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A more balanced outlook for Emerging Markets versus developed markets

By Jan Dehn

Developed markets (DM) benefitted from central bank buying and investors jumping on the bandwagon. No central banks bought Emerging Markets (EM). Asset prices in DM now look more vulnerable than EM asset prices that have priced in tightening since the Taper Tantrum of 2013. China's activity data turns up at the margin as inflation turns down. Momentum in favour of reform appears strong in Brazil's parliament. Peru's discriminating voters live up to expectations as they continue to erode Humala's approval ratings. There were no alliances between the candidates for president in Argentina and India's 'goldilocks' moment continues. Global market sentiment will focus on Greece and this week's FOMC meeting, where the Fed will likely signal whether it intends to hike in September or later.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	14.0	–	-0.22%
MSCI EM Small Cap	21.4	–	-1.10%
MSCI Frontier	11.1	–	0.14%
MSCI Asia	12.7	–	-0.91%
MSCI EMEA	13.3	–	1.38%
MSCI Latam	22.7	–	2.07%
GBI-EM-GD	6.81%	–	0.84%
ELMI+	4.49%	–	0.76%
EM FX spot	–	–	0.82%
EMBI GD	5.78%	338 bps	-0.52%
EMBI GD IG	4.56%	210 bps	-0.58%
EMBI GD HY	7.93%	566 bps	-0.43%
CEMBI BD	5.46%	328 bps	-0.26%
CEMBI BD HG	4.40%	222 bps	-0.34%
CEMBI BD HY	7.45%	528 bps	-0.12%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.5	–	0.12%
2 year UST	0.71%	–	-0.11%
5 year UST	1.71%	–	-0.29%
7 year UST	2.36%	–	-0.46%
10 year UST	3.08%	–	-0.68%
US HY	6.76%	525	-0.19%
European HY	4.47%	438	-0.42%
Barclays Ag	–	443	0.85%
VIX Index*	13.78	–	-0.43%
DXY Index*	95.19	–	-0.11%
CRY Index*	223.53	–	1.00%
EURUSD	1.1224	–	-0.08%
USDJPY	123.57	–	1.21%
Brent	63.1	–	0.67%
Gold spot	1174	–	0.15%

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

Emerging Markets

Developed markets have benefitted tremendously from buying by their central banks over the last few years. Investors have jumped on this bandwagon too. By contrast, no central banks bought EM assets. But this year something changed: the consensus of the past few years that said 'buy DM assets and sell EM assets' is now being challenged for the first time. It is not just that the Fed is preparing to raise interest rates. What has also challenged the consensus is that some DM valuations have begun to get seriously out of line with fundamentals. The strong USD is hurting the US economy. Zero yields at the long end of European yield curves make no sense. This suggests that DM will have more volatility, less upside, and less liquidity going forward. This does not affect EM directly, but it does point to a more balanced outlook for EM versus DM going forward. Indeed, so far this year EM corporate debt has strongly outperformed DM corporates and EM USD denominated sovereign debt has also outperformed sovereign bonds in DM.

Many investors are obviously very focused on the timing and effects of US rate hikes. What do we think and how will EM react? In our view, the Fed is desperate to hike as a way of showing that progress is being made on the long path towards normalisation. But the Fed faces many challenges in hiking. Inflation is still low. Growth has been weaker than expected. The economy remains heavily indebted and productivity is very low. But perhaps the greatest challenge is that asset prices in the US have benefitted far more from easy money than the economy, so the impact on financial markets could be severe. What this means is that if the Fed hikes at all it will hike very little, very slowly and over a long period of time. The impact on EM will be lessened by the fact that EM financial markets have spent the last couple of years pricing in financial tightening – going all the way back to the Taper Tantrum. Technicals are good and investors are underweight. Valuations are also reasonable, especially versus DM. Hence, we may get some volatility, but we do not think that anything the Fed does this year will pose a major threat to EM fundamentally.

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Emerging Markets

Looking further out, EM continues to offer a genuine investment proposition as opposed to opportunities to speculate about central bank asset purchases. That is, EM offers a chance to take exposure to countries and companies that are growing faster, experiencing rapid structural changes and, in many cases, are joining the global capital markets for the first time. EM countries' journeys through the various stages of development can be challenging, but ultimately rewarding. There are also some truly amazing credit stories playing out in EM today. None, of course, is greater than China. As China transitions from export to domestic demand-led growth the opening of its capital markets and the RMB's rise to global reserve currency status will change the world. China's bond and equities markets are equivalent in size to US GDP and the RMB will soon be in great demand as an alternative to conventional reserve currencies all of which are being printed ad nauseum to help developed economies get out of their debt problems. In this environment, however, the main challenge facing investors may be how to tear their eyes away from the speculative froth on display in developed markets.

- China: Industrial production is picking up. Production rose 6.1% yoy in May. Retail sales rose 10.1% yoy. Fixed asset investment expanded marginally less than expected (11.4% yoy versus 11.9% yoy). M0, the narrow money aggregate, increased only 1.8% yoywhich was below expectations, but M1 expanded 4.7% versus 4.0% expected. The broadest money aggregate, M2, expanded 10.8% yoy versus 10.4% expected. New loans and total social financing also rose more than expected (CNY 900bn vs CNY 850bn expected and CNY 1220bn versus CNY 1133bn expected, respectively). Hence, base money is being tightened consistent with interest rate liberalisation, but the banking system is still expanding lending. Overall, this constellation is likely to be viewed with satisfaction by the authorities. Inflation continues to fall in China. In May CPI rose just 1.2%, which means that central government 5 year bonds now once again pay marginally more than 200bps real yield as the People's Bank of China (PBOC) holds back on rate cuts amidst declining inflation (see chart below). In other news, the Ministry of Finance confirmed earlier reports that a second swap of CNY 1trn of local government loans into tradable benchmark bonds took place last week. These swaps are extremely sensible. In addition to extending maturity and assisting with refinancing, the bonds will eventually become an important mechanism for the PBOC to transmit monetary policy signals down to local level. With the completion of this swap, the total amount of local government bonds falling due in 2015 has now been rolled. Depending on how far the Ministry of Finance goes down the road of swaps the municipal bond market in China could eventually be larger than the total EM corporate USD denominated bond market. Finally, MSCI, the index provider, plans to include A-shares in its benchmark index once three remaining issues have been ironed out. MSCI and the Chinese Securities Regulatory Commission have already formed a working group specifically tasked to solve these issues, so index inclusion could happen as early as this year. We note that MSCI indicated that index inclusion, in this specific case, could take place between the usual scheduled meetings. The still unresolved issues include: (a) aligning quota sizes with fund manager AUMs; (b) improving daily liquidity, for example by converting QFII to RQFII; and (c) formal recognition of underlying ownership of assets managed by asset managers on behalf of large clients.

Fig 1: **5 year real central government bond yields**

Source: Bloomberg.

- Brazil: The Senate is expected shortly to vote on a bill that would strip Petrobras of its status of sole operator and compulsory stake holder in Brazil's enormous pre-salt oil fields. Progress through the Senate would have to be followed by passage in the Lower House too. This is worth paying close attention to. The measures in the bill would be extremely positive in bringing Petrobras on to a sustainable footing in the medium term and we do not believe that reform is priced in the market. Other steps will also be crucial, including allowing Petrobras to set fuel prices independently of the government and scrapping minimum local content laws. The momentum in Brazil's congress is currently very positive due to the dominant role of the Democratic Movement Party (PMDB).

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Emerging Markets

Another reform being discussed is the so-called CPMF tax – a tax on financial transactions that could raise as much as 1.1% GDP per year. In other news, the minutes from the last meeting of COPOM, the central bank committee responsible for setting monetary policy, were more hawkish than expected leading markets to price in further hikes. The COPOM minutes emphasised the need to restore the 4.5% inflation target. The most efficient way for the central banks to win back credibility after a period of ignominy is to hike during a period of economic weakness. At 8.5% yoy, inflation remains dramatically above the central bank's target of 4.5%, though much of the recent increase is due to the elimination of energy subsidies (one-off effects). In addition to sounding hawkish, the central bank also scaled down its swap program from USD 350m per day to USD 315m per day, taking the roll-over rate from 80% to 75%. This reduces support for the BRL. Finally, we highlight that the government last week launched a USD 64bn infrastructure investment program. About one third of the spending is scheduled for 2015-2018, the rest afterwards. Projects include railroads, ports and airports. A similar concession program failed to draw interest from the private sector in the past, but this time around the program will be more market friendly as the government cannot rely on BNDES, a state bank, to the same extent due to fiscal constraints. Infrastructure investments take time to implement and can be risky due to corruption and other issues, but addressing the problem of inadequate infrastructure is one of the most important reforms EM countries can do to stimulate growth.

- Peru: Peru is the only country in the world where a president – former President Alejandro Toledo – ruled a significant part of his term in office with a lower approval rating than the country's GDP growth rate. Peruvian voters are delightfully impatient with their politicians and political parties. Ollanta Humala, Peru's current president, is now experiencing this very Peruvian feature of politics as his approval rating has declined to just 16%. He has 13 months left in office and will not be eligible to seek re-election. It remains to be seen if he will break Toledo's record – we doubt it.

- Argentina: On 10 June, the political parties that intend to run in the forthcoming presidential election registered. Each of the three leading candidates – Scioli, Macri and Massa – registered under separate banners, thus ending feverish speculation about a possible alliance between Massa and Macri. The next important date is 20 June, when individuals have to register the specific posts they intend to run for. The focus here will be whether senior officials in the outgoing administration of Cristina Kirchner will be given important jobs in future administrations of either of the candidates challenging for the presidency. Meanwhile, a poll by Poliarquia, a credible pollster, shows Scioli with 34% of voting intensions versus 27% for Macri. For more details on the outlook for Argentina see *"A New Argentina",* The Emerging View, March 2015.

- India: India's 'goldilocks economy' continues. CPI came close to expectations at 5.0% yoy, while industrial production rose much more strongly than expected (+4.5% yoy versus +1.5% yoy). There were also upwards revisions of prior releases. The current account deficit also narrowed to just USD 1.3bn from USD 8.2bn in Q4 2014, mainly due to lower energy imports. The central bank recently indicated that it was done cutting rates on the view that government investment will pick up in the next 12 months.

Snippets:

- Chile: The central bank left rates unchanged at 3.0% with a neutral bias. Inflation has fallen from just below 6% in late 2014 to 4% yoy now. The central bank is targeting 3%.
- Colombia: Inflation was lower than expected in May (0.26% mom versus 0.33% mom expected).
- Hungary: Inflation rose more than expected in May. Prices were up 0.7% in the month versus just 0.2% expected, but the miss was due to volatile non-core elements. Czech inflation exceeded expectations for the same reason.
- Indonesia: The trade surplus was larger than expected in May at USD 955m (USD 661m was expected). Both imports and exports were significantly lower than expected.
- Peru: The policy rate at 3.25% was left unchanged by the central bank – this was in line with the consensus view. Inflation is stable at around 3%. The central bank's target is 2%.
- Thailand: Bank of Thailand left rates unchanged at 1.5%.
- Romania: Law makers in Romania refused to strip Prime Minister Ponta of his immunity despite allegations of corruption by DNA, an independent anti-corruption agency. The decision to let Ponta keep his immunity does not shield him from political fallout, however.
- South Korea: The Bank of Korea cut rates 25bps, but sent a hawkish message to markets. The rate cut was explicitly justified on the grounds of the ongoing MERS outbreak, i.e. tactical and temporary.
- The Philippines: Exports disappointed in April. Exports were down 4.1% yoy versus an expected increase of 8.0% yoy. The big miss was due to declining demand from Japan and Netherlands. Growth is mainly domestic demand driven in The Philippines, but at the margin the weak export print should shave some basis points off the growth rate.

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Global backdrop

The June FOMC meetings on 16-17 June will be the main driver of global sentiment this week. If the Fed is going to raise rates in September – which is the overwhelming consensus – then this is the time to flag it. Recent data releases have been supportive on the growth front, although they have not erased the negative growth print from Q1. Atlanta Fed's tracking of Q2 growth is currently pointing to an annualised rate of expansion in Q2 of 1.9%, or a little less than 0.5% in non-annualised terms. Growth needs to pick up very smartly in the rest of the year if 2015 is going to be the year that the elusive dream of 'exit velocity' is realised. There is still no resolution to the standoff between the Greek government and creditors, mainly other European countries. The IMF pulled out of talks last week and over the weekend the European Union and Greece failed to make progress in talks. An important Eurogroup meeting is scheduled for Thursday. The European Court of Justice also ruled that holders of defaulted Greek bonds from 2011 are free to launch lawsuits in pursuit of compensation. This suggests that Greece could face a long fight with holdout investors, not unlike the issues being experienced in Argentina. Aside from the juicy headlines, we think Greece is relatively uninteresting from an EM perspective – after all, it is just a developed country with an unsustainable debt burden within a Europe whose leaders lack the political courage to take control of the situation. Whatever the final outcome in Greece, it will have no fundamental impact on EM and it is interesting to monitor mainly for signs of what future reforms the European institutions might undertake to ensure there will be no future 'Greek tragedy'.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.30%	3.29%	-4.70%	5.12%	4.11%
MSCI EM Small Cap	-3.28%	9.75%	1.94%	9.96%	6.09%
MSCI Frontier	1.72%	-1.70%	-13.07%	14.04%	7.31%
MSCI Asia	-2.65%	6.60%	5.83%	11.09%	8.50%
MSCI EMEA	-2.12%	1.45%	-16.98%	-0.31%	1.40%
MSCI Latam	1.54%	-5.75%	-23.72%	-6.48%	-4.86%
GBI EM GD	-1.31%	-4.97%	-15.13%	-2.62%	1.11%
ELMI+	-0.35%	-1.10%	-9.84%	-1.41%	0.07%
EM FX Spot	-0.42%	-6.61%	-18.96%	N/A	N/A
EMBI GD	-1.68%	1.55%	0.77%	4.81%	7.06%
EMBI GD IG	-2.10%	0.29%	2.14%	3.61%	6.17%
EMBI GD HY	-1.07%	3.20%	-2.31%	6.72%	8.36%
CEMBI BD	-0.89%	3.72%	2.79%	5.72%	6.55%
CEMBI BD HG	-1.04%	2.16%	3.41%	5.17%	6.34%
CEMBI BD HY	-0.61%	6.66%	1.13%	7.08%	7.17%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.53%	2.68%	10.72%	19.02%	16.32%
2 year UST	-0.25%	0.58%	0.94%	0.52%	0.77%
5 year UST	-0.98%	0.79%	2.24%	0.78%	2.56%
7 year UST	-1.82%	-0.11%	3.14%	0.81%	3.84%
10 year UST	-3.39%	-5.06%	3.86%	-0.07%	5.21%
US HY	-0.88%	3.26%	0.17%	7.78%	9.46%
European HY	-0.97%	3.15%	2.93%	12.42%	11.93%
Barclays Ag	-0.41%	-3.05%	-6.11%	-0.52%	2.44%
VIX Index*	-0.43%	-28.23%	13.14%	-34.72%	-46.73%
DXY Index*	-1.78%	5.45%	18.13%	16.61%	10.70%
CRY Index*	0.16%	-2.80%	-27.89%	-17.89%	-15.17%
EURUSD	2.17%	-7.24%	-17.29%	-11.19%	-8.98%
USDJPY	0.47%	-3.02%	-17.58%	-36.29%	-26.04%
Brent	-3.74%	10.08%	-44.35%	-35.34%	-17.18%
Gold spot	-1.38%	-1.16%	-7.91%	-27.84%	-4.79%

*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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