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Brazil candidates support pension reform

By Jan Dehn

Both candidates in the Brazilian election state they support pension reform. Turkey releases the US pastor. Peru's Keiko Fujimori is sent to prison. Chinese exports surge. Odds rise for payment of October's amortisation of the PSDVSA 2020 bonds. Tito Mboweni stages a welcome return in South Africa. EM currencies rallied last week as US stocks crashed; Fed hikes are not the whole story.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.2	–	-2.02%
MSCI EM Small Cap	9.9	–	-3.19%
MSCI Frontier	10.4	–	-1.66%
MSCI Asia	10.7	–	-3.00%
Shanghai Composite	9.3	–	-7.60%
Hong Kong Hang Seng	6.9	–	-2.19%
MSCI EMEA	8.6	–	0.33%
MSCI Latam	11.4	–	1.01%
GBI-EM-GD	6.77%	–	0.68%
ELMI+	5.57%	–	0.58%
EM FX spot	–	–	0.57%
EMBI GD	6.65%	350 bps	-0.10%
EMBI GD IG	4.99%	182 bps	-0.16%
EMBI GD HY	8.59%	545 bps	-0.04%
CEMBI BD	6.25%	315 bps	0.07%
CEMBI BD IG	5.06%	195 bps	0.04%
CEMBI BD Non-IG	7.82%	471 bps	0.09%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.4	–	-4.07%
1-3yr UST	2.85%	–	0.15%
3-5yr UST	3.00%	–	0.28%
7-10yr UST	3.15%	–	0.49%
10yr+ UST	3.32%	–	0.74%
10yr+ Germany	0.49%	–	0.83%
10yr+ Japan	0.15%	–	0.17%
US HY	6.59%	344 bps	-0.65%
European HY	3.56%	423 bps	-0.45%
Barclays Ag	2.23%	-92 bps	0.60%
VIX Index*	21.31	–	7.09%
DXY Index*	95.25	–	-0.51%
EURUSD	1.1556	–	0.57%
USDJPY	111.90	–	-1.17%
CRY Index*	197.94	–	-0.85%
Brent	81.3	–	-3.07%
Gold spot	1224	–	2.98%

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

Emerging Markets

- **Brazil:** Both candidates in the Brazilian election run-off that takes place on 28 October indicated that they will reform the pension system. Fernando Haddad of the left-wing Workers' Party (PT) said that the pension system needs "immediate action", while Jair Bolsonaro of the right-wing Social Liberal Party (PSL) said pension reform must be done, although he wants changes to the version proposed by current President Michel Temer. Polls show Bolsonaro with a clear lead over Haddad. Meanwhile, core and broad retail sales both expanded at faster than expected rates in August (4.1% yoy and 6.9% yoy, respectively).
- **Turkey:** A Turkish court sentenced US pastor Brunson to three years in prison and then released him immediately on time served. Brunson has already returned to the United States, where US President Donald Trump thanked Erdogan for securing Brunson's release, which suggests that Trump does not understand that it was Turkey's independent Judiciary, not Erdogan, who released Brunson. The release of Brunson, who was convicted of terror-related charges in Turkey, may now result in an easing of tensions between Turkey and the US. In other news, Turkey's current account moved into surplus in August as macroeconomic adjustment began to take a toll on imports. The rate of unemployment increased from 10.2% in June to 10.8% in July. In other news, local media is reporting that Erdogan's AKP is preparing a bill to transfer shares in Isbank owned by the CHP opposition party to the Turkish Treasury.
- **Peru:** Opposition leader Keiko Fujimori was arrested for allegedly receiving illegal campaign funding from a Brazilian construction company. Last year, Peru's former president was removed from office for corruption. While the end of impunity across Latin America creates short-term uncertainties, it is part of a broader trend associated with the rise of middle classes and should be viewed as unambiguously positive, in our view.
- **China:** China pessimists were proven wrong on the impact of US tariffs on Chinese trade as the yoy rate of exports surged to 14.5% in September from 9.1% yoy in August (versus a consensus forecast of 8.2% yoy). The strong export performance meant that China's trade surplus increased from USD 26.7bn in August to USD 31.7bn in September. The government last week announced a boost to construction (as a complement to the previous week's cut in reserves requirements) as China steps up efforts to replace lost growth due to

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Emerging Markets

US trade tariffs with greater domestic demand. The government also announced last week that it is pushing ahead with further reforms of state-owned enterprises. China is responding to protectionism with reform, a winning strategy. Staff at the US Treasury leaked documents showing that China does not fulfil America's own definition of a currency manipulator. Even the US Treasury, it seems, can see that US tariffs are the main reason for the weaker RMB (tariffs are taxes, which reduce demand for Chinese goods in the US, wherefore fewer Dollars flow to China and hence the Dollar rises versus RMB as a direct result of tariffs). The official report from the US Treasury could be released anytime.

- Venezuela: A judge in the so-called Crystallex case scheduled oral arguments for December. This implies that there will be no decision on an appeal by PDVSA prior to the payment of the next amortization payment on the 2020 PDVSA bond. This increases the odds of payment, which is due on 27 October.

- South Africa: Thabo Mbeki's former central bank governor Tito Mboweni has been appointed to the post of Minister of Finance, replacing Nhlanhla Nene. This is a positive development. Mboweni is a solid policy maker, who was credited with the introduction inflation targeting, when he was at the South African Reserve Bank. In other news, manufacturing expanded 0.1% mom in August versus a consensus expectation of a decline of 0.3% mom.

Snippets:

- Chile: Inflation was lower than expected in September (0.3% mom versus 0.4% mom expected).
- Colombia: The yoy rate of core CPI inflation moderated to 2.95% in September from 3.01% in August.
- Republic of Congo: Moody's upgrades the outlook on Congo's sovereign credit rating to stable from negative (Caa2).
- Czech Republic: Inflation slowed to 2.3% yoy in September from 2.5% yoy in August.
- India: The rate of CPI inflation was 3.8% yoy in September, which was lower than expected (4.0% yoy). Industrial production in August was stronger than expected (4.3% yoy versus 3.8% yoy consensus).
- Indonesia: The trade surplus of USD 0.23bn in September was higher than expected (USD 0.5bn deficit). Exports continued to expand, due to cheaper FX than to government policy measures designed to curtail imports.
- Mexico: The rate of growth of industrial production slowed to 0.2% yoy, which was well below expectations (0.9% yoy).
- Pakistan: Finance Minister Asad Umar announced that the government will approach the IMF for balance of payments support.
- Peru: The central bank left the policy rate unchanged at 2.75%.
- Poland: Ratings agency S&P upgraded Poland's sovereign credit rating by one notch to A- citing strong balanced growth and fiscal prudence.
- Saudi Arabia: Stocks declined and credit spreads widened as Europe and the United States stepped up pressure on the government over the disappearance of a journalist.
- Singapore: The Monetary Authority of Singapore tightened monetary policy by increasing the pace of appreciation of the nominal effective exchange rate. The advance estimate of Q3 2018 growth was 2.6% yoy versus 2.4% yoy expected.
- South Korea: The unemployment rate declined to 4% in September from 4.2% in August.
- Romania: Headline inflation moderated slightly to 5.0% yoy in September from 5.1% yoy in August.
- Russia: The current account surplus in Q3 2018 was USD 26bn, which was larger than the USD 24bn surplus anticipated by the consensus. The fiscal surplus increased to 1.5% of GDP in September from 1.1% of GDP in August (12-month rolling basis).

Global backdrop

US stocks dropped about 5% before recovering a fraction of their losses on Friday to end the week down 4.07%. The broad Dollar index was down 51bps. Emerging Markets (EM) currencies rallied 57bps on the week and EM equities, though down, outperformed US equities by 2.05% on the week. US President Donald Trump blamed the decline in US stocks on Fed hikes, but the Fed funds rate is still negative in real terms, so this explanation lacks credence, or, at least, it cannot be the whole story. Our view is that US stocks and the Dollar are overvalued; a healthy US stock market ought not to be this sensitive to rate hikes so early in the hiking cycle. Investors the world over built extremely large exposures in US stocks and the US dollar over the last eight years, because these two trades were the market's favourite ways express bullish views of the US economic recovery in response to enormous stimulus from both fiscal and monetary authorities. We believe that investors are still very heavily positioned in these trades. This means that once the facts no longer

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Global backdrop

support a bullish view of the US economy then much of this money is in the wrong place and will go elsewhere, pushing down stocks and the Dollar simultaneously. Granted, the US economy expanded at a hefty pace of 4.2% qoq saar in Q2 2018, but this strength is a temporary boost caused by a massive unfunded tax cut, which was approved last year. Higher frequency indicators have been softening of late. Apart from weaker housing and softer payrolls, consumer sentiment weakened, core CPI fell short of expectations and initial claims for unemployment benefits were higher than expected. Meanwhile, deeper fundamental indicators, such as debt, productivity, real effective exchange rates and trade policies point to slower growth ahead. Sadly, finance theory does not explicitly incorporate macroeconomics, so economic problems of this kind are often inadequately recognised in markets until they pose a clear and present danger at which point it is usually too late to move.

In European news, the region's GDP growth for Q2 2018 was revised up to 1.8% qoq saar from 1.5% qoq saar previously and in Bavaria the right-wing CSU party lost its absolute majority as voters turned both left and right on the question of immigration. The Social Democrat SPD declined to single digit (9.7%). Far-right anti-immigration AfD garnered about 10% of the vote, while the pro-refugee Green party collected nearly 20% of the votes. CSU is a key coalition partner in Chancellor Angela Merkel's coalition, but the main risk to Merkel probably stems from the SPD, which appears to have been unable to change with the times.

Finally, senior negotiators from EU and UK failed to reach agreement on key issues ahead of a summit scheduled for November. The core issue revolves around finding a solution to the Northern Ireland border problem. A border between Northern Ireland and the Republic of Ireland would be contrary to the Good Friday Agreement, which brought peace to Northern Ireland after many decades of civil war. The alternative of placing the border between Northern Ireland and the rest of the UK (i.e. in the Irish Sea) would end the unity of the United Kingdom as a sovereign nation. EU obviously needs a border, so two options are possible: buy time while de facto remaining in the EU, which would be contrary to the referendum decision to leave EU, or go down the road of hard Brexit, which threatens to re-ignite the Irish issue. At this moment in time, the UK probably faces greater and more obvious macroeconomic risks than any other developed country. In particular, if UK crashes out of the largest free trade area in the world without some kind of deal to soften the blow the economic and political consequences could be extremely serious.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.42%	-13.43%	-10.23%	7.11%	1.89%
MSCI EM Small Cap	-7.38%	-18.63%	-13.45%	2.77%	0.81%
MSCI Frontier	-2.87%	-15.14%	-11.75%	3.54%	2.01%
MSCI Asia	-8.08%	-13.73%	-10.05%	7.44%	4.44%
Shanghai Composite	-7.60%	-19.27%	-21.15%	-5.41%	5.55%
Hong Kong Hang Seng	-6.52%	-8.46%	-6.80%	3.33%	3.38%
MSCI EMEA	-4.52%	-16.00%	-9.17%	1.98%	-3.39%
MSCI Latam	3.24%	-3.66%	-6.93%	11.12%	-2.02%
GBI EM GD	-1.02%	-9.09%	-7.86%	2.66%	-2.27%
ELMI+	-0.37%	-4.84%	-3.06%	2.00%	-1.40%
EM FX Spot	-0.50%	-8.82%	-8.49%	-3.01%	-7.56%
EMBI GD	-1.36%	-4.36%	-3.57%	4.76%	4.82%
EMBI GD IG	-1.36%	-3.11%	-2.22%	3.61%	4.09%
EMBI GD HY	-1.36%	-5.73%	-5.03%	6.06%	5.57%
CEMBI BD	-0.37%	-1.97%	-1.57%	4.78%	4.56%
CEMBI BD IG	-0.41%	-1.39%	-1.23%	3.33%	3.98%
CEMBI BD Non-IG	-0.32%	-2.63%	-1.91%	7.16%	5.34%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-4.97%	5.06%	10.57%	13.40%	12.46%
1-3yr UST	0.04%	0.28%	0.03%	0.37%	0.58%
3-5yr UST	-0.05%	-0.96%	-1.51%	0.12%	0.95%
7-10yr UST	-0.49%	-3.22%	-3.57%	-0.37%	1.73%
10yr+ UST	-1.83%	-7.52%	-5.52%	0.23%	4.11%
10yr+ Germany	-0.62%	2.14%	2.70%	2.34%	6.66%
10yr+ Japan	-0.30%	-0.99%	-0.15%	2.99%	3.81%
US HY	-0.89%	1.65%	1.93%	7.04%	5.18%
European HY	-0.23%	-0.18%	0.06%	5.01%	5.28%
Barclays Ag	-0.46%	-2.81%	-1.87%	1.50%	0.66%
VIX Index*	75.83%	93.03%	121.75%	32.77%	14.20%
DXY Index*	0.13%	3.40%	2.32%	0.93%	18.35%
CRY Index*	1.43%	2.10%	7.09%	-0.53%	-30.87%
EURUSD	-0.41%	-3.74%	-2.03%	1.51%	-14.55%
USDJPY	-1.58%	-0.70%	-0.26%	-5.88%	13.99%
Brent	-1.68%	21.62%	42.26%	66.97%	-26.04%
Gold spot	2.61%	-6.10%	-5.52%	3.42%	-4.59%

*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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