US corporate defaults overtake EM defaults

By Jan Dehn

US corporates are now more risky than Emerging Markets (EM) corporates. Brazilian inflation shows the first signs of moderating. Expectations of a major devaluation in China look increasingly misplaced. Turkey U-turns on monetary policy reform. Russia's current account speaks volumes about its own policy response to lower oil prices as well as EM's external rebalancing in general. The global backdrop improved somewhat last week, not least due to a sharp rise in oil prices.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.2	–	0.21%
MSCI EM Small Cap	10.0	–	-0.38%
MSCI Frontier	7.6	–	-1.94%
MSCI Asia	9.8	–	-0.51%
Shanghai Composite	10.5	–	0.54%
Hong Kong Hang Seng	5.7	–	-1.59%
MSCI EMEA	7.6	–	1.69%
MSCI Latam	9.8	–	-0.31%
GBI-EM-GD	7.08%	–	0.37%
ELMI+	4.33%	–	0.26%
EM FX spot	–	–	0.01%
EMBI GD	6.64%	457 bps	0.59%
EMBI GD IG	5.17%	303 bps	0.49%
EMBI GD HY	8.98%	706 bps	0.72%
CEMBI BD	6.68%	482 bps	-0.36%
CEMBI BD IG	4.95%	309 bps	-0.35%
CEMBI BD Non-IG	9.83%	796 bps	-0.39%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	13.8	–	-0.75%
1-3yr UST	0.88%	–	0.00%
3-5yr UST	1.47%	–	-0.07%
7-10yr UST	2.04%	–	-0.07%
10yr+ UST	2.80%	–	-0.12%
10yr+ Germany	0.48%	–	0.76%
10yr+ Japan	0.23%	–	0.37%
US HY	9.98%	845 bps	0.12%
European HY	6.50%	663 bps	-0.22%
Barclays Ag	–	225 bps	-0.38%
VIX Index*	22.34	–	-1.61%
DXY Index*	99.48	–	0.52%
EURUSD	1.0812	–	-0.73%
USDJPY	118.53	–	1.03%
CRY Index*	163.80	–	0.68%
Brent	31.4	–	9.84%
Gold spot	1104	–	1.35%

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

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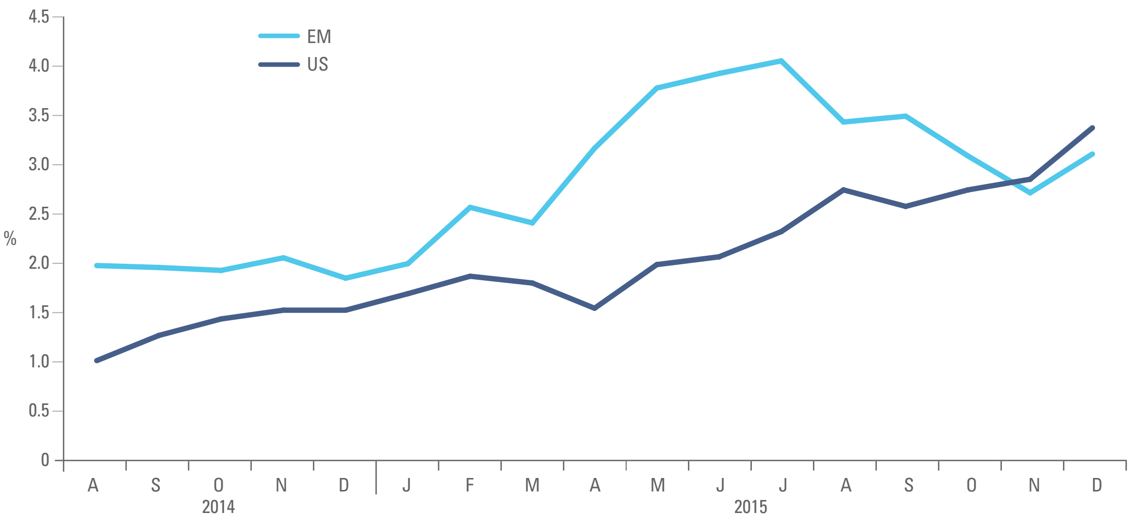
Default rates for High Yield corporates: US versus EM



Source: Ashmore, BAML.

Default rates for US corporates have now overtaken default rates for EM corporates. According to new data published by Bank of America Merrill Lynch – whose corporates indices are the most comprehensive in the industry – the default rate for US High Yield (HY) corporates hit a new high of 3.4% at the end of 2015, up from less than 1% in mid-2014. This means that US corporate default rates have now overtaken default rates

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for EM corporates, which reached 3.1% at the end of 2015. US HY default rates have been rising at an accelerated pace since the middle of 2014, when oil prices began to fall and the US dollar took off against most other currencies. By contrast, EM HY default rates appear to have peaked in July 2015. There is very little evidence that the surge in the US dollar against EM currencies since 2011 has had a major impact on default rates, despite endless regurgitation of fears of massive currency mismatches on corporate balance sheets in EM. By contrast, it would appear that the stronger Dollar is now hurting US corporates, either directly or indirectly via the impact on oil prices.

- Brazil: There is now some evidence emerging that core inflation is beginning to fall in Brazil. The mid-month core CPI index in Brazil, known as IPCA-15, showed the core inflation rate declining by 10bps to 0.68% mom versus 0.74% mom expected. Services prices inflation, in particular, is now showing clear signs of deceleration. Payroll job destruction was also less bad than expected when job losses declined to 88.1K in December from 142.9K in November (seasonally adjusted). The Brazil Central Bank's monetary policy setting committee known as the COPOM this month surprised the market by not hiking the policy interest rate, which stands at 14.25%. The COPOM cited downwards revisions to Brazil's growth rate as the cause of its more dovish turn.

- China: Having talked up the probability of a large devaluation in China many investment banks are now taking the opposite view. U-turns of this type are of course typical of investment banks whose views tend to change with the price action (because they make money on crossing bonds rather than investing per se). In this particular case, the U-turn reflects a number of factors. Firstly, banks are also making revisions to their outlook for US growth and therefore Fed hikes. Secondly, there is growing recognition that a large devaluation makes little sense when China is able to (a) grow solidly, (b) sustain a USD 60bn per month trade surplus and (c) grow its share of global trade despite having one of the most appreciated real effective exchange rates in the world. Thirdly, Vice-President Li Keqiang stated categorically last week that China has no intention of devaluing the RMB. Finally, China is holding the course on overall macroeconomic policy by only easing very gently (both monetary and fiscal) and instead using liquidity instruments to deal with temporary market panics. This is sensible policy. Our view remains that China will do everything it can to avoid destabilising its currency and therefore global financial markets, ahead of the RMB's formal inclusion in the SDR in October of this year. This is not inconsistent with China occasionally clamping down on excessive currency speculation, particularly against CNH. Indeed, the People's Bank of China did precisely this last week, when the bank raised reserve requirements for interbank deposits in the CNH market. The volatility in the CNH markets has recently become excessive relative to what is justified by China's fundamentals. This excessive speculation is partly China's own fault; it happens because most foreign investors can still only 'play' China in the offshore market rather than onshore due to challenges to access. Moreover, RMB is the only EM currency in the global reserve currency system, so it tends to be oversold during bouts of global risk aversion.

- Turkey: The Central Bank in Turkey appears to have either delayed or U-turned on previously stated intentions to revert to a more orthodox monetary policy framework. There are was no mention of 'simplification' of the monetary policy framework at the January monetary policy meeting (where the bank left policy rates unchanged). Attention will now focus on future communications for signals about the intentions with respect to adopting a better policy framework. The Turkish Central Bank has been pursuing over-easy monetary policies for political reasons for several years in order to support President Erdogan's ambitions to become President. Having helped Erdogan achieve this objective, the Central Bank recently issued statements to the effect that the policy would revert to more conventional methods, but the bank now appears to be dithering or even backtracking.

- Russia: There is probably no better example of EM's dramatic external rebalancing than Russia. The current account surplus in 2015 improved to 5.4% of GDP, up from 3.1% in 2014. This is truly remarkable in light of the evolution of oil prices, but reflects Russia's conservative macroeconomic management and willingness to adjust domestic demand in response to changing conditions in the oil markets. EM countries in general have rebalanced their economies significantly in recent years in response to tighter financial conditions (which are largely caused by outflows as global investors have financed their chase of QE-driven assets in developed markets by reducing exposure to non-QE markets, including EM). Huge changes in exchange rates have also shifted production away from non-tradable sectors back towards tradable sectors.

Snippets:

- Argentina: Talks with holdout investors have been postponed to 1 February due to logistical issues. Finance Minister Alfonso Prat Gay said that Argentina is under-leveraged; this is entirely true and that is why the government will prioritise finding a solution with holdout investors.
- Colombia: Retail sales declined 0.3% yoy in November (from +0.2% yoy in October). This is a positive development in the sense that Colombia needs to moderate domestic demand to reflect lower prices for its oil exports.
- El Salvador: Remittances from foreign workers rose 3% in 2015 to reach 15.7% of GDP.

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- **Malaysia:** Bank Negara Malaysia left the policy rate unchanged at 3.25%. The bank eased liquidity conditions, however, by cutting reserve requirements by 50bps to 3.5%. This move reflects the current elevated levels of risk aversion in global markets rather than anything Malaysia-specific. Inflation in December was in line with expectations at 2.7%.
- **Panama:** Canal toll revenues rose 4.2% yoy in the January to November period. Revenues obtained from fees paid by ships passing through the Panama Canal constitute 4.2% of Panama's economy.
- **South Africa:** The yoy rate of inflation rose to 5.3% in December from 4.8% in November. Core inflation was marginally lower than expected (5.2% yoy vs 5.3% yoy anticipated). Agricultural prices and ZAR weakness during last month's investor panic over the change of finance minister appears to have impacted headline inflation.

Global backdrop

The global backdrop turned more positive last week. There were four drivers. Firstly, oil prices rose about 15%. This is positive for financial markets. The economic importance of movements in oil prices tends to be exaggerated, while the financial importance is typically sufficiently appreciated. Sure, changes in oil prices have an impact on consumers and companies, by lowering the prices of energy, but changes in oil have an equally, if not greater financial impact by changing the size of the windfall of oil producers, which directly impacts financial markets. That is, low oil prices have been bad for the stocks. Secondly, after racking up a decent 6.9% real GDP growth rate for 2015 it is becoming increasingly evident that China is once again going to disappoint those who continue to hark on about a hard landing. The latest data shows clearly that services and consumption are the stronger part of the Chinese economy, which suggests that the rebalancing China is seeking to achieve is making good progress. Thirdly, ECB President Mario Draghi hinted at more easing at the ECB's March monetary policy meeting. European PMIs on the other hand disappointed somewhat by dropping to 53.5 in January from 54.3 in December. Finally, concerns about a US recession receded marginally last week as the flash PMI manufacturing index for January (52.7 versus 51.2 in December). However, not all is good as the Philadelphia Fed manufacturing index was in the red for another month, the fifth in a row. Housing starts were softer than expected and the NAHB homebuilder survey was weaker than anticipated in January. Headline inflation has begun its base-effect driven ascent. It has now reached 0.7%, up from just 0% in September 2015. In other news, a fresh poll shows that 53% of Britons now support exiting the EU compared to 47% in favour of remaining within the EU.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-10.49%	-10.49%	-25.89%	-10.61%	-6.40%
MSCI EM Small Cap	-10.10%	-10.10%	-17.67%	-6.10%	-4.83%
MSCI Frontier	-9.62%	-9.62%	-20.69%	-0.43%	-1.95%
MSCI Asia	-10.36%	-10.36%	-20.78%	-4.85%	-2.04%
Shanghai Composite	-17.59%	-17.59%	-11.38%	10.88%	3.96%
Hong Kong Hang Seng	-16.11%	-16.11%	-30.65%	-9.37%	-5.30%
MSCI EMEA	-11.94%	-11.94%	-31.45%	-16.92%	-10.58%
MSCI Latam	-11.35%	-11.35%	-39.69%	-23.29%	-15.91%
GBI EM GD	-2.20%	-2.20%	-18.41%	-10.73%	-3.67%
ELMI+	-2.31%	-2.31%	-8.89%	-6.51%	-3.59%
EM FX Spot	-2.86%	-2.86%	-19.37%	-14.00%	-9.96%
EMBI GD	-1.19%	-1.19%	-0.10%	0.56%	5.09%
EMBI GD IG	-0.41%	-0.41%	-2.32%	0.06%	4.47%
EMBI GD HY	-2.20%	-2.20%	3.32%	1.26%	6.04%
CEMBI BD	-1.09%	-1.09%	0.01%	1.17%	4.09%
CEMBI BD IG	-0.56%	-0.56%	-0.16%	1.89%	4.75%
CEMBI BD Non-IG	-2.02%	-2.02%	0.54%	-0.26%	2.95%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	-6.61%	-6.61%	-5.61%	10.80%	10.55%
1-3yr UST	0.47%	0.47%	0.65%	0.48%	0.69%
3-5yr UST	1.11%	1.11%	1.47%	1.50%	2.09%
7-10yr UST	2.02%	2.02%	1.54%	2.34%	5.42%
10yr+ UST	3.63%	3.63%	-3.10%	4.43%	10.00%
10yr+ Germany	3.29%	3.29%	0.12%	8.09%	10.24%
10yr+ Japan	1.05%	1.05%	3.90%	6.09%	5.53%
US HY	-2.85%	-2.85%	-7.75%	0.18%	4.38%
European HY	-1.58%	-1.58%	-1.07%	5.25%	8.45%
Barclays Ag	-0.03%	-0.03%	-1.57%	2.41%	4.58%
VIX Index*	22.68%	22.68%	34.09%	73.31%	27.00%
DXY Index*	0.86%	0.86%	4.98%	24.74%	27.53%
CRY Index*	-7.01%	-7.01%	-24.38%	-45.27%	-49.99%
EURUSD	-0.46%	-0.46%	-3.79%	-19.70%	-20.97%
USDJPY	-1.41%	-1.41%	0.06%	30.38%	44.11%
Brent	-15.88%	-15.88%	-35.72%	-72.32%	-67.08%
Gold spot	4.08%	4.08%	-13.81%	-33.42%	-17.11%

*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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