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China's financial influence grows ever stronger

By Jan Dehn and Gustavo Medeiros

China is pushing hard for an ever more prominent role in the global financial system. The support for its AIIB initiative directly challenges the old Bretton Woods institutions and rightly focuses on the single most important constraint to continued Emerging Markets (EM) expansion – developing domestic infrastructure which has failed to keep pace with private sector expansion. China has also taken a significant step by allowing local governments to convert or issue RMB 1.5trn of debt and become a key element of the country's debt markets. We also review Brazilian, Argentinean and Venezuelan politics and Russia's economy, which is now adjusting to the policy changes of a few months ago. In the global section we look at slowing US growth and how the FOMC meeting changed little in any meaningful sense and leaves the US in much the same position of high debts and slower growth and in no hurry to hike fast.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	973	–	3.57%
MSCI EM Small Cap	1,020	–	2.23%
MSCI FM	593	–	0.68%
GBI EM GD	6.29%	–	2.70%
EM FX spot	–	–	1.71%
ELMI+	5.01%	–	1.47%
EMBI GD	5.65%	371 bps	1.23%
EMBI GD IG	4.35%	236 bps	1.41%
EMBI GD HY	8.44%	660 bps	0.43%
CEMBI BD	5.46%	369 bps	0.46%
CEMBI BD HG	4.32%	254 bps	0.53%
CEMBI BD HY	8.05%	630 bps	0.31%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2108	1.30%
VIX Index	13.02	-16.59%
5 year UST	1.40%	-16 bps
7 year UST	1.71%	-17 bps
10 year UST	1.92%	-15 bps
US HY	6.73%	0.21%
European HY	4.58%	-0.29%
EURUSD	1.0864	2.52%
USDJPY	119.84	-1.28%
Brent	54.64	1.20%
Copper	278.70	10.95%
Gold	1181.93	2.33%

Additional benchmark performance data is provided at the end of this document.

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- **China:** China continues to aggressively position itself for a much more prominent role in the global financial system. In the past few weeks, it has won notable support for its own Asian Infrastructure Investment Bank (AIIB) initiative, which directly challenges the influence of the IMF and World Bank. This is not 'first-best policy', but China is right to pursue this approach anyway, because the first-best policy is not available given opposition by the largest developed economies, notably the US, to reform of the Bretton Woods institutions. The single most important constraint to continued EM expansion is not external in nature – rather it is domestic in the shape of inadequate infrastructure. The private sector in most EM countries has expanded dramatically in recent decades, but the public sector's ability to expand infrastructure has not kept pace. Also, financial repression and regulatory measures imposed by Western governments have largely made it impossible for institutional investors to channel sufficient funding into EM infrastructure. It appears obvious that the greatest possible boost to global demand and therefore global growth would be unleashed by removing the supply constraints that are the cause of inadequate infrastructure in EM today. As such, China's aggressive policies to expand investment in infrastructure are positive – and are largely being welcomed by most countries.

Another major development in China deserves mention. In a move that will significantly expand the size of the tradable local government universe of fixed income bonds, the Ministry of Finance has granted permission for local governments to convert RMB 1trn of existing debt to bonds. This refinancing operation should ease concerns of those who fear that local governments could not refinance the debt they issued in recent years. This is not net issuance, but as part of the budget the government will also issue RMB 500bn of scheduled new issuance of local government debt in 2015. This will include 1 and 3 year maturities that will now be added to the existing benchmark maturities of 5, 7 and 10-year bonds. We think the Chinese local government bond market will grow to become a central element in the Chinese fixed income universe, akin to the municipal bond market in the US.

- **Brazil:** The popularity of President Rousseff declined to 13%, close to all-time historical lows for a sitting president in Brazil's democratic era. This follows widespread popular protests against the government in the streets of major Brazilian cities this month. But it is not all bad for President Rousseff. Despite the poor sentiment among the electorate, the political environment seems to be improving at a parliamentary level. The main coalition party, PMDB (which controls the lower house, the upper house and vice presidency) is on better

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terms with the workers party after the President fired the education minister who was causing trouble within the coalition. Also, importantly, the government managed to obtain approval for the 2015 budget, which locks in the fiscal adjustment proposed by Finance Minister, Joaquim Levy. Also positive was the fact that a vote on tricky legislation which could have resulted in increases in public sector pensions was postponed. By maintaining good relations in parliament, President Rousseff can stave off the threat of an impeachment process against her, which could pose a real threat to the ongoing (and absolutely necessary) fiscal adjustment. In any case, an impeachment process needs approval by both houses plus the Supreme Court and it would not necessarily help the opposition as the PMDB party would still keep the upper hand in terms of deciding political succession. President Rousseff's troubles emanate from the corruption scandal at Petrobras, which remains the main macro risk. However, the first milestone is rather banal – namely publication of audited numbers. It is likely that these numbers will be forthcoming. Fitch mentioned in a call this week that if Petrobras avoids breaking covenants Brazil would likely keep its Investment Grade status for now.

Meanwhile, all this political noise has been bad for capital flows. With no new debt issuance ytd due to the Petrobras mess and no significant inflows from foreign investors due to the strong USD environment, local hedge funds and corporate FX hedging outflows have been dominant, which has put the BRL under intense pressure. The central bank has announced it will stop underwriting new FX Swaps at the end of this month, thus only rolling over the existing stock of approximately USD 110bn. This makes a great deal of sense. The existing swaps program is large enough to provide hedges for corporations and investors with liabilities in USD. The BRL weakness has helped to push inflation well above the central bank's target in March – the IPCA-15 index pointed to 7.9% yoy inflation. President Rousseff's problems are entirely self-inflicted. Given the evident need for further tightening of both fiscal and monetary policies alongside the continuing sordid saga of Petrobras, it will clearly be some time before President Rousseff's political fortunes turn for the better.

- Russia: The effects of rate hikes and the weaker Russian Ruble are now beginning to have a significant effect on economic activity. Retail sales in February declined by 7.7% yoy and real wages were down 9.9% yoy. Unemployment rose marginally and both fixed investment and industrial production declined. This is no surprise. Domestic demand is bound to fall in response to the large devaluation of the RUB and higher interest rates. This domestic adjustment complements the external adjustment via the currency and should ensure that Russia's current account delivers a decent surplus this year despite lower oil prices. Hence, the pain for Russia's consumers is ultimately necessary to preserve macroeconomic stability in Russia by ensuring that the country continues to live within its means even with a lower oil price environment. Against this backdrop the RUB is slowly recovering. Having traded close to 70 in January, USDRUB last week broke below 60. Meanwhile, more and more officials are beginning to link a dismantling of Russian sanctions with a sustainable peace accord for Eastern Ukraine. This makes sense: the annexation of Crimea by Russia triggered sanctions from the West, which in turn led to Russian meddling in Eastern Ukraine. Thus, a deal between the West and Russia was always going to have to involve discussion of sanctions in connection with the question of a peace settlement in Eastern Ukraine.

- Argentina: Mauricio Macri, presidential candidate for elections scheduled for later this year, has become a great deal more popular following a recent announcement that he will align himself with the Radical Party (the second most important political grouping in Argentina after the Peronist Party and is radical in name only). According to one poll, voter intentions now favour Macri over the favourite Peronist candidate, Daniel Scioli. These are early days, however, and polls in Argentina have a tendency to show different outcomes depending on who commissions them. Even so, this is a positive development. Macri is seen as more market friendly than Scioli, although all contenders are likely to pursue policies that are far more market friendly than the current Kirchner administration.

- Venezuela: President Nicholas Maduro has secured the right to rule by decree until 31 December 2015. This covers the period of the parliamentary election, which is scheduled for December this year. Institutional checks and balances have been systematically dismantled in Venezuela, mainly during the rule of former president, Hugo Chavez. While Chavez was able to rule by decree without triggering a major populist backlash on account of his personal charisma and higher oil prices, Maduro could struggle to do so, especially if he is widely regarded as abusing these powers. In a positive development, the government paid in full and on time its EUR 1bn 2015 bond, which matured last week, confirming the government's high willingness to pay. Also on the positive front, sources at PDVSA, the state oil company, said last week that China was poised to disburse some USD 10bn of a USD 20bn financial commitment announced by Maduro some months ago. If this is confirmed, it should go a long way towards reducing fears of default in an election year.

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Snippets:

- India: The trade deficit declined again. It is now at a 17 month low of just USD 6.8bn. On current trends the trade balance may soon move into surplus, underlining the vast improvement in India's economic conditions since the country was wrongly deemed to be structurally unsound by most bank analysts in 2013.
- South Africa: The current account deficit narrowed to 5.1% of GDP from 5.8% in the previous quarter and 6.2% of GDP in Q3 2014. The market had expected the deficit to be unchanged at 5.8%. The better performance was due to faster-than-expected exports.
- Nigeria: Monthly inflation decelerated moderately in February to 0.7% from 0.81% in January. This change took inflation to 8.4% yoy, largely due to rising food prices as imported goods rose in price due to weakness in the Nigerian Naira. The central bank's target range is 6%-9%.
- Mexico: Retail sales surprised to the upside in January by rising 2.1% mom compared to 0.7% mom expected.
- Hungary: S&P, the ratings agency, raised Hungary's sovereign credit rating to BB+ from BB with a stable outlook.
- Colombia: The central bank left policy rates unchanged at 4.5%. The market had expected a hike of 50bps, but inflation expectations have remained stable despite a weaker currency.

Global backdrop

The US economy is now tracking about 1.5% qoq annualised growth as the data continues to come in softer than expected and the actual outturn may turn out to be even weaker. The latest prints to disappoint include slightly higher claims for unemployment, a weak Philly Fed manufacturing release and weak industrial production data (rose merely 0.1% in February). The drag was mainly from manufacturing. Homebuilder sentiment was also softer than expected. While jobs are being created in the US economy the quality of the expansion is both low and fragile. There is almost no technical progress, public sector investment is non-existent and debt levels remain very high. Despite unprecedented easy monetary conditions, the economy is failing to take off in any conventional sense. As such, the economy is likely to be sensitive to even modest tightening of financial conditions, in our view.

The Fed responded to these conditions by surprising the market to the dovish side. While the Fed dropped its forward guidance ('patience') the members of the FOMC collectively lowered their forecast for the Fed funds rate from 1.125% in December 2015 to just 0.625%. The economic assessment was also revised down, including softer growth projections and a significantly lower assessment of the non-accelerating inflation level of unemployment. This conveniently assumes there is more slack in the economy and therefore provides the Fed with an excuse for postponing tightening, and also puts it in a position to surprise the market, should it feel the need to do so. This all points to greater interest rate volatility, particularly at the short end, as well as more two-way moves on currencies.

The bigger picture remains relatively simple and largely unchanged over the last couple of years: US debt levels are high, the economy is growing much slower than in normal cyclical recoveries and there are still important drags that prevent serious inflation (mainly household debt to income of 100%, labour participation slack and negative housing equity). Given these conditions, the Fed wants to get off zero, but it is in no hurry to hike far or fast.

The likelihood remains that the Fed hikes modestly this year, while the ECB will have to keep its QE programme until 2016, because Europe has no ability to cope with higher yields due to its banking and debt related problems. This suggests that the post-FOMC EUR bounce is temporary and speculators will likely be tempted to use the bounce to reset shorts. The conditions supporting the USD rally have not changed materially other than a brief postponement and will likely remain in place until US inflation resurfaces in earnest in late 2016.

Between now and then the US yield curve will continue to be volatile, especially at the short end, where it is vulnerable to the market's repeated mispricing of the Fed's intentions – typically pricing in too many hikes and then pricing them out again. Meanwhile, the long end remains largely well anchored. This only begins to change dramatically when inflation returns and the market begins to recognise that the Fed cannot hike enough due to high levels of debt and other structural problems. Once this happens the curve is likely to bear steepen sharply as the long end sells off – reflecting the coming decade of inflation and USD weakness. Ultimately, this is the most politically feasible way out of the debt problem, because inflation and currency weakness pass the cost of adjustment to future generations and foreigners.

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Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.0%	1.6%	6.0%	0.2%	2.2%
MSCI EM Small Cap	-1.4%	2.3%	1.9%	2.8%	3.0%
MSCI FM	-1.2%	-2.5%	-0.8%	10.8%	5.5%
S&P 500	0.28%	2.86%	14.92%	16.93%	15.07%
GBI EM GD	-3.27%	-4.25%	-8.57%	-3.84%	0.89%
ELMI+	-1.21%	-3.01%	-8.96%	-3.54%	-1.17%
EM spot FX	-2.98%	-6.46%	-16.97%	NA	NA
EMBI GD	-0.50%	1.28%	6.59%	5.01%	6.93%
EMBI GD IG	-0.42%	1.68%	9.04%	4.69%	6.46%
EMBI GD HY	-0.66%	0.55%	2.37%	5.55%	7.63%
5 year UST	0.58%	1.61%	4.27%	1.98%	3.63%
7 year UST	0.76%	2.19%	7.23%	3.10%	5.41%
10 year UST	0.91%	2.78%	11.17%	4.99%	7.16%
CEMBI BD	-0.01%	1.84%	4.89%	5.23%	6.13%
CEMBI BD HG	-0.01%	1.98%	6.82%	5.63%	6.42%
CEMBI BD HY	0.00%	1.53%	0.93%	4.61%	5.67%
US HY	-0.98%	2.01%	1.37%	7.38%	8.94%
European HY	-0.09%	3.18%	5.74%	12.05%	11.46%
Barclays Agg	-0.82%	-1.78%	-3.13%	0.19%	2.23%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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