Rising up to the challenge

By Alexis de Mones and David Muller

Market sentiment remains cautious on Emerging Markets (EM), even though the rebound in the USD rally loses steam. A number of EM debt and currency markets have been under pressure, particularly in Latin America. In response, EM policy-makers have been actively trying to stabilise excessive FX volatility through a combination of intervention and interest rates hikes, where necessary. Last week, the Brazilian real (BRL) came under attack but the central bank's actions have provided a respite. Details of the IMF support package for Argentina were announced and exceeded expectations. The recent decisions of the central bank of Turkey have helped the Lira (TRY) turn the corner and out-perform last week. The Reserve Bank of India (RBI) also hiked interest rates. In the rest of the world, a tense G7 meeting in Quebec showed the degree of frustration at President Trump's unilateralism among non-US participants. A number of important events and central bank meetings will shape sentiment before the World Cup gets under way.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	0.54%
MSCI EM Small Cap	11.2	–	-0.33%
MSCI Frontier	10.7	–	3.77%
MSCI Asia	11.8	–	1.33%
Shanghai Composite	10.6	–	0.03%
Hong Kong Hang Seng	7.4	–	1.51%
MSCI EMEA	9.4	–	-1.03%
MSCI Latam	11.1	–	-3.66%
GBI-EM-GD	6.54%	–	-0.91%
ELMI+	4.56%	–	-0.26%
EM FX spot	–	–	-0.42%
EMBI GD	6.36%	342 bps	-0.19%
EMBI GD IG	4.93%	197 bps	-0.47%
EMBI GD HY	8.00%	506 bps	0.09%
CEMBI BD	5.99%	309 bps	-0.02%
CEMBI BD IG	4.90%	201 bps	-0.07%
CEMBI BD Non-IG	7.33%	443 bps	0.04%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.9	–	1.66%
1-3yr UST	2.52%	–	-0.01%
3-5yr UST	2.80%	–	-0.08%
7-10yr UST	2.97%	–	-0.20%
10yr+ UST	3.11%	–	-0.58%
10yr+ Germany	0.50%	–	-1.11%
10yr+ Japan	0.05%	–	0.02%
US HY	6.35%	347 bps	0.44%
European HY	3.54%	419 bps	-0.01%
Barclays Ag	2.05%	-92 bps	-0.06%
VIX Index*	12.32	–	-0.42%
DXY Index*	93.42	–	-0.61%
EURUSD	1.1804	–	0.90%
USDJPY	109.95	–	0.13%
CRY Index*	199.79	–	0.93%
Brent	76.5	–	1.61%
Gold spot	1300	–	0.60%

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

Emerging Markets

- **Brazil:** Last week in EM, the projector was pointed squarely on Brazil, where the BRL and local bonds saw their prices fall sharply. This prompted a decisive reaction from central bank governor Goldfajn, with a promise to do more, which managed to stabilise the currency for a while. The current move in BRL is mainly a technical-led sell-off driven by re-calibration of political risk, not a balance sheet crisis, in our view. Since the risk of a new Lula presidency collapsed earlier this year, the market had not really priced in the risk of a leftist candidate possibly winning in October. However, in recent weeks broad popular support for the truckers' strike has revealed how slim the chances are of a centrist, moderate candidate winning the election, and the market's attention has turned to the candidacy of veteran politician Ciro Gomes who currently carries the hopes of the left.

Politics are famously fluid in Brazil, where 20 percent swings in voting intentions happen regularly in the last months of the campaign, so it is too early to call. However at the moment the right-wing populist Jair Bolsonaro still leads the polls, and one must try and understand what a Bolsonaro presidency would mean for economic policy. Few specifics are known at this stage, but we are encouraged that Bolsonaro enlisted the help of a serious orthodox economist as economic advisor called Paolo Guedes, who would be expected to carry on with sound macro policy if he were to inherit the Economics brief.

The market's move in Brazilian bonds has been quite sharp in recent days, as local investors were stopped out of long RL positions, followed by some offshore investors, creating a fair degree of overshoot in FX and local rates. This caused the central bank of Brazil to intervene by providing USD liquidity, mainly through its FX swap program.

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Emerging Markets

In recent months, the central bank had been quite dovish and had acquiesced to a slightly weaker BRL as inflation was below target at less than 3%. This has now changed as the focus is on stability: the good news is that the central bank has a lot of room to intervene, with USD 380bn in reserves, a currency swap program that can be ramped up, and no current account deficit to finance. Of course they will be careful to use the ammunition sparingly, but they also need to announce their intentions clearly to dissuade speculation. Last week, the central bank governor Goldfajn came out in defiant mode and said that he would be happy to offer USD 20bn and he could increase the FX swap program beyond where it was at the peak in 2015, if need be. He also said that he would not increase the Selic rate just to stabilise the currency, but the market is now pricing in 340bps of hikes between now and year-end, so the risk premium is quite high already.

He noted that Brazil's inflation expectations are well anchored and that the country's balance of payments position was solid. Goldfajn made a forceful argument that a floating exchange rate is the economy's first line of defence and that monetary policy will not be used to manage the exchange rate. While the Brazilian curve has priced in a series of rate hikes in the next 12 months, these comments, as well as the country's low inflation rate, seem to indicate that the central bank will not be looking to increase rates any time in the near future. Brazil's headline IPCA printed at 0.4% in May, above the market consensus, likely due to the transportation disruptions arising during the truckers strike.

- Argentina: Treasury Minister Dujovne reached a 'staff-level' agreement with the IMF for a 3-year Exceptional-Access Stand-By Arrangement (SBA) for USD 50bn, well in excess of the USD 30bn that had originally been requested. The agreed amount, as well as an additional USD 5.65bn in credit lines with other multi-laterals, is meant to ensure a positive market reception. In return for the financial support, the IMF obtained a commitment on a more aggressive fiscal adjustment in Argentina than had been pursued by the Macri administration, with a fiscal target for the primary deficit set at -2.7% of GDP for 2018, -1.3% in 2019, 0% in 2020 and a primary surplus starting in 2021. Inflation expectations in Argentina remain unanchored, as both headline and core inflation shift higher, an indication that current inflation targets are ineffective as anchors for the economy. The IMF agreement stipulates revised inflation targets beginning in 2019 at 17%, 13% in 2020 and 9% in 2021. Other commitments were also agreed to, notably a commitment to a market-determined exchange rate and a revision to the central bank's charter to ensure legal independence and autonomy.

- Turkey: Headline inflation rose from 10.8% yoy in April to 12.1% in May, surpassing market expectations. Food and transportation inflation were the primary drivers. At its meeting on June 7, the Central Bank of the Republic of Turkey (CBRT) responded with a larger than expected 125bps hike, bringing its one-week repo rate to 17.75%. This move follows an earlier 300bps hike in the late liquidity lending rate, and the welcome so-called 'simplification' move to a more traditional interest rate corridor at an extraordinary Monetary Policy Committee (MPC) meeting. The Turkish Lira (TRY) reacted well to these changes and was 3.9% stronger on the week against the USD. The stabilisation of the TRY limits the risk of dollarisation and can help shore up support for president Erdogan ahead of the June 24 election. Erdogan remains the clear favourite to win the presidential election, albeit possibly not at the first round of voting, but a coalition of opposition parties are mounting a credible challenge and may be able to wrestle a parliamentary majority away from the leading AKP party.

- Poland: Poland's MPC met on June 6 and, in line with expectations, kept its policy rate unchanged at 1.5%, retaining its dovish outlook. The Committee was comfortable looking through the recent increase in oil prices and the depreciation in the Zloty, and forecasting a lower inflation projection that would permit the Committee to maintain interest rates at the current level well into 2020.

- South Africa: South Africa's reported Q1 GDP showed that output contracted by 2.2% qoq annualized, in a blow to the new Ramaphosa government. The disappointing report showed demand weakness primarily in exports due to slower global demand and supply hits from mining, manufacturing and agriculture. The 24% qoq annualised drag from agriculture was the result of ongoing droughts in the Western Cape region, which accounts for nearly one quarter of South Africa's output. Although seasonal factors clearly impacted the data, the GDP print highlights the remaining structural challenges that the government needs to address. Early evidence of the government's commitment to reform may be seen in the forthcoming amendment to the mining charter, including new rules that address black ownership levels and other targets, as well as a commitment to renewable energy.

- Ukraine: A significant step in Ukraine's return to stability occurred with the passage by the Rada of the Anti-Corruption Court (ACC), a key requirement of the IMF for disbursal of the next USD 2bn tranche of financial support. The IMF must still confirm that the bill meets its requirements. The passage also indicates that agreement on the remaining open items, including a hike in the gas tariff and further fiscal adjustments, is likely. Ukraine plans to issue up to USD 2bn in new bonds, but required the approval of the establishment of the ACC as a pre-requisite.

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Global backdrop

- **India:** The Reserve Bank of India (RBI) increased policy rates by 25bps to 6.25% and maintained a neutral stance. The hike, the first in 4½ years, is an important sign of the RBI's inflation-fighting role as attention turns to the future course of interest rates. The market is likely to price in future rate hikes in the absence of any inflation surprises on the downside. Higher crude oil prices have been driving inflationary expectations higher.
- **Philippines:** Headline inflation increased 4.6% yoy in May in the Philippines, the highest level since 2013, even as monthly CPI increases appear to be moderating. A number of one-off impacts will likely sustain inflationary pressure for the balance of the year, notably transport fare and tobacco tax increases. The central bank (BSP) is expected to hold interest rates steady at its June 21st meeting, but comments from Governor Espenilla were seen as mildly hawkish. The trade deficit widened in April to USD 3.6bn due to a rise in capital goods imports.
- **Venezuela:** In a sign of further deterioration of Venezuela's oil infrastructure, PDVSA advised its overseas customers that it would not have sufficient oil to satisfy its supply contracts for the month of June. Contracts called for delivery of 1.495 mb/d, while PDVSA is believed to only have 694K b/d available for export. In response, China has begun to source replacement supply for its refineries that use Venezuelan heavy crude. Reports indicate that Venezuela is considering a declaration of force majeure on its delivery contracts with crude buyers.

Snippets

- **Chile:** Headline inflation accelerated, reaching the lower end of the target range at 2% yoy, while core inflation remained below the target range. The central bank will likely hold policy rates at 2.5% heading in to the second half of the year.
- **Indonesia:** Headline CPI inflation eased to 3.2% yoy in May, well inside Bank Indonesia's target band of 2.5-4.5%. Despite moderate inflation, Bank Indonesia demonstrated its commitment to stability of the Rupiah with a 50bps hike in May.
- **Colombia:** Polls indicate that right-wing presidential candidate Ivan Duque is maintaining a healthy 15 points lead over Gustavo Petro as the country heads into the June 17th runoff. A Duque victory would not change economic policy radically, but a lower risk of a Petro-led government has been translating into greater strength in the Colombian peso (COP), up a modest 0.4% against USD on the week.
- **Kazakhstan:** The National Bank of Kazakhstan cut its policy rate by 25bps to 9% while maintaining its corridor at +/- 1%. The move followed the release of inflation data showing a decline to 6.2% in May, down 0.3-0.4% from the February - April period.
- **Malaysia:** The governor of the central bank Muhammad Ibrahim resigned halfway through his term, the latest leadership change since the Mahatir Mohamad assumed the prime ministership in a surprise election outcome last month.
- **Mexico:** Leading presidential candidate Andres Manual Lopez Obrador (AMLO) continues to increase his polling numbers. AMLO's party Morena (National Regeneration Party) also is leading in voting intentions and could win a majority in the Senate.
- **Peru:** The Monetary Policy Committee held its policy rate steady at 2.75% but amended its guidance to add economic growth as a condition to alter its accommodative policy position. Following the resignation of David Tuesta as Minister of Finance, Carlos Oliva was named to replace Tuesta. Oliva is viewed as an experienced and well-regarded choice for the position.
- **Russia:** Headline inflation held at +2.4% in May as food and alcohol inflation offset increases in gas prices and in core inflation. Russia is likely to be in a position to continue its rate cutting cycle throughout 2018/2019.

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Global backdrop

The 44th G7 summit meeting took place in Quebec on June 8/9, with deliberations focused on trade relations in light of the decision by the US government to proceed with unilateral tariffs on steel and aluminium, impacting key US allies in Europe and NAFTA partners. Should there be no further shift in US policy, further escalation of trade tensions are likely. Several trading partners have already announced retaliatory measures, imposing tariffs on products from states where President Trump enjoys strong support. This week on June 15, the US government will publish its list of Chinese imports that will be subject to higher tariffs thereafter. The Chinese government has already prepared its own list of American goods to be slapped by retaliatory tariffs. This process of escalation will take place while at the same time the US and Chinese governments are conducting regular rounds of negotiations on a more comprehensive agreement on trade. The latest negotiations were conducted by Wilbur Ross in Beijing, but the distance between the parties remains very large and an agreement remains elusive.

White House economic advisor Larry Kudlow indicated another shift in the US negotiating policy with its NAFTA partners Canada and Mexico, suggesting that the current trilateral negotiations between the three countries be replaced by bilateral negotiations between the US and each of its partners. It is unclear how this proposal would align with the NAFTA framework, which foresees negotiations occurring between the three signatories to the pact. Kudlow also commented that President Trump does not intend to walk away from NAFTA, a threat that the President has repeated numerous times. Mexico and Canada have responded by repeating their commitment to NAFTA remaining a trilateral agreement rather than a collection of bilateral agreements. Perhaps forgetting that NAFTA only involved three countries, Kudlow commented "...oftentimes when you have to compromise with a whole bunch of countries, you get the worst of the deals."

This week markets will hear from the FOMC, the ECB governing council and the BOJ on three successive days. The FOMC is expected to deliver a 25 bps rate hike, but the ECB's Draghi will have a far trickier balancing act: to reassure markets that underlying European economic data is strong enough to consider ending QE this year, whilst at the same time, provide guarantees that the ECB can provide a life-line if peripheral debt prices (read: Italian BTPs) fall out of bed. Buona fortuna!

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.41%	-1.20%	14.36%	8.04%	5.77%
MSCI EM Small Cap	-0.11%	-2.10%	12.25%	4.58%	4.65%
MSCI Frontier	3.97%	-4.01%	9.24%	4.35%	4.73%
MSCI Asia	1.95%	1.98%	17.46%	9.32%	9.27%
Shanghai Composite	-0.62%	-6.65%	-0.26%	-14.03%	9.36%
Hong Kong Hang Seng	1.89%	5.04%	19.58%	-1.01%	7.67%
MSCI EMEA	0.45%	-8.33%	7.67%	3.84%	0.29%
MSCI Latam	-3.34%	-11.28%	0.06%	2.58%	-3.45%
GBI EM GD	-0.93%	-4.59%	-0.58%	3.10%	-1.73%
ELMI+	-0.11%	-1.91%	1.77%	2.23%	-0.79%
EM FX Spot	-0.42%	-4.83%	-4.07%	-3.36%	-7.14%
EMBI GD	-0.50%	-4.57%	-1.57%	4.84%	4.47%
EMBI GD IG	-0.63%	-4.30%	-1.73%	3.21%	3.34%
EMBI GD HY	-0.38%	-4.91%	-1.52%	6.68%	5.81%
CEMBI BD	-0.21%	-2.66%	0.09%	3.98%	4.21%
CEMBI BD IG	-0.20%	-2.40%	-0.43%	2.83%	3.56%
CEMBI BD Non-IG	-0.21%	-2.97%	0.89%	5.68%	5.06%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.77%	4.84%	16.43%	12.45%	13.38%
1-3yr UST	-0.11%	-0.07%	-0.14%	0.43%	0.54%
3-5yr UST	-0.35%	-1.05%	-1.52%	0.65%	0.91%
7-10yr UST	-0.74%	-2.75%	-3.25%	0.91%	1.29%
10yr+ UST	-1.61%	-4.72%	-1.65%	2.91%	3.58%
10yr+ Germany	-1.70%	1.85%	0.69%	3.84%	5.67%
10yr+ Japan	-0.09%	1.32%	2.25%	5.12%	4.91%
US HY	0.53%	0.28%	2.79%	5.33%	5.14%
European HY	0.25%	-0.84%	1.64%	4.18%	6.03%
Barclays Ag	-0.41%	-1.42%	1.19%	2.78%	1.04%
VIX Index*	-20.16%	11.59%	15.14%	-4.12%	-27.83%
DXY Index*	-0.59%	1.41%	-3.96%	-1.63%	15.18%
CRY Index*	-1.50%	3.06%	13.03%	-11.32%	-29.90%
EURUSD	0.95%	-1.67%	5.36%	4.86%	-11.34%
USDJPY	1.04%	-2.43%	0.00%	-10.92%	14.50%
Brent	-1.40%	14.40%	58.88%	17.49%	-25.70%
Gold spot	0.10%	-0.25%	2.68%	9.97%	-5.70%

*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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