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WEEKLY INVESTOR RESEARCH

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Emerging Markets variety versus the singular focus on tapering in the developed world

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We highlight developments from the last week in a number of Emerging Markets (EM) countries of different credit qualities. The coverage highlights the enormous variety of issues affecting the countries in the EM asset class. The diversity of issues stands in sharp contrast with the almost singular focus on central bank policies in the developed economies. Precisely within this sharp contrast also lies an important insight for investors, namely exposure to EM offers genuine diversification, while exposure to developed economies is increasingly akin to making a single bet.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,009	–	-1.55%
MSCI FM	578	–	0.75%
GBI-GD	6.77%	–	-0.82%
ELMI+	4.19%	–	-0.38%
EMBI GD	5.84%	307 bps	-0.25%
EMBI GD IG	4.93%	214 bps	-0.41%
EMBI GD HY	9.44%	691 bps	0.10%
CEMBI BD	5.62%	336 bps	-0.16%
CEMBI BD HG	4.78%	251 bps	-0.09%
CEMBI BD HY	7.57%	536 bps	-0.01%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,805	0.78%
VIX Index	12.26	-6.41%
5 year UST	1.36%	4 bps
10 year UST	2.76%	9 bps
10 year Bund	1.73%	5 bps
EURUSD	1.3527	0.16%
USDJPY	101.73	1.71%
Brent	$110	0.98%
Copper	$328	0.92%
Gold	$1231	-3.59%

Emerging Markets

Developments in Emerging Markets continue to reflect the enormous variety across countries in the asset class. Among the stronger credits in EM we highlight the following country specific developments from the past week:

- Mexico: Domestic demand-led cyclical slowdown continues with the release of retail sales data, which was weaker than expected at -0.41% m-o-m seasonally adjusted for the month of September, though we think this positions Mexico for a very strong performance in 2014, aided by the raft of reforms being implemented by the Pena Nieto administration.
- Malaya: Moody's raised the outlook for Malaysian government bond and issuer rating from stable to positive, citing improvements in fiscal policy, the reform agenda, and economic stability in the face of volatile external markets.
- Chile: Chile's central bank cut the policy rate by 25 bps to 4.5%. This follows a 25 bps cut last month. Chile has little inflation and its currency has been stable in the face of negative EM sentiment. Chile's real GDP growth rate accelerated in Q3 to 4.7% y-o-y from 4.0% y-o-y in Q2, driven mainly by strong export growth. It is a show of strength that the central bank feels that it can cut rates as and when it feels the need to do so. Their main motivation for the cut is to keep domestic demand ticking along smoothly Chile's congressional and presidential elections on 17 October saw former president Michelle Bachelet secure nearly half of the votes, more than 20% more than her main rival Evelyn Matthei. A run-off will now be held on 15 December. Bachelet's party won a majority, but fell short of the number of votes required to change the constitution. Chile's democracy, like most in EM, is now very firmly entrenched.
- China: Chinese officials announced that China intends to widen the trading band for the currency and eventually remove quotas limiting access for foreigners into China's domestic markets. This follows other major reforms announced in the past few weeks. We think opening of the capital account is not imminent, because the PBOC must first be confident in its ability to manage the macro economy using interest rates. Still, the direction of travel is quite clear.
- Israel: Growth slowed in Q3 compared to Q2 as the pace of expansion declined from 4.6% q-o-q to 2.2% q-o-q. However, a number of indicators – including solid consumption growth, rising imports of capital goods and base effects – suggest that Israel's growth outlook is improving as we head into 2014.

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Emerging Markets

- **Russia:** IP growth in Russia softened, posting at 0.1% y-o-y decline. The performance of manufacturing in Russia is mixed across industries, but overall the domestic industrial sector is going through a soft patch at the moment. However, inflation still runs at relatively high levels, so significant policy easing is unlikely at this time.
- **Singapore:** Non-oil domestic exports rose 2.8% y-o-y in October, far more than consensus expectations (-1.1% y-o-y). Unlike many other Asian economies, Singapore's economy is particularly dependent on demand in Japan and the US as well as Asia and Indonesia. The pick-up in exports is therefore noteworthy, in our view.

Among the prominent EM countries currently undergoing macroeconomic adjustment, we highlight the following developments from last week:

- **Turkey:** Turkey's central bank turned more hawkish in the past week, even as it left the bulk of its myriad of policy instruments unchanged. In a clearly hawkish development, the central banks removed the one-month repo facility, a source of liquidity for banks. Banks will now be forced to seek financing in the interbank market, where rates will rise as a consequence. In fact, the central bank explicitly stated that it wished to see interbank market rates rise. The Turkish central bank is reluctant to raise policy rates outright for fear of weakening an over-extended property market and hurting growth ahead of crucial elections next year. Instead, they are managing liquidity and the currency through a slew of unconventional measures.
- **South Africa:** CPI inflation declined to 5.5% y-o-y in October from 6.0% y-o-y in September. Core inflation was unchanged from September at 5.3% y-o-y. We expect the South African Reserve Bank to remain on hold for the foreseeable future.
- **India:** India's central bank governor Raghuram Rajan announced root and branch reform of the heavily statebank-dominated banking sector in India. This is an extremely positive development, in our view. First, the introduction of more competition by allowing new smaller banks and foreign banks to compete with large established state banks will improve India's trend growth rate through more efficient financial intermediation. Secondly, we think a more vibrant banking sector will become a powerful lobby to push for opening India's domestic bond markets to foreign investors. This in turn will significantly improve the monetary transmission mechanism in India.
- **Brazil:** For the third month in a row fiscal revenues were stronger than expected. Federal tax revenues rose 5.4% y-o-y versus an average y-o-y growth rate of 1.4% in 2013 as a whole. Higher tax revenues from corporates and real wage dynamics were the main reasons for the better performance. Inflation slowed more than expected in the first half of November. The main IPCA-15 mid-month consumer price inflation index rose 0.57% m-o-m vs. 0.65% expected. Brazil's recent rate hikes and intervention to stabilise the currency via a USD 60bn swap line have helped to tame inflation rates. A few months ago inflation was threatening the top of the central bank's band of 6.5% y-o-y but is now tracking 5.79% y-o-y.

Finally, among the most imbalanced EM countries we note the following developments:

- **Argentina:** President Kirchner announced a major cabinet reshuffle, which saw Chaco governor Jorge Capitanich take over the post of Cabinet Chief, vice-minister of finance Axel Kicillof take over the post of Finance Minister, former finance minister Hernan Lorenzino will be Argentina's new EU ambassador with special responsibility as chief debt negotiator, while Commerce Secretary Guillermo Moreno will be sent to Italy as a diplomatic representative. Finally, Juan Carlos Fabrega replaces Mercedes Marco del Pont as central bank chief. These changes in the economic team do not signify much, in our view. Kicillof was already the driving force on economic policy, while Lorenzino retains the role as debt handler. The central bank has no de facto independence, so the net changes are the rise of Capitanich and the decline of Moreno. In net terms, these are modest moves in a more moderate direction.
- **Venezuela:** By contrast, in Venezuela President Nicholas Maduro increased the power vested in his person when he won decree powers on economic matters ahead of upcoming local elections. On one hand, it gives more powers for him to deliver the much needed Venezuelan Bolivar Fuerte devaluation and tight fiscal policy, but on the other, Maduro can now change labour laws, taxation, and approve nationalisations. Polls show that 72% of Venezuelans think the economy is a problem. Inflation is running close to 54% and shortages of goods and Dollars are rife.

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Global backdrop

The global backdrop continues to be dominated by central bank policy, notably in the US. Stronger than expected US retail sales took the current pace of US Q4 growth to about 1.6%, while the FOMC minutes were deemed to be less dovish than expected, thus keeping the issue of tapering firmly at the top of the list of global market drivers. Bill Dudley, a key FOMC member with a clear dovish tilt and close ties with Fed Chairman Bernanke also made upbeat comments about the US economy. We think the FOMC minutes have to be discounted somewhat because they reflect the views of all FOMC members, while key decisions are arguably taken by a smaller nucleus of members. Nevertheless, the issue of tapering is not going away, because the rationale for scaling back asset purchases – fear of financial sector bubbles and the economic consequences when they collapse – has not gone away. But the FOMC does not yet seem to have reached agreement on how to anchor interest rate expectations once tapering starts. Indeed, Fed Chairman Bernanke spent considerable time last week reiterating that tapering is not the same as rate hikes, a statement the market completely ignored when he first made this point in May.

The real challenge is not how to anchor the short end but how to anchor long rates. With verbal guidance in tatters after Bernanke's bruising treatment at the hands of the bond market over the summer, we believe the Fed's only tools for managing the long end are QE itself and twist operations. But the room to twist is narrow and if QE is to be scaled back it is hard to see how the Fed can prevent another sell-off in long rates. The Fed was, after all, the only buyer of US treasuries in net terms in Q2. Volatility in US long rates could soon make a return.

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