Finally

By Jan Dehn

The inclusion of Chinese bonds in the GBI EM GD is the single most important development since the inception of the index. We explain why. The price action in EM bonds so far this year has been stellar, especially taking into account the many non-EM risks. Hong Kong moves towards a solution to the political impasse over extradition. The economic team of Alberto Fernandez of Argentina goes on a charm offensive. Lebanon is downgraded, but the news is positive, not negative. Mugabe dies. Mexico presents the 2020 budget. Ukraine and Russia swap prisoners. South African GDP growth bounced strongly in Q2 2019. US payrolls disappoint and Democrats hint at impeachment proceedings. UK's Brexit mess continues. US-China trade tensions ease somewhat.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.6	–	2.44%
MSCI EM Small Cap	10.7	–	1.69%
MSCI Frontier	9.3	–	-0.50%
MSCI Asia	12.3	–	2.42%
Shanghai Composite	10.7	–	3.95%
Hong Kong Hang Seng	7.9	–	3.62%
MSCI EMEA	9.3	–	2.59%
MSCI Latam	12.1	–	3.08%
GBI-EM-GD	5.24%	–	1.55%
ELMI+	4.83%	–	1.25%
EM FX spot	–	–	1.34%
EMBI GD	5.06%	348 bps	0.78%
EMBI GD IG	3.36%	175 bps	0.01%
EMBI GD HY	7.32%	577 bps	1.68%
CEMBI BD	5.08%	357 bps	0.42%
CEMBI BD IG	3.57%	206 bps	0.06%
CEMBI BD Non-IG	7.28%	577 bps	0.93%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	1.91%
1-3yr UST	1.54%	–	0.01%
3-5yr UST	1.44%	–	0.01%
7-10yr UST	1.58%	–	-0.19%
10yr+ UST	2.05%	–	-0.62%
10yr+ Germany	-0.63%	–	-1.61%
10yr+ Japan	-0.26%	–	-0.95%
US HY	5.66%	385 bps	0.31%
European HY	3.77%	419 bps	0.07%
Barclays Ag	1.23%	-35 bps	-0.15%
VIX Index*	15.00	–	-2.88%
DXY Index*	98.42	–	-0.49%
EURUSD	1.1028	–	0.55%
USDJPY	106.93	–	0.66%
CRY Index*	172.62	–	0.55%
Brent	62.2	–	6.00%
Gold spot	1509	–	-1.36%

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

Emerging Markets

- **China:** Finally. JP Morgan announced last week that Chinese government bonds will be included in the main EM local currency government bond index, the GBI EM GD, starting in February 2020. The share of Chinese bonds in the index will gradually be ramped up to 10% over ten months. 10% is the cap on exposures to individual countries in the index. As of December 2018, China's bond markets constitute 51% of all outstanding EM bonds. Other index providers, notably Bloomberg, are also including Chinese government bonds in their benchmark indices and we expect FTSE to add China in its World Government Bond Index before too long. Together, these index inclusions should draw some USD 500bn into the Chinese bond market. Over time, however, this number will rise dramatically as China's economy - and hence its markets – vastly outgrow US over the next two decades. The inclusion of Chinese bonds into the GBI EM GD is the single most important development since the inception of the index.

Unlike all other bond markets currently represented in the index, China's markets behave like a de facto 'safe haven' destination. The fact that EM investors can now seek shelter in bearish moments within the index instead of redeeming outright is likely over time to reduce the volatility of EM currencies versus the Dollar over time, though it may also increase the volatility of EM currencies versus Renminbi. For a far more detailed analysis of the significance of the inclusion of Chinese bonds in the GBI EM GD please see *'How Chinese bonds can enhance your portfolio'*, The Emerging View, March 2018. In other news, the People's Bank of China implemented an across the board reserve ratio cut of 50bps plus additional targeted reserve ratio cuts in response to the recently imposed US trade tariffs, which will reduce demand for Chinese goods as American consumers are taxed more heavily. Index inclusion, slower growth due to reforms and trade tensions and the continuing easing of monetary policy support the case for Chinese bonds, in our view. Finally, we note that Caixin services PMI beat expectations at 52.1 in August (51.7 expected).

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Emerging Markets

- **Price action in EM bonds year to date:** In many ways, this has so far been a remarkable year. US re-engaged heavily in its trade war with China, the US yield curve inverted in a clear sign of approaching recession, Germany is heading into a downturn, Italy has been a mess, UK is imploding and global growth has slowed significantly. Even EM has thrown up a few curve balls, such as Hong Kong and Argentina. Yet, despite these developments, EM bonds have so far continued to perform extremely well. As at the close of business on Friday, EM external sovereign debt, EM local currency government bonds and EM corporate bonds were up 14.4%, 8.5% and 10.4% YTD in Dollar terms, respectively. This strong performance makes one wonder how EM will perform when risk appetite active turns positive.

- **Hong Kong:** In a remarkable, albeit somewhat belated outbreak of pragmatism, Hong Kong Chief Executive Carrie Lam agreed to withdraw legislation allowing extradition to the Chinese mainland. This meets the main demand, though not all the demands, of protesters, whose actions have paralysed much of territory over the last few months. Chinese Premier Li Keqiang supported Lam's decision. Under the handover agreement from Britain to China, there are still a couple of decades until Hong Kong will be fully integrated into China. Hence, there is no need to force an issue, which will take care of itself quite automatically with the passage of time. In an almost classic illustration of how ratings agencies 'close the stable doors after the horses have bolted, Fitch on Friday downgraded Hong Kong's sovereign credit rating from AA+ to AA with negative outlook. Sigh.

- **Argentina:** Members of the economic team of the opposition leader Alberto Fernandez have been meeting investors to reassure them that their policies, if he is elected into office on 27 October, he will be market friendly. This is very positive and consistent with the views, which we have expressed in recent publications.[1] We expect considerable volatility until the political outlook becomes clearer and a future administration has been installed and stated its policy objectives. However, investors should look through the current noise. The intriguing possibility, in our view, is that sensible policies by a future Fernandez Administration could entirely reverse the recent decline in bond prices and usher in a very benign economic upturn in Argentina within a year or so from Alberto Fernandez taking office. Such an upturn would in turn make Alberto Fernandez a shoe-in for re-election in 2023. Industrial production surprised to the upside in July (+3.0% mom). Construction activity was also better than expected.

- **Lebanon:** Fitch, the ratings agency, downgraded Lebanon's sovereign credit rating from B- to CCC on 23 August. S&P, another ratings agency, kept its rating unchanged at B- for another six months of so-called 'grace period'. Sovereign bond price declined somewhat in response, but in our view the news from Lebanon has actually been modestly positive. Specifically, in July, the Parliament passed the 2019 budget, which included important steps towards fiscal consolidation, such as deep spending cuts, which should put the deficit on track to narrow from 11.0% to 7.6% of GDP. The government has also declared a 'state of economic emergency' in order to implement additional fiscal measures. Granted, budget cuts are often difficult to implement, but the recent announcements by the government appear to signal a willingness to act. The government passed an energy sector reform last year, which we expect will unlock billions of Dollars of financial assistance from the Paris Club lenders. As for Lebanon's ability to service debt, the country currently has FX reserves of USD 31.1bn. The next payment obligation is USD 1.5bn in November followed by USD 1.2bn in March next year. There is therefore more than sufficient cover for the pending obligations. Having said that, Lebanon's external position remains fragile with a large current account deficit and a heavy reliance on non-residents deposits in the banking sector, although many of these deposits belong to the Lebanese diaspora, which has remained willing to hold Lebanese bonds in the past. The largest holders of Lebanese sovereign debt are domestic banks (they hold roughly half of the country's USD 32.3bn of FX-denominated debt). We also expect Lebanon to be able to access funding from GCC allies.

- **Zimbabwe:** Robert Mugabe is dead. Mugabe exemplified many first generation post-Colonial presidents in Africa. His view of politics was forged in a no holds barred zero sum conflict with the Colonial power and he took this politics into a post-Colonial world, where it was no longer appropriate. Mugabe will go down in history as a despot, who destroyed the economy of the country he ruled. Zimbabweans can now hope that their country will embark on a path similar to that of many other African countries, which became far more democratically accountable, following the deaths of their first post-Colonial presidents.

- **Mexico:** The government has presented the 2020 budget, which envisages a smaller primary surplus of 0.7% of GDP based on an assumption of 2.0% real GDP growth. This implies a very moderate government debt burden of around 46% of GDP. In other news, investment spending contracted less than expected in June (-8.8% YOY versus -9.2% YOY expected). Investment spending has been weak due to fiscal restraint, the threat of US trade tariffs and uncertainty about prospects for passage of NAFTA II in the US. Consumer and business confidence both improved in August. Sentiment improved on reports that the Mexican government is considering new joint ventures between private oil companies and state-owned oil giant PEMEX.

[1] See: *'Argentina Q&A',* The Emerging View, 23 August 2019 and *'The path to averting a default in Argentina',* Market Commentary, 14 August 2019.

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Emerging Markets

- **Ukraine:** Tensions with Russia have eased as Ukraine and Russia completed a prisoner swap over the weekend. Fitch upgraded Ukraine's sovereign credit rating to B from B- with positive outlook. The National Bank of Ukraine cut the policy rate by 50bps to 16.5%, with more cuts to come if the pace of reforms continues.

- **South Africa:** Real GDP growth surprised sharply to the upside in Q2 2019 by bouncing to 3.1% qoq annualised from -3.1% qoq annualised in Q1 2019. The growth rate was much stronger than expected (2.5% qoq annualised). Mining was strong on the supply-side, while consumption and gross fixed investment buoyed the economy on the demand side. Meanwhile, the current account deficit widened sharply to 4.0% of GDP in Q2 2019 from 2.9% of GDP in Q1 2019 due to a pick up in the volume of imports, reflecting, perhaps, recent positive surprises in terms of domestic economic activity.

Snippets:

- **Brazil:** Monthly IPCA consumer prices inflation slowed from 0.19% in July to 0.11% in August. This means that inflation on a yoy basis is running at a 3.43% rate compared to 4.19% a year ago. Industrial production declined 0.3% in the month of July. The trade surplus on a 12-month basis reached USD 53.1bn in August, up from USD 52.6bn in July.
- **Chile:** Economic activity was 3.2% higher in July on a yoy basis. This was marginally better than the government's expectation (3.0% yoy). The central bank cut the policy rate by 50bps to 2.0% with an easing bias. Commerce activity was strong at 6.5% yoy in August.
- **Colombia:** Monthly CPI inflation moderated to 0.09% in August versus 0.16% mom expected. This ensured inflation of 3.75% on a yoy basis, which was marginally lower than 3.79% yoy recorded in July. The current account deficit was 4.4% of GDP in H1 2029, in line with expectations for the full year.
- **Czech Republic:** Industrial production was strong at 5.6% yoy in June, but probably flattered by a larger number of working days in the month.
- **Hungary:** Hungarian industrial production surged higher at a yoy rate of 8.7% in July, easing beating expectations of 5.9% yoy. Retail sales picked up in July to a yoy pace of 6.4% from 5.2% yoy in June.
- **Malaysia:** The trade surplus increased to USD 3.5bn in July from USD 2.5bn in June.
- **Peru:** At 0.06% mom, CPI inflation was lower than expected in August. The yoy rate of inflation is 2.04%.
- **Philippines:** CPI inflation was 1.7% yoy in August, which was slightly lower than expected (1.8% yoy).
- **Romania:** Retail sales hit a four-month high by rising at 7.9% yoy rate in July, up from 5.9% yoy in June.
- **Russia:** The Central Bank of Russia cut the policy rate by 25bps to 7.00% in line with expectations, but changed forward guidance to neutral from dovish. Consumer prices inflation declined to 4.3% yoy in August from 4.6% yoy in July.
- **Saudi Arabia:** PMI nudged 0.4 points higher to 57.
- **Serbia:** Moody's upgraded Serbia's sovereign credit outlook to positive from neutral with Ba3 rating.
- **Singapore:** PMI improved marginally by 0.1 point in August to 49.9.
- **Taiwan:** August CPI inflation was unchanged from July at 0.4% yoy.
- **Turkey:** President Erdogan is once again issuing clear instructions to the central bank to cut interest rates. Erdogan has purged the central bank of credible officials, so the institution is likely to follow his instructions carefully. As far as we know, Erdogan has never issued an instruction to the central bank to raise rates. CPI inflation is running at a yoy rate of 15% following a 0.9% mom inflation print in August.

Global backdrop

In the US, the gradual weakening of the economic outlook continued with disappointing payroll data on Friday. The economy only created 130K new jobs in August, which was nearly 20% below expectations (160K). There were also downwards revisions and the number was flattered by hiring for the Census, which is a one-off. The emerging softness in the US labour market bears close monitoring. Misguided US policies on trade have already had a chilling effect on business investment at a time when corporate leverage has hit a seventeen year high. ISM entered contraction territory in August, following a similar decline for the PMI last week. Once the softness in industry begins to impact the labour market, consumption will be next to weaken, in our view. On the political front, investigators in the House of Representatives indicate that they have found possible failures in the money laundering controls in Deutsche Bank's dealing with Russian oligarchs.

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Global backdrop

This news comes as the Democrat-controlled House of Representative takes steps to build a case for impeachment of President Donald Trump over alleged money laundering. It is reported that Trump has been banking with Deutsche Bank for decades. Democrats allege that dirty money from Ukraine was funnelled via Russian banks and Deutsche Bank into Trump real estate, possibly to finance Trump's election campaign. Money laundering, they allege, earned the banking intermediaries hefty fees. It remains to be seen if there is any evidence to substantiate these allegations.

In the UK, one does get the impression, at the present time, that rarely in the field of human conflict has so much damage been wrought to so many by so few. The strategy of Prime Minister Boris Johnson to bulldoze his way to a no deal Brexit on 31 October by suspending Parliament has run into hefty headwinds. For one, Parliament did not take the threat of suspension kindly and struck back by passing a law, which forces Johnson to ask the European Union for yet another extension to the Brexit deadline unless he can come up with a deal. A deal seems unlikely, based on news reports that the government is spending "80-90%" of its time preparing for a no deal Brexit. Besides, Johnson says he will rather be "dead in a ditch" than take the begging bowl to Brussels. France has indicated its unwillingness to grant UK a further Brexit extension without a deal. Meanwhile, Johnson's domestic political situation is becoming more challenging by the day. Last week his brother resigned and the Conservatives lost their majority in the House of Commons. Then he forced 21 senior Conservatives out of the party as punishment for not supporting his polices. At the weekend, Amber Rudd, another senior minister, left. The coming days will be interesting: will Johnson resign? Will Britain have a new election? A re-run of the referendum? Or will Johnson break British Law in a bid to force through a no-deal Brexit? Clearly, the political outlook is enormously risky right now and is already impacting the UK economy negatively. The silver-lining from an EM perspective is that Britain is a small and rather insignificant country – its markets no longer can be compared to the global benchmarks – wherefore her self-inflicted malaise is more of a source of amusement than concern, other than, perhaps, pity.

Although there has been no breakthrough, trade tensions between the US and China appear to have eased somewhat. China offered to buy some agricultural goods from the US, where farmers are smarting from Chinese import restrictions. The trade war has taken a toll on the volume of Chinese exports to the US as well, as the volume of US imports to China decreased. Chinese exports declined at a rate of 1.0% yoy in August, which were well below expectations (+2.2% yoy), although Chinese FX reserves increased to USD 3.11trn in August from USD 3.10trn in July. The main victims of the trade war are American consumers, however, whose purchasing power is being eroded by higher trade taxes. Trump's trade war illustrates the foresight exercise by China's leaders in shifting the main engine of growth in China from exports to domestic demand. Trade talks between Chinese and US officials may take place in the coming weeks.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	2.44%	-3.66%	6.69%	1.90%	5.80%	1.08%
MSCI EM Small Cap	1.69%	-4.72%	1.74%	-5.76%	1.21%	-1.01%
MSCI Frontier	-0.50%	0.39%	12.24%	7.84%	8.13%	-0.98%
MSCI Asia	2.42%	-3.72%	6.69%	-0.48%	6.36%	3.27%
Shanghai Composite	3.95%	1.76%	23.09%	14.22%	1.30%	7.46%
Hong Kong Hang Seng	3.62%	-3.10%	6.66%	2.20%	5.62%	2.10%
MSCI EMEA	2.59%	-5.38%	7.29%	10.76%	4.23%	-2.16%
MSCI Latam	3.08%	-5.16%	7.01%	15.08%	5.79%	-3.13%
GBI EM GD	1.55%	-0.21%	8.49%	15.59%	3.24%	-0.35%
ELMI+	1.25%	-1.98%	1.52%	4.67%	1.77%	-0.75%
EM FX Spot	1.34%	-2.95%	-1.28%	0.74%	-3.44%	-6.96%
EMBI GD	0.78%	2.76%	14.39%	14.94%	5.09%	5.62%
EMBI GD IG	0.01%	5.08%	16.62%	16.57%	5.45%	5.56%
EMBI GD HY	1.68%	0.30%	12.09%	13.24%	4.72%	5.48%
CEMBI BD	0.42%	1.44%	10.40%	11.55%	4.99%	4.97%
CEMBI BD IG	0.06%	2.90%	11.81%	12.30%	4.72%	4.75%
CEMBI BD Non-IG	0.93%	-0.55%	8.45%	10.36%	5.53%	5.23%

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Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	1.83%	1.66%	20.50%	5.61%	13.10%	10.44%
1-3yr UST	-0.03%	0.67%	3.16%	4.37%	1.55%	1.34%
3-5yr UST	-0.08%	1.43%	5.58%	7.56%	1.94%	2.33%
7-10yr UST	-0.29%	3.57%	10.75%	13.51%	2.56%	3.84%
10yr+ UST	-0.68%	9.93%	22.00%	24.18%	4.21%	7.20%
10yr+ Germany	-1.61%	6.25%	17.60%	20.22%	4.39%	7.72%
10yr+ Japan	-0.95%	2.41%	7.97%	10.17%	2.60%	5.26%
US HY	0.27%	1.24%	11.30%	6.95%	6.19%	5.00%
European HY	0.07%	1.44%	9.13%	4.91%	4.04%	4.27%
Barclays Ag	-0.15%	1.60%	7.26%	7.71%	1.82%	1.80%
VIX Index*	-20.97%	-0.53%	-40.99%	0.81%	-14.29%	11.11%
DXY Index*	-0.50%	2.38%	2.34%	3.21%	3.24%	16.78%
CRY Index*	1.33%	-4.65%	1.66%	-9.32%	-5.43%	-39.60%
EURUSD	0.33%	-2.99%	-3.85%	-4.88%	-1.83%	-14.76%
USDJPY	0.61%	-0.89%	-2.53%	-3.78%	4.13%	0.69%
Brent	2.90%	-6.57%	15.58%	-19.07%	29.51%	-37.29%
Gold spot	-0.77%	7.04%	17.64%	26.16%	13.61%	20.16%

*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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