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WEEKLY INVESTOR RESEARCH

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Turning the screw in Brazil

By Jan Dehn

Brazil's parliament approves more spending freezes and tax hikes to help bring the economy back to health. China announces another step forward in capital account liberalisation. Russia's economy weakens, but prices rather than quantities appear to be taking the brunt of the adjustment. Malaysia's inflation rate doubles in a month as GST takes effect. Ukraine's parliament votes to give the government the option of a moratorium as debt negotiations continue. Poland's new president sends a warning sign to the governing Civic Platform party ahead of parliamentary elections later this year. Away from Emerging Markets, Janet Yellen cheers on the US economy as she must, while Europe struggles with leftist populists in the south.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	14.8	–	-0.48%
MSCI EM Small Cap	23.0	–	0.02%
MSCI Frontier	11.1	–	-2.09%
MSCI Asia	13.5	–	0.64%
MSCI EMEA	13.8	–	-2.48%
MSCI Latam	23.8	–	-3.37%
GBI-EM-GD	6.52%	–	-1.29%
ELMI+	4.28%	–	-0.98%
EM FX spot	–	–	-1.32%
EMBI GD	5.46%	323 bps	0.16%
EMBI GD IG	4.26%	195 bps	0.23%
EMBI GD HY	7.64%	555 bps	0.06%
CEMBI BD	5.22%	321 bps	0.22%
CEMBI BD HG	4.21%	219 bps	0.14%
CEMBI BD HY	7.13%	515 bps	0.38%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.8	–	0.21%
2 year UST	0.63%	–	-0.06%
5 year UST	1.56%	–	0.02%
7 year UST	1.94%	–	0.26%
10 year UST	2.19%	–	0.92%
US HY	6.44%	513	0.04%
European HY	4.17%	416	0.18%
Barclays Ag	–	445	-1.19%
VIX Index*	12.13	–	-0.25%
DXY Index*	97.02	–	1.76%
CRY Index*	225.56	–	-5.89%
EURUSD	1.0893	–	-2.28%
USDJPY	122.75	–	-1.75%
Brent	65.0	–	1.55%
Gold spot	1196	–	-1.04%

*See last page for index definitions.

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

Emerging Markets

- **Brazil:** Finance Minister Joaquim Levy announced fresh cuts to public spending and new taxes in a bid to rectify the damage inflicted on the public finances and the wider economy by his predecessor, Guido Mantega. The new cuts bring the public spending freeze to more than USD 22bn (about 1% of GDP). While this is a meaningful amount – dwarfing the adjustment undertaken in the European periphery over the recent years, for example – local press reports over the weekend indicated that Levy would have preferred even greater cuts. Taxes will be raised by 5% to 20% on profits in financial institutions. The measures will be very negative for the economy in the short term, but Levy has few options on account of the high level of protection (so-called 'earmarking') afforded to many lines in the Brazilian budget. Despite the pain, these measures are extremely important and should help Brazil to avoid the loss of investment grade status and, far more importantly, enable the economy to stage a recovery toward the end of 2016. Meanwhile, inflation is still high, above the ceiling of the target mainly due to the impact of the removal of subsidies. May's IPCA-15 mid-month CPI index reading was slightly above expectations at 0.60% mom (8.24% yoy versus 8.22% mom in April). Central bank governor Alexandre Tombini's recent comments have been hawkish in nature, which points to further rate hikes despite economic weakness. This is how credibility is restored.

- **China:** One of the world's most important 'breaking news' stories – China's capital account liberalisation – is continuing apace. From July 1 this year, funds for sale in Hong Kong and mainland China will be available to investors in both territories. Initially, sales will be limited to USD 97bn, but this is likely to increase over time. Moreover, we think Chinese savers will eventually have access to investments from beyond Hong Kong, just as foreign investors will gain greater access to opportunities within China. Greater access to more diverse investment opportunities is key to raising consumption levels in China, where precautionary savings are among the highest in the world. One reason why savings are so high is that Chinese savers only have access to very few types of savings instruments. Two important missing components are bonds and foreign assets. The establishment of a mutual fund industry in China alongside the development of the domestic bond market and granting greater access for foreign funds addresses this problem. Mutual fund recognition may be followed by the Shenzen-Hong Kong

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Emerging Markets

Stock Connect, in our view. In other news, PMI improved marginally from 48.9 in April to 49.1 in May. Also, government officials confirmed China's intention to make the Renminbi a global reserve currency, but voiced uncertainty about whether this can be achieved this year or next. We believe the precise timing is largely immaterial; the destination is quite clear. We also believed a large team of financial sector specialists from the IMF are on hand to assist in achieving China's objective of including the Renminbi in the SDR basket.

- Russia: The economic fallout from the determined policy response to last year's triple-whammy of shocks (geopolitical, oil prices and sanctions) is now being felt. In last week's release of macroeconomic data, wages declined by 13.2% yoy versus -9.1% yoy expected, while retail sales also fell more than expected (-9.8% yoy versus -8.1% yoy anticipated). The good news was that both employment and investment held up better than expected. The unemployment rate was 5.8% versus 6.0% expected, while investment fell 4.8% yoy versus a decline of 6.6% expected. Industrial production was also down, but weakness was concentrated in manufacturing rather than mining and utilities. Defence spending also softened. The logical way to interpret this data is that prices in Russia's economy are quite flexible, so that the adjustment in domestic demand can occur via wages rather than just via large reductions in capacity utilisation on the supply side.

- Malaysia: The rate of inflation of 1.8% yoy in April was lower than expected (2.2%). Even so, this was the highest inflation rate in five years due to the introduction of goods and services taxation (GST). GST will cause significant improvements in efficiency in the economy and ultimately raise more revenues for the government, but not without inflicting a one-off increase in inflation as the new taxes become reflected in the prices for consumer goods and services. The inflation rate in March was 0.9% yoy.

- Ukraine: Parliament has approved legislation that gives the government the option to impose a moratorium on repayment of its foreign debt. A moratorium means the government can take a unilateral decision to stop paying coupons and principal on its debt. The bill gives the government a tool that it may or may not choose to employ in ongoing negotiations with bond holders. While a moratorium would immediately reduce payments on foreign debt, in our view it could have high costs over the longer term, such as a lengthy legal wrangle with bond holders. Argentina is an example of what can happen. The government of Argentina has now been locked in such a legal dispute for nearly 15 years with increasing costs for the country in terms of forgone investment and growth.

- Poland: Poland now has a president from the main opposition Law and Justice Party, while parliament is controlled by the governing Civic Platform Party. This is the main result after Andrzej Duda's victory in the weekend's presidential election run-off against incumbent president, Bronislaw Komorowski. The outcome will not have serious immediate implications for governance in Poland due (to the largely ceremonial role of the president) but Duda's victory shows that the Civic Platform Party now has serious work to do ahead of autumn's parliamentary election if it wants to stay in power. In turn, this points to electioneering as the top priority of the government in the next few months in Poland.

Snippets:

- Colombia: The policy rate was left unchanged at 4.5% when the central bank's monetary policy committee met last week.

- Hungary: Ratings agency Fitch upgraded the long-term foreign currency sovereign credit outlook from stable to positive (keeping the rating stable at BB+, just one notch below investment grade).

- Indonesia: Ratings agency Standard & Poor's raised the outlook for Indonesia to positive from stable (keeping the ratings at BB+). (For a recent discussion of the outlook for Indonesia see last week's research note[1]). Bank Indonesia left all three policy rates unchanged in its May policy meeting, but eased credit terms for mortgages and car loans.

- Mexico: The current account deficit narrowed marginally to 3.2% of GDP in Q1 2015 from 3.3% of GDP in Q1 2014.

- Singapore: The real economy expanded 3.2% in the first quarter on a seasonally adjusted annualised rate (saar) basis, versus a consensus expectation of 2.0% qoq saar. Retail and exports explained the better than expected performance.

- South Africa: CPI inflation in April rose to 4.5% yoy from 4.0% yoy in March. The market had expected inflation to rise to 4.6% yoy.

- The Philippines: The trade balance swung into a USD 0.3bn surplus in March after lower than expected imports of oil. Capital goods imports rose strongly (16.7% yoy) in a bullish sign for the economy. Exports rose 2.1% yoy in March.

[1] See: *'Trade surpluses boost Indonesia before infrastructure boom'*, Weekly Research 18 May 2015

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Global backdrop

Headlines in US, Europe and Japan tend to impart volatility onto Emerging Markets (EM) asset prices, but have little impact on their economies. The economic cycles in Europe and the US are more important to EM fundamentals, but the impact is still marginal in most EM economies as the events of the past few years have shown. In one respect, however, the US economy matters far more to EM than developments in either Europe or Japan: monetary and exchange rate policy. Most EM central banks invest the vast majority of their central bank assets in USD denominated paper, particularly US treasury paper. This is fundamentally why US events deserve more attention than European or Japanese events in this global backdrop.

The closely related fall in the Dollar and rise in German bond yields between March and the middle of May of this year went into reverse last week. This means that the world's favourite consensus trade – a stronger USD predicated on a bullish US growth outlook and lower European bond yields consistent with big structural problems, QE and a lower EUR – is back in vogue.

The EUR has notably struggled over the last week owing to rising fears of a Greek default and possible exit from the Eurozone and the protest vote in Spain's local and regional elections this weekend. Specifically, there was no breakthrough in the negotiations between Greece's government and EU leaders at the Riga summit last week and the standoff continued over the weekend. Greece owes the IMF USD 1.6bn during June, with the first payment due on 5 June, and a cabinet minister stated on Sunday that it is a "known fact" that the government has "no money" to make the payment. In Spain, the ruling PP party came first in local and regional elections, but lost a quarter of the support it had gathered in 2011. The vote was a success for leftist populist parties led by Podemos and Cuidadanos, which gathered enough support to spell out their conditions in coalition discussions with the traditional socialist party, PSOE, in large cities such as Madrid and Barcelona.

Federal Reserve Chairwoman Janet Yellen wasted no time by breathing fresh impetus into the bullish USD consensus by announcing that she expects the economy to bounce back and that the Fed will hike rates sometime this year.

That the Fed is so positive about the outlook for the US economy is not surprising – after all, the Fed must cheer on the American economy, because the entire strategy for healing the economy hinges on keeping financial market sentiment buoyant (regardless of how the actual economy performs).

Yellen's words thus serve the essential purpose of shepherding investors to ensure that they are positioned appropriately, that is, long USD and long US stocks. It is, however, a moot point whether the harmony that currently exists between shepherd and sheep means that the sheep actually believe in this path, or whether they are merely doing as sheep do. Regardless of the answer to that question, one thing is clear: if the strong USD/low European yield trade takes hold again it will not have the same longevity as last time. The 'corrections' in the USD and German bond yields of the past couple of months have been very modest. It will therefore not take many trading sessions to get back to March levels, that is to the point where QE-inflated valuations in both currency and bond markets begin to chafe against the economic reality.

In this friction between economic reality and financial market valuations lies a clear warning to markets – that it may simply not be possible to heal the heavily indebted developed economies with monetary policy alone. Incredible amounts of QE and zero interest rates for more than half a decade have singularly failed to raise trend growth rates and fix the economy's debt problems.

The big question investors should ask themselves is this: what will policy makers contemplate next when it becomes clearer that monetary policy is simply not enough? The right answer, of course, is that policy makers should turn to reform, but this seems to be the one thing that they are determined not to pursue. More financial repression, more active currency intervention and trade protectionism seem far more likely.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.05%	8.95%	1.95%	7.56%	6.73%
MSCI EM Small Cap	1.08%	14.22%	8.05%	11.56%	8.43%
MSCI Frontier	-2.73%	-2.65%	-8.95%	12.38%	6.93%
MSCI Asia	-0.51%	11.86%	12.62%	13.52%	10.87%
MSCI EMEA	-1.19%	9.37%	-10.79%	3.18%	4.03%
MSCI Latam	-2.56%	-2.74%	-19.24%	-5.50%	-2.27%
GBI EM GD	-0.76%	-1.91%	-12.41%	-1.50%	2.35%
ELMI+	0.08%	0.73%	-8.27%	-1.16%	0.41%
EM FX Spot	-0.75%	-4.46%	-17.77%	N/A	N/A
EMBI GD	-0.08%	3.59%	3.99%	5.90%	7.72%
EMBI GD IG	-0.32%	2.68%	5.26%	4.88%	6.87%
EMBI GD HY	0.26%	4.75%	1.27%	7.50%	8.96%
CEMBI BD	0.62%	4.75%	4.77%	6.21%	6.80%
CEMBI BD HG	0.02%	3.24%	5.14%	5.76%	6.61%
CEMBI BD HY	1.73%	7.60%	3.59%	7.32%	7.37%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.14%	4.10%	14.63%	19.84%	16.76%
2 year UST	0.06%	0.78%	1.00%	0.61%	0.84%
5 year UST	-0.11%	1.53%	2.40%	1.09%	2.74%
7 year UST	-0.50%	1.27%	3.76%	1.56%	4.15%
10 year UST	-3.24%	-3.45%	4.84%	0.94%	5.53%
US HY	0.27%	4.07%	1.64%	8.04%	9.54%
European HY	0.09%	4.07%	5.17%	12.91%	12.13%
Barclays Ag	-1.58%	-2.45%	-5.46%	-0.33%	2.46%
VIX Index*	-16.63%	-36.82%	6.78%	-44.26%	-64.95%
DXY Index*	2.56%	7.48%	20.69%	17.74%	11.37%
CRY Index*	-1.71%	-1.91%	-26.83%	-20.00%	-9.34%
EURUSD	-2.86%	-9.98%	-20.17%	-12.97%	-10.94%
USDJPY	-2.53%	-2.37%	-16.98%	-35.09%	-26.49%
Brent	-2.65%	13.40%	-41.07%	-39.15%	-9.38%
Gold spot	1.22%	0.66%	-7.49%	-23.98%	-1.47%

*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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