

Real yield pick-up exceeds FX loss in EM local markets

By Jan Dehn and Gustavo Medeiros

The real yield pick-up on EM local currency bonds versus US bonds of similar duration now more than compensates for EM FX losses. Two thirds of Brazilian companies beat earnings estimates. Chinese transactions settling in RMB set a new all-time high. Argentina imposes yet more price controls in a misguided bid to control inflation. Indonesia's current account balance improves. Ecuador records a trade surplus in June. Turkey's central bank tightens liquidity measures to try to contain the currency's slide. Mali's elected government is deposed in a coup-d'état. UAE enters into a peace accord with Israel.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)	Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
MSCI EM	13.5	–	-0.10%	S&P 500	20.6	–	0.77%
MSCI EM Small Cap	11.9	–	-0.36%	1-3yr UST	0.14%	–	0.02%
MSCI Frontier	12.2	–	1.06%	3-5yr UST	0.27%	–	0.08%
MSCI Asia	14.3	–	0.26%	7-10yr UST	0.63%	–	0.49%
Shanghai Composite	12.4	–	0.66%	10yr+ UST	1.33%	–	1.63%
Hong Kong Hang Seng	7.9	–	-0.50%	10yr+ Germany	-0.51%	–	1.51%
MSCI EMEA	10.3	–	-0.75%	10yr+ Japan	0.00%	–	0.04%
MSCI Latam	12.4	–	-3.13%	US HY	5.62%	501 bps	0.05%
GBI-EM-GD	4.45%	–	-0.72%	European HY	4.84%	536 bps	0.11%
ELMI+	2.14%	–	-0.28%	Barclays Ag	0.87%	24 bps	0.22%
EM FX spot	–	–	-0.70%	VIX Index*	22.54	–	0.49%
EMBI GD	4.99%	428 bps	-0.13%	DXI Index*	93.24	–	0.38%
EMBI GD IG	2.78%	201 bps	-0.23%	EURUSD	1.1794	–	-0.64%
EMBI GD HY	8.20%	754 bps	-0.01%	USDJPY	105.87	–	-0.12%
CEMBI BD	4.46%	395 bps	0.12%	CRY Index*	149.96	–	-0.92%
CEMBI BD IG	2.95%	244 bps	0.18%	Brent	44.3	–	-2.36%
CEMBI BD Non-IG	6.61%	609 bps	0.03%	Gold spot	1934	–	-2.58%

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

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The real yield in EM local currency bond markets as defined by the nominal yield for JP Morgan's benchmark index, the GBI-EM GD, minus index-weighted CPI inflation remains higher than trend. Hence, the massive bond purchases by central banks in developed markets (DMs) have not had any discernible impact on real bond yields in EM. This is partly due to the fact that the Quantitative Easing (QE) programs in DMs did not involve the purchase of EM bonds. Rather, QE probably contributed to capital flight from EM as investors sought to chase capital gains in DM's QE sponsored markets in preference to the mere yield available in EM.

Figure 1 shows the long-term trend line for real yields in EM local bond markets using monthly data. As of the end of July 2020, EM local bonds paid investors an above-trend real yield of 2.1% for 5-year, 75% investment grade quality government bonds. In comparison, the US government 5-year real yield was -1.4% at the end of July and broadly similar today (about 0.3% nominal yield and 1.6% core inflation).

Figure 1 also shows that EM real bond yields have become more stable over time as yield cycles in EM have moderated in amplitude and become shorter. The decline in the volatility of EM real yields is due to the rise of local institutional investor bases within EM and their growing share of the market as well as successful EM central bank policies to control inflation. The inclusion of Chinese bonds, now with a 5% weight in the index, has also contributed to lowering volatility, since Chinese bonds not only have low volatility, but also a very low correlation with other EM bonds.¹

The combination of declining volatility and high real yield justify further allocations to EM local currency bonds, in our opinion. However, the value implied by real yields alone rarely drives demand for an asset class, whose appeal is often perceived to be conditional upon investors' views of the Dollar. The Dollar rallied about 10% per year versus EM currencies in the period from 2011 to 2015, but since then the pace of appreciation has slowed

¹ See: *'How Chinese bonds can enhance your portfolio'*, The Emerging View, 16 March 2018.

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markedly to 2.3% per annum, taking into account this year's pullback due to the coronavirus pandemic. In other words, the real yield pick-up on EM local currency bonds versus US bonds of similar duration currently more than compensates for EM FX losses. Going forward, the case for investing is only likely to improve further. As investors start to reduce distended exposures to the US onshore markets, such as stocks, High yield credit, leveraged loans, and US Treasuries – these markets have seen some USD 11trn of inflows from the rest of the world over the past decade – then Dollar weakness versus EM currencies is likely to become much more precipitous. The US net external investment position is currently in deficit to the tune of USD 12trn, or 56% of US GDP.² A reversal is only a matter of time. In situations like these, where the timing is highly uncertain, but positions are severely skewed in one direction the prudent approach is to begin early and to re-allocate consistently, especially taking advantage of intermittent Dollar rallies to reduce exposure in favour of EM local markets.

Fig 1: EM local market real bond yield with linear trend line (from index inception until 31 July 2020)



Source: Ashmore, Bloomberg. Data as at 31 July 2020.

- Brazil:** Brazilian corporations have been quick to adapt to the challenge posed by the coronavirus pandemic with two-thirds of Brazilian companies outperforming earnings expectations in Q2 2020 so far, despite the 41% contraction in earnings per share. The consensus expectation is now for a pick-up in earnings of 120% on a yoy basis by Q2 2021, which, together with multiple expansion, should result in very strong returns over the coming year, in our view. An important potential threat to this outlook in the shape of loss of fiscal control was averted last week, when the Lower House granted support for a presidential veto against unfreezing public sector wages. The upholding of the presidential veto was an important victory for the economic team. In economic news, tax revenues declined at a yoy rate of 17.7% in July, which was better than the 29.6% yoy rate of decline observed in June. The rate of unemployment rose to 13.1% in July from 12.4% in June, however, as the number of unemployed increased by 438K. Brazil's central bank posted a profit of BRL 521bn in H1 2020 due to foreign exchange (FX) gains on its USD reserve positions. This week, the National Monetary Council is likely to debate a possible transfer of BRL 400bn from the central bank to the National Treasury to reduce the government's stock of debt of BRL 4.15trn.
- China:** Transactions denominated in Renminbi (RMB) accounted for 39.3% of all foreign transactions in July, according to data from the State Administration of Foreign Exchange (SAFE). This is the highest percentage of transactions in China's own currency since records began. We expect that this number will continue to rise as RMB gradually assumes its destiny as the dominant global reserve currency of the world. Meanwhile, the US government further tightened restrictions on Huawei's use of semiconductor chips to include 38 Huawei affiliates in 21 countries. Chief Executive of the Semiconductor Industry Association (SIA), John Neuffer, warned that the US restrictions would "bring significant disruption to the US semiconductor industry".
- Argentina:** The Indec economic activity index rose 7.4% in June after a 9.7% increase in May, but the level of economic activity still remains 13% below the pre-coronavirus level in February. Last week thousands of Argentinians across multiple cities protested against government-imposed lockdowns, corruption, and a judicial reform project, which is seen as an attempt by Vice President Cristina Kirchner to avoid criminal charges. Over the weekend, President Fernandez declared via Twitter that he views private TV, mobile phones, and the internet as essential public services, wherefore their prices should be frozen until 2021. According to the local press, the Fernandez Administration is already controlling the prices of more than 2,000 individual consumer goods in a bid to contain inflationary pressures. This is extremely bad policy. Price controls do not address the underlying

² See: '*EM external accounts at the most resilient in two decades*'. The Emerging View, 31 July 2020.

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cause of inflation (excess demand relative to supply), while actively discouraging the supply of goods, which in turn drives prices higher due to scarcity. Argentina is one of the few EM countries in the world that is unable to maintain a basic sustainable path for macroeconomic policy.

- **Indonesia:** Indonesia's current account deficit narrowed to USD 2.9bn in Q2 2020 from USD 3.7bn in Q1 2020. Bank Indonesia maintained the policy interest rate at 4.0% in line with consensus expectations, but eased liquidity via macro-prudential measures in order to support credit growth.
- **Ecuador:** The trade balance was in surplus to the tune of USD 324m in June, a decade high. Exports declined at a yoy rate of 8.3%, but imports were down 21.5% on a yoy basis. In other news, Energy Minister, Rene Ortiz, told daily El Universo that a USD 1.4bn loan from China would settle in the next weeks.
- **Turkey:** The Central Bank of Turkey (CBT) kept the one-week repo policy rate unchanged at 8.25%. At the same time, CBT hiked the reserve requirement ratio for precious metal deposits by 7% and by 2% for currency liabilities. This resulted in the withdrawal of USD 8.5bn of gold and USD liquidity from the market. In a positive development, the Turkish government announced the discovery of a 320bn cubic meter gas field in the Black Sea. Once operational, that is, within the next decade, the gas field should provide enough energy to reduce Turkey's energy imports by the equivalent of about 1% of GDP per annum.
- **Mali:** The military forced President Ibrahim Boubacar Keita to resign following months of street protests. Prime Minister Boubou Cisse was detained and the government was dissolved. The military promised a civil transition with fresh elections. Mali has struggled with jihadists movements in the Sahel for years. The African Union is applying pressure on the military to ensure a return to democracy.
- **United Arab Emirates (UAE):** The UAE reached agreement with Israel to establish diplomatic relations. Several Arab leaders issued statements in support of the agreement, which is conditional upon a halt to Israel's illegal annexation of the West Bank.

Snippets:

- **Angola:** Son of former Angolan President Jose Eduardo dos Santos, Jose Filomeno dos Santos, was sentenced to five years in prison for embezzling foreign exchange reserves during his father's time in office.
- **Belarus:** Incumbent President Alexander Lukashenko pledged to allow new elections after a new constitution has been drafted. The military was deployed in the border with the EU as the Lukashenko Administration alleged that Belarus was under threat of invasion. Street protests with large number of people against alleged rigging in a recent election continued yesterday.
- **Chile:** Real GDP declined by 13.2% in Q2 2020, which was in line with expectations.
- **Colombia:** Ratings agency Moody's downgraded Colombia's real GDP growth forecast to -7.3% for 2020 and predicted an increase in the fiscal deficit. Moody's holds a Baa2 sovereign credit rating for Colombia, which is one notch above both S&P and Fitch.
- **Costa Rica:** Formal negotiations towards an Extended Fund Facility (EFF) with the International Monetary Fund (IMF) are due to start next month, according to the economic team. An EFF programme, if enacted, would provide important balance of payments funding in exchange for structural reforms.
- **Egypt:** The rate of unemployment rose to 9.6% in Q2 2020, which is the highest level in two years. Unemployment was 7.7% in Q1 2020.
- **El Salvador:** FX remittances rose 14% in July, which is a similar acceleration seen in other Central American countries.
- **Ethiopia:** Prime Minister Abiy Ahmed announced a cabinet reshuffle amidst street protests in his native Oromia region.
- **Malaysia:** The yoy rate of the Consumer Prices Index (CPI) declined 1.3% in July after a yoy deflation rate of 1.1% yoy in June.
- **Mexico:** Foreign exchange remittances rose 10.6% on a yoy base in H1 2020. Auto exports from Mexico to the US returned to near pre-pandemic levels.
- **North Korea:** South Korea reported that North Korean leader Kim Jong Un has transferred some duties, including relations with the US, to his sister Kim Yo-Jong.
- **Oman:** Fitch downgraded Oman's sovereign credit rating to BB- with a negative outlook.
- **Pakistan:** The current account swung into surplus of USD 424m in July compared to a deficit of USD 613m in the same month of 2019.
- **Poland:** The yoy rate of core CPI inflation rose to 4.3% in July from 4.1% in June. Industrial production rose at a yoy rate of 1.1% in July from 0.5% in June due a rebound in manufacturing of furniture, computers, electronic equipment and wood products.

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- **Philippines:** The Central Bank kept the policy rate unchanged at 2.25%, which was in line with consensus expectations. FX remittances rose 7.7% on a yoy basis in June after declining 19.3% in the month of May.
- **Russia:** The yoy rate of retail sales growth recovered to -2.6% in July from -7.7% yoy in June. Industrial production also declined at a slower pace than expected (-8.0% yoy in July versus -9.4% yoy in June). The rate of CPI inflation rose to 3.4% on a yoy basis in July from 3.2% yoy in June. Opposition politician Alexei Navalny has been flown to Germany for treatment after an alleged poisoning incident.
- **Singapore:** The yoy rate of core CPI inflation was -0.4% in July, in line with expectations.
- **South Korea:** Exports declined at a yoy rate of 7.0% on the first 20 days of August after declining 13.0% yoy on the same period of July. The yoy rate of Producer Prices Index (PPI) inflation was -0.8% in July, which was an improvement from -1.0% recorded in June. CPI inflation also picked up to 0.6% yoy in July from 0.5% yoy in June.
- **Taiwan:** Export orders rose 12.4% on a yoy basis in July from 6.5% yoy in June with exports of electronics and IT products rising by 25% and 30% on a yoy basis, respectively.
- **Thailand:** The trade surplus was USD 3.3bn in July versus USD 1.1bn expected.
- **Zambia:** The Bank of Zambia cut the policy rate by 125bps to 8.0%. The current account surplus decreased to USD 210m in Q2 2020 despite higher copper prices.

Global backdrop

- **Market sentiment:** The Dollar received a boost against EUR from global manufacturing data late last week, which was better than expected in the United States and worse than expected in Europe. It is uncertain whether the Dollar rally is sustainable, however. Europe emerged sooner from the first wave of coronavirus than the United States, but is now experiencing a surge in cases as a result of lifting lockdowns. A similar pattern is likely in the United States in the coming months, in our view. Meanwhile, investor sentiment was adversely impacted by lack of new information about the Federal Reserve's planned policy review. This means that investors will look to the meeting of central bankers in Jackson Hole this week for signs of further easing in a bid to sustain bloated valuations in stock and bond markets. There is widespread expectation that the Fed will move towards an average inflation target. Inflation has been below target for some time, so the adoption of an average inflation target would enable the Fed to let inflation rise above levels previously deemed to be too high. In our view, average inflation targeting amounts to arguing that you are comfortable on average when your head is in the freezer and your feet are in the oven.
- **Coronavirus:** The total number of coronavirus cases has now surpassed 23 million worldwide. Cases are increasing in Spain, France, and Germany and, to a lesser extent in the UK and Italy. Despite the uptick in cases, a resumption of blanket economic lockdowns looks unlikely as medical systems are gradually becoming better equipped to handle the crisis and interventions are becoming more targeted. Within EM, India and Brazil remain the two main hotspots of the pandemic.
- **US:** Despite last week's better than expected PMI number (53.6 in August from 50.9 in July), US economic data was generally mixed. On the positive side, existing home sales rose 24.7% in July to an annualised pace of 5.9m, from 4.7m in June, the highest level since 2007, buoyed by low mortgage rates and pent-up demand post lockdowns. Housing starts were also strong, up 22.6% to an annual pace of 1.5m in July. On the other hand, the Empire Manufacturing survey was weak. It declined to 3.7 in August from 17.2 in July versus a consensus expectation of 15.0. Mortgage delinquencies also went up 8.2% in Q2 2020, which is the highest level since 2011 (from 4.4% in the previous quarter). Initial jobless claims also surprised to the upside at 1.1m from 960k the previous week. In political news, former advisor to US President Donald Trump, Steve Bannon was arrested on charges of misappropriation of crowdsourced funds to build a wall on the Mexican border. The Washington Post reported that President Trump asked the Department of Homeland Security to pay USD 400m to a company tied to Bannon's wall project. Meanwhile, Democrat Presidential candidate Joe Biden appeared, for the time being, to have managed to unite the Democratic Party during last week's party convention. Vermont Senator Bernie Sanders said that Joe Biden could become the most transformative US president since Franklin Delano Roosevelt if Democrats take control of the Senate and implements the proposals put forward by the task force set up by the presidential candidate. Alexandria Ocasio Cortez, a left-wing firebrand, was named the co-chair of the climate change task force.
- **EU:** Consumer confidence was broadly unchanged at -14.7 as rising coronavirus cases in Spain and France weighed on sentiment. Euro area composite PMI declined 3.3 to 51.6 in August, which disappointed consensus expectations for a small increase. In the UK, public debt surpassed GBP 2trn in July, which is close to 100% of GDP.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	1.30%	10.43%	-0.25%	14.03%	3.68%	9.04%
MSCI EM Small Cap	1.87%	11.34%	-2.77%	8.35%	-0.02%	4.68%
MSCI Frontier	5.18%	4.52%	-11.92%	-8.55%	-1.70%	2.13%
MSCI Asia	2.18%	10.93%	5.77%	20.13%	5.97%	10.54%
Shanghai Composite	2.24%	14.47%	13.32%	20.19%	3.38%	1.53%
Hong Kong Hang Seng	1.74%	6.06%	-5.46%	4.41%	2.10%	4.00%
MSCI EMEA	1.73%	5.03%	-17.31%	-7.87%	-3.34%	1.82%
MSCI Latam	-5.44%	4.92%	-31.94%	-23.23%	-8.74%	2.20%
GBI EM GD	-1.49%	1.48%	-5.51%	-0.39%	0.66%	4.13%
ELMI+	-0.31%	1.50%	-3.93%	0.04%	-0.10%	2.30%
EM FX Spot	-1.29%	0.68%	-10.34%	-7.83%	-6.45%	-3.59%
EMBI GD	0.78%	4.52%	1.64%	3.76%	4.56%	6.44%
EMBI GD IG	-0.18%	4.02%	7.27%	8.64%	7.45%	7.15%
EMBI GD HY	2.00%	5.16%	-4.93%	-2.01%	1.24%	5.60%
CEMBI BD	0.83%	3.18%	3.01%	5.96%	5.19%	6.04%
CEMBI BD IG	0.57%	2.90%	4.88%	6.25%	5.80%	5.57%
CEMBI BD Non-IG	1.20%	3.56%	0.38%	5.45%	4.37%	6.84%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	3.99%	9.85%	6.46%	18.42%	14.04%	13.77%
1-3yr UST	-0.06%	0.03%	3.05%	3.56%	2.58%	1.83%
3-5yr UST	-0.19%	0.08%	6.12%	6.03%	3.92%	2.89%
7-10yr UST	-0.56%	0.31%	11.47%	9.49%	6.45%	4.56%
10yr+ UST	-2.64%	1.47%	22.99%	16.55%	11.85%	8.06%
10yr+ Germany	-0.58%	1.03%	6.97%	-1.57%	7.25%	5.25%
10yr+ Japan	-0.92%	-0.25%	-2.36%	-5.63%	1.58%	3.10%
US HY	0.14%	4.83%	0.85%	4.44%	4.81%	6.36%
European HY	1.29%	2.83%	-3.26%	-0.77%	1.54%	3.49%
Barclays Ag	-0.41%	2.77%	5.83%	5.50%	3.89%	3.85%
VIX Index*	-7.85%	-25.93%	63.57%	13.44%	84.30%	-44.67%
DXY Index*	-0.12%	-4.27%	-3.27%	-4.51%	-0.04%	-0.10%
CRY Index*	4.36%	8.69%	-19.29%	-11.06%	-15.66%	-19.47%
EURUSD	0.14%	4.98%	5.17%	6.24%	-0.04%	1.51%
USDJPY	0.04%	-1.91%	-2.52%	-0.25%	-3.37%	-10.59%
Brent	2.31%	7.65%	-32.88%	-25.35%	-14.87%	3.77%
Gold spot	-2.11%	8.60%	27.48%	26.65%	50.37%	67.44%

*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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