EM assets outperform as DM suffers from poor economic data

By Gustavo Medeiros

Ecuador slashed fuel subsidies. Peru suffers a constitutional crisis. Brazilian pension reform passes the first vote in the Senate. Indonesian President Jokowi pledges to work with unions on labour reforms. Ukraine propose a solution to the Donbass impasse. Turkey presents a new economic programme. Tunisia sees a rise in political uncertainty. Russia presents the 2020-2022 Budget. Mexico's president wants higher wages. India's current account deficit widens. South Korea's deflation is temporary. Chinese PMIs edge higher.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.4	–	-0.46%
MSCI EM Small Cap	10.5	–	-0.23%
MSCI Frontier	9.1	–	-1.04%
MSCI Asia	12.1	–	-0.36%
Shanghai Composite	10.3	–	-2.36%
Hong Kong Hang Seng	7.6	–	-0.63%
MSCI EMEA	8.9	–	-1.77%
MSCI Latam	12.3	–	0.23%
GBI-EM-GD	5.16%	–	1.21%
ELMI+	5.51%	–	0.45%
EM FX spot	–	–	0.70%
EMBI GD	5.12%	358 bps	0.36%
EMBI GD IG	3.44%	187 bps	0.71%
EMBI GD HY	7.40%	589 bps	-0.05%
CEMBI BD	5.05%	360 bps	0.41%
CEMBI BD IG	3.59%	214 bps	0.45%
CEMBI BD Non-IG	7.16%	571 bps	0.34%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	-0.30%
1-3yr UST	1.40%	–	0.44%
3-5yr UST	1.33%	–	0.87%
7-10yr UST	1.52%	–	1.37%
10yr+ UST	2.01%	–	2.16%
10yr+ Germany	-0.59%	–	-0.09%
10yr+ Japan	-0.22%	–	-0.36%
US HY	5.90%	419 bps	-0.49%
European HY	3.94%	446 bps	-0.69%
Barclays Ag	1.23%	-29 bps	0.65%
VIX Index*	17.04	–	-0.18%
DXY Index*	98.87	–	-0.51%
EURUSD	1.0978	–	0.72%
USDJPY	106.90	–	-1.09%
CRY Index*	173.49	–	-2.22%
Brent	58.3	–	-4.03%
Gold spot	1506	–	2.25%

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

Emerging Markets

- **Ecuador:** President Lenin Moreno eliminated fuel subsidies in a policy change, which could save USD 1.4bn per year (1.3% GDP). The measure brings Ecuador in compliance with a key IMF condition and removes a large distortion from the economy, including the prolific fuel smuggling to Colombia and Peru. Bus and truck drivers blocked streets in protest, but Moreno stuck to his decision and over the weekend and the strikers backed down. Although the military supports Moreno, he still needs to win over indigenous groups. To compensate for lower subsidies, the government will increase direct social transfers to 300,000 families by USD 15 per month, in a bid to reduce income inequality. Other measures designed to increase revenues and boost private sector competitiveness have also been submitted to parliament. In other news, Ecuador will be leaving OPEC by 1 January 2020 in order to be able to increase oil exports.
- **Peru:** A constitutional crisis is engulfing Peru. President Vizcarra dissolved Congress and called for fresh legislative elections. Congress voted to suspend Vizcarra and appointed Vice President Araoz as caretaker President. However, Araoz quit shortly after her appointment. Nearly 90% of Peruvians disapprove of Congress, which is controlled by the party of Keiko Fujimori, who is currently serving a prison sentence for receiving undeclared donations from Odebrecht, a Brazilian construction company. The political situation remains fluid, but elections for Congress scheduled for January 2020 are expected to go ahead. In other news, inflation declined to 1.85% in September, below the central bank's 2% target
- **Brazil:** The public sector posted a BRL 13.4bn primary fiscal deficit in August, a marginal improvement compared to the deficit recorded a year ago. Net debt to GDP has increased from 54.1% in December 2018 to 54.8% as of August this year, with the government aiming to slow the accumulation of debt through a combination of privatisations, tax reform and higher growth. The Senate approved the pension reform after an amendment, which reduces the total fiscal savings by BRL 75bn to BRL 800bn. The Senate is expected to cast the second and final vote on the pension reform in the coming week or two.

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Emerging Markets

- **Indonesia:** President Joko Widodo (aka Jokowi) pledged to work with unions to implement an important reform of labour laws by the end of the year. The reform, which will apply to new workers entering the labour force, is expected to be positive for job creation by reducing red tape and other rigidities in the labour market. In other news, the government delayed a controversial criminal bill after protests in 10 cities last week. The yoy rate of CPI inflation increased to 3.4% in September versus 3.5% yoy expected.

- **Ukraine:** In a bid to resolve the ongoing conflict with Russia in Eastern Ukraine, the government of President Volodymyr Zelensky proposed to hold elections in Donetsk and Lugansk and offered to grant special autonomous status for the Donbass region – if the elections are shown to be free and fair. The main condition is the withdrawal of all militants from the region prior to the election. The agreement represents an important step towards a permanent cease-fire in the Donbass region, but will be met with strong opposition in some quarters in Ukraine.

- **Turkey:** Turkey Finance Minister Berat Albayrak unveiled an economic programme for 2020, aiming for 5% real GDP growth, 8.5% inflation, a current account deficit of 1.2% of GDP and a 2.9% of GDP fiscal deficit. In our view, the growth forecast is unrealistic, which brings into question the feasibility of the plan. The government reported a balanced budget in August, which was possible due to a large (TRY 78.3bn), but one-off transfer of profits from the Central Bank to the Treasury. Without the transfer, Turkey's fiscal deficit would have been close to 5% of GDP. A sign that investors are not convinced by the recent stabilisation in economic performance, foreign ownership of local bonds declined from 14% at the end of 2018 to 10.9% as of the end of August. In other news, September CPI inflation declined to 0.99% mom (9.3% yoy). The decline in inflation is mainly due to base effects impacting the prices for food and housing.

- **Tunisia:** Political uncertainty has increased after exit polls from Sunday's parliamentary election show no single party obtaining a majority – in what looks set to be a highly fragmented parliament. The two largest parties – Nahda and Qalb Tounes – have ruled out forming a coalition. A new election in 2020 is possible if no coalition manages to obtain the 109 seats required for a majority in parliament. Turnout in the election declined to 41% from 69% in the 2014 election.

- **Russia:** The draft government budget for the 2020-22 period has been submitted to the Duma. The budget envisages a fiscal surplus, even as expenditure is set to rise by 6% per year. The government will prioritise spending on education, healthcare and infrastructure investment. The breakeven oil price for the budget is below USD 45 per barrel and the government's National Welfare Fund is expected to continue to accumulate reserves. In our opinion, the growth in public spending should enable the economy to grow by about 2% per annum in the next few years. In other news, manufacturing PMI declined to 46.1 in September, the lowest level since 2009. On the other hand, services PMI picked up from 52.5 in August to 53.6 in September.

- **Morocco:** S&P ratings affirmed Morocco's long-term foreign currency debt rating at BBB- revising the outlook to Stable from Negative.

- **Mexico:** President Andres Manuel Lopez Obrador said he wishes to work with unions, businesses and government agencies to explore ways to raise salaries for Mexican workers. Private sector credit expanded at a 5.7% yoy real rate in August versus 4.7% yoy in July. Workers' remittances reached USD 3.4bn in August, which is a 17% yoy increase.

- **India:** The current account deficit increased to 2.0% of GDP in Q2 2019 from 0.7% of GDP in Q1 2019, in line with expectations. Capital inflows and foreign direct investment (FDI) picked up, reaching USD 18.9bn and USD 18.7bn in H2 1019, respectively. The overall balance of payment was in surplus to the tune of USD 14bn. India's manufacturing PMI survey was unchanged in September relative to August (51.4).

- **South Korea:** September yoy CPI inflation was -0.4% due to declining energy, agricultural and public sector prices (for example, school tuition fees declined at a yoy rate of 36%). The reversal of one-off public sector price cuts is likely to bring inflation back to positive levels before the end of the year. In other news, exports declined at a yoy rate of 11.7% in September. Trade tensions with Japan, indirect effects from the United States – China trade war and the ongoing decline in semiconductor prices saw semiconductor exports decline at a formidable yoy rate of 31.5%.

- **China:** China's official manufacturing PMI edged higher to 49.8 in September from 49.5 in August with new orders and production leading the increase. New data on the composition of FX reserves from the International Monetary Fund (IMF) showed that Russia, Brazil and Chile continued to add CNY to their reserves. The total share of US Dollar reserves declined by 0.3% in favour of EUR, JPY and CNY.

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Emerging Markets

Snippets:

- Argentina: Industrial production contracted at a yoy rate of 6.4% in August. The decline was led by lower production of vehicles, furniture, metal and machinery. Construction activity declined at a yoy rate of 5.9%.
- Chile: The economy improved across the board in August. Retail sales expanded at a yoy rate of 2.3%, industrial production was up at a yoy rate of 1.4% (mainly due to stronger mining activity) and yoy real GDP growth was 3.7%.
- Egypt: The country's FX reserves edged marginally higher to USD 45.1bn in September. The Speaker of the parliament announced that "political party and media reforms will be carried out" in an apparent response to anti-corruption protests over the last few weeks.
- Ghana: The PMI increased to 51.45 in September from 50.7 in August.
- Hong Kong: Retail sales in August declined at a yoy rate of 25% in volume terms and 23% yoy in price terms. The decline, which is the worst recorded since the Asian Financial crisis in 1998, was caused by the ongoing protests - disrupting tourism and consumption-related activities. Still, the Markit PMI inched up marginally to 41.5 in September.
- Hungary: Retail sales expanded at a yoy rate of 5.8% in September compared to 6.4% yoy in August.
- Ivory Coast: The government announced a tender of up to USD 1.5bn of bonds issued between 2024 and 2032 and new bonds with 15 years and 30 years maturities. The bonds are denominated in Euros, reinforcing a trend among EM countries to issue more in Euros. This trend is particularly pronounced in countries with strong monetary and economic ties with Europe.
- Kenya: Kenyan PMI improved from 52.9 in August to 54.1 in September. In other news, Q2 2019 real GDP expanded at a yoy rate of 5.6%, which was in line with expectations. CPI inflation in yoy terms was 3.9% in September compared to 5.0% yoy in August.
- Lebanon: Rating agency Moody's placed Lebanon's Caa1 rating under review for a downgrade on the back of alleged weak deposit growth and poor external liquidity.
- Malaysia: The August trade surplus was larger than expected as imports of capital and intermediate goods slowed down faster than anticipated.
- Nigeria: The PMI increased from 56.4 in August to 57.1 in September.
- Philippines: Consumer prices inflation on a yoy basis declined from 1.7% in August to 0.9% in September. Core CPI inflation was stable at 3.0% yoy. With lower food prices accounting for the bulk of the decline in inflation in September.
- Poland: CPI inflation declined from 2.9% on yoy basis in August to 2.6% yoy in September. The National Bank of Poland kept the main policy rate on hold at 1.5% and reiterated that the rate is likely to remain unchanged until mid-2020.
- Romania: Retail sales expanded at a yoy rate of 8% in August, which was stronger than July (7.5% yoy). The economy has been supported by large increases in wages and pensions throughout the course of 2019. The Central Bank left the policy interest rate unchanged at 2.5% in line with expectations.
- Saudi Arabia: Fitch downgraded Saudi Arabia's credit rating from A+ to A with a stable outlook, citing the rising geopolitical tensions in the Gulf. In other news, the yoy real GDP growth rate in Q2 2019 slowed to 0.5% due to softer growth in the oil sector. Construction activity and consumption surprised to the upside.
- South Africa: The ABSA manufacturing PMI declined to 41.6 in September, which is the lowest level since 2008. The composite PMI decline from 49.7 in August to 49.2 in September.
- Taiwan: Yoy CPI inflation was unchanged at 0.4% in September. The market had expected slightly higher inflation of 0.5% yoy.
- Thailand: The yoy rate of CPI inflation declined to 0.3% versus 0.4% expected. The decline was mainly due to lower energy prices.
- Venezuela: President Nicolas Maduro proposed debt restructuring talks, without putting forward any detailed proposal.
- Zambia: The PMI increased to 48.8 in September from 46.0 in August.

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Global backdrop

Stocks in developed economies declined in response to downside surprises in the economic data, re-igniting fears of an economic recession in the US. Bonds rallied on expectations of rate cuts and possible balance-sheet expansion at the upcoming FOMC meeting scheduled for 30 October 2019. Commodity prices declined 2.2% on the week with oil dropping 4.0%. The broad Dollar index (DXY) declined 0.5% and EM currencies appreciated by 70bps versus the Dollar. Last week's price action corroborates our view that a US recession would weaken an overvalued US Dollar, rendering the impact of a US recession on Emerging Market assets more benign than previous episodes.

The President of the New York Federal Reserve, John Williams characterised the recent data as strong "in the rear-view mirror", but "much more mixed" on a forward-looking basis. A lagging indicator, the non-farm payroll survey, was mixed – exhibiting lower than expected numbers of new jobs created however, unemployment rates hit a new low. Hourly wages in yoy terms declined from 3.2% in August to 2.9% in September.

ISM manufacturing slumped to 47.8 in September, which is a full 13 points lower than a year ago and the lowest reading since 2009. New export orders collapsed to 41. Export orders tend to be a leading indicator to the broader PMI, so the weakness in orders could suggest further weakness ahead. The ISM non-manufacturing dropped from 56.4 in August to 52.6 in September, the lowest level in three years. This is the first time that services appear to be afflicted by the weakness, which has been evident in manufacturing for some time.

The probability of a 25bps rate cut by the Federal Reserve on 30 October increased from 40% to 80%, which helped to push the 10-year US Treasury yield to 1.52%. A raft of Federal Reserve speakers said nothing to dissuade the bond market rally. The 30-year mortgage rate is now sitting at 3.7%, just 35bps above the historical lows recorded in 2012 and 2016.

The outlook for a truce in the US/China trade war remains uncertain. Top Chinese negotiator, Liu He is travelling to Washington this week, but has played down the scope of a potential deal. US President Donald Trump previously delayed a 5% tariff increase from 1 October to 15 October.

In other trade news, the World Trade Organization (WTO) ruled that the US can retaliate against the European Union (EU) for subsidising Airbus. Following the ruling, the US government announced USD 7.5bn in new levies on EU exports to the US, which will take effect from 18 October 2019. This includes tariffs of 10% on aircraft and 25% on selected other goods. Both the US and EU subsidise aircraft production, so the WTO is likely to rule in favour of EU complaints against US support for Boeing before too long. These potential tariffs would add to an already large tariff burden in the US. Ongoing trade wars, instigated by the US, constitute a supply shock – pushing up prices and lowering economic activity.

In Europe, economic data was also poor. Euro-area GDP growth slowed to 1.25% in Q2 2019. German car production was stable in September, however remains some 30% lower than in Q3 2018. Euro-area core CPI inflation was only 1.0% on a yoy basis in September.

In geopolitics, a Turkish military ground and air operation into Northern Syria look set to commence at any time after US President Donald Trump indicated that US forces would no longer protect Kurdish rebels (which were instrumental in the defeat of ISIS). Turkey says it wants to create a safe zone for refugees, although, it is also likely that Turkey wants to fight the Syrian Kurdish YPG militia – regarded as a terrorist organisation by the Turkish government.

Finally, in the UK the Brexit saga continues as Prime Minister Boris Johnson proposed a system that would allow Northern Ireland to remain within the EU regulatory regime. Johnson's proposal for the border arrangement has not yet been met with approval from EU officials. The government has acknowledged for the first time that it may be forced to seek a delay to the 31 October Brexit deadline unless a deal is reached.

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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	-0.41%	-0.41%	5.70%	1.53%	5.72%	2.80%
MSCI EM Small Cap	-0.08%	-0.08%	1.94%	-2.39%	1.15%	0.15%
MSCI Frontier	-0.77%	-0.77%	9.79%	5.97%	6.68%	-1.36%
MSCI Asia	-0.60%	-0.60%	5.24%	0.45%	5.90%	4.45%
Shanghai Composite	0.77%	-1.36%	19.32%	5.51%	1.18%	6.42%
Hong Kong Hang Seng	-0.52%	-0.52%	4.01%	-0.14%	5.33%	3.45%
MSCI EMEA	-0.77%	-0.77%	4.82%	5.15%	3.92%	-0.38%
MSCI Latam	0.96%	0.96%	7.56%	5.57%	6.85%	-0.04%
GBI EM GD	1.42%	1.42%	9.39%	13.76%	3.55%	0.91%
ELMI+	0.63%	0.63%	2.05%	4.46%	1.99%	-0.01%
EM FX Spot	0.99%	0.99%	-1.53%	-1.01%	-3.34%	-6.13%
EMBI GD	0.40%	0.40%	13.44%	13.14%	4.74%	5.80%
EMBI GD IG	0.74%	0.74%	16.07%	16.48%	5.47%	5.78%
EMBI GD HY	0.02%	0.02%	10.71%	9.70%	3.95%	5.64%
CEMBI BD	0.36%	0.36%	11.04%	11.36%	5.19%	5.23%
CEMBI BD IG	0.42%	0.42%	12.00%	12.87%	4.88%	4.89%
CEMBI BD Non-IG	0.27%	0.27%	9.68%	9.30%	5.76%	5.69%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-0.80%	-0.80%	19.59%	3.83%	13.38%	10.68%
1-3yr UST	0.42%	0.42%	3.50%	4.98%	1.70%	1.40%
3-5yr UST	0.86%	0.86%	6.09%	9.02%	2.21%	2.42%
7-10yr UST	1.36%	1.36%	11.34%	16.65%	3.05%	3.89%
10yr+ UST	2.09%	2.09%	22.27%	30.74%	5.35%	6.88%
10yr+ Germany	0.06%	0.06%	17.26%	22.25%	4.66%	7.40%
10yr+ Japan	0.03%	0.03%	6.22%	9.72%	1.73%	4.82%
US HY	-0.48%	-0.48%	10.87%	6.11%	5.81%	5.15%
European HY	-0.63%	-0.63%	8.02%	3.42%	3.92%	4.24%
Barclays Ag	0.76%	0.76%	7.13%	9.35%	2.11%	2.19%
VIX Index*	4.93%	4.93%	-32.97%	14.98%	26.41%	-0.93%
DXY Index*	-0.51%	-0.51%	2.80%	3.39%	2.31%	15.40%
CRY Index*	-0.26%	-0.26%	2.17%	-12.83%	-7.87%	-38.03%
EURUSD	0.72%	0.72%	-4.28%	-4.46%	-2.00%	-13.35%
USDJPY	-1.09%	-1.09%	-2.55%	-5.59%	3.82%	-1.05%
Brent	-4.03%	-4.03%	8.42%	-30.69%	12.32%	-36.67%
Gold spot	2.25%	2.25%	17.39%	26.71%	19.78%	24.53%

*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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