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The Brazilian Real depreciates for good reasons as Chile intervenes *con gusto*

By Gustavo Medeiros

The BRL devalues as companies repay USD loans to borrow in BRL instead. The Central Bank of Chile intervenes *con gusto*. China frontloads infrastructure bond issuance as Alibaba debuts in Hong Kong. The Polish Supreme Court rules against banks on CHF-denominated loans. Sri Lanka's new President slashes taxes, endangering fiscal stability. Colombia presents a new progressive tax bill cutting VAT for poorest 20%. Mexico unveils private sector infrastructure package to fight stagnation. Nigeria FX reserves decline further. Thailand manufacturing falters, but tourism rises.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.1	–	-0.80%
MSCI EM Small Cap	11.3	–	0.39%
MSCI Frontier	12.0	–	0.16%
MSCI Asia	12.8	–	-0.24%
Shanghai Composite	10.5	–	-0.46%
Hong Kong Hang Seng	7.7	–	-1.95%
MSCI EMEA	9.4	–	-2.49%
MSCI Latam	13.0	–	-1.99%
GBI-EM-GD	5.26%	–	-0.64%
ELMI+	3.23%	–	-0.17%
EM FX spot	–	–	-0.58%
EMBI GD	5.13%	332 bps	0.13%
EMBI GD IG	3.57%	173 bps	0.23%
EMBI GD HY	7.31%	553 bps	0.01%
CEMBI BD	5.03%	329 bps	0.15%
CEMBI BD IG	3.69%	194 bps	0.09%
CEMBI BD Non-IG	6.94%	520 bps	0.24%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.4	–	1.26%
1-3yr UST	1.64%	–	0.01%
3-5yr UST	1.67%	–	0.00%
7-10yr UST	1.83%	–	-0.07%
10yr+ UST	2.27%	–	0.52%
10yr+ Germany	-0.31%	–	-0.01%
10yr+ Japan	-0.05%	–	0.28%
US HY	5.59%	370 bps	0.49%
European HY	3.68%	400 bps	0.71%
Barclays Ag	1.41%	-42 bps	0.02%
VIX Index*	12.62	–	-0.51%
DXY Index*	98.30	–	-0.02%
EURUSD	1.1019	–	0.12%
USDJPY	109.62	–	-0.60%
CRY Index*	176.66	–	-4.07%
Brent	61.2	–	-3.82%
Gold spot	1457	–	0.03%

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

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- **Brazil:** The Brazilian Central Bank intervened twice in the spot market last week, selling between USD 2bn to USD 3bn to avoid an overshoot on BRL. It was the first intervention in the spot market since 2009. Intervention is likely to bring stability to the currency, while avoiding an inappropriate tightening of liquidity conditions. The BRL has weakened this year for 'good' reasons. Local interest rates have declined to the lowest level since the inception of the inflation targeting regime, thanks to declining inflation and a full restoration of central bank credibility. Low rates have in turn allowed companies to repay USD-denominated debt and borrow in local currency at similar level of interest rates, but without the currency risk. This has led to an increase in the demand for Dollars to repay debt, pushing BRL lower in the short term, but ushering in a far more stable long term capital structure for Brazilian companies. The country's risk premium already reflects this improvement in credit quality as the sovereign spread trades close to investment grade (IG) countries, such as Mexico, even though Brazil is still far from getting upgraded back to IG.

More recently, the BRL weakened for technical reasons. Investors went long BRL in anticipation of large foreign direct investment (FDI) into the oil and gas sector in the recent so-called 'transfer of rights' concessions. The auction was a success for Petrobras, which secured the right to operate very productive assets. However, foreign participation was slim (only 10% of one field), which left currency speculators frustrated. The unwinding of these speculative long BRL positions additionally coincided with well-known year-end seasonal dividend remittances.

Finally, BRL took a hit from a data release, which, mistakenly, showed Brazil's trade deficit widening significantly. Last week, however, the November export numbers were corrected, so that the trade balance is now in surplus to the tune of USD 37.6bn year to date (as of fourth week of November).

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The combination of repayments of Dollar-denominated debt, the unwinding of frustrated speculative BRL longs and confusion over the macro data have conspired to weaken BRL in recent months, but we remain positive in the BRL and Brazilian equities over the medium term. The decline in local interest rates in the context of low inflation means equity portfolio flows should be more critical than fixed income inflows. As the Brazilian economy rebounds, earnings growth is likely to act as a magnet for foreign capital, which, alongside FDI inflows, should be supportive for BRL.

- Chile: The Central Bank of Chile (BoC) announced a USD 20bn intervention in the market for the Chilean peso (CLP), including the sale of USD 10bn via the spot market and USD 10bn via FX futures between now and May 2020. It is the first time the central bank has directly sold Dollars into the spot market since 2002. If fully implemented, the BoC sales will be equivalent to 65% of the average daily CLP trading volume, i.e. enormous. The BoC reserved discretion over timing and size of auctions, boosting the impact of the intervention and announced it would buy CLP bonds in order to reinject CLP absorbed after the USD sales, keeping liquidity in the system unchanged (sterilised intervention).

The BoC's intervention follows weeks of political protests in Chile. The size and method of intervention are such that they are likely to be an effective deterrent against excessive CLP weakness, in our view, which is essential to stabilise confidence in the Chilean economy. The proposed sale of USD 10bn represents roughly 25% of Chile's stock of FX reserves, but even if the entire programme is implemented BoC would still hold an appropriate 5-6 months of import cover.

- China: The Ministry of Finance announced the pre-approval of CNY 1tn of local government project bond issues for 2020. The proceeds of the bonds are destined to finance counter-cyclical infrastructure projects intended to stabilise growth early next year. Total gross issuance of Chinese debt is estimated to reach CNY 47-48tn in 2020 compared to approximately CNY 44tn in 2019, according to Standard Chartered Bank. On a net basis, issuance is likely to rise to CNY 12-13tn in 2020 from an estimated CNY 11tn in 2019. In other news, industrial profits dropped by 9.9% on a yoy basis in October, which is the lowest level since 2011, reflecting the impact of the trade war and cyclical challenges in specific industries. However, high-frequency data improved with Manufacturing PMI rising to 50.2 in November, from 49.3 in October, the first print above 50 in seven months with new orders and production rebounding the most. Non-manufacturing PMI accelerated to 54.4 from 52.8 with a strong rebound in services and healthy construction activity. On the inflation front, pork prices plunged by 16.5% in the month of November (as of 28 November) on the back of rising imports and growth in livestock.

In the equity space, technology giant Alibaba raised USD 11bn in a successful Hong Kong listing. The funds raised will be used to invest in cloud computing, financial technology, logistics, media and entertainment projects in mainland China. The company has 693 million retail consumers in China as of September 2019. Lastly, MSCI, an index provider, completed the final phase of the increase of China A-shares in MSCI's indices in 2019. China A-shares will now be 4.1% of MSCI EM as of the end of November 2019 compared to 2.5% in August 2019. MSCI estimates a passive inflow of USD 6.7bn as a result of the increase in index weight. This is positive for Chinese stocks, but marginally negative for stocks in other large Emerging Markets countries, at least in the short term.

- Poland: Poland's Supreme Court issued a ruling relating to CHF-denominated mainly mortgage loans that were made mostly between 2005 and 2011. The ruling allows borrowers to convert their CHF-denominated mortgages into local currency loans at the exchange rate at which they originally took up the loan, thus transferring currency losses to the banks. However, each case will be decided on an individual basis at the discretion of local courts. The Polish Banking Association estimates that the conversion will cost the banks at least at PLN 60bn, or the equivalent of 2.7% GDP. Hungary implemented similar policies some years ago. The ruling in Poland is likely to impact the banks over time, on a case by case basis, reducing the impact in the system, in our view. In other news, real GDP growth was 3.9% on a yoy basis in Q3 2019, down from 4.6% yoy in Q2 2019. Domestic demand was the main growth driver and net exports posted a positive contribution, but investment eased.

- Sri Lanka: President Gotabaya Rajapaksa announced tax cuts equivalent to USD 2bn, or around 2% GDP per year. He cut the rate of VAT from 15% to 8% and abolished a 2% 'nation-building tax', which had been put in place in order to fund infrastructure projects. The fiscal measures add to long-standing concerns over fiscal policy and excessive government indebtedness in Sri Lanka. The IMF is likely to object to the measures, triggering an early exit from the IMF programme. Tax cuts may be successful in boosting the economy, but only if they are accompanied by a large programme of privatisation, which can reduce the size of the government and stabilise the debt metrics.

- Colombia: The government has put forward a new tax reform bill to replace the 2018 Financing Law, which was revoked by the constitutional court in October of this year. President Ivan Duque included a VAT rebate for the 20% poorest of Colombians in a bid to appease demonstrators. Protest organisers have sent a letter to Duque listing five topics for discussion, including economic and social policy; peace accord implementation; security and human rights; political reform and corruption and; environmental policy. In the meantime, demonstrators have called a new demonstration for 4 December.

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- Mexico: A review of GDP data revealed that the Mexican economy has not grown in real terms in 2019. The current account balance recorded a USD 2.5bn surplus in Q3 2018 following a USD 8.7bn surplus in the previous quarter. To rekindle growth, President Antonio Manuel Lopez Obrador (AMLO) unveiled an infrastructure investment plan worth MXN 859bn (USD 44bn) across 147 projects on highways, railways, ports, airports and telecom. Most of the capital comes from the private sector. In other news, a poll conducted by El Universal showed that support for AMLO's party Morena declined to 36.6% from 48.4% in July. While his party is unpopular, AMLO remains popular. The polls shows that 65.5% of Mexicans believe that AMLO cares about ordinary Mexicans.

- Nigeria: Gross foreign exchange reserves declined to USD 39.9bn as of 25 November 2019, which is the lowest level since January 2018, according the Central Bank of Nigeria. Reserves peaked at USD 45.2bn in June 2019 and have since declined in spite of the imposition of restrictions on imports of food into the country. Import restrictions are threatening macroeconomic stability due to a resulting increase in inflation as local producers fails to replace lost imports. Import substitutions policies of this kind were common in the 1960 and 1970s and have been widely discredited as ineffective. In other news, Nigeria's manufacturing PMI rose to 59.3 in November from 58.2 in the previous month.

- Thailand: Manufacturing production dropped to a rate of -8.5% on a yoy basis in October down from -5.1% yoy in September. Motor vehicle production led the decline. On the other hand, tourist arrivals rose at a yoy rate of 12.5% in October, up from 10.1% yoy in September with strong increases in Malaysian travellers. The government approved measures to inject THB 150bn before the end of 2019 mostly as debt relief for rice farmers and loans to finance small scale investment in rural villages. In other news, CPI inflation rose by 0.2% on a yoy basis in November, from 0.1% in October. Core CPI inflation was stable at 0.5% on a yoy basis.

- South Korea: Industrial production declined at a yoy rate of 2.5% in October from 0.4% yoy in September. Auto production deteriorated, but semiconductors and shipping recovered. Exports declined to a yoy rate of 14.3% in November, from 14.8% yoy in October. Exports ex-vessel rebounded strongly with semi-conductor volumes rising by 10% on a yoy basis in spite of prices remaining depressed. Consumer confidence rebounded to 100.9 in November from 98.6 in October. In other news, CPI inflation rose to 0.2% on a yoy basis in November, from 0.0% yoy in October, below consensus expectations.

Snippets:

- Angola: Gross FX reserves increased by USD 200m to USD 15.5bn in October. Reserve stabilisation is a sign that external accounts are stabilising following the 59% ytd depreciation of the Kwanza.
- Argentina: President-elect Alberto Fernandez re-stated that he does not want to impose a haircut on the government debt, saying that the rest of the world is not responsible for his predecessor Mauricio Macri's borrowing.
- Croatia: Industrial production increased at a 0.3% yoy rate in October compared to 2.0% yoy in September, disappointing consensus expectations. Retail sales expanded at a yoy rate of 3.1% in October, down from 3.5% yoy in the previous month.
- Czech Republic: Real GDP growth was 2.5% in yoy terms in Q3 2019 compared to 2.8% yoy in Q2 2019. Government consumption and net exports were the main drivers of growth.
- Hungary: Real GDP expanded at a yoy rate of 5.0% in Q3 2019, up from 4.9% yoy in Q2 2019. Consumption, fixed capital formation and exports led the strong growth momentum.
- India: The rate of real GDP growth decelerated from 4.5% on a yoy basis in Q3 2019 from 5.0% yoy in Q2 2019. The main positive contributor to growth was government consumption, while private consumption and capital expenditure declined. Manufacturing PMI stabilized at 51.2 in November from 50.6 in October, primarily via manufacturing of consumer goods.
- Indonesia: CPI inflation declined from 3.0% on a yoy basis in November from 3.1% yoy in October, marginally below consensus expectations. Low inflation leaves the door open for further monetary policy easing in 2020.
- Kenya: The Central Bank cut its policy rates by 0.5% to 8.5% in line with consensus expectations. The removal of the interest rate cap on bank lending, which previously impaired the transmission of monetary policy changes to the wider economy was an important consideration behind the rate cut. Consumer prices index (CPI) inflation was 5.6% on a yoy basis in November, up from 5.0% yoy in October.
- Singapore: Industrial production surged to a rate of 4.0% in yoy terms in October, which was a marked improvement from 0.7% yoy in September. Electronic and biomedical sectors were the main contributors to the rebound.

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- **South Africa:** The IMF warned that South Africa would endure a prolonged period of weak economic growth, rising unemployment, inequality and higher risk of credit ratings downgrades unless the government acts fast to implement reforms. The economy has been suffering since former President Jacob Zuma was in power. Current President Cyril Ramaphosa has struggled to implement economic reforms due to infighting within the ANC party.
- **Taiwan:** Industrial production declined by 2.9% on a yoy basis in October, from -0.7% yoy in September. Electronic goods remain in expansion, but the contraction in non-electronics production worsened. Imports of semiconductor equipment reached all-time highs, corroborating the recent evidence of improvement in this sector.
- **Ukraine:** The approval rating of President Volodomyr Zelensky normalised to 52%, according to a poll from the Kyiv International Institute of Sociology. The first round of land bill and privatisation measures, which have been approved by the Rada, Ukraine's parliament, are unpopular measures, but likely to boosting Ukraine's growth potential.
- **Uruguay:** Luis Lacalle Pou from the opposition Partido Nacional will assume the presidential office from 1 March 2020. Lacalle's economic plan includes a USD 900m (1.7% GDP) fiscal consolidation, which will be implemented by cutting expenditures in a bid to support private sector-led growth and contain inflation.

Global backdrop

Trump signed the Hong Kong Human Rights and Democracy Act, which institutionalises an annual review of Hong Kong autonomy from Beijing. The act, though offensive to China, does not appear to have change prospect for a trade deal between China and the United States. The Chinese authorities have taken comfort from the fact that the bill grants discretion to President Donald Trump whether to enact the bill or not. For now, it would appear that Trump does not want to invoke the law in the so-called 'phase 1' agreement. China is displaying clear pragmatism in separating political noise from what matters in trade negotiations. Meanwhile, US authorities said a trade deal is "millimeters away". The deal may involve a rollback of tariffs on USD 360bn of Chinese exports and the cancellation of incoming duties on China in exchange for which China commits to purchasing up to USD 50bn of US agricultural produce.

US data was broadly better than expected. Inflation surprised on the downside, while economic activity increased. The core PCE deflator declined to 1.6% on a yoy basis in October from 1.7% yoy in September. Durable goods orders increased by 0.6% in November versus a 0.9% contraction in October with core capital goods and non-defence capital goods improving more than expected. The housing market remains near the highest levels since 2007 with 733k new home sold in October compared to 738k in September. The better economic data boosted the Atlanta Fed GDP now-cast for Q4 2019 real GDP growth to 1.7% yoy from 0.3% yoy. Lastly, the US trade balance narrowed to 66.5bn in October from 70.5bn in September, driven by lower imports of consumer goods (due to the tariff hike from 1 September).

In Germany the left-wingers Norbert Walter-Borjans and Saskia Esken won the dispute for the leadership of the SPD party against current finance minister Olaf Scholz. The SPD is in a coalition government with Chancellor Angela Merkel's CDU. The election could lead to some volatility of the government in Germany as the SPD tries to renegotiate the terms of the alliance, but will most likely lead to more fiscal expenditure over the medium term. Euro area economic sentiment showed some signs of stabilisation by inching up 0.5 to 101.3 in November. Manufacturing remains the weakest sector, whereas consumer confidence is resilient. Euro area core inflation increased to 1.3% on a yoy basis in November from 1.1% yoy in the previous month as the rate of unemployment remained stable at 7%.

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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	-0.13%	4.09%	10.51%	7.67%	9.41%	3.52%
MSCI EM Small Cap	-0.61%	3.22%	5.31%	3.70%	4.82%	1.40%
MSCI Frontier	1.38%	2.20%	13.07%	9.76%	8.59%	0.96%
MSCI Asia	0.25%	4.81%	11.02%	8.09%	9.91%	5.07%
Shanghai Composite	-1.94%	-1.13%	17.97%	13.69%	-1.81%	3.52%
Hong Kong Hang Seng	-2.20%	1.00%	5.60%	0.66%	5.57%	2.23%
MSCI EMEA	-0.09%	2.72%	8.51%	6.88%	7.19%	0.05%
MSCI Latam	-4.11%	0.17%	6.72%	5.98%	7.86%	0.52%
GBI EM GD	-1.82%	1.03%	8.97%	10.39%	6.26%	0.71%
ELMI+	-0.63%	1.40%	2.83%	3.53%	3.67%	0.64%
EM FX Spot	-1.56%	0.40%	-2.10%	-2.06%	-1.70%	-5.77%
EMBI GD	-0.48%	-0.20%	12.77%	14.29%	6.45%	5.31%
EMBI GD IG	0.20%	0.52%	15.82%	17.72%	7.46%	5.25%
EMBI GD HY	-1.27%	-1.04%	9.54%	10.68%	5.36%	5.28%
CEMBI BD	0.38%	1.23%	12.00%	12.80%	6.23%	5.30%
CEMBI BD IG	0.13%	0.48%	12.07%	13.37%	5.95%	4.68%
CEMBI BD Non-IG	0.72%	2.28%	11.87%	12.02%	6.72%	6.23%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	3.63%	5.87%	27.63%	16.10%	14.89%	10.96%
1-3yr UST	-0.04%	0.29%	3.37%	4.20%	1.79%	1.29%
3-5yr UST	-0.24%	0.06%	5.24%	6.95%	2.56%	1.99%
7-10yr UST	-0.65%	-0.49%	9.30%	12.29%	4.15%	3.00%
10yr+ UST	-0.52%	-1.37%	18.12%	24.59%	7.84%	5.26%
10yr+ Germany	-0.73%	-3.71%	12.84%	14.54%	5.50%	5.77%
10yr+ Japan	-0.49%	-1.12%	4.99%	6.62%	1.90%	4.08%
US HY	0.33%	0.60%	12.08%	9.68%	6.32%	5.40%
European HY	1.15%	0.99%	9.78%	8.93%	4.43%	4.38%
Barclays Ag	-0.76%	-0.10%	6.22%	8.37%	3.91%	2.04%
VIX Index*	0.00%	-22.29%	-50.35%	-30.16%	-10.62%	-1.79%
DXY Index*	0.03%	-1.08%	2.22%	1.06%	-2.45%	10.89%
CRY Index*	0.00%	1.56%	4.04%	-2.80%	-7.85%	-30.27%
EURUSD	0.01%	1.06%	-3.78%	-2.95%	3.33%	-11.04%
USDJPY	-0.12%	-1.34%	0.04%	3.66%	3.55%	8.76%
Brent	-1.94%	0.72%	13.79%	4.28%	12.41%	-13.21%
Gold spot	-0.49%	-0.93%	13.68%	18.15%	23.73%	21.48%

*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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