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WEEKLY INVESTOR RESEARCH

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Fear – and how to trade it

By Jan Dehn

Financial markets tend to resort to rules of thumb during bouts of risk aversion, such as the recent fear of trade wars. Yet, since markets often misprice risk during bouts of risk aversion, rules of thumb trading can itself lead to major misallocations of capital and new and different types of mispricing. This is why making big investment decisions during panics is a bad way to manage investments. The Weekly also covers Mexico, where it is third time lucky for AMLO, Argentina's struggle to regain investor confidence and the recovery in Brazil's credit markets. The global backdrop is dominated by concerns over immigration in Europe and the growth outlook in the US as core PCE hits the Fed's target and the White House lets out news of Trump's FART Act.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.7	–	-1.46%
MSCI EM Small Cap	10.6	–	-2.07%
MSCI Frontier	10.1	–	-3.49%
MSCI Asia	11.3	–	-2.18%
Shanghai Composite	9.7	–	-1.32%
Hong Kong Hang Seng	6.9	–	-2.07%
MSCI EMEA	9.2	–	1.03%
MSCI Latam	11.2	–	1.60%
GBI-EM-GD	6.59%	–	-0.43%
ELMI+	4.95%	–	-0.43%
EM FX spot	–	–	-0.46%
EMBI GD	6.53%	367 bps	-0.39%
EMBI GD IG	4.88%	202 bps	0.20%
EMBI GD HY	8.44%	558 bps	-1.00%
CEMBI BD	6.08%	325 bps	-0.05%
CEMBI BD IG	4.90%	207 bps	0.25%
CEMBI BD Non-IG	7.55%	472 bps	-0.42%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.5	–	-1.31%
1-3yr UST	2.52%	–	0.10%
3-5yr UST	2.72%	–	0.23%
7-10yr UST	2.84%	–	0.44%
10yr+ UST	2.97%	–	1.05%
10yr+ Germany	0.30%	–	1.35%
10yr+ Japan	0.03%	–	0.02%
US HY	6.49%	363 bps	-0.53%
European HY	3.91%	454 bps	-0.85%
Barclays Ag	1.99%	-85 bps	0.15%
VIX Index*	16.09	–	2.32%
DXY Index*	94.78	–	0.49%
EURUSD	1.1653	–	-0.44%
USDJPY	110.67	–	0.82%
CRY Index*	200.39	–	2.85%
Brent	78.3	–	4.76%
Gold spot	1250	–	-1.25%

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

Emerging Markets

Financial markets react in a very predictable fashion whenever a new source of fear comes along. Since new scary things can be difficult to fully parameterise, let alone define, market participants tend to default to simple rules of thumb at such times, especially during the early phases, when uncertainty is greatest.

The rules of thumb inevitably boil down to allocating capital to pre-designated 'safe' assets and withdrawing it from pre-designated 'risky' assets. In currencies, investors tend to leg it into JPY, CHF and USD when they get scared and sell EM FX, NOK, SEK, AUD and CAD. In stocks, they shed cyclicals and growth stocks in favour of defensives. In bonds, they usually switch into IG and US Treasuries from EM bonds and high yield bonds.

These simple rules of thumb are extremely pervasive, because they confer three distinct advantages to investors during bouts of risk aversion. First, they give the impression that managers are doing something. Second, they obviate the need for managers to think through the scary thing before taking action. Third, they provide the comfort of 'shelter in numbers', since all investors more or less apply the same rules of thumb, i.e. do the same trades.

Sadly, this also means that the rules of thumb rarely result in optimal performance, especially over the cycle. Rather, rules of thumb can end up creating new and equally extreme mispricing, just in different markets. Markets often overstate the 'scariness' of new scary things, so 'risky' assets are almost always oversold, while 'safe' assets are overbought.

As an example, consider the last time EM markets priced in a scary thing, which was the start of the normalisation of US monetary policy. This process began with Bernanke's tapering announcement in May 2013 and ended with the first Fed hike in December 2015. EM markets literally sold off over this entire period without a break. In the end, EM local bond markets had not only priced tapering and the first Fed hike, but also the entire Fed hiking cycle plus another 45bps of hikes! Specifically, EM bond yields pushed as high as 7.25%, which was a full 45bps higher than yields in 2006, when the Fed funds rate was 5.25%. No wonder, then, that EM bonds racked up 26% return in USD terms in 2016 and 2017.

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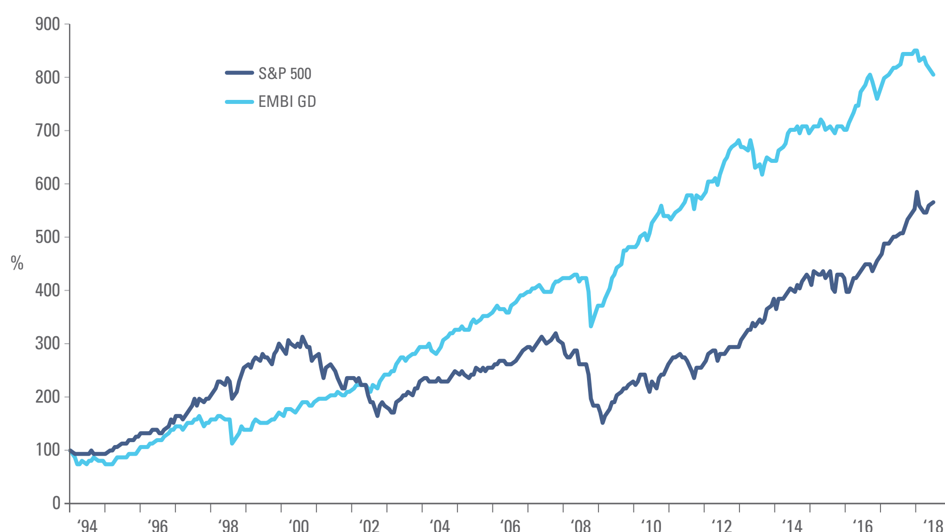
Emerging Markets

Investors would be wise to bear this experience in mind as they observe the current EM gyrations in response to the latest scary thing, namely US protectionism. The markets are once again in a state of heightened uncertainty. How far will Trump go? He has already pulled out of TPP and threatened NAFTA; will he also pull out of WTO? Will he extend his newly confirmed powers to ban US travel by also barring entry to, say, Chinese visitors to the US? Will China and Europe retaliate to the unilateral imposition of tariffs by the US? If so, how and what will happen to growth? The full scope of the protectionism threat is clearly difficult to quantify. In the face of such uncertainty, investors have reacted precisely as one would expect; the Dollar has rallied, US Treasuries have stopped selling off, stocks have disappointed compared to previous years, particularly taking into account the massive corporate tax cut, and, of course, EM assets have seen a predictable pullback, especially in currencies.

So, what is an investor to do? Ironically, the answer is to buy 'risky' assets, regardless of the prevailing trepidation in the market. Not only is buying likely to prove lucrative over the cycle, but it may also turn out to be one of the safest things to do.

Fig 1: **S&P 500 and EMBI GD**



Source: Ashmore, Bloomberg.

Why lucrative? The biggest mispricings tend not to occur during bull markets; rather they occur during panics, such as Trump's protectionism. That is not to say that markets do not get mispriced during bull markets, but the grossest mispricing in bull markets almost always tends to be concentrated in rather narrow segments of the market, such as individual countries or sectors, while mispricing is far less pronounced the vast majority of assets. However, when risk aversion strikes then all 'risky' assets tend to be liquidated, often quite indiscriminately, while enormous volumes of capital funnel into a very narrow set of designated 'safe' assets, which then quickly assume de facto bubble-like valuations. Clearly, such price action is even more unsustainable than the pricing which prevails during bull markets. A simple way to verify this is to glance at the long-term trend in any asset class. Figure 1 shows US stocks (S&P 500) and EM external sovereign bonds. Clearly, the periods with the most unsustainable valuations were the big pullbacks in the markets, while the overall trends were, in both cases, unambiguously higher. Hence, buying in panics was extremely lucrative, consistently.

Why do we think buying risky assets in times of panic is safer? Because the vast bulk of assets, whose prices decline during panics recover, and if one buys while the assets are cheap, the upside is greater for a given risk. The vast majority of companies and countries are healthy, resilient and adaptable. They are only being sold, because of their pre-designation as 'risky' assets. Liquidating during bouts of risk aversion almost certainly backfires by crystallising temporary losses. The general rule is to not make big decisions at times of maximum uncertainty, because valuations, positions and even the perception of reality are all at their points of maximum distortion precisely at the height of risk aversion.

The right strategy with respect to 'risky' assets during panics is to begin to build positions with a view to establishing the basis for strong future performance when markets recover. Never, never, never judge performance solely on the basis of returns during the height of a risk aversion event itself; the real test of the manager is whether strong performance is achieved over the full cycle of the market, that is, over the downturn as well as the subsequent recovery.

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Emerging Markets

- **Mexico:** Andres Manuel Lopez Obrador aka AMLO won the Mexican presidential election with a decisive mandate on the back of a high participation rate. He also secured a strong position in both chambers of the parliament, although not the two-thirds majority required for constitutional changes. He should therefore be able to rule with a stable government. His post-election speech was market-friendly, emphasising macroeconomic stability and respect for central bank independence. We see one potential downside risk and one potential upside risk relative to current market expectations. The downside risk is that AMLO's administration, like so many other left-wing governments in Latin America, succumbs to corruption. However, this risk will take time to materialise, if at all. The upside risk is that AMLO tackles Mexico's most serious economic problem: monopolies. By increasing competition in the Mexican economy, AMLO could kill three birds with one stone: increase the lot of his constituency, weaken his main political opponents and improve Mexico's economic performance in general. In other news, the 12-month rolling trade deficit was roughly unchanged in May compared to April (USD 11.5bn and USD 11.2bn, respectively). Both exports and imports were stronger than expected in a sign of healthy underlying economic activity. The rate of unemployment declined to 3.2% in May from 3.4% in April. This is the lowest level of unemployment for twelve years. Retail sales expanded at a yoy rate of 3.3% in April compared to 3.1% yoy expected.

- **Argentina:** The central bank left the policy rate unchanged at 40%. The central bank is expected to make fresh announcements regarding the conduct of monetary policy in the coming days following the appointment of Luis Caputo as Governor. The monthly proxy for real GDP growth pointed to a decline of the yoy rate to 0.9% in April from a stronger an expected 2.0% yoy rate in March. The cause of the slowdown in real GDP was likely caused by a decline in agricultural output due to drought.

- **Brazil:** Bank lending increased 0.5% in the month, or 1.3% yoy in May compared to 0.7% in April. Earmarked (government directed) lending declined at a rate of 3.5% yoy in May, while non-earmarked (commercial) lending increased at a yoy rate of 6.2% yoy (5.0% yoy in April). The expansion in commercial credit alongside a decline in government lending is efficiency improving. It also coincides with a decline in non-performing loans to 4.6% in May from 5.9% in the same month last year. Brazil is in the early stages of a multi-year cyclical upswing, which the markets are finding it difficult to focus on due to the proximity of and uncertainty associated with October's presidential election. The trade surplus was USD 5.6bn in May compared to USD 7.4bn in May last year. The rate of unemployment declined to 12.7% in May from 12.9% in April. The government's primary deficit was BRL 8.2bn in May, or 1.4% of GDP, which is significantly down from 2.6% in July 2017. Public sector net debt declined to 51.3% of GDP from 52% of GDP in April.

Snippets:

- **Bahrain:** Saudi Arabia, Kuwait and United Arab Emirates pledged support for Bahrain public finances, which are strained.
- **Chile:** Profits of industrial enterprises surged at a yoy rate of 15.6% in May against the backdrop of an already solid rate of profit growth of 14.1% yoy in April.
- **China:** The Caixin small manufacturers' PMI moderated marginally to 51.0 in June from 51.1 in May. The official services PMI increased to 55 in June from 54.9 in May, while the official manufacturing PMI declined to 51.5 from 51.9.
- **Colombia:** The central bank left the policy rate unchanged at 4.25%.
- **Costa Rica:** The government adopted a strong stance against union-led protesters in the education and health sectors in order to secure an ongoing fiscal consolidation.
- **Czech Republic:** The Czech National Bank surprised the market by hiking the policy rate by 25bps to 1%. The market had expected no hike.
- **Ecuador:** The government has outlawed the use of temporary labour contracts in government for this year and 2019. The decision will save the government up to USD 0.5bn and marks the latest positive development in the government's overhaul of the public finances.
- **India:** The Manufacturing PMI surged to 53.1 in June from 51.2 in May.
- **Indonesia:** Bank Indonesia surprised the market by hiking the benchmark interest rate by 50bps to 5.25%. The market has only expected a hike of 25bps. The rate of CPI inflation eased to 3.1% yoy in June from 3.2% yoy in May.
- **Nigeria:** The 2018 Budget looks set to deliver a fiscal deficit of 1.7% of GDP compared to 2.2% of GDP in 2017.
- **Singapore:** Industrial production easily beat expectations in May by rising at yoy rate of 11.1% versus 10.0% yoy expected. The yoy rate of core inflation 1.5% in May, up from 1.3% yoy in April.
- **South Korea:** Consumer sentiment weakened in June due to growing fears arising from US protectionist measures against China. June exports were down 0.1% yoy following extremely strong exports in May (+13.2% yoy).

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Emerging Markets

- **Sri Lanka:** The yoy rate of CPI inflation increased to 4.4% in June from 4.0% in May. Core inflation was 3.4% yoy in June (3.2% yoy in May).
- **Taiwan:** Industrial production increased 1.3% in the month of May. This is equivalent to a yoy growth rate of 7.1% compared to 6.0% yoy expected. The Nikkei PMI accelerated to 54.5 in June from 53.4 in May.
- **Thailand:** The rate of CPI inflation declined to 1.4% yoy in June from 1.5% yoy in May. The trade surplus increased to USD 2.7bn in May from USD 0.2bn in April. Exports increased as a yoy rate of 13.0% in May while imports increased at a rate of 11.7% yoy. Industrial production expanded at a yoy rate of 3.2% in May from 3.1% yoy in April, while capacity utilisation increased to 69.4 from 67.7. Private consumption was also strong (5.6% yoy).

Global backdrop

The European Union Summit delivered a deal on immigration, which could reduce divisions within a very tribalistic union. The deal would strengthen the external borders of the EU, create holding centres to speed up handling of refugees' cases and the put in place new rules for distributing refugees across EU member states. All very sensible stuff. However, the leaders of Europe will now have to go home to sell the deal to their partisan coalition partners and populations, which is where the problems really begin. In Germany, Merkel's main coalition partner, CSU, looks on the verge of pulling out of her government, which could result in a minority government in Germany.

Earlier, the Eurogroup successfully awarded Greece debt relief in the shape of a 10-year extension of maturity on its EFSF liabilities. This means that Greece can now look forward to seeing its debt to GDP ratio dip below 100% by 2060!

US GDP growth was 2.0% in Q1 versus 2.2% expected and 2.2% in the last quarter. In other words, the US economy has so far slowed following last year's massive corporate tax cut, though the market still clings to the hope of a significantly stronger print for Q2. A stronger print seems likely, but the stimulus from the tax cut is a sugar high, which, by virtue of stimulating demand rather than removing supply-side constraints to growth, does not lay the foundation for a sustained expansion of the US economy. May core PCE inflation was high enough to finally push the yoy inflation rate for this index to 2.0%, the Fed's target. On the other hand, personal consumer spending slowed sharply in May (declining from 0.6% mom sa in April to just 0.2% mom sa). Durable goods orders and pending home sales also declined. On the positive side, the US trade deficit narrowed to USD 65bn due to higher than expected agricultural exports. Sadly, agricultural exports will soon become the target of Chinese retaliatory tariffs in response to President Donald Trump's tariffs on China, so they may well fall in the coming months. In other trade-related news, Trump's tariffs against China are due to kick in this week, while Canadian counter-tariffs against the US took effect at the weekend. Each time a country imposes a tariff it is in effect taxing its own people by increasing prices of the affected goods. Tariffs cause major price distortions between trade and non-traded goods and reduce choice for consumers. As such, they simply do not pass the smell test from an economist's perspective. Yet, the tariff stink may get much worse as the White House let out the idea of a FART (Fair and Reciprocal Tariff) Act, which would inflate Trump's licence to emit new tariffs at will.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.13%	-6.60%	8.53%	6.02%	5.39%
MSCI EM Small Cap	-6.54%	-8.40%	5.87%	2.77%	4.54%
MSCI Frontier	-3.51%	-10.91%	1.68%	2.19%	4.47%
MSCI Asia	-4.79%	-4.76%	10.13%	7.30%	8.45%
Shanghai Composite	-7.28%	-12.91%	-8.59%	-10.84%	9.96%
Hong Kong Hang Seng	-6.76%	-3.87%	10.78%	-1.82%	7.21%
MSCI EMEA	-2.22%	-10.77%	6.22%	1.31%	0.25%
MSCI Latam	-3.04%	-11.00%	0.15%	2.30%	-2.13%
GBI EM GD	-2.86%	-6.44%	-2.33%	1.96%	-1.40%
ELMI+	-1.63%	-3.41%	0.50%	1.42%	-0.79%
EM FX Spot	-2.10%	-6.44%	-5.22%	-4.13%	-7.09%
EMBI GD	-1.19%	-5.23%	-1.60%	4.63%	5.14%
EMBI GD IG	0.03%	-3.67%	-0.50%	3.43%	4.35%
EMBI GD HY	-2.45%	-6.89%	-2.86%	6.05%	6.09%
CEMBI BD	-0.42%	-2.87%	-0.14%	3.95%	4.71%
CEMBI BD IG	0.10%	-2.10%	-0.31%	2.95%	4.16%
CEMBI BD Non-IG	-1.06%	-3.80%	0.24%	5.45%	5.45%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.62%	2.65%	14.36%	11.92%	13.40%
1-3yr UST	0.01%	0.05%	0.01%	0.41%	0.58%
3-5yr UST	-0.04%	-0.74%	-0.98%	0.62%	1.13%
7-10yr UST	0.06%	-1.97%	-1.78%	1.04%	1.93%
10yr+ UST	0.18%	-3.00%	-0.13%	3.46%	4.50%
10yr+ Germany	0.28%	3.91%	5.27%	4.48%	6.46%
10yr+ Japan	0.14%	1.55%	2.62%	4.75%	5.07%
US HY	0.40%	0.16%	2.62%	5.53%	5.51%
European HY	-0.42%	-1.50%	1.05%	4.33%	6.08%
Barclays Ag	-0.44%	-1.46%	1.36%	2.58%	1.49%
VIX Index*	0.00%	45.74%	43.92%	-4.17%	-2.13%
DXY Index*	0.32%	2.88%	-0.89%	-1.39%	13.44%
CRY Index*	0.00%	3.36%	14.65%	-10.76%	-28.35%
EURUSD	-0.26%	-2.93%	2.53%	5.12%	-10.22%
USDJPY	-0.07%	-1.79%	-2.39%	-10.07%	9.98%
Brent	-1.45%	17.08%	63.38%	26.13%	-24.72%
Gold spot	-0.27%	-4.09%	2.43%	7.17%	0.50%

*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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