The Big Picture on Risk

By Jan Dehn

Developed economies squandered huge advantages, but asset prices rallied, so their markets are now more expensive than justified by fundamentals. EM countries saw asset prices fall sharply, but fundamentals held up against major headwinds, so now there is value. Juxtapose these two images, one of bloated and overpriced markets in rich countries, the other of leaner fitter markets in EM, and what emerges is a picture of severe price distortions across global assets.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	1.05%
MSCI EM Small Cap	10.2	–	0.96%
MSCI Frontier	8.9	–	-0.07%
MSCI Asia	11.1	–	1.37%
Shanghai Composite	9.7	–	3.10%
Hong Kong Hang Seng	7.4	–	1.46%
MSCI EMEA	8.7	–	-0.11%
MSCI Latam	11.6	–	1.65%
GBI-EM-GD	6.63%	–	1.13%
ELMI+	5.20%	–	0.62%
EM FX spot	–	–	0.69%
EMBI GD	6.90%	382 bps	-0.52%
EMBI GD IG	5.19%	209 bps	-0.16%
EMBI GD HY	8.87%	580 bps	-0.89%
CEMBI BD	6.36%	335 bps	-0.25%
CEMBI BD IG	5.19%	218 bps	0.00%
CEMBI BD Non-IG	7.97%	496 bps	-0.57%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.3	–	-1.54%
1-3yr UST	2.82%	–	0.35%
3-5yr UST	2.90%	–	0.79%
7-10yr UST	3.09%	–	1.31%
10yr+ UST	3.36%	–	1.85%
10yr+ Germany	0.39%	–	0.32%
10yr+ Japan	0.10%	–	0.47%
US HY	7.19%	412 bps	-1.66%
European HY	4.36%	506 bps	-1.74%
Barclays Ag	2.21%	-88 bps	0.40%
VIX Index*	18.93	–	1.57%
DXY Index*	96.30	–	-1.25%
EURUSD	1.1430	–	1.89%
USDJPY	112.80	–	0.92%
CRY Index*	187.69	–	-0.76%
Brent	66.8	–	-4.81%
Gold spot	1221	–	1.68%

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

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The Big Picture on Risk

UK's Brexit debacle highlights a habitual problem in global markets of under-pricing of risks in developed economies (for more details on Brexit see the Global Backdrop section). Markets have blind faith in developed countries, yet every single market-moving risk off episode of the past twenty years has been caused by developed economies. Today, there are plenty of serious inadequately priced risks in developed countries, including an anti-trade and fiscally populist Administration running the United States, a fiscal mess in Italy and the contracting economies of Germany and Japan. It is wrong to regard countries as risk free just because they have high GDP per capita figures. Rich countries, just like EM countries, sometimes screw up quite seriously. The difference is that risks in developed countries are rarely priced in. This is particularly worrisome if we look forward. Developed countries are staring at the end of a period of unprecedented tailwinds. As recently as 2015-2016, Quantitative Easing (QE) policies were keeping real yields well below zero, while fiscal stimulus has contributed more than 40% of GDP growth over the past decade in the US. During this period of extreme stimulus, investors went very long developed market assets. Unfortunately, developed countries did not deal with any of the underlying problems, which led to their crisis in 2008/2009. In fact, policies just got worse, including further increases in debt, neglect of reforms, protectionism, withdrawing from international agreements and Brexit in the UK. In short, developed economies squandered huge advantages, but asset prices rallied, so their markets are now more expensive than justified by fundamentals.

The exact opposite is true in EM. EM countries were put through the wringer during the QE period, yet proved far more resilient fundamentally than expected. Between 2010 and 2015, one third of all foreign money left EM, the Dollar rallied 45% against EM currencies, commodity prices plunged by 50% and EM bond yields priced in a de facto Fed funds rate of 5.75%. These restrictive financial conditions tightened so much that growth slowed and EM experienced the longest earnings recession in history. While the impact on EM asset prices and sentiment was severe, EM fundamentals held up remarkably well. Defaults were few and idiosyncratic. There were hardly any balance of payments problems or IMF programmes. EM government

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policies remained extremely conservative, which meant that there was little pass-through from currency weakness to inflation. FX reserves were stable. Orthodox fiscal policies kept debt levels in check at levels far lower than those in developed countries. Thus, EM countries saw asset prices fall sharply, but fundamentals held up against major headwinds, so now there is value.

Compare these two images, one of bloated and overpriced markets in rich countries, the other of leaner fitter markets in EM, and what emerges is a picture of severe price distortions across global assets. It is neither right nor sustainable that German 10yr bonds price in a terminal fed funds rate of 50bps when the US bonds price the Fed to stop at 350bps and EM bonds price the funds rate to peak at 520bps. It also makes zero sense that the Dollar trades 20% higher than where real exchange rates growth differentials and productivity says it should trade versus EM currencies. One of the highly distorted markets, US equities, has finally begun to show signs of repricing. The prospect of less fiscal stimulus under a lame duck Trump Administration and tighter Fed policies plays an important part here because US markets typically only outperform EM during bouts of severe government stimulus. As such, the next couple of years are ominous for US stocks and the Dollar alike.

Markets are skittish. Regard the skittishness as a warning, a wake-up call. The recent stock market volatility in the US, the budget mess in Italy, the poor growth numbers out of Germany and Japan and last week's collapse of the Pound are not just random. They are signs of diminishing returns to the myopic policies in developed countries over the past decade. Downside risks are large and investors are not pricing them right. EM economies are also risky, of course, like all countries, but at least, in EM, everyone recognises that these risks exist, so the discussion is about whether the price of the risk is right. The big QE trades of 2010-2015 – long positions in Dollars, US stock and European core government bonds – may unwind in a gentle fashion, but only if there are no accidents. Brexit reminds us that accidents can happen. The best way to protect against accidents is to take exposure to countries, which have already overcome all shocks you can throw at them. That is EM.

- CEE4: Growth rates in Poland, Hungary and Romania, which make up three of the four central and eastern European countries, surprised sharply to upside in Q3 2018. Romania racked up 1.9% real GDP growth in the quarter followed by 1.7% qoq growth in Poland and 1.2% qoq growth in Hungary. In all three cases, the growth rates were significantly higher than expected (1.1% qoq, 0.9% qoq and 0.7% qoq, respectively). Only Czech Republic, the fourth country in this group, delivered disappointing growth (0.4% qoq versus 0.7% qoq expected).

- Brazil: Roberto Campos Neto, who heads up trading at Banco Santander in Brazil, will be Brazil's new central bank President. This is good news. Campos Neto is market friendly and understands how both the markets and the Brazilian economy work. Campos Neto will also be a familiar face to investors, who regularly trade with local banks in Brazil. Campos Neto replaces Ilan Goldfajn, who has done an excellent job at the central bank, including bringing the rate of inflation down from 8.6% at the start of his tenure to 4.6% today. In other news, Joaquim Levy, former finance minister, was appointed as the new head of BNDES, a large government development bank. Levy is a highly credible choice, who will have a strong mandate to undertake infrastructure investment, privatisations and restructure local government finances. Vice-president elect Hamilton Mourao said last week that the government may privatise 140 out of Brazil's 150 state-owned companies. We think this is probably a tad too optimistic. Retail sales growth was 8.7% qoq saar in Q3 2018.

- China: There are tentative signs that trade tensions between China and the United States could be easing, though it is too early to declare an end to the US-instigated trade war between the two countries. China last week delivered a letter to the US government with its response to US demands for trade reform. Last week, White House Economic Advisor Larry Kudlow reprimanded "Death by China" trade fanatic Peter Navarro for inappropriate comments on the prospects for a trade deal. US Commerce Secretary Wilbur Ross indicated that the aim of the upcoming G20 meeting between the US and Chinese leaders is to define a framework for resolving the trade dispute. Our view is that trade tensions will not go away, but may decelerate as tariffs begin to hurt American businesses by driving up their costs. This has already started to happen and will get much worse if the US escalates further.

The US case against China over trade is almost 100% political. Credible academics agree that the US case is weak.[1] In fact, not a single US company is forced to operate in China and all US companies operating in China are fully aware of the terms under which they are there. In other news, MSCI, the index provider, confirmed that trade war concerns have not affected China's reform efforts, which are continuing apace. In terms of demand management, PBOC Governor Yi Gang met with senior commercial and state bankers in China to encourage the banks to increase credit supply following a slow-down in credit growth in October.

Total aggregate financing slowed to RMB 729bn in October from RBM 2168bn in September. Retail sales and property sales have also slowed of late. However, industrial production expanded at a yoy rate of 5.9% in October versus 5.8% yoy expected and fixed asset investment, led by infrastructure spending, picked up

[1] See for example https://www.project-syndicate.org/commentary/ustr-section-301-report-biased-by-stephen-s--roach-2018-04?barrier=accesspaylog

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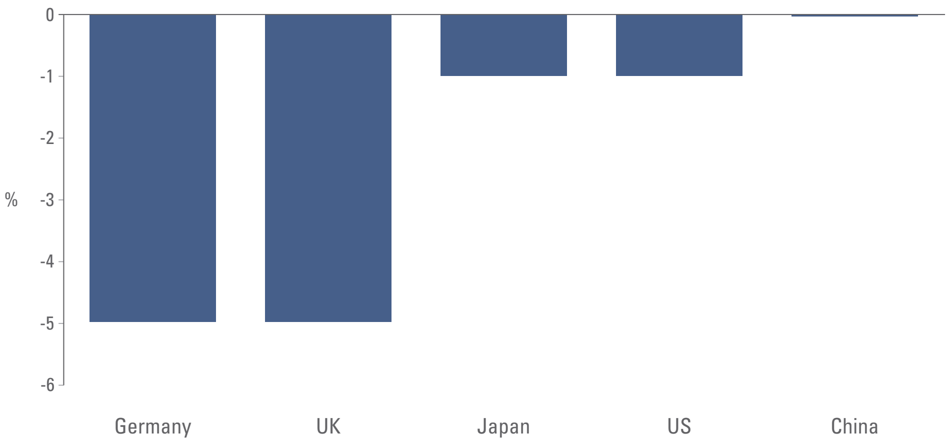
(5.7% yoy in October from 5.4% yoy in September). House prices also appreciated from 7.6% yoy in September to 8.4% yoy in October. An upcoming VAT tax cut could add as much as 1.4% to GDP next year. Do not bet against China. In fact, the sooner China is admitted to the main benchmark indices, the better. Take for example Chinese bonds: this year Chinese 5-year bonds have outperformed US, Japanese, UK and German 5-year bonds in USD terms (Figure 1).

Fig 1: **5-year bonds – year to date returns (in USD)**



Source: Ashmore, Bloomberg, as at 16 November 2018.

- Argentina: Congress approved the 2019 Budget with a strong majority (45 vs 24, one abstention). The Budget is consistent with the recently approved IMF programme, which provides USD 56bn of funding. IMF funding is necessary because Argentina's government has not yet acquired the basic skills required to keep an economy stable. Fortunately, inflation has finally begun to undershoot expectations as CPI inflation slowed to 5.4% mom in October from 5.5% mom expected (7.6% mom in September). Late as usual, S&P Global Ratings lowered Argentina's sovereign credit rating by one notch to B. Last in, first out.

- Malaysia: At USD 3.8bn, Malaysia's current account surplus was marginally smaller in Q3 2018 than in the previous quarter (USD 3.9bn). The real economy expanded at a yoy rate of 4.4% in Q3, which was slightly below market expectations (4.6% yoy). Still, growth picked up strongly on a sequential basis: 6.7% qoq saar from 1.2% qoq saar in Q2. This was mainly due to strong private consumption growth (10.3% qoq saar) following a recent cut in taxes.

- Turkey: TRY rallied last week on news that the US government is considering the possible extradition of exiled Turkish cleric Fethullah Gulen. President Erdogan of Turkey regards Gulen as an enemy. Extradition would represent a significant improvement in relations between Turkey and United States. Meanwhile, the economy has entered a deep contraction; industrial production dropped 2.7% on a yoy basis in September versus +1.5% yoy expected.

- Indonesia: The trade deficit reached USD 1.8bn in October from a surplus of USD 0.3bn in September. Exports picked up but imports picked up more. The central bank is aware of the dangers of excess domestic demand, so decided to hike the policy rate by 25bps to 6.00%. The reserve requirements for banks was also raised to 3%. These are strong policy interventions and markets liked them.

- India: Indian policy banks could be recapitalised with government bonds, according to a member of the central bank's board. The trade deficit widened to USD 17.1bn in October from USD 14.0bn in September, but the recent fall in the price of oil may narrow the trade deficit going forward. Industrial production was 4.5% higher in September compared to the same month in 2017. This was better than expected (4.3% yoy). The yoy rate of CPI inflation was 3.3% in October versus 3.6% yoy expected.

Snippets:

- Colombia: The yoy real GDP growth rate was 2.7% in Q3 2018. The market had expected 2.6% yoy. Retail sales expanded at a strong 5.9% yoy rate in September versus 5.2% yoy expected. Fitch affirmed Colombia's investment grade sovereign credit rating at BBB with stable outlook.
- Mexico: The central bank hiked the policy rate by 25bps to 8%, while maintaining a hawkish bias.
- Philippines: The central bank hiked the policy rate by 50bps to 4.75%, taking total hikes this year to 175bps. Remittances from workers based overseas increased at yoy rate of 2.3% (USD 2.24bn) in September.
- Poland: The yoy rate of inflation was 1.8% in October, down from 1.9% yoy in September.

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- **Russia:** US Congressional sources indicated that there is insufficient time to impose additional sanctions on Russia this year. Russia's federal budget surplus was 2.0% of GDP in October, up from 1.5% of GDP in September (on a 12-month rolling basis).
- **Saudi Arabia:** The US announced sanctions against seventeen Saudis deemed to have been involved in the Khashoggi murder.
- **Singapore:** Non-oil domestic exports increased at a yoy rate of 6.7% in October compared to 6.6% yoy in September. September retail sales were softer than expected (1.9% yoy versus 2.1% yoy expected).
- **South Africa:** Home Affairs Minister Malusi Gibaba resigned from the government as the purge of ministers from the Zuma era continues.
- **South Korea:** The unemployment rate dropped to 3.9% in October from 4.0% in September.
- **Sri Lanka:** The central bank hiked the policy rate by 50bps to 9% in a surprise move. The hike comes amidst a political crisis.
- **Thailand:** The Bank of Thailand kept the policy rate unchanged at 1.5%.
- **Venezuela:** IMF confirmed that the government of Venezuela has started to provide macroeconomic data to the IMF.

Global backdrop

On the long list of inadequately priced risks in developed markets, Brexit ranks near the top. Last week Brexit-related risks moved from the theoretical to very real. While Prime Minister Theresa May's ministers approved her Brexit plan, she soon faced a wave of resignations, including her own minister in charge of Brexit, Dominic Raab. Cabinet approval was always the most likely outcome, because the members of Cabinet are May's closest allies, but May's real test will be to get parliamentary approval for her plan. May can play two cards to try to win. Her first card is to label her opponents as wreckers hell bent on hurting the country. This is a powerful argument. After all, not only is her plan the only plan available, it is also genuinely the least bad option from an economic perspective. May's deal sacrifices UK political influence in Europe in order to protect the UK economy (by allowing the UK to remain within the EU Customs Union during the transition). Any other deal structure would be catastrophic in economic terms. May's second card is to emphasise the transitory nature of her Brexit deal, in other words, that UK will 'soon' be free of the EU. Unfortunately, this is not an easy sell, because the Brexit plan defines the date of Independence as "20XX". In other words, how can May argue credibly that UK will 'soon' be independent if she cannot even provide a firm date? May's detractors, both on the Left and the Right, will emphasise that her plan delivers exactly the opposite of what people voted for in 2016. The plan gives up control to Brussels and eliminates the possibility of striking independent trade deals with third parties. While this is only a temporary state of affairs, UK politics is super-myopic.

The situation facing the UK is now both highly uncertain and genuinely risky. There are three scenarios: May's plan goes ahead, UK heads for hard Brexit, or UK returns to the EU. If May survives, the UK will continue on the current fragile path into a long period of great uncertainty. If May fails, either the country will be led by hard Brexiteers, who will take the UK out of the EU without a deal and thereby trigger a serious economic disaster, or, if such a government fails or collapses, after a general election, a Corbyn-led government will lead the UK. Corbyn also favours Brexit and would pursue bad economic policies.

Polls show that Brits now favour remaining in the EU, but neither Labour nor Hard Brexiteers would support a second referendum on EU membership, since they have already nailed their anti-EU colours to the mast. Hence, perhaps the most likely way to get back to the EU would be to form a cross-party 'majority of national unity' from moderates from Left and Right in the House of Commons, which can push through legislation for a second referendum on the question of EU membership. This would give the British people the option to choose again. If they vote to remain in the EU, the economic problem would be solved. If the people still prefer to leave, perhaps this time the sitting UK government will handle the process in a less childish manner.

In other developed market news, real GDP growth went into outright contraction in both Japan and Germany in Q3 2018. Japan's growth rate was -0.3% qoq in Q3, while the German economy contracted 0.2% on a qoq basis. In Italy, the government continues to insist on a deficit, which exceeds EU limits, so the EU's excess deficit procedure now looks set to go ahead. Eventually, Italy could be fined to the tune of 0.2% of GDP.

In the US, Fed Chairman Powell indicated that the US economy is now facing headwinds and that the Fed will have to think about how much and how quickly to change rates. US core CPI inflation declined to 2.1% yoy in October from 2.2% yoy in September and 'control group' retail sales expanded at a mom rate of 0.3% in October versus 0.4% mom expected. Retail sales were revised down by 0.2% mom in September. October

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industrial production was 0.1% mom versus 0.2% expected and 0.3% last month. Jobless claims for unemployment benefit rose marginally, while the Philadelphia Fed manufacturing survey disappointed (12.9 versus 20 expected and 22 last). Import prices were higher than expected. Demand for consumer and industrial loans weakened in Q3 2018, according to the Senior Loan Officer Opinion Survey. Finally, we note that the budget deficit was USD 100.5bn in October, which is 60% higher than at the same time last year.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	3.21%	-5.77%	-12.79%	-9.91%	9.58%	2.37%
MSCI EM Small Cap	4.28%	-6.70%	-18.04%	-13.76%	4.56%	1.43%
MSCI Frontier	1.48%	-2.11%	-14.48%	-10.44%	3.62%	1.86%
MSCI Asia	3.81%	-7.45%	-13.10%	-11.25%	9.37%	4.83%
Shanghai Composite	2.94%	-5.02%	-17.01%	-19.26%	-7.45%	7.03%
Hong Kong Hang Seng	4.39%	-3.92%	-5.92%	-4.49%	6.19%	3.71%
MSCI EMEA	4.11%	-2.90%	-14.58%	-5.68%	5.95%	-2.75%
MSCI Latam	0.22%	3.69%	-3.23%	0.55%	13.68%	-1.51%
GBI EM GD	2.56%	0.55%	-7.64%	-4.06%	4.49%	-1.58%
ELMI+	1.43%	0.27%	-4.23%	-2.12%	3.10%	-1.07%
EM FX Spot	1.48%	-0.44%	-8.77%	-6.77%	-1.65%	-7.26%
EMBI GD	-0.22%	-2.38%	-5.35%	-4.05%	4.45%	4.66%
EMBI GD IG	-0.20%	-2.48%	-4.21%	-3.35%	3.49%	3.94%
EMBI GD HY	-0.25%	-2.27%	-6.59%	-4.90%	5.47%	5.35%
CEMBI BD	0.10%	-0.50%	-2.10%	-1.44%	4.59%	4.36%
CEMBI BD IG	0.01%	-0.69%	-1.68%	-1.18%	3.19%	3.77%
CEMBI BD Non-IG	0.21%	-0.25%	-2.56%	-1.68%	6.85%	5.12%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	1.07%	-5.84%	4.10%	7.87%	12.31%	11.00%
1-3yr UST	0.24%	0.38%	0.63%	0.55%	0.58%	0.60%
3-5yr UST	0.45%	0.54%	-0.37%	-0.63%	0.57%	0.96%
7-10yr UST	0.76%	0.39%	-2.36%	-2.50%	0.38%	1.79%
10yr+ UST	1.47%	-1.62%	-7.32%	-6.13%	1.02%	4.21%
10yr+ Germany	-0.07%	1.03%	3.84%	3.69%	3.00%	6.69%
10yr+ Japan	0.31%	0.54%	-0.16%	0.22%	3.30%	3.89%
US HY	-1.00%	-2.58%	-0.08%	0.79%	6.93%	4.50%
European HY	-1.23%	-2.39%	-2.34%	-2.12%	3.68%	4.47%
Barclays Ag	0.40%	-0.72%	-3.07%	-2.06%	2.22%	0.59%
VIX Index*	-10.83%	56.19%	71.47%	65.62%	11.42%	41.37%
DXY Index*	-0.86%	1.22%	4.53%	2.81%	-2.72%	19.32%
CRY Index*	-1.72%	-3.83%	-3.19%	-1.42%	1.94%	-31.12%
EURUSD	1.04%	-1.50%	-4.79%	-2.58%	6.48%	-15.57%
USDJPY	0.12%	0.80%	-0.10%	-0.16%	8.93%	-11.22%
Brent	-11.55%	-19.31%	-0.18%	6.43%	51.09%	-37.57%
Gold spot	0.48%	2.49%	-6.31%	-4.41%	12.79%	-4.32%

*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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