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Volatility spikes do not last very long: spotting an opportunity

By Jan Dehn

EM FX volatility has spiked to levels last seen during 08/09 and in the run-up to Lula's presidency in 2002. It is difficult to see why such a strong response is justified in the current circumstances and spikes in FX volatility of this magnitude tend in any case to be very short-lived. This report examines the causes and opportunities created by this occurrence. Elsewhere, there is election fever in Brazil, sanction fears in Russia, Trump sends tweet missiles at South Africa, Ecuador cuts spending and secures new funding, Venezuela undertakes meaningless reforms and Costa Rica undertakes meaningful reforms. The global backdrop is deteriorating again at the margin as markets continue to discount dangerously growing risks in developed markets.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	3.46%
MSCI EM Small Cap	10.8	–	2.20%
MSCI Frontier	10.1	–	-0.37%
MSCI Asia	11.6	–	2.81%
Shanghai Composite	9.8	–	3.09%
Hong Kong Hang Seng	7.2	–	3.92%
MSCI EMEA	9.5	–	6.61%
MSCI Latam	11.6	–	1.79%
GBI-EM-GD	6.81%	–	1.60%
ELMI+	4.47%	–	0.84%
EM FX spot	–	–	1.24%
EMBI GD	6.45%	359 bps	0.47%
EMBI GD IG	4.76%	190 bps	0.30%
EMBI GD HY	8.44%	559 bps	0.65%
CEMBI BD	6.15%	333 bps	0.07%
CEMBI BD IG	4.84%	202 bps	0.03%
CEMBI BD Non-IG	7.83%	501 bps	0.12%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	1.41%
1-3yr UST	2.65%	–	-0.03%
3-5yr UST	2.75%	–	-0.13%
7-10yr UST	2.85%	–	-0.16%
10yr+ UST	3.01%	–	-0.19%
10yr+ Germany	0.37%	–	-0.67%
10yr+ Japan	0.10%	–	0.20%
US HY	6.23%	333 bps	0.35%
European HY	3.43%	408 bps	0.14%
Barclays Ag	2.03%	-82 bps	0.33%
VIX Index*	12.03	–	-0.83%
DXY Index*	94.56	–	-0.70%
EURUSD	1.1714	–	1.24%
USDJPY	111.05	–	0.67%
CRY Index*	192.87	–	2.87%
Brent	76.6	–	5.51%
Gold spot	1213	–	1.43%

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

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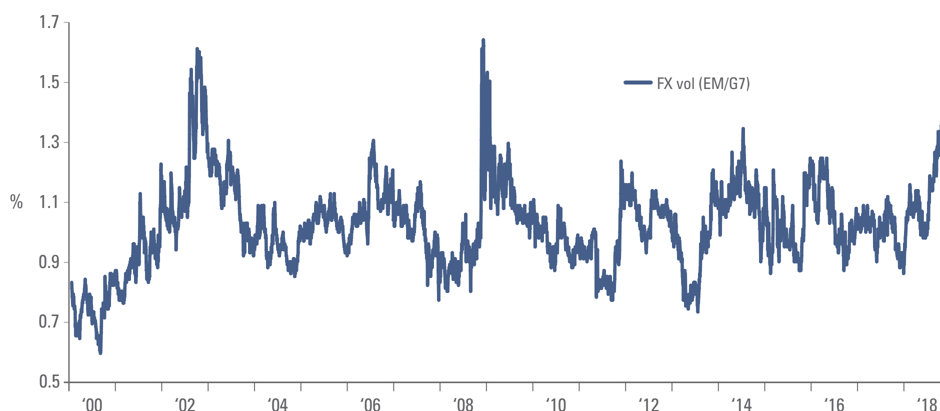
Based on the ratio of volatility of EM currencies to G7 currencies, which is a simple but powerful measure of sentiment towards EM, the EM universe should have collapsed in 2018. Figure 1 shows that EM currency volatility spiked this year relative to G7 currencies to levels last seen in late 2002 ahead of Lula's election in Brazil and in 2008/09 when the entire Western banking system collapsed. This seems a bit excessive. Besides, spikes in FX volatility never last for very long. So, is this an opportunity?

Fig 1: **Ratio of FX volatility (EM vs G7)**



Source: Ashmore, Bloomberg.

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The answer depends on what caused the spike. Did temporary or permanent factors cause the spike in EM FX volatility? Was the spike mainly market-based or did it originate from serious underlying erosion in EM fundamentals relative to fundamentals in developed countries? As far as EM fundamentals are concerned, it seems difficult to establish a case for serious, broad-based and systemic erosion. Instead, there have been a series of idiosyncratic events most of which have come and gone with no lasting impact. They include elections in Mexico, Turkey and Colombia, which certainly spooked some investors for a short time, but with 70 investable countries in EM most of which have elections on a regular basis EM actually has important elections *every single year*, so why should this year's elections have moved markets so much?

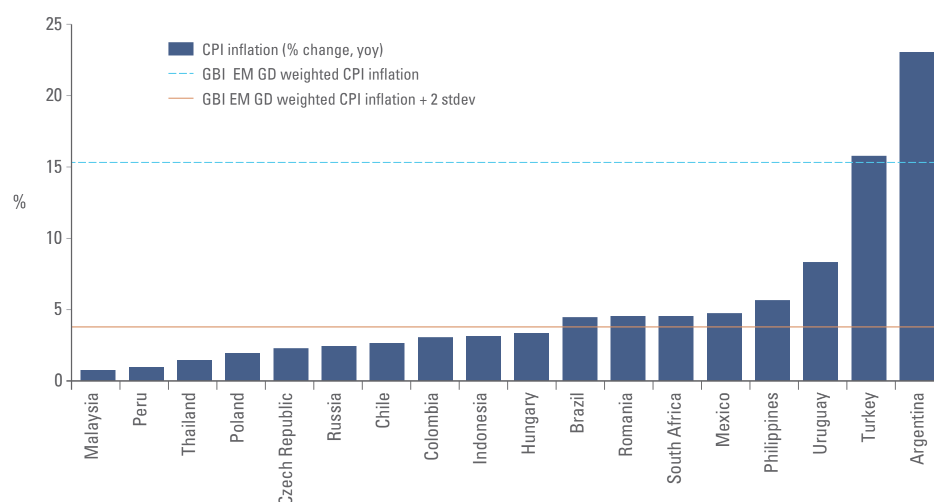
The US imposed sanctions against Russia (some of which are still pending), but the US has been sanctioning Russian entities for years and there are currently more than 700 Russians under sanction. This is hardly earth shattering news and besides, this situation is very specific to Russia.

The currency debacle in Argentina attracted attention for a while, but the government quickly engaged the IMF and the story went away. Besides, Argentina is a very small part of the indices and known to have macroeconomic imbalances after more than a decade of terrible policies under the Kirchners.

More recently, Turkey has run into trouble. However, Turkey's macroeconomic problems have been eight years in the making and clearly self-inflicted. Most EM managers are underweight Turkey and the problem is idiosyncratic. For example, Turkey's inflation rate is more than two standard deviations wider than the rest of EM based on members of the JP Morgan GBI EM GD index (Figure 2).

Looking ahead, there are still some concerns about the Brazilian election, but this is obviously a Brazil-specific situation with no obvious links to, say, Indonesia, Uruguay, Poland, Ghana or any other EM countries for that matter.

Fig 2: **July CPI inflation**



Source: Ashmore, Bloomberg, JP Morgan.

If 2018 was a case of 'nothing to see here' in terms of EM fundamentals then perhaps EM currency markets reacted strongly to events emanating from outside of EM? This seems more likely, in our view. The single most important change in the global currency markets in 2018 was a sharp recovery in the Dollar driven by four very specific, but temporary factors:

- Fed Chairman Powell was more hawkish than expected as he sought to establish his independence and credibility shortly after taking office.
- Unfunded tax cuts generated a temporary sugar high for US growth.
- Trump launched all-out trade war against China.
- The Dollar found room to bounce after its 20% fall against EUR in 2017 as Europe's economy slowed in Q1.

The Dollar surge triggered a rather vicious bout of profit taking in EM FX as well, because EM local markets had racked up very strong returns in 2016-2017. Combining all these factors, the conclusion seems clear that the spike in EM FX volatility was largely due to temporary factors without strong basis in fundamentals. The vast majority of EM economies have not exhibited signs of fundamental stresses at all. External balances are far stronger than prior to the Taper Tantrum (the average improvement in EM current accounts is more than 5% of GDP). EM inflation is much lower (3.2% in 2018 vs 5.2% in 2013). Bond yields are much higher (6.85% in 2018 vs 5.25% in 2013). Many EM countries have gone through significant reforms since 2013, especially in places like China, Indonesia, India and across Latin America. EM growth looks set to be stronger this year than last year, according to the IMF. In short, a mismatch between very large shifts in valuations and very modest changes in fundamentals has emerged, pointing to value. Add to that, material redemptions have not accompanied the sell-off in EM FX this year, which suggests that EM asset managers are now sitting on considerable firepower.

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What could continue to hold back EM?

Four things: the Dollar, China-US trade, the Brazilian election and Trump tweet missiles.
Consider each in turn:

1. US dollar: Increasingly it looks as if the Dollar surge is running out of steam. Powell's comments are priced in, US growth likely peaked in Q2 and EURUSD has corrected sharply to the downside. If rates, growth and valuations will no longer drive the Dollar what will? Indeed, after the mid-term elections the US economy will face growing growth challenges. If the House goes to the Democrats, which is a distinct possibility, they will set up committees to hound Trump based on evidence from the Mueller Inquiry and other sources. Given the late stage of the business cycle, there will be growing risks of a slowdown in economic growth exactly as the 2020 presidential election gets underway. Based on the flattening of the yield curve and weakness in housing, Fed hawkishness is likely to wane. In short, the Dollar looks to have downside.
2. China-US trade: Trump will come under pressure from the corporate lobby in Congress not to jeopardise US growth prospects with additional trade restrictions after the mid-term elections. The only thing that matters after the midterm elections is the 2020 election and a slowdown in growth between now and then could spell trouble for the Republicans. That is why taking the foot off the tariff pedal is critical. China will welcome a de-escalation and will certainly not escalate unilaterally. Hence, while an outright reduction in tariffs seems unlikely the market will be able to frame the trade war risk and 'move on' in a way that the problems have been defined and adequately priced.
3. Brazil election: Brazil is the second largest bond market in EM and the upcoming election looms as a still to be fully quantified risk. The final round of the election is on 28 October. Depending on the polls, the market may be able to price the eventual outcome ahead of time. Regardless of who wins, we think the post-election focus in Brazil will quickly shift to pension reform. In short, BRL becomes a buy around the time of the peak in election-related noise, just as MXN was earlier this year. For further details, see the Brazil section below.
4. Trump tweet missiles: After coming under serious political pressure at home as a result of the convictions of close associates Cohen and Manafort, Trump has discovered a strategy to distract attention away from his domestic problems. He does this by sending out tweet missiles aimed at Mexico and China to Turkey and Russia and Venezuela and Iran and South Africa. Each time he does so he causes turmoil. He can then tell voters, "Look! I did that! Look how strong I am". Obviously, these interventions work well for Trump politically, but they have a price. They constitute an immediate and serious threat to the countries that are targeted by Trump, while the others seek to fly under Trump's radar to avoid becoming targets. All will draw the conclusion that they can no longer trust in America as a strategic partner.

Turning points are always difficult to pinpoint with any accuracy, so investors should add in small increments rather investing everything at once. The balance of risks are slowly beginning to favour EM now and should pave the way for a recovery in sentiment in the asset class this year, which will continue into 2019 and beyond.

- Brazil: Election fever is gripping Brazil. Polls continue to show strong leads for pro-dictatorship candidate Jair Bolsonaro and former President Lula, who is languishing in jail. Voting intentions in favour of jailbird Lula stand at 39%, up from 30% in June, while Bolsonaro is polling 22%, up from 19% in June. Mainstream candidates have so far been unable to make an impression. This is making markets nervous (or excited depending on how you are positioned). Much can change in the next couple of months. Importantly, TV campaigning starts on 31 August and Geraldo Alckmin of PSDB, a centrist, controls about 50% of all TV time. Brazil is 100% political noise; the economic backdrop is solid. Growth is picking up and inflation is very modest. Mid-month inflation was just 0.13% mom in August, which translates into 4.3% yoy inflation (down from 4.48% in July). The Brazilian central bank will likely sit on the sideline as long as EM as a whole remains stable, but if the external environment worsens, the central bank may step in to ensure that BRL volatility does not begin to impact inflation expectations. In general, traders expect that the BRL could weaken further in the run-up to the election only to rally sharply afterwards, just as happened in Mexico earlier this year.

- Russia: The market continues to focus on prospects of additional US sanctions on Russia. The sanctions against Russia are pushed by Congress, which recognises that they can squeeze Trump on account of his close ties with Putin and alleged links to Russian finance. If the Mueller Inquiry uncovers links of Trump with Russian election interference then Trump is obviously at risk, but so is Russia, which will likely be sanctioned even harder. However, each successive round of US sanctions on Russia will have diminishing effects as Russia removes itself ever further from US systems. Europe will likely seek ways to avoid getting impacted by US sanctions, because Europe remains critically dependent on Russian gas supplies. In the final equation, US soft power will have no effect on Russia at all as shown in Iran, Cuba and North Korea, but it will continue to pose serious risks to Europe and other countries, which blindly accepted their links to the US as risk free.
For more details on the erosion of US soft power see *"The Flipside of Turkey: America's use of soft power"*, Weekly Investor Research, 20 August 2018.

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- **South Africa:** US President Trump issued a threatening tweet against South Africa based on a Fox News report about alleged land invasions in connection with South Africa's effort to reform its extremely unbalanced landownership structure. ZAR immediately fell 1%. Fox News is widely recognised as a political news outlet much like CNN and MSNBC, so when Trump fires tweet missiles based solely on Fox reports he risks taking decisions based on inaccurate information. As for real news on the land reform process, President Cyril Ramaphosa indicated last week (in comments made prior to Trump's tweet) that South Africa's land reform will be an orderly process, which will involve rapid release of public lands for redistribution rather than focusing on privately held productive land. While land reform is notoriously difficult countries as Colombia has shown it can be done without major social upheaval and economic costs.

- **Ecuador:** Bonds responded positively to news the Moreno Administration is cutting spending by USD 1.3bn, while at the same time securing USD 1bn in fresh funding. President Lenin Moreno has steadily pursued structural reforms and improved the institutional framework since taking over from former President Rafael Correa, a defaulter. Ecuador has only ever repaid one external bond in full.

- **Venezuela:** The government has launched a new economic program and a new currency with great fanfare. Unfortunately, the currency is pegged to the Petro, a fictional currency, while the economic measures, such as a hike in VAT and fuel prices, are so riddled with exemptions and offsetting spending commitments as to be entirely ineffective. The market was completely rational in ignoring the announcement of economic reforms. In other news, the Trump Administration is considering more sanctions on Venezuela, which could include penalties for US oil companies if they sell Venezuelan oil.

- **Costa Rica:** The fiscal reform has made it through the committee stage in parliament. Parliament will vote on the bill in September. The bill should shave some 3% of GDP off the fiscal deficit over four years.

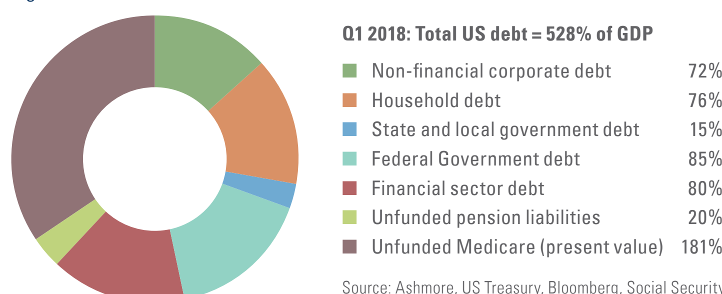
Snippets:

- **Argentina:** The state-run oil company YPF raised fuel prices by just under 1%.
- **China:** The government is considering a reduction in the risk rating of municipal bonds, which could free up banks and other financial institutions to buy some RMB 3trn more bonds.
- **Hungary:** The central bank left the policy rate unchanged at 90bps.
- **Mexico:** Retail sales increased as a yoy rate of 3.7% in June, up from 3.6% yoy in May.
- **South Korea:** Exports expanded at a yoy pace of 15% in the first 20 days of August, up from 9.3% yoy in the same period in July.
- **Taiwan:** Exports expanded at a yoy rate of 8.0% in July versus the Bloomberg expectation of 2.9% yoy.

Global backdrop

US President Donald Trump's former campaign manager and personal lawyer were convicted of multiple crimes. This underlines that corrupt and illegal practices are a global problem. The S&P 500 stock index touched a new all-time high on the same day that the news about the convictions emerged. Failure to price in known political risks makes markets risky, because the risks can then suddenly re-surface in worse form later resulting in rather spectacular crashes. Investors are also ignoring economic risks. Housing and the flattening of the US yield curve, while not failsafe predictors of the business cycle, are sending clear warning signals right now. Given the late stage of the US business cycle, protectionist policies, political noise, the overvalued Dollar and Fed tightening it seems reckless to ignore these signs. Finally, investors are ignoring fiscal risks. A new report from the US Congressional Budget Office shows that the US government would have to reduce its primary deficit by 2% of GDP starting in 2019 and sustain this lower deficit until 2048 in order to lower the debt burden back to 78% of GDP, which prevailed around the time of the crisis of 2008/09.[1] Most likely, there will be no deficit reduction at all. The Trump Administration recently passed a large unfunded tax cut, which will increase rather than decrease fiscal deficit. The US economy already carries a debt burden equivalent to 528% of GDP including unfunded pension and Medicare liabilities, according to figures from the US Treasury (Figure 3). This may be why the US stock market struggles every time the 10yr Treasury yield approaches 3%.

Fig 3: **Total US debt as of Q1 2018**



Source: Ashmore, US Treasury, Bloomberg, Social Security Administration.

[1] https://www.cbo.gov/system/files?file=2018-08/54181-DebtTargets.pdf

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.52%	-5.88%	1.16%	12.57%	6.01%
MSCI EM Small Cap	-1.95%	-9.02%	0.86%	9.15%	5.23%
MSCI Frontier	-4.00%	-11.32%	-4.68%	5.42%	3.49%
MSCI Asia	-0.56%	-4.37%	3.98%	13.85%	8.83%
Shanghai Composite	-3.19%	-14.00%	-14.54%	-1.28%	8.18%
Hong Kong Hang Seng	0.23%	-2.27%	1.68%	8.05%	6.05%
MSCI EMEA	-4.69%	-10.82%	-3.29%	5.97%	0.09%
MSCI Latam	-5.07%	-7.71%	-8.99%	10.07%	-0.34%
GBI EM GD	-4.05%	-8.52%	-7.84%	3.93%	-0.87%
ELMI+	-1.76%	-4.29%	-2.80%	3.08%	-0.62%
EM FX Spot	-3.19%	-8.13%	-9.11%	-2.20%	-6.79%
EMBI GD	-1.13%	-3.85%	-2.31%	5.37%	5.68%
EMBI GD IG	0.23%	-2.08%	-0.79%	4.41%	5.11%
EMBI GD HY	-2.52%	-5.73%	-3.98%	6.47%	6.20%
CEMBI BD	-1.01%	-2.46%	-1.10%	4.68%	4.87%
CEMBI BD IG	0.10%	-1.00%	-0.31%	3.53%	4.47%
CEMBI BD Non-IG	-2.35%	-4.22%	-1.95%	6.66%	5.39%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	3.05%	9.71%	20.87%	15.72%	14.50%
1-3yr UST	0.27%	0.31%	-0.08%	0.46%	0.61%
3-5yr UST	0.53%	-0.43%	-1.41%	0.49%	1.20%
7-10yr UST	1.08%	-1.48%	-2.71%	0.64%	2.25%
10yr+ UST	1.78%	-2.72%	-1.99%	2.24%	5.13%
10yr+ Germany	1.36%	4.23%	3.26%	2.80%	7.13%
10yr+ Japan	-0.94%	0.11%	0.35%	3.96%	4.57%
US HY	0.76%	2.02%	3.76%	7.11%	5.67%
European HY	0.25%	0.29%	1.67%	4.90%	5.93%
Barclays Ag	0.12%	-1.50%	-1.26%	2.38%	1.21%
VIX Index*	-6.24%	8.97%	6.27%	-53.82%	-27.05%
DXY Index*	0.00%	2.64%	2.55%	-1.61%	16.12%
CRY Index*	-0.85%	-0.51%	8.35%	-2.14%	-34.77%
EURUSD	0.20%	-2.42%	-2.21%	4.73%	-12.19%
USDJPY	-0.72%	-1.46%	1.65%	-8.76%	13.73%
Brent	3.21%	14.60%	47.68%	53.11%	-34.29%
Gold spot	-0.90%	-6.89%	-7.41%	7.01%	-14.42%

*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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