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Impunity in retreat

By Jan Dehn

The imprisonment of former Brazilian President Lula for corruption-related crimes is only the latest in a growing list of examples of Emerging Markets (EM) leaders being held to account for misdeeds. Impunity is in retreat in EM. While this observation does not apply to all countries in EM, the retreat of impunity is nevertheless one of the broad trends in EM with origins in the end of the Cold War and the rise of the Middle Class. We therefore expect the trend to continue and to strengthen over time. In country-specific news, the US sanctioned more rich Russians, Ecuador put forward a bold fiscal plan, India opened its bond market further to foreign investors and Viktor Orban scored yet another solid election win on the back of the European Union's inability to define effective border and immigration policies. In the global backdrop, Trump's escalation of his Trade War with China created uncertainty in the global backdrop, weighing on EM stocks and currencies.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	-0.73%
MSCI EM Small Cap	11.4	–	0.49%
MSCI Frontier	11.1	–	-0.36%
MSCI Asia	11.4	–	-0.85%
Shanghai Composite	10.7	–	0.29%
Hong Kong Hang Seng	7.2	–	-2.71%
MSCI EMEA	9.5	–	-0.11%
MSCI Latam	12.4	–	-0.12%
GBI-EM-GD	6.02%	–	-0.60%
ELMI+	3.69%	–	-0.29%
EM FX spot	–	–	-0.61%
EMBI GD	5.73%	295 bps	0.41%
EMBI GD IG	4.52%	173 bps	0.31%
EMBI GD HY	7.09%	432 bps	0.50%
CEMBI BD	5.49%	276 bps	0.21%
CEMBI BD IG	4.56%	184 bps	0.04%
CEMBI BD Non-IG	6.62%	389 bps	0.41%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.1	–	-1.35%
1-3yr UST	2.29%	–	0.02%
3-5yr UST	2.61%	–	-0.03%
7-10yr UST	2.80%	–	-0.17%
10yr+ UST	3.04%	–	-0.72%
10yr+ Germany	0.50%	–	-0.10%
10yr+ Japan	0.04%	–	0.02%
US HY	6.25%	354 bps	0.29%
European HY	3.10%	386 bps	0.14%
Barclays Ag	–	250 bps	0.01%
VIX Index*	21.49	–	1.52%
DXY Index*	90.11	–	0.06%
EURUSD	1.2277	–	-0.20%
USDJPY	107.05	–	1.09%
CRY Index*	192.25	–	-3.11%
Brent	67.4	–	-0.34%
Gold spot	1331	–	-0.74%

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

Emerging Markets

- **Impunity in retreat:** Literally millions of people in Emerging Markets live miserable lives in abject poverty as a direct result of the corruption in the highest echelons of society, including among political leaders. It is therefore a good thing, in our view, that former Brazilian President Lula Inacio da Silva surrendered to police over the weekend in response to a Supreme Court decision to deny him habeas corpus in relation to charges of corruption. Lula may serve up to twelve years in jail for his crimes. Lula is by no means the only EM leader to receive punishment in one way or another for abuse of power. In fact, impunity is in retreat in numerous EM countries. In recent years government leaders have been toppled and/or jailed for corruption and other forms of abuse of power in South Korea, Thailand, Peru, Pakistan, Romania, South Africa, Argentina, Zimbabwe and others. That is not to say that EM has stamped out impunity, far from it. However, the retreat of impunity is a trend, which will get even more pronounced in the future. The origin is the end of the Cold War during which impunity was the norm in EM, where Superpower sponsored despots, for the most part, governed countries. The period since 1989 has witnessed a major shift towards local political accountability with much greater democracy across the EM universe. The main exceptions today pertain to very resource rich countries, where autocrats still cling on to power aided by their monopolistic control over commodities, such as oil. The broad shift towards local political accountability has resulted in better economic policies, stronger growth rates and greater political stability, which has enabled middle classes to gain importance in many EM countries, with obvious positive implications for institutional development, particularly the rule of law.
- **Russia:** The US government imposed fresh sanctions on individuals close to Russian President Vladimir Putin, but refrained from imposing broader economic or financial sanctions. The rate of inflation in Russia increased marginally to 2.4% yoy in March from 2.2% yoy in February and GDP growth in Q4 2017 was 0.9% yoy, which was lower than expected (1.4% yoy) due to a surge in imports.

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Emerging Markets

- **Ecuador:** The government issued a new economic plan, which is positive for the sovereign's creditworthiness. The plan envisages public sector spending cuts of one billion Dollars per year to 2021 with a view to achieving a medium term fiscal deficit target of 2.5%. The spending cuts will be realised by cutting subsidies, rationalising the structure of the government and closing state-owned enterprises.

- **India:** The Reserve Bank of India (RBI) further liberalised the quota regime governing foreign investments into the Indian bond market. Under the new rules, foreign investors will be able to buy up to 6% of outstanding Indian bonds compared to 5% before (the change implies incremental foreign purchases of USD 8.4bn of government bonds and USD 6.9bn of corporate bonds). President Modi's 'Make in India' policies have so far not extended meaningfully into the financial space due to three constraints: strong vested interests opposed to liberalisation, misguided perceptions in India about the country's vulnerability to cross-border capital flows and weak public sector bank balance sheets. In other news, the RBI left the policy rate unchanged and lowered its own inflation forecast for the 2018/2019 and 2019/2020 fiscal years. Services PMI improved to 50.3 in March from 47.8 in February.

- **Hungary:** Prime Minister Viktor Orban secured a fourth term in office after securing a convincing win in the Hungarian election at the weekend. His strong stance against immigration, which is popular in Hungary, is in large part a product of the European Union's inability to implement effective EU-wide border controls and immigration policies. This inability, in turn, reflects the fact that too much power in the European Union still rests with self-serving national governments instead of the EU itself. As far as Hungary is concerned we believe that Orban's re-election with a strong mandate is positive, because it signals political stability.

Snippets:

- **Brazil:** Industrial production turned positive in February (0.2% mom versus -2.2% mom in January (both seasonally adjusted rates).
- **Colombia:** Inflation was lower than expected in March (3.14% yoy versus 3.37% yoy in February)
- **Chile:** The rate of CPI inflation dropped below the central bank's target range in March. Specifically, inflation was 1.8% compared to 2.0% in February. The central bank's target range is 2%-4%. Meanwhile, retail sales accelerated to a yoy pace of 4.0% in February from 3.8% yoy in January.
- **China:** The Caixin Services PMI for March was 52.3 versus 54.2 in February. China's FX reserves increased in March by USD 8.3bn to reach USD 3.143trn.
- **Czech Republic:** Industrial production (IP) and retail sales moderated in February, while construction activity accelerated. IP was 2.7% yoy vs. 5.5% yoy in January, while the yoy growth rate of retail sales in January slowed to 6.6% from 8.4% the previous month. Construction activity accelerated (8.6% yoy in February versus 7.5% yoy in January).
- **Hong Kong:** The PMI moderated to 50.6 in March from 51.7 in February, while retail sales surged to a much stronger than anticipated 29.8% yoy in February (January retail sales were 4.2% yoy).
- **Malaysia:** Exports surged to sizzling pace of 35.6% qoq saar in February. The trade surplus for the month was USD 2.3bn.
- **Mexico:** Gross fixed investment expanded at a yoy rate of 4.1% in January compared to -0.4% yoy in December.
- **Philippines:** The yoy rate of inflation increased to 4.3% in March from 3.8% in February.
- **Poland:** The rate of inflation moderated to 1.3% yoy in March from 1.4% yoy in February. Markets had expected 1.7% yoy inflation in March.
- **Sri Lanka:** The central bank cut the policy rate by 25bps to 8.5% in recognition of slower growth and lower inflation in recent data releases.
- **Uruguay:** The March rate of inflation dropped back below 7% (6.65% yoy versus 7.07% in February).

Global backdrop

The global backdrop remained uncertain last week due to the US-instigated trade war with China with significant risk aversion towards the end of the week. The uncertainty is not over, because China has yet to respond to President Donald Trump's announcement of a further USD 100bn of US tariffs on Chinese imports last week. In a classic example of good cop/bad cop, US Treasury Secretary Steven Mnuchin played down the risk of a trade war, while Director of Trade Policy, the heterodox economist Peter Navarro, argued for further escalation. In the end, of course, Trump will decide and he is undoubtedly eyeing the Chinese reaction in the hope of striking a deal at some point. Meanwhile, Fed Chairman Jerome Powell largely ignored the Trade War in comments issued on Friday. He signalled gradual rate increases against the backdrop of somewhat conflicting signals from the US labour market. The headline payroll number was about 100K weaker than

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Global backdrop

expected, but since last month's payroll number was about 100K stronger than expected this latest miss may be much of a muchness. The greater concern is the rising inflation in wages, which are now almost back to the levels, which prevailed prior to the Developed Market Crisis of 2008/2009. The widening US trade deficit is also a concern, because of the Trump Administration's misguided (or deliberately erroneous) view that trade deficits justify interference in free trade. The worry here is not just that protectionism jeopardises the well-established benefits of free trade, but also that the US economy actually needs to rely more on external demand at this stage of the business cycle. The US economy labours under a rather large stock of debt (526% of GDP if one includes unfunded pension and Medicare liabilities) after thirty years of debt-fuelled consumption-led growth, which places a natural limit on the room to rely on domestic demand going forward. Also, US interest rates are gradually rising as the Fed normalises monetary policy, so debt servicing costs will increasingly eat into disposable income. "I'm not saying there won't be a little pain," Trump said on Friday in relation to his Trade War. On this point, we wholeheartedly agree with the US President.

The other protagonist in the Trade War, President Xi Jinping of China, faces a very different macroeconomic situation. Chinese interest rates are higher, growth is stronger and debt levels are materially lower. The most important difference, however, may be that China has a genuine alternative to exporting. China has prepared for a world of less external demand for its goods for some time, starting soon after the 2008/2009 Developed Market Crisis. This decision now looks extremely prescient. China can replace external demand, which is lost due to tariffs, with demand from consumers at home on account of the country's extraordinarily high saving rate of nearly 50%. In fact, we expect that Chinese consumers will emerge as the world's single most important source of demand over the next few decades, ultimately replacing the US consumer who occupied this position in the years since the mid-1980s. For further discussion of the Trump Trade War, please see *'The limits of protectionism'*, Market Commentary, 4 April 2018.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.73%	0.64%	23.71%	7.82%	5.76%
MSCI EM Small Cap	0.49%	0.66%	18.90%	6.43%	5.26%
MSCI Frontier	-0.36%	4.78%	25.51%	6.84%	8.26%
MSCI Asia	-0.85%	-0.26%	24.35%	8.53%	8.86%
Shanghai Composite	-1.19%	-5.30%	-0.84%	-4.98%	9.65%
Hong Kong Hang Seng	-0.26%	2.21%	21.12%	1.85%	6.87%
MSCI EMEA	-0.11%	-0.96%	19.90%	3.84%	1.20%
MSCI Latam	-0.12%	7.98%	18.28%	7.95%	-1.33%
GBI EM GD	-0.60%	3.82%	12.55%	4.19%	-1.03%
ELMI+	-0.29%	2.22%	8.57%	3.14%	-0.21%
EM FX Spot	-0.61%	1.45%	4.27%	-2.50%	-6.56%
EMBI GD	0.41%	-1.35%	4.29%	5.58%	4.39%
EMBI GD IG	0.31%	-2.13%	2.90%	2.99%	2.92%
EMBI GD HY	0.50%	-0.62%	5.64%	8.72%	6.09%
CEMBI BD	0.21%	-0.92%	3.55%	4.88%	4.07%
CEMBI BD IG	0.04%	-1.30%	2.12%	3.02%	3.28%
CEMBI BD Non-IG	0.41%	-0.43%	5.56%	7.79%	5.09%

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.35%	-2.10%	12.62%	10.03%	13.20%
1-3yr UST	0.02%	-0.13%	-0.05%	0.35%	0.51%
3-5yr UST	-0.03%	-0.77%	-0.62%	0.44%	0.76%
7-10yr UST	-0.17%	-2.03%	-1.02%	0.06%	0.85%
10yr+ UST	-0.72%	-3.99%	1.99%	0.21%	2.36%
10yr+ Germany	-0.03%	1.07%	-0.85%	-0.82%	4.71%
10yr+ Japan	0.02%	1.03%	2.39%	4.26%	3.51%
US HY	0.29%	-0.57%	3.80%	5.16%	5.03%
European HY	0.14%	-0.41%	3.97%	4.28%	6.34%
Barclays Ag	0.01%	-1.40%	2.63%	2.60%	3.26%
VIX Index*	7.61%	94.66%	66.98%	64.17%	67.37%
DXY Index*	-0.04%	-2.18%	-10.94%	-9.12%	9.48%
CRY Index*	-1.59%	-0.83%	2.75%	-11.05%	-33.93%
EURUSD	-0.38%	2.27%	15.86%	15.17%	-6.15%
USDJPY	0.72%	-5.00%	-3.51%	-11.22%	8.11%
Brent	-4.07%	0.81%	22.03%	19.16%	-36.54%
Gold spot	0.48%	2.17%	6.11%	11.43%	-16.02%

*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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