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WEEKLY INVESTOR RESEARCH

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Bigger is better

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New index changes proposed by JP Morgan for its suite of EM fixed income indices will favour larger issues and issuers. As such the index changes, if adopted, will make it easier for Wall Street banks to trade EM securities, but at the cost of smaller, less liquid issuers. We also discuss the implications for Brazil of S&P's negative outlook, Mexico's domestic demand, potential changes in the monetary policy framework in Turkey, subsidy changes in UAE and possible new Chinese money for Venezuela and Argentina. The global backdrop remains challenging for EM as US growth and employment costs continue to disappoint.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.8	–	-0.91%
MSCI EM Small Cap	19.7	–	-2.96%
MSCI Frontier	10.4	–	-1.31%
MSCI Asia	11.8	–	-1.71%
MSCI EMEA	12.3	–	0.47%
MSCI Latam	21.4	–	1.23%
GBI-EM-GD	6.72%	–	-0.35%
ELMI+	4.52%	–	-0.29%
EM FX spot	–	–	-0.30%
EMBI GD	5.80%	358 bps	0.39%
EMBI GD IG	4.55%	227 bps	0.48%
EMBI GD HY	7.94%	587 bps	0.27%
CEMBI BD	5.56%	358 bps	-0.18%
CEMBI BD HG	4.47%	247 bps	0.04%
CEMBI BD HY	7.68%	571 bps	-0.58%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.6	–	1.19%
2 year UST	0.69%	–	0.09%
5 year UST	1.56%	–	0.39%
10 year UST	2.20%	–	0.74%
30 year UST	2.91%	–	1.00%
US HY	7.13%	576	0.36%
European HY	4.59%	459	-0.28%
Barclays Ag	–	226	0.24%
VIX Index*	12.12	–	-1.62%
DXY Index*	97.36	–	0.86%
CRY Index*	202.57	–	-2.47%
EURUSD	1.0969	–	-1.29%
USDJPY	124.19	–	-0.79%
Brent	51.1	–	-4.43%
Gold spot	1094	–	-0.31%

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

Emerging Markets

- **Indices:** Bigger is better, according to new proposed changes to the JP Morgan (JPM) suite of Emerging Markets (EM) fixed income indices. A proposed minimum size criterion for index inclusion for local currency bonds and a new methodology for calculating country weights in the 'diversified' indices will end up assigning greater weights to the bigger, more liquid countries and bonds. This directly serves the interest of Wall Street market-makers, but does it benefit investors and issuers in the EM asset class? The implication for investors that manage to benchmarks could be that they are forced to concentrate yet more money into a still narrower set of securities and countries. For smaller issuers, it will prove harder to gain an institutional investor base if these proposals are adopted, in our view. A third proposed change – to include ratings agency, Fitch, alongside S&P and Moody's in the list of eligible ratings agencies for the purpose of classifying countries within JPM's range of indices – should be beneficial.

  Specifically:

  - A minimum USD 1bn notional issue size criterion will be applied to local currency bonds in the GBI EM index suite. JPM estimates that this change will have almost no impact on the current composition of the GBI indices (only one, Peruvian, bond is impacted). On the other hand, the minimum size criterion will become a new hurdle for countries seeking index inclusion. It does not replace JPM's subjective 'index replicability' criterion, which allows the investment bank to include or exclude countries solely based on its own assessment of liquidity. Moreover, it is not in the interest of bond holders that the minimum size for eligible local bonds will now be twice as large as that for global bonds (typically Euroclearable bonds issued off-shore in London or New York under English or NY law). This new restriction seems designed to serve the interests of Wall Street market-makers, who want only to trade the most liquid bonds. While the asset class continues to grow, end-investors will be forced into the ever narrower index universe (the GBI already excludes some 85% of local currency securities). As for issuers, the measure is particularly bad for many smaller EM markets which, by virtue of not being included in the index, will in effect be cut off from global finance. Ultimately, these index changes will not derail the development of the local bond asset class, however, so the longer term effect of these changes will be to undermine the relevance of the GBI EM range of indices as far as representativeness of EM local markets is concerned.

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Emerging Markets

- 'Diversified' now means less diversified. JPM's suite of 'diversified' indices currently cap the index weight of larger countries in order to broaden the index to include more countries by re-balancing weights across large and small issuers. The new proposals recommend that the methodology for calculating country weights be changed to give greater weight to the largest issuers in EM. For example, CEMBI BD weights will increase by 2%-3% for Brazil and China and 1%-2% change for Russia, while Mexico's weight would rise by 1%-2% for in the EMBI GD index, each at the expense of smaller countries. The GBI EM GD index would also give greater weight to bigger countries such as Indonesia, Colombia and Thailand. Other large countries such as Malaysia and South Africa are already at the 10% limit. Again, this may beneficial for market-makers in London and New York, but it will not serve the interests of the asset class going forward. Ultimately, investors who are unable to look beyond the indices when investing will have access to a narrower universe of opportunities, while issuers will now find it harder to gain an institutional investor base unless they are 'big'.
- Sovereign ratings for index purposes will be determined based on ratings of three ratings agencies instead of two. JPM proposes that Fitch be included alongside S&P and Moody's with the lower of two ratings being used if only two of the agencies rate the credit/issue in question. This is a progressive step, because it expands the rated universe of EM debt by some USD 15bn, according to JPM. However, JPM also estimates that some 3% of EM bonds across the EMBI and CEMBI universes will change from HY to IG and vice versa. For better or worse, mostly worse, credit rating today forms the basis for the global regulatory system. As such, the eligibility of Fitch ratings should be welcomed.

JPM's proposed changes have not yet been formally adopted, but chances are that they will be. They are usually discussed with investors through JPM's investment committee, although this committee only has advisory powers. Unlike many other index providers, such as MSCI and Bank of America Merrill Lynch, JPM insists that it alone will make final decisions regarding index rules. This increases the risk that the changes serve the interests of the bank rather than those of bond holders and issuers, or both. Changes are typically announced in accordance with a set of established procedures and usually well in advance to eliminate the possibility of market manipulation.

In other index news, Bank of America Merrill Lynch (BAML), another index provider, has decided to launch non-EM versions of its High Yield indices following recent volatility in Brazil and Russia. Existing indices that include EM names will not be terminated, however. Full details are likely to be announced in September. BAML's Global HY index includes about 18% EM names. Exclusion of some or all of these names could result in some selling, especially in Latin America, to the extent that investors opt to switch to non-EM versions of the indices. However, many investors are likely to prefer indices that include EM names, in our view. Dropping names after they have been through a period of volatility is also odd – after all, periods of volatility affect all markets. Typically, these periods present the biggest opportunities, especially in EM where volatility so often far exceeds risk. Besides, excluding EM issues will only make the indices narrower and therefore riskier. The effect will be limited due to the fact that BAML's indices are not the main indices followed by dedicated EM investors.

- **Brazil:** Following hot on the heels of the Brazilian government's softening of its fiscal targets last month, S&P last week placed Brazil's sovereign credit rating on negative outlook (S&P's current rating is BBB-, which is one notch above the minimum threshold for IG status). S&P's negative outlook brings it in line with those of Fitch and Moody's, which also have Brazil at two notches above sub-IG but with negative outlook (BBB and Baa2, respectively). Under the new index rules that are likely to prevail at the time of a possible downgrade from IG in 2016 – see previous section – an EM country is likely to have to be downgraded from IG status by at least two of the three large ratings agencies in order to exit the IG indices, while a downgrade from a single ratings agency is sufficient to downgrade the country in local currency space. Whether Brazil is now downgraded to sub-IG depends on the Brazilian government's ability to arrest the deterioration in the fiscal outlook. Recent numbers continue to be very weak. Hence, the softer pace of austerity recently adopted by the government – mainly in response to severe weakness in the real economy – is clearly pushing Brazil closer to losing its IG rating, but going forward much will depend on the trajectory for growth. Here, the outlook is not exactly stellar. A large corruption scandal is weighing on consumer and business sentiment and the central bank only last week raised rates yet another 50bps to 14.25%, although it signalled that it intends to hike no further from here.

Outright cuts in rates will likely depend on inflation, which we think will drop substantially over the next twelve months – with positive effects. Ultimately, the growth trajectory is now likely to be the main determinant of the outlook for the public finances. JPM estimates that IG-only passive investors own some USD 830m of Brazil sovereign foreign currency denominated bonds (out of a total stock of approximately USD 32bn). The equivalent number for Brazilian IG corporates is about USD 1.45bn out of a total corporate debt stock of about USD 142bn. Selling from passive local currency IG funds in the event of a loss of IG rating would be USD 1-1.5bn out of total foreign holdings of about USD 123bn. In other words, IG-only holdings are very small. Total foreign holdings, however, are significant. Foreigners own about USD 12bn of Brazil's foreign sovereign bonds and about USD 20bn of its foreign currency denominated corporate bonds. Hence, the initial impact of a downgrade on Brazil's spreads is likely to boil down to how the much larger universe of unconstrained investors behave. Net net, this means that Brazil is now vulnerable to speculative trading pressures. Indeed, the situation is a typical example

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of a country getting into some kind of trouble, which then leads to an excessive reaction on the part of investors. As always, this is highly inefficient and ultimately creates considerable value for those willing to undertake a sober analysis of the actual risks and step in to buy when prices overshoot. The latest example was in Russia in Q4 2014, where spreads dramatically 'overshot' in precisely this way, only to give way to the best performance of any bond market in the world in Q1 2015. Finally, we note that exclusion of Brazil from the main IG indices will likely lead to significant increases in index weights for other countries, including South Africa, Poland, Malaysia and Turkey in local currency indices, and China, Indonesia, Mexico, Philippines and Turkey in sovereign indices. In the corporate space, South Korea and UAE are likely to be the big beneficiaries.

- Mexico: The gradual firming in domestic demand continues. Credit to the private sector increased at a rate 7.0% yoy in June. This is a 50% increase in the pace of credit growth in June last year (4.7% yoy). The central bank left rates unchanged at 3.0%, but noted upside risks to inflation from continued MXN weakness. The Foreign Exchange Commission responded to currency weakness by stepping up daily USD sales to USD 200m (subject to 1% or greater daily move in MXN) and maintained the program until end-September.

- Turkey: Central Bank of Turkey Governor Erdem Basci conceded that the current heterodox framework for monetary policy in Turkey may have to change. This is positive, in our view, though we expect the high probability of an election will ensure that changes are going to be very small, at least to begin with. Basci has used volatility as a policy instrument in order not to have to raise interest rates (in support of President Erdogan's electoral ambitions). This policy has backfired. While it has deterred speculation in the currency, it did little to calm domestic credit growth or anchor inflation expectations.

- United Arab Emirates: The government announced that fuel prices will be linked to global prices as of 1 August. This is likely to have a significant positive effect on UAE's public finances. Fuel subsidies are currently about 5% of total government spending. This is a positive development, in our view, especially if similar policies are also adopted elsewhere in region.

- Venezuela: China renewed a USD 5bn credit line to Venezuela, according to the government. This shows that Venezuela continues to replenish its holdings of USD despite falling oil prices. Reserves rose by USD 1.3bn to USD 16.6trn last week due to the latest PetroCaribe deal (with Jamaica). Local media reported that the government is working on a strategy to buy back external debt in H2 2015. This would be intelligent, in our view. The debt is trading near recovery value, which means that the sovereign can make more money from buying back its debt at current prices than it lost in its recent PetroCaribe transactions (these involved early redemptions at significant discounts of obligations to Venezuela by other countries in the Caribbean basin).

- Argentina: Local media reports that the government is in talks with China for another USD 5bn in addition to the current USD 11bn currency swap program with China. The program now constitutes 24% of total reserves in Argentina. In other news, industrial production picked up for the first time in two years, rising 0.9% yoy in June versus -0.5% yoy expected. The economy has considerable upside potential, but elections, macroeconomic imbalances and the uncertainties around holdout investors will likely prevent a strong cyclical pick-up, in our view.

Snippets:

- Chile: Labour market numbers in June picked up for the first time since August last year suggesting that cyclical downturn in the country may be ending. Employment growth firmed to 1.5% yoy from 1.2% yoy in May.

- China: The official PMI for July was 50. This was slightly softer than both the survey (50.1) and the June print (50.2). The Caixan/Markit manufacturing PMI also declined to 47.8 in July, down from 49.4 in June. Further rate cuts and more fiscal stimulus are widely expected and, unlike most Western economies, China has more than adequate room to support growth should it prove necessary.

- Colombia: The central bank left rates unchanged at 4.5%, but Governor Uribe stated in the post-decision press conference that it was a split decision with some members of the committee willing to hike rates.

- Indonesia: inflation was unchanged at 7.3% yoy in July. Core inflation declined slightly and now sits at a very manageable 4.9% yoy.

- Russia: The Central Bank of Russia cut the policy rate by 50bps to 11%, but dropped its promise to cut more. Instead, the evolution of rates will now depend on the evolution of growth and inflation.

- South Korea: Industrial production bounced back strongly in June, up 2.3% yoy (-1.6% yoy in May). Part of the reason for the sharp recovery is the release of new automobile and smartphone models. Exports outperformed expectations by a factor of two in July, declining by 3.3% yoy versus -6.8% yoy expected. This pushed the current account surplus to USD 12.2bn versus a previous high of USD 8.7bn.

- Taiwan: Q2 2015 growth underwhelmed at 0.6% yoy, down from 3.4% yoy in Q1. Domestic demand was solid, but exports slowed significantly.

- Thailand: Headline inflation was -1.05% yoy in July, slightly lower than expected (-1.0%).

- Ukraine: The IMF confirmed President Poroshenko's statement from last week that it will disburse the next instalment of USD 1.7bn under the country's adjustment program.

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Global backdrop

Global financial markets continue to look more and more distorted by hyper-easy monetary policies in Western economies. QE is not only driving a misallocation of resources away from investment in the real economy in favour of financial markets, but it is also strongly encouraging those financial flows to be concentrated in the 'bubble markets' in developed economies. This sucks finance away from the healthier, EM part of the global economy, which is self-defeating for the global recovery. Risk aversion remained elevated on account of global growth fears. US treasury yields declined last week in response to a sharp downward revision in the employment cost index and weaker GDP growth.

Employment costs in the US increased by just 0.2% in Q2 compared to 0.6% expected. In particular, discretionary pay (bonuses, commissions, etc.) was much weaker than expected, while the increase in regular compensation was largely unchanged. The softer read on discretionary pay goes hand in hand with sluggish growth, which we attribute to sharp real exchange rate appreciation caused by a combination of USD strength, low investment rates and falling productivity growth rates.

New data shows that US real GDP growth was 2.3% qoq annualised in Q2, which can only be described as weak given the very soft print for Q1 (revised from -0.2% to +0.6% qoq annualised). The details of the GDP numbers were also discouraging. Inventories rose at an unsustainable rate in Q2, which bodes poorly for growth in coming quarters. Most analysts now have forecast for Q3 at between 2.0% and 2.5% qoq annualised and about 2% for the year as a whole. Growth in 2012-2014 was also revised down by 0.3% each year, which means that the average growth rate in the entire expansion phase has been just 2.1% per year, despite hyper-stimulatory policies.

The FOMC last week offered very few new insights into its plans for the timing the first rate hike of this cycle. The change in wording of the statement was extremely marginal; in effect the FOMC is firmly sat on the fence and merely shifted its weight from one buttock to the other! Crude oil prices continued to decline despite a larger than expected drawdown in inventories.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.88%	-4.03%	-13.09%	0.93%	0.91%
MSCI EM Small Cap	-7.71%	-0.05%	-7.92%	5.49%	2.25%
MSCI Frontier	-2.91%	-6.29%	-18.10%	11.30%	5.35%
MSCI Asia	-6.30%	-1.12%	-6.04%	6.56%	5.14%
MSCI EMEA	-4.65%	-0.75%	-15.97%	-3.22%	-1.19%
MSCI Latam	-8.35%	-14.08%	-30.37%	-10.88%	-7.88%
GBI EM GD	-2.56%	-7.32%	-16.68%	-5.31%	-0.65%
ELMI+	-2.50%	-3.69%	-11.65%	-3.05%	-1.38%
EM FX Spot	-3.29%	-10.04%	-21.04%	-10.00%	-7.21%
EMBI GD	0.49%	2.17%	0.60%	3.21%	6.01%
EMBI GD IG	0.39%	0.93%	2.25%	2.00%	5.26%
EMBI GD HY	0.64%	3.79%	-2.96%	5.12%	7.13%
CEMBI BD	-0.05%	3.66%	2.33%	4.40%	5.67%
CEMBI BD HG	0.29%	2.57%	3.29%	4.07%	5.65%
CEMBI BD HY	-0.65%	5.71%	0.11%	5.33%	5.86%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.10%	3.35%	11.20%	17.57%	16.22%
2 year UST	0.09%	0.59%	0.74%	0.42%	0.69%
5 year UST	0.60%	1.73%	3.10%	1.21%	1.94%
10 year UST	1.57%	1.72%	5.68%	1.16%	4.64%
30 year UST	4.43%	-1.10%	10.36%	0.85%	7.64%
US HY	-0.73%	2.01%	-0.16%	5.99%	8.11%
European HY	1.06%	3.46%	3.49%	11.14%	10.88%
Barclays Ag	0.83%	0.09%	2.36%	3.57%	4.77%
VIX Index*	0.00%	-36.88%	-28.83%	-22.51%	-46.44%
DXY Index*	0.02%	7.85%	19.75%	18.19%	20.80%
CRY Index*	0.00%	-11.91%	-30.74%	-32.63%	-26.77%
EURUSD	-0.14%	-9.35%	-18.25%	-11.45%	-17.08%
USDJPY	-0.24%	-3.50%	-17.47%	-36.81%	-30.93%
Brent	-2.13%	-10.87%	-51.26%	-53.09%	-38.20%
Gold spot	-0.16%	-7.91%	-15.04%	-31.77%	-7.84%

*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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