The General in his Labyrinth[1]

By Jan Dehn

In 1989, Gabriel Garcia Marquez, a Nobel Prize winning Colombian author, penned *"The General in his Labyrinth"*, a novel about the fictionalised pathetic last seven months of the life of Simon Bolivar, the liberator of the northern half of South America. Venezuelan President Nicholas Maduro, whose government is pursuing a revolutionary path named after Bolivar, is now facing a complex set of domestic and external challenges, which may yet lead Maduro into a similarly pathetic demise.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	1.42%
MSCI EM Small Cap	9.4	–	0.89%
MSCI Frontier	8.4	–	0.73%
MSCI Asia	11.1	–	1.45%
Shanghai Composite	8.6	–	0.22%
Hong Kong Hang Seng	7.4	–	2.23%
MSCI EMEA	8.7	–	1.68%
MSCI Latam	11.4	–	0.35%
GBI-EM-GD	6.36%	–	0.72%
ELMI+	5.16%	–	0.33%
EM FX spot	–	–	0.19%
EMBI GD	6.37%	361 bps	1.02%
EMBI GD IG	4.79%	200 bps	0.47%
EMBI GD HY	8.21%	546 bps	1.58%
CEMBI BD	6.00%	331 bps	0.59%
CEMBI BD IG	4.85%	216 bps	0.47%
CEMBI BD Non-IG	7.59%	490 bps	0.75%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.3	–	1.11%
1-3yr UST	2.60%	–	0.01%
3-5yr UST	2.59%	–	-0.02%
7-10yr UST	2.75%	–	0.02%
10yr+ UST	3.05%	–	0.32%
10yr+ Germany	0.20%	–	1.40%
10yr+ Japan	–	–	0.47%
US HY	7.10%	429 bps	0.30%
European HY	5.03%	522 bps	0.03%
Barclays Ag	2.01%	-74 bps	0.53%
VIX Index*	17.42	–	-0.64%
DXY Index*	95.77	–	-0.56%
EURUSD	1.1411	–	0.40%
USDJPY	109.34	–	-0.29%
CRY Index*	180.68	–	0.92%
Brent	60.9	–	-2.95%
Gold spot	1301	–	2.00%

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

Emerging Markets

- **Venezuela:** As explained in the Weekly last week, pressure is mounting on Venezuela's President Nicholas Maduro as domestic and external circumstances conspire to dislodge him from power.[2] The origin of Maduro's current predicament is that he was elected illegitimately last year. This marked a major departure from previous Venezuelan elections, whose outcomes were widely regarded as reasonably fair reflections of the will of the majority of Venezuelans. Unlike the past, a number of large Latin American democracies, including Argentina, Brazil and Colombia, are today run by right-leaning governments, which would be happy to see Maduro go.

A domestic challenger has also emerged to take on Maduro in the shape of Juan Guaido, speaker of the National Assembly. Guaido claims to be the legitimate leader of the country on the grounds that Maduro did not win the presidency fairly.

Lastly, the fact that US President Donald Trump has become a lame duck at home (witness his defeat at the hands of Nancy Pelosi in the battle of funding for his Mexican Wall) means that the US government is suddenly in need of an easy-to-win foreign policy issue. Trump has accepted Guaido as the legitimate ruler of Venezuela and is calling for Maduro to step down, supported by a number of influential European countries.

Needless to say, Maduro does not want to go gently into that good night. His government is one of the most corrupt and inept in the world with alleged links to drug trafficking and a very poor record on human rights. Many in the Maduro administration therefore have much to fear if they are booted out of power. Maduro is drawing support from two sources. First, the senior brass in the Venezuelan military has pledged loyalty to Maduro, but officers in the junior ranks are restless. Moreover, Maduro's relationship with the military is ultimately that of a business relationship: he has to pay for support. This makes Maduro vulnerable to certain types of sanctions, which could complicate or even staunch entirely the flow of oil out of Venezuela as well as the flow of money back to the country to pay the military for support. Guaido is aware of this and has already urged the military to switch sides, but senior officers may need more concrete guarantees before they change their allegiance.

[1] *"The general in his labyrinth"* is the title of a novel by Gabriel Garcia Marquez about the last seven months in the life of Simon Bolivar.

[2] See global backdrop section in *'Where will global growth come from?'*, Weekly investor research, 21 January 2018.

Emerging Markets

US policy is clearly important here, because oil markets still mainly trade in Dollars and Venezuela retains major assets in the US, including the Citgo chain of petrol stations. In a bid perhaps designed to mollify the US, Maduro over the weekend reversed an earlier decision to expel all US diplomats from the country. Maduro hopes that members of the Senate and the House of Representatives with strong vested interests in preserving current business ties between Venezuela and the US will lean on the Trump Administration to call off the attack dogs, but relations between Congress and the Trump Administration are not what they used to be.

The other source of potential support for Maduro comes from so-called 'friendly' nations, such as Iran, Turkey, Russia and China. This existence of ties between Venezuela and these countries hint at a broader Cold War style stand-off behind the confrontation between Maduro and Guaido. We do not share this perspective. Granted, Russia and especially China have economic interests in the country. But all four countries have been cleverly taking advantage of Venezuela's self-inflicted weakness; we do not see them standing up for Maduro in the same way that, say, Russia stood up for Assad in Syria. In fact, official Chinese policy towards Venezuela is that China wants good ties with the country, not with any given president. Russia stopped extending fresh credit to Venezuela some time ago. Relations with Iran and Turkey were always political rather than meaningful in terms of economic content.

In short, Maduro looks vulnerable both domestically and externally. For investors, this is good news. The regime change option implicit in Venezuela's defaulted bonds is rising in value. Venezuela is bankrupt despite sitting on the largest oil reserves in the world. A new government would want to increase oil production as quickly as possible. In order to do so, it must reform the hydrocarbon law and raise fresh financing as quickly as possible, which in turn requires the default to be cured; we believe recovery value on bonds to be materially higher than current bond prices.

- Argentina: The trade balance delivered a larger than expected surplus of USD 4.1bn in December. The volume of exports increased at a yoy pace of 20%, but collapsing domestic economic activity is also helping to restore external balance: the monthly GDP proxy (EMAE) was down 7.5% yoy in November compare to -4.2% yoy in October. Much of the decline in domestic demand can be attributed to fiscal tightening as the government racked up a fiscal surplus of 2.7% of GDP in 2018, in line with the target agreed with the IMF.

- Mexico: November retail sales expanded at a yoy rate of 3.4% in line with expectations, while overall economic activity in November was up 1.7% yoy, down from 2.0% yoy in October. Inflation in the first two weeks of January was just 0.11% mom, which was well below expectations (0.25% mom). The rate of unemployment ticked up marginally in December to 3.35%.

- China: S&P Global, a leading ratings agency, has been approved by PBOC to enter the Chinese credit rating market. This illustrates China's continuing commitment to open the Chinese markets to international competition on the terms used in international markets. It is also a clear sign that index inclusion for Chinese bonds is close. Meanwhile, PBOC introduced a new instrument to allow qualified banks to swap perpetual bonds for central bank bills. Perpetuals with AA or higher rating can also be used as collateral for central bank financing. These new instruments will ease liquidity in the Chinese banking system as the economy undergoes a cyclical downturn. Industrial profits contracted at yoy rate of 1.9% in December, but rebounded 2.9% mom in seasonally adjusted terms. Markets will likely focus on a meeting between Chinese Vice Premier Liu Hu and US trade representative Robert Lighthizer and US Treasury Secretary Steven Mnuchin this week.

- Russia: Russia achieved twin surpluses in 2018. Having already attained external surplus, the government revealed a fiscal surplus of 2.8% of GDP for the year. Meanwhile, mining and oil production picked up in December relative to November, according to new data from Rosstat.

Snippets:

- Brazil: Mid-month inflation in January declined to 3.77% yoy from 3.86% yoy in December's mid-month CPI data release.
- Colombia: Retail sales rose strongly in November (+10.8% yoy). Industrial production was 4.7% higher on yoy basis.
- India: Priyanka Gandhi has been appointed General Secretary of the Congress Party in Uttar Pradesh, India's most important state from a political perspective.
- Indonesia: The government has issued new regulations, which enable special Dollar denominated accounts to be established within the domestic banking system. This is designed to help exporters to repatriate export proceeds to Indonesia in order to take advantage of special tax incentives.
- Malaysia: The central bank left the policy rate unchanged at 3.25% in line with expectations. CPI inflation in December was lower than anticipated (0.2% yoy versus the 0.3% yoy market consensus).
- Nigeria: The central bank left the policy rate unchanged at 14%. President Buhari has replaced a senior judge, which has raised questions among members of the opposition ahead of the upcoming election.

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Emerging Markets

- **Pakistan:** Saudi Arabia and UAE have offered Pakistan up to USD 30bn in loans and investment, according to the Wall Street Journal. Bonds responded positively to the news.
- **Philippines:** Q4 2018 GDP growth was solid at 6.1% yoy, up from 6.0% yoy in Q3 2018.
- **Poland:** A former financial regulator has implicated Poland's central bank governor Glapinski in bribery allegations. Poland goes to the polls in October. Glapinski is a close ally of Jaroslaw Kaczynski, who is the head of the ruling Law and Justice party.
- **Russia:** The Russian central bank has resumed FX purchases, which were put on hold in August 2018.
- **Singapore:** The yoy pace of industrial production declined to 2.7% in December from an usually strong reading of 7.6% yoy in November. CPI inflation was 0.5% yoy in December.
- **South Africa:** Headline inflation declined to 4.5% yoy in December from 5.2% yoy in November.
- **South Korea:** Bank of Korea left the policy rate unchanged at 1.75% in line with market expectations. Q4 GDP growth was strong at 3.1% yoy versus 2.7% yoy expected in a Bloomberg survey of forecasters.
- **Taiwan:** Industrial production contracted 0.4% in the month of December after contracting 2.1% in the month of November.
- **Thailand:** The military government has announced that national elections will be held on 24 March this year.
- **Turkey:** The government has transferred a large stock of central bank profits to the central government accounts as a revenue.

Global backdrop

The balance of power has shifted in Washington. US President Donald Trump suffered a humiliating defeat at the hands of House of Representatives Speaker Nancy Pelosi over the Mexican Wall issue. Politics aside, the real significance of Trump's lame duck status is that the Trump Administration can no longer rely on fiscal stimulus in case the economy slows. This increases the downside risks to the US economy and forces the Fed to be more dovish, all else being even. As existing home sales collapsed to the tune of 6.4% in December, JP Morgan, an investment bank, reduced its Q1 2019 growth rate forecast for the US from 2.0% qoq ar to 1.75% qoq ar. Barclays Capital also revised down their growth expectation for the US economy. Meanwhile in Europe, following weaker PMI readings across the continent ECB President Mario Draghi guided lower expectations for growth, but ECB officials did not hint at imminent change in monetary policy.

In general, three forces continue to shape the global financial landscape. The first force is Quantitative Easing (QE), which created capital gains in US stocks, the Dollar and European bonds, which were so large that they induced a flight of capital from higher yielding Emerging Markets (EM). This force is now in reverse, which is a positive for EM. The second force is relative value, which now dominates performance and flows. As QE forces fade, relative value is favouring EM for two reasons. One is that developed markets no longer offer much in the way of capital gains, the other that relative yields now strongly favour EM. In other words, EM is now finally benefitting from a genuine search for yield. The third force acting on markets is that developed countries are making more and more policy mistakes as their economic and political circumstances get more complicated. Brexit is an obvious example, but there are plenty of other examples. In the last year alone, for example, the US government has made four serious policy mistakes: Congress approved a large fiscal stimulus at full employment (bad timing); the Fed confused a transitory fiscal stimulus-induced boost in growth for higher trend growth (rooky error); Trump abandoned America's long-standing commitment to free trade; and Trump shut down the US government. The first three of these policy mistakes all pushed up the Dollar for a time, creating headwinds for EM in 2018, but these headwinds are already reversing.

In general, going forward we expect the relative value forces to continue to support EM for several years against a backdrop of frequent bouts of volatility caused by an increasing incidence of policy errors in developed countries. Investors should ruthlessly exploit such bouts of volatility to add to EM positions in order to make more money, but also in order to reduce risk in their portfolios.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	6.93%	6.93%	6.93%	-16.14%	16.01%	4.46%
MSCI EM Small Cap	3.77%	3.77%	3.77%	-20.95%	8.55%	2.20%
MSCI Frontier	4.43%	4.43%	4.43%	-18.09%	9.19%	0.86%
MSCI Asia	5.79%	5.79%	5.79%	-16.01%	14.50%	6.24%
Shanghai Composite	4.32%	4.32%	4.32%	-24.88%	-1.87%	7.24%
Hong Kong Hang Seng	7.40%	7.40%	7.40%	-15.46%	14.52%	5.66%
MSCI EMEA	8.78%	8.78%	8.78%	-16.27%	16.42%	0.28%
MSCI Latam	12.27%	12.27%	12.27%	-7.07%	24.81%	2.73%
GBI EM GD	3.35%	3.35%	3.35%	-7.76%	7.98%	0.38%
ELMI+	1.75%	1.75%	1.75%	-4.79%	5.20%	-0.09%
EM FX Spot	2.32%	2.32%	2.32%	-10.69%	0.69%	-6.01%
EMBI GD	3.70%	3.70%	3.70%	-0.91%	6.88%	5.58%
EMBI GD IG	2.27%	2.27%	2.27%	0.10%	5.38%	4.72%
EMBI GD HY	5.19%	5.19%	5.19%	-1.98%	8.56%	6.38%
CEMBI BD	2.22%	2.22%	2.22%	0.32%	6.33%	4.68%
CEMBI BD IG	1.50%	1.50%	1.50%	0.95%	4.47%	4.08%
CEMBI BD Non-IG	3.19%	3.19%	3.19%	-0.42%	9.41%	5.44%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	6.41%	6.41%	6.41%	-4.28%	14.69%	10.51%
1-3yr UST	-0.01%	-0.01%	-0.01%	1.77%	0.80%	0.78%
3-5yr UST	-0.18%	-0.18%	-0.18%	1.95%	0.76%	1.34%
7-10yr UST	-0.26%	-0.26%	-0.26%	2.11%	0.56%	2.38%
10yr+ UST	-0.46%	-0.46%	-0.46%	-0.02%	0.96%	4.70%
10yr+ Germany	1.63%	1.63%	1.63%	9.16%	3.56%	7.19%
10yr+ Japan	0.95%	0.95%	0.95%	3.32%	3.39%	4.28%
US HY	3.83%	3.83%	3.83%	0.79%	9.49%	4.45%
European HY	1.95%	1.95%	1.95%	-2.58%	4.95%	4.03%
Barclays Ag	0.66%	0.66%	0.66%	-2.19%	2.73%	0.98%
VIX Index*	-31.47%	-31.47%	-31.47%	57.22%	-22.30%	10.25%
DXY Index*	-0.42%	-0.42%	-0.42%	7.53%	-2.78%	18.87%
CRY Index*	6.41%	6.41%	6.41%	-9.90%	9.36%	-35.97%
EURUSD	-0.51%	-0.51%	-0.51%	-7.84%	4.31%	-16.53%
USDJPY	-0.33%	-0.33%	-0.33%	0.35%	-7.98%	6.23%
Brent	13.18%	13.18%	13.18%	-13.66%	79.67%	-43.31%
Gold spot	1.48%	1.48%	1.48%	-2.90%	16.69%	3.55%

*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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