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WEEKLY INVESTOR RESEARCH

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Rising political noise in Brazil

By Jan Dehn

Political noise levels are on the rise in Brazil over the government's pension reform. In Russia, the data was strong and the central bank tilted in a dovish direction. Kazakhstan's President Nazarbayev announced the start of what is likely going to be a long transition of power. Thais voted. The National Development Bank (NDB) lends money to South Africa's ESKOM. Benin joined global capital markets. Africa's sovereign foreign currency-denominated bond market reached USD 100bn in size with more than a dozen countries represented in the main benchmark indices. China enters Bloomberg Barclays Global Aggregate index next month: what does it mean for you? Finally, we note that market sentiment towards EM soured last week despite the fact that most of the bad news was happening in developed economies. How very odd.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	0.24%
MSCI EM Small Cap	10.1	–	-0.26%
MSCI Frontier	8.7	–	0.21%
MSCI Asia	12.0	–	1.03%
Shanghai Composite	10.1	–	2.73%
Hong Kong Hang Seng	7.8	–	0.08%
MSCI EMEA	8.5	–	-0.02%
MSCI Latam	11.0	–	-4.81%
GBI-EM-GD	6.19%	–	-0.23%
ELMI+	5.63%	–	-0.17%
EM FX spot	–	–	-0.54%
EMBI GD	6.04%	357 bps	0.66%
EMBI GD IG	4.38%	188 bps	1.14%
EMBI GD HY	7.86%	542 bps	0.20%
CEMBI BD	5.69%	332 bps	0.60%
CEMBI BD IG	4.50%	213 bps	0.74%
CEMBI BD Non-IG	7.34%	496 bps	0.42%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.1	–	-0.75%
1-3yr UST	2.30%	–	0.27%
3-5yr UST	2.23%	–	0.59%
7-10yr UST	2.44%	–	1.09%
10yr+ UST	2.89%	–	2.38%
10yr+ Germany	-0.01%	–	2.46%
10yr+ Japan	-0.08%	–	0.74%
US HY	6.49%	394 bps	0.28%
European HY	4.41%	456 bps	0.17%
Barclays Ag	1.79%	-65 bps	0.95%
VIX Index*	16.98	–	3.88%
DXY Index*	96.48	–	-0.05%
EURUSD	1.1316	–	-0.19%
USDJPY	110.07	–	-1.22%
CRY Index*	184.18	–	-0.67%
Brent	66.7	–	-1.23%
Gold spot	1318	–	1.10%

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

Emerging Markets

- **Brazil:** President Jair Bolsonaro's honeymoon period is over. Last week, Brazil found itself firmly in the grip of heighted political noise as the battle over pension reform moves into gear. The reform is a critical piece of legislation, which will determine whether Brazil's fiscal trajectory becomes sustainable or not. As noted in previous versions of this Weekly, the period until Q3 2019, by which time we expect the pension reforms to have passed, is likely to be characterised by elevated levels of noise. Last week illustrated this point perfectly as markets reacted with great volatility to almost every political development. The key political developments were:

(a) Former President Michel Temer was arrested by the so-called Carwash probe: Temer's arrest gave rise to fears that other members of Congress could be vulnerable to prosecution, thus making it harder to pass the pension reform.

(b) The government submitted a pension reform proposal for the military (separate from the main public sector pension reform): markets noted that the government had had to grant significant benefits to members of the military in order to obtain the required support for this reform, giving rise to fears of dilution of the main reform.

(c) Congress Speaker Rodrigo Maia called for more decisive leadership from Bolsonaro to get the pension reform passed: markets are worried that maybe Bolsonaro's political skills, which, beyond getting elected president, are unproven.

The political noise in Brazil is taking place amidst softening economic data. The central bank left the policy rate unchanged at 6.5%.

- **Russia:** Both industrial production and retail sales beat expectations in February. Industrial production was up 4.1% yoy in February versus 1.5% yoy expected, while retail sales accelerated to 2.0% yoy from 1.6% the previous month. The Central Bank of Russia left the policy rate unchanged at 7.75%, but officials revised their inflation forecasts lower, which may signal cuts later this year. The combination of strong positive economic

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Emerging Markets

momentum and declining inflationary pressures is known as 'Goldilocks' and it tends to bode well for investment returns, especially in bonds.

- Kazakhstan: President Nazarbayev has resigned as president after almost thirty years in power. Senate Speaker Tokayev will take over as president until elections, which are scheduled for April 2020. Nazarbayev retains control of key security institutions and remains the Head of the ruling party, so his resignation should be seen as part of a longer transition process.

- Thailand: Thailand held a long-awaited general election yesterday. The official result will not be announced until 23 May, but preliminary results may emerge sooner. The Bank of Thailand left the policy rate unchanged at 1.75%.

- South Africa: The New Development Bank (NDB) is planning to extend nearly USD 800m in new loans to ESKOM, South Africa's state energy company. NDB is also known as the 'BRICS Bank'. Retail sales beat expectations in January (1.5% mom versus 0.4% mom consensus). Inflation was in line with expectations (4.1 yoy).

- Benin: Benin's inaugural Eurobond of EUR 500m was placed at a yield of 6%. The bond issue was more than two times over-subscribed. If one includes JP Morgan's main EUR denominated fixed income index, there are now 160 individual Emerging Markets (EM) bond markets (corporate and sovereign) formally represented within the established EM fixed income benchmark indices. Seven EM countries only issue international bonds in EURs. They are Bulgaria, Czech Republic, Macedonia, Montenegro, Albania, Estonia and, now, Benin.

- African bonds: With recent bond issues from Benin and Ghana, the Eurobond fixed income market in Africa has reached USD 100bn, a milestone of sorts. Africa's GDP exceeds USD 2trn. There are more than a dozen African sovereign issuers, plus, of course, corporate issuers. Their ability to tap global financial markets is a hugely positive development, because it opens up more avenues for financing investment and more opportunities for investors to take exposure to regions, both in the public and private sectors. Africa's improving access to global financial markets aids the region in diversifying away from its two main financing sources: foreign aid and China.

- China: Chinese local currency government bonds are due to enter the Bloomberg Barclays Global Aggregate index next month. To illustrate what this means for investors, we have estimated efficient allocations to Chinese bonds for USD, EUR, GBP and JPY-based investors using performance data for the past five and ten years. We also estimated the efficient allocations to Chinese bonds for USD-based investors in a forward-looking framework and in USD-hedged portfolios. We find that Chinese bonds offer meaningful advantages to investors in all these contexts, wherefore we expect significant participation as index inclusion gets underway. Some USD 300bn is likely to flow into the Chinese bond market in the first rounds of index inclusion. This is roughly equivalent to one third of all outstanding bonds in the entire Dollar-denominated EM sovereign government bond market. For more details please see: *'The future is now: index inclusion for Chinese bonds'*, The Emerging View, 22 March 2019.

Snippets:

- Argentina: The primary surplus reached ARS 23bn (0.1% of GDP) in February, which is in line with the IMF program target. This was Argentina's second consecutive monthly primary fiscal surplus.
- Chile: Real GDP growth was 4.0% in 2018, according to the central bank.
- Colombia: The central bank left the policy rate unchanged at 4.25%.
- Egypt: Fitch upgraded the sovereign debt rating to from B to B+ with stable outlook.
- Indonesia: Bank Indonesia left the policy rate unchanged at 6.0% in line with expectations, but slightly eased macro-prudential rules to enable banks to lend a bit more without facing tighter reserve requirements.
- Malaysia: CPI inflation was -0.4% yoy in February versus -0.3% yoy expected.
- Mexico: The government indicated last week that some of Mexico's fiscal stabilisation fund could be used to repay PEMEX debt.
- Philippines: The central bank left the policy rate unchanged at 4.75%.
- Poland: Construction output growth was up 15.1% mom in February, while retail sales beat expectations at 5.6% mom (versus 5.3% mom expected). Industrial production was up 6.9% yoy versus 4.5% yoy expected.
- Romania: The government lowered its proposed bank tax rates significantly, easing concerns about the quality of the investment environment.
- South Korea: The export slowdown moderated in March relative to February; 20-day exports were down 4.9% yoy compared to -11.7% yoy in February.
- Sri Lanka: The economy racked up 3.2% real GDP growth in 2018, despite considerable political and policy uncertainty in Q4 last year.

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- Taiwan: The central bank left the policy rate unchanged at 1.375%.
- Turkey: Political noise levels are rising sharply ahead of local elections scheduled for 31 March. The Turkish lira took a significant hit last week as global sentiment weakened.
- Venezuela: Intelligence agents from the government of Nicholas Maduro arrested two officials close to opposition leader Juan Guaido.

Global backdrop

In a classic example of investor irrationality, EM markets pulled back last week in response to bad news primarily in developed countries. In our view, Developed economies are messing up along three specific dimensions:

First, the Fed has now become a huge source of global market volatility. Responding to clearly weakening data, the Fed last week promised no rate hikes at all in 2019 and downgrading US growth and inflation forecasts. The Fed's new dovish stance marked the completion of what can only be described as a truly spectacular U-turn. Less than a year ago, a gung-ho Powell promised four hikes in 2019 and quantitative tightening. Last year, Powell's hawkishness caused significant volatility in global markets. Today, his dovishness is also moving markets. Central banks are often criticised for causing instability rather than calm. One can certainly level this criticism at the Powell Fed. In our opinion, the Fed committed a rooky error last year by mistaking a 'sugar high' from the Trump tax cut for higher trend growth. The only positive thing one can say about the Powell Fed's U-turn is that at least it has recognised the error of its ways and is now taking corrective action. US President Donald Trump has nominated Stephen Moore for a seat on the Federal Reserve Board. Unfortunately, Moore does not command the respect of serious economists, so in our view, the quality of decisions at the Fed will decline if his nomination is approved.

Second, the data in developed economies continues to soften. In the US, factory orders, durables, mortgage applications, manufacturing PMI and services PMI all deteriorated, while the government posted its largest ever monthly budget deficit in February (USD 234bn). Deficits will worsen sharply as the economy slows further. Meanwhile, German and French PMIs were quite simply dismal, although European consumer confidence was better than expected. The US Treasury curve has now inverted, which has been an extremely reliable indicator of recession in the past. Hence, do not dismiss the weak data in developed economies. Central banks in rich countries do not have enough ammunition to cure recession and investors still have far too much money in these markets. A serious downturn could usher in more fiscal spending, although Trump's lame duck status in the House of Representatives means that this cannot be taken as given. Of course, governments in developed countries already have too much debt to begin with. The end-result of piling yet more debt on old debt is higher inflation and currency debasement.

Thirdly, developed economies are currently the source of serious political risks, most obviously in the UK, but also elsewhere. In the UK, the gift of Brexit certainly keeps on giving. The EU agreed to extend the Brexit deadline to enable UK Prime Minister Theresa May one more chance to obtain approval for her Withdrawal Agreement. Failing this, the EU has also granted the UK Parliament a longer deadline to come up with an alternative solution. This buys time, but does not provide much clarity. It is unclear if May will survive for long enough to see her deal passed or whether a a new Tory leader can do any better. It is also unclear if the deeply divided UK Parliament can do any better. Meanwhile, it was reported that over a million people took to the streets of London to demand a new referendum on the Brexit over the weekend. This is the world's largest financial centre we are talking about here. The United States is also a source of political risk at home and overseas. Within the US, Special Council Robert Muller has now submitted his report on Russian election interference in 2016. Trust that his conclusions will become a source of major political noise in the US in the coming days and weeks. Abroad, US President Donald Trump last week recognised Israeli sovereignty over the Golan Heights, which is Syrian territory. Israel occupied the Golan Heights in the 1967 war. UN Security Council Resolution 497 labels Israel as an occupying power. By condoning annexation of foreign territory by means of war, the Trump Administration undermines international law, which will encourages rogue behaviour in others and make the global investment environment less predictable. Trump's decision to lift Treasury sanctions against North Korea's dictatorship, because Trump 'likes' Chairman Kim Jong Un does not instil great confidence either.

It is entirely normal practice of investors to take out their fears about US and Europe by selling EM, but that does not make the practice intelligent. In 2008/2009, Europe and the US both went into simultaneous deep recessions and the entire Western banking system collapsed. EM fundamentals were largely unscathed. EM asset prices tend to over-react to events, even events, which have no bearing on the ability and willingness to pay within EM itself. Our advice: use silly pullbacks like that to build positions.

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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	0.92%	10.00%	10.00%	-8.95%	11.47%	5.17%
MSCI EM Small Cap	1.23%	8.06%	8.06%	-12.41%	6.63%	2.40%
MSCI Frontier	1.44%	7.12%	7.12%	-14.22%	7.04%	1.00%
MSCI Asia	1.79%	11.49%	11.49%	-7.04%	12.51%	7.61%
Shanghai Composite	5.55%	24.48%	24.48%	-2.56%	3.37%	11.16%
Hong Kong Hang Seng	1.32%	13.76%	13.76%	-3.53%	13.47%	8.18%
MSCI EMEA	-1.11%	5.81%	5.81%	-12.48%	6.60%	0.18%
MSCI Latam	-3.76%	6.55%	6.55%	-7.42%	11.14%	1.09%
GBI EM GD	-0.62%	3.66%	3.66%	-6.22%	4.11%	-0.01%
ELMI+	-0.26%	1.95%	1.95%	-3.50%	2.96%	-0.28%
EM FX Spot	-1.34%	0.84%	0.84%	-9.91%	-2.24%	-6.55%
EMBI GD	1.09%	6.60%	6.60%	4.51%	5.76%	5.67%
EMBI GD IG	1.85%	5.38%	5.38%	5.83%	4.52%	4.94%
EMBI GD HY	0.38%	7.89%	7.89%	3.13%	7.15%	6.27%
CEMBI BD	1.18%	5.05%	5.05%	4.55%	5.80%	4.99%
CEMBI BD IG	1.39%	4.38%	4.38%	5.27%	4.35%	4.37%
CEMBI BD Non-IG	0.89%	5.93%	5.93%	3.69%	8.16%	5.81%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	0.70%	12.26%	12.26%	8.07%	13.23%	10.69%
1-3yr UST	0.49%	0.86%	0.86%	2.70%	1.04%	0.97%
3-5yr UST	1.08%	1.42%	1.42%	4.02%	1.19%	1.72%
7-10yr UST	2.14%	2.49%	2.49%	6.15%	1.24%	2.91%
10yr+ UST	3.96%	3.38%	3.38%	6.76%	1.67%	5.27%
10yr+ Germany	3.61%	5.03%	5.03%	10.68%	3.03%	7.57%
10yr+ Japan	1.18%	2.86%	2.86%	3.95%	0.62%	4.62%
US HY	0.59%	6.89%	6.89%	5.56%	8.29%	4.67%
European HY	0.76%	5.31%	5.31%	1.63%	4.90%	4.23%
Barclays Ag	1.39%	2.34%	2.34%	-0.13%	1.81%	1.12%
VIX Index*	14.88%	-33.20%	-33.20%	-31.72%	15.20%	21.11%
DXY Index*	0.33%	0.32%	0.32%	7.87%	0.35%	20.68%
CRY Index*	0.79%	8.47%	8.47%	-6.15%	6.97%	-38.77%
EURUSD	-0.48%	-1.32%	-1.32%	-9.06%	1.33%	-18.15%
USDJPY	-1.19%	0.35%	0.35%	4.42%	-2.66%	7.64%
Brent	1.03%	24.00%	24.00%	-5.31%	64.96%	-37.65%
Gold spot	0.36%	2.77%	2.77%	-2.62%	8.30%	0.52%

*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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