Weekly Update

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Emerging markets – headwinds but no crisis

As highlighted last Friday, the last few months have seen the dollar rally, with the DXY index against other advanced world currencies up 4.5% since end March. With sizeable tax cuts boosting the US economy, the Federal Reserve has continued gradual normalization of its monetary policy, scaling back the reinvestment of maturing bonds in US Treasuries and preparing to hike rates at least two more times before end-2018. In previous cycles, the combination of dollar strength and rising US rates has been challenging for emerging markets (EM), as it has represented a marked tightening of financial conditions, both directly and indirectly. What is the outlook this time round?

Emerging market crises tend to show a number of common characteristics:

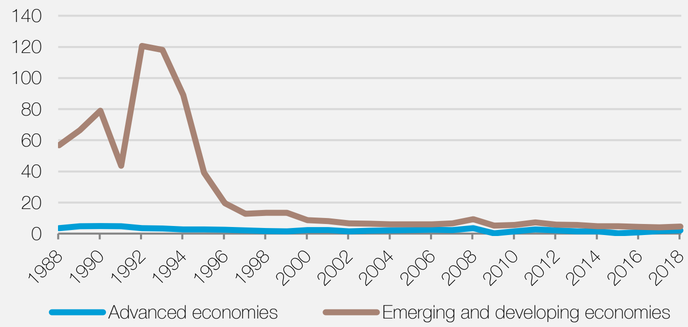
1. Weakening currencies. According to the JP Morgan EM Currency index, emerging currencies have weakened by around 4.9% year-to-date, rather more than the 2.0% decline in advanced economy currencies against the dollar. At current levels, EM look rather oversold and trade close to their lows since the turn of the century.
2. Rising inflation. Inflation in the developing world has converged with advanced economies over the past two decades and the International Monetary Fund (IMF) expects this to continue. This has enabled many EM central banks to ease monetary policy to support their domestic economies.
3. Current account problems. According the IMF's April 2018 World Economic Outlook, EM economies registered a modest 0.1% aggregate deficit compared to their GDP at end 2017, hardly a worrying imbalance. However, this masks sharp disparities between countries – China and Russia are in surplus while India and Brazil are in deficit.
4. Breaks in the weakest links. Recent weeks have seen turmoil in a number of troubled economies, most notably Venezuela, Argentina and Turkey. Each has experienced uncomfortably high inflation – indeed, hyperinflation in Venezuela's case, with prices up over 13'000% year-on-year in April. In Argentina and Turkey, the central banks have been forced to hike rates dramatically to bolster their tumbling currencies, down 44% and 35% respectively over the past two years.

In summary, while the environment has turned less supportive for emerging markets in recent months, we do not believe that the ingredients are in place for an EM crisis. Inflation is generally low, monetary policy supportive and macro fundamentals do not suggest many dangerous imbalances. The above-mentioned exceptions have suffered from economic mismanagement, but this does not appear to be wide-spread.

Bottom line. Emerging assets have underperformed modestly year-to-date, with the MSCI EM index down 3.3% versus -0.5% for the MSCI World, in large part due to currency weakness. While headwinds should continue to blow, earnings growth should be supportive (the IBES consensus for 2018 is +15.7% versus +14.8% for developed markets), valuations are not extreme (the forward P/E is 10.9x versus 14.1x for the MSCI World) and EM currencies are close to multi-decade lows. Our current House Views suggest a neutral stance, with a clear preference for Asia.

Convergence between inflation in developing and advanced economies

Inflation, % YoY



Source: IMF World Economic Outlook, 2018

Emerging currencies remain close to their lows

JP Morgan Emerging Market Currency Index

Source: Bloomberg, 30/05/2018

This week and next

EUROZONE

- Business climate edged up to 1.45 in May, nearing December's decade highs.
- Economic sentiment fell to 125.5 in May but exceeded expectations.
- The unemployment rate fell from 8.6% to 8.5% in April instead of the expected 8.4%. This is the lowest rate since December 2008.
- In its first estimate, consumer price inflation ex food and energy edged up from 1.1 to 1.3 in May. This 5-year high is encouraging for the European Central Bank.

Next week's key events		Per.	Prev.	Cons.
5 Jun	Business confidence (final)	May	54.1	--
7 Jun	Revised GDP growth, YoY	Q1	2.5%	--

UNITED KINGDOM

- Consumer confidence improved slightly to -7 in May – a level last recorded in March.
- House prices growth slowed to 2.4% YoY in May.
- Manufacturing confidence rose to 54.4 in May 2018 from the previous month's 17-month low of 53.9, and well above market expectations of 53.5.

Next week's key events		Per.	Prev.	Cons.
5 Jun	Services confidence (PMI)	May	52.8	--
7 Jun	Halifax House Prices, MoM	May	-3.1%	--

UNITED STATES

- Q1 GDP was revised down from 2.3% to 2.2% in the second estimate.
- Consumer confidence. The Conference Board measure rose from 125.6 to 128 in May. However, the University of Michigan index edged down for the third month in a row, reaching 98 in May.
- Durable goods orders fell -1.7% MoM in April versus +2.7% a month earlier.

Next week's key events		Per.	Prev.	Cons.
1 June	Unemployment rate	May	3.9%	3.9%
1 June	ISM manufacturing confidence	May	57.3	58.1

ASIA & EMERGING COUNTRIES

- In China, manufacturing confidence surprised on the upside, rising from 51.4 to 51.9 in May, a 7-month high. Trade tensions with the US have had little impact on business activity so far.
- In Japan, the jobless rate remained unchanged at 2.5% in April which should help wage growth increase. Retail sales growth rose from 1% to 1.6% YoY in April. Consumer price inflation excluding fresh food slowed for the third consecutive month, reaching 0.5% YoY in May vs 0.9% in February.

Next week's key events		Per.	Prev.	Cons.
5 June	Japan: services confidence (PMI)	May	52.5	--
8 June	China: trade balance (bn$)	May	28.38	--

Sources: Datastream, Blloomberg, 4 June 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets for currencies and commodities

	Thursday close	6mth target
EUR/USD	1.17	1.23
GBP/USD	1.33	1.40
EUR/CHF	1.15	1.18
USD/JPY	109	110
Brent	$77.1	$65
Gold	$1304	$1275

Forecast figures are not a reliable indicator of future performance

Question time

Past performance should not been seen as a guarantee of future returns.

EQUITIES

Chinese addition to MSCI EM index: what impact?

Since yesterday, three MSCI indices (Emerging Markets, All Country World and China) include 220+ large cap A-shares – yuan-denominated Chinese stocks traded on domestic stock exchanges.

This marks another step towards opening the market to international investors. While MSCI took the decision a year ago, the review of A-shares actually began four years earlier when capital mobility restrictions, quota allocation and capital gains tax issues were key concerns for foreign institutional investors. But over recent years, Chinese authorities have made significant efforts to improve market access. The biggest development was the launch of the Stock Connect programs in November 2014 (Shanghai stock exchange) and December 2016 (Shenzhen stock exchange). These cross-border trading programs between Hong Kong and mainland stock exchanges allow foreign investors to buy Chinese domestic shares.

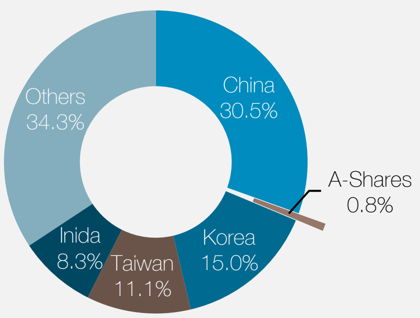
The inclusion of A-shares will be partial – only 5% of their free-float market capitalisation will be included in the MSCI Emerging Markets index for now. This will take place in two stages – half was added on 31 May and another 2.5% will follow in September. The A-share weight will still be marginal, at around 0.8% of the EM index, taking the overall allocation to Chinese equities to 31.3%. According to MSCI, if A-shares were fully represented, their share would rise to 16.2% of the index (see chart) taking all types of Chinese equities to 40%.

As a result, fund managers tracking the MSCI Emerging index will need to buy A-shares in size via Stock Connect, leading to around 22 bn$ inflows according to MSCI estimates.

All in all, although the inclusion is limited, it represents a sea-change for foreign investors, forcing them to consider domestic Chinese markets for the first time.

MSCI EM Index with 5% China A-Shares

MSCI EM breakdown (%)



Sources: MSCI, May 2018

Market performance

Past performance should not been seen as a guarantee of future returns.

Interest rates

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-35 bp	1 bp	↑	0 bp	-1 bp	-1 bp
3mth Euribor (EUR)	-32 bp	0 bp	→	1 bp	1 bp	1 bp
3mth Libor (USD)	232 bp	0 bp	→	30 bp	63 bp	111 bp
3mth Libor (GBP)	61 bp	0 bp	→	3 bp	9 bp	32 bp
10-year US Treasury bond	286 bp	-12 bp	↓	-1 bp	45 bp	66 bp
10-year German bond	34 bp	-13 bp	↓	-27 bp	-8 bp	4 bp
10-year French bond	68 bp	-8 bp	↓	-13 bp	1 bp	-4 bp
10-year UK bond	128 bp	-16 bp	↓	-25 bp	5 bp	31 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0.0%	→	-0.3 %	-0.5 %	0.7 %
BAML EURO Corp HY	-0.7%	↓	-0.9 %	-1.2 %	1.7 %
BAML GBP Corp IG	0.6%	↑	0.6 %	-1.3 %	-0.2 %
BAML US IG	0.7%	↑	-0.2 %	-2.6 %	0.1 %
BAML US HY	0.0%	→	0.0 %	-0.3 %	2.3 %
JPM Global EM Sov. Plus	-0.4%	↓	-3.1 %	-4.8 %	-0.7 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1.17	-0.2 %	↓	-4.1 %	-2.6 %	4.0%
EUR/CHF	1.15	-0.8 %	↓	0.1 %	-1.5 %	5.9%
GBP/USD	1.33	-0.6 %	↓	-3.3 %	-1.5 %	3.2%
USD/JPY	109	-0.4 %	↓	2.0 %	-3.4 %	-1.8%
USD/BRL	3.72	2.0 %	↑	14.7 %	12.4 %	15.4%
USD/CNY	6.41	0.5 %	↑	1.3 %	-1.5 %	-5.9%
USD/RUB	62.4	1.3 %	↑	10.7 %	8.1 %	10.1%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	0.7 %	↑	0.7 %	-0.9 %	-1.4 %
United Kingdom (3-7yr)	0.7 %	↑	1.2 %	0.0 %	-0.8 %
Germany (3-7yr)	0.6 %	↑	1.4 %	0.7 %	-0.1 %
Japan (3-7yr)	0.0 %	→	0.0 %	0.0 %	0.0 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	509	-1.1 %	↓	-0.9 %	0.4 %	12.4 %
Eurostoxx 50	3 407	-2.8 %	↓	1.5 %	-0.1 %	-0.7 %
DAX	12 605	-2.0 %	↓	1.4 %	-2.4 %	-0.1 %
CAC 40	5 398	-2.1 %	↓	3.8 %	4.0 %	5.5 %
S&P 500	2 705	-0.8 %	↓	0.2 %	2.0 %	14.4 %
FTSE 100	7 678	-0.4 %	↓	7.6 %	1.9 %	6.3 %
SMI	8 457	-3.6 %	↓	-1.9 %	-6.8 %	-3.0 %
Topix	1 747	-1.6 %	↓	-0.3 %	-2.9 %	13.8 %
IBOV Brazil	76 754	-4.2 %	↓	-10.1 %	0.5 %	22.4 %
MICEX Russia *	2 303	0.4 %	↑	0.3 %	9.2 %	21.2 %
MSCI EM	1 121	-1.2 %	↓	-5.7 %	-2.4 %	14.4 %
SENSEX 30 India	35 322	2.2 %	↑	3.7 %	4.9 %	15.1 %
Hang Seng (H-K)	30 469	-0.8 %	↓	-0.3 %	3.0 %	23.5 %
Shanghaï Composite	3 095	-1.9 %	↓	-5.0 %	-6.4 %	-0.7 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$77	-2.5 %	↓	17.3 %	15.7 %	54.2 %
Gold	$1 304	-0.1 %	→	-1.2 %	0.0 %	2.9 %
Silver	$16.5	-0.8 %	↓	0.5 %	-2.9 %	-4.8 %

Source: Datastream, on 31 May 2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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