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IDEA

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Global EM Strategist | Global

Is a US Equity Correction Good for EM?

Weaker US equities have not hurt EMFX thanks to a weaker DXY and cleaner positioning. EM credit is more vulnerable due to heavier positioning, upcoming issuance and correlation with US credit. We downgrade our stance to bearish but keep local markets at neutral.

Local versus credit: The US equity bull market has not exactly been a boon for EM fixed income. So could its end provide some relief? Higher volatility suggests that investors should remain cautious but we think that local markets and credit can react a bit differently. The key lies with USD. This year, the outperformance of US assets helped to attract capital inflows and strengthened USD. A weaker US equity market could rebalance flows and put USD under downward pressure, providing support to EM. Combined with light positioning, we see a neutral stance on EM local markets as still appropriate. Equity weakness should see AXJ underperform. We see credit a bit differently. Technicals are not as supportive and, although a stable USD will help, the correlation with US credit markets (where we see wider spreads) is strong. We lower our stance on credit to bearish.

If geopolitical risks lead to higher oil prices, oil-importing sovereign credits could come under pressure and as such we dislike Indonesia, Sri Lanka, Pakistan and Lebanon. Within oil exporters, we are looking to switch out of Qatar into Mexico in the belly, and think that Bahrain could give up some of its gains, given the strong rally we have seen in these credits recently.

Are moderating FX reserves in EM a worry? Overall FX reserve levels don't look worrying, but there are numerous smaller sovereigns where reserves have fallen and may start to raise concerns. Of the ten with the largest falls in the past three months in percentage terms, Argentina, Ecuador, Ukraine, Sri Lanka, Angola, Ghana and Kenya lack sufficient reserves to various extents. On the other hand, risks in Mongolia, Oman and Nigeria are manageable.

Turning neutral on Brazil credit: We think that the market is already pricing in an orthodox policy mix. The pension reform is a key risk but this is still several months away and in between the market is likely to price in a more benign outcome including the potential for various alliances to be formed. As such spreads should remain supported in the near term. We favour the long end of the curve and look to sell the 5y CDS-bond basis. We also move Brazil local rates to a like as the market should continue to price out rate hikes.

New trades: We recommend receiving 2y2y TIIE as the market has done a good job of pricing in Banixco's cautious message. We look to sell INDON 10y, sell INDON 5y CDS as the basis has risen by 20bp in past month. We expect the curve to steepen with the expected multi-tranche issuance from PLNIJ.

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Could EM credit and local diverge?

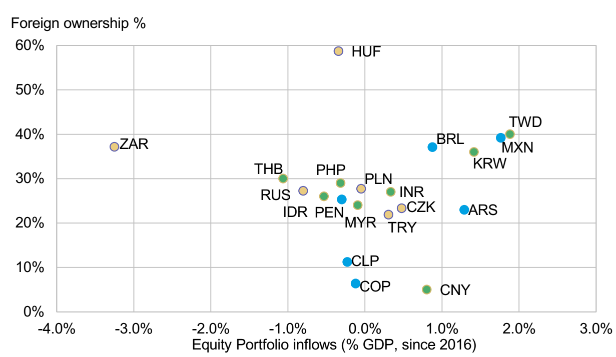
James Lord, Simon Waever, Andres Jaime

We expect EM credit spreads to re-test the wides and turn back to a bearish stance. This next leg of weakness will be driven by a further correction in DM risk assets as well as more sovereign issuance into year-end. For local currency, we think that some weakness is likely too but we do not see the case for a big move. Valuations and positioning are more favourable than credit, while further downside in US assets could weaken USD. As such, we stick to a neutral view on FX overall but recommend some short positions in markets that we think could be vulnerable due to equity volatility, a pick-up in trade tensions or with a strong domestic rationale.

We switched to a neutral view on EM fixed income on September 24 (see Closing the Short). In the past three weeks EM credit spreads are a bit wider while local currency product is a bit stronger. We think that the risks are tilted towards near-term weakness and revert back to a bearish stance on credit. We leave the FX and local rates stance at neutral for now as we see some offsetting factors. Having outperformed so far this year, we see credit as more vulnerable than local markets on account of positioning, valuations and supply/issuance factors. We also think that USD could trade on the back foot as US assets weaken, supporting local currency over credit.

Strategy implications: In credit, our portfolio allocations and trades were already defensive since we only expected a temporary reprieve. We prefer IG over HY, including having likes on Colombia, Chile and Russia. Cheap valuations should also shield the higher-beta credits Oman and Pemex that we expect to outperform. Finally, single B credits should overall come under pressure, and we dislike Sri Lanka, Pakistan and Lebanon. Our only likes in the single B space are Egypt and Argentina. Brazil should see its spreads supported in near term before a trickier 2019 and so we turn neutral.

Exhibit 1: Where are positioning risks in EM equities?



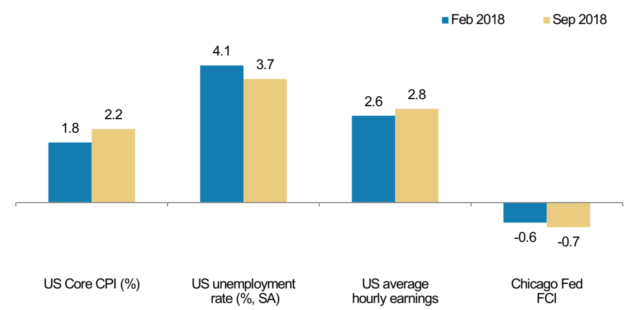
Source: Datastream, Morgan Stanley Research

In local markets, we stick with a neutral view overall. Trade tensions and equity sensitivities mean that our dislike list is dominated by Asia. India, Indonesia, Korea, the Philippines, Singapore and Taiwan FX are all on our dislike list. As Exhibit 1 shows, Korea and Taiwan in particular have received a higher degree of equity inflows than most EMs this year, while foreigners own a comparatively large stock of domestic equity market cap. Both currencies would also likely weaken in the event of additional trade tensions. We hold a long THBKRW 3m NDF position. Mexico also looks exposed on this metric. However, local rates markets are pricing in a cautious outlook and we think that sufficient risk premium exists to recommend receiving 2y2y TIIE. Reduced election risks mean we move Brazil local rates to like.

Why we are cautious on risk

Fed not coming to the rescue: It is too early to think that the Fed will respond to the market weakness by adjusting policy. Inflation remains high and wages are accelerating amid a very tight labour market. Fed policy has not yet even reached neutral levels. Our colleagues in US economics and rates strategy point out that former president of the New York Fed William Dudley commented on February 8 that the 10% decline in the S&P 500 seen over the preceding two weeks was "small potatoes". Considering that the unemployment rate has declined, wages have accelerated and financial conditions have eased since this time, not the mention that the S&P 500 is still above the level at the time this comment was made, it doesn't seem likely that we have seen sufficient weakness for a switch in Fed policy. Our colleagues also point out that the weakness in US equities needs to be sustained for a long enough period of time such that it can be expected to have affected the economic outlook. A quick correction of the order we have seen so far may not be sufficient.

Exhibit 2: Inflation pressure higher and financial conditions looser since February 2018



Source: Haver Analytics, Morgan Stanley Research

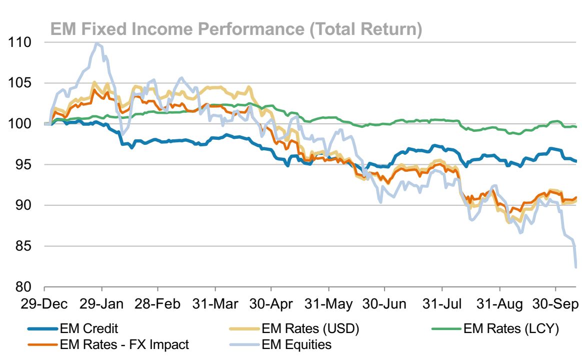
Furthermore, President Trump's comments regarding monetary policy may make it harder for the Fed to actually switch to a more dovish stance (a widely shared view in the market and most recently promoted by Larry Summers).

Continued DM asset price volatility and weakness: The fact that US monetary policy is unlikely to help to support a rebound in US equity and credit markets any time soon is a negative. Volatility in US asset prices, all else being equal, is a negative headwind for EM for obvious reasons. As we explain later, this might also lead to a weaker USD, so there are some offsetting factors. But in and of itself, more weakness and volatility in US risk assets is bad for risk assets in EM. We think that this will mostly impact credit over local markets though.

Why we think that credit will suffer more than local markets

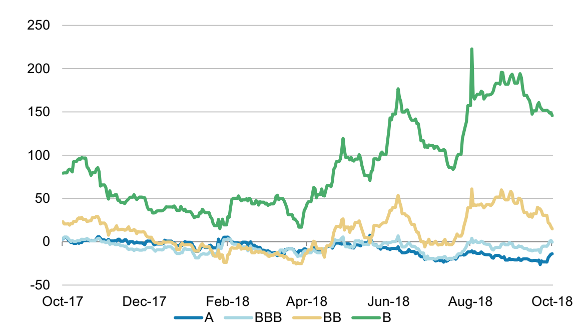
Credit valuations not as cheap as they appear: We think that valuations in local markets are more attractive than in credit. Simply looking at the year-to-date performance of the two asset classes would suggest this (Exhibit 3). However, in credit, the problem is also that the majority of the spread widening this year has been driven by HY and in particular by just a handful of credits including Argentina, Turkey and Ecuador. EM IG credits are flat year-to-date and in fact outperformed US IG (Exhibit 4).

Exhibit 3: We expect EM local markets to outperform credit



Source: Datastream, Morgan Stanley Research

Exhibit 4: EM credit cheapness versus US credit driven by single Bs (EM sovereign versus US credit spreads, bp)

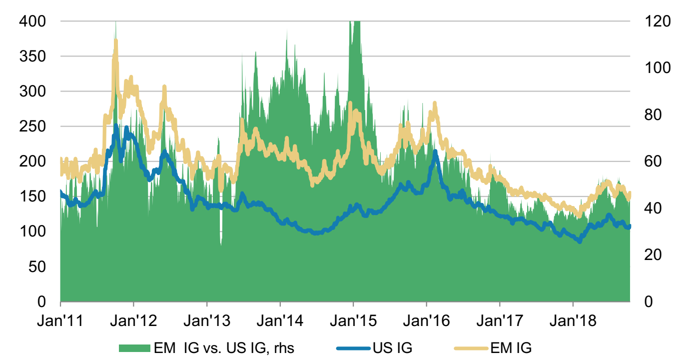


Source: Bloomberg, Morgan Stanley Research

US credit weakness ahead... US IG is only 15bp wider year-to-date while US HY is actually 3bp tighter. We expect this to change with US credit spreads widening into the end of the year, led by HY. US GDP growth (and PMIs) are peaking. Earnings growth is probably peaking as we write, with comps getting tougher beginning as soon as 4Q18. Margins are set to contract, with rising costs in many parts of the economy (energy, transportation, labour, funding, tariffs, materials), despite consensus expectations for expanding margins next year. And we think that even defaults will drift higher next year (see US Corporate Credit Strategy Brief, September 25, 2018).

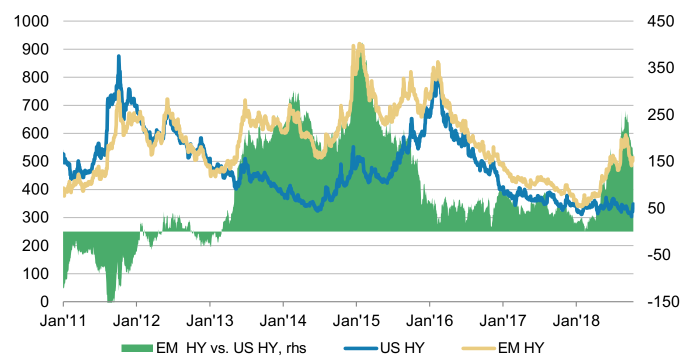
...with EM cheapness only providing relative outperformance: The valuation cushion EM has already built up should certainly help to shield EM from some of the knock-on impacts of US credit weakness. However, EM spreads would still widen outright, even if we expect them to outperform US credit. EM credits that have barely widened on a year-to-date basis would be particularly vulnerable. This includes the broad EM IG complex, where correlations to US IG remain very high.

Exhibit 5: EM and US IG credit highly correlated...



Source: Bloomberg, Morgan Stanley Research

Exhibit 6: ...but EM and US HY credit less so

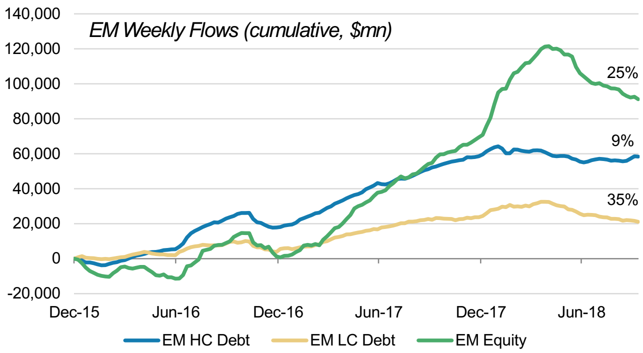


Source: Bloomberg, Morgan Stanley Research

Targetting the EMBIG to reach 420bp: Our US credit strategists expect US IG spreads to widen by another 15bp and US HY by 50bp in the near term, before giving way to further weakness into 2019. We run a historical analysis to estimate the impact this would have on both the overall EM sovereign index (EMBIG) and its IG and HY sub components. Importantly, in addition to having US IG and HY as explanatory variables we also include the DXY. As explained below, the fact that we expect the DXY to remain range-bound is an important support for EM local markets so it's only fair to include it for EM credit as well. In the end, the regression suggests that US credit moves outlined above would translate into an EMBIG widening of 42bp, and 27bp and 68bp for the IG and HY subcomponents, respectively. For the EMBIG this would see spreads widen to around 410-420bp, which is consistent with our own year-end forecast of 420bp for the EMBIG.

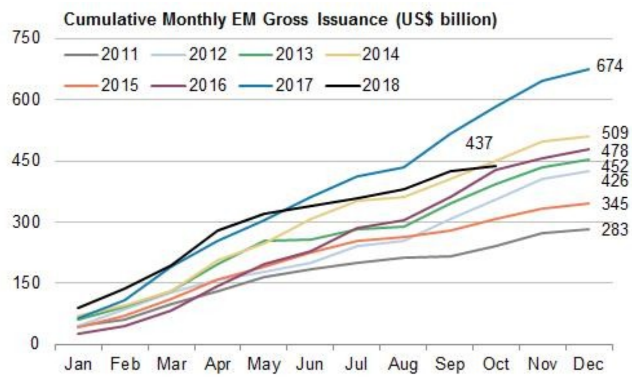
EM credit has weaker technicals as well: First, the outflow picture is more supportive of EM local currency resilience versus credit. EM local currency product has seen persistent outflows over the last six months whereas credit has not (Exhibit 7). EM-dedicated local currency funds have seen about 35% of the cumulative inflows leave the market since the peak of inflows in early 2018. The equivalent number for credit is just 9%. The total quantity of inflows into local currency product was also smaller during this period than for credit markets. Second, after a very subdued September, we expect supply to pick up materially in the weeks ahead to fulfill remaining financing needs in addition to opportunistic issuance ahead of 2019. Indeed, supply was already an important factor we expected to contain any tactical rallies (see here for more details on our credit views and where we expect supply to come from).

Exhibit 7: Local currency funds have seen a much larger reversal already*



Source: EPFR, Morgan Stanley Research; *% refers to total outflows as proportion of cumulative inflows from January 2016 to peak.

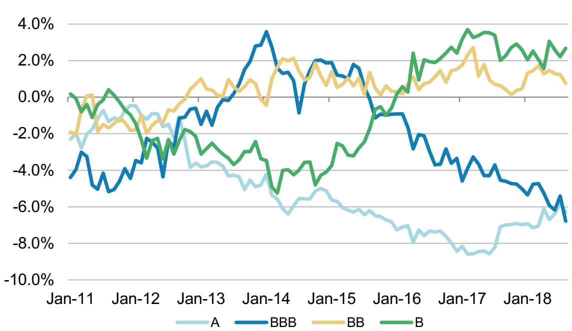
Exhibit 8: We expect more issuance ahead following a lacklustre September



Source: Bond Radar, Morgan Stanley Research

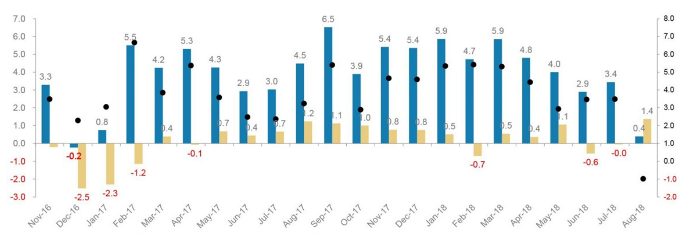
Finally, we estimate current positioning as being more defensive in local markets. Not only has more money left local market funds versus credit, but the funds that are left in the respective asset classes are also deployed more defensively in local markets compared to credit. Put simply, most EM local currency funds have raised their allocations to low yielders and reduced them to high yielders (Exhibit 10). The data we have on this are only as of end-August, so it has potentially changed in recent weeks in line with the minor recovery in EM fixed income. However, the performance of the average EM local currency fund relative to benchmark over September and early October suggests that positioning has remained defensive. In credit markets, investors remain exposed to high yield, with the three biggest overweights still Argentina, Brazil and Ukraine. We also estimate that betas of portfolios are slightly OW with cash balances of 4.4% (see EM Technical Watch, September 26, 2018).

Exhibit 9: Credit investors still OW high yield....



Source: EPFR, Morgan Stanley Research

Exhibit 10: ....while LCY investors are OW low yield

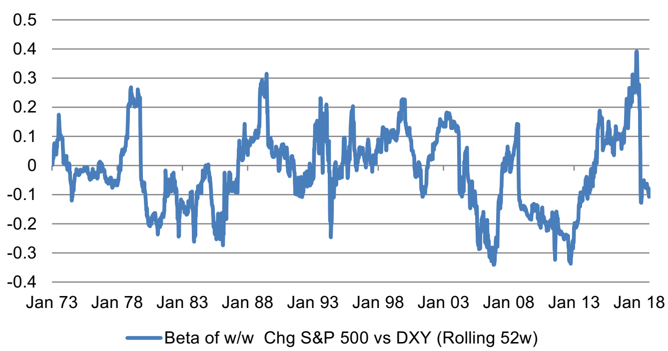


Source: Company websites, Morgan Stanley Research

USD weakness to shield local assets: The common market perception is that equity market volatility and risk-aversion should lead to USD strength. The concept of the USD smile reinforces this notion. However, it is not always the case that USD strengthens while the US equity market is weakening. Exhibit 11 shows the rolling 52-week beta of weekly returns between the S&P 500 and DXY and illustrates that there is no consistent relationship between the two over time. In other words it is possible for the

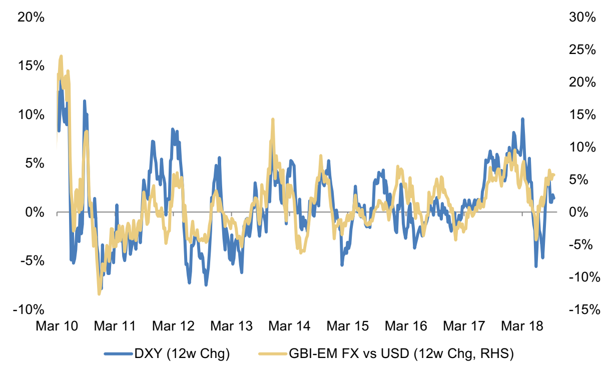
DXY and S&P to move in opposite directions. This is a key part of our rationale for why EM local markets could do ok despite expected equity market declines. As Exhibit 12 shows, the performance of the GBI-EM FX index is persistently highly correlated with the DXY. Meanwhile, the performance of EMFX and the S&P 500 over the past few years clearly demonstrates that US equity performance is not a particularly significant driver of EM currencies. The question is, is there any reason to think that USD would drop as US equities weaken? We address this next.

Exhibit 11: Relationship between DXY and S&P not consistent over time



Source: Bloomberg, Morgan Stanley Research

Exhibit 12: DXY and EMFX consistently highly correlated

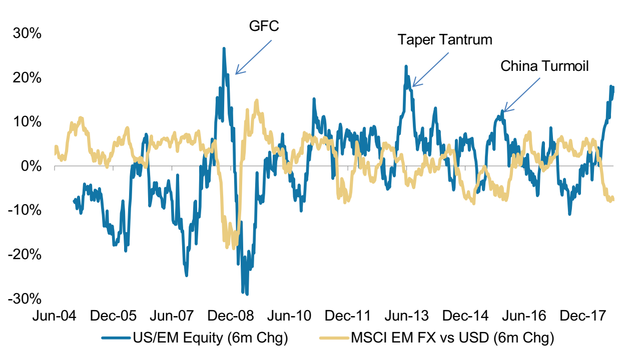


Source: Bloomberg, Morgan Stanley Research

Will USD weaken as US equities drop?

There are a number of reasons to think so: First, recent US equity market strength and outperformance has been associated with USD strength. With global liquidity conditions less ample this year compared to the past, investors have been more discerning in where to place their capital and in recent months the US markets have commanded a premium, sucking in capital from the rest of the world. It would therefore stand to reason that as the US equity market comes under pressure, the pulling power of US markets for international capital is less significant and thus helping to put some downward pressure on USD.

Exhibit 13: US equity underperformance tends to weaken USD

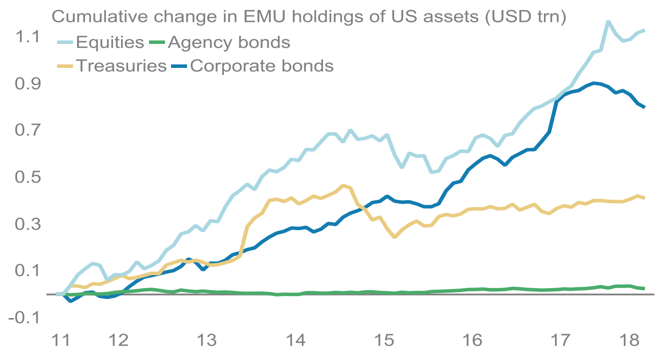


Source: Bloomberg, Morgan Stanley Research

An additional factor to consider is how EM equities trade in a US equity bear market. Will the fact that EM equities have weakened significantly already mean that they could outperform? If so, the chances of EM currencies remaining resilient would increase. Indeed, the relative performance of EM versus US equities appears to be correlated with EMFX performance versus USD. Exhibit 13 shows the six-month relative outperformance of the S&P 500 versus the MSCI EM (in local currency terms) and also the six-month change in the MSCI EMFX index versus USD. As is clear from the chart, there is a negative correlation between these two indices, suggesting that should US equities start to underperform then EMFX would perform better.

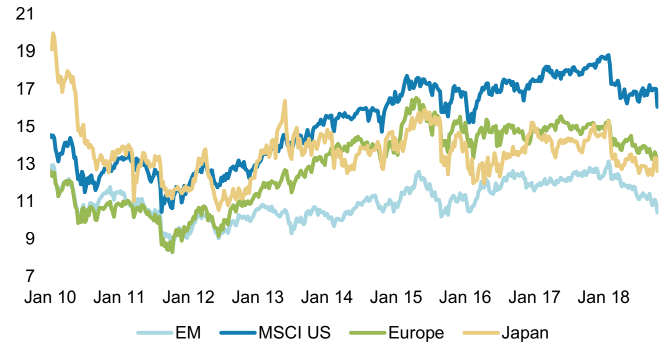
Second, European investors have increased their US asset holdings significantly over the past few years. Lower yields and weaker growth at home have led to an increase in Europe's foreign asset holdings, mirroring the continent's large current account surplus. While Europe still runs a net negative foreign portfolio asset position, the gross asset side of the equation has grown significantly in recent years. European equities have been weak for a while, leading to a substantial 12-month forward P/E discount relative to the US. EM and Japan equities show similar valuation trends versus the US.

Exhibit 14: Europe has increased exposure to US assets



Source: Macrobond, Morgan Stanley Research

Exhibit 15: MSCI EM the cheapest of the bunch

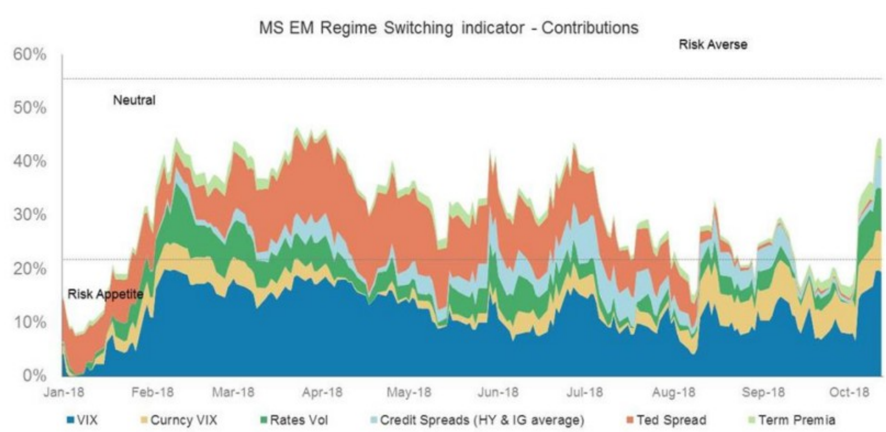


Source: Datastream, Morgan Stanley Research

Third, a stable TED spread suggests that risk-aversion is not of the USD-positive kind: On October 8 our regime-switching model triggered a 'sell' signal, after briefly moving to the 'euphoria' zone (below the model-defined threshold of 22%) on October 2. However, an important distinction (in terms of the components of the model generating the signal) needs to be made between this signal and the sell signal triggered back in 1Q18 (see Global EM Strategist: Shifting Down a Gear, March 12, 2018).

As opposed to the initial sell-off in EMFX that was partially explained by a USD funding squeeze due to the very high T-bill issuance, the recent increase in our risk index (MSCEEMRI Index in Bloomberg) has almost zero contribution from the TED spread (Exhibit 16). This suggest to us that, coupled with much cheaper valuations in EMFX and the source of risk weakness stemming from US assets, local markets will likely be more resilient than in the past as USD is less likely to head higher.

Exhibit 16: TED spread has not widened as risk appetite shifted neutral, suggesting little upward pressure on USD



Source: Bloomberg, Morgan Stanley Research

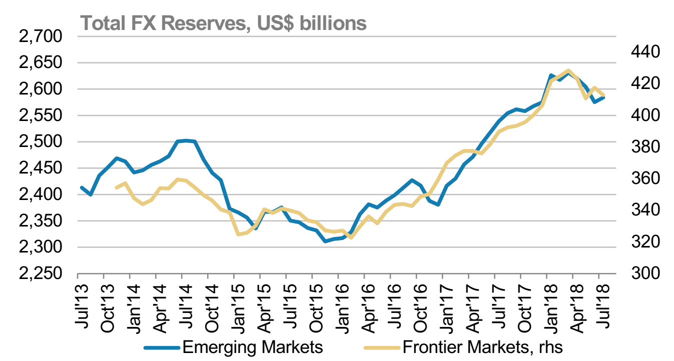
EM credit: Should we worry about falling FX reserves?

Simon Waever, Jaiparan Khurana

Bottom line: Of the ten sovereigns with the largest falls in FX reserves in the past three months in percentage terms, Argentina, Ecuador, Ukraine, Sri Lanka, Angola, Ghana and Kenya lack sufficient reserves to various extents. On the other hand, risks in Mongolia, Oman and Nigeria appear manageable. We would also highlight Turkey, Lebanon and Bahrain as credits which haven't seen a large drawdown in reserves but their external liquidity looks weak based on our analysis below.

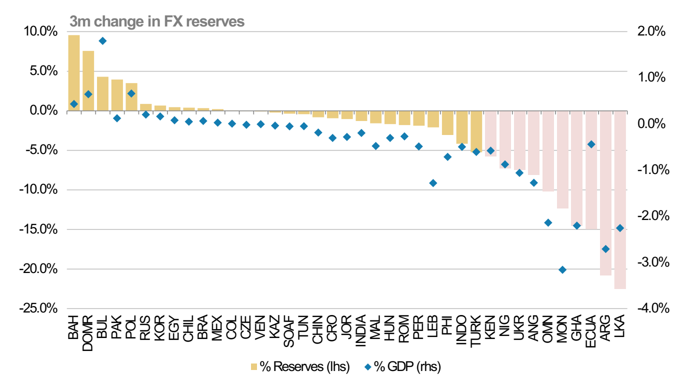
FX reserves falling again: After rising significantly throughout 2016 and 2017, the FX reserves of EM credits have started to fall recently (Exhibit 17). Several factors are behind this but the weaker US dollar in 2016-17 which then reversed in 2018 will have been a significant driver. Smaller impacts will also have come from valuations effects due to higher DXY and G3 bond yields. Overall, levels don't look worrying. However, away from the larger EM credits there are numerous smaller credits where reserves have fallen significantly and may start to raise concerns (Exhibit 18).

Exhibit 17: Emerging and frontier market FX reserves now falling...



Source: Haver Analytics, Morgan Stanley Research; EM includes Brazil, Chile, Colombia, Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, South Africa, Tunisia and Turkey. FM includes Angola, Argentina, Bahrain, Bulgaria, Croatia, Dominican Republic, Ecuador, Egypt, Ghana, Jordan, Kazakhstan, Kenya, Lebanon, Sri Lanka, Mongolia, Nigeria, Oman, Pakistan, Romania, Serbia, Ukraine, Venezuela

Exhibit 18: ....with select high yielders in particularly seeing significant falls



Source: Haver Analytics, Morgan Stanley Research; Note: We have highlighted the ten biggest movers in red.

Assessing reserve coverage: Exhibit 19 compares the FX reserves across EM versus various vulnerability metrics, including imports, total external debt and short-term debt. Where available we also use the IMF's Assessing Reserve Adequacy (ARA) metric and finally our own External Coverage Ratio (ECR, defined as reserves versus next 12 months' funding needs approximated by the current account, short-term external debt and long-term external debt amortisations in the next 12 months where available).

Next, we plot the ECR against the external debt/current account receipts to assess the external liquidity of the sovereigns (Exhibit 20). In addition, we plot public external debt/GDP against total external debt/GDP to sense the driver behind the external debt (Exhibit 21).

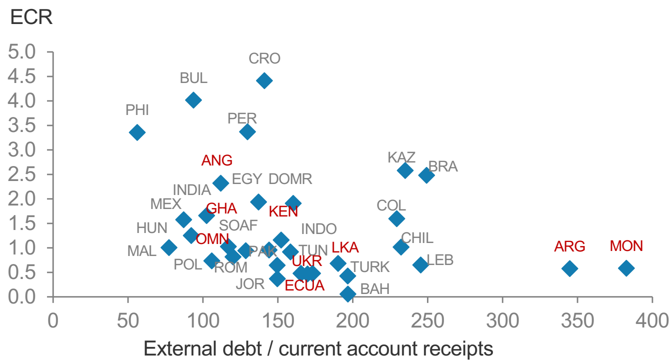
The analysis would suggest that of the ten sovereigns with the largest moves in FX reserves in the past three months in percentage terms, **Argentina, Ecuador, Ukraine, Sri Lanka, Angola, Ghana and Kenya lack sufficient reserves to various extents.** On the other hand, **risks in Mongolia, Oman and Nigeria appear manageable.** We would also highlight **Turkey, Lebanon and Bahrain as credits which haven't seen a large drawdown in reserves but their external liquidity looks weak** based on our analysis. We look into these below, including any adjustments to the FX reserves we think need to be made at the country level.

Exhibit 19: Assessing reserve coverage across EM

Country	Reserves (US$ mm)	% of GDP	As of	1Y Change (US$ mm)	1Y Change (% GDP)	1m Change (US$ mm)	Month of Imports	% of Total Ext. Debt	% of ST Ext Debt	% IMF ARA	Current Account	Funding Needs	ECR
CHIN	3,087,025	22.9%	9/30/2018	-21,485	-0.16%	-22,691	17.7	165%	275%	82%	67,286	1,123,374	2.9
INDIA	400,525	14.9%	9/30/2018	320	0.01%	423	9.7	76%	392%		-67,250	174,604	1.7
INDO	114,848	11.4%	9/30/2018	-14,554	-1.45%	-3,079	7.6	32%	230%	119%	-22,116	103,125	0.9
KOR	403,000	24.3%	9/30/2018	18,326	1.11%	1,869	9.3	93%	334%	106%	91,058	168,115	5.2
MAL	103,000	29.7%	9/30/2018	1,801	0.52%	-1,405	5.7	45%	101%	111%	11,808	114,584	1.0
PHI	75,161	22.7%	9/30/2018	-5,801	-1.75%	-2,773	8.6	103%	585%	183%	-3,648	18,753	3.4
LKA	7,180	7.8%	9/30/2018	-100	-0.11%	-1,404	2.0	14%	96%		-3,085	7,474	0.7
MON	2,854	22.4%	8/31/2018	1,255	9.86%	-99	6.4	10%	86%		-1,566	3,338	0.6
PAK	9,885	3.2%	8/31/2018	-4,796	-1.56%	-326	1.9	11%	113%	26%	-18,130	8,724	0.4
BUL	27,782	43.6%	8/31/2018	-1,290	-2.03%	5	9.5	66%	286%	157%	2,785	9,703	4.0
CRO	19,114	31.9%	8/31/2018	1,611	2.69%	-88	8.4	38%	318%	107%	1,679	6,011	4.4
CZE	144,142	58.9%	9/30/2018	-2,616	-1.07%	-370	9.6	69%	142%		489	113,141	1.3
HUN	27,558	17.6%	9/30/2018	1,331	0.85%	-756	2.9	18%	176%	89%	3,128	25,154	1.3
POL	107,379	19.5%	9/30/2018	1,292	0.24%	-458	4.9	27%	202%	105%	0	146,264	0.7
ROM	34,997	14.6%	9/30/2018	-2,944	-1.23%	192	4.6	30%	224%	114%	-9,578	33,500	0.8
KAZ	30,028	16.3%	9/30/2018	-2,181	-1.18%	-482	11.5	18%	360%	146%	-3,316	8,340	2.6
RUS	371,858	23.6%	9/30/2018	30,508	1.94%	-1,643	17.7	72%	673%	219%	81,977	128,602	8.0
TURK	78,460	11.0%	8/31/2018	-13,033	-1.83%	0	3.9	17%	64%	54%	-12,843	171,991	0.4
UKR	16,638	13.2%	9/30/2018	-2,000	-1.58%	-592	3.7	14%	96%	61%	-4,044	31,741	0.5
BAH	1,947	5.0%	8/31/2018	562	1.43%	626	1.7	3%	6%		-1,593	33,353	0.1
EGY	44,463	17.8%	9/30/2018	7,926	3.18%	41	7.9	50%	386%	146%	-5,962	17,001	1.9
JOR	11,083	26.5%	8/31/2018	-28	-0.07%	402	6.5	38%	96%	81%	-3,929	13,382	0.6
LEB	33,919	59.8%	8/31/2018	-107	-0.19%	-292	20.3	56%	89%		-14,171	40,421	0.6
OMN	15,373	18.8%	7/31/2018	-3,399	-4.16%	-543	8.0	28%	281%		-10,844	5,473	0.9
TUN	4,708	11.3%	9/30/2018	-960	-2.30%	296	2.5	13%	79%	59%	-3,971	7,501	0.4
ANG	16,475	14.4%	9/30/2018	-3,235	-2.83%	-627	13.7	37%	N/A	89%	-7,017	90	2.3
GHA	6,693	12.9%	8/31/2018	-389	-0.75%	-342	6.1	37%	229%		-2,124	4,398	1.0
KEN	8,436	9.4%	9/30/2018	537	0.60%	-216	5.9	34%	378%		-4,682	2,608	1.2
NIG	44,305	11.1%	9/30/2018	11,145	2.80%	-1,533	17.1	201%	1937%		14,889	4,515	4.3
SOAF	50,394	13.4%	9/30/2018	1,010	0.27%	546	6.9	28%	150%	62%	-13,937	38,782	1.0
ARG	49,003	10.3%	9/30/2018	-1,234	-0.26%	-3,655	8.3	19%	80%	70%	-12,361	72,713	0.6
BRA	380,738	19.9%	9/30/2018	-506	-0.03%	-655	26.1	56%	623%	158%	-17,184	136,468	2.5
CHIL	37,135	12.4%	9/30/2018	-603	-0.20%	354	6.5	20%	226%	81%	-5,698	30,921	1.0
COL	59,217	17.6%	9/30/2018	-5	-0.00%	-24	14.7	47%	416%	160%	-9,771	20,054	2.0
DOMR	7,435	9.2%	8/31/2018	1,151	1.42%	43	3.9	36%	233%	69%	-707	3,192	1.9
ECUA	2,693	2.5%	9/30/2018	331	0.31%	-357	1.5	6%	264%	17%	-742	4,921	0.5
MEX	262,782	21.9%	9/30/2018	535	0.04%	-40	7.0	58%	520%	158%	-25,185	85,218	2.4
PER	57,998	25.3%	9/30/2018	-6,425	-2.81%	-2,447	16.7	84%	580%	246%	-2,289	14,923	3.4
VEN	8,451	8.8%	9/30/2018	-1,478	-1.53%	108	3.2				-17,778	0	-

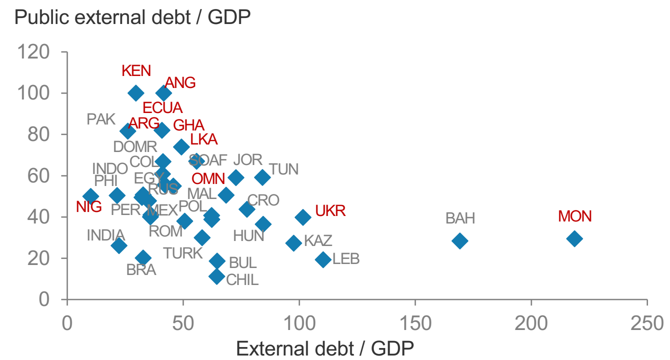
Source: Haver Analytics, Moody's, Bloomberg, IMF, Morgan Stanley Research; Note: External Coverage Ratio is defined as reserves vs. next 12 months' funding needs approximated by the current account, ST external debt and LT external debt amortisations in the next 12 months where available. We include the IMF Flexible Credit Lines for Mexico and Colombia.

Exhibit 20: External position: Liquidity assessment



Source: Haver Analytics, Moody's, Bloomberg, Morgan Stanley Research; Note: We highlight sovereigns which have seen the largest 3m decline in FX reserves in % terms. ECR is defined in Exhibit 19.

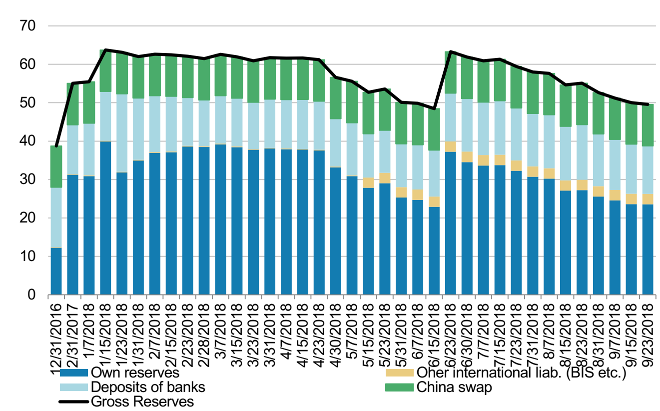
Exhibit 21: External position: Credit assessment



Source: Haver Analytics, Moody's, Bloomberg, Morgan Stanley Research; Note: We highlight sovereigns which have seen the largest 3m decline in FX reserves in % terms.

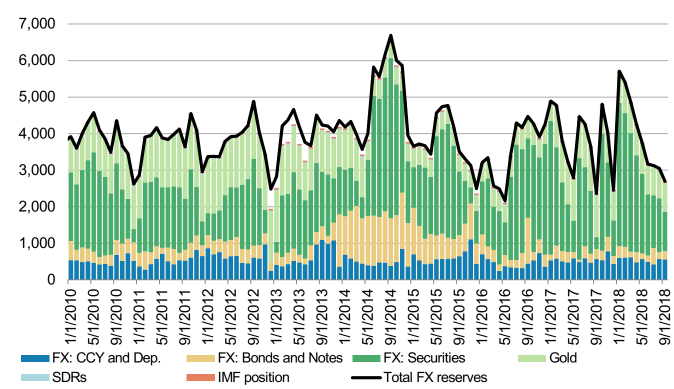
Argentina – manageable even if not comfortable: Low FX reserves versus an overvalued currency, a large current account deficit and growing external debt were in part responsible for the market weakness so far this year. FX reserves still look insufficient, particularly when looking at the net reserves which strip out the deposits of banks and the swap with China, leaving around US$23.6 billion. However, the new monetary policy, including a crawling FX band, and the rapidly falling current account deficit (we expect US$10 billion in 2019) should reduce pressure on reserves ahead. The fact that more than 75% of Lebacs have been unwound already is also supportive. From here, FX interventions will only happen above 44 (which moves higher at 3% per month) at a pace of US$150 million a day. While future IMF tranches will go to the budget and not the BCRA, a large part of the disbursements will still end up at the BCRA since the budget is spent in local currency outside of FX debt repayments. Note that gross reserves should also increase if the currency swap with China is extended by US$9 billion from the current US$10.8 billion.

Exhibit 22: Argentina FX reserves still under pressure



Source: BCRA, Morgan Stanley Research

Exhibit 23: Ecuador FX reserves back to very low levels



Source: Haver Analytics, Morgan Stanley Research

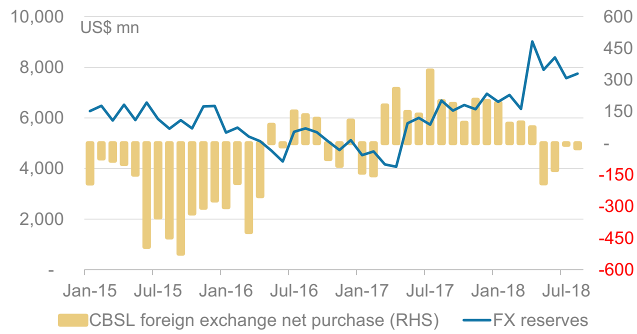
Ecuador – very low: FX reserves have been falling every month since the US$3 billion bond issuance in January 2018 which replenished FX reserves to more comfortable levels of US$5.7 billion. While the pace did slow in July and August to less than US$100 million, it again accelerated to fall by US$357 million in September. With a roughly flat current account, the drain is coming from the capital account, which is perhaps not surprising, given that it's hard to control flows in a fully dollarised economy in addition to the wide fiscal deficit that requires funding. Historically, a drop in reserves has been followed by external bond issuance. This seems less likely at this point given the high yields the bonds are trading at and the less accommodative external environment. Instead, the authorities have relied on more creative financing, including a repo, and bi/multilateral financing. We expect this to remain the case, which will keep FX reserves low for the time being, in turn leaving Ecuador very vulnerable to external shocks.

Ukraine – only sufficient with the IMF: Since peaking at US$19 billion last November, reserves have been falling gradually to stand at US$16.6 billion, with the pace picking up in recent months. Reserves look low versus imports, debt repayments and the current account deficit. This is why it's important that Ukraine stays engaged with the IMF. We expect it to do so, perhaps by initiating a new 1.5-year SBA to cover funding needs through the 2019 election (see Ukraine: Kyiv Trip Takeaways – Cautiously Optimistic, but Watch Elections, September 27, 2018). However, in a bear scenario of no new IMF package, reserves will likely not appear sufficient and market pressure could follow on both the FX and credit spreads.

Sri Lanka – we turned cautious recently: Sri Lanka's ECR is below 1. At the same time, with higher oil prices – fuel imports stand at 17% of total – the current account deficit is widening, making us cautious. While short-term external debt has always been high in Sri Lanka, this time around, the sovereign and the quasis also face US$1.9 billion of eurobond redemptions in 2019, which increases the rollover risks. Demand for FX loans by corporates in refining and power generation may itself increase – due to higher working capital requirements with higher oil prices – which may also absorb the US$ liquidity in the banking sector. We are seeing portfolio outflows from the local currency bond markets of late and CBSL net purchases of foreign exchange have also turned negative in the past four months. Lastly, the IMF programme ends in early 2019. For details, see Sri Lanka Sovereign: Turning Cautious, October 3, 2018.

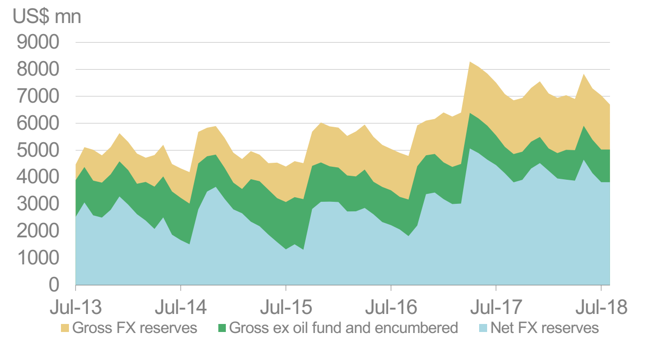
Angola – not as bad as it looks? FX reserves have moderated by US$3.2 billion in the past year. This may look a bit concerning at first glance as Angola had also issued US$3.5 billion of US$ bonds in this period and higher oil prices should have had a positive impact on the current account balance (the IMF forecasts a 2.1% deficit for 2018). That said, we are not overly concerned as Angola has undertaken significant reforms towards FX management which would explain part of the weakness in FX reserves. The central bank has let USDAOA move gradually to 305 from 165 at the start of 2018. At the same time, the parallel market exchange rate had declined from over 400 to 370 now, indicating easing of the US$ demand in the economy. We also think that Angola may have cleared some of the outstanding arrears – which were largely denominated in US$. Lastly, Angola is in talks with the IMF for a funded programme which would be fairly positive, if it materialises.

Exhibit 24: The Central Bank of Sri Lanka has turned to a net seller of US$



Source: Haver Analytics, Morgan Stanley Research

Exhibit 25: Ghana's FX reserves adequacy is lower than what gross levels suggest



Source: Haver Analytics, Morgan Stanley Research

Ghana – moderation is not in the price yet: FX reserve adequacy has clearly improved in the past few years but we think the improvement has now stalled. First, a key driver of FX reserve build-up was portfolio inflows into the local bond markets. With inflation having bottomed out, cedi bond yields have started to rise. We haven't seen a significant exodus of portfolio flows yet but inflows have dried up. Second, the cedi has been tightly managed of late and has remained flat to the US$, which led to it outperforming other EMFX significantly. If the cedi's valuation starts to catch up to EM peers, it could bring investor attention to Ghana's external position and the adverse impact of weaker FX on its debt dynamics. Third, the fiscal deficit so far in 2018 has exceeded the targeted level. Markets already have concerns about the 2019 deficit in the run-up to the 2020 elections. Lastly, Ghana's IMF programme – a key anchor on the external side – also rolls off in 2019 and the authorities have mentioned that they are not looking to renew a funded programme. Similarly, FX reserve moderation in **Kenya** is a concern as its current account deficit is already high at over 5% of GDP and it's a large net oil importer.

We saw the risks in Mongolia, Oman and Nigeria as manageable. **Mongolia's** external debt seems to be high but is largely attributed to the private sector. The current account deficit is fully funded by FDI, i.e., the basic balance is in surplus. Rolling over short-term debt should be straightforward given the strong performance under the IMF programme. **Oman** is a net oil exporter and the IMF assesses its external breakeven oil price at US$80.3/bbl for 2019, meaning that the funding needs could decline if oil prices stay around the current levels. Also, its stock of external debt does not seem as high as some of the peers we highlighted above. **Nigeria** is already running a current account surplus. While we have seen a drawdown in FX reserves – likely due to portfolio outflows from local bond markets – the overall stock of external debt is fairly small.

We also highlighted Turkey, Bahrain and Lebanon. **Turkey's** ECR is low and the banking sector has large external funding needs over the next 12 months. The rollover rates and cost of funding need to be monitored. **Lebanon** is a large net oil importer and while the gross FX reserves look strong, the net reserves are likely lower. Non-resident deposit inflows into Lebanon in 2018 have also been subdued despite higher deposit rates on offer. **Bahrain's** FX reserve adequacy is also low but it has recently reached an agreement to receive US$10 billion of support from Gulf allies over the next five years. Higher oil prices should help to narrow its current account deficit, given its oil exporter status, and capital outflows, a drag on the BoP position, should also abate following the GCC support package.

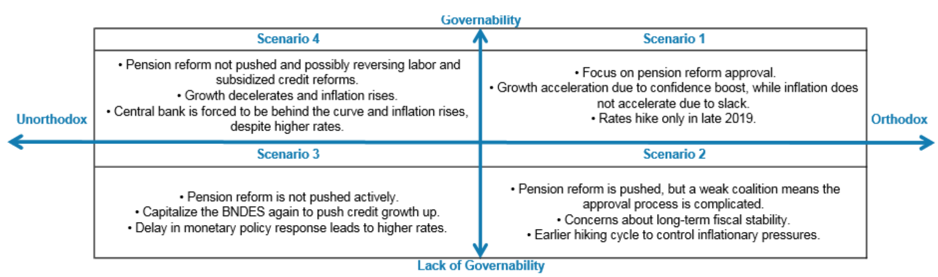
Brazil credit: Near-term support ahead of a trickier 2019

Simon Waever

We think that the market is already pricing in an orthodox policy mix – the question is whether a new administration will also have governability. In the end, we think that any administration will struggle in this respect, particularly when it comes to the pension reform that needs to be addressed in 2019. However, this is still several months away and in between the market is likely to price in a more benign outcome including the potential for various alliances to be formed. As spreads should remain supported, we turn neutral on Brazil credit. We favour the long end of the bond curve and also recommend selling the 5y CDS-bond basis, given that the CDS still looks cheap.

The first round saw a convincing result in favour of Bolsonaro (46%) versus Haddad (29%), which has since been followed by polls suggesting still strong support for Bolsonaro in a second round run-off, with Datafolha showing Bolsonaro ahead with 58% versus Haddad at 42%. This 16-17pp gap is higher than the previous three elections where the first round winner also won the second round (8pp in 2014, 14pp in 2010 and 7pp in 2006). This suggests that the market should be increasingly pricing in a Bolsonaro win.

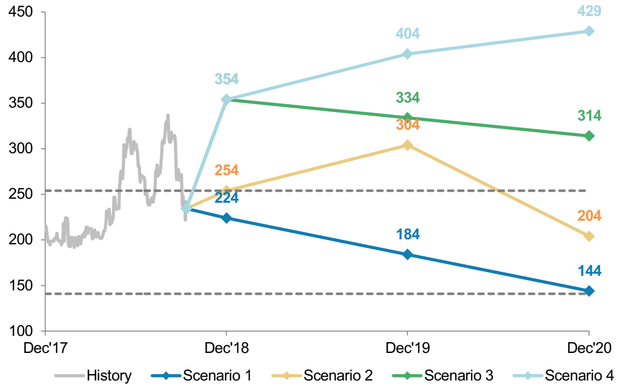
Exhibit 26: Brazil: Election scenarios



Source: Morgan Stanley LatAm Economics

To gauge what exactly the markets are pricing in terms of future policy, we return to our scenario table laid out in our pre-election note (see Brazil: Looking Back to Look Ahead: A Defining Vote, September 4, 2018). This suggests that markets are fully pricing in an orthodox policy outlook, with the main difference being whether the incoming administration would have governability (scenario 1) or not (scenario 2); see Exhibit 27. It's too early at this stage to know which outcome will eventually materialise. That said, if the Mexico playbook is anything to go by, there is little incentive for the incoming administration not to go along with a market-friendly rhetoric and for other smaller parties not to fall in line. After all, it will only be in 2019 that the actual tough decisions will need to be made with regards to reforms, and in particular the pension reform (see The starting point: a fiscal problem). As a result, we think that spreads will hover between scenarios 1 and 2 in the coming months. We therefore remove our current dislike stance and turn neutral. Clearly we underestimated the speed at which the market would price in a market-friendly outcome in the elections.

Exhibit 27: 10y bond spread scenarios



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 28: Brazil valuation monitor

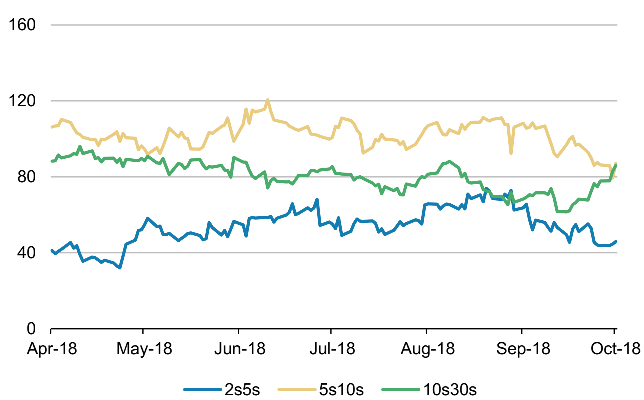
Instrument	Outright valuations				Relative Valuations				
	Min	Current	Max	Z-score		Min	Current	Max	Z-score
BRAZIL 23	88	148	229	0.2	5s10s curve	79	84	121	-2.8
BRAZIL 28	192	232	337	-0.3	Brazil 10y vs. EM BB avg.	-21	-20	61	-1.5
BRAZIL 47	273	322	404	-0.1	10s30s curve	62	90	101	0.7
Brazil 5y CDS	143	233	310	0.5	CDS-bond basis	46	85	94	1.4
PETBRA 23	179	212	346	-0.6	5s10s curve	111	148	170	0.6
PETBRA 28	311	360	486	-0.3	Petbra 10y vs. Brazil	108	128	180	-0.5
					Petbra 10y vs. US BB	88	131	254	-0.6
PETBRA 44	388	421	532	-0.8	10s30s curve	43	60	94	-0.6

Source: Bloomberg, Morgan Stanley Research

To turn outright bullish we would need actual evidence of the social security reforms being tackled as only this would see Brazil decouple from BB spreads and move back towards BBBs. The reason why we don't want to position for this already is that historically such challenging reforms do not pass without a degree of market pressure. This is unlikely to be any different in this time around in 2019, particularly given the very polarised Congress composition. One important point to monitor will be the fuel pricing policy and its impact on Petrobras. Our equity analysts' base case with 60% probability is for a 'social subsidy' leaving a refining margin of US$2/bbl. However, in an upside scenario (25% probability), the market is fully liberalised.

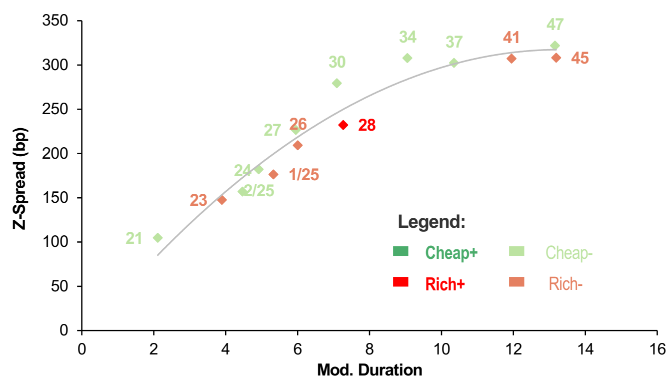
Long end of the curve and CDS offer most value: The 10y sector has outperformed since the turn in spreads early September to leave the 5s10s flat and the 10s30s steeper (Exhibit 29). In the long end, the 2047 is in particular shown as cheap (Exhibit 30). In the shorter end of curve, the CDS still offers much better value than the cash bonds and we stick with our recommendation to sell the CDS-bond basis, using the 5y CDS and the Brazil 2025 bond.

Exhibit 29: 10y sector has been outperforming...



Source: Bloomberg, Morgan Stanley Research

Exhibit 30: ...to leave the 2028 looking rich and 2047 cheap



Source: Bloomberg, Morgan Stanley Research; See EM Sovereign Credit Rich and Cheap Watch, October 9, 2018.

South Africa: Why we are still bearish

Min Dai

This was first published in MTBPS Preview: A Slow but Steady Improvement Under Way.

How to position into the medium-term budget update (MTBPS) is a question about expectations, valuation and positioning in ZAR. We have analysed all three factors: we believe that investors could take the number from this MTBPS with a pinch of salt should the Treasury maintain its growth assumption of 1.8%Y in 2019 and 2.1%Y in 2020. Valuation in ZAR is not cheap while positioning in bonds is heavy. We remain bearish on SAGBs and recommend buying USDZAR, targeting 15.5.

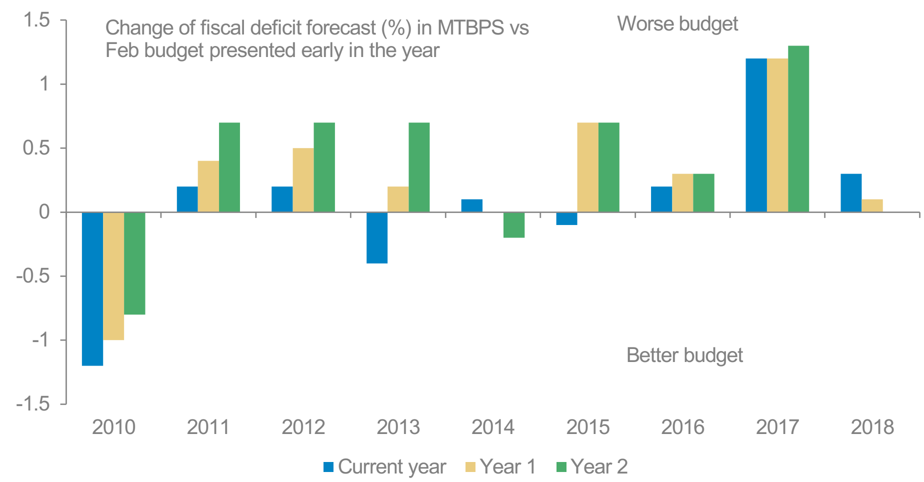
MTBPS expectation: Our economist expects the MTBPS on October 24 to show that the 2018/19 consolidated fiscal deficit is likely to print at 3.9% of GDP and for gross national government debt to reach 56.0% of GDP (February 2018 estimate of -3.6% and 55.1%, respectively). By 2020/21, he sees the consolidated fiscal deficit at 3.5% and gross national government debt at 57.2%. Further downward revisions to the growth outlook pose the largest risk to this view (see more details in Economics: A slow but steady improvement under way).

From the market perspective, how to position into the MTBPS is a question about expectations, valuation and positioning in ZAR. After an analysis of each factor, we remain bearish on SAGBs and recommend buying USDZAR, targeting 15.5.

Lower budget deficit in the next two years driven by a better growth assumption... We believe that most investors expect the fiscal deficit to widen in this MTBPS, given weak GDP growth, and it shouldn't be a surprise should the Treasury revise up this year's fiscal deficit by our economist's forecast of 0.3pp. What investors would focus on would be the fiscal deficit in the next two years: given that traditionally the Treasury doesn't announce any new measures to increase revenue or cut expenditure in the MTBPS, investors would be presented with a budget that shows an improving fiscal deficit based on the assumption of a better growth outlook and therefore higher fiscal revenue.

...but the track record of the growth assumption isn't great: As seen in Exhibit 31, for most of the past eight years the Treasury has had a tendency to present an optimistic budget in February's report and revise the deficit higher in its MTBPS, and most of the upward revision is driven by downside revisions to the growth outlook. Therefore, we believe that investors could take the number from this MTBPS with a pinch of salt should the Treasury maintain its growth assumption of 1.8%Y in 2019 and 2.1%Y in 2020.

Exhibit 31: How does the MTBPS compare to the February budget in the past seven years?

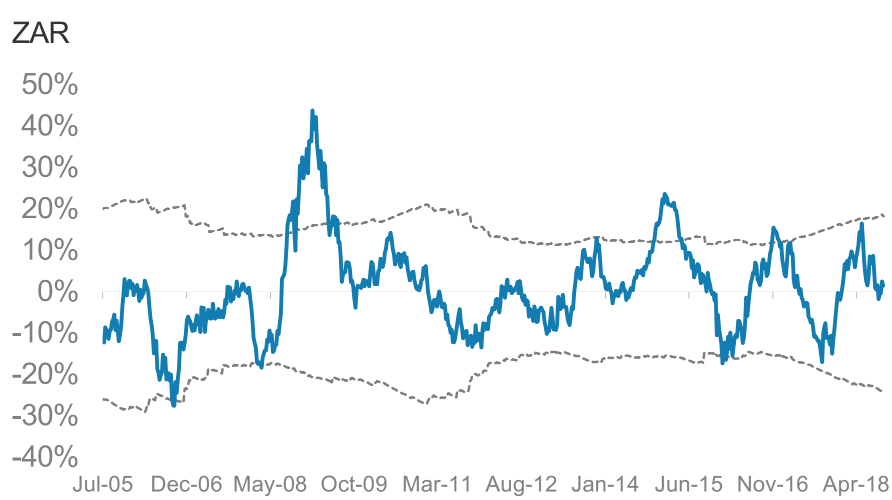


Source: National Treasury, Morgan Stanley Research

Local market not as cheap as the nominal level suggests: Meanwhile, investors often say that the valuation in the local market has already adjusted to reflect the weak growth and challenging EM environment. It is true that ZAR now trades above the level before the ANC elective conference and the R186 yield is close to the highest level seen post last year's MTBPS. However, we need to stress that the weakness in ZAR is more or less a reflection of broad EM weakness: our risk premium model suggests that the current ZAR risk premium is close to zero (Exhibit 32). In SAGBs, the yield level is high but the UST yield is almost 100bp higher than late last year – the spread between SAGBs and UST yield has compressed significantly. This suggests to us that SAGBs isn't as cheap as the nominal level shows.

The alternative to assess the valuation of SAGBs is to break down the R186 yield into 10yr UST yield, 10yr South Africa and US inflation and 10yr South Africa credit risks measured by CDS. Following the same logic we discussed in Local market strategy: Staying short, we believe that the fair value of R186 should be around 9.40% and locals are likely to be an aggressive buyer only when it trades 50bp above this level.

Exhibit 32: ZAR risk premium back to zero



Source: Bloomberg, Morgan Stanley Research

Positioning remains heavy: We believe that foreigners are quite complacent, which is reflected in the positioning. Despite ZAR selling off more than 15% in the past few months, we haven't seen any reduction in bond positioning by foreigners, based on Treasury data (SABO data are misleading, in our view). South Africa remains the second-biggest OW in cash bond terms and the biggest OW in duration terms in the GBI-EM portfolio (Exhibit 33). The latest development in the UST market is negative for South Africa. Should EM funds decide to cut their EM duration, South Africa will likely suffer, given its heavy positioning and better liquidity.

Exhibit 33: South Africa remains the second-biggest OW in cash bond terms and the biggest OW in duration terms in the GBI-EM portfolio (see more details in The GBI-EM Investors' Lowdown)

	Benchmark		Current Allocation		Bond	Bench	Bench	Bench	Fund	Fund
Country	Jul-18	Aug-18	S Avg	W Avg	OW/UW	Duration	CTD	CTD (%)	CTD	CTD (%)
ARS	0.9	0.6	1.1	1.1	0.5	2.91	0.02	0.36	0.03	0.7
BRL	10.0	10.0	10.0	10.8	0.0	2.82	0.28	5.71	0.28	6.2
CLP	2.6	2.6	2.5	2.2	-0.1	1.81	0.05	0.95	0.04	1.0
COP	7.9	7.4	7.5	7.4	0.1	5.02	0.37	7.50	0.38	8.3
CZK	4.5	4.8	0.8	0.9	-4.0	5.13	0.25	4.99	0.04	0.9
HUF	4.6	4.8	3.4	3.6	-1.3	4.22	0.20	4.06	0.14	3.2
IDR	9.1	9.6	9.9	9.6	0.4	5.93	0.57	11.47	0.59	12.9
MXN	10.0	10.0	11.5	12.1	1.5	5.20	0.52	10.53	0.60	13.2
MYR	5.5	5.9	5.0	5.6	-0.8	4.46	0.26	5.32	0.22	4.9
PEN	3.0	3.1	3.7	4.0	0.6	7.43	0.23	4.74	0.28	6.1
PLN	9.1	9.7	7.6	8.1	-2.1	4.09	0.40	8.01	0.31	6.9
RON	2.7	3.0	1.3	1.4	-1.7	3.62	0.11	2.17	0.05	1.0
RUB	7.8	7.5	7.2	7.2	-0.3	4.74	0.36	7.21	0.34	7.5
THB	8.0	8.4	6.3	6.0	-2.1	7.19	0.60	12.22	0.45	10.0
TRY	5.0	3.4	2.8	3.4	-0.6	2.84	0.10	1.98	0.08	1.8
ZAR	8.8	8.6	9.6	9.7	1.0	7.33	0.63	12.77	0.70	15.4

Source: Company websites, Morgan Stanley Research; *CTD: contribution to duration.

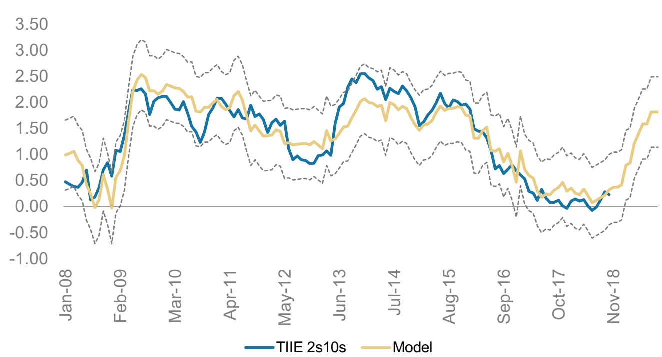
Local rates: Receive 2y2y TIIE

Andres Jaime, Gilberto Hernandez-Gomez

We recommend receiving 2y2y in forward TIIE with a stop-loss at 8.50% and a target of 7.00%. Despite the hawkishness from the last Banxico statement due to more challenging external financial conditions, we think that the market's reaction of pricing in an additional 15-20bp of hikes provides a very good opportunity to tactically receive rates in the belly as we expect that Banxico will remain on hold and maintain a hawkish bias in the near term before signalling the start of the easing cycle.

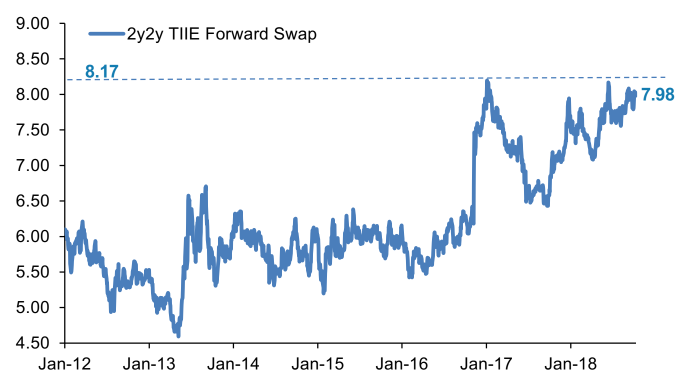
As opposed to FX, we think that rates have higher risk premium – induced by the very cautious central bank stance – and, consequently, a more asymmetric risk/reward profile. In order to assess which part of the curve offers a better risk/reward, we calculate excess term premium in 2s10s TIIE, which we define as the residual of 2s10s TIIE differential regressed by the monetary policy gap (a proxy for current fondeo versus neutral), inflation volatility and US 10y term premium.

Exhibit 34: TIIE 2s10s versus modelled 2s10s suggests further steepening and a lower preference for duration extension



Source: Bloomberg, Morgan Stanley Research

Exhibit 35: 2y2y TIIE forward swap back near local highs



Source: Bloomberg, Morgan Stanley Research

Our 2s10s model suggests that the curve remains too flat when assuming that Banxico signals next year its intention to normalise monetary policy, a key reason why we keep recommending 5s10s steepeners. However, the recent spike in rates offer good tactical opportunities to receive outright.

In line with our 5s10s steepener view, we prefer to extend duration beyond the short end and recommend 2y2y receivers. While risks continue to point to Banxico keeping a defensive stance, the market is already pricing in around 20bp of hikes in the very short end, while 2y2y is trading close to historical highs. Therefore, **we recommend receiving 2y2y in forward TIIE with a stop-loss of 8.50% and a target of 7.00%,** allowing us to reflect our view that in the near term we do not expect a major shift in messaging from Banxico and we expect the market to price out any chance of a hike. Risks include additional hikes from Banxico, higher inflation pressures along with a stronger dollar environment and substantially higher US rates.

Sovereign credit: Sell INDON 10y, sell INDON 5y CDS

Jaiparan Khurana

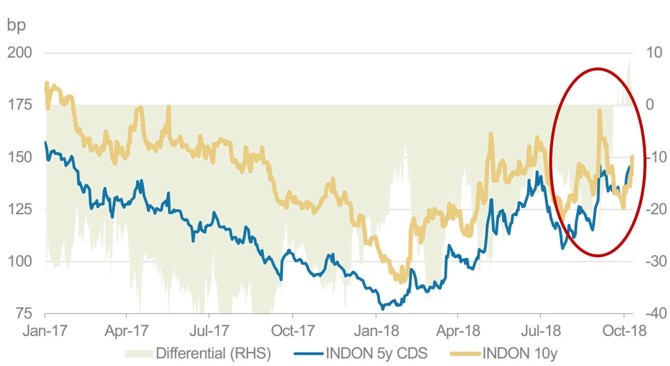
We previously expressed a dislike valuation stance on the Indonesia sovereign curve by recommending to buy KSA 49 versus INDON 48; the trade hit the target earlier this month. With the relative underperformance of the Indonesia sovereign curve, we seek to express our view via a curve trade instead. As our key concern relates to technicals as opposed to fundamentals – large impending supply among the decline in index weight of Indonesia – we think that the INDON sovereign curve should in fact steepen.

We express the view by looking to sell INDON 10y and selling INDON 5y CDS. The 5y CDS-10y bond basis has turned flat from being -20bp a month ago, and -38bp at the wides of 2018. We think the move has made INDON 5y CDS an unattractive hedging tool. The basis hasn't been this flat since the 2013 taper tantrum. The similar measure across broader EM peers is mostly negative as expected. The measure is positive in other Asian sovereigns such as Malaysia and the Philippines but it is largely explained by strong onshore support in those sovereigns for the cash bonds.

We see the potential supply as a catalyst for the aforementioned trade to perform. Perusahaan Listrik Negara (PLNIJ), a 100% sovereign-owned entity, is looking to issue eurobonds in the near term. The PLNIJ 10y trades 60bp wide of INDON 10y, and any new issuance could offer some concession as well, given the weaker market backdrop. PLNIJ is also looking to undertake euro-denominated issuance which typically trades well wide of the US$ curve on a cross-currency swap basis, given its index ineligibility. As such, the new PLNIJ bonds (US$ and EUR) could come at an attractive level over the sovereigns, prompting rotation away from the sovereign curve into the new PLNIJ issuance. This may pressure the INDON 10y.

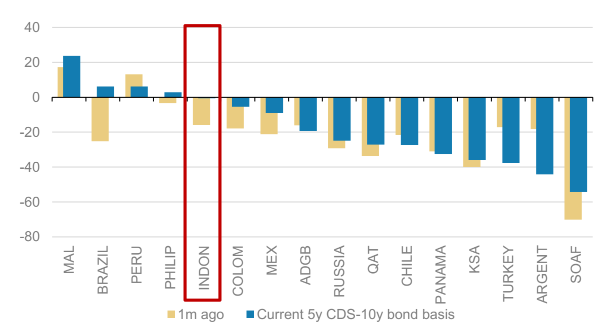
We sell INDON 10y, sell INDON 5y CDS targeting the 5y CDS-10y cash basis to go to -25bp and set a stop loss at +20bp. We are also long 10y US Treasuries to express the trade in spread terms. Risks include further weakness in IDR which in turn leads to concerns about external debt in Indonesia and further curve flattening.

Exhibit 36: INDON 5y CDS has underperformed the 10y bond



Source: Bloomberg, Morgan Stanley Research

Exhibit 37: The 5y CDS-10y bond basis is mostly negative across EM but flat in Indonesia



Source: Bloomberg, Morgan Stanley Research

Asset allocation

Asset Class	FX	Rates	Credit
Stance	Neutral	Neutral	Bearish
Likes	**FX**	**Rates**	**Credit**
	Argentina	Brazil	Argentina
	Czech Republic	Chile	Chile
	Peru	Mexico	Colombia
	Russia	Peru	Egypt
	Thailand		Oman
			Russia
Dislikes	**FX**	**Rates**	**Credit**
	Colombia	Hong Kong	Indonesia
	India	Korea	Lebanon
	Indonesia	South Africa	Pakistan
	Korea	Turkey	Sri Lanka
	Philippines		
	Singapore		
	South Africa		
	Taiwan		

Trades overview

Exhibit 38:

Trade		Status	Entry Date	Entry Level	Current	Target	Stop	Notional ($m or k DV01*)	Gross P&L bp	Gross P&L US$k
SOVEREIGN CREDIT										
Country RV	Buy Mexico 2026 vs. Qatar 2026		24-Sep-18	32	38	5	50	10x9.7	(6)	(4)
	Buy Pemex 2047 vs. Mexico 2047		24-Sep-18	222	213	175	260	10x8.2	9	90
Curve RV	Buy Ghana 2030 vs. Ghana 2026 (z-spread)		21-Aug-18	9	-1	-50	40	10x10	10	20
	Buy Argentina 2026 vs. 2048 (DV01 neutral)		24-Sep-18	-22	-52	50	-70	10x10	(30)	(93)
	Sell Brazil 5y CDS-bond basis (Brazil 2025)		24-Sep-18	55	54	20	85	10x10	1	(25)
	Sell INDON 2028, Sell INDON 5y CDS	New	15-Oct-18	At publication		-25	20	10x10	-	-
LOCAL RATES										
Directional	Long PeruGB 23, FX-Unhedged		15-Aug-18	4.41	4.43	4.10	4.55	10	(2)	(22)
	Pay 5y HKD		17-Sep-18	2.88	2.93	3.10	2.75	10	5	50
	Receive 2y2y TIIE Forward Swap	New	15-Oct-18	At publication	8.01	7.00	8.50	10	-	-
Curve RV	Chile 1s5s10s CLPxCAM Butterfly		11-Jun-18	33	25	12	40	10	8	42
	5s10s TIIE Steepener		15-Aug-18	23	28	50	10	10	5	34
CURRENCIES										
Directional	Long THB 3m NDF/ KRW 3m NDF		11-Oct-18	34.28	34.63	35.3	33.75	10	-	-
	Long USD/COP 3m NDF		11-Oct-18	3102	3107	3223	3033	10	-	-
	Long USD/ZAR		5-Oct-18	14.87	14.45	15.50	14.10	10	-	(202)
Closed Trades										
Closed long USD/INR 3m NDF at 75.00 on 11-Oct-2018. Closed short USD/CLP 3m NDF at 685 on 9-Oct-2018. Closed Buy USD/IDR 3m NDF vs Sell USD/IDR 6m NDF at 280 5-Oct-2018.										

Source: Morgan Stanley Research; Note: Hold to Maturity (HTM).

Local markets snapshots

Andres Jaime, Ioana Zamfir, Gilberto Hernandez-Gomez, Min Dai, Belle Chang

LatAm Local Markets		
	FX	Rates
ARS	**Like:** The REER has reached levels that imply a risk premium equivalent to its peers when adjusting by its own external imbalances. In fact, the current valuation is close to the level it reached after the end of the convertibility era, implying a quite stressed scenario even when taking into account the current backdrop. The new IMF package, drastically reducing the need for Argentina to tap debt markets next year, coupled with a narrowing current account deficit and fiscal consolidation, should reduce some of the pressure on the exchange rate.	Additional support from the IMF along with much cleaner positioning has helped, but with the renewed focus on a 0% nominal monetary base growth we believe that local rates will trade higher in the near term. As we mentioned previously, short-term rates will have to absorb part of the FX volatility, particularly as confidence levels, which have improved slightly, may still be too low to lead to a substantial pick-up in demand for local rates in the short term. Likewise, with the 2019 budget proposal still going through Congress, there are still some risks relating to fiscal adjustment.
BRL	Looking ahead, we think that there could be further downside for USDBRL, if news flow begins to suggest the possibility of stronger coalition support for the more orthodox candidate. In our view, this would prompt the markets to price in a higher likelihood of fiscal reforms getting passed next year, which would be positive for the real. If such a scenario begins to materialise, we see 3.50 as the next level to fade as we approach the second round of elections.	**Like:** We see a higher term premium in Brazilian local rates relative to fair value. The recent stabilisation in the currency suggests that inflation should remain in line with the BCB's outlook. As changes to the inflation outlook is one of the main factors that could prompt hikes, as suggested by the BCB's October statement, we believe that the markets will continue to price out hikes embedded in the curve for the remainder of the year.
CLP	Since the start of the month, CLP depreciated by almost 4.5% versus USD, on the back of more muted copper price action and lower risk appetite. Our economists expect BCCh to kick off the hiking cycle this month and raise rates by 25bp, though this has already been priced in. With growth beginning to show signs of moderation, copper prices remaining more muted and lingering trade risks, we prefer to be neutral CLP.	**Like: CLPxCAM 1s5s10s butterfly:** Local rates maintain an asymmetric risk that tilts to the upside as fundamentals continue to improve and inflation pressure begins to feed into the real economy. Despite GBI-EM investors being slightly underweight Chilean local rates, we see value in 5y swaps relative to the curve. Excess term premium in 1s5s CLPXCAM has been elevated on a historical basis. We have been playing the cheapness of the 5y tenor through a duration-neutral 1s5s10s CLPxCAM butterfly, giving us a pure play on the 5y relative value on the curve.
COP	**Dislike: Long USDCOP 3m NDF:** COP has been one of the worst-performing major EM currencies versus USD this month, depreciating by ~4% and hitting fresh YTD lows. If risk appetite continues to deteriorate, we believe that COP could come under pressure, given a less hawkish BanRep and lower carry, coupled with the lack of immediate idiosyncratic catalysts and potentially less oil price upside for the rest of the year (our forecast is US$85/bbl by year-end). This is in line with our risk premia model, which triggered a sell signal for COP at the end of August, suggesting reduced upside potential for the currency in the near term.	Our economists expect BanRep to keep rates on hold until 2H19. At that point, policy-makers will likely kick off the tightening cycle and bring rates to 5.00% by year-end as the output gap begins to narrow. The market is currently pricing in about 50bp more by end-2019, suggesting some value in the short end (1-2-year sector of the curve).
MXN	While we think that USDMXN could trend higher if risk appetite continues to decline, we do not think that MXN would underperform overall EM currencies significantly. More specifically, we see reduced near-term idiosyncratic risks for the currency, given the recently announced USMCA agreement reducing trade-related uncertainty and a more neutral tone from the incoming administration suggesting a lower likelihood of near-term disruptions in Mexico's investment narrative.	**Like: 5s10s TIIE steepener and receive 2y2y TIIE:** We continue to see the risk of a deterioration in Mexico's investment narrative in the medium term and prefer rates relative to MXN to gain Mexico exposure as monetary policy is already very tight. In line with our 5s10s steepener view, we prefer to extend duration beyond the short end and recommend 2y2y receivers. The market is already pricing in around 20bp of hikes in the very short end, while 2y2y is trading close to historical highs.
PEN	**Like:** Loose monetary conditions with improving investment but little to no inflation should keep monetary policy anchored. We note that the new administration has started to put forth objectives on improving investment, increasing tax revenues and boosting growth. As a low-yielder, PEN should outperform the rest of LatAm in the coming months.	**Like: Long PeruGB 23:** With inflation at 1.28%Y in September 2018, inflation expectations anchored and growth below potential, the central bank is maintaining a loose policy stance, keeping rates lower for longer. With favourable realised real rates, strong external balances and FX volatility management, Peru remains a very attractive investment for local rates investors. We prefer the PeruGB 2023s due to good carry and a steep roll-down, with 2020s trading 40bp through the monetary policy rate of 2.75%.

CEEMEA Local Markets		
	FX	Local Rates
CZK	**Like:** We still prefer FX to rates in the Czech Republic, given that the appreciation in CZK is still less than what the CNB forecasts. CZK would likely outperform during this period of risk-aversion with equities dropping but with EUR strength. CZK would be undermined if EURUSD started to drop. Our economist sees another hike by year-end to 1.75% and two more in 2019 to 2.25%. We expect CZK to outperform should EM volatility resume.	The CNB hiked by 25bp in September, as expected by consensus. The market is pricing in another three rate hikes before the end of 2019, in line with our economist's forecast. However, EURCZK struggled to move lower and is currently higher than the CNB's forecast of 25.3 by 2018 and 24.3 by 2019. This suggests that without the tightening from the FX, the CNB has to compensate by hiking more than what's in the price.
HUF	The NBH has made changes to its monetary policy framework which suggest a gradual shift in a less dovish direction. This should help the currency to perform better, but as monetary tightening progresses in other countries we are not convinced that the NBH is doing enough for HUF to outperform. A strong move higher in European core yields would likely put some pressure on HUF.	The upside surprise in Hungary September CPI and higher core rates have pushed HUF rates to their highest level since 2015. The upward trend is clear as the NBH is no longer able to control the long end of the curve. The Bubor fixing has been stable and EURHUF has behaved well. This suggests that the front end could offer attractive carry to receive.
ILS	USD strength has weighed on ILS recently. Fundamentals remain strong and there may be an opportunity for more material gains later in the year should the USD bear trend resume as we expect. The BoI recently signalled that the inflation environment is moving towards entrenchment within the target range, which marks a more hawkish tone which should benefit ILS. Amir Yaron, a professor of banking and finance at the Wharton School of the University of Pennsylvania, has been announced by the prime minister as the preferred successor to Dr Karnit Flug as Governor of the Bank of Israel.	**UAH FX:** We see deteriorating risk/reward on UAH long positions. The balance of payments position is deteriorating gradually and FX valuations have worsened. Seasonality for UAH is turning from a tailwind to a headwind. Yet, we acknowledge that NBU policy remains a source of support.
PLN	PLN continues to trade in a resilient fashion, failing to move much in response to either equity weakness or USD strength. The economy remains in good shape. The main risks for the currency remain EUR and perceptions about eurozone stability, and relations between Poland and the EU. We do not see any reason for a bearish stance on the currency.	Inflation remains low, which allows the NBP to stay dovish and anchors the front end, while the long end will be subject to the move in core rates, which is heading higher due to a more hawkish ECB and the increase in global wages. The Treasury could start to issue more in 4Q to prefinance next year's budget. The curve should continue to steepen, in our view.
RUB	**Like:** RUB has come under some pressure following recent announcements on possible sanctions escalation from various countries. We removed our long RUB position versus MXN given these headlines. However, we remain of the view that various congressional bills proposing harsher sanctions against Russian entities are unlikely ahead of the midterms, given the short timetable. As such, we do not think the sell-off in RUB will be long-lasting in light of strong oil prices and fundamentals.	Post sell-off in the past two months, the market now prices in another 25-50bp of rate hikes, in line with our economist's forecast. Real rates in Russia have also been creeping higher and the current level is the highest since 2010. Our latest GBI-EM fund tracker shows that GBI-EM investors are now slightly UW OFZs and MW RUB. Positioning is cleaner in Russia after almost RUB 500 billion of foreign selling since April. While the Treasury struggles to issue, the MinFin has leeway to reduce the supply, given the cash holdings it has. We are neutral on OFZs.
TRY	We maintain a neutral view on TRY, though recent inflation data and UST yield moves raise the risks for the currency. On the plus side, there is continued evidence of economic rebalancing that should lower the demand for USD. TRY is cheap on a REER/PPP basis and it is expensive in nominal terms for investors to be short TRY. Additional moves higher in UST yields would likely put some pressure on the currency.	**Dislike:** With Pastor Brunson being released, the market could refocus on Turkey's fundamentals now. The current account surplus in August was a positive surprise but the capital account showed significant outflows from domestic deposits, causing FX reserves to drop. While the currency has stabilised, inflation continues to move higher.
ZAR	**Dislike: Long USDZAR:** The rebound in ZAR was short-lived and we stick to a bearish view. The economy has been in recession and the C/A data are poor. We do not see the basis for a continued rebound in the currency, particularly since real money positioning in SAGBs is still heavy, in our view. The medium-term budget later in October is a risk for the currency, in our view, given the pressure to support growth ahead of the elections.	**Dislike:** We recommend that investors fade the recent rally in SAGBs. The recent weaker-than-expected GDP print should raise concerns about fiscal revenues and hence the fiscal deficit. While our economist expects Moody's to keep South Africa's rating unchanged, we believe that the long end should price in more risk premium, given that foreigners are still very OW the long end of SAGBs and they haven't sold their holdings in the recent sell-off.

AXJ Local Markets		
	FX	**Rates**
CNY	With increasing trade tension, heightened volatility in the onshore stock market and a slower domestic economy, the PBOC eased monetary policy by cutting the RRR after the one-week holiday. The widening rate differential is likely to keep depreciation pressure on CNH. With asymmetric capital controls, the PBOC is able to reduce FX depreciation by applying the countercyclical factor, without burning FX reserves. USDCNH should move higher should USD remain strong but CNH could outperform its AXJ low-yielding peers.	The PBOC cut the RRR after the Golden Week to offset the roll-off of MLF and upcoming large tax payment in October. However, it does show that the PBOC would like to keep a relatively easy monetary policy when domestic growth is slowing down, despite higher UST yields. The divergent monetary policy should support spread widening,, i.e., higher UST yields versus lower CGBs yields. Most of the local government bond issuance is behind us, reducing the supply risk for the market. We would like to receive rates on any spike.
INR	**Dislike:** We remain bearish, given increased inflation pressure driven by rising oil prices and concerns about widening twin deficits. With global EM remaining volatile, we see the Asia high yielder INR as vulnerable. However, press reports are indicating that the Indian government is reconsidering attracting FX deposits from non-resident Indians to bolster INR. It could cause USDINR to go lower should it be announced. We close our long USDINR 3m NDF position.	We took off our long USDINR 3m NDF trade as we are concerned that the non-resident deposit scheme could cause a rally in INR. The RBI has been reluctant to hike rates and last Friday's CPI did surprise on the downside, supporting rates. Should INR continue to trade at an elevated level, the market could see an increasing chance that the authorities could go for administrative tools such as non-resident deposits, rather than rate hikes. We could see some short-term rally should it happen.
IDR	**Dislike:** We turn bearish as we see IDR remaining volatile, given the resumption of global EM sell-off sentiment. It is true that the government has taken a series of steps to control import growth to limit the size of its C/A deficit, as well as another 25bp hike to support rate differentials. Yet, given the twin deficit issue, investors should remain cautious, especially with a backdrop of rising UST yields.	Since the authorities now allow USD supply to foreigners, this should help the price discovery mechanism in the INDOGBs market, which has been under pressure due to IDR depreciation. Should global volatility continue, IDR could take most of the shock and bond yields could be range-bound. We are neutral on INDOGBs.
KRW	**Dislike: Long THBKRW 3M NDF:** We see more KRW weakness as likely, given the backdrop of continuing weak domestic growth momentum, disappointing employment conditions and growing household debt. Despite the more hawkish BoK recently, the rates market has already priced in a 25bp hike in 4Q18. In addition, with KRW underperforming the most among the region post the recent UST sell-off, KOSPI weakness could weigh on KRW further.	**Dislike:** While trade tension and slower growth should anchor the long end of KTBs, the recent hawkish comment from the BoK and higher core rates should warrant some caution. We have turned bearish on rates after being bullish for the past few months and would use the dip to pay rates, given higher core rates driven by DM wage inflation.
MYR	We turn neutral on MYR due to what we observe as opposing trends. First, we see oil prices remaining at high levels, which should support MYR as Malaysia is one of the few oil exporters in the region. However, details on tax reform remain unclear and news that the new government will not follow the fiscal targets set by the old one suggest upside risk to the budget. We continue to see USDMYR climbing higher slowly but MYR should remain stable on a TWI basis.	We retain our neutral view on Malaysian rates as we expect inflation to remain weak due to the change in tax scheme and decline in fuel prices. Malaysia hasn't benefitted from higher oil prices, given that its main export is palm oil, which hasn't rallied at all. MYR rates are likely to trade sideways, given that the central bank is in no rush to hike rates and Malaysia's current account surplus shields it from external volatility.
SGD	**Dislike:** We move from neutral to bearish on SGD. Despite the positive current account and the relatively healthy economy, SGD has been trading close to the top band of its NEER and could trade weaker should trade tension continue. Equity inflows are also important and the decline in global equity markets doesn't bode well for SGD.	We remain neutral on SGD rates as we see the historical widening between USD and SGD rates resulting from Fed hikes to be largely over. With more rounds of tariffs likely to be implemented, we think that economic data may begin to weaken, impacting inflation and bringing about lower rates.
TWD	**Dislike:** We turned bearish on TWD despite Taiwan having a current account surplus and the economy holding up relatively well. With trade tensions between China and the US unresolved and potential political tensions developing, we see downside risks for TWD, given material foreign exposure in its equity market.	With the CBC retaining a relatively dovish stance and trade tensions lingering, we are biased to see rates lower. August headline CPI surprised the market on the downside, reversing the upside surprise in July. Trade tension supports most of the low yielders in the region, including TWD.
THB	**Like: Long THBKRW 3M NDF:** Amid higher oil prices affecting Asia's high yielders and equity outflows affecting the lower yielders, we see THB as an island of stability due to its strong C/A balance and domestically driven growth profile. In the latest meeting, two of the seven BoT members voted for a hike and BoT officials recently conducted media interviews indicating the strength of consumers and that corporates can withstand 1-2 hikes. As such, we see long THB to be a good hedge for a further deterioration in equities or general EM sentiment.	Thailand's local market sees two conflicting drivers: On the one hand, THAIGBs were seen as a safe haven during the period when EM had significant volatility. On the other hand, higher global core rates, along with somewhat hawkish comment from BoT officials, should continue to push yields higher. We believe that the latter factor should outweigh the former, given global wages on the rise. Thailand's yield should continue to move higher, in our view.
PHP/ HKD	**PHP FX: Dislike:** We see the Asia high-yielders as more vulnerable amid the recent EM volatility. With the BSP having a limited impact on stabilising PHP and with the widening twin deficits, the longer-term outlook for PHP remains challenging, in our view.	**HKD rates: Dislike: Pay 5y HKD swap:** With the Fed pressing ahead with its hiking cycle, Hong Kong banks hiking prime rates and expectations for HSI underperformance, we see liquidity conditions tightening further and USDHKD heading back gradually to the ceiling at 7.85.

Sovereign credit snapshots

Simon Waever, Jaiparan Khurana

Credit	Commentary and curve preference	Curve
Latin America		
Brazil	**Sell Brazil CDS-bond basis (using 2025 bond):** We think that the market is already pricing in an orthodox policy mix – the question is whether a new administration will also have governability. In the end, we think that any administration will struggle in this respect, particularly when it comes to the pension reform that needs to be addressed in 2019. However, this is still several months away and in between the market is likely to price in a more benign outcome including the potential for various alliances to be formed. As spreads should remain supported, we turn neutral on Brazil credit. We favour the long end of the bond curve given a steeper 10s30s curve and also recommend selling the 5y CDS-bond basis, given that the CDS still looks cheap.	Long-end
Chile	**Like:** Fundamentals are positive following a market-friendly outcome in the elections, which we think is likely to boost reforms and growth. Recent headwinds have been falling copper prices and the downgrade from Moody's to A1, yet we think that copper prices are closer to stabilising here on the back of tightening supply while the downgrade should have little impact. We think that Chile should reverse the recent underperformance versus Peru, where the 10y bonds are now wide to Peru.	Belly
Colombia	**Like:** While we remain concerned about longer-term fiscal sustainability in Colombia, this is unlikely to be the driver of spreads for now, particularly given oil prices that are now higher than budget assumptions. Following the recent issuance of US$2 billion, including a US$1 billion 2019 bond buyback, issuance needs over the next 15 months are only US$1.5 billion in external bond markets against a US$1 billion redemption. The 10s30s curve has continued to flatten and we therefore move our preference to the 10y sector of the curve instead. We also like EUR bonds in the belly and 5y CDS in the front end.	Belly
Mexico	**Buy Pemex 2047 versus Mex 2047; sell Qatar 26 versus Mexico 26:** We expect policy continuity to hold for the early part of the six-year term, potentially even extending beyond 2019. Adding the supportive external factors of strong US growth and a significant reduction of NAFTA tail risks suggests that Mexico should perform well. However, positioning in Mexico is back to neutral, showing that the market has broadly covered their UW allocations they had into the elections. While sovereign spreads look fair, Pemex has underperformed and looks cheap, particularly given where sovereign spreads are. We think this accounts for upcoming supply in addition to fundamental risks associated with the incoming administration, particularly given that certain non-market-friendly stances have been softened recently, including amounts to be spent on new refineries, the extent of foreign participation in the oil sector and fuel pricing policies. The recent discovery of two shallow water fields is also positive. A steep 10s30s USD curve makes the long end of Pemex attractive, while the 10y sector of the EUR curve also looks attractive.	Belly
Peru	We think that the outperformance of Peru versus Chile is coming to an end, given that Peru 10y bonds are now trading slightly inside Chile 10y bonds and with 30y bonds now only 40bp wide compared to 61bp in mid-June. While domestic data are holding up well, we think that this is now in the price, while at the same time political uncertainty continues to increase.	Long end
Argentina	**Like: Buy ARGENT 2026 versus 2048:** We expect Argentine spreads to outperform and maintain our like on Argentina. A more front-loaded schedule removes liquidity risks, leaving open the option to not tap the bond market at all until 2020 apart from rolling over the Letes. Solvency has clearly deteriorated yet high intra-public sector holdings provide a partial offset. Technicals are still far from clean yet positioning reduced somewhat in August while potential negative net supply of US$3.3 billion until 2020 in addition to coupons of US$12.5 billion should be supportive factors. Valuations are still cheap at 200bp wide to single Bs, with our target being 50bp wide in the near term. As spreads rally, we expect the curve to steepen and recommend buying Argentina 2026 versus 2048.	Belly
Venezuela (see the end of the report for important note regarding economic sanctions)	After the elections in May most bond prices have fallen. This is in line with the policy continuity scenario we laid out in our pre-election note, a scenario in which the market needed to price out any chance of a near-term policy change and also increase the probability of a bear case scenario of no policy change at all in the coming years. At the same time, our base case remains that deteriorating domestic conditions necessitate a change in policy over the coming year, with pressure in particular coming from the continuously falling oil production and hence export revenues. This means that our strategy remains to buy bonds on dips to position for a recovery rate that is higher than current prices. So far we have favoured VENZ over PDVSA and the VENZ 23, 24 and 28 bonds in particular, looking to establish longs at prices between 25-28. However, PDVSA has underperformed materially since the election, raising the question of whether it's worth switching some exposure from VENZ to PDVSA, particularly given our view that there is a chance that claims could be collapsed in an eventual recovery. Overall, we stick with our view of favouring VENZ high-coupon bonds, yet at prices of 20 some of the low-coupon PDVSA bonds also look attractive such as PDVSA 24 and 26.	VENZ, high-coupon bonds

Credit	Commentary and curve preference	Curve
Europe		
Russia	**Like:** Strong and still improving fundamentals and a supportive oil outlook suggest a bullish view. Low foreign ownership from a historical standpoint also makes this point. At this stage the potential for additional US actions is the main risk, as shown by the spread widening in early August to wides of 70bp versus the BBB average. However, since then spreads have come down and are now 46bp wide to BBBs, and we think that Russian spreads have room to outperform further. The current very hawkish outline of US actions may be opposed due to its wide-ranging impact, including on US bondholders themselves as outlined by the US Treasury earlier in the year, while focus in the US may also turn increasingly towards other factors. With the 10s30s curve having flattened recently, we move our preference back to the belly of the curve.	Belly
Turkey	We expect market focus to shift back to Turkey's fundamentals post the release of Pastor Brunson. On fundamentals, the current account adjustment is under way, but investors would want to see successful rollover of short-term external debt and any potential impact of the economic adjustment on corporate and banking sector balance sheets to take a more constructive view on credit. With the rally in the past few weeks, most of the good news seems to be priced in, but foreign investor positioning has reversed to an underweight, which is a positive technical. There may be a pick-up in supply from both the sovereign and banks if spreads grind tighter. We expect the TURKEY 10s30s curve to steepen.	Front end
Ukraine	Confirmation of a new IMF deal should see yields rally further. However, we expect the rally to be limited and stay neutral, favouring the short end. First, the news has not been confirmed by the IMF yet. Second, valuations are not cheap yet. Third, a eurobond issuance is likely to follow a deal, which may require high new issue concessions, given the current weak EM backdrop. Fourth, uncertainty about policy continuity is likely to stay, given elections in 2019. Finally, Ukraine is already a large overweight by EM debt-dedicated funds.	Front-end
Middle East and North Africa		
Qatar	**Sell Qatar 26 versus Mexico 26:** Qatar has navigated the challenges from the diplomatic rift with Gulf Cooperation Council (GCC) allies fairly well. Qatari risk is still cheap on a ratings-adjusted basis but has outperformed KSA significantly in the past month. We think that the bid from Qatari banks for Qatar sovereign paper could increase over the next 6-12 months.	Belly
Saudi Arabia	KSA spreads will likely remain anchored as fiscal deficits consolidate. The KSA curve also continues to offer value on a ratings-adjusted basis against both other EM sovereigns and US corporate credits, which should see international demand. While supply was a concern for markets, the size of the recent sukuk sale was much below market expectations and most corporate supply seems to getting out of the way for 2018. That said, any geopolitical noise needs to be monitored.	Long end
Oman	**Like:** Fitch has decided to affirm the ratings at IG, which clears near-term uncertainty, and fiscal performance in 7M18 has been strong, with a 35%+ consolidation in the deficit. As the sovereign retains its IG ratings it will be a costly UW from a portfolio perspective, given wide spreads, which in turn should keep valuations supported. Investors could also look to rotate out of the quasi sovereigns back onto the sovereign curve given the potential privatisations of electricity companies which will make them EMBI-ineligible.	Long end
Bahrain	Higher oil prices, EMBI index inclusion, a larger-than-expected Gulf support package, approval of VAT law in the lower house and declining supply expectations are all positive factors. Yet, we think this is going to mainly impact the front end for now, where investors are yet to factor in a significantly reduced rollover risk. Given the wide EGYPT-BHRAIN differentials in the long end, we think that further upside for BHRAIN 30y would only be gradual.	Front end
Egypt	**Like:** Egypt's C/A deficit narrowed in 2017, and the sovereign is done with the planned external debt issues to plug the financing gap for 2018. Portfolio outflows in local bond markets haven't had a negative impact on EGP stability or the external position. We think that the EGYPT 10s30s curve is steep. Egypt's EUR issuance is also slightly cheap compared to the US$ curve.	Long end
Lebanon	**Dislike:** Recent debt swaps were a par-to-par exchange, rather than NPV-neutral, in our understanding, which would underscore some of our concerns about weak deposit growth rates for the banking sector. The debt swaps will likely put pressure on the long end of the curve over the medium term. Higher oil prices could also increase the external funding gap. In addition, inflation has picked up. A delay in forming a government would impact investor sentiment, especially given upcoming maturities.	Front end
Sub-Saharan Africa		
South Africa	Most optimism has been priced out of the SOAF curve and the supply by the sovereign and the quasis is out of the way. The level of OW positioning was also reduced last month. We think that this leaves the risk/reward balanced and as such shift our preference to the long end of the curve – given the lower cash prices – over the front end.	Long end
Angola	An ongoing discussion with the IMF for support via an EFF (funded) instead of previously talked about support via a PCI (non-funded) should provide even more credibility to the reform process. The IMF programme should also provide more transparency about the bilateral borrowings. Higher oil prices are credit-positive and there are signs of arrears clearance as well. Angola's 2018 supply is also out of the way. We prefer the belly of the curve.	Belly
Ghana	**Buy GHANA 30 versus GHANA 26:** The policy response to a weaker cedi needs to be monitored as foreign holdings of local bonds are a significant proportion of FX reserves and are declining. A credit-negative response could lead to further portfolio outflows, adding pressure on the external position. We think that the mid-year budget showed commitment towards meeting the fiscal target but investor expectations were for a VAT rate hike which didn't materialise. We think that risk remains to the downside while the new GHANA 8y makes the GHANA 30 look cheap.	Belly

Credit	Commentary and curve preference	Curve
Asia		
Indonesia	**Dislike: Sell INDON 2028 (Treasury-hedged), sell INDON 5y CDS:** We see limited scope for Indonesia's outperformance, given the heavy supply expected from the sovereign and quasis. FX reserves have also moderated from the peak, which should keep investors cautious. EMBI rebalancing will also likely impact Indonesia negatively. We prefer the sukuks over conventionals in the belly.	Sukuks in the belly
Philippines	A slight moderation in credit metrics is not worrying to us as onshore dollar liquidity remains strong, which should continue to support PHILIP spreads. The sovereign wants to revisit global bond markets in 2H18, and we think that issuance will likely be longer-dated. We prefer the PHILIP 30-34 bonds, which trade wide due to their high cash price. We expect the premium to narrow gradually.	Belly
Malaysia	We think that, while fiscal uncertainty increases at the margin post the elections, the supply-demand dynamics remain supportive for MALAYS sovereign credit, which should anchor spreads. Higher oil prices are also positive, which should negate any concerns about slippages in the upcoming budget. However, quasi-sovereigns' spreads could come under pressure if their cash outlay increases on the back of higher royalties/dividends, or if there are delays in asset monetisation. Positioning is also likely to be heavier in select EMBI-eligible quasi-sovereign credits.	Front end
Sri Lanka	**Dislike:** Oil prices have started to impact the trade balance and a pick-up in political noise could impact investor sentiment. LKR is also coming under pressure, and this is credit-negative as a large proportion of sovereign debt is denominated in foreign currencies. The IMF and Sri Lanka also did not reach a staff-level agreement in the recent review. We prefer the 5y part of the curve as defensive positioning.	Front end
Mongolia	While we are constructive on the fundamentals, we are neutral on valuations on concerns relating to copper price moderation. On fundamentals, Mongolia's twin deficits have been consolidating sharply but there seem to be some disagreements with the IMF in the fifth review as it has not concluded as scheduled. The liquidity pressure has eased with the rebuilding of FX reserves. The sovereign should also make structural improvements and further liability-management exercises are also likely in 2019.	Long end
Pakistan	**Dislike:** With elections out of the way, the key driver of Pakistan credit spreads should be the progress in arranging a new IMF programme. While the authorities have already formally requested for a programme – sooner than our expectations – we still think disbursements in near term are unlikely. Given the large funding needs of the sovereign, CPEC-related borrowings and a likely request by the fund for upfront fiscal adjustment and potentially support from bilateral lenders to supplement IMF's lending, we think that the tieing up of the financing may take longer than markets currently expect.	Belly

Live trades: Rationale and risks

Exhibit 39: Trades

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Rates						
Chile 1s5s10s butterfly	11-Jun-18	33	12	40	We favour the belly relative to the rest of the curve. Excess term premium in 1s5s CLPXCAM has become elevated on a historical basis. We see value in 5y swaps relative to the average rate between 2yr and 10yr swaps.	Continued underperformance of 5yr swap rates due to external rate pressures. China slowdown as a result of deleveraging or trade tensions with the US.
5s10s TIIE steepener	15-Aug-18	23	50	10	We believe that there is a higher premium in the short/belly part of the curve created by a historically tight monetary policy stance. Therefore, we prefer to focus on the belly of the curve as a higher USD would likely push Banxico to pull the trigger again, keeping longer tenors anchored. In addition, increased risk sentiment paired with a higher volatility regime should increase risk premium on the curve.	USD strengthening beyond our forecasts, prompting the market to price in additional hikes, or an improvement in risk sentiment that would bring a lower volatility regime.
Long PeruGB 23, FX-unhedged	15-Aug-18	4.41	4.10	4.55	We still prefer bonds in the belly of the Soberanos curve (5y) given elevated carry and roll-down. Due to illiquidity in the short end, local financial entities' have increased their demand for 2020s as a proxy for short-term local rates.	Inflation expectations accelerate to the upside along with growth expectations, forcing the BCRP to increase its long-term neutral rate or start the hiking cycle earlier than 1Q19.
Pay 5y HKD	17-Sep-18	2.88	3.10	2.75	The rise in US interest rates is filtering into the HK economy as the HKMA continues to defend USDHKD at the 7.85 level. With our equity strategists downgrading the HSI, we see outflows from HK continuing and Hibor remaining on an upward trend.	Stronger Hang Seng performance and a more dovish Fed.
Receive 2y2y TIIE forward swap	15-Oct-18	At publication	7.00	8.50	While risks continue to point to Banxico keeping a defensive stance, the market is already pricing in 20bp of hikes in the very short end, while 2y2y is trading near historical highs. We prefer the 2y2y as it allows us to better reflect our view that in the near term we do not expect a major shift in messaging from Banxico.	Additional hikes from Banxico. Higher inflation pressures along with a stronger dollar environment and substantially higher US rates.
Trade	**Date**	**Entry Level**	**Target**	**Stop**	**Rationale**	**Risks**
Buy Mexico 2026 vs. Qatar 2026	24-Sep-18	32	5	50	Potential index inclusion is fully priced in for Qatar, leaving little upside. In Mexico, we anticipate policy continuity in the years ahead, leaving Mexico to benefit from strong US growth and NAFTA uncertainty fading.	The risk to the trade would be announcements on fiscal expansion in Mexico.
Buy Pemex 2047 vs. Mexico 2047	24-Sep-18	222	175	260	Pemex is trading cheap, accounting for fundamental risk and potential supply. Our base case sees no unwinding of reforms.	The risk to the trade is negative announcements regarding the future opening of the Mexican oil sector to foreign investment.
Buy Argentina 2026 vs. 2048 (DV01-neutral)	24-Sep-18	-22	50	-70	A more supportive external backdrop and manageable funding needs should see Argentina spreads rally further, given they're still cheap, and the curve should also steepen further.	The risk to the trade is renewed currency weakness requiring FX interventions and use of FX reserves, which would again question the sustainability of the balance of payment flows.
Sell Brazil 5y CDS-bond basis (Brazil 2025)	24-Sep-18	22	20	85	CDS is cheap in Brazil, both relative to its own history and when compared to the rest of EM. USDBRL moving lower should see CDS tighten as well.	The risk to this trade is local sentiment deteriorating significantly as it may lead to increasing hedging of Brazil risk, which historically has been done via CDS.
Buy Ghana 2030 vs. Ghana 2026	21-Aug-18	9	-50	40	We think the downside of GHANA 30 could be protected compared to the GHANA 26 given the partial World Bank guarantee.	Any liability management by Ghana is likely to benefit the GHANA 26 more than the GHANA 30.
Sell INDON 2028 (Treasury-hedged), Sell INDON 5y CDS	15-Oct-18	At publication	-25	20	Indonesia 5y CDS trading flat to 10y cash bonds makes it an ineffective hedge. Impending supply by Indonesia corporates could lead to underperformance of INDON 10y as investors rotate from the sovereign to the corporate curve.	The risk to the trade could be further weakness in IDR which in turn leads to concerns about external debt in Indonesia and further curve flattening.

Source: Morgan Stanley Research

Exhibit 40: Likes/dislikes

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Like Brazil Local Rates	15-Oct-18	NA	NA	NA	We see a higher term premium in Brazilian local rates relative to fair value. The recent stabilisation in the currency suggests that inflation should remain in line with the BCB's outlook. As changes to the inflation outlook was one of the main factors that could prompt hikes, as suggested by the BCB's October statement, we believe that the markets will continue pricing out hikes embedded in the curve for the remainder of the year.	Significant weakness in the currency, materially impacting the inflation outlook and prompting the BCB to hike.
Dislike Korea Local Rates	01-Oct-18	NA	NA	NA	While trade tension and slower growth should anchor the long end of KTBs, the recent hawkish comment from the BoK and higher core rates should warrant some caution. We have turned bearish on rates after being bullish for the past few months and would use the dip to pay rates, given higher core rates driven by DM wage inflation.	A drop in oil prices and renewed downward pressure on core rates.
Like Mexico Local Rates	24-Sep-18	NA	NA	NA	Risk premia in local rates should begin to decline, given the current EM reprieve, coupled with a temporary stabilisation in the investment narrative.	A negative shift in broader EM sentiment.
Dislike Hong Kong Local Rates	17-Sep-18	NA	NA	NA	The rise in US interest rates is filtering into the HK economy as the HKMA continues to defend USDHKD at the 7.85 level. With our equity strategists downgrading the HSI, we see outflows from HK continuing and Hibor remaining on an upward trend.	Stronger Hang Seng performance and a more dovish Fed.
Dislike South Africa Local Rates	07-Sep-18	NA	NA	NA	The recent weaker-than-expected GDP print raises concerns about South Africa's sovereign rating and the subsequent risk of position reduction in SAGBs adds to this negative backdrop for South Africa local markets. We highlight that foreign real money investors are already very long SAGBs in their portfolio and, even though a downgrade is unlikely, the potential implications of forced selling mean that markets may build in some additional risk premium in the near term.	Stabilisation of broader sentiment towards EM.
Dislike Turkey Local rates	25-Jun-18	NA	NA	NA	Our economist believes that the CBT could continue to keep a tight monetary policy but the market could question the durability of it, given the government's pro-growth stance. Turkey's fiscal policy has been a historical source of stability for the economy. Should the government increase its fiscal deficit and should local banks not be able to step up purchases due to high loan growth, a lack of foreign buying of TURKGBs could keep pressure on local bond yields. Position isn't as light as peoples' perception. We believe that any rally should be faded, especially in the front end.	A risk to this trade would be a rally in EM.
Like Peru Local Rates	27-Feb-18	NA	NA	NA	Economic activity has surprised to the upside resulting from increased public and private investment, while inflation risks remain benign. In addition, tax revenues have also picked up. Political risks have also reduced substantially for now and we think these factors will support Peruvian local assets in the long run. We prefer bonds in the belly of the curve (5yr-7yr).	Risks include further escalation of political uncertainty; such a scenario could potentially increase longer-term yields as some outflows would increase term premia and the macro anchor could be somewhat loosened. On the other hand, a sharper increase in investment could lead to a less accommodative stance than currently envisaged, leading to higher rates and firmer inflation.
Like Chile Local Rates	15-Aug-18	NA	NA	NA	The 1s/5s/10s butterfly and the excess term premium in 1s5s CLPXCAM trade more than 2 standard deviations above their respective five-year averages. Through this we conclude that the five-year tenor on the curve is cheap on a relative basis. Therefore we would expect defensive inflows into local rates to focus on the five-year point.	Inflation expectations accelerating to the upside along with growth expectations, forcing the BCCh to increase its long-term neutral rate.
Like Chile Hard Currency Bonds	15-Aug-18	NA	NA	NA	Chile now trades cheap for its rating, being wide to the Philippines, Poland and Peru, despite credit metrics still being stronger. We expect copper prices to rebound from here yet limited further falls are also manageable.	A significant sell-off in UST yields or large fall in copper prices.
Like Russia Hard Currency Bonds	25-Jun-18	NA	NA	NA	Stable and slowly improving macro, higher oil prices and reduced positioning should help Russia outperform in a more challenging external backdrop. Russia also trades cheap to BBB, having underperformed recently.	Falling oil prices, new sanctions.
Like Colombia Hard Currency Bonds	26-Nov-17	NA	NA	NA	We think growth has troughed and with now higher oil prices the fiscals also look more realistic over the coming year, which should give Colombia adequate breathing space from the rating agencies. We expect policy continuation following elections	A fall in the oil price, new unknown candidates in the election.
Like Oman Hard Currency Bonds	24-Sep-18	NA	NA	NA	Continued fiscal consolidation and higher oil prices should see Oman outperform, particularly given it's one of the cheaper trading IG credits	Fall in oil prices or signs that recent fiscal consolidation is unwinding, for instance via the re-instatement of year-end bonuses
Like Argentina Hard Currency Bonds	24-Sep-18	NA	NA	NA	A more supportive external backdrop and manageable funding needs should see Argentina spreads rally further given they're still cheap, and the curve should also steepen further	The risk to the trade is renewed currency weakness requiring FX interventions and use of FX reserves, which would again question the sustainability of the balance of payment flows
Like Egypt Hard Currency Bonds	15-May-18	NA	NA	NA	Egypt's twin deficits are consolidating and reforms under the IMF programme remain on track. The sovereign has also completed its planned 2018 global bond issues.	Portfolio outflows from local bond markets could widen the external financing gap.
Dislike Indonesia Hard Currency Bonds	15-Aug-18	NA	NA	NA	Still wide double deficits and low reserve coverage leave Indonesia vulnerable to increasing EM risk-off sentiment.	Strong push for tighter fiscal policy.
Dislike Pakistan Hard Currency Bonds	25-Jun-18	NA	NA	NA	FX reserves are moderate compared to total external funding needs. Higher oil prices are also negative for the current account position. Large sovereign supply in 2H18 is also likely.	An IMF programme, if it materialises, will be seen as positive for credit spreads by the markets.
Dislike Sri Lanka Hard Currency Bonds	3-Oct-18	NA	NA	NA	Higher oil prices, LKR weakness, and upcoming redemptions to limit spread tightening.	Extension of IMF programme beyond 2019.
Dislike Lebanon Hard Currency Bonds	9-Apr-18	NA	NA	NA	We think Lebanon valuations are not attractive versus peers, and the benefits of the CEDRE conference will only be over the medium term.	Large concessionary funding in the near term and decline in global oil prices.

Source: Morgan Stanley Research

Exhibit 41: History of recommendations for EM stances

History of recommendations for Russia Hard Currency Bonds		
Trade	Entry Date	Exit Date
Like Russia Hard Currency Bonds	22-Aug-17	09-Apr-18

History of recommendations for Argentina Hard Currency Bonds		
Trade	Entry Date	Exit Date
Like Argentina Hard Currency Bonds	14-Jul-16	25-Jun-18

History of recommendations for Oman Hard Currency Bonds		
Trade	Entry Date	Exit Date
Dislike Oman Hard Currency Bonds	13-Nov-17	30-Apr-18

History of recommendations for Sri Lanka Hard Currency Bonds		
Trade	Entry Date	Exit Date
Dislike Sri Lanka Hard Currency Bonds	24-Nov-17	27-Mar-18

History of recommendations for Turkey Local Currency Bonds		
Trade	Entry Date	Exit Date
Like Turkey Local Currency Bonds	29-Jan-18	12-Mar-18
Like Turkey Local Currency Bonds	23-Apr-18	01-May-18

History of recommendations for South Africa Local Currency Bonds		
Trade	Entry Date	Exit Date
Dislike South Africa Local Currency Bonds	31-Mar-17	31-Oct-17
Like South Africa Local Currency Bonds	18-Dec-17	15-Aug-18

Source: Morgan Stanley Research

Exhibit 42: History of recommendations for EM trades

Buy Mexico 2026 vs. Qatar 2026													
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
QATAR 3.250 06/02/2026	2-Jun-26	Switch out of MEX 26 into QATAR 26	27-Nov-17	18.00	29-May-18	0.00	-25.00	45.00	$10mx$10m	XS1405782159	18	169
MEX 4.125 01/21/2026	21-Jan-26	Switch out of MEX 26 into QATAR 26	27-Nov-17	18.00	29-May-18	0.00	-25.00	45.00	$10mx$10m	US91086QBG29	18	169

Sell Brazil 5y CDS-bond basis (Brazil 2025)												
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
SOAF 5.875 09/16/2025	16-Sep-25	Buy South Africa 2025 vs. Brazil 2025	31-Oct-17	86bp	01-Feb-18	30bp	40bp	110bp	USD10mn	US836205AR58	59	411
BRAZIL 4.250 01/07/2025	7-Jan-25	Buy South Africa 2025 vs. Brazil 2025	31-Oct-17	86bp	01-Feb-18	30bp	40bp	110bp	USD10mn	US105756BV13	59	411
REPSOU CDS USD SR 5Y D14	5y	Sell South Africa 5y CDS vs. Brazil 5y CDS	21-Aug-18	-22.00	28-Aug-18	-89.00	-70.00	10.00	$10m	REPSOU CDS USD SR 5Y D14	67	259
BRAZIL CDS USD SR 5Y D14	5y	Sell South Africa 5y CDS vs. Brazil 5y CDS	21-Aug-18	-22.00	28-Aug-18	-89.00	-70.00	10.00	$10m	BRAZIL CDS USD SR 5Y D14	67	259

Sell INDON 2028 (Treasury-hedged), sell INDON 5y CDS												
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
SOAF 5.875 06/22/2030	22-Jun-30	Buy South Africa 2030 vs. Indonesia 4.1% 2028 (z-spread)	14-Jun-18	151.00	15-Aug-18	147.00	100.00	180.00	$10m	US836205AY00	4	24
INDON 4.100 04/24/2028	24-May-28	Buy South Africa 2030 vs. Indonesia 4.1% 2028 (z-spread)	14-Jun-18	151.00	15-Aug-18	147.00	100.00	180.00	$10m	US455780CF11	4	24

Source: Morgan Stanley Research

Definition of terms

Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

Sell/Short: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be negative over the relevant time period.

Selling Protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying Protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

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Like: Based on current market conditions as of the date of this report the analyst expects that the relevant securities of the issuer that is subject of the recommendation will perform favorably over the relevant time period as compared to the overall market of comparable securities by other issuers. This is not intended to be, nor should it be interpreted as a formal fundamental rating of the issuer or its creditworthiness.

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Global Stock Ratings Distribution

(as of September 30, 2018)

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	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
STOCK RATING CATEGORY	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MISC
Overweight/Buy	**1178**	**37%**	**308**	**42%**	**26%**	**562**	**40%**
Equal-weight/Hold	**1378**	**44%**	**343**	**46%**	**25%**	**625**	**44%**
Not-Rated/Hold	**49**	**2%**	**5**	**1%**	**10%**	**7**	**0%**
Underweight/Sell	**554**	**18%**	**83**	**11%**	**15%**	**224**	**16%**
TOTAL	**3,159**		**739**			**1418**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.
Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.
Not-Rated (NR) - Currently the analyst does not have adequate conviction about the stock's total return relative to the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

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