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Why a big defeat for Maduro in Venezuela could be good for the country

By Jan Dehn

President Nicholas Maduro's popularity is collapsing ahead of the parliamentary elections on 6 December, but a strong win for the opposition may turn out to be good for the country. Brazil's economy sinks even lower as Fitch pushes the country's credit rating one step closer to junk status. China's growth rate and especially its trade balance beat expectations. Russian production picks up and Bank of Indonesia signals that a rate hike may now be on the cards. Singapore eases monetary policy and Argentina's likely next president announces his choice of economy minister. In the US, the 'risk free' status of the US Treasury market is back in the hands of member of Congress as the debt ceiling draws ever closer.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	0.71%
MSCI EM Small Cap	12.1	–	2.13%
MSCI Frontier	8.8	–	-0.35%
MSCI Asia	11.5	–	2.05%
Shanghai Composite	12.8	–	6.56%
Hong Kong Hang Seng	7.5	–	2.21%
MSCI EMEA	9.8	–	-0.15%
MSCI Latam	13.1	–	-3.74%
GBI-EM-GD	6.76%	–	0.01%
ELMI+	3.99%	–	0.27%
EM FX spot	–	–	-0.30%
EMBI GD	5.92%	387 bps	0.74%
EMBI GD IG	4.65%	252 bps	0.61%
EMBI GD HY	8.04%	617 bps	0.93%
CEMBI BD	5.96%	416 bps	0.59%
CEMBI BD HG	4.49%	268 bps	0.57%
CEMBI BD HY	8.53%	675 bps	0.62%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	0.93%
1-3 year UST	0.61%	–	0.12%
3-5 year UST	1.36%	–	0.21%
7-10 year UST	2.04%	–	0.45%
10+ years UST	2.89%	–	0.96%
US HY	7.96%	668 bps	0.09%
European HY	5.35%	540 bps	0.28%
Barclays Ag	–	227 bps	0.37%
VIX Index*	15.05	–	-2.37%
DXY Index*	94.88	–	0.04%
EURUSD	1.1321	–	-0.51%
USDJPY	119.40	–	-0.44%
CRY Index*	199.45	–	-1.86%
Brent	49.7	–	-0.30%
Gold spot	1173	–	0.77%

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

Emerging Markets

- **Venezuela:** The government is desperately seeking to claw back some popularity ahead of the 6 December parliamentary election. Last week the government therefore raised the minimum wage by 30%, but in the context of 80% inflation this measure is unlikely to make much difference to the election result. A new poll published last week shows that President Nicholas Maduro's approval rating is now down to 20% from 27.4% in June, while opposition politicians stand to scoop up 66% of the votes in the parliamentary election. What will the opposition do if it manages to snatch a sizeable majority of the seats in parliament? In our view, the opposition is likely to first to use its newfound powers to secure the release of political prisoners, particularly leaders such as Leopoldo Lopez. They will then seek to force the government to increase transparency in a bid to reveal where all the oil money has gone. By exposing what they expect to be widespread corruption they hope to once and for all undermine the illusion that the Chavista government is acting in the interest of Venezuela's huge population of poor people. Clearly, this will increase the pressure on President Maduro, whose options are narrowing. Pressure on Maduro is also likely to be rising from within the Chavista movement itself. Maduro will therefore be forced into a choice – whether to become even more authoritarian even as his support wanes, which is clearly a very risky strategy, or to start to work with the opposition. Our view is that neither the government nor the moderate elements of the opposition (the majority) favour a default. Instead, we think one outcome of greater cooperation between Maduro and the opposition could be a less adversarial attitude towards companies seeking to invest in Venezuela's oil sector.

- **Brazil:** Two of the remaining three downside events for the Brazilian outlook were realised in part in the past week. The economy took another leg down when retail sales declined sharply (core retail sales were -6.9% lower yoy, while broad retail sales came at -9.6% yoy). The broader economic activity index also softened sharply at -4.5% yoy in August. The continuing decline in the economy is putting even more pressure on the fiscal balances, so the second remaining downside event – Brazil's humiliating demotion from the investment grade club – also took a step closer, when Fitch, a ratings agency, downgraded the government's long-term

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Emerging Markets

external borrowing credit rating to BBB-, which is just one notch above junk. Fitch noted that the outlook remains negative and that Brazil faces more than a 50% probability of being downgraded to junk. S&P, another ratings agency, has already downgraded Brazil to junk, so a single notch downgrade from either Fitch or Moody's, another ratings agency, would be sufficient to trigger forced selling by passive IG-only funds. There were no major new developments regarding the final downside risk – impeachment of President Dilma Rousseff. Our view is that Brazil's economic crisis is cyclical at root, while we expect an impeachment process to proceed along the lines set out in Brazil's constitution, wherefore the current troubles in Brazil present a significant opportunity to buy Brazilian assets at attractive prices.

- China: Real GDP expanded marginally faster than expected (6.9% yoy versus 6.8% yoy anticipated). Within the overall growth story, the demand side is holding up, but the supply-side is softening. Thus, retail sales were stronger than expected at 10.9% yoy (versus 10.8% expected) and credit and money supply data also beat expectations. On the other hand, industrial production and fixed asset investment were weaker than anticipated (5.7% yoy versus 6.0% expected and 10.3% yoy versus 10.8% expected, respectively). This pattern of improvement on the consumption side of the economy and adjustment on the supply-side is entirely consistent with China's stated objective of rotating away from high-investment/high-saving/high growth towards high-consumption/lower saving/lower investment growth. The transformation of China's economy will take a few years during which growth can be expected to be tepid. The good news is that China has enormous room to expand consumption given its 49% savings rate, so China has a bright future ahead as a domestic demand driven economy.

Meanwhile, inflation declined to just 1.6% yoy in September after hitting 2.0% in August and China produced a massive beat on its trade balance, which came at USD 60.3bn versus USD 48.2bn expected. Much of the surprise was due to a bigger fall in imports, which was immediately attributed to slower growth in China. But in fact import volumes rose and the main drag was due to lower oil prices, so the import number does not actually support an overly pessimistic view about the domestic demand story in China. There were also encouraging signs of the export side. Firstly, exports were far less weak than expected (-3.7% yoy versus -6.0% yoy expected). Secondly, exports to the US rose strongly, which is probably due to the strong USD, because exports to Europe were much softer, despite healthy European demand. Thirdly, it is notable that the share of high tech in Chinese exports is now rising significantly (25% yoy). China is on track to emerge as a major competitor to European and US manufacturing sectors due to China's heavy investment in R&D, a fact that still has not been fully appreciated in the West.[1] In other news, it was announced that Chinese provinces, which between them account for some 50-60% of China's GDP will be enrolled in a new scheme that allows commercial banks operating here to use local government loan assets as collateral in exchange for liquidity from PBOC. This will help to deepen and broaden the financial market in China and should stimulate demand. The policy is clearly liquidity support, not Quantitative Easing (QE). In QE, central banks buy assets in exchange for printed money. In this policy, the central bank lends money in exchange for collateral.

- Russia: Industrial production in Russia increased by 0.6% mom in August. This was better than expected. The government's budget performance also beat expectations as non-oil revenues rose faster than GDP, while expenditure slowed. The adjustment to falling oil prices in Russia was decisive from day one. Domestic demand was reduced via rate hikes, while a weaker RUB helped to insulate the public finances and central bank reserves from the external shock. The weaker RUB is now helping the production and export sides of the Russian economy, while the adjustment in domestic demand is still putting a dampener on growth.

- Indonesia: Bank of Indonesia (BI) left rates unchanged at 7.5%, but the message from BI was clearly that a rate cut could be a possibility in upcoming meetings. The truth is that Indonesia, along with many other Emerging Markets (EM) countries, has achieved significant macroeconomic adjustment over the past few years of heady USD appreciation. The currency is now rebounding and the external balance continues to improve. Indonesia's trade surplus rose to USD 1bn in August from USD 0.3bn in July, which means that YTD Indonesia has racked up a surplus of USD 7.1bn compared to a deficit of USD 1.7bn at the same point in 2014.

- Singapore: The Monetary Authority of Singapore (MAS) eased monetary policy very modestly by allowing the slope of the appreciation of the SGD (in trade weighted terms) to be reduced slightly. MAS had been expected to ease more than it did by sections of the market. In our view, however, cautious easing is the sensible strategy. Retail sales rose strongly in August, probably in part reflecting excitement surrounding Singapore's 50th anniversary celebrations.

- Argentina: Daniel Scioli, the likely next president of Argentina, has announced that Silvina Batakis will be his next economy minister. Batakis has been an effective and pragmatic technocrat, who steered the finances of the Province of Buenos Aires through tough times with considerable success. Importantly, the province of Buenos Aires has successfully issued foreign currency denominate bonds in recent years. While the overall direction of economy policy is likely to be determined at the level of presidency the handling of the holdout issue is ultimately even more important, because Argentina needs to swiftly regain access to international capital markets after the election. The first round of the presidential elections is on 25 October.

[1] See *'China's R&D Revolution'*, The Emerging View, May 2015.

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Snippets:

- **Chile:** The central bank raised interest rates by 25bps to 3.25%
- **Egypt:** A lengthy process of parliamentary and gubernatorial elections has begun. The election will stretch over three months and is aimed to restore democracy to Egypt.
- **India:** September's wholesale prices were 4.5% lower this year than at the same time in 2014. Low inflation in EM countries is impressive, because unlike developed economies where inflation is currently depressed by excessive debts and other drags the only thing that keeps prices in check in EM countries is credible monetary policies. India's trade balance was stronger than expected in September with imports falling sharply mainly due to lower fuel prices.
- **Nigeria:** Inflation edged marginally higher to 9.4% yoy in September from 9.3% in August, despite a raft of heterodox measures to keep the Naira strong. The overall macroeconomic stance is not credible resulting in pent-up inflation pressure as economic agents anticipate a future capitulation by the central bank regarding its Naira policy. This is understandably sapping foreign interest in Nigerian government bonds.
- **Peru:** The central bank left rates unchanged at 3.5%. The monthly activity indicator was 2.6% higher in August compared to the same month last year, signifying a slowdown from July, where activity was 3.3% higher than in the same month in 2014.
- **Philippines:** Remittances from workers declined 0.6% yoy in August, a rare decline which is probably due in part to PHP strength versus the currencies in some of the countries that host many overseas Philippine workers.
- **Poland:** Parliamentary elections will be held on Sunday 25 October. Recent polls put the socially conservative, interventionist and slightly Eurosceptical Law and Justice (PiS) party in the lead. CPI inflation reached -0.8% yoy in September. Inflation has now been below the central bank's 1.5-3.5% inflation target range for nearly three years.
- **South Korea:** The Bank of Korea left rates unchanged at 1.5% in October. The rate of unemployment declined to 3.5% in September from 3.6% in August.
- **Turkey:** The current account deficit narrowed to USD 2.3bn in August from USD 3.9bn in July due to improvements in the trade and services balances. Turkey extracted concessions on visa-free European travel for Turks in exchange for help with Syrian refugees following a meeting with German Chancellor Angela Merkel at the weekend.

Global backdrop

The main data released last week was retail sales, which were soft. US job openings also disappointed and Industrial Production has now weakened in eight of the nine months of 2015. Empire manufacturing disappointed too. On the other hand, consumer confidence was solid, but what does that tell us if actual spending is weak? CPI inflation was slightly higher than expected (1.9% yoy versus 1.8% yoy in August) but remains below the target of 2%. In fact, slightly higher core actually shaves 0.1% of real demand and so reduces growth in Q3 by 0.1%. The Atlanta Fed last week reduced its Q3 real GDP growth rate estimate to 0.9% qoq annualised. More importantly, the US Treasury said that the US government will now hit the debt limit on 3 November, two days sooner than previously estimated. At that point, all extra-ordinary measures will have been exhausted and the government will have less than USD 30bn in cash left. This hoard of cash is expected to be used up by sometime between 10 and 16 November, which just happens to be when the Treasury must make payments on its 3 year, 10 year and 30 year bonds. The government's spending authority expires on 11 December. Fortunately, the decision to raise the debt and spending limits – and therefore protecting the alleged 'risk free' status of Treasuries – now rests entirely with members of the US Congress all of whom are of course known for their far-sighted sagaciousness.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	9.32%	-7.37%	-8.33%	-2.13%	-2.35%
MSCI EM Small Cap	7.45%	-2.92%	-4.47%	1.59%	-1.54%
MSCI Frontier	1.35%	-12.45%	-19.60%	6.36%	1.70%
MSCI Asia	9.57%	-3.97%	-1.09%	3.47%	1.69%
Shanghai Composite	11.11%	6.48%	46.18%	20.46%	5.22%
Hong Kong Hang Seng	13.09%	-8.51%	7.67%	4.75%	-1.34%
MSCI EMEA	10.00%	-3.77%	-9.38%	-5.89%	-4.15%
MSCI Latam	8.16%	-23.20%	-31.72%	-15.72%	-12.13%
GBI EM GD	6.52%	-9.36%	-15.30%	-7.00%	-2.83%
ELMI+	3.70%	-4.06%	-9.14%	-4.20%	-2.60%
EM FX Spot	4.42%	-12.63%	-19.13%	-11.22%	-8.70%
EMBI GD	2.99%	2.92%	1.87%	1.89%	4.99%
EMBI GD IG	3.33%	1.17%	1.00%	1.02%	4.25%
EMBI GD HY	2.54%	5.28%	2.75%	3.15%	6.09%
CEMBI BD	1.87%	2.73%	1.11%	2.85%	4.51%
CEMBI BD HG	1.25%	2.43%	1.73%	2.95%	4.79%
CEMBI BD HY	2.93%	3.17%	-0.34%	2.78%	4.07%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	5.98%	0.38%	11.42%	14.18%	13.93%
1-3 year UST	0.07%	1.02%	0.85%	0.59%	0.73%
3-5 year UST	0.07%	2.77%	2.25%	1.60%	1.75%
7-10 year UST	0.12%	3.67%	3.80%	2.13%	4.26%
10+ years UST	0.15%	0.61%	4.35%	3.39%	7.79%
US HY	2.07%	-0.25%	-0.72%	4.00%	6.73%
European HY	1.80%	1.97%	4.43%	8.27%	9.62%
Barclays Ag	0.70%	0.39%	0.95%	2.96%	4.35%
VIX Index*	-38.57%	-21.61%	-31.56%	-11.78%	-27.05%
DXY Index*	-1.53%	5.11%	11.48%	19.16%	21.35%
CRY Index*	2.93%	-13.27%	-26.84%	-34.83%	-31.92%
EURUSD	1.24%	-6.44%	-11.52%	-13.08%	-18.04%
USDJPY	-0.23%	-0.37%	11.79%	50.53%	46.47%
Brent	2.77%	-13.29%	-42.31%	-54.87%	-38.71%
Gold spot	5.23%	-1.24%	-5.77%	-31.86%	-12.51%

*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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