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WEEKLY INVESTOR RESEARCH

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# Ecuador goes to the IMF

By Jan Dehn

Ecuador's new IMF programme is excellent news. In South Africa, the government announced fresh capital for Eskom and plans to near-privatise the company. Brazil's pension reform made it to parliament; markets will now become more volatile as they fret over each stage of the approval process, which may last months. The Mexican central bank shifted in a slightly dovish direction amidst extreme bearishness among local investors. Argentina had strong trade and fiscal numbers in January. In India, the most recent central bank minutes revealed a healthy spread of views on the monetary policy committee. China and the US appear to be moving yet closer to a final trade deal. Tensions are escalating on the Venezuelan borders with Colombia and Brazil. The global backdrop section asks why voters sometimes elect governments with destructive economic policies and provides an update on the impact of US developments on EM.

| Emerging Markets | Next year forward PE/Yield | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| MSCI EM | 10.8 | – | 2.79% |
| MSCI EM Small Cap | 9.9 | – | 1.97% |
| MSCI Frontier | 8.9 | – | 0.95% |
| MSCI Asia | 11.6 | – | 3.16% |
| Shanghai Composite | 9.9 | – | 4.54% |
| Hong Kong Hang Seng | 7.9 | – | 4.48% |
| MSCI EMEA | 8.6 | – | 2.70% |
| MSCI Latam | 11.5 | – | 1.18% |
| GBI-EM-GD | 6.28% | – | 0.79% |
| ELMI+ | 5.21% | – | 0.64% |
| EM FX spot | – | – | 0.60% |
| EMBI GD | 6.21% | 354 bps | 0.52% |
| EMBI GD IG | 4.58% | 189 bps | 0.14% |
| EMBI GD HY | 7.91% | 527 bps | 0.88% |
| CEMBI BD | 5.85% | 328 bps | 0.29% |
| CEMBI BD IG | 4.71% | 213 bps | 0.23% |
| CEMBI BD Non-IG | 7.42% | 485 bps | 0.38% |

| Global Backdrop | Next year forward PE/Yield/Price | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| S&P 500 | 15.0 | – | 1.76% |
| 1-3yr UST | 2.51% | – | 0.07% |
| 3-5yr UST | 2.49% | – | 0.09% |
| 7-10yr UST | 2.68% | – | 0.07% |
| 10yr+ UST | 3.04% | – | -0.16% |
| 10yr+ Germany | 0.11% | – | 0.10% |
| 10yr+ Japan | -0.04% | – | 0.30% |
| US HY | 6.65% | 395 bps | 0.51% |
| European HY | 4.69% | 484 bps | 0.65% |
| Barclays Ag | 1.93% | -75 bps | 0.36% |
| VIX Index* | 13.55 | – | -1.36% |
| DXY Index* | 96.41 | – | -0.49% |
| EURUSD | 1.1357 | – | 0.41% |
| USDJPY | 110.79 | – | -0.15% |
| CRY Index* | 183.00 | – | 1.67% |
| Brent | 65.7 | – | -1.20% |
| Gold spot | 1330 | – | 0.21% |

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

## Emerging Markets

- **Ecuador:** Other than Spain, no other country has defaulted as frequently as Ecuador. It is therefore welcome news, whenever Ecuador secures a lot of fresh money and commits to important structural reforms. This is exactly what happened last week, when President Lenin Moreno announced an IMF programme with more than USD 10bn in new multilateral financing. The new financing significantly reduces near-term default risk. Accompanying reforms will also improve Ecuador's credit fundamentals. The news is therefore very positive, in our view. The reforms are likely to include changes to the VAT regime, energy subsidies and labour market reforms. The objective of these reforms is to improve productivity, which is particularly important in Ecuador, which, by dint of using the Dollar as its currency, does not have the option to devalue. Alejandro Werner, IMF's chief for the Latin America region, indicated that Ecuador will not need to issue bonds for financing purposes for the next three years. This may be the case, but Ecuador may still be active in global debt markets if only to take advantage of opportunities to undertake credit enhancing liability management operations, depending on market conditions. We expect a somewhat more volatile period for Ecuadorian assets in the coming months as investors evaluate Ecuador's ability to deliver on the reforms required under the IMF programme.

- **South Africa:** The South African Budget was market friendly. The Budget allocates a significant capital injection of ZAR 23bn to the energy parastatal, Eskom. Eskom bonds rallied following the announcement. In exchange for the capital injection, the government signalled its intention to place Eskom on commercial terms, de facto privatising the company. If Eskom is required to operate on commercial terms, such as Brazil's Petrobras and Colombia's Ecopetrol, this will significantly reduce the quasi-fiscal burden inflicted on the South African government. In other news, CPI inflation dropped sharply to 4.0% yoy in January from 4.5% yoy in December. The market expectation was for inflation of 4.3% yoy. Core inflation slowed to 4.3% yoy from 4.4% yoy over the same period.

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## Emerging Markets

- **Brazil:** The all-important pension fund reform has finally reached parliament. There will now be several months with feverish speculation as the reform makes its way through various committees in the Lower House and the Senate as well as through plenary sessions in both houses and finally past the Judiciary. Final approval may not happen until Q3 2019. We expect Brazilian markets to trade with greater volatility during this period, in much the same way that markets trade around elections. We expect a meaningful reform to emerge at the end, so temporary bouts of volatility during the passage through Congress, should be used to add exposure. After all, once the reform is out of the way, Brazil has a long and sustained cyclical upswing ahead. In other news, mid-month CPI inflation in February declined to 3.73% on a yoy basis from 3.77% yoy in the middle of January.

- **Mexico:** Minutes from Banxico's February rate-setting meeting pointed to a slightly dovish shift in sentiment. Mexican pension funds and other domestic investors are extremely bearish about the outlook under President Andres Manuel Lopez Obrador, fearing both fiscal deterioration and unpredictable decisions from the Mexican parliament. Unlike South Africa, the Mexican government is not showing any sign of wanting to place PEMEX, the national oil company, on a more commercial footing. If growth slows and inflation moderates, however, Mexico's high yielding bond may offer decent value, especially at the short end of the curve. One positive development in Mexico is that new regulations for the domestic pension funds is underway, which would allow these institutions to take more exposure to foreign markets and to engage in more actively managed funds. This simply reflects the increasing sophistication of the Mexican pensions system. Mexican inflation in the first half of February was -0.10% mom, reducing the yoy rate of inflation to 3.89% from 4.21% in mid-January 2019.

- **Argentina:** The trade surplus was a solid USD 372m in January, which is a dramatic improvement from the deficit of USD 917m in the same month of 2018. The trade balance is adjusting due to a meaningfully more competitive exchange rate plus significant domestic demand adjustment under the ongoing IMF programme. The primary fiscal surplus in January was a startling 324% better on a yoy basis, while tax revenues were 443% better than the same period last year. Interest payments have increased due to the devaluation last year, but tax revenues have gone up three times as much as interest payments.

- **India:** Minutes of the monetary policy committee meeting in February revealed a dovish bias, but also a very divided committee. There are strong disinflationary trends across EM, but India is also stimulating quite heavily on the fiscal side. Some members favoured caution in light of the inflation risk arising from the fiscal side, while other members argued for an even larger cut (the RBI cut 25bps in February). A good spread of opinions within the committee is healthy.

- **China:** The likelihood that China and the United States strike a deal on trade increased significantly over the weekend, when US President Donald Trump announced a delay (of unspecified duration) to a planned increase in the tariff rate from 10% to 25% on USD 200bn of Chinese imports. The tariff hike was due to come into effect on 2 March 2019. Trump and Chinese President Xi Jinping are expected to meet later in March. The United States is now seeking a resolution to its own instigated trade war to avoid recession. Besides, the trade war has served its main political purposes to help Republicans in the November 2018 mid-term elections and to give US President Donald Trump the opportunity to conclude a deal. China's growth outlook is stabilising, while the US economy is slowing. Delaying the deal further would therefore merely shifts the balance of power in the negotiations further towards China. We expect the final trade agreement to be underwhelming in terms of content, just as was the case with NAFTA II. It made political sense for the Trump Administration to tear things up only to put them back together again with very few changes to the original arrangements, but the US and global economies have paid a price due to the resulting uncertainty and bouts of volatility. In other news, the flow of FX of USD 5.8bn into China in January was the strongest in nearly five years amidst a strengthening RMB.

- **Venezuela:** Tensions have erupted into violent confrontations at Venezuelan border crossings with Colombia and Brazil. The Venezuelan government is blocking humanitarian supplies from crossing the border. This may well be used by opponents of Venezuelan President Nicolás Maduro as a pretext for stepping up pressure on Maduro to go even further. Opposition leader Juan Guaidó has called for all means to be employed to remove Maduro. Senior US officials are also ramping up the rhetoric against Maduro. The border between Colombia and Venezuela has been closed. Guaidó and his foreign allies are hoping that the Venezuelan military will abandon Maduro as the pressure is ramped higher.

Snippets:

- **Colombia:** Domestic demand is now running at a high pace as sentiment has moved on from tax reforms and political noise. Retail sales were 7% higher in December than in the preceding year and infrastructure investment was strong (5.3% yoy in Q4 2018).
- **Croatia:** CPI inflation declined to 0.2% yoy in January from 0.8% yoy in December.
- **Egypt:** The government tapped the global bond market with benchmark bonds in the 5 year, 10 year and 30 year sectors.
- **Hungary:** Ratings agency S&P upgraded Hungary's long-term sovereign credit rating to BBB from BBB-. The outlook was changed to stable from positive.

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## Emerging Markets

- **Indonesia:** Bank Indonesia left the policy rate unchanged at 6% in its February meeting, while signalling the intention to ease macro-prudential measures.
- **Malaysia:** CPI inflation was -0.7% yoy in January versus -0.4% yoy expected.
- **Peru:** Real GDP growth accelerated strongly in Q4 2018, rising to 4.8% yoy compared to 2.4% yoy growth in Q3 2018.
- **Russia:** The rate of growth in industrial production slowed to 1.1% yoy in January from 2.0% yoy in December. Real wage growth slowed from 2.9% yoy in December to 0.2% yoy in January. Retail sales also slowed following a hike in VAT.
- **Sri Lanka:** The government is considering an offer of a USD 1.5bn currency swap with China as it prepares to issue new Dollar-denominated sovereign bonds.
- **Taiwan:** The pace of decline in exports orders slowed to -6.0% yoy in January from -10.5% yoy in December. European demand recovered amidst continuing decline in US and Chinese demand.
- **Thailand:** Exports declined sharply in January (-5.7% yoy). Imports, reflecting domestic demand, surged to 14% yoy, partly a payback for the -8.2% yoy drop in December. The net result was a trade deficit of USD 4.0bn in January compared to a trade surplus of USD 1.1bn in December.
- **Turkey:** The primary fiscal deficit increased sharply to 2.2% of GDP in January from 1.5% of GDP in December. Turkey is trying to adjust to a loss of investor confidence – and hence financing – by spreading losses throughout the banking system, including state-owned banks.

## Global backdrop

Why do voters sometimes vote governments into power, whose policies are directly destructive for the economy? There are plenty of examples of such election outcomes, including the UK and Brexit, Venezuela under Chavismo, Argentina under the Kirchners, Italy under its current populist leadership, etc.

The answer is very simple: the majority of voters do not believe that the economy is working for them. If the economy is doing nothing for them, why not destroy it in the vain hope that, maybe, a better economy can emerge from the old? Sadly, it is usually hugely inefficient to destroy whole economies and often ends up hurting the poorest segment of the population the most, the very ones who voted the populist into office.

The only way to avoid these destructive cycles of populism is to ensure that the economy works for a large majority of the population. This can only happen if the gains from growth are distributed more evenly across the population. One way to ensure this happens is to deal with corruption, which not only results in massive enrichment of the few, but also robs countries of resources and opportunities. This would enable the many to improve their lot through education, infrastructure, health care, etc. It is also important that inequality is not allowed to get too far out of control. This may involve a moderate degree of progressive taxation and some modest transfer payments to the most vulnerable, but certainly neither punitive taxation of businesses nor large unrequited transfer payments. Rather, the way forward is to ensure economies are flexible enough that everyone can find jobs most of the time and that lower income groups have the means to improve their productivity, especially via education, health care and access to credit.

The party in developed economies is over. Years of hyper-stimulus are behind us. Growth is slowing. The old problems of debt and low productivity are returning, but now accompanied by high inequality and over-valued asset prices. The biggest mispricing in developed markets are in the Dollar, US equities and European fixed income, which were the big popular long trades in response to Quantitative Easing (QE).

How will negative news in Europe and the United States affect EM? Negative news in Europe mainly affects EM in the short term by triggering bouts of risk aversion, but rarely leave a lasting impact, neither on EM asset prices nor on EM fundamentals. Negative news in the United States, on the other hand, has a more profound effect on EM, because most EM external debt trades as a spread over US Treasuries, while most EM currencies trade against the Dollar. Hence, anything that shifts the Dollar and the US yield curve shows up in EM asset prices.

The data in the United States deteriorated further last week with poor manufacturing data, poor durable goods data, poor PMI data, poor leading indicators data and poor existing home sales data. Claims data is still holding up, but it is a well-known fact that labour market indicators lag the business cycle. If the US economy is indeed slowing, then investors have far too much money in US stocks and the Dollar. Both rallied over the last eight years as flighty risk-seeking capital from all over the world sought to participate in the enormous capital gains in the US stock market. In a slowing economy, the big capital gains are over. If US stocks only deliver 5-6% return per year in the next few years – which is roughly equivalent to historical long-term returns – then EM bond markets should handsomely beat US stock market returns. For example, if there is no rally at all, EM Dollar denominated and local currency bonds should, at the current yields of 6.3%, deliver some 37% compounded return over the next five years. Moreover, if, as we expect, EM currencies recover some 20% then the total return on EM bonds will be 57% over the next five years, or 11.4% return in Dollars, which is twice as much as US stocks.

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## Global backdrop

Of course, if the US slowdown is more serious, then investors may have to sell far more Dollars and stocks because US policy makers may find it difficult to get out of a recession. After all, fiscal stimulus is no longer a given because Democrats control the House of Representatives and, at the current Fed funds rate, the Fed can only cut 250bps, which is only half of what the Fed usually cuts in recessions. Minutes from the Fed's January FOMC meeting showed that nearly all members favoured stopping the reduction in the Fed's asset holding this year. It is difficult to remember the last time the Fed U-turned so dramatically in such a short time. The fact that it has is positive, but it should not have fallen into the trap of getting hyper-hawkish in April last year on the back of a clearly unsustainable fiscal stimulus unleashed upon the American economy at the point of full employment.

## Benchmark performance

| Emerging Markets | Month to date | Quarter to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|---|
| MSCI EM | 0.94% | 9.77% | 9.77% | -9.35% | 15.30% | 4.82% |
| MSCI EM Small Cap | 1.18% | 6.63% | 6.63% | -13.90% | 8.94% | 2.37% |
| MSCI Frontier | 2.62% | 7.50% | 7.50% | -13.46% | 8.10% | 1.41% |
| MSCI Asia | 2.54% | 10.03% | 10.03% | -7.34% | 15.25% | 6.93% |
| Shanghai Composite | 8.50% | 12.44% | 12.44% | -12.11% | 0.74% | 8.24% |
| Hong Kong Hang Seng | 3.55% | 12.87% | 12.87% | -5.06% | 16.19% | 6.88% |
| MSCI EMEA | -3.02% | 7.47% | 7.47% | -14.18% | 11.57% | -0.27% |
| MSCI Latam | -1.01% | 13.81% | 13.81% | -4.29% | 20.38% | 2.78% |
| GBI EM GD | -1.17% | 4.23% | 4.23% | -5.86% | 6.49% | 0.17% |
| ELMI+ | -0.58% | 2.12% | 2.12% | -3.24% | 4.60% | -0.25% |
| EM FX Spot | -1.36% | 2.23% | 2.23% | -9.33% | -0.41% | -6.29% |
| EMBI GD | 0.65% | 5.09% | 5.09% | 3.06% | 6.60% | 5.62% |
| EMBI GD IG | 0.39% | 3.27% | 3.27% | 3.81% | 4.91% | 4.61% |
| EMBI GD HY | 0.89% | 6.97% | 6.97% | 2.21% | 8.47% | 6.67% |
| CEMBI BD | 0.84% | 3.58% | 3.58% | 2.96% | 6.34% | 4.76% |
| CEMBI BD IG | 0.76% | 2.75% | 2.75% | 3.63% | 4.54% | 4.12% |
| CEMBI BD Non-IG | 0.95% | 4.69% | 4.69% | 2.19% | 9.30% | 5.58% |

| Global Backdrop | Month to date | Quarter to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|---|
| S&P 500 | 3.45% | 11.74% | 11.74% | 5.35% | 15.10% | 10.98% |
| 1-3yr UST | 0.11% | 0.37% | 0.37% | 2.33% | 0.82% | 0.84% |
| 3-5yr UST | 0.03% | 0.45% | 0.45% | 3.26% | 0.69% | 1.42% |
| 7-10yr UST | -0.03% | 0.71% | 0.71% | 5.24% | 0.19% | 2.51% |
| 10yr+ UST | -0.07% | 0.60% | 0.60% | 6.63% | 0.05% | 5.02% |
| 10yr+ Germany | 0.66% | 2.84% | 2.84% | 11.94% | 2.14% | 7.30% |
| 10yr+ Japan | 0.95% | 2.04% | 2.04% | 3.70% | 2.59% | 4.52% |
| US HY | 1.21% | 5.78% | 5.78% | 4.13% | 10.22% | 4.58% |
| European HY | 1.27% | 3.77% | 3.77% | 0.24% | 5.66% | 4.18% |
| Barclays Ag | -0.47% | 1.05% | 1.05% | -0.54% | 1.98% | 0.93% |
| VIX Index* | -18.23% | -46.70% | -46.70% | -17.83% | -29.09% | -0.88% |
| DXY Index* | 0.87% | 0.25% | 0.25% | 7.27% | -0.90% | 20.31% |
| CRY Index* | 1.87% | 7.77% | 7.77% | -6.63% | 12.52% | -39.32% |
| EURUSD | -0.79% | -0.96% | -0.96% | -7.79% | 3.08% | -17.37% |
| USDJPY | -1.72% | -0.99% | -0.99% | -3.48% | 1.99% | -7.72% |
| Brent | 6.16% | 22.12% | 22.12% | -2.39% | 86.17% | -40.01% |
| Gold spot | 0.64% | 3.68% | 3.68% | -0.30% | 7.85% | -0.81% |

*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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