MyStratWeekly
Market views and strategy

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N° 019 // **April 26, 2021**

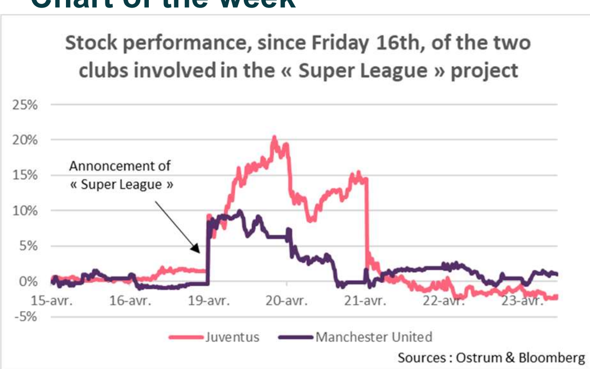
Topic of the week: Emerging; at a crossroads

- **The "reflation trade" eventually leads to a "sudden-stop".**
- **This episode also highlights the acceleration of the opening of China's financial sector as well as the inability to generate sustainable growth since the 2008 financial crisis.**
- **Covid-19 could be an opportunity to embark on a green, more sustainable, and more equitable development path.**

Market review: US greenback drifts lower before FOMC

- **Fed tapering announcement delayed until Jackson Hole**
- **ECB left policy unchanged amid cacophony within council**
- **Yields and spreads broadly stable**
- **Upbeat earnings releases in Q1**

Chart of the week



The stock market applauded with both hands the "Super League" project proposed by a group of European clubs. The two listed ones that took part in the project, Juventus and Manchester United, saw their stock price surge at the opening on Monday.

The rapid collapse of the project brought the stock value back to the level of the previous week.

The stock market confirmed unequivocally that it was indeed a very good project from a financial point of view. On the sporting side, however, it's a different story.

Figure of the week

88 %

The share of stocks in the S&P above their 200-day moving average. This is close to a record high.
It also shows the breath of the rally.

Source : Ostrum AM

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● **Topic of the week**

Emerging markets: at the crossroads

The election of Joe Biden as President of the United States was seen as a positive for emerging markets. While emerging market performance since the US election has indeed been encouraging, the acceleration of "reflation trade" has also created collateral damages. Over the first quarter, emerging markets experienced significant capital outflows that led to higher local interest rates and depreciation of their currencies. This umpteenth episode of "sudden-stop" comes in the midst of a health crisis that could also worsen their long-term economic prospects.

The context

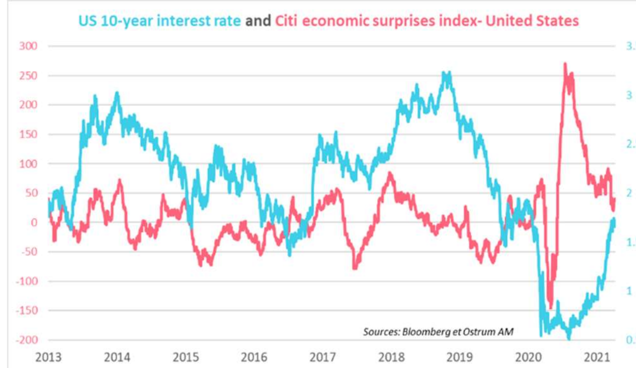
The "reflation trade" theme and its consequences on financial markets

The "reflation trade" theme began in November 2020 on the financial markets after the US elections and the announcement of vaccine discovery. The timing of global monetary and fiscal policy, with ambitious policies, and the prospect of rapid vaccination against Covid-19, have been prime catalysts.

It resulted in a rapid increase in commodity prices. Industrial metal prices rose sharply, particularly those of copper which reached highs since 2012 (+40% over the period from November to its peak on February 26, 2021).

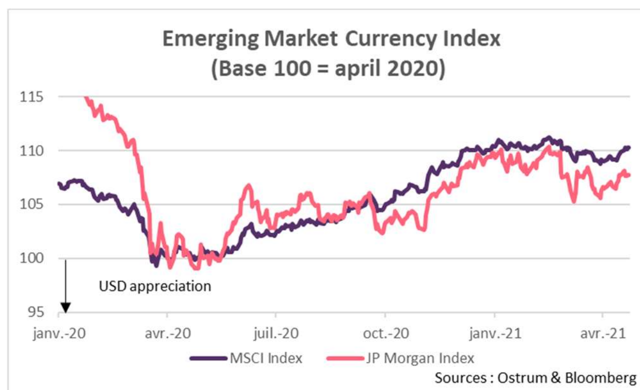
Brent prices, which averaged $42.2 in 2020, also rose by almost +88% in November until their peak of March 5, 2021, at $69.

Inflation expectations are up too in the wake of higher crude oil prices, which helped to push up the long-term nominal interest rates of the main money markets. The largest increase was in the United States. This is linked to a faster and stronger than expected economic recovery, as shown in the chart below.



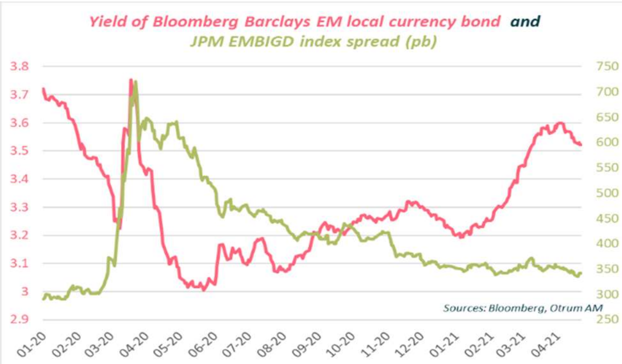
Citi's economic surprises indicator for the United States and the evolution of the US 10-year interest rate are quite well correlated. It is noted, however, that over the recent period, the Citi economic surprises indicator has rebounded sharply to record highs, leading to the acceleration of the US 10-year interest rate.

One of the consequences is the reduction of the interest rate differential between the United States and the rest of the world, which was also a support for the greenback over the first quarter of this year. Emerging market currency indices have been up significantly since April last year, 10.2% for the MSCI Index, 7.8% for the JP Morgan; however, they have suffered somewhat over the first quarter as the dollar rebounded by 1.1% against the MSCI Index and by 2.7% for the JP Morgan Index. Even since then, the weakness of the dollar has resumed.



Contagion effect on emerging markets

The chart below shows the yield of the Bloomberg Barclays Index for local EM sovereign. This has increased since the beginning of the year in the wake of the rise in US long-term interest rates. However, this effect is purely related to the movement of the benchmark risk-free asset, the EMBIGD spread, which measures the risk of emerging countries, stabilized over the period and even tended to tighten albeit very slowly.



Contrary to what has been observed on the Treasury bond markets of the main money markets, the rise in local rates in emerging countries is not linked to the rise in inflation expectations.

Inflationary pressures remain subdued overall, reflecting the weakness of core inflation (inflation excluding food and energy). Moreover, inflation rates are below the central bank target.

The acceleration of inflation in a number of emerging countries is linked to rising commodity prices such as food and energy, which have led to sizeable base effects.

The « reflation trade » eventually led to a « sudden stop ».

Emerging countries have thus suffered over the first quarter of this year an umpteenth episode of «sudden stop», that is to say massive and brutal outflows of capital. This episode occurs when an equilibrium is broken. In the case of emerging countries, this balance was based on low US interest rates, which reduced the pressure on their dollar indebtedness and their probability of default. The rise in US interest rates has changed this balance by driving a revaluation of their hard currency debt and credit risk profile.

According to the IFF, capital outflows from emerging countries reached nearly the same levels as in the "Taper Tantrum" phase of 2013, when Bernanke, then governor of the Fed, announced by surprise the imminent end of his purchases of financial assets by the Fed. This meant a tightening of US monetary policy. March this year was indeed the worst month for emerging markets since September 2020, with capital outflows of $4.79 billion up to March 26 (according to the IFF), this number follows $1.94 billion in February. These figures are compared to the year 2020, when portfolio inflows totaled $313 billion in 2020, which represented $48 billion less than in 2019.

Capital outflows from emerging countries in the first quarter contributed to an increase in their local interest rates and the depreciation of their currencies.

Which countries have been most affected?

Emerging countries with large financing needs, characterized by high current and fiscal deficits, were the most affected. These countries were grouped into a group called "Fragile Five," (Morgan Stanley 2013). Brazil, South Africa, Indonesia and Turkey are included (see chart below).

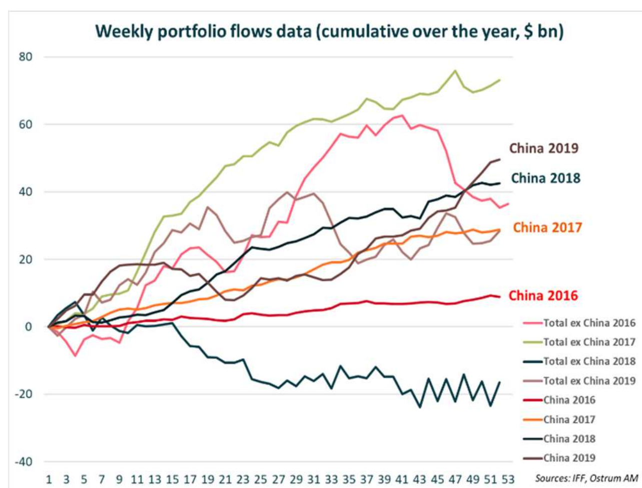
India, which was also a member of the club in 2013, had a more moderate reaction to its local interest rates, reflecting the weak positioning of investors in its domestic markets.

Emerging countries with a significant foreign presence in their domestic financial markets are the most sensitive to a reversal in foreign investor sentiment as well as rising US interest rates.

It seems to us that this umpteenth shock that has hit emerging countries since the 2008 financial crisis, highlights both new and old problems for emerging countries: the acceleration of the opening of the Chinese financial sector and their inability to generate sustainable growth since the 2008 financial crisis.

The Chinese exception

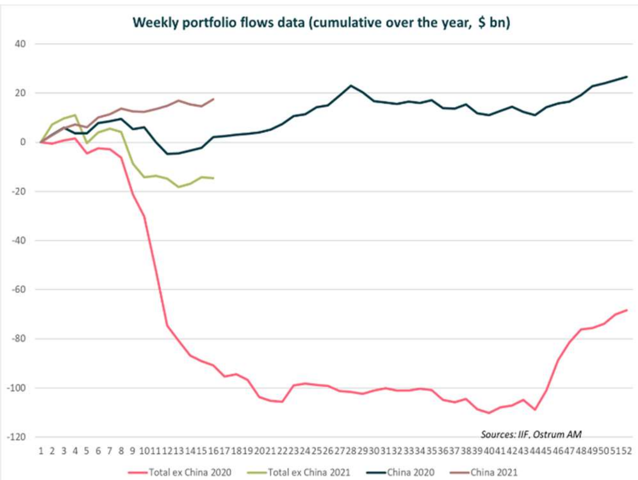
The chart below illustrates the gradual opening of the Chinese financial sector to foreign investors. It represents portfolio flows (equities and interest rates), cumulated over 1 year, to emerging countries and those to China for the years 2016 to 2019. From year to year, portfolio investment flows to China are increasing.



This was facilitated by the creation in July 2017 of the "Bond Connect" platform that enabled foreign investors to process local domestic bonds via the Hong Kong Stock Exchange. In the past, they had to open expensive domestic deposit accounts.

Thus, the lifting of restrictions on domestic financial markets, but also the introduction of Chinese A-shares and domestic bonds in the main global indices, has increasingly opened up access to China's domestic financial assets for foreign investors.

The other point raised by the chart is that the inflow of portfolio flows to China continues even during "sudden-stop" episodes, such as in 2018 (US monetary policy tightening and the China-US trade war). On the last two episodes of sudden-stop, health crisis 2020 and 2021, we find once again the same dynamic (below) as the previous one: the attraction for the Chinese financial markets does not weaken.



This enthusiasm of foreign investors for China, reflects the rapid exit of the health crisis and strong growth prospects of the country compared to other emerging countries.

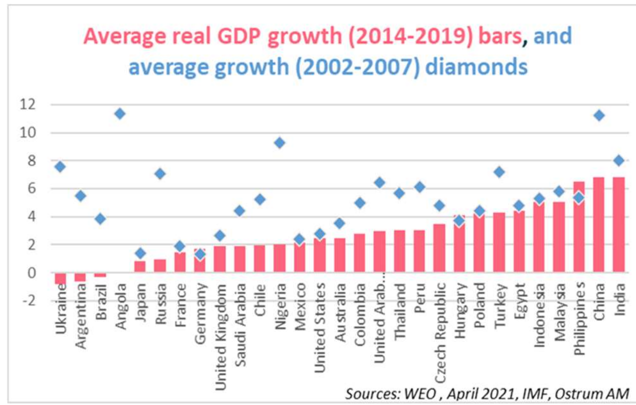
In its World Economic Outlook of April 2021, the IMF expects growth for 2021 of 8.4% for China, while the growth of other emerging countries, excluding China and India, is expected to be 4.2%. This trend is expected to continue and increase at the risk of disrupting once again capital flows to emerging countries.

China's new "dual circulation" economic strategy aims to strengthen domestic demand while continuing its trade with the outside world. This also involves the internationalization of the yuan, the creation of the digital yuan[1] will accelerate it, and the opening of its financial sector.

A cruel lack of growth after the 2008 financial crisis

A large part of the enthusiasm of investors around emerging markets was based on the theme of growth, in particular the differential with the developed countries. However, since the 2008 financial crisis, growth in emerging countries has slowed sharply compared to these countries.

This can be seen in the graph below which shows the average real GDP growth over two periods: 2002-2007, before the financial crisis and 2014-2019, more recent period (source: WEO, April 2021, IMF).



At the far right are China and India with growth around 7% over the period 2014-2019. At the left end, large emerging countries such as Brazil, Russia followed by Argentina and Ukraine.

The drop in commodity prices, including oil prices in 2014, could account for some of the slowdown in growth for both producing and exporting countries. Among commodity exporters, a sharp deterioration in the terms of trade (for energy exporters) and a sharp increase in private debt are the main factors associated with the slowdown in investment growth.

However, the slowdown in growth goes beyond the countries that produce and export raw materials. Virtually all countries have lower average growth over 2014-2019 than 2002-2007. This slowdown is related to weak investment growth in these countries.

Since 2010, investment growth in emerging markets has slowed significantly from an average of 10% in 2010 to 3.4% in 2015. Investment growth was also below its long-term average in nearly 70% of emerging markets in 2015![2].

For commodity importers, the slowdown is linked to the slowdown in FDI (Foreign Direct Investment) and the spin-offs of major economies. The rebound in commodity prices could therefore support the recovery of investment, but it seems that the problem is not exclusively related to this and one must remain cautious about the rebound potential.

In addition, political uncertainty has also contributed to lower investment growth in several emerging countries.

[1] See MyStratWeekly « Electronic currencies » 6 April 2021.

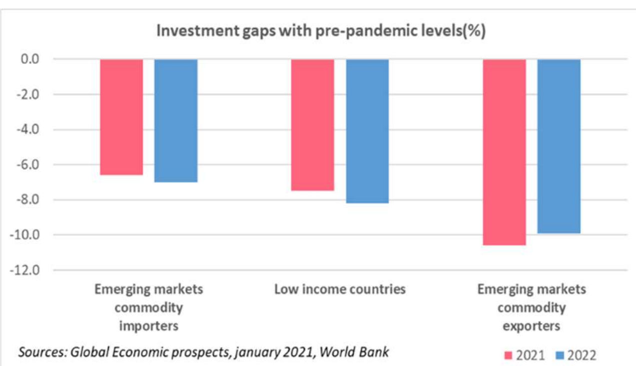
[2] Source: World Bank, "Weakness in investment growth: causes, implications and policy responses", 2017

Covid-19: an electric shock for emerging countries?

For the first time in the history of globalization, the downward trend in global poverty has reversed and the pandemic is expected to push more than 100 million people into extreme poverty, even though there is considerable uncertainty about the end result[3]. Inequalities are also expected to worsen, negatively impacting the most vulnerable and low-income populations: women, migrant workers, workers in the informal economy.

Covid-19 has also worsened the long-term prospects of emerging countries, reflecting the collapse of investment and induced distortions in school education. The closure of schools in order to curb the spread of the epidemic, has accentuated inequalities especially vis-à-vis populations who have limited access to infrastructure and technology, such as the Internet and computers. It is also a loss of human capital.

Investment growth is expected to pick up again in 2021, but despite increased advances in digital technology, this is not enough to reverse the sharp contraction in 2020, as shown in the chart below. The gap in investment with its pre-pandemic level is not closing in the three groups of emerging countries.



However, as we saw in the previous paragraph, without an urgent correction of the trajectory, investments could remain weak in the coming years.

We therefore need an impetus or else we face the risk of losing the economic development trend of recent decades for emerging countries. To do this, the debt burden must be lightened to free up some fiscal room for maneuver.

As we have already mentioned in a previous MyStratWeekly[4], emerging debt is changing rapidly. Debt, which was already high before the pandemic, worsened (both domestic and external) because of the drop in income in emerging countries linked to the pandemic.

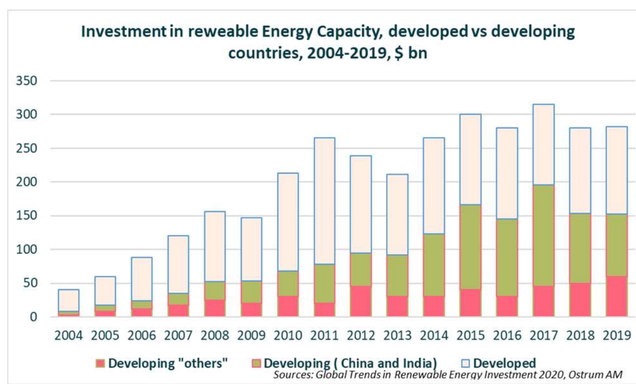
Since the beginning of the health crisis, the international community has mobilized around them to avoid a financial crisis. These include the new debt negotiation framework initiated by the G-20 in April 2020, the Debt Service Suspension Initiative (DSSI), which enables the 73 poorest countries that request it. The IMF also plans to increase its lending capacity by $650 billion to help countries that are poor and heavily affected by the pandemic.

Emerging countries could seize these opportunities that ease the financial pressure, to create this much-needed major boost. Improving the business environment, increasing the flexibility of the labour market and products, and strengthening transparency and governance, will enable investment to be relaunched and allocated more effectively.

Another positive point is that emerging countries are increasingly embarking on a greener and more equitable development path in their recovery policies. Some were already timidly on this path before the pandemic and are now stepping up their efforts.

Climate and environmental challenges, in addition to excessive debt and low investment, add to the urgency of political action.

Investing in green infrastructure projects, phasing out fossil fuel subsidies and providing incentives for environmentally sustainable technologies can support long-term growth, reduce carbon production, create jobs and help adapt to the effects of climate change.



Emerging countries accounted for the majority of global investments in renewable energy capacity for the first time in 2015 and have maintained their position since then. In 2019, their investments accounted for $152 billion, or 54% of the total global investment. China and India are of course investing the most, but other emerging countries increased their investments to $59 billion in 2019, double their investments in 2016.

[3] World Bank, Global Economic prospects, January 2021

[4] See MyStratWeekly « Emerging Countries Debt; Changing » 1st February 2021.

Conclusion

The increase in U.S. long-term interest rates has given rise to a “sudden-stop” in emerging markets in the first quarter of this year. It has led to an increase in local interest rates and currency depreciation.

However, this episode also reveals new and old structural problems: the opening of the Chinese financial sector, disrupting capital flows to emerging markets and the inability to generate sustainable growth associated with weak investment.

Investors’ enthusiasm for emerging markets was based on the theme of growth, particularly the differential with developed countries. This approach is being challenged by the Covid-19 which has seriously deteriorated the long-term economic prospects of these countries, reflecting the sharp contraction in investment which is already weak and the distortions on school education which penalize human capital. Covid-19 must be used as an electric shock to emerging countries to generate a strong impetus at the risk of denting the last decades of economic and financial development. To do this, they benefit from international financial assistance that allows them to make room for budgetary maneuvering. They can take the opportunity to put in place measures to support the recovery of investment as well as to address environmental and climate challenges. Many recovery policies in emerging countries are based on a greener development path. The crisis could then be a chance for emerging countries to embark on a greener, more sustainable and more equitable development path.

Zouhoure Bousbih

Market review

US greenback drifts lower before FOMC

The formal announcement of the Fed's tapering may come at Jackson Hole. The ECB leaves policy unchanged as the BoC scaled back QE.

An ECB meeting without any real takeaways did not prevent a resurgence of volatility in the financial markets. US indices fell twice early on last week for the first time since last fall. Prices reverted higher but intra-day volatility reflects a tug of war between strong quarterly earnings releases and elevated valuation levels. Technical indicators portray overbought market conditions in the United States conducive to portfolio realignments. The US 10-year note is hovering around 1.55%. The latest US bond auctions attest to solid final demand for Treasuries thanks to foreign interests. The bearish consensus on US Treasuries in the first quarter appears to have shifted back to the US dollar as it did at the end of 2020. The Bund remains above -0.30% and sovereign and credit spreads are generally stable.

Equity volatility has increased in response to plans to hike capital gains taxes in the United States. Joe Biden will speak next week regarding the American Families Plan expected to be around $ 1 trillion. New expenditure mainly targets health, personal services and education. Capital gains would be taxed at 39.6% compared to the 20% currently for individuals with annual income over $ 1 million. Tax hikes are expected to bring in $ 370 billion over a decade. Other income tax measures will complement the funding of the second part of the infrastructure plan.

Against this backdrop of massive fiscal easing and a strong recovery in activity, the FOMC will meet on April 28th. Jerome Powell has been talking about tapering recently, but formal announcement may come around the end of summer (Jackson Hole), especially as Fed policymaker deems the acceleration in prices temporary. Reducing asset purchases requires a decrease, uncertain at this stage, in the federal financing requirement and confirmation of the lasting return of foreign investors to the US debt market. The tapering scenario is likely to result in a gradual reduction of $ 10 billion in purchases of T-notes at each FOMC in 2022. Peak monetary stimulus has indeed passed. The Bank of Canada has thus reduced its asset purchases from 4 to 3 billion C $ per week and foresees rate liftoff in 2022. In the euro area, cacophony reigns within the ECB. The Central Bank controls market prices by modulating its day-to-day purchases. The issue is that the PEPP envelope, set at € 1,850 billion, will require a reduction in the pace of purchases in the second half of the year.

Across fixed income markets, the buybacks of short positions went hand in hand with the return of non-resident investors on US Treasuries' markets. Japanese buying flows in particular probably hovered around $ 30bn in April and successful Treasury bond auctions (20-year note) highlight solid final demand. T-note yields thus oscillate in a narrow range around 1.55%. It will nevertheless be worth watching bond issuance this week as 5-year and 7-year securities sales this week will fetch a whopping $123bn. Two-year notes should be underpinned by the outlook for near-zero rates until 2023. The Fed remains key to market direction and, pending a hypothetical signal from Washington this week, concern over twin deficits is shifting to the dollar, where short positions have increased again. In the euro zone, the Bund is holding above -0.30%. The weight of QE will prevent an upward drift in German benchmark yields, but the acceleration in the vaccination effort and encouraging PMIs in April maintain an upward bias in the near term. Sovereign spreads remain inert after a deluge of issuance at the start of the month.

Credit is experiencing slight tightening in contrast to moderate widening in the US market, which is nevertheless supported by more inflows. Both Euro and US spreads trade near 90bp vs. their respective sovereign bonds. High beta segments including hybrid bonds, COCOs, financial subordinated bonds moved sideways in a sluggish market. The primary market is quite active on high yield, as issuers refinance early fearing worsening market conditions after 60bp tightening this year.

The quarterly earnings season for Q1 2021 has started in Europe and the United States. American publications come out above expectations in more than three-quarters of the cases after 121 communications. As regards the first 25% of publications, profit growth stands at 45% year-on-year. The basic resource sector is recovering rapidly as metal prices continue to rise (especially copper). In addition, the American banking sector has benefited a lot from the sharp rise in IPOs in the United States. Final flows to the asset class remain strong in the United States, and like interest rates, non-residents remain buyers of US equities. In Europe, European equities are driven by stellar luxury publications. Exposure to Chinese consumers is supporting sales despite weak tourism activity. The technology (semiconductors in particular) is benefiting from the effect of the scarcity on prices. Note that the Euro Stoxx 50 is now more weighted in technology stocks, hence a stronger correlation with US large caps.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	26-Apr-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.69 %	-1	+3	+1
EUR Bunds 10y	-0.26%	-2	+10	+32
EUR Bunds 2s10s	43 bp	-1	+7	+31
USD Treasuries 2y	0.16 %	+0	+2	+4
USD Treasuries 10y	1.57 %	-3	-10	+66
USD Treasuries 2s10s	142 bp	-3	-12	+63
GBP Gilt 10y	0.76 %	+0	+0	+56
JPY JGB 10y	0.08 %	-1	0	+6
€ Sovereign Spreads (10y)	26-Apr-21	-1wk (bp)	-1m (bp)	YTD (bp)
France	34 bp	+9	+10	+11
Italy	106 bp	+4	+10	-5
Spain	66 bp	+1	+3	+4
Inflation Break-evens (10y)	26-Apr-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	131 bp	0	+11	-
USD TIPS	234 bp	-1	-2	+35
GBP Gilt Index-Linked	346 bp	-1	-8	+46
EUR Credit Indices	26-Apr-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	85 bp	-1	-7	-7
EUR Agencies OAS	39 bp	+1	-1	-2
EUR Securitized - Covered OAS	31 bp	+0	-2	-2
EUR Pan-European High Yield OAS	305 bp	+7	-18	-53
EUR/USD CDS Indices 5y	26-Apr-21	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	51 bp	+1	-3	+3
iTraxx Crossover	250 bp	+3	-13	+9
CDX IG	51 bp	+0	-6	+1
CDX High Yield	291 bp	-1	-4	-2
Emerging Markets	26-Apr-21	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	340 bp	+1	-14	-12
Currencies	26-Apr-21	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.211	+0.58	+2.66	-0.96
GBP/USD	$1.393	-0.44	+0.99	+2.01
USD/JPY	¥107.67	+0.36	+1.83	-4.06
Commodity Futures	26-Apr-21	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$65.0	-$2.1	$0.5	$13.3
Gold	$1 781.6	$10.1	$49.1	-$112.7
Equity Market Indices	26-Apr-21	-1wk (%)	-1m (%)	YTD (%)
S&P 500	4 180	-0.13	5.17	11.29
EuroStoxx 50	4 013	-0.16	3.80	12.97
CAC 40	6 265	-0.51	4.61	12.85
Nikkei 225	29 126	-1.88	-0.17	6.13
Shanghai Composite	3 441	-1.05	0.67	-0.92
VIX - Implied Volatility Index	18.04	4.63	-4.08	-20.48

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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