EM local bond yields set a record low despite outflows

By Jan Dehn

EM local bond yields set a record low despite outflows. Argentina went down the road of financial repression. Brazil's Treasury reiterated a commitment to sound fiscal policy amidst rising political tension. South Korea's data was mixed with weaker exports and stronger industrial production. China's weight in the GBI-EM GD was increased to 2% at the end of April. President Moreno's approval rating improved over his handling of the coronavirus crisis in Ecuador. Peru's congress approved a raid on pension funds. Economic activity slowed in Thailand. Ivory Coast opposition leader Guillaume Soro disappeared from the political stage after a court ruling. After a strong week for Emerging Markets (EM) assets, sentiment soured over the weekend as US President Donald Trump ramped up attacks on China. The US growth outlook also looks bleak as much of the economic fallout from the coronavirus outbreak is likely to have implications beyond the lifting of lockdowns.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	4.27%
MSCI EM Small Cap	9.8	–	5.50%
MSCI Frontier	10.3	–	4.19%
MSCI Asia	11.8	–	3.86%
Shanghai Composite	10.1	–	0.77%
Hong Kong Hang Seng	7.4	–	3.83%
MSCI EMEA	9.0	–	3.61%
MSCI Latam	8.3	–	9.22%
GBI-EM-GD	4.87%	–	1.99%
ELMI+	2.47%	–	1.89%
EM FX spot	–	–	1.26%
EMBI GD	6.78%	609 bps	1.67%
EMBI GD IG	3.98%	325 bps	1.51%
EMBI GD HY	11.12%	1,048 bps	1.88%
CEMBI BD	5.97%	541 bps	0.66%
CEMBI BD IG	3.93%	337 bps	0.69%
CEMBI BD Non-IG	9.12%	856 bps	0.60%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.3	–	-0.19%
1-3yr UST	0.19%	–	0.01%
3-5yr UST	0.35%	–	0.00%
7-10yr UST	0.62%	–	-0.28%
10yr+ UST	1.25%	–	-1.57%
10yr+ Germany	-0.59%	–	1.83%
10yr+ Japan	0.00%	–	-0.15%
US HY	8.05%	745 bps	0.66%
European HY	7.30%	742 bps	0.61%
Barclays Ag	1.02%	40 bps	0.89%
VIX Index*	37.19	–	1.26%
DXY Index*	99.32	–	-0.72%
EURUSD	1.0943	–	1.04%
USDJPY	106.73	–	-0.48%
CRY Index*	117.63	–	4.87%
Brent	26.2	–	31.22%
Gold spot	1699	–	-0.88%

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

Emerging Markets

- **Flows:** Citing an outflow of USD 100bn, the International Monetary Fund (IMF) last week noted on its blog that the coronavirus outbreak has triggered the worst outflow from EM in the history of the asset class.[1] Similar statements have been issued by a number of investment banks. Still, flow numbers have to be placed into perspective. While there have undoubtedly been outflows, the precise size of the flows is difficult to establish, since the flows of many larger institutional investors both within and outside of EM are not included in the numbers. Besides, flow numbers tend to be reported in absolute Dollar terms, so they naturally rise every year as the asset class grows larger. In fact, the flow reported by IMF is tiny compared to the size of the EM fixed income asset class of more than USD 26trn (BIS, as of end-2018). Finally, we note that the size of the flow does not appear to have had much of an impact on local government bond yields in EM. This can be seen in Figure 1, which shows the yield on JP Morgan's GBI-EM GD index (an index of local currency denominated bonds in 19 EM countries). As of Friday 1 May 2020, the yield was at an all-time low of just 4.87%, which indicates that whatever the size of the flow, it was not material enough to move yields sharply higher, at least not for very long.

This places the coronavirus sell-off in sharp contrast with the 2008/2009 sell-off, which saw the yield on EM local currency government bonds spike briefly to 8.99%. Why the difference? First, EM inflation rates are lower. Second, positioning among foreign investors is lighter after ten years of Dollar strength. Third, EM central banks have developed a number of new policy instruments, which have given them greater control over their own bond markets, much like in developed countries, in fact.

[1] See: https://blogs.imf.org/2020/04/14/covid-19-crisis-poses-threat-to-financial-stability/

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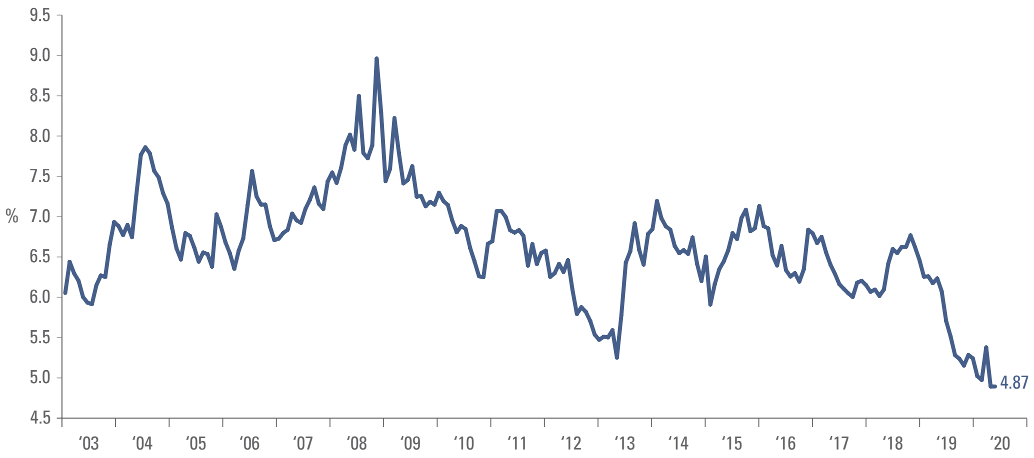
Emerging Markets

Our view is that when the coronavirus shock is behind us many investors will look back upon this time and realise that EM local bond markets have come of age. EM central banks have been able to roll out an unprecedented range of conventional and unconventional easing measures that one would ordinarily associate with DMs, with the notable difference that EM bonds still offer much higher yield. Granted, EM currencies have moved sharply lower in this crisis, but so have other non-Dollar currencies like EUR, GBP, AUD and CAD. The sell-off in EM FX clearly destabilised neither local rates nor pushed up inflation, which also remains near historical lows.

Fig 1: **EM local currency bond yields have remained low despite outflows**



Source: Ashmore, Bloomberg. Data as at 1 May 2020.

- Argentina: The National Securities Commission issued new regulation, which requires mutual funds to invest at least 75% of their assets in ARS-denominated instruments. Mutual funds have to meet the requirement by 15 May 2020. This amounts to financial repression designed to support the exchange rate and lower the domestic interest rate.

- Brazil: The Brazilian Treasury strongly reiterated the government's commitment to sound fiscal policy, emphasising that a cap on spending is mandated under the country's constitution. The statement from the Treasury followed a ruling by the Supreme Court that President Jair Bolsonaro can be investigated for various crimes alleged by former Justice Minister Sergio Moro. Meanwhile, in economic news the rate of unemployment picked up by a modest 0.1% to 11.5% in March, while inflation continued to fall. Specifically, the headline IPCA-15 consumer prices inflation print was just 2.9% on a yoy basis in April, which was down from 3.7% yoy in March, while core IPCA-15 inflation declined to 3.05% yoy, down from 3.3% yoy in March.

- South Korea: The yoy rate of Consumer Prices Index (CPI) inflation declined sharply to just 0.3% in April from 0.7% in March. Industrial output was up 4.6% mom in March versus -1.3% mom expected. On the other hand, exports contracted by 24.3% on a yoy basis in April, partly due to 8% fewer working days in the month. Still, even with the working day adjustment the export numbers were weak. The weakness was concentrated in exports to developed countries, while exports to China picked up. The government approved a supplementary fiscal stimulus of 0.6% of GDP.

- China: The weight of Chinese bonds in JP Morgan's GBI-EM GD increased to 2% as of end-April 2020. The index weight will eventually reach 10% over the next eight months, provided that JP Morgan sticks to the schedule. Manufacturing PMI was 50.8 in April, which is slightly down from March (52.0). Export-related activities in particular weakened.

- Ecuador: The latest poll from Cedatos showed that President Lenin Moreno's approval rating has improved from 14% to 24% over his handling of the coronavirus outbreak as IMF approved USD 643m in emergency financial assistance to the country.

- Peru: The Peruvian parliament approved a law that allows pensioners to withdraw up to 25% of their pension savings. President Vizcarra has not yet signed the bill. The law could pull the rug from under the domestic bond market, thereby threatening economic stability in the country. Vizcarra's response is therefore very important.

- Thailand: Private consumption declined at a yoy rate of 0.6% in March due to the ongoing lockdown over coronavirus with weakness concentrated heavily in the consumer durables segment (-22% yoy), while non-durable consumption remained positive (0.7% yoy). Tourist arrivals were also 76% lower in March compared to the same month last year.

- Ivory Coast: Opposition leader Guillaume Soro has effectively been removed from the political stage after an Abidjan court sentenced him to 20 years imprisonment (in absentia) over alleged embezzlement of public funds.

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Emerging Markets

Snippets:

- **Botswana:** The central bank cut the policy rate by 50bps to 4.25%.
- **Chile:** S&P Ratings affirmed Chile's sovereign debt credit rating of 'A+', but reduced the outlook to negative from stable.
- **Colombia:** The central bank cut the policy interest rate by 50bps to 3.25%.
- **Costa Rica:** The IMF approved a disbursement of USD 504m under the Rapid Financing Initiative.
- **Dominican Republic:** The IMF approved USD 650m in support under the Rapid Financing Initiative.
- **Ethiopia:** The IMF approved a USD 411m disbursement to Ethiopia under the Rapid Credit Facility.
- **Ghana:** S&P Ratings cut the outlook on Ghana's sovereign credit rating to negative from stable. Ghana is rated 'B' by S&P.
- **Hungary:** The National Bank of Hungary embarked on QE policies with HUF 1trn of bond purchases schedule for the next three months. The liquidity created will be sterilised with deposit tenders on a weekly basis.
- **India:** Manufacturing PMI for April declined sharply to 27.4 from 51.8 in March as a result of lockdowns.
- **Indonesia:** The yoy rate of headline CPI inflation declined to 2.67% in April from 2.96% in March, while the rate of core inflation slowed to 2.85% yoy in April from 2.87% in March.
- **Kazakhstan:** The National Bank of Kazakhstan left the policy rate unchanged at 9.50%.
- **Malaysia:** The trade surplus was MYR 12.34bn in March versus MYR 11.60bn expected. Manufacturing PMI declined to 31.3 in April from 48.4 in March.
- **Mexico:** The rate of unemployment declined to 3.3% in March from 3.7% in February.
- **Nigeria:** Nigeria tapped the IMF for funding for the first time in the country's history with a credit line of USD 3.4bn.
- **Pakistan:** The fiscal deficit could hit 9.6% of GDP in 2020, according to government sources, but the government will push ahead with a privatisation programme in order to meet the growing financing needs.
- **Poland:** The yoy rate of CPI inflation declined sharply to 3.4% yoy in April from 4.6% yoy in March.
- **Russia:** The yoy rate of retail sales growth picked up from 4.6% in February to 5.6% in March versus 2.0% yoy expected, even as coronavirus numbers worsened.
- **Saudi Arabia:** The Q1 2020 fiscal deficit was SAR 34bn, which is SAR 60bn greater than the same quarter last year. Lower oil prices accounted for the bulk of the weakness in the fiscal outturn.
- **Taiwan:** Real GDP growth was 1.5% on a yoy basis in Q1 2020 compared to 3.3% yoy in Q4 2019.
- **Vietnam:** The yoy rate of CPI inflation was 2.93% in March, while the country racked up a USD 3bn trade surplus in the January-April period.
- **Zambia:** The government received USD 145m in funding from the World Bank and the African Development Bank.

Global backdrop

Market sentiment broadly favoured EM asset classes last week, pushing EM stock prices up 4.27% compared to -0.19% for US equities. Meanwhile, EM local currency bonds returned 1.99% in USD terms compared to 0.00% for US bonds of the same duration (roughly 5 years). EM external debt returned 1.67% compared to -0.28% for the US 10-year Treasury bond. EM and US high yield corporate bonds were up roughly by the same amount (0.60% and 0.66%, respectively). Crude oil prices rose more than 30% last week.

However, market sentiment took a decisive negative turn on Friday as US President Donald Trump linked an alleged Chinese cover-up about the origin coronavirus with potential trade sanctions, thus threatening to re-ignite the trade war between the two countries. Trump's attacks on China were then repeated by several other senior US government officials, but the Trump Administration's Office of the Director of National Intelligence stated that coronavirus was not man-made or genetically modified.

The attacks on China are likely to be part of a broader political strategy ahead of the November 2020 presidential election to pass blame for the coronavirus situation in the US to China. As such, the situation could yet worsen. The attacks on China from senior Administration officials have intensified as the number of deaths from

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Global backdrop

coronavirus in the US, which already exceed the number of American's killed in the Vietnam War, continue to reach new highs. Also, Democrat presidential candidate Joe Biden now leads Trump in many polls, often beyond the statistical margin of error, especially in crucial battleground states. For example, in Florida Joe Biden leads Trump by 6 percentage points (University of North Florida poll) and 4 percentage points (Quinnipiac University poll), while Biden leads Trump by 8 percentage points in Michigan (Fox News poll). In Pennsylvania, Biden has a similar lead over Trump (Fox News poll), while Biden leads Trump by 3 percentage points in Wisconsin (Marquette University Law School poll). Regardless of the rationale for the attacks on China, they are clearly bad news from an economic perspective at a time, when the US and other economies are reeling from an unprecedented collapse in economic growth. US real GDP growth was -4.8% qoq ar in Q1, but some banks say that growth could be as weak as -38% qoq ar in Q2.[2]

In addition to rising political noise, the market is also increasingly becoming concerned about the how strongly the US economy will be able to bounce back from lockdown. Our view is that the US economy was already approaching the end of its cyclical expansion prior to the coronavirus outbreak. The length and depth of the downturn now underway is therefore not just going to be determined by the lifting of lockdowns. Rather, it will also depend on the extent to which defaults and unemployment go up as well as how much debt is accumulated, because these kinds of economic setbacks tend to take far longer to reverse. The increase in corporate defaults as well as the rise in unemployment, with accompanying mortgage repayment failures, are likely to inflict serious losses on the US financial sector, which in turns results in a tightening of credit conditions. Tighter credit conditions then lead to lower investment, which weakens productivity growth. Low productivity growth makes it difficult to regain competitiveness without a long period of unemployment to depress wages, or a much weaker Dollar.

The US government is not sitting idly by. Monetary stimulus is already so pervasive that Fed asset purchases – rather than economic fundamentals – is now the single most important determinant of the prices of government bonds, corporate bonds, and, indirectly, stocks. However, in pushing up asset prices and driving down interest rates aggressively, monetary easing also acts as a kind of financial repression.

Meanwhile, fiscal policy is likely to continue to seek to stimulate aggregate demand at a time, when the economy is already groaning under too much debt (which itself is an indication of excess demand stimulus in the past).

The combination of low rates, manipulated financial asset prices, and heavy fiscal stimulus at a time of already excessive debt means that asset prices now bear less and less resemblance to the state of the underlying economy, almost like in a classic command economy. This is not sustainable, but how asset prices are finally reconciled with the fundamental reality remains unclear. It could be via some crash, perhaps in the currency space, but it could also happen via a slow economic death as the US government gradually encroaches on ever larger segments of the American economy. Clearly, this expansion of the government is happening, because the powers that be want to avoid economic pain, but the continuing attempts to achieve this using demand-side measures alone, when the problems are increasingly concentrated on the supply-side of the economy, seem ever more grotesque.

[2] Morgan Stanley *"US Economics: 1Q GDP: The First Quarter of Contraction"*, 29 April, 2020.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.88%	8.21%	-17.29%	-12.57%	0.56%	0.15%
MSCI EM Small Cap	-0.38%	13.53%	-22.06%	-19.37%	-5.87%	-4.15%
MSCI Frontier	0.04%	6.82%	-21.63%	-13.63%	-2.57%	-2.26%
MSCI Asia	-0.64%	8.27%	-11.60%	-7.85%	3.27%	1.85%
Shanghai Composite	4.00%	4.00%	-6.22%	-4.84%	-0.98%	-6.48%
Hong Kong Hang Seng	4.65%	4.65%	-10.09%	-9.72%	3.35%	-3.41%
MSCI EMEA	-1.39%	9.40%	-27.67%	-24.25%	-6.15%	-4.80%
MSCI Latam	-1.87%	4.34%	-43.22%	-38.71%	-11.64%	-6.53%
GBI EM GD	-0.99%	2.89%	-12.76%	-3.86%	-0.35%	0.33%
ELMI+	-0.01%	1.11%	-7.46%	-4.14%	-0.18%	-0.05%
EM FX Spot	-0.99%	0.12%	-14.21%	-13.57%	-7.03%	-6.35%
EMBI GD	0.15%	2.40%	-11.30%	-4.95%	0.73%	3.00%
EMBI GD IG	0.02%	2.34%	-3.22%	5.79%	4.76%	4.34%
EMBI GD HY	0.33%	2.48%	-20.52%	-16.55%	-3.93%	1.36%
CEMBI BD	-0.02%	4.08%	-6.51%	-0.31%	2.54%	3.68%
CEMBI BD IG	0.05%	3.52%	-2.75%	3.71%	3.89%	3.77%
CEMBI BD Non-IG	-0.12%	4.93%	-11.60%	-5.78%	0.68%	3.63%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-2.79%	9.67%	-11.83%	-1.23%	7.94%	8.25%
1-3yr UST	-0.04%	0.09%	2.85%	5.34%	2.67%	1.86%
3-5yr UST	-0.10%	0.14%	5.53%	9.33%	4.05%	2.95%
7-10yr UST	-0.12%	0.53%	10.73%	17.35%	6.85%	4.69%
10yr+ UST	-0.06%	1.96%	23.28%	37.27%	13.78%	8.72%
10yr+ Germany	0.01%	3.31%	8.56%	13.99%	7.59%	4.68%
10yr+ Japan	-0.12%	0.43%	-0.42%	1.57%	2.24%	3.60%
US HY	-0.18%	4.31%	-8.92%	-4.33%	1.79%	3.39%
European HY	0.01%	6.37%	-10.81%	-7.51%	-0.49%	1.54%
Barclays Ag	-0.05%	1.92%	1.58%	6.34%	3.83%	2.87%
VIX Index*	8.90%	-30.54%	169.88%	188.97%	255.54%	189.42%
DXY Index*	0.31%	0.28%	3.04%	1.85%	0.53%	4.02%
CRY Index*	0.37%	-3.42%	-36.69%	-35.29%	-33.55%	-48.37%
EURUSD	-0.11%	-0.80%	-2.42%	-2.29%	-0.37%	-1.82%
USDJPY	-0.42%	-0.75%	-1.73%	-3.63%	-5.10%	-11.15%
Brent	3.80%	15.35%	-60.26%	-62.98%	-45.78%	-60.53%
Gold spot	0.74%	7.72%	11.98%	32.62%	38.34%	42.97%

*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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