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WEEKLY INVESTOR RESEARCH

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Uzbekistan looks set to become the 73rd EMBI GD member

By Jan Dehn

Uzbekistan issued its inaugural sovereign Dollar-denominated bond last week. This means that Uzbekistan will likely become the 73rd EM country in the JP Morgan EMBI GD index. The enormous diversity of this index underlines the foolishness of treating the asset class as a homogenous entity. Indeed, this point is also illustrated by the distinctly diverse set of news stories across existing index members in the past week. We highlight the good and the bad news in this Weekly. Good news for Chinese bondholders as inflation declines. Bad news for Russian bondholders as the United States moves to impose further sanctions. Good news for Brazilian bondholders as the government pension reform looks likely to deliver the expected savings. Bad news for Argentina's government as inflation surges on changes in regulated prices. Good news for Papua New Guinea as Moody's changes the sovereign credit outlook from negative to stable. Bad news for Mexico as AMLO disappoints and industrial production slows. Good news for Modi in India as the data comes in solid.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	-0.50%
MSCI EM Small Cap	9.7	–	-0.44%
MSCI Frontier	8.8	–	0.77%
MSCI Asia	11.3	–	-0.29%
Shanghai Composite	9.2	–	2.45%
Hong Kong Hang Seng	7.6	–	-0.18%
MSCI EMEA	8.5	–	-2.09%
MSCI Latam	11.5	–	1.13%
GBI-EM-GD	6.29%	–	-1.00%
ELMI+	5.54%	–	-0.50%
EM FX spot	–	–	-0.85%
EMBI GD	6.27%	360 bps	0.10%
EMBI GD IG	4.59%	189 bps	-0.08%
EMBI GD HY	8.05%	539 bps	0.25%
CEMBI BD	5.88%	329 bps	0.20%
CEMBI BD IG	4.73%	214 bps	0.19%
CEMBI BD Non-IG	7.47%	487 bps	0.21%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.9	–	2.56%
1-3yr UST	2.52%	–	-0.05%
3-5yr UST	2.49%	–	-0.17%
7-10yr UST	2.66%	–	-0.23%
10yr+ UST	3.00%	–	-0.32%
10yr+ Germany	0.11%	–	-0.36%
10yr+ Japan	-0.02%	–	-0.16%
US HY	6.74%	402 bps	0.56%
European HY	4.82%	501 bps	0.41%
Barclays Ag	1.95%	-71 bps	-0.34%
VIX Index*	14.91	–	-0.81%
DXY Index*	96.67	–	-0.39%
EURUSD	1.1333	–	0.51%
USDJPY	110.53	–	-0.14%
CRY Index*	181.33	–	3.29%
Brent	66.1	–	7.46%
Gold spot	1325	–	1.30%

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

Emerging Markets

- **Uzbekistan:** Uzbekistan successfully placed an inaugural sovereign Dollar denominated benchmark bond in the global bond market last week. Uzbekistan will likely join the JP Morgan EMBI Global Diversified in March as the index's 73rd country. The EMBI GD is now incredibly diversified. The diversity underlines the foolishness of treating the EM sovereign bond asset class as a homogenous entity. Looking ahead, it is worth bearing in mind that there are some 165 EM countries in the world, so the diversity party is still only just getting started!

- **China:** Good news. CPI inflation slowed to 1.7% yoy in January from 1.9% yoy in December. The slowdown in inflation is creating more room for monetary stimulus, if necessary. As it happens, evidence is now arriving to suggest that policy easing is having the desired effect. Credit numbers significantly beat expectations in January and export growth was also strong (rebounding from -4.4% yoy in December to +9.1% yoy). Import growth also beat expectations, which points to better than anticipated domestic demand. Meanwhile, China's low inflation rate is great for the local currency bond market, which will be included in the Barclays/Bloomberg Global Aggregate starting in April. Finally, we note that China's FX reserves increased to USD 3.09trn in January, the third consecutive monthly increase.

- **Russia:** Bad news. Try to name just one downside risk for a US politician of any persuasion of supporting further sanctions on Russia! It is not easy to think of one. That is why US Senators last week introduced yet more proposals for Russian sanctions, this time targeting Russian banks seen to be involved in operations in Syria and Crimea. Not only is the downside from supporting sanctions small or non-existent, there may be outright benefits from doing so. For example, Democrats see additional sanctions on Russia as a means of

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Emerging Markets

pressuring President Donald Trump on account of his obvious fondness for his Russian counter-part, President Vladimir Putin. For Republicans, the same is true. Republicans have an incentive to exploit Trump's links to Putin to ensure that Trump does not hamper American business further, say, by raising tariffs too much. It is therefore our base case that the US will continue to step up sanctions on Russia. What does that mean for investors in Russian bonds? It means that liquidity, that is, the ability to trade Russian bonds declines. This will not hurt Russia much, but it will certainly hurt American savers and others who invest in Russian bonds.

- Brazil: Good news. After months of speculation, the Brazilian government presented some details of the upcoming pension reform. The retirement age will be raised to 65 years for men and 62 years for women. This is somewhat less aggressive than earlier announcements (see *Weekly Investor Research*, 11 February 2018), but since the increase in retirement ages will be phased in more quickly the government still believes that it can reach the target saving of BRL 1.1trn. In other Brazilian news, economic activity rebounded in December. The monthly IBC-Br economic activity index was up 0.2% mom, which was well above consensus (0.0%), while services activity also did far better in December than anticipated (+0.2% mom versus -0.3% mom expected).

- Argentina: Bad news. In a blow to the government, inflation rebounded to 2.9% mom in January from 2.6% mom in December (and 2.5% mom expected). More importantly, core inflation increased from 2.7% mom in December to 3.0% mom in January. The rise in headline inflation was mainly due to tax-related increases in administered prices. However, shocks to headline prices, whether caused by exchange rate movements or regulated prices, immediately get reflected in core inflation in Argentina, because the government has zero inflation fighting credibility. Argentina's lack of macroeconomic policy credibility makes it all the more painful to squeeze inflation out of the system. However, if Argentina remains within the ongoing IMF program throughout this presidential term and the next, which currently seems likely, the government should eventually be able to achieve credibility in monetary policy terms. At that point, it will no longer have to worry about pass-through from temporary inflation shocks to the core inflation indices.

- Papua New Guinea (PNG): Good news. When PNG issued its inaugural sovereign Dollar denominated bond not so long ago, the government was met with widespread derision in media and other circles. This is not unusual. Emerging Markets countries are often greeted with ridicule when they seek entry into global financial markets for the first time. Clearly, such ridicule reflects very badly on the critics. Market participants should welcome new entrants. Gaining access to global financing markets for the first time is a landmark event, which should be celebrated by all. PNG has responded to the arrogance of incumbents in the best way possible: by proving the detractors wrong: Moody's last week moved PNG's credit rating outlook from negative to stable on declining refinancing risk.

- Mexico: Bad news. In public comments last week, President Andres Manuel Lopez Obrador failed to live up to investors' expectations regarding government support for PEMEX. Without strong government support, the company will continue to be an inefficient and expensive employment agency with a bit of an oil business on the side. The company is a major cash cow for the government, which means it does not have the means to invest to develop Mexico's considerable oil assets. In another negative development, industrial production declined at a yoy rate of 2.5% in December following a weak print of 0.8% yoy in November.

- India: Good news. The economic data continues to be strong, which must be pleasing for President Narendra Modi as he heads into the April/May general election. The trade deficit widened to USD 14.7bn in January after dropping to USD 13.1bn in December, a 10 month low. Imports picking up reflect solid domestic demand. Exports also picked up after a slowdown in December (5.1% mom sa in January vs 1.7% mom sa in December). Industrial production was also solid at 2.4% yoy in December, which was well above the consensus expectation of 1.6% yoy. Finally, CPI inflation was just 2.05% yoy in January versus 2.5% yoy expected. Goldilocks.

Snippets:

- Colombia: Retail sales registered a solid yoy gain of 7% in December, but manufacturing production registered an unexpected decline (-0.8% yoy).
- Czech Republic: Real GDP growth expanded at a yoy rate of 2.9% in Q4 2018, up from 2.4% yoy in Q3 2018. The market had only expected growth of 2.4% yoy, based on the consensus compiled by Bloomberg. The Q4 2018 growth rate was the fastest in the last six quarters.
- Ecuador: IMF and the government confirmed last week that talks are underway for an agreement. An IMF program will significantly reduce Ecuadorian sovereign credit risk, in our view.
- Hungary: Real GDP growth was 5.0% yoy in Q4 2018, which was better than expected. Headline inflation was unchanged at 2.7% yoy in January.
- Indonesia: The seasonally adjusted trade deficit narrowed to USD 0.9bn in January from USD 1.1bn in December.
- Malaysia: Real GDP growth was 4.7% in yoy terms in Q4 2018, which was stronger than in Q3 2018 (4.4% yoy). It was also better than expected (4.5% yoy).

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Emerging Markets

- **Nigeria:** The Nigerian Election Commission postponed the general election for one week citing logistical challenges.
- **Pakistan:** The government of Imran Khan moved closer to an IMF program as government and IMF officials both stated that their differences in opinion over program details were narrowing.
- **Philippines:** The trade deficit narrowed to USD 3.8bn in December, in line with expectations.
- **Poland:** The yoy CPI inflation rate declined to just 0.9% in January from 1.1% in December. Growth decelerated to 4.9% yoy in Q4 2018 from 5.1% yoy in Q3 2018.
- **Romania:** Real GDP growth was 0.7% qoq in Q4 2018, in line with expectations. January CPI inflation was also in line with expectations at 3.3% yoy.
- **Singapore:** The economy was 1.4% larger in Q4 2018 than in Q3 2018 on an annualised basis, according to official data from the government. On a yoy basis, the Q4 2018 real GDP growth rate was 1.9%.
- **South Africa:** Retail sales were weaker than expected in December.
- **South Korea:** The rate of unemployment surged to 4.4% in January from 3.8% in December. The increase in unemployment was mainly due to a sharp rise in the participation rate of elderly people in response to a government program aimed at increasing the number of elderly people in the work force.
- **Taiwan:** The decline in Taiwanese exports slowed significantly in January. Exports were down 0.3% on a yoy basis, which was marked improvement from the 3.0% yoy contraction in December. Export growth, though negative, was dramatically better than the consensus expectation of a contraction of 3.5% yoy.
- **Thailand:** Real GDP growth was 3.7% yoy in Q4 2018, up from 3.2% yoy in Q3. The growth rate in Q4 2018 was higher than expected (3.6% yoy). The Q4 2018 growth rate implies that the economy expanded 4.1% in real terms for 2018 as a whole, which is an improvement relative to 2017 (4.0%).
- **Turkey:** The current account swung into deficit in December to the tune of USD -1.4bn compared to a surplus of USD 1.1bn in November. Most of the swing can be attributed to seasonal effects. The central bank eased lira reserve requirements for Turkish banks by 100bps in a sign that financial conditions are slowly improving. S&P, the ratings agency, also affirmed Turkey's sovereign credit rating of B+ with a stable outlook.
- **Ukraine:** Television comedian Volodymyr Zelensky leads in polls ahead of the 31 March general election. Zelensky is polling 19% of voting intensions, according to Rating Group, a pollster. His poll rating is up from 14% in December. Yulia Tymoshenko, a former prime minister, is currently polling 18%, down from 21%. Petro Poroshenko, incumbent President of Ukraine, is polling 15%, up from 12% in December.

Global backdrop

Global stocks continue to hang on to every headline pertaining to President Donald Trump's trade war against China. We think the conflict will have a benign outcome because if Trump continues to push up tariffs he will personally be responsible for the next US recession. Recession will in turn make him (and many Republicans in Congress) unelectable in 2020. If Trump is not re-elected, he will go down in history as a one term president. Other one term presidents include George Bush Senior and Jimmy Carter.

Meanwhile, the risks to the economy should not be discounted. US retail sales and industrial production both softened significantly in January, while initial claims for unemployment once again failed to decline as much as expected following the end of the government shut down. In this context, it is clearly positive that the Fed has already reversed its policy mistake from last year, when it promised to hike rates four times in 2019. The risks remain, however, with the late stage of the business cycle, lack of investment, low productivity due to lack of reform, excessive debt as well as the very badly timed 2017 tax cut and Trump's very damaging trade war. A slowdown is not a problem per se. However, if the slowdown turns into recession then... Houston, we have a problem. First, the Trump Administration is no longer in a position to be able to count on fiscal stimulus because Nancy and Donald do not get along. Second, the Fed can only cut rates by 250bps in case of an onset of a recession. A resumption of Quantitative Easing (QE) would therefore become necessary, but QE would likely have a very different effect from last time, since asset prices have already been pushed to bubble levels. The only untapped policy option to help ease the economic pain is the Dollar, which could sink meaningfully. While we expect the Dollar to decline 20% over the next several years in an orderly fashion, the Dollar could crash outright if recession strikes.

In Europe, both the economy and sentiment remain weak. A poor industrial production number in Europe last week (-0.9% mom versus -0.4% mom expected) reinforced the perception of gloom. On the other hand, the recent spate of negative economic news is now sparking talk of more corporate bond purchases by the ECB. At country level, the government in Spain called an election but this is nothing to worry about. Fortynine of Europe's fifty independent countries are democracies. On average, they hold elections every four years. This

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Global backdrop

means that Europe has approximately 12 elections every year. There was also positive news. The slump in European car production – triggered by the introduction of a new emissions testing scheme – finally appears to be over. Finally, as usual in recent times, further bad news emanated from the UK as Prime Minister Theresa May's latest proposal to resolve the Brexit impasse was defeated in Parliament. Hard Brexit is now only six weeks away and is not priced in to the market. The UK economy is already showing serious signs of slowing, including negative economic growth in December and declining inflation. Hold on to your hats and glasses!

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.81%	6.79%	6.79%	-11.90%	15.43%	4.30%
MSCI EM Small Cap	-0.77%	4.57%	4.57%	-15.37%	9.20%	2.07%
MSCI Frontier	1.66%	6.50%	6.50%	-13.70%	8.40%	1.32%
MSCI Asia	-0.61%	6.65%	6.65%	-10.34%	15.03%	6.44%
Shanghai Composite	3.78%	7.56%	7.56%	-14.11%	1.39%	7.26%
Hong Kong Hang Seng	-0.89%	8.03%	8.03%	-9.18%	16.22%	5.96%
MSCI EMEA	-5.57%	4.64%	4.64%	-16.82%	11.97%	-0.86%
MSCI Latam	-2.16%	12.49%	12.49%	-4.17%	22.39%	2.32%
GBI EM GD	-1.94%	3.42%	3.42%	-6.98%	6.61%	0.04%
ELMI+	-1.21%	1.47%	1.47%	-4.41%	4.46%	-0.39%
EM FX Spot	-1.95%	1.62%	1.62%	-10.52%	-0.35%	-6.41%
EMBI GD	0.13%	4.55%	4.55%	2.78%	6.99%	5.60%
EMBI GD IG	0.26%	3.13%	3.13%	3.73%	5.28%	4.65%
EMBI GD HY	0.02%	6.04%	6.04%	1.76%	8.92%	6.61%
CEMBI BD	0.55%	3.28%	3.28%	2.74%	6.44%	4.77%
CEMBI BD IG	0.53%	2.52%	2.52%	3.47%	4.54%	4.14%
CEMBI BD Non-IG	0.57%	4.29%	4.29%	1.88%	9.62%	5.58%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	2.78%	11.02%	11.02%	3.65%	16.46%	10.82%
1-3yr UST	0.00%	0.27%	0.27%	2.23%	0.78%	0.82%
3-5yr UST	-0.13%	0.28%	0.28%	3.11%	0.63%	1.39%
7-10yr UST	-0.18%	0.56%	0.56%	5.01%	0.14%	2.50%
10yr+ UST	0.27%	0.95%	0.95%	5.96%	0.16%	5.12%
10yr+ Germany	0.56%	2.74%	2.74%	12.53%	2.39%	7.28%
10yr+ Japan	0.65%	1.73%	1.73%	3.56%	3.22%	4.39%
US HY	0.86%	5.41%	5.41%	4.04%	10.82%	4.62%
European HY	0.61%	3.09%	3.09%	-0.31%	5.99%	4.12%
Barclays Ag	-0.83%	0.68%	0.68%	-1.39%	1.95%	0.86%
VIX Index*	-10.02%	-41.35%	-41.35%	-23.38%	-31.10%	7.50%
DXY Index*	1.14%	0.52%	0.52%	8.50%	-0.29%	20.83%
CRY Index*	0.94%	6.79%	6.79%	-6.33%	12.01%	-39.25%
EURUSD	-1.00%	-1.17%	-1.17%	-8.66%	2.03%	-17.63%
USDJPY	-1.48%	-0.76%	-0.76%	-3.56%	2.45%	-7.39%
Brent	6.80%	22.86%	22.86%	1.94%	92.82%	-40.16%
Gold spot	0.29%	3.32%	3.32%	-1.58%	7.66%	0.23%

*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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