Yemen and the new political reality in the Middle East

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A coalition of Arab states attacked Yemen and oil prices rose. We put developments in Yemen in their broader context to explain why they are not going to have a lasting impact on either Saudi Arabia or oil prices. Brazil tapers its swap program. China takes yet another step towards capital account liberalisation and Australia, Russia, Netherlands and Denmark apply to join the AIIB as founder members. The results of Nigeria's election should be become clear in the course of this week, and we anticipate a return of 'Eurofudge' in negotiating Greek reforms.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	967	–	-0.81%
MSCI EM Small Cap	1,024	–	0.34%
MSCI FM	581	–	-1.46%
GBI EM GD	6.32%	–	-0.81%
EM FX spot	–	–	-0.60%
ELMI+	4.85%	–	-0.06%
EMBI GD	5.58%	361 bps	0.23%
EMBI GD IG	4.27%	227 bps	0.26%
EMBI GD HY	8.39%	653 bps	0.19%
CEMBI BD	5.42%	363 bps	0.17%
CEMBI BD HG	4.30%	250 bps	0.05%
CEMBI BD HY	7.96%	619 bps	0.44%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2061	-2.02%
VIX Index	15.07	12.38%
5 year UST	1.43%	4 bps
7 year UST	1.76%	5 bps
10 year UST	1.96%	5 bps
US HY	6.70%	0.21%
European HY	4.59%	0.16%
EURUSD	1.0845	-0.80%
USDJPY	119.71	-0.06%
Brent	55.79	-0.13%
Copper	277.35	-3.45%
Gold	1187.30	-0.08%

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

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- **Yemen:** Yemen has once again grabbed the headlines as Saudi Arabia and a coalition of nine other states began a military campaign against the Houthi rebels, including air strikes and blockades on the Yemeni coast.

What should investors make of this development? While the Yemeni situation has caused some volatility in the Saudi Arabian local stock market we think investors should look through the noise. Saudi Arabia's ability both to pay and to fight is strong and formidable and its oil fields are not close to Yemen. The Saudi Arabian economy is solid. Even the recent decline in reserves of USD 20bn has to be seen in the context of Saudi Arabia's enormous stock of reserves (in excess of USD 700bn) and is in any case explained in part by one-off factors. The situation in Yemen should also not have a sustained impact on oil prices. What matters far more to the price of oil is that the oil rig count in the US is now down 45% since oil prices began to decline last year and we think the impact of this reduction will see oil average around USD 60 per barrel for 2015.

All facets of the Yemeni conflict are consistent with the new political reality in the Middle East according to which revolutionaries aim to take over individual Arab states, starting with the weakest and most dysfunctional (hence their focus on Iraq, Afghanistan, Libya, Syria and now Yemen). Yemen is an extremely unstable country with a long history of deep internal divisions along Sunni and Shia lines. The state is weak, the country is very poor and it has been subjected to numerous foreign interventions into its domestic affairs, going back decades. The trigger for this most recent episode of unrest was the take-over in September 2014 of Sanaa, the Yemeni capital, by the Houthis, an armed Shia political movement, which has since gone on to consolidate its control of the country. Allegations are rife that Iran supports the Houthis, though the Houthis officially deny this. The allegations are based on observations of senior Houthi figures in Iran's holy city of Qom and unconfirmed reports of Iranian pilots flying Yemeni planes. To complicate matters further, Al Qaeda in the Arabian Peninsula (AQAP), which is Yemen's powerful Al Qaeda affiliate, along with Islamic State, a Sunni extremist group, have capitalised on the political chaos to carry out their own attacks.

So, is Yemen important? In theory, Yemen could become the battleground for a proxy war between Iran and Saudi Arabia. There is a precedent: in the 1960s Yemen became an ideological battleground for the pan-Arab nationalist vision of President Gamal Abdel Nasser of Egypt. There are some geo-strategic considerations too. The Bab al-Mandab strait, a 20 mile wide corridor which is one of the world's most significant trade routes – offering access to the Red Sea and the Suez Canal – is important to maintain global trade flows. Iran sees Yemen as an opportunity to partially encircle the oil-rich kingdom, since Yemen is in Saudi Arabia's backyard.

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In practice, however, developments in Yemen are unlikely to pose a genuine threat to the stability of the Arabian Peninsula as a whole, in our view. Several factors speak in support of this view. Firstly, Riyadh would not allow control of Yemen to fall into Iranian hands. King Salman of Saudi Arabia, who only took over in January, will want to show resolve and steadfast decision-making. Secondly, other Gulf Arab states, except Oman, also see Yemen is an opportunity to show strength and unity as they also see Iran as a possible threat to their own stability. Thirdly, developments in Yemen will only pose a threat if Iran's involvement is stepped up significantly. To this end, US foreign policy in the region, which is perceived by most Arab countries as one of apathy, could actually be helpful, particularly if the ongoing negotiations with Iran result in some leverage over Iranian involvement in Yemen. Most Gulf States, however, are prepared to act on their own as they see American disengagement as problematic, because it creates a vacuum, which is being filled by Islamic State and other extremist elements.

- Brazil: Brazil has begun to 'taper' its FX swap program, initially by capping its size at USD 113bn (equivalent to 30% of Brazil's FX reserves). The effect of this change in policy is to make the Brazilian Real (BRL) more flow dependent. This is good news at the margin, because adjustment of the currency is part of Brazil's economic medicine following the poor policies of former Finance Minister, Guido Mantega. February's current account balance surprised on the upside, so the weaker currency may already be having an effect. The swap program works as follows: The central bank sells USD and buys BRL forward (i.e. settlement at a future date). At the expiry of the swap contract there is a cash settlement in BRL representing the difference between the swap rate and the fixing. Thus, the swap program works exactly the same way as selling USD in the market except that it compresses the forward points, which makes it cheaper for hedgers to buy USD futures to hedge their exposures (which is precisely what the central bank wanted to achieve with the programme). The central bank will not unwind the swap program, but they are no longer offering new contracts. Expiring contracts will be rolled if there is demand. Approximately USD 10bn expires every month. If the central bank opts not to roll the swaps that expire then it is the equivalent of buying USD as hedgers will have to buy USD to keep the same position. The program is no longer being increased as it is large enough to provide the hedges demanded by local corporates and fund managers. A more laissez-faire approach to the currency is part of the ongoing macroeconomic adjustment. BRL will now trade with a higher beta – as indeed it always has under conditions with fewer interventions.

In other news, President Dilma Rousseff has replaced Mantega as Chairman of Petrobras, the scandal-ridden state oil company, whose ratings outlook was downgraded to negative from stable by ratings agency, S&P. Petrobras' new chairman on an interim basis is Luciano Coutinho, former president of state bank BNDES and a long-serving ally of both former president Lula and President Dilma Rousseff. It has been reported that Murilo Ferreira, current CEO of Brazilian mining company, Vale, will be appointed as the permanent new Chairman on April 29. Meanwhile, Brazil's resilient labour market is finally beginning to crack. Unemployment rose to 5.9% in February from 5.3% in January. Ultimately, Brazil's inflation problem will be solved by squeezing the labour market using a combination of fiscal and monetary policy instruments. Productivity enhancing reforms, sadly, are not on the agenda. Hence, there will be a political price to pay: Rousseff's approval rating has now hit a new low of just 18.9%, according to a poll from local polling firm, MDA.

Brazil's economy expanded 0.1% in 2014, according to new data released by the government. GDP growth was revised up in 2012 and 2013 to 1.8% from 1.0% and to 2.7% from 2.5%, respectively. These revisions resulted in a decline in Brazil's total debt to GDP from 63.5% to 58.9% in 2014. Brazil, like many other Emerging Markets (EM) countries, frequently experiences significant upwards revisions to GDP when benchmark weights are revised, because the structures of their economies changes rapidly, while benchmark revisions only occur a larger time intervals.

- China: The China Securities Regulatory Commission took yet another step to liberalise China's capital account by permitting domestic fund managers to invest in Hong Kong stocks via the Shanghai-Hong Kong Stock Connect. In the past only equity asset managers with Qualified Domestic Institutional Investor (QDII) approval were allowed to invest abroad. Chinese onshore equity funds manage about RMB 1.3trn of assets.

China's manufacturing PMI softened to 49.2 in March. Much of the manufacturing sector is export oriented and facing significant headwinds from the Chinese Renminbi's relative strength and the ongoing interest rate liberalisation in China. However, we think this adjustment is a necessary part of turning China into a domestic demand-led growth economy and manufacturing weakness and even softer GDP growth should not be confused with a poor outlook for the economy over the medium and long term. Zhou Xiaochuan, governor of the PBOC, reiterated that China has room to ease policy if the economy softens more than expected.

In other news, Australian Prime Minister Tony Abbott said his country intends to join AIIB, a Chinese-led development bank to promote infrastructure investment in Asia. Australia joins a growing number of Western countries, including Britain, France and Germany, who have joined AIIB as founder members, against the wishes of the US. Over the weekend, Russia, Netherlands and Denmark also applied to become founder

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members. The conventional Bretton Woods institutions have had a near-monopoly on infrastructure funding in much of EM for the past half a century. Yet, growth in much of EM is severely constrained by a lack of infrastructure (a much more serious constraint to EM growth than, say, a stronger Dollar, portfolio outflows or falling commodity prices). China has a proven track record of delivering infrastructure projects, the required funding and the productive capacity to help to address these problems in Asia as well as the rest of EM. As such, the AIIB ought to be replicated for other EM regions. For a more detailed discussion of the role of infrastructure in EM please see *"Convergence, Global Imbalances and the Role of Infrastructure in EM",* Emerging View, June 2013.

- Nigeria: Nigeria's presidential election got underway at the weekend with voting taking place across the country both on Saturday and Sunday. Accompanied by the usual idiosyncratic irregularities and obstacles, results have begun to trickle in to the election commission, where they will be collated and a final result should be forthcoming sometime this week. For further details, please see *"Nigeria: After the election",* Market Commentary, March 2015. In other news, the central bank left rates unchanged at 13%. Nigeria has not completed its adjustment to lower oil prices, but we expect more decisive adjustment when the election process has finally been completed.

Snippets:

- Mexico: Inflation surprised to the downside at 0.18% in the first half of March versus 0.25% expected. Like in other EM countries, the evidence of pass-through from weaker currencies to inflation is non-existent. This is due to credible monetary policies and more diverse economies that allow importers to switch to domestically produced goods when import costs rise.

- The Philippines: The central bank left rates unchanged at 4.0%. The Philippines, like several other EM countries, is experiencing 'goldilocks' moments of strong growth and declining inflation.

- Argentina: US District Court Judge, Thomas Griesa, banned Euroclear from aiding in the payment of coupons on exchange bonds issued under local law. Other local law bonds that were not issued as part of the 2001 and 2005 exchanges have so far not been affected by Griesa's rulings. Imports contracted 25% yoy in February. The decline in imports, which is due to import controls and weak domestic demand, has helped to keep the current account in surplus. For more details on Argentina's outlook please see *"A New Argentina",* Emerging View, March 2015.

- Venezuela: President Maduro's approval rating rose a few points to 25%, according to a new poll from Datanalysis, a credible pollster. Maduro faces voters in December parliamentary election, where his coalition looks set to lose his majority. However, Maduro has a trump card. He recently passed measures that allow him to rule by decree. These powers may come in handy if voters do not understand what is required of them.

- Pakistan: Moody's, the ratings agency, raised the outlook on Pakistan's sovereign debt rating from stable to positive. Pakistan is rated Caa1 by Moody's.

- Ukraine: Moody's lowered Ukraine's long-term foreign currency credit rating to Caa3.

- Hungary: The monetary policy committee cut interest rates by 15bps to 1.95% as inflation continues to decline. The central bank sees headline inflation at 0% this year.

- Peru: The central bank eased credit conditions by lowering reserve requirements from 8% to 7.5%.

Global backdrop

The main change in the global environment was a spike in oil prices due to the situation in Yemen. As for Europe, Japan and the US the big picture is largely unchanged. European economic data continues to perform better than expected. Lending to households and businesses rose strongly in February on the back of QE from the ECB as well as a dramatic decline in borrowing costs for governments. For example, 30 year German bonds now pay just 63bps in yield, while Italian 10 year bonds yield 1.36%. Japan has receded from investors' radar screens due to lack of catalysts, though we note that CPI inflation in that country is now back to zero and industrial production declined 3.4% in February. Imports rose strongly at the same time, so net exports will produce a major drag on growth in Q1. Turning to the US, dovish comments from Fed Chairwoman Janet Yellen suggest that the likelihood of draconian tightening of monetary policy is extremely remote. The US data itself is mixed. Q4 2014 growth was revised down from 2.4% to 2.2%, while weak durables led most banks to revise down their forecast for Q1 2015 growth down to close to 1%. Services PMI and manufacturing PMI were both marginally stronger than expected and US home sales also accelerated. US CPI was broadly in line with expectations. Manufacturing surveys were mixed and consumer confidence rose marginally in March compared to February.

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This week will be another important one for 'Eurofudge', that is, the amazing capacity of European politicians to hammer out compromises from seemingly mutually irreconcilable positions. The challenge of the week will be Greece's reform package, whose reception among the Eurogroup members will go a long way to determining whether Greece is heading for a Euro exit or will stay within the European family of nations. Our money is on another victory for 'Eurofudge'. In the US, the main focus will be payrolls, which will be released on Good Friday (3 April).

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.09%	0.48%	1.02%	-0.36%	2.09%
MSCI EM Small Cap	-1.43%	2.25%	1.35%	2.94%	2.99%
MSCI FM	-2.86%	-4.09%	-4.16%	10.07%	4.57%
S&P 500	-1.93%	0.60%	13.75%	15.87%	14.42%
GBI EM GD	-2.80%	-3.79%	-9.98%	-3.95%	1.06%
ELMI+	-0.43%	-2.24%	-9.08%	-3.41%	-0.93%
EM spot FX	-2.52%	-6.02%	-17.52%	NA	NA
EMBI GD	0.11%	1.90%	5.71%	5.23%	7.11%
EMBI GD IG	0.31%	2.42%	8.66%	4.87%	6.65%
EMBI GD HY	-0.25%	0.96%	0.58%	5.84%	7.79%
5 year UST	0.58%	1.60%	4.23%	1.69%	3.72%
7 year UST	0.67%	2.10%	6.90%	2.66%	5.58%
10 year UST	0.73%	2.59%	10.12%	4.39%	7.42%
CEMBI BD	0.37%	2.21%	4.56%	5.26%	6.20%
CEMBI BD HG	0.24%	2.22%	6.42%	5.56%	6.49%
CEMBI BD HY	0.64%	2.18%	0.74%	4.85%	5.72%
US HY	-0.72%	2.28%	1.33%	7.42%	8.93%
European HY	0.05%	3.33%	5.61%	12.22%	11.37%
Barclays Agg	-0.55%	-1.51%	-3.39%	0.00%	2.48%

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

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