EM local currency assets' time to shine

By Gustavo Medeiros

EM CPI inflation declined to a record low in May, according to preliminary data. EM bonds received the largest inflows in three months. China reportedly agreed to suspend debt repayments for 77 countries as part of the G20 proposal for debt relief for poorer countries. Argentina postponed the deadline for debt restructuring to 12 June as the gap between creditors and the country continued to narrow. Chinese data surprised to the upside as the central bank announced targeted stimulus to small companies. Ecuador announced a timeline for debt re-profiling. South Korea announced a third round of fiscal stimulus. The IMF approved a USD 5.2bn stand-by facility for Egypt. The IMF asked for further fiscal consolidation in Pakistan. Angola cleaned up the non-performing loans position in the largest state owned bank. Moody's downgraded India to the lowest investment grade rating with negative outlook.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.5	–	7.88%
MSCI EM Small Cap	11.0	–	8.99%
MSCI Frontier	11.6	–	1.44%
MSCI Asia	13.0	–	7.60%
Shanghai Composite	10.5	–	2.83%
Hong Kong Hang Seng	7.8	–	5.92%
MSCI EMEA	10.3	–	7.31%
MSCI Latam	12.5	–	15.83%
GBI-EM-GD	4.62%	–	3.03%
ELMI+	1.76%	–	2.42%
EM FX spot	–	–	3.40%
EMBI GD	5.61%	–	2.46%
EMBI GD IG	3.22%	219 bps	0.49%
EMBI GD HY	8.97%	804 bps	4.96%
CEMBI BD	5.15%	436 bps	1.57%
CEMBI BD IG	3.56%	277 bps	0.67%
CEMBI BD Non-IG	7.46%	668 bps	2.82%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	19.8	–	4.96%
1-3yr UST	0.22%	–	-0.14%
3-5yr UST	0.47%	–	-0.57%
7-10yr UST	0.90%	–	-1.84%
10yr+ UST	1.68%	–	-4.84%
10yr+ Germany	-0.28%	–	-3.91%
10yr+ Japan	0.00%	–	-0.81%
US HY	6.06%	536 bps	3.10%
European HY	5.40%	568 bps	3.01%
Barclays Ag	1.08%	18 bps	0.02%
VIX Index*	24.52	–	-2.99%
DXY Index*	96.90	–	-0.93%
EURUSD	1.1287	–	1.36%
USDJPY	109.47	–	1.75%
CRY Index*	138.98	–	6.73%
Brent	43.2	–	12.71%
Gold spot	1691	–	-2.77%

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

Emerging Markets

- **EM Local Bonds:** Local currency bonds in Emerging Markets (EM) have racked up a return of 18.5% in USD terms since markets bottomed out in the third week of March. The strong performance has been supported by a combination of declining inflation and currency gains. CPI inflation weighted by the JP Morgan GBI-EM GD declined to a record low of just 2.3% on a yoy basis in May, based on the 58% of index constituents, which had reported inflation as of the end of last week. Low inflation in turn allowed the yield on the GBI-EM GD to drop to 4.6%. Despite the rally, the real yield is still a healthy +2.3%, down from 2.5% in April, but higher than the long-term average real yield since 2002 of 2.1%. The GBI-EM GD weighted policy rate also hit a record low of 2.9% in May compared to 3.2% in April and 4.4% in December 2019. This is the first time in modern EM history that EM central banks have been able to ease monetary policy in a crisis. Several EM central banks have also been able to purchase local bonds for the first time with a significant degree of success, according to the BIS.[1] The ability of central banks to ease into the downturn provides an important cushion against the coronavirus-induced global economic downturn.

As shown in Figure 1, EM policy rates have declined faster than bond yields, so EM yield curves have steepened significantly, aided, in part, by selling of bonds by some investors, which has increased the credit risk premium. Our view is that curves are likely to flatten as perceived risks recede and flows return to the asset class, leading to yet more capital gains for investors in EM local currency bonds. EM equities should also benefit as companies are supported by lower cost of funding.

[1] https://www.bis.org/publ/bisbull20.htm

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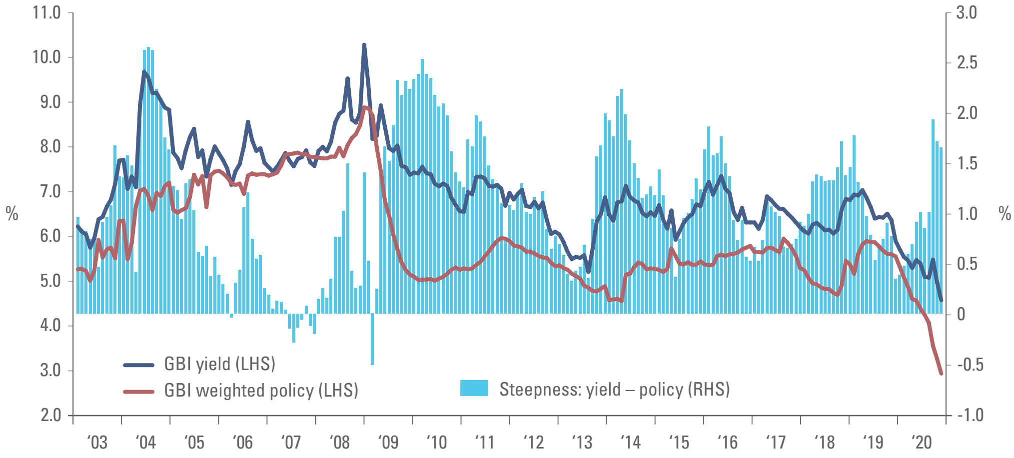
Emerging Markets

Figure 1: **GBI yield versus GBI-EM GD weighted policy rates**



Source: Ashmore, BIS, Bloomberg, JP Morgan. Data as at 31 May 2020.

The strong performance of local rates has been concealed by poor EM FX performance during the sell-off as the USD strengthened, as often happens during risk aversion events. However, this trend is now reversing. Since the end of March, the Dollar has weakened significantly. Last week alone, the DXY Dollar Index declined 0.9% and the index is down 5.7% since the peak in March. In the context of broad Dollar weakness, EM FX outperformed with a return of 3.4% last week and EM currencies are now 9.5% higher than the trough in March.

The Dollar sell-off is only in its early stages, in our view. EM currencies remain close to their cheapest levels in both nominal and inflation-adjusted terms, while the Dollar is close to its highest levels on both these measures. Nationwide protests in the US reflect a large and intractable problem of income inequality. Growing dissatisfaction will eventually be reflected at the ballot box, where voters will increasingly favour candidates that support redistribution in a bid to reduce inequality. Such policies are likely to increase government spending even further, thereby reducing already weak total factor productivity growth further. The prospects of declining productivity and higher future taxes are likely to drive capital out of the US economy over time.

- **Flows:** EM bonds received inflows of USD 2.3bn between 28 May and 03 June, according to data from EPFR reported by Bank of America Merrill Lynch. This is the largest inflow in three months. EPFR data only captures as a small segment of the investor base. Many institutional investors, which hold the vast majority of EM assets, have segregated accounts for which flows are not published. The inflow to EM bonds was split into USD 1.6bn in inflow to Dollar-denominated bonds and USD 0.7bn to local bonds. The new issuance market turned higher with USD 18.8bn in new deals priced last week compared to USD 4.8bn in the previous week. Brazil issued USD 3.5bn in 5-year and 10-year bonds, while Colombia issued USD 2.5bn in 10-year and 30-year bonds.

- **Debt relief:** The Global Times reported that China has suspended debt repayment for 77 EM countries as they work with the G20 countries to carry out the debt relief.[2] China has already announced USD 2bn in assistance over two years, including medical supplies and emergency funds for countries impacted by coronavirus. If confirmed, Chinese debt relief would be particularly positive for countries with large indebtedness to China that are currently requesting IMF assistance including Angola and Zambia. China also deepens ties with 77 countries – more than one third of the world's countries. This helps China to increase its global influence at a time, when the US is turning inwards.

- **Argentina:** Finance Minister Martin Guzman said the scope for further improving the terms of the government's debt restructuring offer is limited, but he nevertheless extended the deadline for a deal to 12 June. Argentina's representative at the IMF, Sergio Chodos, said the government "could improve a little more" on the second proposal, which was presented to investors the week before last. Officials at the IMF wrote a technical note supporting the restructuring offer. In other news, tax collections declined by 23% on a yoy basis in May after a 22% yoy decline in April.

- **China:** The Caixin Services PMI rose to 55.0 in May – the strongest reading since October 2010 – from 44.4 in April, thereby surprising to the upside relative to the median expectation of 47.3. Construction projects are also on the rise as high frequency data shows cement shipments rising 11.3% on a yoy basis in May from 9.7% yoy in April. Heavy truck sales increased by 62% on a yoy basis in May from 61% yoy in April. In terms of the

[2] https://www.globaltimes.cn/content/1190790.shtml#.Xt1rWqaSNpN.twitter

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external balances, China's trade surplus increased to USD 62.9bn in May from USD 45.3bn in April, thus beating the median expectation of a surplus of USD 41.4bn. Exports declined by 3.3% on a yoy basis, buoyed by an increase in exports of anti-epidemic medical equipment while imports declined by 16.7% yoy mostly due to lower commodity prices. The stronger than expected net export performance will positively impact the estimate of GDP growth in Q2 2020. The People's Bank of China (PBOC) established a program worth RMB 400bn to purchase bank loans extended to small and medium sized enterprises (SMEs), which should enable banks to lend up to RMB 1trn to SMEs in the coming quarters, according to the central bank. In other news, foreign investors' holdings of Chinese bonds rose by CNY 112bn (USD 16bn) in March after an increase of CNY 43bn in April.

- Ecuador: The Vice Minister of Economy Esteban Ferro presented a new economic scenario as well as the government's strategy to re-profile its debt. Ecuador's real GDP is expected to contract by 6.7% in 2020 compared to an estimate of -0.2% in December. The lower growth rate should increase the primary fiscal deficit to 4.5% of GDP for 2020 versus the surplus of 3.7% of GDP expected back in December prior to the coronavirus outbreak and the collapse in oil prices. The resulting increase in the government's gross financing needs is USD 13.5bn of which USD 5.0bn will be funded by multilaterals (including a new USD 0.8bn facility from IMF), USD 2.6bn in local markets, and USD 2.4bn via new loans from China. In order to fund the remaining USD 3.5bn financing gap for 2020 as well as to reduce the gross financing needs for the next 10 years to a maximum 6% of GDP per year, the government announced a debt re-profiling exercise, which has been anticipated by bond holders following the consent solicitation for a delay in coupon payments in April. The government will enter dialogue with investors by the end of June and aim to execute the transaction by the end of July. The IMF continue to provide strong support for the government of Ecuador, including technical assistance and additional funding. The price of the Ecuador 2030 bond has rebounded strongly from a low of 20c on 23 March to 46c as of 5 June as investors have begun to price in a market-friendly re-profiling of the debt.

- South Korea: The government announced a third increase in budget support worth KRW 35.3trn (approximately 1.8% of GDP) adding the largest fiscal stimulus since 2009. South Korea's fiscal deficit is now expected to be 5.8% of GDP compared to 3.5% of GDP in the government's original budget. In other news, the yoy rate of CPI inflation dropped to -0.3% in May from +0.1% yoy in April in line with the median analyst expectation.

- Egypt: The IMF announced a USD 5.2bn stand-by financing deal subject to board approval. The facility will allow Egypt to alleviate the economic impact from the coronavirus shock and protect the progress made during the previous IMF program. The fiscal deficit increased to EGP 330bn (USD 21bn) in the first three quarters of the 2019/2020 fiscal year. Higher spending on wages and debt service costs represented the bulk of the deterioration.

- Pakistan: Local news agencies reported that the IMF is asking for further fiscal consolidation, including freezing of government salaries in exchange for a new funded program. The Minister for Industries and Production, Hammad Azhar, said that the government has decided to privatise the loss-making Pakistan Steel Mills. Gross FX reserves declined by USD 1.7bn to USD 16.9bn in the week ending on 29 May due to external debt repayments.

- Angola: The largest state owned bank in Angola, BPC, will transfer 80% of its bad loans worth AOA 950bn (USD 1.7bn) to the government's asset management vehicle Recredit. Marking down bad loans is an important step towards increasing confidence in the banking system and credit creation.

- India: Moody's downgraded India's sovereign credit rating to Baa3 from Baa2, which is the lowest investment grade rating. This brings Moody's into line with S&P and Fitch. Moody's cited elevated levels of public debt and growth concerns as reasons for the downgrade. Moody's maintained a negative outlook for the rating, which implies a potential downgrade to below investment grade over the next six months to two years. India's services PMI increased to 12.5 in May from 5.4 in April. The improvement was small despite the easing of lockdowns, which began in mid-May.

Snippets:

- Brazil: Federal government revenues declined by 32% on a yoy basis in April, while expenditures rose by 45% yoy. This resulted in a record BRL 93bn fiscal deficit in April. Industrial production (IP) declined by 18.8% in April, which is the worst drop on record, but better than the median consensus expectation of a 28.3% decline.
- Chile: CPI inflation declined to 2.8% on a yoy basis in May from 3.4% yoy in April, thereby surprising to the downside versus the consensus expectation.

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- **Costa Rica:** Finance Minister Elian Villegas confirmed that the government has submitted an application for a stand-by agreement with the IMF. A deal with the fund would reduce funding uncertainty and provide a roadmap for fiscal consolidation.
- **Hong Kong:** The composite PMI improved to 43.9 in May from 36.9 in April due to a partial easing of movement restrictions and stronger economic performance in China.
- **Ivory Coast:** Fitch kept Ivory Coast's rating at 'B+' with a positive outlook due to stronger performance than other single-B rated peers.
- **Indonesia:** CPI inflation declined to 2.2% on a yoy basis in May from 2.7% in April, thus taking the inflation rate close to lower end of Bank Indonesia's 2% to 4% inflation band. Lower inflation allows for lower policy rates, in our view.
- **Malaysia:** Malaysia registered the first monthly trade deficit since 1997 in April as exports declined by 23.8% on a yoy basis and imports declined at a rate of 8.0% yoy.
- **Mexico:** Private consumption declined by 2.4% in March after a 0.5% decrease in February. Investment also declined by 3.1% in March following a 3.6% fall in the previous month.
- **Nigeria:** Nigeria cut oil production to 1.4 million barrels per day (mbpd) in order to comply with the OPEC+ deal. The production number is far below the original budget estimate of 2.1 mbpd in 2020.
- **Philippines:** The yoy rate of CPI inflation declined to 2.1% in May from 2.2% yoy in April, in line with consensus expectations. The rate of unemployment rose to a record 17.7% in April from 5.3% in January, with the bulk of the impact suffered by the service sector.
- **Qatar:** Kuwaiti Prime Minister Shaikh Sabah Al Khaled said he has increased hopes of achieving a deal to end the Golf Corporation Council (GCC) rift with Qatar. An end to the dispute would be positive for the banking system and improve trade flows across the region.
- **Senegal:** S&P kept Senegal's sovereign credit rating at 'B+' with a stable outlook. The ratings agency forecast a fiscal deficit of 3.6% for 2020 and debt peaking at 64% of GDP this year.
- **South Africa:** Central Bank Governor Lesetja Kganyago suggested that the monetary authority is ready to deploy further monetary policy easing in the future.
- **Thailand:** The yoy rate of CPI declined to -3.4% in May from -3.0% yoy in April.
- **Turkey:** CPI inflation rose to 11.4% on yoy basis in May from 10.9% in April.
- **Uruguay:** CPI inflation inched up to 11.1% on a yoy basis in May from 10.9% yoy in April.
- **Venezuela:** President Nicolas Maduro agreed with opposition leader Juan Guaido to seek funding for testing, protective equipment, and public health campaigns. This is is the first major agreement between the politicians.
- **Vietnam:** The National Assembly is likely to approve a free trade agreement with the European Union over the next weeks. The deal would lower trade tariffs and increase the scope for foreign direct investment (FDI). The EU is Vietnam's second largest trading partner.

Global backdrop

- **US:** There was a very big positive surprise on the US labour market data as non-farm payrolls registered 2.5m new jobs in the month of May. This represented a whopping 10m surprise versus the median expectation of 7.5m in new layoffs. The leisure sector added 1.2m jobs in April after 6.9m layoffs in April. The construction sector added 464k jobs and 225k jobs were created in manufacturing. The unemployment rate declined to 13.3% from 14.7% in April despite a 0.6% increase in the participation rate to 60.8%. Average hourly earnings declined by 1% as low wage employees were hired. The share of unemployed reporting that they are temporarily laid off remained high at 73% in May compared to 78% in April, which suggests scope for further improvement in the employment situation in the coming month. However, other economic indicators pointed to more muted improvement. The ISM manufacturing survey inched up to 43.5 in May from 41.5 in April, while the non-manufacturing survey rose to 45.4 from 41.8. Both indices therefore point to a lengthier contraction than expected. April construction spending declined by 2.9%, which was less than the 6.5% drop expected based on the median Bloomberg expectations survey.

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Global backdrop

On the fiscal front, the Trump administration announced another USD 1trn of government spending to boost the economy. President Donald Trump is probably looking to spend his way into re-election as his rejection rate increased to 53.1% in 5 June from 50% in 5 April and his approval rate declined to 41.6% from 45.8% over the same period according to quality weighted poll-of-polls from FiveThirtyEight.[3] Trump's net approval rating at this stage in the political business cycle is lower than every president since 1945 with the sole exception of George H. W. Bush. Trump's tough stance against street protests appears to have backfired following his poor handling of the coronavirus outbreak.

In other news, US trade representative Robert Lighthizer said China was doing enough to honour the phase one of the trade agreement in contradiction of media reports that China was not honouring the soybean import quota under the agreement.

- Euro area: The European Central Bank (ECB) increased the size and duration of its pandemic emergency purchase programme (PEPP) from EUR 750bn to EUR 1.35trn. Net purchases under the PEPP will also be extended from the end of 2020 until at least June 2021 with maturities of existing securities re-invested until at least the end of 2022. Germany also announced a stimulus package amounting EUR 130bn, which includes a cut in value added tax (VAT) for the period from July to December 2020 as well as support for municipalities and improved incentives to buy electric cars. In economic news, the euro area unemployment rate inched up to 7.3% in April from 7.1% in March, surprising the median expectation of an increase of 8.2%. The low level of unemployment is explained by wage subsidy schemes, which have been introduced widely across the euro area, whereby governments pay a good part of the salaries of workers to prevent dismissals. Without the scheme, the unemployment rate would probably be greater than 20%. Eurozone retail sales declined 19.6% in April after an 8.8% decline in March, slightly better than the median expectation. The Eurozone producer price index (PPI) declined to a yoy rate of -4.5% deflation in April from -2.8% yoy in March. Prices are likely to decline further as governments cut taxes to revive the economy. In Germany, factory orders and factory sales declined by 25.8% and 22.8%, respectively in April, which was close to the consensus expectation.
- UK: The number of employees supported by the government furlough subsidy scheme is now close to one-third of the labour force, according to the government. The scheme will gradually be unwound starting in August and closed by the end of October, according to the Chancellor of the Exchequer Rishi Sunak.
- Oil: The Organisation of the Petroleum Exporting Companies (OPEC) agreed to extend record production cuts of 9.6m bpd to the end of July. Countries that failed to implement the target cuts in May, such as Iraq, Nigeria, Kazakhstan, and Angola will be asked to make extra reductions between July and September. Brent futures rose by 12.7% last week to USD 42.3 per barrel.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	7.88%	18.71%	-9.27%	2.74%	2.33%	3.25%
MSCI EM Small Cap	8.99%	27.16%	-12.70%	-5.65%	-2.82%	-1.62%
MSCI Frontier	1.44%	14.57%	-15.94%	-9.80%	-2.05%	-0.48%
MSCI Asia	7.60%	15.91%	-5.36%	7.00%	3.72%	4.16%
Shanghai Composite	2.83%	6.88%	-3.63%	4.73%	0.54%	-8.29%
Hong Kong Hang Seng	5.92%	6.23%	-8.73%	0.96%	2.54%	-2.50%
MSCI EMEA	7.31%	23.62%	-18.27%	-11.40%	-2.61%	-0.56%
MSCI Latam	15.83%	31.17%	-28.62%	-21.46%	-3.79%	-0.74%
GBI EM GD	3.03%	12.61%	-4.52%	4.21%	1.83%	3.04%
ELMI+	2.42%	5.10%	-3.81%	-0.33%	0.47%	1.23%
EM FX Spot	3.40%	7.34%	-8.02%	-6.80%	-5.32%	-4.39%
EMBI GD	2.46%	11.11%	-3.76%	1.94%	3.03%	4.99%
EMBI GD IG	0.49%	7.64%	1.79%	8.97%	6.00%	5.80%
EMBI GD HY	4.96%	15.76%	-10.22%	-5.98%	-0.36%	4.02%
CEMBI BD	1.57%	9.87%	-1.31%	4.42%	4.12%	4.82%
CEMBI BD IG	0.67%	7.00%	0.52%	5.86%	4.70%	4.59%
CEMBI BD Non-IG	2.82%	14.11%	-3.87%	2.33%	3.34%	5.19%

[3] https://projects.fivethirtyeight.com/trump-approval-ratings/?ex_cid=rrpromo

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Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	4.96%	24.05%	-0.26%	15.29%	11.62%	11.05%
1-3yr UST	-0.14%	0.07%	2.83%	4.27%	2.62%	1.87%
3-5yr UST	-0.57%	-0.08%	5.29%	7.07%	3.81%	3.02%
7-10yr UST	-1.84%	-1.02%	9.02%	11.90%	5.87%	4.79%
10yr+ UST	-4.84%	-4.73%	15.19%	21.64%	10.17%	8.24%
10yr+ Germany	-3.91%	-3.64%	1.25%	2.12%	5.34%	5.12%
10yr+ Japan	-0.81%	-1.13%	-1.96%	-2.02%	1.78%	3.68%
US HY	3.10%	12.49%	-1.78%	3.99%	4.00%	5.06%
European HY	3.01%	12.92%	-5.32%	-0.28%	1.14%	2.84%
Barclays Ag	0.02%	2.44%	2.10%	4.87%	3.43%	3.54%
VIX Index*	-10.87%	-54.20%	77.94%	50.43%	141.34%	60.37%
DXY Index*	-1.47%	-2.17%	0.53%	0.37%	-0.02%	1.68%
CRY Index*	5.09%	14.11%	-25.20%	-20.32%	-21.08%	-37.69%
EURUSD	1.67%	2.32%	0.65%	-0.22%	0.65%	-0.04%
USDJPY	1.52%	1.79%	0.79%	0.94%	-0.49%	-12.07%
Brent	22.25%	89.93%	-34.56%	-31.76%	-9.76%	-31.11%
Gold spot	-2.25%	7.24%	11.47%	27.36%	32.34%	44.06%

*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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