Quarterly Market Letter

December 2019

2020 Should Be A Good Year For Emerging Markets

Macroeconomic Developments

Strong flow momentum meets geopolitical speed bumps: New Year optimism halted by U.S. military action.

- **Environment of diminished recession fear:** Fed on hold; stable bond yields; an upturn in global economic activity. Mild optimism for EM supported by U.S. – China (seemingly close) deal in January, and/or Chinese stimulus efforts. There are reasons for moderate near-term optimism, as long as there is no 'sudden stop' or reversal in capital flows. The lax monetary policy in the developed world and capital flows to EM provide at the same time more favorable debt dynamics and hence space for fiscal easing.
- **The U.S. and Europe have averted the risk of recession.** Decisions made by the Fed and the ECB have artificially extended the business cycle. In 2019, the stock and bond markets have been driven by monetary policy (low rates and a dovish Federal Reserve) and the trade dispute between the U.S. and China.
- **The global economy is still fragile.** U.S. growth sub-2% in 2019 Q4 and 2020 Q1, then recovering. Tepid European recovery – the best hope is continued German wage gains. Modest world trade revival in 2019 Q3 to continue into 2020. Confidence for a 2020 global growth rebound has been rising, but this turn towards stronger growth has yet to take hold. Despite the record age of the expansion, the private sector continues to run a healthy financial surplus.

- **Rising geopolitical risk:** Following its targeted killing of Iran's second most powerful leader, which surprised market participants, there has been a bout of risk aversion (Oil, gold jumped, but not the USD). Historically, geopolitical conflict isn't necessarily a negative for equity market returns, unless energy prices spike. We ignore Trump´s plans, and this event could catalyze into a greater near-term conflict between the U.S. and Iran, and have profound consequences for the region. However, tail-risks are likely to remain regional. An extended trade dispute with China, which is possible, would continue to add volatility to stock markets. The risk of an abrupt exit of the UK from the EU has disappeared even if Boris Johnson is committed to performing Brexit no matter what.

- **2020 is an election year in the US.** The Trump impeachment should be a non-event. Trump needs the trade truce as much as Xi Jinping does. The fading growth drag from the trade war and the increasingly positive growth impulse from easier financial conditions should put the global economy on a better footing in 2020. The Fed's stance and Trump's behavior ahead of 2020 presidential polls will have a disproportionate influence on markets. If Trump decides to play nice, the Fed remains a benign influence (even if no further rate cuts in 2020), and China stabilizes its annual growth rate just below 6%, then EM equities should do rather well in 2020.

Global Drivers

Fears of a recession in 2020 have been replaced by expectations of faster growth.

Global Growth

Stabilization, but no rebound yet. Consensus expects in growth pickup next year.

Investors have been focusing on the notion that the downturn in the global economy is bottoming out in the hope that 2020 will prove a better year for economic growth with recession averted. However, the timing and magnitude of this rebound remain uncertain. PMIs show further signs of bottoming. By region, advanced economies' manufacturing PMIs edged lower again while much of Asia continued to improve. By sector, even in countries where manufacturing weakened, service sector PMIs improved, raising the global composite. One of the main supportive forces of EM growth over the last two decades is China. China's economic growth is likely to slow to just short of 6% in 2020, due to trade tariffs as well as the government's continued focus on reform and controlling leverage. The IMF's 3.0% growth forecast for 2019 is the lowest level since 2008-9, however a slight pick up to 3.4% is expected in 2020, driven by a rebound in several countries EM countries. Probably not fast enough to assume booming commodity prices in 2020 – annual GDP growth during the 2005-8 commodity price boom averaged in excess of 5%. The fastest growth accelerations in MSCI EM in 2020 are expected to be Turkey, Saudi Arabia, Argentina, Brazil, Peru, the UAE, Mexico, Russia and Qatar; the biggest decelerations are expected to be Hungary, Pakistan, Poland and China. The fastest growth accelerations in MSCI Frontier Markets in 2020 are expected to be Oman, Kuwait, Morocco, Tunisia, Sri Lanka and Senegal; the biggest decelerations are expected to be Lithuania, Romania, Bangladesh, Croatia and Estonia.

Global Liquidity

No choice for the Fed but to maintain an accommodative policy.

In removing its pledge to "act as appropriate to sustain the expansion" from the statement, the FOMC has shifted from an easing bias to an on-hold bias. Manufacturing recession is close, but no broad recession in sight. Powell was wrong with his normalization policy and had to back-paddle for the better part of this year. The Fed has commenced manipulating the short end with its QE-style pumping of new liquidity into the money markets. Fed officials appear to have settled on a consensus that monetary policy is "in a good place," and the bar for a change in either direction over the next year appears high. Instead, the most interesting monetary policy development might be the conclusion of the Fed's framework review in mid-2020. We expect the FOMC to adopt average inflation targeting, setting a target of somewhat above 2% for

expansions. A key question is the extent to which the latest shift in global tail risks and tempered easing bias from the G-3 central banks will affect EM central banks. The inflationary environment that EM is facing is rather benign, primarily because of the absence of any positive (especially Chinese) stimulus to commodity prices.

Commodities

Early 2020 oil price rise changes little, but if it rises further, the effects could be significant.

Middle Eastern geopolitics has driven the oil price up. On January 6th, Brent crude was just under USD70/bl, up from USD66/bl (+6%) from end-2019. The current level of the oil price isn't likely to cause much alarm. Good news for commodity-linked currencies, and Russia, which could end up being the main beneficiary. EM has acquired 'China-dependence', due to the fact that the global investment cycle is so important in shaping the global trade cycle and the global commodities cycle. Think apropos dollar; pundits have been calling for dollar weakness, wrongly so far. What is behind this is that Trump is suspected of looking for more dramatic measures in his economic war against China and the rest of the world when re-elected. It should not surprise us if the White House were to think of implementing a Plaza Accord of sorts, and a sense of what this could mean might well trickle through in the coming year. This is to be played by ear, but betting on the dollar to jump from here better avoided. Supply cuts and growth outlook lift oil prices. Saudis are finally showing discipline in controlling output. OPEC+ has announced to reduce crude oil production levels.

EM Investment Outlook

Base-case investment thesis for 2020: Emerging Market stocks set to outperform and credit spreads to tighten a little bit. Stay long EM and Chinese equities.

- The near-term outlook for EM might well be somewhat supported by a combination of capital inflows and policy-easing. EM external debt should benefit against the backdrop of lower U.S. Treasury yields.
- **U.S. dollar is heading lower**, which is a tailwind for EM. The Fed's notable increase in its balance sheet, up about USD 300bn, and monetization of escalating Treasury issuance, bolsters the case for much higher gold prices as part of what might be called a 'currency debasement' trade. There is a constructive outlook on the equity market going into the new year. If Trump were to be re-elected, as is to be expected, another massive leg up around his pro-business stance, an indication of another monster of a tax cut, and promises on infrastructure spending would be likely. Even though America has already entered a manufacturing recession, services, the consumer, and the Fed will manage to hold the economy steady. The Fed cannot help but keep accommodating the U.S. economy and financial system.
- **Supportive technical conditions** for the EM sovereign credit markets in 2020: lowest net supplies by EM sovereigns since 2008.
- The U.S. stock market ended 2019 with a record run based on a Phase One trade deal with China, institutional Fear Of Missing Out (FOMO), projections by the Federal Reserve that interest rates will not change in 2020, and expectations the U.S. and global economy will strengthen in 2020. U.S. 10-year yield was

pulled down by East Asia / Japan weakness, now up a bit. **Emerging-market equities are generally inexpensive**—and, by some measures, quite attractive— relative to equity and bond markets globally. EM-DM growth differential is expected to move in favor of EM in 2020 (which can be supportive to relative performance of EM vs DM equities).

- **Real interest rate differentials between EM and DM are high**, despite EM central banks lowering nominal policy rates, upon lack of inflation in most EMs likely to prove supportive for EM local rates. The search for yield in a low-interest rate environment should underpin a demand for EM financial assets. While the short term real interest rate differential has been coming down since Q1 2017, that differential is still not too low. The real interest rate differential at the longer end of the yield curve is rather high by historical standards, and this should strengthen the 'magnet' for capital flows to EM. A favorable asset reallocation trend can be expected to extend into 2020 as the widening EM/DM growth differential and the still more attractive relative valuation of EM yields vs. DM will continue to induce inflows. Current light positioning provides technical support.
- **EM still remains under-represented** in global bond indices, even though EM economies account for about 50% of global GDP.
- **Fiscal loosening** might already be under way. An aggregate of most of the larger EMs (excluding China) is set to see some primary balance loosening this year. EM have to be cautious when using the near-term fiscal space, since accumulated debt might stay with them for longer than currently expected.
- **Not afraid of duration**: 10-year yields to keep oscillating between 1.5-2% for the year. Inflation pressures remain in check, given the deterioration in economic data and earnings, and the Fed has already shown its dovish hand. The global negative-rate environment has moderated to an extent.

Currencies

EMFX: not all are cheap. Long BRL, MXN, RUB and INR, with ZAR and TRY on the negative side.

Longs MXN, BRL, RUB and INR, and Ukraine as a frontier trade. On the negative side, ZAR may be consensus, and TRY also given a too dovish central bank. EM real effective exchange rates (REERs) look undervalued relative to historical averages, however, it is mostly commodity exporters that could be judged cheap. Most EMs are still net debtors to the world, although there are notable exceptions. The logic of deteriorating debt dynamics limiting fiscal space applies to the external environment: lower growth means that EM need to run higher current account balances in order to stabilise debt. In an environment of headwinds to exports, this would imply a weaker currency in order to limit import growth. A further challenge to EM comes from rising protectionism.

Risks

Markets Are Priced for Perfection, Not Disappointment.

- **U.S. stocks overvalued and peaking**, facing a slowing corporate earnings problem in 2020. A corporate earnings recession should not be ruled out. Expectations for growth in 2020 are likely too high, especially early in the year. Sentiment is extremely bullish so a correction is possible in Q1. If the U.S. corrects, EM should pull back as well. Then another rally to new highs is likely and EM would be expected to outperform. If the S&P is up in 2020, EM is

likely to be up more, and if the S&P is down EM is likely to be down less.

- **Election risks:** Politics will likely grab the headlines in the U.S. this year and cause bouts of investor anxiety and volatility. The U.S. election result in November, could start a bear market, which is the most likely cause of a future U.S. recession. Do not underestimate the "Trump Put": **Donald Trump is already in the midst of his re-election campaign. He is running it on two things, a sound economy and a booming stock market. That's why we had the half-hearted but necessary truce in trade with China and this ominous White House summon of Jay Powell.** Fiscal and monetary stimulus conditions are already abundant. President Trump has demonstrated himself to view the performance of the stock market as a direct reflection on his administration. Given that we are heading into an election year, it should be assumed that the current administration will go to extensively great lengths to at minimum keep the stock market steady through much of the year ahead. Upside risk: A trade deal with China stokes economic optimism and results in economic growth and corporate earnings running ahead of expectations while inflationary pressures remain contained. Goldilocks returns once again. Downside risk: The deterioration in key economic readings and corporate earnings begins to overwhelm the offset the fiscal and monetary stimulus.
- The "Risk on/off" indicator is the USD-CNY exchange rate. When CNY slips, so do equities. U.S. earnings expectations in the current quarter and into 2020 will likely be dented by tariff increases, which are already burdening both U.S. corporates and households. The U.S. 10-year Treasury yield can act as a signal of fresh pressure in the dollar repo market and signal a return to risk-off themes.
- A more justifiable concern is the credit markets. Starved of yield many of the investment-grade funds moved down the credit curve at the very point when rating downgrades have started to accelerate or outright expanded their high yield exposure. The doomsayers have been on to it for a while predicting a collapse of the **leveraged loan market** to the tunes that the mortgage market was annihilated in 2007. They are probably not wrong, but it may be a long while before such a scenario materializes.
- Some bond strategists are talking about a "great rotation" from bonds to stocks for 2020 – especially in the U.S. Treasury market. Globally, this year saw the fourth consecutive increase of bond supply, the highest level since 2009. The U.S. budget deficit already amounts to an annual USD 1tn. The Fed is also taking on the role of the main buyer, thus shrinking UST supply.
- Rising Iran/U.S. Tensions: Iraq's parliament voted to pursue the removal of U.S. troops from the country – something President Donald Trump reacted to with a threat of sanctions against the American ally. Iran said it will no longer comply with uranium enrichment limits under the 2015 nuclear deal.

Emerging Market Equities

From a sector standpoint, we are overweight Energy going into 2020. Oil prices were up +10% in December and show no signs of abating given heightened volatility from the Middle East. Political instability around key producers Venezuela, Libya, and Nigeria and recent events in Iran should also sustain the recent price rally.

We have been overweight Energy since mid-2018, as we believed the markets were mis-pricing the geopolitical risks around industry spare capacity. Market participants are generally underweight the sector and given the magnitude of price drops in recent years and the growth of U.S. shale, consensus has not formed yet that the recent rally has staying power. The majority of our Energy holdings are Chinese super-majors and associated oilfield services companies. China is trying to increase its energy independence and increasing capital expenditures accordingly, which creates a favorable long-term backdrop for these companies regardless of short-term oil price fluctuations.

We continue to maintain our overweight position in technology companies. If our current portfolio weights in Information Technology and Communications Services were added together, we would roughly be in line with corresponding weights in the MSCI EM Index. Nevertheless, we believe the current index classifications mischaracterize many technology companies into the wrong sectors, so the actual weight of technology in our portfolio is larger than initial impressions.

For example Alibaba, one of the largest technology companies in the world, is classified as Consumer Discretionary in the MSCI EM Index. Their closest U.S. competitor Amazon is also in the same sector in the S&P 500. We believe they both are miscategorized, as more appropriate sectors may be Information Technology or Communication Services. It could even be Consumer Staples given consumers' daily usage and dependence on their products!

The growth of technology has definitely blurred the lines on other sector classifications as well. Two examples from our portfolio: ZTO Express and Ping An Insurance. ZTO is a China-based logistics and delivery company; they are classified in the Industrials sector but are almost entirely dependent on e-commerce growth for future profitability. Coincidentally, Alibaba is their largest client and one of their largest investors. Ping An is one of the world's largest insurers and is classified in the Financials sectors, but they are also one of the leading global innovators in the burgeoning fintech space. They have over 500 million combined users in their online ecosystem and have made such progress that they are now selling some of their fintech solutions to other institutions. Boasting an R&D team of over 23,000 people and planning to spend over $15bn in R&D over the next decade, Ping An has already filed numerous patents in artificial intelligence (AI), blockchain, and cloud computing. While the underlying insurance trends are still favorable, we believe more value will be created for shareholders long-term by their technology innovations.

One risk in having an overweight in this space is recent newsflow that the U.S. administration is looking into potential capital controls on Chinese equities listed in the U.S., either through a forced delisting of Chinese ADRs (American Depositary Receipts) from U.S. exchanges or limits on how much U.S. investors are able to own of these securities. While the timing and magnitude of these potential actions are unknown, the threat itself adds an extra layer of uncertainty to owning U.S. – listed Chinese ADRs, which are mostly technology companies. We believe such actions could be extremely harmful to U.S. investors, as they would lose access to many innovative companies that are at the leading edge of many important global trends. Chinese tech companies for example, have some of the highest earnings growth rates in our investment universe. As a result, we are seeing many

Chinese companies look to list in Hong Kong. The advantage of this is two-fold: mitigating the risk of U.S. sanctions and providing access for the first time to the mainland Chinese investor base through the Hong Kong Connect. Alibaba recently had a successful Hong Kong listing, and we would expect more companies to follow suit. Progress on the recent Phase One trade agreement somewhat lowers this risk but we are carefully watching developments.

In spite of this overhang, many positive catalysts are still in store for Chinese technology companies in 2020. The rollout of 5G helps the entire value chain, from the need to process larger amounts of data in the cloud to the acceleration of AI and quantum computing. The regulatory environment seems to be easing after a tough 2019, and valuations are also attractive relative to U.S. counterparts. The underperformance of Chinese technology names listed in the U.S. relative to its U.S. peers has been especially pronounced; we believe this is due to normalize, given the relatively stronger earnings growth profiles of the Chinese companies.

From a country standpoint, we remain confident on China's short and long-term prospects, given a reduction in trade war friction and significant easing measures meant to stimulate the economy. It is especially important for China to show economic growth in 2020, as the Communist Party celebrates its 100-year anniversary in 2021 and economic traction will be an important data point. We also expect Brazil to continue its economic revival in 2020, as there are many market-friendly members in the Bolsonaro administration who are quietly making much-needed reforms to the country's pension system and looking into privatizing inefficiently run state-owned enterprises. We are maintaining our underweight to India, as recent country-wide protests around a controversial citizenship bill calls into question the political capital that the Modi government needs to enact necessary structural reforms.

In 2019, the relative outperformance of growth vs. value in EM (roughly 13%) was one of the worst we have seen in many years. We would expect that to normalize in 2020, especially given the larger weight to the Energy sector in the value indices. Large cap stocks also had broad outperformance vs. mid and small cap stocks. That trend may continue given outsize flows to EM ETFs that are weighted by market capitalization.

In summary, the Phase One trade agreement between the U.S and China that will hopefully be signed in 1Q, accommodative central bank policies, and a potential weakening of the U.S. dollar (given twin current account and fiscal deficits) all are catalysts for EM outperformance in 2020. The most important catalyst is a word not used much these days: valuation. As mentioned in prior commentaries, EM has significantly underperformed its developed counterparts since the Global Financial Crisis. Relative and absolute valuations are the most attractive we have seen in years. Emerging markets still have a favorable demographic dividend and strong GDP growth that will command more of a premium as developed markets slow down.

Country Updates

China

Continued monetary and fiscal easing to support the economy in 2020. Growth tracking an early turn up. More policy support is needed to stabilize growth.

2020 starts with an upbeat tone with the RRR cut, proposed signing of the 'phase one' deal, and Chinese equities hitting a multi-month high. Manufacturing stabilized, services moderated. Gradual fiscal and monetary policy easing to continue in 2020. In 2020, China's real GDP growth will likely dip below 6%. But as long as Chinese consumers continue to contribute a growing share of overall GDP, pessimism about China's prospects will be unwarranted.

Despite some respite from trade tensions, China is still facing multiple headwinds, which call for more forceful counter-cyclical policy measures. New export orders returned to expansionary territory for the first time since May 2018, supporting faster expansion in manufacturing production. However, employment indices remained at low levels, and business expectations moderated.

The Chinese economy has been hit hard by the Sino – U.S. trade war, with Chinese stocks in the eye of the trade storm. Naturally, Chinese shares have been bombed out, unloved and under-owned. With China-related stocks dominating the EM index, the latter has also languished to a point of gross undervaluation. Currently, EM equities are trading at 12 times forward earnings, while the same ratio for Chinese stocks is 11 times. It is important to note that these multiples are calculated at trough earnings. Should earnings ever rebound, it will further deflate P/E ratios for EM stocks and Chinese shares, making them downright cheap.

Chinese credit creation has quickened, and manufacturing PMI is perking up. This suggests that the recessionary pressure is being quickly spent and industrial profits are making a bottom. Many have argued that China's economic growth will not rebound, largely following an L-shaped contour. This may be right, but it misses a key point: There are many highly volatile components of the Chinese economy that generate large cycles in asset prices. Corporate profit growth is one such component. With Chinese corporate profits on the cusp of recovery, stock prices usually rise first.

China 2025 may currently be out of the limelight, but it is still very much alive as a national ambition as is to be expected that Belt and Road initiatives will be sped up. Meanwhile, domestic reforms are hastily being introduced. A 3-year plan is being launched to revamp the state-owned industry, with an attempt to bring in private-sector investors. The PBoC has established a new benchmark lending rate for the lending mechanism, resulting in a lower cost for corporate debt. And despite the nearing economic war, Beijing will gradually open up the financial sector further to foreigners. The conflict with America, in particular, is leaving its scars, but the nominal growth rate is poised to moderate in any case. As China's economy is modernising and maturing, as it is transitioning from an emerging market export-led model to a domestic consumption powerhouse. China might be supported by a trade deal or a policy stimulus, but not both: if a trade deal materializes, China is less in need of a stimulus and might therefore dial it back.

India

Protracted road to a weak recovery in FY21.

High frequency data suggest that growth has bottomed. Manufacturing PMI rose to a seven-month high in December. Growth forecast 5% in the year through March 2020, according Statistics Ministry. This compares with 6.8% expansion in the previous year. Inflation also has continued to rise sharply.

Growth momentum started worsening from end-2017. What makes the recent slowdown

different is the significant weakness in consumption that had been unveiled following the significant withdrawal of leverage, unveiling the fragile nature of India's consumption growth story in the last few years in the absence of significant income or employment growth.

Risk aversion and credit freeze: While India's banking system was burdened by high NPAs dragging down credit growth, the Non-banking Finance Companies (NBFCs) to some extent provided some support until September 2018. Some defaults and concern over their asset quality dried up access to wholesale funding channels. With funding disappearing, total financial flow to commercial sector declined very sharply by 88% YoY in 1HFY20.

Policymakers believe that the current slowdown is mostly cyclical. As a result, the monetary policy response has been to cut repo rate and move the banking system into substantial surplus liquidity. Fiscal authorities have refrained from large-scale new expenditure announcements but with a sharp cut in corporate tax rates, the fiscal impulse is likely to be positive in FY20. The RBI has endeavored to ensure that the INR does not appreciate against peers despite large BoP surplus.

Measures to stimulate growth have not yet delivered their desired results and hence even their effectiveness has been questioned. In the near term, high frequency data shows no signs of investment recovery and only limited signs of consumption stabilization. Even with recovery in sequential real GDP growth, the 2HFY20 growth rate could be ~4.8-5.0%.[1]

LatAm

Protests have surged through the region. Increased social pressure towards redistribution. Additional fiscal pressures.

Despite the uncertainties generated by widespread protests and social unrest, LatAm is the region that has one of the most promising growth accelerations for the next year. Still, growth in the region should remain well below the decade average. Inflation will be largely in check, while rates will be relatively flat, with the exception of Mexico where the easing cycle will continue for a longer time. Current account deficits are capturing more attention, starting with Colombia. Fiscal consolidation continues to be a theme in many countries, but now with the added concern that the medium term impact of protests is towards more fiscal pressure.

A greater social pressure for redistribution implies a greater fiscal burden in the medium term, though there is space for taxation to pick up the slack. If protests are long-lasting, governments may be forced to have a policy response or even be forced to make greater modifications to economic institutions. In response to calls for redistribution, governments may need to increase coverage of social safety nets. In a longer-term perspective, pension systems might have to change in order to account for aging populations, but social pressures could imply a more permanent and prominent role for the government. These repercussions ultimately imply larger fiscal expenditures for governments.

Growth, or lack thereof, is an important determinant for recent social unrest. The underlying causes of the recent outburst of protests and its timing in Latin America: most of these events share the common issue that

[1] HSBC Global Research, Economics – Data Reactions, Jan 13 2020

growth expectations are less optimistic than they were a generation ago. As a result, younger individuals believe that growth, on its own, cannot provide a catch-up in income levels with advanced economies or even other EM economies to the same extent that previous generations did. This, in turn implies that conventional growth promoting policies are not enough to improve the lives of all individuals in society, and thus some redistribution of income (and perhaps wealth) going forward becomes a focus of protesters' demands.

Sustained demands for social expenditures as a form of redistribution are going to continue to be heard going forward. Chile has already announced better health and medicine insurance plans in response to the recent outburst of unrest. Both student and teachers' unions seeking better protection for the education sector are among the organizers leading ongoing protests in Colombia. Securing government provision of these goods and services can be seen as a way to insure a minimum set of conditions to avoid a return to poverty. This implies that such requests are not likely to ease, especially as growth slows. In addition, this slowing growth also suggests waning fiscal resources to meet these demands, which implies these ultimately amount to a call for redistribution.

Argentina

Pragmatism in the first 20 days of the Fernández administration.

The government unveiled the first measures related to debt, fiscal policy and monetary policy. The Treasury announced the postponement of U.S. $9bn payments of short-term USD notes (Letes). Congress approved an emergency bill.

The government is opening "good faith" negotiations with external debt holders.

In all, assuming no further spending increases, the changes introduced could drive the primary balance into balance next year.

The main mandate of the new administration is to revive consumption with an investment revival, to reverse economic stagnation with a consistent and sustainable fiscal consolidation path.

S&P revised Argentina's rating back up to CC credit rating from SD (selective default) from Dec. 20 following the government's unilateral reprofiling of local law USD denominated short-term treasury notes (Letes).

Brazil

High hopes. Easing cautiously. Some traction for economic recovery.

Economic activity indicators continue to underpin the prospects for a recovery. Economic activity data for the last quarter of 2019 have been encouraging. The unemployment rate in November surprised favorably, both in terms of headline and composition, given signs of improvement in formal jobs.

Market friendly reform (federative pact, fiscal emergency and public funds) continues to be in the pipeline, however, the Brazilian government has decided to delay a second round of fiscal reforms. Bolsonaro's announcement was a setback for Finance Minister Paulo Guedes, who vowed to continue with the reforms despite the recent unrest in Chile. Datafolha released a poll showing that the rejection rate ("bad or terrible") for Bolsonaro is actually declining (from 38% in August to 36%) while his approval rate ("great or good") is growing (from 29% to 30%).

After pension reform, the government is promising to present other structural reforms but the friction of the PSL government party, the lower incentives for Congress to move forward with those reforms compared to the pension reform and the usual negative effects of municipalities elections (in Oct-20) in Congress activities along 2H20 suggest a scenario of limited approvals of government initiatives along 2020.

As broadly expected, Brazil's central bank (BCB) cuts its policy rate by 50bp to 5%, and signaled another 50bp cut, as inflation stays close to 3.5%. More data dependent for 2020, despite the BCB's inflation models suggesting room for significant easing.

Mexico

Gap between the policy rate and inflation means upside for bonds. focus on any negative rating actions along with Pemex.

Growth will be low in the coming years but possibly better than expectations. The budget for 2020 was mostly "reasonable" and allows for stable debt/GDP even under more conservative growth estimates. There is a widening gap between domestic sentiment and investor's perception. A majority of Mexicans still love AMLO (his approval ratings are at 67%). Still, investment is dormant.

Colombia

On hold. Relatively insulated from global trends, aside from the oil channel.

Room for modest easing by the second half of 2020. President Duque's popularity has fallen since strikes began according to polls, though not too much as they were already quite low (from 26% to 24%). Colombia has faced fiscal challenges ever since oil prices collapsed five years ago. The question for oil exporters and oil infrastructure providers is whether sufficient new oil opportunities exist to boost oil reserves.

Domestically, the story is encouraging for 2020 with growth driven by strong domestic demand and higher capital investment. An important source of risk is the widening current account deficit and Colombia's dependence on foreign capital flows, as there is a structural demand for USD to finance the CA deficit.

Chile

Protests have affected activity and sentiment considerably. The promise of a new constitution.

Activity recovered a bit in November but business confidence plunged to a record low. Social protests will result in a structural increase in social spending and more bond issuance that should grant a higher premium in the longer end of the curve. Political agreements around the constitutional process should prevent any extreme measures from entering the new constitution but it could be a long and noisy process. Social demands will be incorporated slowly into the business environment: higher labor costs but more consumer spending may offset that effect.

Peru

Political environment seems benign for 2020.

Economic growth will likely remain stable at 3%, below historical trend. Successful resolution of political frictions will impact economic outcomes in the long-run.[2] Debt/GDP will stay low, even leaving space to welcome extra spending. Lack of dynamism of internal demand.

[2] Scotiabank Fixed Income, Pacific Alliance Fixed Income Outlook 2020

Ecuador

In need of fiscal consolidation, but with little appetite in the population for it.

The IMF program will need to be renegotiated given that the significant fiscal consolidation envisaged (5% of GDP of deficit reduction in three years) seems implausible now: three out of four Ecuadorians disapprove of President Lenin Moreno.

Russia

Russia has restored its geopolitical standing despite the never-ending sanctions regime. It has successfully deepened its relationship with China. It has assumed a leadership role in the Middle East. It has turned into a premium arms supplier for the likes of Saudi Arabia, Turkey, Iran, India, and China. It has negligible debt and has quasi-ditched the dollar for gold reserves.

It is a great beneficiary of low global interest rates, which should facilitate a continuation of the gradual monetary easing that started in 2015. Russia's growth strategy is "to be more like the Czech Republic": prudent fiscal policy and low interest rates. It is a long journey, but one that is well on track.

Ukraine

Positive surprise to market expectations: IMF and peace.

Ukrainian authorities and the IMF reached a staff-level agreement on a new 3y, $5.5bn EFF facility. The IMF statement commended the government on its reform initiatives. President Volodymyr Zelensky has consolidated power, after securing a majority in the snap general elections in July 2019.

Normandy meetings: "full and comprehensive" ceasefire in east Ukraine.

Turkey

Improvement in domestic demand, but not a V-shaped rebound.

Further monetary easing, coupled with a moderate budget stance. Positioning in the local equity and bond market remains modest, which should support a phase of currency stability in the coming quarters.

Sri Lanka

Avoid chasing high carry. New leadership, old worries.

The newly elected government has a populist agenda that could further intensify fiscal risks and the finance ministry has already stated that fiscal deficit in 2019 could shoot up to 7%. It is yet to be seen whether the new government is able to renegotiate the existing IMF deal which is ending in June 2020.

The Rajapaksa-led government recently introduced a series of tax cuts, which should give a boost to the economy in the near-term, especially to consumption and construction. Government debt at 90% of GDP (one of the highest among its Asian peers), leaves no fiscal space for the government to manoeuvre.

Africa

More than half of the world's top-30 fastest growing countries in 2020 are expected to be in Africa. 16 out of the top 30 countries are: South Sudan, Rwanda, Cote d'Ivoire, Ethiopia, Senegal, Benin, The Gambia, Uganda, Niger, Kenya, Mozambique, Djibouti, Burkina Faso, Guinea, Mauritania, Egypt.

Ethiopia and Tanzania remain the stand-out growth stories in the East along with Cote d'Ivoire and Senegal in the West. Meanwhile Kenya stands in the middle ground in African growth terms. Macroeconomic reform story

remains robust in Morocco, certainly compared to Tunisia, Morocco is yet to break out of the agricultural dominated growth cycle. Automotive industry continues to develop and Morocco overtakes South Africa as the largest producer and exporter of cars in Africa. Politics has continually delayed long overdue fiscal adjustment since Tunisia's Jasmine Revolution of 2011 with growth subsequently unable to really recover. There has not yet been a devaluation of the Central African Franc (XAF) with the peg to the Euro remaining intact. But there is now ample evidence that there are severe strains in the foreign exchange markets of all CEMAC members. This does not have to lead to a XAF devaluation, although it is a potential outcome.

South Africa

Worsening policy mix; fiscal outlook grimmer than expected. Likelihood of a rating downgrade by Moody's.

Substantial fiscal deterioration with the prospect of 6% deficits over time. The Treasury now projects the government debt ratio to exceed 70% within three years and reach near 80% by 2027—versus estimates earlier this year for debt to stabilize at 60% of GDP. All of this leaves markets nervous. South Africa could lose its investment grade, which would likely result in substantial capital outflows and higher borrowing costs. For now, Moody's has maintained the lowest IG rating but changed its outlook to negative (Fitch and S&P already have a sub-IG rating). The fiscal policy delay likely prevents the SARB from easing, notwithstanding downside surprises to inflation and a sharply deteriorating growth picture.

On 27 March: a further loss of investment grade status would mean the country would be removed from the FTSE Russell World Government Bond Index.

Nigeria

Naira — Short-Term Support, Medium-Term Challenges.

A US$6b decline in foreign reserves in the past six months has raised questions over the sustainability of balance of payments dynamics, with implications for the Naira. The current account balance has slid into a 1.5% of GDP deficit, down from a 2.9% surplus in the previous 18 months. Over time, Nigeria's current account balance is likely to deteriorate. With an effective currency peg in place and the inflation differential with major trading partners in the order of 8-10pp, rapid real Naira appreciation should eventually weigh on the trade balance, building depreciation pressure on the Naira. With structural capital outflows of 2-3% of GDP, implying a medium-term headwind, an adjustment to the Naira is likely to be needed. In the short run, BoP dynamics imply a stabilisation of FX reserves in a US$35-40bn range in 2020.

Egypt

Growth is not enough.

Macroeconomic reform under its IMF program. However, Egypt broadly needs a growth rate of 6% just to meet the demographic challenge of absorbing all the potential new entrants into the workforce.

We thank you for your continued support.

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