Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update
Weekly Update

October 11, 2018

Brazil turns to the right - Emerging Markets Update

Brazil was the main emerging market (EM) story this week as far-right politician Jair Bolsonaro scored a near-outright victory in first round elections over the weekend. Unfortunately, US rates also grabbed the headlines as a sharp rise in yields and a steepening of the curve impacted broader risk markets. US equities traded off as investors rotated from growth stocks into value names, while EM assets bore the brunt of the pain with equities down over 4% and local rates and FX both selling-off in the order of 1%. Italy also remained in the headlines as the government confirmed its plan for looser fiscal policy with a deficit of 2.4% for 2019, which in itself is based on some fairly aggressive growth assumptions. While this has yet to materially impact broader markets, Italian spreads are not too far from the potential contagion zone.

In EM News:

- In Brazil, Jair Bolsonaro and his Social Liberal Party (PSL) put in a solid showing in the first round of the elections, although it was not enough to avoid a second round run-off against Workers' Party (PT) candidate Fernando Haddad. Expectations are that Bolsonaro will win the second round and the positive showing by his PSL party and other smaller parties that are aligned to Bolsonaro represents a clear shift to the right in the Brazilian population, creating some hope that fiscal reform may be passed.
- Turkish CPI printed at a nasty 24.5% year-on-year in September, capping a 6.3% monthly rise in inflation. With the economy entering a sharp contraction, we would expect domestic demand to fall off materially and for the FX to be the key channel for inflation. Gaining control of the currency via credible central bank actions and fiscal consolidation should be the number-one priority. Markets are also watching the Pastor Brunson case closely, with this Friday being the day he may be released if the Turkish authorities so choose.
- China cut the reserve requirement ratio for banks again over the weekend (which will release the equivalent of USD175 billion), providing another sign that the government will look at further easing measures to prop-up growth. The offshore yuan (CNH) declined for the second week in a row and is fast closing in on the psychologically important '7' level.
- South Africa's Finance Minister Nhlanhla Nene admitted meeting with the Gupta family on multiple occasions, forcing President Ramaphosa into a difficult situation and ultimately making Nene's position untenable.
- Asian currencies, including the Indian rupee, the Indonesian rupiah and the South Korean won all suffered as a result of higher US rates, rising oil prices and concerns over trade.
- Gulf allies officially signed a USD10 billion support package for Bahrain.

Weekly market snapshot as of 10/5/2018

	Total return 1 week	Total return MTD	Total return QTD	Total return YTD	Spread change 1 week	Spread change MTD	Spread change QTD	Spread change YTD	Current spread	Current YTM
Hard currency corp	-0.46%	-0.46%	-0.46%	-2.11%	(3)	(3)	(3)	31	291	5.88%
Hard currency corp - IG	-0.46%	-0.46%	-0.46%	-1.52%	(5)	(5)	(5)	10	188	4.88%
Hard currency corp - HY	-0.46%	-0.46%	-0.46%	-2.85%	(0)	(0)	(0)	63	439	7.45%
Hard currency sov	-1.26%	-1.26%	-1.26%	-4.27%	5	5	5	55	340	6.62%
Local currency corp	-1.30%	-1.30%	-1.30%	-3.08%	4	4	4	(33)	134	7.00%
Local currency sov	-1.68%	-1.68%	-1.68%	-9.70%	n/a	n/a	n/a	n/a	n/a	6.76%
Local currency sov - rates	-0.63%	-0.63%	-0.63%	-0.39%	n/a	n/a	n/a	n/a	n/a	n/a
Local currency sov - FX	-1.07%	-1.07%	-1.07%	-9.34%	n/a	n/a	n/a	n/a	n/a	n/a

Movers and shakers on the week

Sovereign credit		Corporate credit		EM FX		Local rates	
Zambia	3.63%	Pulp & Paper	0.33%	Argentina	7.78%	Argentina	2.23%
Lebanon	1.00%	Transport	0.28%	Brazil	3.01%	Brazil	1.06%
Costa Rica	0.72%	Industrial	-0.14%	Malaysia	-0.20%	Philippines	0.22%
Senegal	-3.11%	TMT	-0.59%	Indonesia	-1.83%	South Africa	-1.55%
Turkey	-3.18%	Oil & gas	-0.65%	Colombia	-1.85%	Indonesia	-1.72%
Argentina	-3.71%	Infrastructure	-0.94%	South Africa	-4.03%	Turkey	-4.55%

Source: Bloomberg, JPMorgan. Past results are not indicative of future results.

In EM corporates news:

- An Indian infrastructure lender continued to default on debt obligations with no sign of new financing despite the government reconstituting the board in an attempt to instil confidence in the lender. Indian oil companies also came under pressure as the government asked downstream companies to absorb a INR1/ litre price cut, which would severely impact their margins. This is another sign of the increasing burden higher oil prices are putting on the major oil-importing countries.
- Asian technology companies came under pressure as it was revealed that China had used a tiny chip placed in computing hardware to infiltrate US companies. While details were scarce, investors chose to sell first and ask questions later.
- Brazilian corporates began to trade well after a couple of months in the doldrums as the cloud of election uncertainty began to lift.

Outlook:

The US economy is going from strength to strength while the rest of the world is experiencing a series of growth downgrades, as evidenced by the recent IMF report. EM growth in particular has taken a hit as vulnerable countries like Turkey and Argentina have seen material growth revisions, and most importantly as the impact of the Chinese deleveraging and trade war with the US impacts the growth outlook for China. In response, the Chinese continue to add stimulus to the economy with local government bond issuance (which feeds infrastructure spending) up materially in the third quarter. This is likely to provide support to commodities, with EM commodity exporters like Brazil being the net beneficiaries. With oil prices well supported in the mid USD80 a barrel range, the commodity environment continues to create a differentiated EM space with Asia suffering disproportionately, given its status as a net commodity importer.

For this week, the crucial data print for markets will be US CPI on Thursday, which needs to be in line for risk markets to be able to stabilise. Although not the base case, any overshoot will lead to further upside in Treasury yields and is likely to impact all risk markets, not just EM, given the implications for the Fed hiking cycle. Turkey watchers will also be eagerly anticipating the possible release of Pastor Brunson on Friday. For the rest of the month, Italy and Brazil are likely to have a big impact on risk sentiment, with Brazil seemingly headed for a market-friendly outcome as Bolsonaro remains ahead in the second round polling. If Brazil can get through the elections unscathed, then it seems possible that many of the more troublesome EM countries will manage to stabilise their situations, at least for the near term.

US monetary and trade policy will remain a headwind for the asset class, but a more constructive EM policy response combined with a solid technical picture and relatively cheap valuations should, in our view, provide some support for EM into the end of 2018.

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