The Earth just moved in Brazil

By Jan Dehn

The last major political event in the EM calendar in 2018 is now truly underway. The first round of the presidential election gave a resounding victory to right-winger Jair Bolsonaro as Brazilians sought change after years of graft, crime and stagnation under PT and PMDB-led administrations. Beyond the initial market euphoria at Bolsonaro's victory, the two longer-term drivers of performance will be the pension reform and a potentially long sustained cyclical upswing. Meanwhile, the US bond market is causing concerns in global fixed income markets. There are very different levels of the Fed funds rate priced into various markets. US bonds are pricing the Fed to hike more or less in line with the FOMC's own predictions, but EM bonds now price in about 200bps more than the hikes the Fed says it will deliver. By contrast, European bonds do not even price in what the Fed has done so far. What does this mean for EM bonds?

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.4	–	-4.48%
MSCI EM Small Cap	10.1	–	-4.33%
MSCI Frontier	10.6	–	-1.23%
MSCI Asia	10.9	–	-5.24%
Shanghai Composite	9.7	–	3.43%
Hong Kong Hang Seng	7.0	–	-3.74%
MSCI EMEA	8.6	–	-4.83%
MSCI Latam	11.7	–	2.20%
GBI-EM-GD	6.76%	–	-1.68%
ELMI+	6.17%	–	-0.95%
EM FX spot	–	–	-1.06%
EMBI GD	6.62%	339 bps	-1.26%
EMBI GD IG	4.96%	171 bps	-1.20%
EMBI GD HY	8.56%	534 bps	-1.32%
CEMBI BD	6.26%	307 bps	-0.44%
CEMBI BD IG	5.06%	187 bps	-0.45%
CEMBI BD Non-IG	7.82%	463 bps	-0.41%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	-0.95%
1-3yr UST	2.89%	–	-0.11%
3-5yr UST	3.07%	–	-0.39%
7-10yr UST	3.23%	–	-1.19%
10yr+ UST	3.41%	–	-3.23%
10yr+ Germany	0.56%	–	-1.44%
10yr+ Japan	0.16%	–	-0.47%
US HY	6.41%	320 bps	-0.44%
European HY	3.29%	401 bps	0.22%
Barclays Ag	2.26%	-97 bps	-1.05%
VIX Index*	14.82	–	2.70%
DXY Index*	95.81	–	0.52%
EURUSD	1.1504	–	-0.64%
USDJPY	113.77	–	-0.14%
CRY Index*	199.04	–	3.88%
Brent	83.5	–	-1.69%
Gold spot	1196	–	0.62%

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

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- **Brazil:** The first round of the Brazilian election delivered what the polls of the last few months have been predicting, namely a run-off between left-winger Fernando Haddad and right-winger Jair Bolsonaro. The twist relative to expectations was that Bolsonaro did better than pre-election polls had predicted and his party, PSL, emerged as the second largest party in parliament. Bolsonaro obtained 46% of the votes, which is 4% short of a first-round victory, while Haddad obtained 29% support. There were no claims of election fraud or episodes of election-related violence. The two candidates will now face each other on 28 October.

Bolsonaro and Haddad continue to have high rejections rates (though Bolsonaro evidently less so now) and neither Haddad's party, the PT, nor Bolsonaro's PSL have majorities in Brazil's 513-seat parliament; PT commands about 57 seats, while PSL will have about 51 seats. The lack of parliamentary majorities means that both candidates now have to turn towards the centre in order to broaden their appeal ahead of the second round. The two centrist parties of PSDB and PMDB will therefore be very influential not just in terms of deciding who wins on 28 October, but also in terms of defining the post-election legislative agenda. This is a clear positive, particularly if Bolsonaro wins on 28 October, since Bolsonaro has explicitly supported fiscal austerity in his campaign, while PSDB and PMDB are known to support a much-needed reform of the pension system without which fiscal austerity in Brazil is meaningless.

Speculation may now emerge that current President Michel Temer may offer Bolsonaro to pass the pension reform before the end of his term, i.e. this calendar year. This would be very bullish. Pension reform is by far the most pressing issue in Brazil from an investor perspective due to the massive fiscal cost of the deficit in the public system (about 3% of GDP per year). By the way, our expectation is that the government will approve pension reform regardless of who wins, because it is the only way to avoid a fiscal crisis.

Brazil's election has so far been a classic lesson in Emerging Markets (EM) politics: the vast majority of voters in EM, including in Brazil, are dirt poor. Without inflation hedges, social security or unemployment benefits,

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they suffer immensely when the economy does badly. They are now punishing the parties they hold responsible for the stagnation, graft and the rise in crime of the last few years (case in point: ex-President Dilma Rousseff lost her seat in the Senate) and they are voting into power new faces, whom they hope can do a better job. The lesson is that it is critical for the rise and subsequent staying power of EM politicians that they deliver stability and growth; their ideological persuasions are very much of secondary importance.

Once the election is out the way, the pension reform issue will take centre stage. The other focus will be the business cycle. The Brazilian economy adjusted sharply over the last few years. Inflation is low, the currency is cheap, external balances are healthy. Brazil is therefore ripe for a long and sustained upswing in the business cycle, which could support Brazilian markets long after the noise surrounding the election has faded into nothingness.

What about risks? Markets would sink if the polls show Haddad posing a serious threat to Bolsonaro in the run-off on 28 October. Markets would fear further fiscal deterioration and a weak government. Markets would also fear that Haddad, who owes much of his political success to jailed former President Lula, would repay Lula by pardoning him. As for Bolsonaro, a large part of the fear, which surrounded him prior to yesterday, revolved around his lack of support in parliament, but this fear has now reduced after PSL's strong showing in the parliamentary elections. Bolsonaro also has a strong economic team led by Paulo Guedes, a renowned economist. Hence, the remaining concern is that Bolsonaro, who has spoken fondly of the 1964-1985 dictatorship in Brazil, may undermine the democratic system in Brazil.

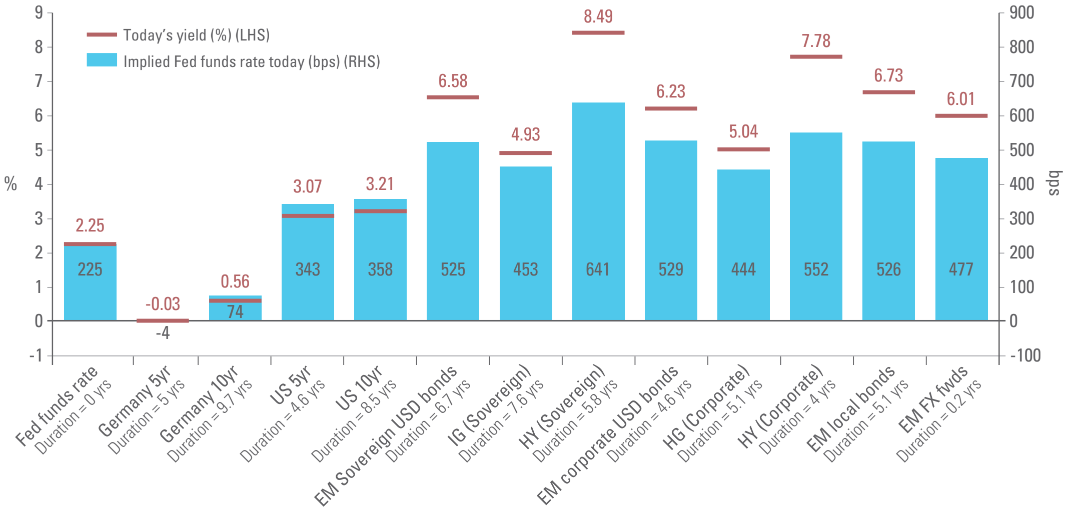
Rising US Treasury yields: Risk aversion hit global markets last week pulling stocks lower across all markets, including EM. The cause was rising US yields. The 10-year US Treasury yield rose above 3.20%. US stocks did not like it one bit and EM assets sold off too as per the 'normal' rule of thumb, which governs how many investors behave when they get nervous. Since they get nervous a lot, bouts of risk aversion are both frequent and normal occurrences. In fact, they tend to be caused by sudden changes in markets as much, if not more, than by levels. For example, 3.2% on the 10-year US Treasury yield is not likely to seriously upset anyone's stomach, because the 10-year US Treasury yield averaged exactly 3.2% throughout the entire period from 1 January 2008 to the middle of 2011, when US and Europe were reeling due to the crisis engulfing their banks. Besides, real 10-year yields today is just 1%, which is actually lower than the average real yield of 1.38%, which prevailed between 2008 and mid-2011.

Beyond the usual knee-jerk negative reactions to sudden movements in US yields, which, admittedly, are very irritating, but one gets used to them, are there serious grounds to worry about EM in the current US rate environment?

The first point to make is that periods of rising US rates have usually been very good periods for EM fixed income and the last two and a three-quarter years since the first Fed hike in December 2015 have been no exception. EM sovereign Dollar have returned 16.4%, corporate bonds have returned 15.7% and local currency government bonds have returned 15.3% over this period (all USD returns). Also, EM and frontier equities have delivered 38.0% and 17.1% in USD terms over the same period, respectively.

Still, one should not be complacent. There are no such things as risk free markets, even in EM, so movements in US bonds should always be taken seriously, at least until markets diversify away from the Dollar as the near-exclusive unit of account for international trade and financial flows. One way to assess the vulnerability of various fixed income markets to changes in US rates is to ask how many hikes are currently priced into each market? A simple way to do this is to go back to the last peak in Fed funds rate of 5.25% in late 2006 and look at where various bond markets traded at the time. If we assume that a constant relationship exists between Fed funds rates and bond yields over time, then it is straight-forward to derive what today's bond yields imply for the Fed funds rate, i.e. what each individual market currently prices in in terms of the Fed.

Fig 1: **Bond yields and implied Fed funds rates**



Source: Ashmore, Bloomberg, JP Morgan.

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Figure 1 shows the result of this exercise. The horizontal lines indicate the current levels of yields across a selection of markets (in percentage points, left hand scale). For completeness, we have included the Fed funds rate as well as US and German 5 and 10 year bonds. The remaining markets are the major EM fixed income markets, including their high yield and high-grade sub-categories. The columns indicate what Fed funds rates (in bps, left hand scale) are currently implied by today's level of yields.

Three observations stand out: First, EM external debt, corporate debt and local currency bonds markets all price in very similar Fed funds rates ranging from 525bps to 529bps. Investment grade bonds price in somewhat lower Fed funds rates; high yield bonds somewhat higher yields. Regardless of credit quality, however, these are extraordinary high levels considering that the FOMC's own estimate of the terminal Fed funds rate is about 300bps and that Fed fund futures and Overnight Index Swaps (OIS) both discount the FOMC's current DOT plot (which shows where Fed members expect rates to go over the next few years) by about 20%.

Second, the US Treasury market is now pricing in a terminal Fed funds rate of about 350bps. This suggests that the Fed per se is not likely to move the US Treasury market far beyond current levels. There are risks, of course. However, the US business cycle expansion is now into its 10th year with a growing number of ominous indications that growth may slow significantly in the next couple of years, including the softening of the US housing market. Hence, sustained upside in yields seems unlikely barring an eruption of inflation. Protectionism is currently the largest source of risk of higher inflation, in our view.[1]

Thirdly, German bonds yields do not even price in the current level of the Fed funds rate. Granted, German bonds respond to the ECB interest rates rather than the Fed, but the correlation between US and German bonds is very high, since the bonds tend to be traded in the same portfolios. Besides, the ECB is scaling back QE and on the threshold of hiking rates (while the Fed may be nearing the end). On balance, it seems risky to sit on long positions in European bonds at this point.

The fact that different markets can price in such different Fed funds rates is testament to the lingering effects of Quantitative Easing policies. The US has been unwinding QE for some time, Europe is still very much in the midst of QE and EM never did QE. Altogether, it seems sensible to take exposure to bonds, which already fully price in 'normal' interest rates. In EM, investors are paid more than the risk they are taking; they are also shielded from Fed hikes.

- China: PBOC cut reserve requirements by 100bps as part of a program to stimulate domestic demand as trade tariffs imposed by the US begin to weaken exports. China's rotation into domestic demand-led growth is part of a broader plan of adjustment, which predates Trump's tariffs. FX reserves declined by USD 23bn to USD 3.09trn, probably in part due to rising US Treasury yields. The Caixin PMI services index surged to 53.1 in September from 51.5 in August.

- Index news: JP Morgan announced that Dollar-denominated sovereign and quasi-sovereign bonds issued by the governments of Kuwait, Qatar, Saudi Arabia, UAE and Bahrain will be eligible for inclusion in the EMBI Global Diversified index beginning January 2019. The phase-in will take nine months and the eventual weight of these bonds in the index will reach more than 11%. The total number of bond markets formally represented in all the four main EM fixed income benchmark indices will rise to 161 as a result. JP Morgan will also re-assess China's eligibility for inclusion in the GBI index of local currency bonds in 2019 due to recent progress in accessibility.

Snippets:

- Argentina: The central bank has more work to do, because inflation expectations continue to drift higher. The September survey shows that inflation expectations for 2018 as a whole is now 44.8%, up 4.5% from last month. However, if the central bank follows through on its new zero money base growth target, inflation will come down sharply next year.
- Brazil: Industrial production at a 2.0% yoy rate in August. The business confidence index remained elevated at 59.5.
- Chile: Retail sales were 4.8% higher in August than in the same month of 2017. The market had expected 2.8% yoy growth.
- Colombia: Headline inflation increased to 3.23% yoy in September from 3.10% yoy in August, but core inflation drifted lower. Food prices accounted for the rise in headline inflation.
- India: In a sign that the 2019 election is coming closer, the government cut duties on fuel to prevent rising oil prices from turning into a political problem. Oil marketing companies will suffer. This is bad policy, but not entirely surprising given the proximity of the election (scheduled for April or May next year). Manufacturing PMI increased to 52.2 in September from 51.7 in August. Services PMI slowed marginally. The Reserve Bank of India kept the policy rate unchanged at 6.5%.
- Indonesia: Inflation moderated to 2.9% yoy in September from 3.2% yoy in August.
- Malaysia: The trade surplus was USD 0.4bn in August compared to USD 2.1bn in July.
- Mexico: The central bank maintained the policy rate of 7.75% with hawkish tilt. Remittances were up 9.1% in yoy terms in August. Gross fixed investment and consumption both rebounded in July after the election.

[1] See https://www.ft.com/content/eda6cbfa-c6f8-11e8-ba8f-ee390057b8c9

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Global backdrop

- **Peru:** CPI inflation was lower than anticipated (0.19% mom versus 0.25% mom expected).
- **Philippines:** At 6.7% yoy, inflation was lower in September than expected (6.8% yoy).
- **Poland:** The National Bank of Poland kept the policy rate unchanged at 1.5%.
- **Romania:** National Bank of Romania kept the policy rate on hold at 2.5%.
- **Russia:** The 2019-2021 fiscal program maintains a very prudent stance, while shifting spending towards infrastructure, health care and education. Military and security spending is being cut. The economy expanded at rate of 1.9% yoy in Q2 2018. Inflation increased to 3.4% yoy in September from 3.1% yoy in August.
- **South Korea:** The yoy rate of inflation increased to 1.9% yoy in September from 1.4% yoy in August. The increase in inflation was due to the end of a temporary cut in electricity tariffs. Industrial production was up 1.4% in August, taking the yoy growth rates to 2.5% from 1.3% in July. Exports declined in September due to the lunar holiday, but should bounce back strongly in October.
- **Sri Lanka:** FX reserves dropped to USD 7.2bn following repayment of a government bond.
- **Turkey:** State-owned banks are funding by issuing bonds to the Unemployment Insurance Fund, according to a government spokesperson. This indicates that the government will do whatever it takes to ensure that government bonds can continue to finance. The yoy rate of inflation spiked to 24.5% in September. This is what happens when currencies weaken in countries, where central banks have no credibility.
- **Zambia:** The 2019 fiscal year budget envisages a decline in the fiscal deficit to 6.5% of GDP from 7.4% of GDP in the 2018 fiscal year.

Global backdrop

Unemployment dropped to a multi-year low, but payrolls missed. The trade deficit widened. ISM services were strong, but ISM manufacturing was weak. The S&P 500 Homebuilder Industry index dropped sharply and stocks lost steam after US Treasury yields went above 3.2%. The VIX index spiked to 16 and the Brent oil price remained elevated around 85 Dollars per barrel. The Trump Administration continued to step up the anti-China rhetoric, which has now become a central element in the midterm election strategy. The EU is considering additional sanctions on Russia, but must balance its measures against Europe's near-total dependence on Russian gas.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.48%	-11.64%	-6.79%	9.74%	2.62%
MSCI EM Small Cap	-4.33%	-15.96%	-9.41%	5.02%	1.69%
MSCI Frontier	-1.23%	-13.71%	-10.40%	4.82%	2.42%
MSCI Asia	-5.24%	-11.07%	-5.44%	10.41%	5.36%
Shanghai Composite	3.67%	-12.63%	-13.72%	-0.46%	7.76%
Hong Kong Hang Seng	-4.43%	-6.41%	-3.85%	6.35%	3.96%
MSCI EMEA	-4.83%	-16.28%	-7.23%	3.54%	-3.13%
MSCI Latam	2.20%	-4.62%	-9.38%	12.71%	-1.92%
GBI EM GD	-1.68%	-9.70%	-8.70%	3.79%	-2.28%
ELMI+	-0.95%	-5.39%	-3.46%	2.63%	-1.45%
EM FX Spot	-1.06%	-9.34%	-9.22%	-2.11%	-7.64%
EMBI GD	-1.26%	-4.27%	-3.41%	5.16%	5.02%
EMBI GD IG	-1.20%	-2.96%	-2.06%	4.02%	4.23%
EMBI GD HY	-1.32%	-5.69%	-4.88%	6.43%	5.89%
CEMBI BD	-0.44%	-2.03%	-1.50%	5.03%	4.64%
CEMBI BD IG	-0.45%	-1.44%	-1.16%	3.43%	4.03%
CEMBI BD Non-IG	-0.41%	-2.72%	-1.85%	7.70%	5.47%

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Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.95%	9.52%	15.25%	15.57%	13.58%
1-3yr UST	-0.11%	0.13%	-0.13%	0.30%	0.54%
3-5yr UST	-0.39%	-1.29%	-1.81%	-0.06%	0.88%
7-10yr UST	-1.19%	-3.90%	-4.03%	-0.66%	1.53%
10yr+ UST	-3.23%	-8.84%	-6.16%	-0.35%	3.73%
10yr+ Germany	-1.44%	1.30%	1.96%	2.03%	6.41%
10yr+ Japan	-0.47%	-1.16%	-0.51%	2.97%	3.73%
US HY	-0.44%	2.12%	2.42%	7.92%	5.35%
European HY	0.22%	0.27%	0.76%	5.51%	5.49%
Barclays Ag	-1.05%	-3.39%	-1.96%	1.51%	0.48%
VIX Index*	22.28%	34.24%	53.58%	-14.93%	-27.14%
DXY Index*	0.72%	4.01%	2.15%	0.52%	19.68%
CRY Index*	1.99%	2.67%	9.99%	-1.13%	-30.89%
EURUSD	-0.86%	-4.17%	-2.01%	2.02%	-15.24%
USDJPY	0.06%	0.96%	0.97%	-5.14%	17.45%
Brent	0.99%	24.93%	50.20%	57.47%	-24.16%
Gold spot	0.32%	-8.19%	-6.82%	5.03%	-9.32%

*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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