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WEEKLY INVESTOR RESEARCH

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A big week for central banks

By Jan Dehn

This was a big week for central banks. Brazil surprised the markets by hiking rates 25bps despite serious economic weakness and Russia jacked up rates by 150bps in a bid to keep inflation under control amidst continuing RUB weakness as attention now shifts to currency intervention measures. Both Brazil and Russia are dealing with self-inflicted problems. The Fed ended QE, which means that the Fed is no longer pro-actively easing policy, though tightening is not on the cards anytime soon. But the biggest event of the week was Bank of Japan's big QE bazooka, which fired in dramatic fashion in one of the most obvious manifestations to date that what developed market governments cannot fix by reform they aim to fix by devaluing their currencies and inflating away their debt. As for the rest of Emerging Markets (EM), they are largely passive observers of the printing frenzies orchestrated by the central banks in developed economies. The first order impact of easier monetary policies in Japan ought to be positive for asset prices, but markets are obsessed with zero-sum trades in the currency space. Thus expectations of ECB QE and Japan's latest monetary splurge could well set in motion another temporary surge in the USD versus both EUR and JPY that ultimately could also leave EM FX in its wake. Less myopic investors should look to such a development with relish for the opportunity it provides to protect the purchasing power of capital at more attractive entry points by adding to positions in EM local markets.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,011	–	3.38%
MSCI EM Small Cap	1,043	–	2.08%
MSCI FM	668	–	0.06%
GBI EM GD	6.41%	–	0.27%
ELMI+	3.36%	–	-0.28%
EMBI GD	5.22%	286 bps	0.40%
EMBI GD IG	4.29%	189 bps	0.06%
EMBI GD HY	7.16%	495 bps	1.06%
CEMBI BD	5.21%	308 bps	0.09%
CEMBI BD HG	4.30%	215 bps	-0.02%
CEMBI BD HY	7.19%	510 bps	0.32%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2018	2.89%
VIX Index	14.03	-12.53%
5 year UST	1.61%	12 bps
10 year UST	2.32%	6 bps
US HY	6.21%	0.02%
European HY	5.24%	-0.17%
EURUSD	1.2497	-1.61%
USDJPY	113.69	5.16%
Brent	85.38	0.92%
Copper	314.43	0.37%
Gold	1171.79	-4.68%

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

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- **Brazil:** The monetary policy rate setting committee of the Brazilian central bank (COPOM) raised rates by 25bps to 11.25% in a move that goes a long way towards restoring the credibility of monetary policy. Few things create as much respect for central banks as hiking into economic weakness. The move also supports the insight that inflation is 'worse than death' for most EM governments. This is the first major policy change since the re-election of President Dilma Rousseff. Attention is now turning to the question of who will become Brazil's next finance minister and what the government will do to remedy a growing fiscal problem. September's fiscal numbers were very poor with the deficit twice as wide as expected. The primary surplus on a 12 month basis is now just 0.61% of GDP versus the 1.9% primary surplus target defined in the Budget Law. Having acknowledged the impossibility of fulfilling the target, the government will now have to get a new budget approved in Congress for the 2013 budget (failures to meet targets have to be approved by Congress). President Dilma Rousseff will have few options but to change due to deep divisions in Congress after the recent election campaign, a large Petrobras scandal and very low poll ratings. Opposition party PSDB has sent a petition to the Electoral Court requesting an audit of the voting system, though the party is not questioning the final result or asking for a full recount of votes.
- **Russia:** The central bank hiked 150bps, taking the policy rate to 9.5%. The FX market was not hugely impressed, because USDRUB briefly fell, but then rose to higher levels than before the rate hike. This is telling price action. It suggests that Russian households may be getting concerned with the pace of RUB weakness and are converting their savings to Dollars. So far the Russian government has been happy to let the RUB weaken in line with oil prices – the chart below shows that the fall in oil has almost perfectly been offset by the fall in RUB. But when households begin to panic about the RUB then it matters very little that the Russian central bank offers 1.5% more in interest on an annual basis. Hence, FX policy may soon have to change. In fact, the only way to break the momentum of a budding currency crisis is to slam the market down with huge

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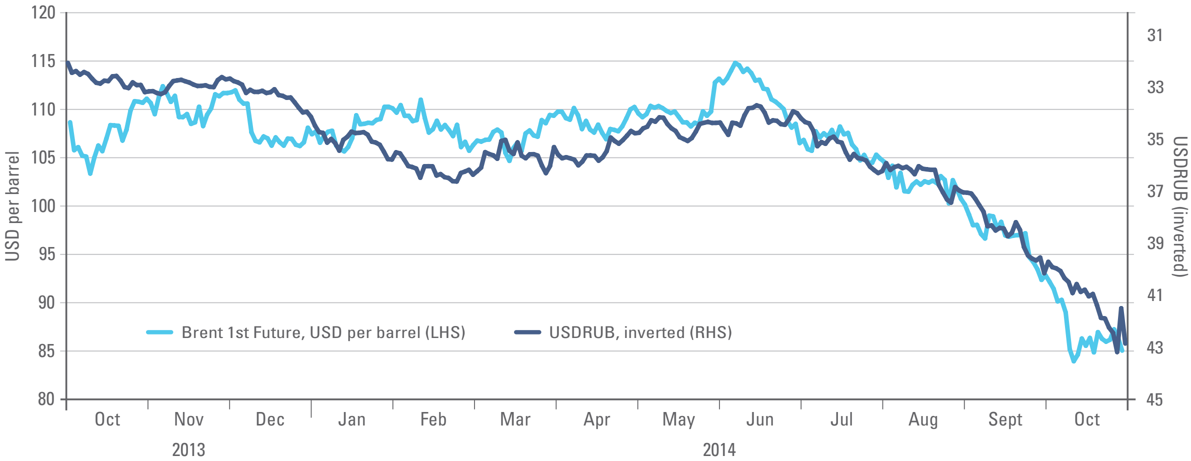
force. That moment may be drawing nearer. The good news is that Russia has a frightening monetary arsenal at its disposal. Russia's FX reserves stand at USD 439bn.

Fig 1: **USDRUB and oil**



Source: Ashmore, Bloomberg.

- **Ukraine:** The EU brokered an agreement between Russia and Ukraine that enables gas once more to flow to Ukraine. Under the agreement, Ukraine gets a USD 100 per 1000m^3 discount on the price of gas. Ukraine is also allowed to pay past-due bills in instalments between now and year-end. The EU and the IMF may disburse funds early to enable Ukraine to overcome the near-term cash flow challenges associated with the repayment of arrears. Going forward, Ukraine will have to pre-pay gas supplies. It is unclear if Russia was able to extract concessions regarding sanctions behind the scenes. In any case, the questions of sanctions may resurface following elections in Luhansk and Donetsk over the weekend. The elections were widely condemned by the West, but have received support from Russia.
- **Argentina:** As time passes without a resolution to the stand-off between US Law and Argentina over payments to holdout investors, more and more bonds issued under New York Law are drawn into default. Thus, on 30 October the grace period on various series of Par bonds expired, pushing these bonds into default. Par bonds have a low Dollar price, therefore they are more likely to be accelerated (acceleration requires 25% of holders and can be reversed if requested by 50% of holders). Acceleration would lump some exchange bond holders (a term used to refer to those holders of defaulted securities from 2001 who decided to accept new bonds in exchanges conducted in 2005 and 2010) together with holdout investors to create a larger group of holdouts. This would reduce the odds of existing holdout investors getting paid in full and reduce the odds of a quick deal in January once the so-called RUFO clause expires. However, holders of Par bonds may still have an incentive to accelerate, because the eventual recovery value on their bonds may well turn out to be higher than current prices (the various series of Par bonds trade in the mid-50s). Meanwhile, Argentina has activated its newly established swap line with China by drawing USD 814m worth of CNY in exchange for crediting China's central bank with the equivalent in Argentine pesos (the CNY can then be changed to USD in Hong Kong). The total size of the swap arrangement is the equivalent of USD 11bn. The terms for disbursement have not been made public, but reportedly each tranche must be agreed on a case by case basis.
- **China:** The big transformation of China from the world's leading exporter to a domestic demand-led economy received another boost this week, when the government introduced further measures specifically aimed to boost consumption. The measures include improved access to social security. This is critical in order to bring down China's high precautionary saving rates. There will also be measures aimed at improving income distribution and consumer protection. We think one of the most powerful drivers of consumption will be the development of the domestic bond market; wider access to government bonds for savers will stabilise savings and thus contribute to lower precautionary savings rates. Meanwhile, official PMI numbers declined marginally in October to 50.8 from 51.1 in September, while HSBC's PMI number was unchanged mom at 50.4. Services PMI declined marginally from 54 to 53.8. This suggests that parts of the supply-side in the Chinese economy are moderately slowing. We expect China's economy to continue to gradually slow, but we note that growth and PMI are two entirely different things.
- **Venezuela:** PDVSA, the national oil company, paid its 2014 bonds in full and on time. Given that the sovereign has also recently met its payments on a maturing 2014 bond, the country's amortisation and interest payment schedule now eases considerably. Specifically, debt service payments now drop below USD 1bn in November, then fall below USD 100m in December and January before rising to USD 770m in February. The next major amortisation payment is in fact not until Q4 2015, more than a year away. Meanwhile, technicals have improved sharply following selling by some investors who undoubtedly paid far too much attention to warnings of imminent default by very vocal but very poorly informed 'Venezuela watchers'.

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- **The Philippines:** The Philippines is the gift that keeps on giving. The latest present was in the shape of improving fiscal numbers. September's budget data shows that the fiscal deficit year to date is PHP 31bn, which is dramatically better than the PHP 101bn deficit recorded over the same period in 2013. The improvement is largely due to very strong receipts from both customs and tax revenues. The Philippines' strong public finances puts the country in a strong position to counter business cycle downturns with fiscal stimulus and should enable the government to make infrastructure investments in order to raise productivity levels. In Q3 2011, investors dumped Philippine bonds when Greece blew up in a typical 'rule of thumb' mindless dump of EM assets. Spreads widened from 160bps to nearly 300bps at the time. Today The Philippines has been upgraded to investment grade by all ratings agencies and trades at a spread of just 130bps. Greece has and never had any material economic connections with the Philippines. Congratulations to those who accepted then what the Philippines had to offer and what the country continues to offer – superior economic performance and rewards for investors.
- **South Korea:** Industrial production rose 1.9% yoy in September, a major improvement from August's -2.8% yoy rate. Manufacturing led the recovery. However, PMIs for October undid much of this improvement by falling marginally to 48.7 from 48.8 in September. The current account surplus widened to USD 7.6bn in September from USD 7.2bn in August. The year-to-date current account surplus now stands at USD 62bn, which is 11% higher than last year. Exports in October rose to the highest ever level of USD 51.8bn, which is 2.5% higher than at the same time last year. Korea's export performance is impressive, especially when viewed against the backdrop of deliberate currency manipulation by Japan. Korea, like most other EM countries, has recently experienced relief for consumer demand and the balance of payments due to declines in commodity prices. Korea's currency is likely to be under constant appreciation pressure versus the JPY, in our view.
- **Uruguay:** As suggested by exit polls (that we reported last week), Tabare Vazquez, candidate for the ruling Frente Amplio party, won the first round of the presidential election by securing 48% of the vote against National Party candidate Luis Lacalle Pou with 31%. Since no candidate secured 50% of the vote, Vazquez and Lacalle will now face off in a second round on 30 November. The result of the parliamentary vote was the Frente Amplio secured the majority of the seats in the Lower House. The Senate is finely balanced with 15 seats for Frente Amplio and 15 seats for the opposition. The result of the presidential election will therefore be important, because the vice president automatically becomes leader of the Senate. President Mujica leaves office on 1 March 2015.
- **Thailand:** Both exports and imports rose strongly in September. Exports were up 3.2% yoy, while imports rose a massive 14.4% yoy. Both sets of numbers handsomely beat expectations. This points to higher overall levels of economic activity. The decline in oil prices will help to prevent any serious deterioration in the trade balance in Thailand, in our view. Oil accounts for more than 8% of Thailand's imports.
- **Indonesia:** Core inflation declined marginally to 4.02% in September versus 4.04% in August. The broadly benign domestic inflation outlook in Indonesia plus low oil prices constitute an optimal constellation for the new government to slash energy subsidies. We expect the first of the subsidy cuts to be implemented in the course of this month.
- **India:** HSBC's PMI for October rose to 51.6 from 51 in September. India is experiencing a gentle economic upswing, which is likely to get stronger in the next 12 months of the back of rising investment, lower oil prices, and rising agricultural output. As the economy picks up we expect the Modi administration to get more aggressive on reforms.
- **Zambia:** President Michael Sata died last week after a period of illness. Chief of the ruling PF party, Edgar Lungu, has been appointed acting president pending elections to be held within 90 days. Zambia has one of the longest and strongest records of democracy in Africa. We see no reason to believe that the transition will pose challenges.

- **Reforms:** The World Bank's *"Doing Business 2015"* report – a document that monitors reforms and ranks countries according to their business friendliness – identified nine EM economies among the 10 top reformers in the world. Tajikistan, Benin, Togo, Ivory Coast, Senegal, Trinidad and Tobago, Congo Democratic Republic, Azerbaijan, and UAE occupied 9 of the 10 top positions among countries that had enacted three or more reforms in 2013/14. The only developed country to make the top-10 was Ireland. A popular (mis)perception is that EM countries do not reform, when in fact EM countries are not only regular reformers but tend to do so aggressively. Having said that, the record of reform within EM is far from uniform. Some countries, such as China, are positively addicted to reform, while others, such as Argentina and Venezuela, wouldn't know a reform if it hit them in the face. Developed economies typically only reform at gun point, such as the periphery of Europe was forced to do during the European debt crisis. As Japan showed clearly during the past week, developed economies tend to deal with their deeper structural challenges by increasing public spending and/or printing money.

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Snippets:

- **Taiwan:** Real GDP expanded 3.8% in Q3 with a significant acceleration in fixed capital formation and strong consumption.
- **Ghana:** Standard & Poor's, the ratings agency, downgraded Ghana's sovereign debt rating to B-. While Ghana's economy and public finances are challenged, the downgrade is somewhat late, because Ghana's fundamentals may arguably bottomed out already. Ghana has general difficulties containing wage costs and has one of the most vicious political business cycles in the world.
- **Mexico:** The trade balance posted a larger than expected surplus in September of USD 590m. Mexico's trade balance this year is nearly twice as good as last year (USD 1.8bn vs USD 3.0bn January to September). Mexico's trade balance has steadily improved since 2009.

Trivia:

- **Why does the Chinese currency have two names, Yuan and Renminbi?**

In fact, the Chinese currency does not have two names. The name of the currency is Renminbi, while Yuan is the denomination unit. Thus, you call the currency Renminbi, but you don't spend, say, 5 Renminbi. You spend 5 yuan. In English, we do not make this distinction between the name of the currency and the denomination unit (i.e. we spend "a Dollar", and the name of the currency is the "Dollar"). In Mandarin, there is separate name for the currency and the units in which it is denominated.

Global backdrop

The FOMC confirmed widely held expectations by ending asset purchases and promising to keep rates low for a 'considerable' time. In addition, the FOMC noted improving labour markets and declining inflation expectations in recognition that recent employment data has been solid and breakeven inflation expectations have fallen sharply. There is no expectation that the Fed will actually tighten policy (quantitatively or qualitatively) anytime soon. Still, on balance, the market interpreted the FOMC statement as hawkish. What, then, does this mean for the global backdrop for EM investors?

Firstly, between now and the next FOMC, when the Fed is next expected to adjust its forecast for policy rates the market will have to contend with a mildly hawkish tilt.

Thus, if US growth and inflation fail to pick up significantly in the near-term the Fed looks too aggressive, which can render the US stock market vulnerable. After all, US stocks recovered from their October sell-off mainly because market expectations of Fed hikes were pushed to the very back-end of 2015.

On the other hand, if the US data does pick up, the long-end of the curve looks quite vulnerable. The term premium for 10yr US treasury bonds is negative, which means that investors are paying for the right to be invested in higher beta 10yr bonds, when they could just roll much lower beta shorter rate positions. This state of affairs reflects (a) that the Fed has removed a lot of duration from the market via QE; (b) lingering uncertainty about the economic future, which gives Treasuries a certain hedging value if, as happened in October, stocks collapse; and (c) low inflation expectations. We think inflation risks rise materially as we head toward 2016 due to tighter labour markets, lower negative home equity, and falling debt to income ratios for US households. Since the Fed is unlikely to be able to tighten monetary policy very quickly, long duration positions remain very risky, in our view. And the risk will only rise over time.

As for the US data, it remains distinctly mixed. Initial claims were in line with expectations. Consumer confidence rose strongly on the back of lower oil prices. But the Case-Schiller 20-city house price index declined for the fourth month in a row and durable goods spending was notably weaker in September. ISM services and pending home sales also slowed, but Chicago PMI rose strongly. The big headline number last week was Q3 GDP, which came stronger than expected at 3.5% qoq annualised, but this was entirely due to a surge in defence spending. Government spending is hardly the stuff that exit velocities are made of. Indeed, private sector consumer spending softened from 2.5% qoq annualised in Q2 to 1.8% in Q3 (versus 1.9% expected). September's real personal consumption expenditure declined in real terms by 0.2%. Q4 growth now looks to be tracking 2.5% qoq annualised. Hence, the GDP growth trajectory in the US is now: 4.2% in Q2, 3.5% in Q3 (2.8% net of defence spending), and now 2.2 for Q4. If growth continues to decelerate this way and inflation expectations remain subdued (1.58% for 5 year breakeven) then Fed hikes in Q1 2015 look increasingly inconsistent with the fundamental outlook.

Even so, concerns about a mismatch between the Fed's hiking ambitions and the US economy's ability to handle financial tightening have become less immediate following news that GPIF, the enormous Japanese government pension fund, is said to be about to increase its holdings of foreign and domestic equities at the expense of its holding of JGBs. GPIF's reduction in JGB holdings will not destabilise the local bond market, because Bank of Japan (BOJ) announced last week major additional JGB purchases via more QE (in other

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Global backdrop

words, BOJ is paying for bonds by printing money). The positive net foreign asset purchases will increase the flow into long USDJPY positions. The resulting JPY weakness will help Japan export at the expense of other countries, though the official pretext for the move was weakness in real household spending and slowing core CPI inflation, not a desire to engage in competitive devaluations.

What does more QE from Japan do for EM? The first order impact should be positive, because monetary easing always helps asset prices, everywhere. On the other hand, markets are obsessed with G3 currencies – US Dollar, Euro, and the Japanese yen – so the risk is that 'momentum jockeys' in their excitement to go long Dollars against JPY and EUR simply leave EM FX in their wake. But EM is very much a neutral bystander in the G3 printing party, so we expect the impact on EM FX to be modest. Short-term momentum aside, EM central banks are not printing and the purchasing power of capital is therefore far better protected in EM currencies than in any of the G3 currencies, in our view.

The main lesson from Japan, however, is that the general direction of travel in heavily indebted developed countries is towards ever more desperate measures to create inflation and currency weakness. Yet, most of the problems in Japan and other developed economies are structural in nature...debt, lack of reform and demographics. These problems do not get solved by super-easy monetary policy. At best, super-easy monetary policy provides an enabling environment in which to undertake reforms. Sadly, reforms are not taking place.

Amidst the Japanese fireworks, Europe took a backseat: Banks eased lending conditions in Q3 but the pace of easing slowed compared to Q2 as the announcement effect from targeted LTROs began to fade. Overall lending standards remain very tight, reflecting the fact that the Eurozone's largely insolvent banking system is beset with huge systemic risks due to high levels of financial interdependence and a dysfunctional ABS market (preventing banks from originating small SME loans). The ECB announced that its purchases of ABS will begin in November. On the other hand, the bear sentiment about European growth may have been overstated recently. German labour market numbers were significantly stronger than expected in October as unemployment dropped by 22K, while retail sales continue to rise on a yoy basis. These data are inconsistent with a big downshift in German and European growth as predicted in many quarters following recent weakness in industrial production (which may be due to summer holiday effects). Our view is that Europe and global growth dynamics have changed far less than implied by sentiment.

Emerging Markets	Year to date	1 year	3 years	5 years
MSCI EM	3.8%	1.0%	3.6%	5.0%
MSCI EM Small Cap	5.7%	3.4%	6.0%	6.5%
MSCI FM	16.5%	21.1%	15.1%	8.1%
S&P 500	10.99%	17.26%	19.74%	16.67%
GBI EM GD	1.56%	-2.68%	0.90%	4.55%
ELMI+	-2.18%	-3.64%	-0.55%	0.79%
EM spot FX	-6.02%	-9.00%	NA	NA
EMBI GD	9.87%	8.55%	7.01%	8.36%
EMBI GD IG	10.16%	8.18%	5.57%	7.12%
EMBI GD HY	9.40%	9.43%	9.46%	10.29%
5 year UST	3.05%	1.36%	1.16%	3.43%
7 year UST	5.86%	3.09%	1.98%	4.91%
10 year UST	9.88%	6.23%	3.08%	5.99%
CEMBI BD	7.21%	6.92%	6.76%	7.45%
CEMBI BD HG	7.88%	7.27%	6.30%	7.07%
CEMBI BD HY	5.76%	6.17%	8.07%	8.63%
US HY	4.66%	5.91%	9.64%	10.90%
European HY	4.76%	6.77%	13.96%	12.66%
Barclays Agg	1.65%	0.22%	0.72%	2.59%

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

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