Weekly commentary

After Brexit, does EM offer a safe haven?

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July 18, 2016

Key takeaways

- After an initial negative reaction to the Brexit result, emerging markets (EM) assets have performed extraordinarily well.
- We estimate the direct macroeconomic impact of Brexit on EM to be weak at most.
- EM Americas and Middle East present the strongest return opportunities given their low dependence on European demand.
- U.S. interest rates pose a potential headwind for emerging markets fixed income (EMFI) assets.

Full commentary

After an initial negative reaction to the Brexit result, risk aversion subsided and most EM countries have recouped their losses. Assets were initially hit by fear, however many investors saw a chance to reallocate to EM bonds and most indices now stand significantly stronger than pre-referendum.

Britain's vote to leave the EU has counter-intuitively accelerated investor flows into EM, by providing an escape from the uncertainty of Europe, offering both carry and underlying duration advantage. Of course the idea of EMFI acting as a "safe haven" is preposterous, but geographically EM is far from the epicenter of European political and economic risk. EM countries have limited exposure on aggregate, with EM exports to the UK accounting for just 0.6% of total EM Gross Domestic Product (GDP). EM countries with strong links to Europe will be more sensitive, as we watch over the middle-term how this story unfolds for the rest of the EU. We believe Latin America and the Middle East regionally offer the strongest return opportunities given their low export dependence on Europe, while country spreads (over Treasuries) remain elevated coming out of the oil shock of 2014-15.

Investor insatiability for duration and credit continues to underpin hard currency technicals, especially amid a lighter expected EM issuance calendar for the remainder of the year. Despite notable compression since February, spread levels appear historically elevated and could plausibly break through to a new lower trading range in the second half of 2016. Credit curves remain steep, even after June's reversal, and may experience normalization if flows persist. More surprisingly, EM currencies have also benefited from a tailwind, helped by a combination of the general carry trade environment and post-Brexit expectations of an extended Federal Open Market Committee (FOMC) pause.

Positive EM stories are overtaking negative EM stories on the proverbial front page. Idiosyncratic changes in news flow have become helpful at the margin. Investors have "discovered" a new market called Argentina; Brazil is on the right track again; oil prices have recovered and oil credits from Mexico to Saudi Arabia are no longer flashing warning signs. Indeed, one EM country, Russia, ostensibly benefits from Brexit, since a divided Europe is less likely to renew sanctions.

What's missing from this rosy picture? What are the potential risks for investors? We are primarily concerned about another developed market that has counter-intuitively incentivized flows into EMFI: the U.S., and particularly interest rates. U.S. Treasury yields now stand at historically low levels, whilst asset price inflation is strong, core Personal Consumption Expenditure (PCE) prices are firm and U.S. wages are clearly accelerating. Looking forward a year from now it's entirely possible to envision the U.S. economy on a solid footing, inflation rising, an overheating real estate market and fiscal stimulus from the new president. All of that points to the U.S. Federal Reserve hiking and would necessitate a repricing of the underlying yield curve.

This week's market developments

Monday, July 11
- Japan PPI growth remained at -4.2% y.o.y. for June

Tuesday, July 12
- US Wholesale Inventories growth decreased to 0.1% m.o.m. for May

Wednesday, July 13
- Eurozone Industrial Production growth decreased to -1.2% m.o.m. (s.a.) for May

Thursday, July 14
- US PPI Final Demand growth increased to 0.5% m.o.m. for June

Friday, July 15
- Eurozone CPI growth decreased to 0.2% m.o.m. for June
- US Retail Sales growth increased to 0.6% m.o.m. for May
- US CPI growth remained at 0.2% m.o.m. (s.a.) for June
- US Industrial Production growth increased to 0.6% m.o.m. (s.a.) for June.
- University of Michigan Consumer Sentiment Index (preliminary estimate) decreased to 89.5 for July

Source: Bloomberg, as of end July 18, 2016

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on September 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.40 %	July 27, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.22 %	July 21, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.01 %	July 29, 2016
BoE	-50 basis points	March 5, 2009	0.50 %	0.34 %	August 4, 2016

Source: Bloomberg

Next week's market developments

Tuesday, July 19

- UK CPI growth is expected to increase to 0.4% y.o.y. for June
- UK Core CPI growth is expected to increase to 1.3% y.o.y. for June
- UK PPI Output growth is expecwted to increase to -0.5% y.o.y. for June
- US Housing Starts are expected to increase to 1,166,000 for June

Wednesday, July 20

- UK ILO Unemployment Rate is expected to remain at 5.0% for May
- Eurozone Consumer Confidence (advance estimate) is expected to decrease to -8.0 for July

Thursday, July 21

- Japan All Industry Activity Index growth is expected to decrease to -1.1% m.o.m. for May
- US Existing Home Sales are expected to decrease to 5,480,000 for June
- US Leading Index growth is expected to increase to 0.2% for June

Friday, July 22

- US Markit Manufacturing PMI (preliminary estimate) is expected to increase to 51.5 for July
- Eurozone Markit Manufacturing PMI (preliminary estimate) is expected to decrease to 52.0 for July
- Eurozone Markit Services PMI (preliminary estimate) is expected to decrease to 52.3 for July
- UK Markit Manufacturing PMI (preliminary estimate) is expected to decrease to 47.8 for July
- UK Markit Services PMI (preliminary estimate) is expected to decrease to 48.8 for July

Source: Bloomberg, as of end July 18, 2016