Ashmore

Brazil votes for continuity, but change is coming

By Jan Dehn

Brazil's voters return Dilma to power, but it is unlikely that her second term will be anything like the first as the limitations to current policies have been reached. Exit polls suggest a near-optimal election outcome in Ukraine's parliamentary elections. Uruguay appears to be heading for a second-round run-off on 30 November in an election that is likely to put sensible people in power regardless of who wins. Tunisia takes a big step forward towards institutionalising democracy in the tricky aftermath of a long period of authoritarian rule. Jokowi appoints a technocratic cabinet as his government prepares to maximise its influence despite a weak position in parliament. Argentina tapped markets for almost USD 1bn in a first Dollar-linked bond, while sentiment in Venezuela continues to erode faster than the quality of the credit. China's demand-side continues to soften gently, while the supply-side of the economy is doing better than expected.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	984	–	0.28%
MSCI EM Small Cap	1,024	–	-0.17%
MSCI FM	671	–	0.27%
GBI EM GD	6.46%	–	0.07%
ELMI+	3.19%	–	-0.18%
EMBI GD	5.28%	298 bps	0.17%
EMBI GD IG	4.34%	200 bps	-0.12%
EMBI GD HY	7.44%	534 bps	0.72%
CEMBI BD	5.19%	316 bps	0.23%
CEMBI BD HG	4.29%	224 bps	0.01%
CEMBI BD HY	7.19%	520 bps	0.69%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1965	3.20%
VIX Index	16.11	-13.25%
5 year UST	1.51%	10 bps
10 year UST	2.28%	9 bps
US HY	6.20%	0.87%
European HY	5.23%	0.97%
EURUSD	1.2690	-0.83%
USDJPY	107.80	0.92%
Brent	84.97	0.82%
Copper	311.41	1.32%
Gold	1230.97	-1.14%

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

Emerging Markets

- **Brazil:** President Dilma Rousseff was re-elected with approximately 52 per cent of eligible votes versus 48 per cent for opposition challenger Aecio Neves. A Dilma win has more or less been priced in over the last few weeks as her polls began to show a consistent lead over Neves. What is next? The economic policies adopted by finance minister Guido Mantega have significantly undermined business confidence in Brazil over the last couple of years in response to which the government has stepped up public spending orders to sustain an ever-weakening economic momentum against a backdrop of a weaker currency, widening external balances, and stubbornly high inflation. For example, the current account deficit in September rose to USD 7.9bn compared to USD 7.0bn expected (and USD 2.8bn in the same month last year). The twelve-month deficit is 3.7% of GDP of which now only about 80% is financed by FDI inflows (down from 120% in 2012). This testifies to the 'stagflationary' conditions that prevail in the country. The one bright spot has been very low unemployment, though this has partly been achieved on the back of a declining participation rate. Given this vantage point, the newly re-elected Dilma administration has little choice but to make changes, in our view. We expect a new and more market-friendly economic team as Mantega is replaced. We also expect fiscal measures to be implemented in order to reverse the on-going deterioration in the public finances and to avoid a sovereign downgrade. We expect Dilma's administration to have a weak position in congress and for her second term to become increasingly dogged by scandal. We expect no major economic reforms. Changes in the economic team and a fiscal adjustment should ensure – after a couple of quarters of recession – a return to growth of around 2-3% in real terms. Brazil is a large and important EM country, but Brazil's chosen path is not representative of the direction of travel of many other EM countries. Within Latin America, for example, countries such as Colombia, Peru, Chile, and Mexico have opted for reform-led prudent policies, while the administrations in power in Argentina and Venezuela have pursued populist policies that are far more extreme than anything we are likely to see in Brazil. EM is a hugely diverse universe, not just globally, but also within each region.
- **Ukraine:** Exit polls show that President Poroshenko and Prime Minister Yatsenyuk plus their allies secured more than two thirds of the votes in the parliamentary elections that were held in Ukraine over the weekend. The result, if confirmed, is extremely positive for several reasons. Most importantly, the outcome gives a strong mandate for further reform and eventual EU accession. This should in turn make the EU inclined to extend further financing towards Ukraine following November's IMF review. Secondly, the outcome would be a strong

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Emerging Markets

endorsement of Poroshenko's plan for a negotiated settlement of the conflict in Eastern Ukraine and will likely ease the passage of possible constitutional changes to grant greater autonomy for the region. Poroshenko's block secured 23 per cent of the votes, while Yatsenyuk captured 21 per cent, according to Reuters. The Selfhelp party, a pro-EU movement allied with Poroshenko, secured 13 per cent of the vote. Occupied areas in Eastern Ukraine and Crimea did not vote in the election.

- Uruguay: At the time of writing, exit polls suggest that the election in Uruguay will go to a second round on 30 November. Exit polls show a first round lead for Tabare Vazquez, a former president aligned with current President Mujica, who cannot seek re-election on constitutional grounds. However, Vazquez's first-round lead is not large enough to prevent a run-off against centre-right challenger Luis Lacalle Pou. The market has paid little attention to this election, because both sides are likely to pursue market friendly policies, though we think a Lacalle government could prove more dynamic by virtue of being newly restored to power. The Broad Front of left-leaning parties backing Vazquez has been in power since 2005.

- Tunisia: Parliamentary elections took place in Tunisia over the weekend, which are likely to see moderate religious party Ennahda and the secular alliance Nidaa Tounes gaining the most seats. The successful conduct of elections is extremely important in countries that have recently escaped dictatorship. The tendency has been for most countries with long histories of dictatorships to go through a difficult transition to democratic politics due to an entrenched culture of zero-sum politics. Most of the North African countries caught up in the Arab Spring thus continue to experience transitional challenges, even reversals to dictatorship, such as in Egypt, but Tunisia has so far been the exception. Each successful experience with democratic elections is likely to further institutionalise consensus politics and thus remove the country further from reverting to the dictatorships of old.

- Indonesia: President Jokowi appointed a cabinet of technocrats following his inauguration last week. Former minister in charge of state-owned enterprises Sofyan Djalil was appointed coordinating minister for economics, while Bambang Brodjonegoro was appointed Vice Finance Minister to run the finance ministry. Jokowi's grip in parliament is tenuous, so he will likely pursue changes in economic policy that do not require major legislative changes. The good news is that the scope for implementing such measures, including all-important reductions in energy subsidy policies in order to increase infrastructure spending, is considerable. The appointment of a technocratic cabinet suggests that Jokowi will indeed go down this road.

- Argentina: The government successfully auctioned USD 983m of US Dollar-linked bonds. The deal size was increased from an anticipated USD 500m and demand was 2.4 times the eventual supply. The bond has a 1.75% coupon and 2-year maturity. The Dollar-linked bond issue shows that Argentina can raise financing despite defaulting on its New York law bonds (due to a ruling by a New York court that bars payment agents from processing coupon payments).

- Venezuela: Sentiment continues to remain weaker than justified by fundamentals. Venezuela has strong incentives to continue to pay. Foremost among these are the large US dollar working capital requirements of PDVSA. Without access to Dollars, oil production would soon cease and the government would be in deep trouble. In addition, the government has begun to scale back a hugely expensive program of giving huge volumes of virtually free oil to Cuba and other regional allies. Venezuela has also obtained flexibility in the payment terms of a large program of supply to China. Taking into account other potential measures such as cuts in imports, domestic fuel price hikes, and asset sales in addition to devaluation we think Venezuela can and will pay with relative ease at current oil prices.

- China: China's gradually decelerating economy continues to confound doomsday predictions of a hard landing. Q3 real GDP growth at 7.3% was 0.1% faster than expected, while industrial production rose 8% yoy in September compared to 7.5% yoy expected and 6.9% in August. HSBC's manufacturing PMI also rose to 50.4 in October, a better print than in September (50.2). Thus, the supply-side of the economy looks solid. It is the demand side of the economic growth, which is currently gently softening. This is mainly due to China's liberalisation of interest rates, a gradual strengthening currency, and the uncertainty caused by on-going reforms intended to convert China into a more domestic demand-led economy. Retail sales, while still strong, thus rose 11.6% yoy in September compared to 11.7% expected, while fixed asset investment rose 16.1% yoy, which was 0.2% yoy shy of expectations.

Snippets:

- Mexico: Real supply-side GDP growth in August slowed to a yoy pace of 1.9% from 2.4% in July (working day adjusted). However, the demand-side continues to improve. Retail sales rose for the third consecutive month (0.6% mom sa, or 4.4% yoy).

- South Korea: Real GDP accelerated in Q3 to 0.9% qoq sa from 0.5% qoq sa in Q2. This means that the economy is now expanding at a yoy pace of 3.2% in real terms. The sequential pick-up in the pace of growth suggests that rate cuts and stimulus measures by the government are working. Exports expanded 3.9% yoy in the first twenty days of October, which is a good result given solid gains of 9.5% yoy of growth in September.

- Taiwan: Taiwanese manufacturing – a bellweather for Asian trade more generally – rose smartly at a 10.3% yoy pace in September. The consensus was for exports to rise only 6.8% yoy.

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Global backdrop

The ECB's asset quality review and stress test of European banks showed that about one fifth of European banks are either directly or borderline at risk of insolvency if macroeconomic conditions become more challenging (i.e. Europe falls into a deep recession). Southern Europe continues to face the greatest challenges. This is despite zero risk ratings for large parts of the balance sheet exposures of the banks. For example, a Wall Street Journal article recently made clear that several Southern European countries have recently passed legislation that converts deferred tax assets into deferred tax credits, a legal trick that improves banks' capital positions since tax credits count towards capital but tax assets do not.[1] Besides, Europe's banks remain inefficient with huge reliance on interbank credit lines. A weakly capitalised and inefficient banking system subject to material systemic risk can do little to improve the efficiency of monetary policy, including QE. This underscores the risk facing the Eurozone economies as the US slowly moves towards interest rate increases: heavily indebted, Europe will struggle to generate inflation to help keep real rates low. The resulting rise in real rates raises the spectre of a future European debt crisis caused by increases in US rates. The silver-lining is that these stress tests further deepen integration of the Eurozone member states – the fact that the stress tests have been undertaken by the ECB marks a de facto transfer of banking supervision from entirely discredited national regulators within member states to a central, transnational institution. In another positive development, flash PMIs for the Eurozone rose a modest 0.2 to 52.2, which was far better than the expectation of a 0.5 decline. The ECB began buying covered bonds in line with prior announcements, but there was no official confirmation of the timing and size of rumoured potential future corporate bond and government bond purchases by the ECB.

Brent oil prices stabilised to around USD 85 per barrel as Saudi Arabia announced cuts in daily production of 328K barrels. WTI is trading roughly USD 5 per barrel lower. Oil markets are rife with speculation about the cause of a recent sharp fall in oil prices. We think the main reason is a perceived drop in demand caused by speculation about slower European, Chinese, and US growth going forward. Many of these perceptions have been based on a few releases of high frequency data points that point to slower growth, but we doubt that underlying trend growth rates have actually changed materially. Even so, this does not mean that oil reverts to previous levels soon. What is more likely to happen is that oil trades in these new lower ranges for some time until inventories decline sufficiently to cause perceived demand to be revised higher again.

US data is always important for EM. The latest data releases suggest a slight moderation in the pace of growth, while five-year inflation break-evens remain extremely depressed at 1.5% (well below the Fed's inflation target). Among the more important data releases in the past week we highlight:

- US CPI inflation was 1.7% yoy in September, down from 2.1% in May.
- New home sales in the US came in line with expectations at 467,000 in September, but sales in August and July were revised substantially lower from 504,000 to 466,000 and from 427,000 to 404,000, respectively. The revisions suggest that sales of US single-family homes is still running at less than half of the pace that prevailed from 2000-2008.
- Existing home sales recovered after a weak August to reach a run-rate of 5.2m on a Seasonally Adjusted Annual Rate (SAAR) basis, which is slightly below the post 2008/2009 peak. In contrast to new home sales, existing home sales are higher than before the 2008/2009 US sub-prime crisis.
- Markit's manufacturing PMI declined to a still-solid 56.2 in October from 57.9 in September. We note in passing that cycles in PMIs occur regardless of the underlying trend rate of growth, which remains about 2%.

Looking ahead, the focus in likely to be on Wednesday's FOMC statement plus the first advance release of Q3 GDP growth. The Fed is likely to formally end asset purchases, but to maintain interest rates unchanged for a "considerable period". There will be no update of the "dots" at this meeting, that is, the FOMC member's individual forecasts for the timing and size of interest rate changes. The gulf between the 'dots' and the market's expectations of rate hikes has become a chasm following a collapse in inflation expectations and fears of slower growth, partly due to the sharply rising Dollar between July and September. The Dollar has since weakened marginally.

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[1] http://online.wsj.com/articles/ecb-should-stop-southern-european-games-with-bank-capital-heard-on-the-street-1413198242

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.0%	0.5%	-1.9%	4.1%	3.2%
MSCI EM Small Cap	-3.6%	4.4%	1.6%	6.8%	5.1%
MSCI FM	-4.2%	17.3%	22.3%	15.7%	7.2%
S&P 500	-0.29%	8.03%	14.45%	18.65%	15.09%
GBI EM GD	1.77%	1.76%	-4.05%	1.55%	4.15%
ELMI+	-0.01%	-1.72%	-3.69%	-0.08%	0.51%
EM spot FX	-0.07%	-5.64%	-9.53%	NA	NA
EMBI GD	1.21%	9.34%	7.70%	7.41%	8.07%
EMBI GD IG	1.94%	10.10%	7.69%	5.99%	7.04%
EMBI GD HY	-0.14%	7.96%	7.91%	9.76%	9.68%
5 year UST	1.46%	3.52%	1.92%	1.57%	3.70%
7 year UST	1.90%	6.45%	3.42%	2.52%	5.25%
10 year UST	2.28%	10.52%	6.49%	3.71%	6.33%
CEMBI BD	0.76%	7.05%	6.89%	7.29%	7.40%
CEMBI BD HG	1.00%	7.86%	7.31%	6.70%	7.07%
CEMBI BD HY	0.28%	5.34%	6.04%	8.89%	8.45%
US HY	0.94%	4.72%	6.20%	10.29%	10.85%
European HY	-0.04%	4.86%	7.42%	15.20%	12.62%
Barclays Agg	0.94%	2.59%	0.65%	1.13%	2.79%

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

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