January 2020

Monthly Commentary

Emerging market debt update

Market review

The de-escalation in US-China trade tensions, with the agreement on a phase one deal and partial backtrack on tariffs, resulted in a positive sentiment driving returns for the remainder of 2019. This led to December being one of the best months of the year across emerging-market assets. As widely expected, the US Federal Reserve kept interest rates unchanged in December, highlighting that the current policy stance is appropriate. This was in a similar fashion to October's meeting, when Chairman Jerome Powell signalled a pause in rate cuts. As a result, the 10-year US Treasury yield rose by 14 basis points (bps), reaching 1.92% at the end of the month. Supported by rising trade optimism and OPEC+ production curbs, the Brent crude oil price rose by 5.72% to US$66 per barrel at the end of the month.

In hard-currency debt, the JP Morgan EMBI Global Diversified index returned 2.01%, while the benchmark spread tightened by 34bps to 291bps over US Treasuries. By credit quality, high-yield assets outperformed investment-grade assets in the more positive market environment formed at the end of the year. By country, the positive performance was led by Argentina, Ecuador, Zambia and Angola. The worst performers over the month were Suriname, Slovakia and Malaysia. In Argentina, the economic emergency bill, approved by Congress before Christmas, was welcomed by investors as a sign of willingness to service debt. Ecuadorian assets were boosted by the completion of the second and third review of the International Monetary Fund (IMF) programme, which unlocked further funding. Suriname successfully raised US$125 million on the international markets, in a transaction which saw delays and amendments during the month and caused fluctuations in asset prices.

In local-currency debt, the JP Morgan GBI-EM Global Diversified index (unhedged in US dollar terms) returned 4.13%, while the yield of the index fell by 4bps to 5.22% at the end of the month. The positive return was driven mostly by emerging-market currencies, supported by the US-China phase one deal, while bond returns also contributed positively to performance. Colombia and Chile were the best performers over the month. Meanwhile, at the other end of the spectrum, Turkey and the Dominican Republic were the only two countries that detracted from performance, on the back of negative currency returns. As inflation returned to double-digit territory in Turkey and President Erdogan warned of shutting down two of its most critical NATO installations on its territory if the US imposes sanctions, the currency weakened and bonds underperformed over the month.

Country News

In **Argentina**, Alberto Fernandez was sworn in as president on 10 December. In his inauguration speech, among plans for prioritising the low income earners, President Fernandez noted that the 2020 Budget discussion would be possible once debt negotiations were complete, by April or May according to his expectations. The 'Social Solidarity and Output Recovery Law', proposed by the new government and passed by Congress in the week before Christmas, includes measures that increase government expenses for social assistance. Additionally, it also significantly increases some taxes, aiming at a top-down reallocation of resources. In the third quarter of 2019, the trade deficit narrowed to US$1.1 billion, from a deficit of US$7.4 billion in the same quarter of 2018. This was driven by continued harvest normalisation and declining imports, and triggered a sharp adjustment in the current account balance. This trend continued into the fourth quarter of 2019, with the trade surplus registered in November being the highest since mid-2009. In the monetary-policy space, the new Central Bank of Argentina board trimmed the Leliq rate floor by 5%, from 63% to 58%, and maintained capital controls.

In **Brazil**, the consolidated public sector posted a BRL15.3 billion primary deficit in November, bringing the 12-month rolling primary deficit to 1.2% of GDP, down from 1.3% of GDP in the previous month. The current account posted a US$2.2 billion deficit in November, coming in below market expectations due to volatile components. From January to

November, declining exports led to the current account deficit widening to US$45 billion, from US$35 billion in the same period in 2018.

In **Ecuador**, the IMF concluded the combined second and third reviews of the US$4.2 billion programme, unlocking approximately US$500 million in disbursements. This followed the National Assembly's approval of the government's amended tax reform, which aims to boost tax revenue by US$600 million per year. This would be through a number of measures, including raising taxes for high earners and companies with annual sales above US$1 million. In mid-December, the National Assembly also approved the 2020 budget law, with a deficit of US$3.4 billion, equivalent to 3.1% of GDP.

In **Chile**, manufacturing activity recovered in November to 3.2% year on year (y/y), following a protest-led contraction in the previous month. However, industrial production was dragged down by a 7.1% y/y contraction in mining activity in November. This resulted in the sharpest industrial activity contraction since April 2017, at 10% on a sequential quarter-on-quarter (q/q) basis. The central bank kept the monetary-policy rate on hold at 1.75% in December, with the minutes highlighting stable rates in the short term as domestic shocks added significant uncertainty to the economic outlook.

Banco de **Mexico** cut the policy rate by 25bps, bringing it to 7.25%, in line with market expectations. The board noted that the weakness in economic activity is expected to persist, with the balance of risks tilted to the downside. Headline inflation moved below the 3% target in November, coming in at 2.97% in annual terms. Core inflation also moderated from last month's reading, reaching 3.65% y/y. The drop was driven by November's seasonal sales, but held up by the stickiness in services prices. The National Commission of Minimum Wages voted unanimously for a 20% increase in the minimum wage in 2020, bringing the accumulated expansion close to 40% since December 2019, fulfilling one of the main commitments of the current administration. Congress ratified the US-Mexico-Canada Agreement with little opposition, including a bill banning tax waivers.

The US and **China** announced a limited phase one trade deal that removes some tariffs on Chinese exports in return for the Chinese government's commitment to increase purchases of US agricultural products, improve openness in its financial sector and the protection of intellectual property. Both sides also agreed to not manipulate their currencies, while the US is considering an up to 50% reduction in existing tariffs. This development was followed by news of better economic figures out of China, with November growth data beating market expectations: industrial production increased 6.2% y/y, from 4.7% y/y a month earlier, retail sales growth picked up from 7.2% y/y to 8.0% y/y and fixed asset investment accelerated to 5.2% y/y, from 3.7% y/y in October.

In **India**, the Monetary Policy Committee surprised the market by keeping the repurchase rate on hold at 5.15%, against an expected 25bps cut. The decision to keep rates unchanged was justified by the spike in consumer price index inflation above the central bank's target of 4%, reaching 5.54% y/y in November, on the back of food, housing and services. At the same time, the committee sharply lowered the fiscal year 2020 GDP growth projection to 5.0%, from 6.6–7.2% previously, and noted that the inflation spike would be transient. As such, the monetary-policy guidance remained dovish and the pause in rates temporary, according to the central bank's governor.

In **Indonesia**, headline inflation eased further, from 3.00% y/y in November to 2.72% y/y in December, as food prices continued to decline. Meanwhile, core inflation remained low at 3.02% y/y, versus 3.08% previously, due to subdued demand. Foreign reserves were relatively stable at US$126.6 billion in November after increasing by more than US$5 billion since the beginning of the year. The growth in reserves was supported by resilient surpluses in the capital and financial accounts. After posting the sixth trade surplus this year, amounting to US$161 million in October 2019, Indonesia recorded a trade deficit of US$1.3 billion in November, despite imports contracting deeper than exports – by 9.2% y/y versus 5.7% y/y. As expected, Bank Indonesia (BI) left the seven-day reverse repurchase rate unchanged at 5.0% for the third month in a row in December, having cut by a cumulative 100bps in 2019. BI expressed a preference for an accommodative monetary-policy stance going forward, but with a higher priority for maintaining external stability than for boosting growth.

In **Russia**, the second reading of third-quarter GDP figures confirmed the acceleration in the pace of growth to 1.7% y/y during the quarter, from 0.9% y/y in the previous quarter, on the back of agricultural and manufacturing output growth. The Central Bank of Russia cut the key rate by 25bps to 6.25%, in line with market expectations, acknowledging the faster-than-expected slowdown in inflation but highlighting the improving domestic-demand dynamics during the previous two quarters. The forward guidance changed from the last meeting, with the central bank's governor implying the need for time to assess whether further easing is necessary. Consumer inflation slowed to 3.5% y/y in November, from 3.8% in October, driven by weak food and core inflation. As a result, the central bank revised its end-2019 inflation forecast down from 3.2–3.7% y/y to 2.9–3.2% y/y, but kept the end-2020 forecast unchanged at 3.5–4.0% y/y.

In **South Africa**, annual GDP growth slowed to 0.1% in the third quarter, from 0.9% previously, pushed down by a q/q contraction of 0.6%. The decline was driven by mining and manufacturing output falling by 6.1% q/q and 3.9% q/q, respectively. Meanwhile, agriculture contracted 3.6% q/q, from a fall of 4.2% q/q in the second quarter, as the dry season extended. The current account deficit narrowed slightly to 3.7% of GDP in the third quarter from a revised 4.1% of GDP in the second quarter. The improvement was driven by the trade balance moving from a deficit of 0.6% of GDP in the second quarter to a surplus of 0.8% of GDP in the third quarter. This was due to weak imports from deteriorating domestic demand and as export volumes increased. In line with consensus expectations, inflation edged down 10bps in November to 3.6% y/y. Meanwhile, core inflation also slowed by 10bps to 3.9% y/y, the slowest rate since the end of 2011. The main factor behind the weak inflation pressures was the deflation in transport prices as petrol and diesel prices declined by 13c per litre and 16c per litre, respectively.

The **Turkish** economy expanded by 0.9% y/y in the third quarter, its first positive annual growth rate in a year. Factors that contributed to the expansion included the higher number of working days compared to the same quarter in 2018, improvements in domestic demand and a change in inventories. Annual inflation reverted to double-digit territory in November, reaching 10.6% y/y from 8.6% y/y in October, due to unfavourable base effects. The Central Bank of Turkey delivered its fourth rate cut in 2019, lowering its policy rate by 200bps in December; rate cuts since June have now amounted to 1,200bps. The easing also continued through the credit channel, where the bank moved from a nominal to a real loan growth target for banks, which will benefit from lower reserve requirements as a result.

Outlook

Emerging-market growth should be lifted by a phase one US-China trade deal and a mild recovery in major emerging economies, after prolonged weakness. We believe global growth will fare better than expected, thanks to Eurozone growth bottoming out, improvements in Chinese economic activity and a milder-than-anticipated US slowdown. While the inflation outlook turned less benign for the new year, global monetary policy will remain accommodative in the face of the weak growth environment. The key risks to our view remain continued dollar strength, the persistence of US exceptionalism, a deeper China slowdown and a re-escalation in trade wars.

Emerging Market Debt team
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