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Cold Turkey

By Jan Dehn

Turkey votes for pluralism over single strong leader. The PRI receives a rebuke from voters in Mexico, but the coalition holds on. Brazil's Petrobras comes to market with a 100 year bond nearly four times oversubscribed. JP Morgan extends Index Watch for Nigeria's local bonds. China launches a market for certificates of deposit to link policy rates more directly to deposit rates. Romania's anti-corruption agency bares its teeth. India's Rajan cuts one last time and places the ball in the government's court. The RUB reacts strongly to the central bank's announcement that it will build reserves. Meanwhile, a strong US payrolls print pushes bond yields higher in developed economies.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	14.0	–	-2.08%
MSCI EM Small Cap	21.7	–	-2.20%
MSCI Frontier	11.1	–	1.58%
MSCI Asia	12.9	–	-1.76%
MSCI EMEA	12.9	–	-3.45%
MSCI Latam	22.1	–	-0.52%
GBI-EM-GD	6.78%	–	-2.13%
ELMI+	4.52%	–	-1.11%
EM FX spot	–	–	-1.23%
EMBI GD	5.70%	326 bps	-1.17%
EMBI GD IG	4.49%	199 bps	-1.53%
EMBI GD HY	7.83%	553 bps	-0.64%
CEMBI BD	5.39%	319 bps	-0.63%
CEMBI BD HG	4.33%	212 bps	-0.70%
CEMBI BD HY	7.40%	520 bps	-0.49%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.5	–	-0.65%
2 year UST	0.72%	–	-0.11%
5 year UST	1.74%	–	-0.53%
7 year UST	2.39%	–	-1.14%
10 year UST	3.10%	–	-2.22%
US HY	6.63%	514	-0.69%
European HY	4.34%	425	-0.56%
Barclays Ag	–	439	-1.25%
VIX Index*	14.21	–	0.37%
DXY Index*	96.24	–	-1.15%
CRY Index*	222.53	–	-0.65%
EURUSD	1.113	–	1.93%
USDJPY	125.4	–	-0.42%
Brent	63.03	–	-2.85%
Gold spot	1173.63	–	-1.47%

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

Emerging Markets

- **Turkey:** Turkish voters decided that a single party majority government in Turkey under a powerful President Erdogan with executive powers was not their cup of tea, at least not now. Erdogan's ruling AK party obtained only 41% of the votes, or 258 seats in parliament, which is too few even for a simple majority (276 seats). The big winners were the nationalist right-wing MHP, which collected more than 16% of the votes and 81 seats in parliament and the Kurdish HDP, which secured nearly 13% of the votes and 79 seats in parliament. The Republican Peoples Party (CHP) secured 132 seats. The outcome effectively ends President Erdogan's dreams of an executive presidency and shifts power back to the Prime Minister, who will be most closely involved in forming and maintaining a working coalition, unless the AK party wants to try to go it alone with a minority administration. The outcome increases odds of another election soon and reduces the likelihood that the package of economic reforms the government has been promising in the past 12 months will be enacted. As such, this election outcome may be good news for democracy in Turkey, but it will be received with scepticism by febrile investors. Borsa Istanbul, Turkey's main stock exchange, opened down 8.2% on 8 June, while USDTRY rose to 2.77 (from 2.66). In response, the central bank this morning took steps to increase access to USD liquidity by cutting USD interbank deposit rates to 3.5% from 4.0% and EUR interbank deposit rates to 1.5% from 2.0%. Official final results will take a few days, but the political landscape could remain unclear for some time. Prime Minister Ahmet Davutoglu, or another person chosen by President Erdogan, will then be asked to form a new government, which must be put before a confidence vote in parliament within 45 days. Between now and then, let the political horse-trading begin!

- **Mexico:** Preliminary results from the Mexican mid-term elections show that the PRI-led coalition has increased its slim majority due to a strong performance from the Greens, a coalition partner. PRI candidates for the states of Queretaro and Nuevo Leon were defeated by National Coalition Party (PAN) and independent candidates, respectively. Net-net, the result does not change the political outlook in Mexico very much, but it does send a warning to the PRI to improve the quality of governance.

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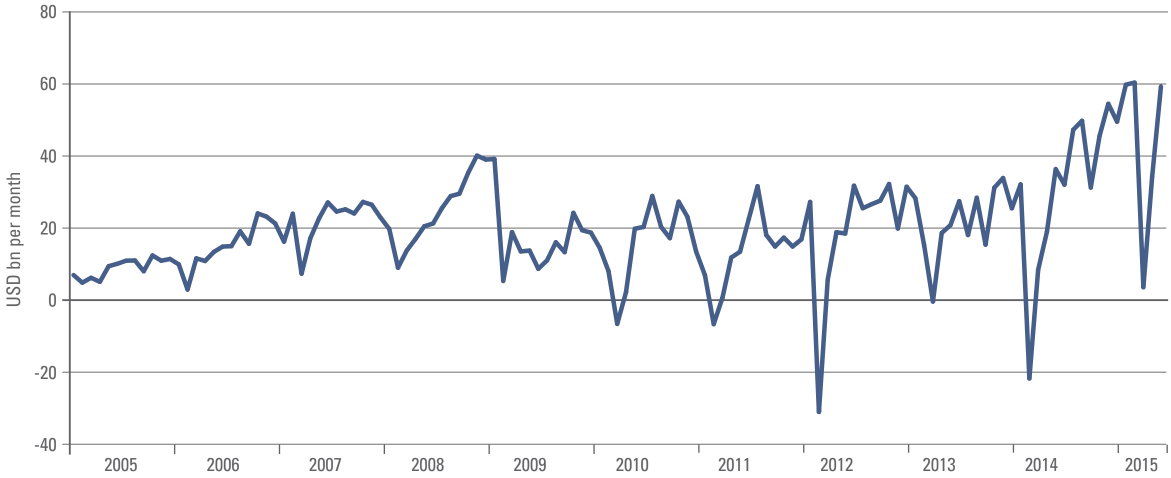
Emerging Markets

- **Brazil:** Petrobras' successful issue of USD 2.5bn of 100 year bonds at a yield of 8.45% – which is 0.4% lower than guidance – was a powerful suggestion that investors see value in Brazil, despite recent difficulties. Demand for the bond exceeded USD 7bn. The central bank raised policy rates by 50bps to 13.75%. This means that the hiking cycle has now reached 650bps. There was no change in the statement. The Brazilian central bank is clawing back credibility, aided by explicit support from the finance minister.For more details on the outlook for Brazil please see *"Brazil's slow rise from the ashes",* The Emerging View, June 2015.

- **Nigeria:** JP Morgan's investment bank arm has extended the index watch for Nigeria's local bond markets in the GBI-EM indices until the end of the year. JP Morgan put Nigeria on index watch – meaning that the country could be dropped from the index – last year due to measures taken by the outgoing Nigerian government that JP Morgan thought would impede investors' ability to replicate index positions. In fact, local bond indices typically replicate Emerging Markets (EM) local markets particularly badly. Only 16 EM countries are represented, partly due to the index providers' lack of local market making capabilities in most EM countries (by contrast the index covering USD-denominated government bonds that are traded in New York and London covers 63 countries). If Nigeria was to be dropped from the index, the GBI-EM would capture fewer than 10% of EM countries. Our expectation is that the new Nigerian government will gradually address the issues that have prompted JP Morgan to place Nigeria on index watch.

- **China:** In yet another step on China's rapid journey towards capital account liberalisation, the PBOC announced a new certificate of deposit (CD) scheme under which banks and cooperatives can issue large CDs with up to nine different maturities (1 month to 5 years). In a further step towards capital account liberalisation, the onshore repo market will also be opened to offshore financial institutions. The new CD market will be important as collateral in repo transactions and will trade with both fixed and floating rates, benchmarked to the Shanghai Interbank Offered Rate (SHIBOR). SHIBOR is also the benchmark money market rate. The CD market marks a big step towards removal of the cap on deposit rates and directly links deposit rates with money market rates. As such, this particular liberalisation plays a critical role in the transmission of monetary policy. As China turns to domestic demand led growth the temperature of the domestic economy will increasingly be regulated via interest rates, rather than exchange rates. This is why interest rates are being liberalised and why bond market development – notably the muni bond market – is so important. Higher consumption will also increase imports, so to finance the current account China is liberalising the capital account too. To ensure that financial flows into China are stable and long-term in nature, CNY will be made a global reserve currency in the near future. China's reforms are well-thought through and the timing is immaculate: central banks in the countries that today supply more than 95% of the world's reserve currencies are pursuing policies that will ultimately undermine their currencies, including zero interest rates, money printing, failing to deleverage and unwillingness to reform. In other news, HSBC's services PMI in May rose to 53.5 from 52.9 in April, while the trade surplus rose sharply to USD 59.5bn in May from USD 34.1bn in April. After a sharp dip in China's trade surplus in March due to season effects surrounding the Chinese New Year, the trade surplus is now back to near all-time highs. The main driver was weaker imports, though exports were also stronger than expected. Import demand is slowing as China liberalises interest rates and undertakes dramatic reforms of the capital account, local government and other sectors of the economy.

Fig 1: **Trade balance**



Source: Bloomberg.

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Emerging Markets

- Romania: DNA, a credible independent institution with a track record of exposing high level corruption, has accused Prime Minister Ponta of forgery, tax-fraud and money laundering. President Johannis has requested Ponta to resign, but he has refused on the grounds that he has a majority in parliament (parliament has to approve a prosecution request). The growing clout of anti-corruption organisations such as DNA is good news, because it holds out the hope for less impunity at the heart of government. Near-term, the issue will increase the level of uncertainty in Romania, but the country's economic and fiscal position remains solid.

- India: Raghuram Rajan, governor of the Reserve Bank of India (RBI), shut the door on further monetary policy easing after cutting rates 25bps to 7.25% last week. Further cuts are of course not impossible, but they would require a major shift in the outlook, in our view. Inflation expectations have converged to target and government-led investment is likely to trigger a cyclical upturn in the economy in the next 12 months. Besides, inflation risks are tilted marginally to the upside, albeit for temporary reasons (a delayed monsoon). Finally, Rajan is now passing the baton to the government after taking a risk by cutting pre-emptively last year in a bid to help the government through the challenges of passing reforms. Rajan's credibility is extremely high and he remains pivotal to maintaining investors' confidence in India.

- Russia: The central bank got a bit more than it bargained for when officials said last week that they want to rebuild reserves to USD 500bn (current reserves are USD 356bn). The market took this as a sign that central bank would aggressively buy Dollars resulting in a sharp rise in USDRUB from a 52 to a 56 handle. The sharp weakening of the RUB will probably result in marginally slower rate cuts in the coming months. Inflation has started to fall as the effect of the sharp RUB decline last year begins to ebb; in May inflation fell to 15.8% yoy from 16.4% yoy in April.

- Ukraine: The economy is beginning to show signs of improvement after a long and very deep slump. Reserves increased by USD 1.3bn last month to USD 9.9bn. This follows two consecutive months of current account surplus. Daily deposit withdrawal limits were also increased to UAH 300,000 from UAH 150,000. On the other hand, tensions escalated in Eastern Ukraine last week prompting EU officials to suggest that sanctions against Russia could be extended for another six months. President Poroshenko calmed tensions somewhat by stating that Ukraine is not yet ready for a referendum on NATO membership. In a more interesting twist, Poroshenko has appointed former Georgian president Mikheil Saakashvili governor of Odessa region.

Snippets:

- Dominican Republic: Parliament has approved a law that allowing President Medina to run for president again in 2016
- Ghana: The government will scrap its remaining fuel subsidies by September. This action is being taken to reduce government expenditure while at the same time encouraging supply.
- Indonesia: The government will raise its foreign currency borrowing from 20% to 30% of total gross borrowing this year, restricting supply of domestic paper.
- Ivory Coast: The IMF completed its seventh review and noted the country's strong performance, including an appropriate fiscal stance despite emerging budgetary pressures. The IMF disbursed USD 70m following the review.
- Malaysia: The trade surplus of MYR 6.89bn in April was higher than expected (MYR 6.0bn) – mainly due to lower imports.
- Poland: The central bank left rates unchanged at 1.5%.
- Thailand: Headline inflation was -1.3% yoy in May versus -1.1% yoy expected. Core inflation was also lower than expected at 0.9% yoy.
- The Philippines: Core CPI declined sharply to just 2.2% in May from 2.5% in April. Markets had expected core inflation of 2.4% yoy. Headline inflation declined to 1.6% in May from 2.2% yoy in April. The Philippines Misery Index – an index that sums inflation and unemployment – is at its lowest ever level.
- Uruguay: S&P, a ratings agency, raised the country's long-term sovereign credit rating from BBB- to BBB with stable outlook. The macroeconomic situation in Uruguay has actually stagnated in recent years due to lack of reform, but ratings agencies work in mysterious ways.
- Venezuela: Foreign exchange reserves reached a new low of USD 16.9bn last week before bouncing back marginally to USD 17.2bn. The continuing reluctance of the Maduro administration to reign in the demand for USD for imports following last year's fall in oil prices is draining the country's reserves. In 2002, the reserves briefly dipped below USD 10bn.

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Global backdrop

Developed bond markets had another bad week. 10 year US treasury yields rose 29 basis points to 2.41%, while German 10 year yields ended the week at 0.84%, up from 0.48% at the end of the previous week. A subtle change occurred towards the end of the week, when the US treasury market took over from the German bond market as the primary tormentor following the stronger than expected US payroll number. On one hand, the better US data was warmly received by the USD bullish crowd (i.e. global consensus), which has remained largely loyal to the ideas that (a) the US will recover faster that other developed countries and (b) the Fed will hike rates sooner and by more than other developed market central banks, despite weak US growth in Q1. On the other hand, stock markets ended on a weaker note after the stronger data. This tendency for the stock markets to react negatively to positive economic data is, of course, a familiar symptom of the sickness that has infected developed financial markets since the 08/09 crisis. The cause of the sickness is obvious – the marginal contribution of cheap money to valuations has been far greater than the contribution of recovery in the underlying economy. Hence, the prospect of tighter money, even when aided by better than expected economic news, rightly frightens the market. And it is very difficult to see how a normalisation of monetary policies in these countries – starting in the US and later bound to take hold in the other developed economies – can take place without inflicting enormous damage to valuations in developed markets. The fact that trend growth rates are miserably low and debt levels too high only complicates matters further. Governments have not done anything to complement the easing policies of their central banks. Hence, not only are financial markets now very sensitive to tighter financial conditions, but so are economies. Net-net, the 'fast money crowd' and banks will jump on the payroll number to help increase trading volumes, but the Fed and other developed market central banks will be more circumspect. William Dudley, President of the Federal Reserve Bank of New York, welcomed the stronger payroll number, but noted that falling productivity lies behind much of the labour market improvement. Lael Brainard, another influential Fed official, said that it is 'difficult to dismiss more significant drag on the economy' from 'foreign cross-currents'. The market overwhelmingly continues to expect a first hike from the Fed in September. If this is to happen, the FOMC will almost certainly have to make a signal to that effect in its next meeting on 16-17 June.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.08%	3.52%	-2.55%	6.31%	4.25%
MSCI EM Small Cap	-2.20%	10.98%	4.70%	11.39%	6.28%
MSCI Frontier	1.58%	-1.84%	-13.15%	13.68%	6.74%
MSCI Asia	-1.76%	7.58%	7.78%	12.76%	8.53%
MSCI EMEA	-3.45%	0.07%	-16.60%	0.21%	1.20%
MSCI Latam	-0.52%	-7.66%	-21.47%	-6.44%	-4.45%
GBI EM GD	-2.13%	-5.76%	-15.12%	-2.62%	1.21%
ELMI+	-1.11%	-1.84%	-10.14%	-1.48%	0.12%
EM FX Spot	-1.23%	-7.37%	-19.32%	N/A	N/A
EMBI GD	-1.17%	2.07%	1.48%	5.51%	7.27%
EMBI GD IG	-1.53%	0.87%	2.73%	4.28%	6.41%
EMBI GD HY	-0.64%	3.65%	-1.35%	7.45%	8.54%
CEMBI BD	-0.63%	3.99%	3.36%	6.01%	6.62%
CEMBI BD HG	-0.70%	2.51%	3.85%	5.42%	6.42%
CEMBI BD HY	-0.49%	6.78%	1.99%	7.48%	7.20%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.65%	2.56%	10.06%	20.17%	16.89%
2 year UST	-0.15%	0.69%	0.97%	0.54%	0.80%
5 year UST	-0.70%	1.08%	2.31%	0.86%	2.61%
7 year UST	-1.37%	0.35%	3.42%	0.88%	3.92%
10 year UST	-2.73%	-4.41%	4.40%	-0.29%	5.33%
US HY	-0.69%	3.46%	0.68%	8.17%	9.37%
European HY	-0.56%	3.58%	3.94%	12.84%	11.83%
Barclays Ag	-1.25%	-3.86%	-6.72%	-0.90%	2.33%
VIX Index*	2.67%	-25.99%	32.43%	-33.07%	-57.83%
DXY Index*	-0.69%	6.61%	19.69%	16.64%	8.87%
CRY Index*	-0.29%	-3.23%	-27.10%	-18.45%	-11.02%
EURUSD	1.31%	-8.02%	-18.08%	-11.08%	-7.03%
USDJPY	-1.00%	-4.43%	-18.24%	-36.61%	-27.15%
Brent	-3.86%	9.94%	-41.97%	-36.63%	-12.82%
Gold spot	-1.42%	-1.21%	-6.39%	-26.34%	-5.65%

*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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