Volatility and opportunity

By Gustavo Medeiros

Ecuadorian bonds experienced considerable price volatility due to inaccurate journalism. Uruguay's new government was sworn in and announced a positive reform agenda. India GDP showed signs of an economic rebound. The South Africa budget delivered the first real effort at reform under President Cyril Ramaphosa by embedding a wage freeze for the next three years. In Brazil, the rate of unemployment declined further amidst a significant primary surplus in January. In Argentina, a mission from the International Monetary Fund arrives this week. South Korea kept interest rates unchanged. China's purchasing managers index collapses as expected, but the People's Bank of China pledged to make ample liquidity available and to cut rates. Mexico recorded a current account surplus in Q4 2019. The Romanian President appointed another Prime Minister, who is unlikely to obtain enough support to win a confidence vote. In Malaysia, the government announced a sizeable fiscal stimulus in response to coronavirus.

In global news, financial markets the world over were extremely volatile due to fears over the spread of coronavirus. The prospect of Bernie Sanders winning the Democrat Party nomination may also have weighed somewhat on sentiment in US markets, but the odds of Bernie Sanders winning now appear to be dwindling somewhat, although Super Tuesday (3 March 2020) could change all that. Late last week, in response to serious declines in the US stock market, Federal Reserve Chairman Jerome Powell issued an unusual statement signalling a rate cut in the upcoming March meeting. Coordinated global central bank easing cannot be ruled out and would likely have a positive impact on asset prices in the short term. The combination of easier monetary policy in the US plus fiscal stimulus in China, Malaysia, Singapore, Hong Kong, Italy and other countries could usher in a 'v-shaped' recovery, if, as we expect, coronavirus turns out to be transitory.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	-7.23%
MSCI EM Small Cap	10.0	–	-7.70%
MSCI Frontier	8.7	–	-3.64%
MSCI Asia	11.5	–	-5.50%
Shanghai Composite	9.7	–	-5.24%
Hong Kong Hang Seng	7.4	–	-4.53%
MSCI EMEA	8.3	–	-11.96%
MSCI Latam	9.7	–	-10.87%
GBI-EM-GD	4.95%	–	-3.18%
ELMI+	4.23%	–	-1.25%
EM FX spot	–	–	-2.41%
EMBI GD	4.98%	380 bps	-2.10%
EMBI GD IG	3.29%	207 bps	-1.00%
EMBI GD HY	7.33%	618 bps	-3.40%
CEMBI BD	4.66%	358 bps	-1.00%
CEMBI BD IG	3.30%	222 bps	-0.12%
CEMBI BD Non-IG	6.68%	560 bps	-2.18%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.3	–	-11.44%
1-3yr UST	0.81%	–	0.84%
3-5yr UST	0.88%	–	1.60%
7-10yr UST	1.12%	–	2.75%
10yr+ UST	1.69%	–	4.74%
10yr+ Germany	-0.60%	–	3.11%
10yr+ Japan	0.00%	–	1.13%
US HY	6.23%	500 bps	-2.56%
European HY	3.91%	482 bps	-2.95%
Barclays Ag	1.07%	-5 bps	1.38%
VIX Index*	40.11	–	23.03%
DXY Index*	97.91	–	-1.45%
EURUSD	1.1067	–	1.97%
USDJPY	108.34	–	-2.15%
CRY Index*	159.45	–	-15.20%
Brent	50.9	–	-9.54%
Gold spot	1601	–	-3.53%

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

Emerging Markets

- **Ecuador:** Last week was characterised by extreme volatility in Ecuadorian bonds due to shoddy journalism. Bloomberg incorrectly reported that Ecuador was looking to restructure its debt. This report, coming amidst general nervousness in the market, sent bonds tumbling. Subsequently, Finance Minister Richard Martinez issued a press statement clarifying Ecuador is working on two liability management operations. One is to reduce the stock of short-to-medium term domestic debt amortisations and the other to minimise amortisations of specific bilateral loans with China.

In sharp contrast to the impression created by the Bloomberg article the Government's plans boost creditworthiness. Bonds recovered sharply as the truth emerged and Bloomberg withdrew the original article. The experience is a reminder that investors should seek independent confirmation of much of the news surrounding EM rather than taking the often speculative and sometimes outright misinformed reporting at face value, in our view.

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Emerging Markets

- **Uruguay:** Luis Lacalle Pou was sworn-in as President, thus ending fifteen years of government by the centre-left Frente Amplio coalition. The incoming liberal government pledged to submit reforms for approval in parliament, including: (a) tax benefits for small companies; (b) reforms in the energy sector; (c) a fiscal rule tied to the business cycle, and; (d) appointing a commission to implement public sector pension reform.

- **India:** The country's yoy real Gross Domestic Product (GDP) growth rate was 4.7% in Q4 2019, which was in line with consensus expectation. Growth was 5.1% yoy in Q3 2019. There were significant upwards revisions to GDP growth in both Q2 and Q3 2019, including 5.0% to 5.6% in Q2 and from 4.5% to 5.1% in Q3. Markit's manufacturing purchasing manager's index (PMI) inched lower to 54.5 in February from 55.3 in January, showing relative resilience in the face of the coronavirus outbreak.

- **South Africa:** Finance Minister Tito Mboweni unveiled the 2019-20 Budget, which included a cumulative reduction in the public sector wage bill of ZAR 160bn (USD 10.2bn) to be implemented over the next three years. There were also other fiscal saving taking the total fiscal adjustment to ZAR 260bn. Despite these positive developments, the fiscal deficit is expected to remain large at 6.8% in 2020 and 5.7% in 2021 due to subdued growth and a cut in corporate taxes and additional funding to bail out Eskom, the loss-making state-owned energy company. The government's debt burden is therefore likely to continue to rise towards 70% of GDP over the next three years, but could be even worse, taking into account possible implementation risks (for example, the bulk of the wage cuts depend on striking agreements with the South Africa's powerful unions). Overall, the likelihood of a ratings downgrade by Moody's in 2020 has increased, in our view.

- **Brazil:** The rate of unemployment inched lower to 11.5% in seasonally adjusted terms in January from 11.6% in December. The central government achieved a BRL 44.1bn primary surplus in January as revenues increased by 3.9% on a yoy basis in real terms and expenditures declined by 3.3% on the same basis. Credit expanded by 0.7% in seasonally adjusted terms in the month of January. In a sign of the economic fallout arising from the coronavirus outbreak in China, the association of electrical and electronic industries (Abinee) reported that 4% of Brazilian companies are operating with partial factory shutdowns and 15% are scheduling stoppages over the next few days due to problems in sourcing parts from China. The Brazilian Central Bank intervened, selling USD via swaps to provide liquidity for hedging demand.

- **South Korea:** The consumer sentiment index declined to a six-month low of 96.4 in February from 104.2 in January. This is the sharpest decline since 2015 and can be attributed to the impact of coronavirus. The Bank of Korea (BoK) adopted a wait-and-see approach, keeping interest rates unchanged at 1.25% against a broad consensus expectation of a cut to 1.00%. BoK indicated that it expects the negative impact of coronavirus to peak in March. BoK also raised the limit on a lending facility for distressed small and medium sized-enterprises by KRW 5trn to KRW 30trn. Exports rose by 4.5% on a yoy basis in February, which was better than the consensus expectation. However, taking into account the timing of the Lunar New Year on a per day basis exports declined at a yoy rate of 11.7% in February. The number of cases of coronavirus reached 4,212 on 2 March, mostly concentrated in the Daegu province.

- **China:** The official PMI dropped to 35.7 in February, which is the lowest number on record. This reflects the impact of the quarantine imposed after the Lunar New Year in a bid to contain coronavirus. Non-manufacturing PMI declined to 29.6, while the Caixin PMI dropped somewhat less to 40.3 in February from 51.1 in January. Small business sentiment as compiled by the Cheung Kong Graduate School of Business tumbled to 37.3 in February from 56.2 in January. However, bottom-up forward-looking data is more encouraging: as of 27 February, 75% of workers across the 500 largest manufacturers had returned to work. The Chinese government also announced tax exemptions equivalent to 0.6% GDP of which small and medium sized companies will receive almost 90%. At the same time, the Deputy Governor of the People's Bank of China (PBOC) Guoqiang Liu pledged to provide ample liquidity via reserve requirement ratio cuts and increased re-lending and re-discounting of credit. Additional policy rate cuts have not been ruled out either.

- **Malaysia:** The government announced a large stimulus package of MYR 20bn (approximately 1.2% of GDP) in response to coronavirus. The fiscal deficit is expected to rise to 3.4% of GDP. The stimulus measures are aimed at supporting individuals and affected businesses. In other news, Muhyiddin Yassin was appointed as Malaysia's new Prime Minister by the King. Mr. Yassin is the leader of opposition Malaysian United Indigenous Party. Odds of a snap election are building as it remains unclear if Mr. Yassin's coalition can command a majority. Former Prime Minister Mohamad Mahathir claims to have enough votes to bring the government down.

- **Argentina:** The International Monetary Fund (IMF) will send a mission to Argentina this week to continue discussions about an economic program and debt re-profiling. The public sector registered a primary deficit of ARS 3.7bn in January. Revenues increased by 40.3% on a yoy basis, but expenditures rose by 51% yoy due to grants to retirees, social programs and transfers to provinces.

- **Mexico:** The current account deficit declined to 0.2% of GDP at the end of 2019 compared to 1.9% of GDP deficit at the end of 2018. Foreign Direct Investment (FDI) declined marginally to 2.3% of GDP in 2019 from 3.2% of GDP in 2018. Core inflation remained unchanged at 3.7% on a yoy basis on the first half of February.

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Emerging Markets

In other news, Pemex announced a net income loss of USD 18.4bn. This marks the 7th consecutive year of negative earnings, thus increasing the likelihood of downgrade of the company to sub-investment grade this year. A downgrade is already partially priced into the market. Oil production increased to 1.724 million barrels per day in January, which is the highest level of output since October 2018.

- Romania: President Klaus Johannis appointed erstwhile Finance Minister Florin Citu to the post of Prime Minister. The socialist PSD party holds most seats in parliament and is unlikely to accept Citu's nomination. Johannis intends to force a second no-confidence vote in parliament by 9th April, which in turn could lead to new elections. Polls suggest the PSD would lose seats to the President's PNL (liberal) party. An eventual PNL government would likely seek to reverse the ballooning of public expenditures set in motion by PSD. PSD has legislated for a further 40% increase in pensions by September 2020. If implemented, this would increase the fiscal deficit by 2.5% GDP at a time when Romania is already breaching the maximum 3% of GDP deficit limit agreed under the Maastricht treaty.

Snippets:

- Chile: Industrial production rose 1.8% on a yoy basis in January and retail sales expanded by 0.1% yoy. Both prints were close to consensus expectations.
- Colombia: The approval rate of President Ivan Duque declined to 23% in February, according to a Gallup poll. This is his lowest approval rating since assuming office in August 2018.
- Dominican Republic: Opposition parties organised a march to protest against the cancellation of regional elections last week.
- Hungary: The National Bank of Hungary kept policy rates unchanged. The deposit rate was kept at -0.05%, while the lending rate was maintained at 0.90%. This was in line with consensus expectations. The Central Bank has tightened liquidity over the last four weeks, removing HUF 330bn (USD 1bn) from the system by unwinding via FX swaps.
- Hong Kong: The government announced a bold fiscal stimulus package of HKD 120bn (4% of GDP) aimed at: (a) supporting small businesses via tax cuts, utility subsidies and finance guarantees; (b) boosting household consumption via HKD 10k of handouts to individuals; and (c) stabilising the property market by offering HKD 10m in mortgage relief.
- Indonesia: Consumer prices index (CPI) inflation rose to 3.0% on a yoy basis in February from 2.7% yoy in January. Food prices accounted for the bulk of the increase, while core CPI inflation actually inched lower to 2.8% on a yoy basis in February from 2.9% yoy in January. Markit's manufacturing PMI survey rose to 51.9 in February from 49.3 in January.
- Kenya: The rate of CPI inflation increased to 6.4% on a yoy basis in February from 5.8% in January.
- Nigeria: The stock of foreign exchange reserves declined to USD 36.4bn in February from USD 38.1bn in January. This is the lowest level since Q4 2017 and USD 9bn lower than the peak in reserves recorded at USD 45.1bn in May 2019.
- Poland: The real GDP growth rates in Q4 2019 was revised higher to 3.2% on a yoy basis due mainly to a higher contribution from net exports amidst declining imports.
- Singapore: Industrial production rose by 18.2% in January compared to 6.3% in December. This beat market expectations due to a 59.5% surge of pharmaceutical output, which compensated for a 3.8% reduction in other types of manufacturing.
- Slovakia: The opposition Ordinary People party received 25% of the total votes cast in the parliamentary election, thus taking 53 seats in the 150-member parliament. New Prime Minister Igor Matovic campaigned on an anti-corruption platform similar to that which brought Zuzana Caputova to the presidency last year. The new government is expected to run larger fiscal deficits in the coming years.
- Thailand: Economic data surprised on the downside with consumption expanding at a yoy rate of 1.2% in January compared to 2.0% yoy in Q4 2019. Manufacturing and private investment declined at rates of 4.6% yoy and 8.1% yoy, respectively. The trade deficit widened to USD 1.6bn in January from a surplus of USD 0.6bn in December. Tourism arrivals grew at 2.5% on a yoy basis in January, unchanged from December.
- Tunisia: The Tunisian parliament approved a government coalition with 129 votes in favour and 77 against. Prime Minister Elyes Fahkfakh faces significant economic challenges due to years of fiscal deficits leading to high inflation and poor debt dynamics.
- Turkey: The real GDP growth rate was 6.0% yoy in Q4 2019, which beat consensus expectations. Government and household spending accounted for the bulk of the expansion as consumer loans are currently running at an extremely fast 40% yoy rate. CPI inflation yoy rose to 12.7% in February from 12.2% yoy in January. Consumer prices are likely to remain under upwards pressure due to exuberant credit growth and the negative real policy rate (-2.0%).

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Global backdrop

"...the only thing we have to fear is... fear itself."

Franklin Delano Roosevelt

Global markets were extremely volatile last week as cases of coronavirus skyrocketed outside of China. Meanwhile, the number of cases in China are getting under control. Market participants are watching the number of cases in Asia, Europe and the US. They are likely to rise as more people get tested. Key to the evolution of asset prices is how politicians respond to the outbreak. There is little evidence that quarantining populations works, except, perhaps, shutting schools. Quarantining causes disruption to the day to day lives of workers and impedes travel, which can lead to an even deeper slump. Either way, if coronavirus evolves like other viruses then activity should normalise as temperatures rise in the northern hemisphere in the course of Q2.

Coronavirus is not as deadly as SARS. It also seems likely that the more it spreads the less fatal it becomes as doctors and hospitals learn how to deal with the outbreak. There is scientific evidence that the virus' ability to spread declines as temperature rises. The Atlantic magazine published an interview with Harvard epidemiology professor Marc Lipsitch, wherein he predicts that the vast majority of the population will, at some point, get the virus, given how fast it spreads. However, he also said that it is likely that many will have a 'mild' version of the disease, "or maybe asymptomatic". With death rates across the working-age population just slightly higher than normal flu, the main fear about coronavirus is fear itself.

The panic caused by the spread of the virus from China to other countries with cold weather, including Iran, Italy, Korea and Japan along with the disruption in global supply chains has led many investment banks to cut their forecasts for global real GDP growth to between 2.0% and 3.0% in 2020, which is the lowest level since 2009. A sharp but transitory downturn in growth is now broadly priced into gold and the market for US Treasury bonds, possibly also in equities and credit spreads. Despite the sizeable 15.8% peak-to-trough correction in US stocks (S&P 500), the index is still trading at 28x earnings (on a 10yr moving average basis). This is only down marginally from 31.2x prior to the sell-off. The valuation level is not as bad as the staggering 41.2x prior to the 'dot-com bubble' in 2000, but it remains much higher than the 24.5x average since 1996, particularly given the much lower productivity growth of the US economy today and far worse debt dynamics.

US markets are also quite distorted. For example, in 2000 10-year US Treasury bond paid a yield of 6%, which compared favourably to stocks trading at 2.4% earning return (S&P 500 at 41.2x 10-year average earnings). Today, the S&P has an earning yield of 3.6% against a 10yr US Treasury bond yielding a paltry 1.10%. From a narrow yield perspective, Americans may therefore be tempted to buy US equities, thinking there is no real alternative in bonds. In reality, of course, investors have many other options. The MSCI EM, for example trades at 18.6x 10-year average earnings, which implies an earning yield of 5.4%. In the fixed income space, EM debt offers 4.9% yield in US dollar terms and 5.0% yield for 5-year local currency sovereigns, which is almost 5x more than 10-year US Treasury bonds. It also worth remembering that the deflation of the dot-com bubble marked the beginning of a ten-year bear market cycle for the Dollar as investors diversified away from US assets, investing in more attractive assets overseas.

The VIX spike last week is a buy signal, in our view – see our note from Friday "It is here again – the VIX spike!" *Market Commentary*, 28 February 2020.[1] The US Federal Reserve and other central banks are likely to react to the panic. Fed speakers initially downplayed the need for an imminent policy rate cut, but this changed with comments from Jerome Powell on Friday. As recently as last Tuesday, Fed Vice Chairman Richard Clarida said it was "too soon" to say whether the virus would result in a material change in the outlook. Powell said that the Fed will "use our tools and act as appropriate to support the economy". The last time the Fed issued a similar statement was in 1987 when Alain Greenspan responded to the 22.6% crash in US stocks on Black Monday. Jerome's words imply that a 25bps rate cut is now priced in for the March meeting with 50% odds of a 50bps cut. Powell's statement may also motivate other central banks to act. This week there will be monetary policy committee meetings in Australia and Canada. Market prices may therefore recover somewhat this week, although if the virus spreads further and faster there could be more dips to buy into between now and summer.

In other news, Joe Biden won his first Democratic Party nomination in the state of South Carolina. Poor performances by moderate candidates Pete Buttigieg and Tom Steyer prompted their departure from the race. This should benefit Biden and Bloomberg at the margin. Tomorrow, on 'Super Tuesday', fourteen states will vote, comprising more than one-third of all delegates. As of yesterday, polls were suggesting that Sanders is still in the lead in seven out of eight states. A big Sanders victory could add pressure to US asset prices and weaken the US Dollar. However, the path to nomination is now less straight-forward for Sanders. The statistical model from fivethirtyeight.com assigns a 66% chance to the possibility that no candidate will obtain the required

[1] See: *'It is here again – the VIX spike!'* Market Commentary, 28 February 2020.

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1,991 delegates (out of 3,979) required to win nomination. If no candidate achieves the threshold, a second ballot is convened, where the pledged delegates and another 771 'super' delegates vote for the top three contenders. This should increase the odds that a moderate candidate, such as Biden, wins the nomination.

In Europe, the economic data was better than expected. The German IFO expectations survey improved to 93.4 in February from 92.9 in January. French business and consumer confidence also improved more than expected. UK consumer confidence surprised to the upside, despite remaining at depressed levels. Italian epidemiologists suggested that containment measures taken can keep the outbreak of coronavirus under control. Indeed, last Wednesday authorities started to relax certain control measures, including the all-important decision to allow bars to reopen! Italian Finance Minister Roberto Gualtieri said the government is going to propose a further EUR 3.6bn in extraordinary crisis spending.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-5.26%	-9.68%	-9.68%	-1.54%	5.25%	3.12%
MSCI EM Small Cap	-7.06%	-10.76%	-10.76%	-6.57%	-0.29%	0.14%
MSCI Frontier	-5.88%	-5.93%	-5.93%	5.10%	4.79%	1.67%
MSCI Asia	-2.86%	-7.18%	-7.18%	0.38%	6.90%	4.38%
Shanghai Composite	-3.23%	-5.57%	-5.57%	0.33%	-1.63%	-0.68%
Hong Kong Hang Seng	0.60%	-7.75%	-7.75%	-5.92%	3.98%	0.43%
MSCI EMEA	-12.01%	-16.22%	-16.22%	-9.00%	0.26%	-1.02%
MSCI Latam	-12.05%	-16.97%	-16.97%	-11.63%	0.72%	1.14%
GBI EM GD	-3.41%	-4.65%	-4.65%	3.73%	3.95%	2.01%
ELMI+	-2.19%	-3.47%	-3.47%	-0.66%	1.88%	1.30%
EM FX Spot	-3.41%	-6.00%	-6.00%	-7.12%	-3.70%	-4.74%
EMBI GD	-0.97%	0.54%	0.54%	9.68%	5.67%	5.97%
EMBI GD IG	0.56%	2.86%	2.86%	15.89%	7.40%	5.76%
EMBI GD HY	-2.77%	-2.15%	-2.15%	3.36%	3.77%	6.33%
CEMBI BD	-0.01%	1.53%	1.53%	10.58%	5.90%	5.86%
CEMBI BD IG	0.88%	2.48%	2.48%	12.12%	6.09%	5.10%
CEMBI BD Non-IG	-1.22%	0.24%	0.24%	8.51%	5.69%	7.15%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-8.23%	-8.27%	-8.27%	8.18%	9.86%	9.21%
1-3yr UST	0.90%	1.45%	1.45%	4.72%	2.29%	1.63%
3-5yr UST	1.68%	3.14%	3.14%	8.20%	3.52%	2.58%
7-10yr UST	3.15%	6.47%	6.47%	15.11%	5.88%	3.82%
10yr+ UST	6.70%	14.00%	14.00%	31.64%	11.14%	6.33%
10yr+ Germany	3.35%	8.40%	8.40%	16.80%	7.06%	4.92%
10yr+ Japan	1.36%	2.14%	2.14%	5.17%	3.36%	4.25%
US HY	-1.41%	-1.38%	-1.38%	6.10%	4.86%	5.19%
European HY	-2.14%	-2.05%	-2.05%	4.06%	2.93%	3.57%
Barclays Ag	0.67%	1.96%	1.96%	7.92%	4.39%	2.90%
VIX Index*	0.00%	191.07%	191.07%	195.58%	239.63%	207.59%
DXY Index*	-0.23%	1.57%	1.57%	1.43%	-4.20%	2.56%
CRY Index*	0.00%	-14.18%	-14.18%	-12.15%	-15.55%	-28.17%
EURUSD	0.36%	-1.31%	-1.31%	-2.41%	5.33%	-1.05%
USDJPY	0.53%	-0.25%	-0.25%	-3.04%	-5.31%	-9.81%
Brent	0.81%	-22.83%	-22.83%	-21.73%	-7.53%	-14.46%
Gold spot	0.94%	5.51%	5.51%	24.41%	29.69%	32.65%

*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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