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WEEKLY INVESTOR RESEARCH

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Old wives' tales

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The strong performance of bonds in Emerging Markets during the now completed Fed hiking cycle and amidst elevated levels of global risk aversion shows that something else entirely is driving performance in EM. The alleged vulnerability of EM fixed income markets to Fed hikes and global risk aversion is an old wives' tale. The Weekly also discusses index inclusion for Chinese government bonds, reforms in South Africa and a local election in Turkey.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	3.84%
MSCI EM Small Cap	10.3	–	2.18%
MSCI Frontier	9.3	–	0.86%
MSCI Asia	12.2	–	4.06%
Shanghai Composite	10.4	–	4.49%
Hong Kong Hang Seng	8.0	–	4.98%
MSCI EMEA	9.5	–	3.16%
MSCI Latam	11.9	–	4.55%
GBI-EM-GD	5.69%	–	2.19%
ELMI+	5.20%	–	1.22%
EM FX spot	–	–	1.38%
EMBI GD	5.56%	347 bps	1.55%
EMBI GD IG	3.89%	176 bps	1.20%
EMBI GD HY	7.52%	547 bps	1.90%
CEMBI BD	5.30%	333 bps	0.73%
CEMBI BD IG	4.00%	204 bps	0.68%
CEMBI BD Non-IG	7.16%	518 bps	0.81%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	2.22%
1-3yr UST	1.75%	–	0.16%
3-5yr UST	1.77%	–	0.21%
7-10yr UST	2.04%	–	0.23%
10yr+ UST	2.57%	–	0.09%
10yr+ Germany	-0.30%	–	0.40%
10yr+ Japan	-0.16%	–	0.88%
US HY	5.75%	361 bps	1.01%
European HY	3.89%	418 bps	1.23%
Barclays Ag	1.51%	-53 bps	0.87%
VIX Index*	15.40	–	0.12%
DXY Index*	96.12	–	-1.44%
EURUSD	1.1387	–	1.51%
USDJPY	107.39	–	-1.06%
CRY Index*	178.52	–	3.71%
Brent	65.4	–	7.35%
Gold spot	1406	–	4.93%

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

Emerging Markets

- **Old wives' tales:** Based on closing prices on Friday, 22 June, Emerging Markets (EM) local currency government bonds were up 8.0% year to date in Dollar terms, while longer-duration sovereign Dollar-denominated bonds were up 11.2% year to date. It is tempting to attribute these stellar performances to the recent dovish tilt by the Fed and the ECB. After all, many investors still believe that EM will underperform in a rising rate environment. Yet, closer inspection reveals the plain nonsensicality of attributing EM's strong performance to easy monetary policies in the US and Europe.

First, the strong performance of EM bonds this year was well underway before the Fed and the ECB got dovish last week. Rather, EM returns this year owe more to the pullback in EM markets in 2018 than anything the central banks have done. As we have noted on countless previous occasions, our view is that you should not sell EM bonds during bouts of risk aversion, especially when risk aversion emanates from outside of the asset class. In 2018, this was clearly the case. EM pulled back due to three policy mistakes in the US (badly timed fiscal stimulus, misplaced Fed hawkishness and US President Donald Trump's trade war with China). The secret to making money is to buy EM when it is cheap. EM got cheap last year due to US policy mistakes; this year those who bought into the weakness are reaping the reward. This story is as old as the hills.

Second, contrary to the perceptions of many investors, EM bonds generally do extremely well during Fed hiking cycles. Why? Because EM markets tend to price in far too many hikes before they even begin, so when the actual hiking cycle kicks off EM bonds are well placed to rally. This hiking cycle was no different. In Q1 2016, EM bonds priced in a terminal Fed funds rate of 5.65%! Was this insane? Yes, it was. Did investors spot the insanity? Only the happy few did. Since the first Fed hike in December 2015, that is, through the entire Fed hiking cycle, EM local currency government bonds have returned a stellar 26.8% in Dollar terms, or 8.9% on average per year, while sovereign Dollar-denominated bonds have returned 27.4% or 9.1% on average per year. Since the start of the Fed rate hiking cycle, the US 10-year Treasury yield is down circa 25bps from 2.30% to 2.05%, so performance has not come in the main from falling Treasury yields, but from the market dramatically over-pricing interest rate risk in EM bonds. The result? EM bonds have outperformed US government bonds by a factor of 3-4 times since the first Fed hike. Clearly, the notion that EM cannot perform in hiking cycles is an old wives' tale in our view.

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Emerging Markets

Here is another old wives' tale: EM cannot perform during periods of heightened global uncertainty. The last three and a half years have not only witnessed the entire Fed hiking cycle, it has been replete with many other events, which many investors would readily classify as negative for EM. It is hard to know where to begin, but here are just some of the more obvious so-called negatives:

- US abandoning free trade (NAFTA, TPP)
- US abandons global leadership (pulls out of Iran nuclear accord and global climate accord)
- Trump's trade war against China and repeated threats to place tariffs on Europe.
- Major US stock market volatility
- US sanctions on Russia and Turkey
- Brexit in the UK
- The decline of Angela Merkel, Europe's anchor of stability
- Yellow Vests in France
- Slower growth in China
- Slower global growth

The strong EM performance in this context clearly shows that negative developments need not be bad for EM performance. One obvious reason is that EM now gets 90% of its financing at home, so global developments, which influence investor sentiment, have much less effect than they had in the past. Besides, it is becoming increasingly ridiculous to argue that the risk-reward in EM is somehow inferior to that of developed markets, where the yields are incredibly low, growth is slowing and policies are deteriorating.

Instead of incessantly worrying about short-term risk factors and US monetary policies, which clearly do not matter much other than in the very short term, investors should focus their attention on the more relevant question: What is that powerful energy, which has been propelling EM markets forward for the past few years in spite of Fed hikes and mounting global risks? Only by answering this question is it possible to form realistic predictions about future returns in EM bond markets. Hint: you can find the answer here: *'The 2019-2023 EM fixed income outlook'*, The Emerging View, 6 December 2018.

- **China:** The latest update from JP Morgan's Index Governance Consultation shows that Chinese government bonds now meet all twelve of the Bank's index accessibility criteria. This implies that inclusion of Chinese government bonds in the GBI EM GD is now, to quote JP Morgan, "getting close to the finish line". This probably means formal index inclusion starting in Q4 2019. Under JP Morgan's current projections, on-the-run Chinese bonds will have a weight of 7.2% in the GBI EM GD, which will be achieved over a period of eight months. The inclusion of China will take the total number of countries in the GBI EM GD to 20. Brazil and Mexico will retain a 10% index weight, but all other countries will see their index weights decline in order to make room for Chinese bonds. Over time, we would expect China's weight to hit 10%, the index limit. Meanwhile, cross-border capital inflows increased to USD 13.3bn in May from USD 2.8bn in April. Chinese bonds are ultimately going to be competing with US, European and Japanese bonds for share in global bond portfolios more so than with EM bonds. This is because Chinese markets are destined to replace US markets as the global benchmarks due to their size and liquidity, in our view. We note in passing that the London-Shanghai Stock Connect has now been launched. This means that global investors can access Chinese stocks trading in Shanghai, while investors in China can access stocks listed on the London Stock Exchange. For a detailed analysis of how Chinese bonds will affect EM bond portfolios, please see: *'How Chinese bonds can enhance your portfolio'*, The Emerging View, 16 March 2018.

- **South Africa:** President Ramaphosa emphasised reforms in his state of the nation address last week. He dismissed changes to the mandate of the South African Reserve Bank and said that the government will increase investments and reduce red tape. The government also announced that it will front-load support for ESKOM, the loss-making energy utility pending more detailed information on reforms for the state-owned enterprise. The state of the nation address does not reveal much in the way of detail, but the direction of travel is now clear: South Africa is moving firmly towards reforms. In other news, core inflation was unchanged at 4.1% yoy in May. This was a bit below expectations (4.2% yoy).

- **Turkey:** President Erdogan's bet that a re-run of the mayoral election in Istanbul would favour his candidate but backfired spectacularly at the weekend, when opposition candidate Ekrem Imamoglu increased his margin of victory to an unassailable 54% versus 45% for Erdogan's man, former Prime Minister Binali Yildirim. Voters turned against Erdogan's increasingly divisive politics and his failing economic policies. Greater Istanbul makes up one fifth of the entire Turkish electorate, so the loss is significant. Moreover, it will also weaken Erdogan's party's ability to raise funding, so it could yet turn out to be far more serious for Erdogan than a mere a blip in an otherwise stellar political career. The market will now focus on how, if at all, Erdogan's policies will change in response to this political bloody nose, or whether, instead, Erdogan will call a general election before his support withers further. The other focus will be on the S-400 missile issue: the US is threatening sanctions if Turkey, a NATO member, buys a missile system from Russia. Trump and Erdogan are due to meet at the G20 this week.

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Emerging Markets

Snippets:

- Argentina: Real GDP contracted at a qoq seasonally adjusted annualised rate of 0.9% in Q1 2019. We expect positive growth in Q2, which is the main harvest season in Argentina.
- Brazil: The central bank left the policy rate unchanged at 6.5%.
- Colombia: The central bank left the policy rate unchanged at 4.25% and indicated that it has no intention to cut rates.
- Ecuador: Fiscal performance in Q1 2019 disappointed, according to new numbers from the government. This suggest that the fiscal effort in the remaining three quarters of the year will be stepped up, in our view.
- Indonesia: Bank Indonesia left the policy rate unchanged at 6.0% and cut the reserve requirement ration by 50bps. The trade balance swung into surplus in May to the tune of USD 0.2bn, which was far stronger than expected (the Bloomberg consensus expectation was for a deficit of USD 1.4bn).
- Mexico: The Senate approved NAFTA II by a large majority. The big question is now whether the US can approve the new trade agreement, having unilaterally abandoned the old one. Developed economies are generally far less able and willing to undertake structural reforms than Emerging economies.
- Pakistan: Reza Baqir, central bank governor, announced last week that talks with the IMF have been concluded. This should pave the way for disbursement of IMF support once the IMF board has approved the arrangement.
- Peru: Real GDP growth slowed to 3.1% yoy in April from 3.8% yoy in March, based on the 12-month moving average.
- Philippines: The central bank left the policy rate unchanged at 4.5%. The market had expected a cut.
- Russia: Weekly inflation was zero for the third week in a row.
- Singapore: Non-oil domestic exports declined by less than expected in May (-15.9% yoy versus -16.5% yoy expected). Like exports in other Asian economies, Singapore exports are being adversely impacted by Trump's trade war. Core inflation was unchanged in May at 1.3% yoy.
- South Korea: The decline in South Korean exports appears to be abating. Exports in the first twenty days of June were 10% lower yoy versus -12.4% yoy in May. The main improvement was in semiconductors (-24.3% yoy versus -33% yoy in May).
- Taiwan: The central bank left the policy rate unchanged at 1.375%.
- Thailand: Lower exports to China and the US resulted in a trade surplus of only USD 182m versus a forecast of USD 580m and a deficit of USD 1.46bn in April.

Global backdrop

The Fed hiking cycle may already be over. Certainly, markets are pricing in lower rates for the second half of the year and the Fed itself indicated in so many words last week that it could start to cut the Fed funds rate as early as next month. The flash June PMI reading was 50.1, down from 50.5 in May and now very close to contraction territory. Services PMI also declined. Investors should now remind themselves why they bought so many US equities and why they went so long Dollars over the last decade. We suspect that most of these investments were predicated on a bullish view of the US economy and a hawkish view of the Fed. If growth is now slowing and the Fed is cutting, much of this money will be in the wrong place and should seek out better risk-reward elsewhere.

ECB's Mario Draghi was also dovish in response to sharply falling inflation expectations in Europe more so than weaker economic activity (Euro area flash PMIs actually rose to 52.1 in June from 51.8 in May). Unlike the US, where the most popular trade in the past decade has been stocks, in Europe the big money has gone into bonds. The money sitting here seems less risky than they money sitting in US stocks if Western economies are due to slow.

What does all this dovishness mean for EM? Not much. EM valuations are attractive in both absolute terms and relative to valuations in developed economies, so EM bonds can deliver attractive returns from yield alone.

Trump is imposing yet more sanctions on Iran. Tensions with Iran began to increase after the US accused Iran of breaking the terms of a nuclear accord. There is zero evidence that Iran broke the terms of the accord, so this amounts to pure provocation and markets are right to wonder why the US would do such a thing. As for the effectiveness of the sanctions, this will clearly be a case of diminishing marginal effectiveness, since 80% of the Iranian economy is already under US sanctions. The fact that oil prices reacted positively to the news suggests that markets are more worried about the wider regional implications, since US and Iran are locked into several proxy conflicts in the region, notably in Yemen.

Finally, we note that Trump now intends to have an extended meeting with Chinese President Xi Jinping at the upcoming G20 meeting in Japan. For our view on Trump's trade war against China, see: *'Trade war infinity or end-game skirmish?'*, Weekly Investor Research, 28 May 2019.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	5.86%	0.29%	10.26%	0.44%	11.52%	2.95%
MSCI EM Small Cap	3.44%	-1.41%	6.25%	-7.00%	5.79%	0.85%
MSCI Frontier	2.05%	4.28%	11.48%	1.15%	7.54%	-0.62%
MSCI Asia	5.82%	-1.34%	9.94%	-2.70%	12.01%	5.30%
Shanghai Composite	4.29%	-1.88%	21.61%	7.05%	3.82%	10.62%
Hong Kong Hang Seng	5.90%	-2.37%	9.73%	0.40%	12.40%	4.86%
MSCI EMEA	6.10%	7.58%	13.60%	10.78%	8.94%	-0.89%
MSCI Latam	7.47%	5.81%	14.20%	23.93%	13.47%	-0.35%
GBI EM GD	4.80%	4.93%	7.99%	8.68%	4.73%	-0.37%
ELMI+	2.19%	1.59%	3.09%	3.24%	3.01%	-0.55%
EM FX Spot	2.37%	1.18%	1.44%	-1.26%	-2.03%	-6.74%
EMBI GD	3.29%	3.96%	11.19%	12.44%	6.03%	5.39%
EMBI GD IG	2.60%	4.54%	10.78%	12.70%	5.30%	5.01%
EMBI GD HY	3.98%	3.42%	11.70%	12.25%	6.88%	5.46%
CEMBI BD	1.82%	3.12%	8.43%	9.86%	5.66%	4.84%
CEMBI BD IG	1.58%	3.39%	8.32%	10.30%	4.73%	4.43%
CEMBI BD Non-IG	2.16%	2.75%	8.56%	9.29%	7.20%	5.32%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	7.34%	4.59%	18.87%	9.48%	14.48%	10.73%
1-3yr UST	0.42%	1.37%	2.37%	4.02%	1.36%	1.22%
3-5yr UST	0.62%	2.20%	3.82%	6.39%	1.55%	2.05%
7-10yr UST	0.80%	3.37%	6.33%	9.92%	1.67%	3.30%
10yr+ UST	0.15%	4.79%	9.68%	12.15%	2.16%	5.75%
10yr+ Germany	2.16%	4.42%	10.08%	14.17%	3.17%	7.75%
10yr+ Japan	1.80%	2.65%	6.03%	6.60%	0.90%	5.18%
US HY	2.30%	2.52%	9.97%	6.94%	7.55%	4.70%
European HY	2.08%	1.74%	7.47%	3.87%	4.78%	3.92%
Barclays Ag	1.74%	2.81%	5.07%	5.59%	1.66%	1.30%
VIX Index*	-17.69%	12.33%	-39.42%	11.84%	-40.22%	26.96%
DXY Index*	-1.67%	-1.19%	-0.05%	1.69%	0.71%	19.66%
CRY Index*	1.80%	-2.85%	5.13%	-9.63%	-5.39%	-42.78%
EURUSD	1.94%	1.52%	-0.72%	-2.71%	2.44%	-16.31%
USDJPY	-0.82%	-3.12%	-2.11%	-2.17%	5.08%	5.32%
Brent	1.44%	-4.34%	21.60%	-13.41%	35.14%	-42.84%
Gold spot	7.68%	8.78%	9.61%	11.07%	6.86%	6.62%

*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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