as detrimental for wage inflation as is commonly hypothesised. Global demand and supply dynamics as well as the barriers, which may threaten their efficient operation, are likely to be the most important determinants of inflation.

In US news, despite strong survey data, most hard economic data in the US is now weakening. Q1 2018 US GDP growth forecasts are being revised lower across the board. The Trump Administration has the November mid-term election in view and wants to take action to counter the threat from slowing growth and uncertainty from the Muller Inquiry. The action has so far taken two forms. First, the Administration has announced its intention to apply additional protectionist measures against China in particular. Second, the Trump Administration axed several of its most experienced and highly qualified officials in favour of lower quality 'yes' people. These actions were not welcome in stock market, which declined last week, though it lent some support to the Dollar. The silver lining was that inflation fears, which just a few weeks ago caused a pullback of 10% in the US stock market (a clear sign that macroeconomic risks are not priced in at all), retreated temporarily as core CPI inflation came in at 0.2% mom in February, pegging the yoy core inflation rate at a comfortable below target 1.8%. In turn, this enabled the 10-year US Treasury yield to decline somewhat in the course of the week. The Trump Administration's renewed focus on turning around its political fortunes are entirely justified. Only last week, Conor Lamb, a Democrat, narrowly defeated a Trump-sponsored Republican candidate in the Southwestern Pennsylvania Congressional district election. Lamb's victory is irrelevant in itself except for the fact that Trump won this blue-collar district by a handsome 20% margin in November 2016. If a swing of this magnitude is repeated across the country in the Mid-term election, the political outlook in the US will look distinctly different come November. This will not be good news for markets, because further marginalisation is likely to render President Trump even more inclined to lean on his sole remaining area of policy influence: trade policy.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.58%	4.94%	29.21%	11.86%	5.97%
MSCI EM Small Cap	0.41%	1.88%	21.79%	9.19%	5.17%
MSCI Frontier	0.48%	4.67%	26.79%	7.54%	8.42%
MSCI Asia	2.43%	4.64%	31.53%	12.17%	9.32%
Shanghai Composite	0.32%	-1.11%	2.09%	0.11%	10.08%
Hong Kong Hang Seng	2.35%	8.23%	25.21%	6.25%	6.91%
MSCI EMEA	-1.90%	2.29%	20.55%	8.79%	0.85%
MSCI Latam	-0.87%	8.18%	19.23%	11.88%	-1.63%
GBI EM GD	-0.22%	3.16%	12.37%	6.04%	-0.99%
ELMI+	0.24%	2.05%	9.03%	4.44%	-0.24%
EM FX Spot	-0.42%	1.59%	4.17%	-1.08%	-6.52%
EMBI GD	0.01%	-2.02%	4.92%	6.36%	4.55%
EMBI GD IG	0.07%	-2.60%	3.83%	3.91%	3.25%
EMBI GD HY	-0.05%	-1.50%	5.97%	9.11%	6.04%
CEMBI BD	0.01%	-0.93%	4.57%	5.42%	4.18%
CEMBI BD IG	0.06%	-1.26%	3.15%	3.52%	3.45%
CEMBI BD Non-IG	-0.06%	-0.49%	6.58%	8.43%	5.09%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.52%	3.37%	17.85%	12.06%	14.34%
1-3yr UST	0.05%	-0.30%	0.07%	0.42%	0.49%
3-5yr UST	0.13%	-1.11%	-0.12%	0.67%	0.79%
7-10yr UST	0.31%	-2.77%	-0.10%	0.35%	1.12%
10yr+ UST	0.97%	-5.22%	3.77%	0.36%	3.20%
10yr+ Germany	1.42%	-0.07%	0.47%	-0.96%	5.35%
10yr+ Japan	0.30%	0.85%	2.48%	4.72%	4.66%
US HY	-0.34%	-0.59%	4.77%	5.47%	5.09%
European HY	0.18%	-0.19%	4.42%	4.39%	6.46%
Barclays Ag	-0.10%	-1.74%	3.43%	2.81%	3.46%
VIX Index*	-9.27%	63.13%	59.66%	28.00%	25.16%
DXY Index*	-0.67%	-2.30%	-10.26%	-9.32%	8.46%
CRY Index*	-0.28%	-0.23%	4.84%	-8.33%	-34.02%
EURUSD	1.04%	2.63%	14.73%	15.58%	-4.35%
USDJPY	0.54%	6.20%	6.07%	13.83%	-10.32%
Brent	-0.46%	-2.08%	26.51%	20.30%	-39.06%
Gold spot	-0.43%	0.75%	6.35%	12.07%	-18.62%

*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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