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IDEA

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Global EM Strategist | Global

EM Bulls Tested

We've spent the last two weeks discussing our year-ahead outlook with investors. We received pushback on our constructive view on EM fixed income. The common doubt is whether EM can withstand a US-led global growth downturn. We address this and other feedback inside.

Glass half-empty: After a torrid year for EM assets, many investors would no doubt be pleased if our constructive views on the asset class pan out. However, many are sceptical and quite downbeat about the outlook. Chief among concerns is the global growth outlook and EM's ability to withstand a downturn. With the US and Europe slowing, investors see China as a significant risk. While Morgan Stanley's view is that China's growth will stabilise following ongoing stimulus efforts, investors are not so confident, particularly with the risks around trade negotiations. They also question whether USD can weaken amid slowing European growth.

Where else are we out of consensus? Many investors now see Mexican assets as cheap and negative sentiment stretched. We are not so sure. In local rates, FX and credit we do not see enough risk premia and positioning remains a concern amid fiscal and other policy headwinds. Rallies will be short-lived, in our view. Moreover, investors do not seem prepared for the entry of China into the Global Aggregate Index due to operational issues, trading concerns and valuations. We expect to see inflows after inclusion from April 2019 (see here for more). Finally, investors question our preference for some of the GCC oil-exporting credits in light of the recent oil downturn. See inside for our views on these topics.

Duration gains: Since we published 2019 Global EM Fixed Income Outlook: From Zero to Hero, EMBI Global Diversified spreads are roughly flat but total returns are 1.3% with UST yields providing a boost. The latter has also helped duration in local markets, with local rates and FX both delivering 0.3% for a total return of 0.6% for the GBI-EM. In fact, the target on our long India government bond recommendation has already been hit and we are re-entering the trade, setting our sights on a bigger rally.

Still preferring the high yielders: We continue to prefer the high-yielders in EM local markets (we hold likes for South Africa, India and Indonesia for both rates and FX). We dislike local rates in CEE and Korea, though these markets have participated in the global fixed income rally and we've been stopped out of our pay 10y PLN and KRW positions. We think that front-end payers in CZK make sense, given the limited rate hikes now priced in. In credit, we still think that HY will lead the recovery in 2019 but are selective for now with likes on Argentina and Ukraine, but dislikes on Ghana, Lebanon and Pakistan. Mexico remains our key IG dislike in credit.

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Happy holidays and all the best for 2019: *This will be our last Global EM Strategist of 2018. We wish all our readers a happy holiday and we look forward to speaking to you in the New Year.*

Addressing investor feedback and questions
Asset allocation; Trades overview
Snapshots; Live trades: Rationale and risks

Addressing investor feedback and questions

During the two weeks of marketing since we published our 2019 EM Fixed Income Outlook, many common questions and concerns were raised. We present some of the most frequently asked, with our responses. Overall we found investors sceptical about our bullish outlook for EM fixed income in 2019.

Broad EM feedback

How can we stay bullish EM when global growth is slowing and US risk markets are under pressure?

This was one of the most frequent pushbacks against our constructive view. Our economists are expecting global growth to slow and our outlook for US risk assets is far from positive. The concern is that the policy response to a growth slowdown could be slow to materialise and EM will not escape from volatility in risk assets that results. Our point is that although global growth is slowing, we are not expecting any region to fall into recession. Our forecasts suggest that global growth should only be dropping back to trend, but not below. The US economy will lead the slowdown, but again will avoid recession and domestic drivers in EM will thus be sufficient to keep overall growth resilient even as external demand wanes. With US growth leading the downturn and EM growth holding up, capital flows should rebalance and move away from the US and help USD weakness. We admit that the pathway to a better outlook for EM does depend on the Fed adjusting its stance sufficiently to allow USD to weaken. A slow response that tightens financial conditions would likely see some pressure coming to EM. As such, it is a fine line we are treading between USD weakness and EM outperformance, and a further tightening of financial conditions. We are reassured that there are already clear signs of the Fed adjusting its stance, moving away from autopilot on rate hikes to data dependency. We await the December FOMC meeting to see how the SEP may shift.

The market has already priced out hikes for 2019, yet USD is stable. Isn't that a concern for our USD-bearish call?

During the latter stages of our recent marketing, investors were quick to point out that USD had not really weakened much despite the moderation in expectations for Fed rate hikes in 2019. However, we have also seen rate hike expectations drop back in other parts of the world, muting the impact on USD. We don't see this as evidence that USD will not go down as the Fed continues to adjust its rhetoric, as we do expect the ECB to hike in 2019 and Bund yields to move higher. We'd also make the following observation: Market expectations about rate hikes can shift around *in response* to explicit guidance from central bank officials and/or in response to economic data and financial conditions in *anticipation* of a shift in policy and guidance from the authorities. While the impact on the interest rate market may be similar, in that in both cases expectations for monetary policy will shift, the impact on other asset prices can differ. In the former case, where central bank officials are providing the explicit guidance, and if that guidance is dovish, risk assets will likely respond more positively and USD is more likely to drop. The problem for USD and EM more recently is that while the rate market is anticipating that the Fed will likely shift, the more limited shift in actual guidance from the Fed is keeping financial conditions tighter and USD stronger. As the Fed adjusts, we'd expect EM to benefit. There are examples in EM where we see a similar divergence in asset prices depending on whether the rates market is anticipating a policy shift or being reactive to guidance. For example, in Turkey, in past episodes of currency weakness, the market typically starts to anticipate rate hikes from the central bank. However, the uncertainty over whether they would actually come meant that the currency would not benefit from those rising yields. Typically it would only be when the central bank actually delivered the hikes or confirmed that it would act that TRY would respond.

Why do we prefer local over credit, when the full-year returns are roughly the same?

Our total return expectations from end-November (when we published the outlook) to the end of 2019 are indeed similar. Given the greater volatility in the $ returns of local currency EM bonds, arguably EM credit is a safer bet for the expected return. However, we have not yet shifted the stance on EM credit to bullish, matching our bullish stance on EM local markets. There are two reasons why we expect the near term to be somewhat more challenging for EM credit. First, we expect EM sovereigns to front-load issuance into 1Q19. This will likely mean that EM credit underperforms in the initial part of the year. Our current plan is to use this issuance period to shift to a more constructive stance, equivalent to what we currently have for local markets. Second, the weakness in US risk assets, and credit markets in particular, could spill over into EM credit. Historically, the correlation between the two asset classes is strong. However, as USD starts to weaken, we expect that EM credit will rebound alongside EMFX. After all, EM credit spreads tracked EM local markets weaker for most of 2018 even as US credit markets were resilient.

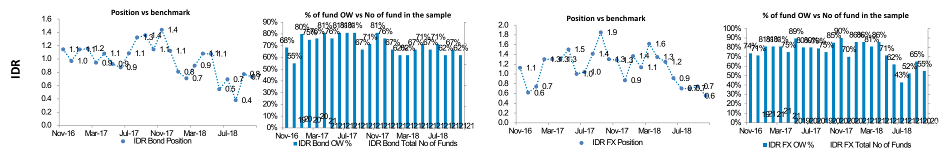
Regional/country feedback

Do we still like high yielders in Asia, given the recent rally?

Being long Indonesia and India local currency bonds have been key recommendations in our Asia portfolio (see Carry, alpha, risk hedges in our 2019 outlook). With INDOGBs and IGBs rallying 100bp and 80bp from the peak of the yield, investors pushed back our bullish view. We believe that both countries are still attractive, given current valuations.

Real rates are still high in both Indonesia and India. Admittedly, real rates in Indonesia could be lower should the government reduce fuel subsidies. But the fact that BI has IDR stability as its mandate suggests that the authorities would react should IDR volatility increase. This would help ongoing inflows into INDOGBs. The absolute level of foreign ownership of INDOGBs is high now (IDR 900 trillion) but 38% ownership is well below the all-time high of 42%. Lastly, our GBI-EM position tracker suggests that real money positioning isn't heavy. We are long INDOGBs and short USDIDR 3m NDF.

Exhibit 1: Positioning in INDOGBs/IDR isn't heavy



Source: Company websites, Morgan Stanley Research

In India, while oil prices remain volatile, we believe that India should continue to benefit from lower oil prices and the market hasn't fully priced that in. USDINR remains at an elevated level. Portfolio flows haven't recovered yet, with US$7 billion of outflows from bonds and US$5 billion from equities. The resumed inflows along with a narrower current account deficit to fund should push INR stronger. Our long IGBs Jan 2028 trade hit its target and we re-enter the trade. We were stopped out of our pay 1y INR NDOIS trade.

What is investors' feedback on China bond index inclusion?

As we discussed in EM Strategy Update: Unprecedented Inflows into the Chinese Bond Market, December 5, 2018, so far the inflows into the Chinese bond market have been dominated by reserve managers and overseas banks. However, real money investor involvement is very limited and our sense is that many are not prepared. This is because: i) There is still a huge difference in liquidity of on-the-run and off-the-run bonds; ii) The benchmark bond changes four times a year, which makes it hard for investors, especially passive funds, to track; iii) The hedging cost in CNH is punitive while hedging CNH CGBs with the onshore CNY forward could create basis risks; and iv) Investors are still concerned about the valuation in CNH or CGB durations. As a result of these concerns and limited allocations so far, we expect real money investors to represent a strong push factor in April 2019, prompting inflows into the Chinese bond market.

At what price is Mexico a buy?

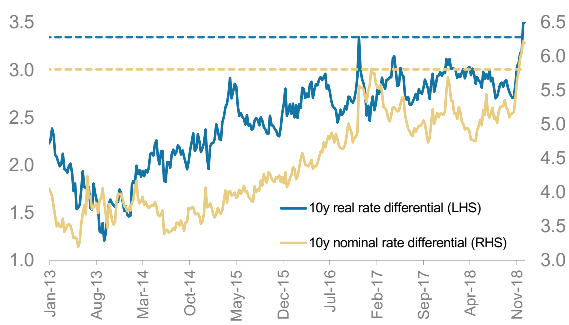
Sentiment has soured on Mexico very quickly and the majority of investors we met had a cautious view, something our economists also found in their meetings (see Debates From the Road, December 7, 2018). However, most investors were also looking for the price at which to add risk. We don't think that we're close to those levels yet.

Local markets: In this new regime (see Mexico Strategy and Economics: A New Higher Vol Regime: Will Banxico React? November 13, 2018), we think that real rates differentials versus the US are the new benchmark for assessing cheapness rather than nominals. In an environment where markets are pricing in some probability of a de-anchoring of nominal variables (Exhibit 2) as already validated by Banxico (see Banxico's Inflation Report), we believe that a share of the increase in rates, particularly nominals, is permanent. Due to the high uncertainty regarding the macro policy direction, we argue that the real rates differential should trade in a new range above the 3% mark. On that front, we might be tempted to receive close to a 4% differential, which implies a further increase of ~50bp.

FX: While carry remains attractive, we are worried about Banxico's independence being put into question. Our measure of idiosyncratic risk premia (IRP) remains relatively low (Exhibit 3) compared to the risks as Banxico has anchored the exchange rate and the shape of the curve with a very hawkish stance. While not the base case yet, any perception of Banxico's independence being put into question would likely have a disproportionate impact on nominal assets, implying a very fat tail to the downside. As such, we would require much weaker levels in the exchange rate close to 22 in order to become more constructive.

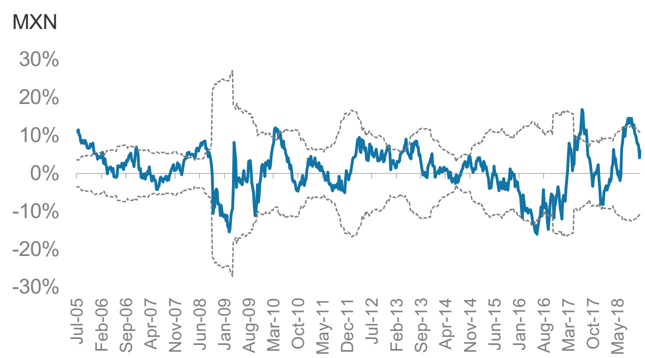
Credit: Despite trading at a discount to IG peers and pricing in two downgrades already, we think that it's too early to buy into the weakness. While there are likely to be tradeable rebounds, we see three important risks: First, we expect fiscal slippage, with increased spending unlikely to be covered by planned revenues. Second, the energy sector continues to be a focus, given the weak fundamentals and high financing needs of Pemex, particularly if the plan to build a new refinery goes ahead. Third, we don't expect negotiations between the government and Mexcat bondholders to go smoothly even if a solution should be forthcoming in the end. Positioning by EM debt-dedicated funds across Mexico is not that light yet crossover investors still have significant positioning which leaves technicals challenged as well. This means that the spread over sovereign of Pemex should widen, even though later in 2019 we expect government support to be forthcoming for Pemex, which may then see a recovery.

Exhibit 2: Rates should trade above pre-mid-2018 highs as Mexico is in a new regime



Source: Bloomberg, Morgan Stanley Research; Note: Dotted lines denote pre-election highs.

Exhibit 3: MXN IRP looks low relative to risks



Source: Morgan Stanley Research

Can GCC oil exporters outperform with the recent moderation in oil prices?

Our oil strategists expect oil prices to continue to rally on back of the OPEC+ agreement, after the steep decline in recent weeks. They think that the production cut announced by OPEC+ is likely sufficient to balance the market in 1H19 and prevent inventories from building, and estimate Brent to reach US$67.5/bbl by 2Q19 (see The Oil Manual: OPEC+: Back to Balance, December 8, 2018).

Qatar offers good risk/reward: Based on the IMF estimates of the fiscal breakeven oil prices, Kuwait, Abu Dhabi and Qatar will likely be in a fiscal surplus even against the aforementioned oil price backdrop, whereas Saudi Arabia, Oman and Bahrain will be registering deficits. Of these, Kuwait and Abu Dhabi sovereign spreads arguably reflect their strong fundamentals and little upside can be expected. Qatar's fiscal performance in 9M18 was strong and it registered a fiscal surplus. Despite the surplus, it borrowed US$12 billion from G3 bond markets. While the sovereign could have injected some of these proceeds into its sovereign wealth funds, we think that the over-funding for 2018 reduces the pressure significantly on the sovereign to issue bonds in 2019. Qatar spreads should also benefit from increased demand on the back of its inclusion in EMBI. More importantly, if oil prices moderate significantly from here, it will indeed take Qatar spreads wider but the widening could be even more pronounced in broader EM sovereigns on back of risk-aversion (not our base case for 2019), similar to what happened in 2015-16. As such, we think that Qatar still offers a good risk/reward compared with some EMBI IG sovereigns such as Malaysia.

Still reasons to be constructive on Saudi Arabia: Saudi Arabia will still be registering deficits and sovereign supply is likely to exceed US$10 billion in 2019. Yet, we think that there are reasons to be constructive. First, in the recent oil price moderation, the impact on Saudi Arabia will be cushioned by the benefits from the higher production volumes. With Saudi Arabia having issued debt more than twice the size of its 9M18 deficit of SAR 49 billion, there is no pressure to tap global bond markets imminently. Second, like Qatar, Saudi Arabia should also benefit from EMBI inclusion from 2019. However, the current size of off-benchmark positioning in KSA is much smaller than in QATAR in the run-up to inclusion. The positioning hasn't increased much in recent months as oil prices were moderating. We think that investors are likely to run underweights in UAE and Kuwait and have a modest overweight in Saudi Arabia. Third, a key overhang on the KSA complex is potentially large quasi-sovereign supply. However, if oil prices moderate further or sovereign spreads go wider, that potential supply will likely be diverted towards syndicated loan markets over bond markets. Lastly, our base case is for tighter EMBI spreads in 2019 and, as such, KSA is likely to benefit the most as its differential over the KUWIB, ADGB and QATAR curves has increased in the past two months.

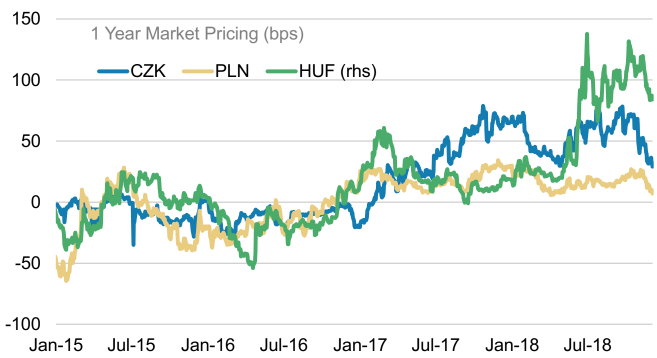
A better outturn for Oman fiscal could lead to spread tightening: Our like on Oman was tactical in the run-up to the Moody's and Fitch rating decisions and OPEC meeting. Moody's did not downgrade Oman in November and we don't expect Fitch to downgrade Oman in December either. OPEC also delivered with a production cut. It is also important to note that current expenditure in Oman usually spikes in December on the back of year-end payments. As we entered December with a sharp decline in oil prices, there is a likelihood that the year-end bonuses could be curtailed and some of the expenses which were committed but not yet disbursed could be rolled back, leading to a smaller deficit. We think that these factors could lead to some near-term spread tightening. However, we would look to turn neutral ahead of supply as twin deficits in Oman will remain large with Brent at US$67.5/bbl. Going forward, supply should remain large, driven by moderating FX reserves. Bahrain's breakeven is the highest but for now the spread trajectory will likely be dictated by reforms committed under the GCC US$10 billion support package. If reforms stay on track – it has already made progress on VAT implementation – we think that Bahrain spreads could decouple from broader HY oil exporters.

Should we pay CEE rates again?

CZK front-end payers more attractive than in PLN or HUF: The recent drop in oil prices and softer global growth dynamics have caused markets to reduce rate hike expectations substantially in many markets, including CEE. Exhibit 4 shows the extent of re-pricing across CZK, PLN and HUF. Of the three markets, we are more inclined to pay the front end of CZK than the other two. The market is now pricing around one rate hike from the Czech National Bank over the next 12 months, whereas our economist is forecasting three rate hikes in 2019. As our economics team explains here, the drop in oil prices is far less important than the ongoing strong wage growth dynamics in the Czech economy, with 3Q wages coming in at 8.5%Y, compared to the CNB's forecast of 8.2%Y.

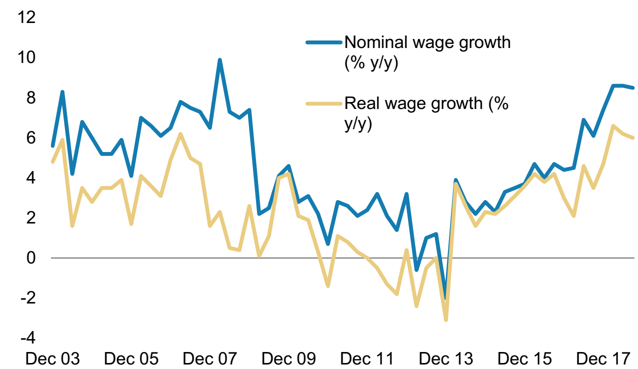
While the drop in oil prices might impact on headline inflation, core remains more important to the central bank. Moreover, to the extent that oil prices matter for the *market* (rather than the CNB), we noted above that our oil strategists are expecting oil prices to rebound following the recent OPEC+ agreement. With CZK also quite weak, markets are pricing in a very muted outlook in terms of monetary tightening. We think that selling EURCZK and paying front-end rates is an attractive combination.

Exhibit 4: Too few rate hikes priced in for CZK



Source: Bloomberg, Morgan Stanley Research

Exhibit 5: Czech wage growth still strong



Source: Bloomberg, Morgan Stanley Research

Elsewhere in CEE, we do not think that the risk/reward is attractive enough to pay front-end rates in either Hungary or Poland. In Poland, there is little risk premia for rate hikes in the market, yet we are not forecasting adjustment from the NBP either so it is hard to justify recommending a front-end payer here. We had recommend paying 10y PLN swaps as one of our trades for the year ahead to position for a rising Bund yield backdrop. However, the sharp oil price drop and soft European data have meant that this trade came under immediate pressure. With oil prices potentially rebounding, the rationale for the trade is now better, but we would prefer to wait for European data to pick up before re-engaging with the trade.

Asset allocation

Asset Class	FX	Rates	Credit
Stance	Bullish	Bullish	Neutral
Likes	**FX**	**Rates**	**Credit**
	Argentina	Brazil	Argentina
	Brazil	Chile	Chile
	Chile	India	Colombia
	Czech Republic	Indonesia	Oman
	India	Peru	Saudi Arabia
	Indonesia	South Africa	Ukraine
	Poland		
	Russia		
	South Africa		
	Ukraine		
Dislikes	**FX**	**Rates**	**Credit**
	China	Czech Republic	Ghana
	Colombia	Hungary	Lebanon
	Korea	Korea	Mexico
	Malaysia	Mexico	Pakistan
	Mexico	Poland	
	Philippines	Turkey	

Trades overview

Exhibit 6:

			Entry					Notional	Gross P&L	
Trade		Status	Date	Level	Current	Target	Stop	($m or k DV01*)	bp	US$k
SOVEREIGN CREDIT										
Country RV	Buy COLOM 2027 vs. MEX 2027 (z-spread)		25-Nov-18	-15	-25	-40	5	10x10	10	63
	Buy TURKEY 2023N vs. SOAF 30 (z-spread)		25-Nov-18	84	100	-15	155	10.5x9.5	(16)	(168)
Curve RV	Sell INDON 2028, Sell INDON 5y CDS		15-Oct-18	-2	-13	-25	20	10x10	11	129
	Switch out of MEXCAT 2026 into 2046 (notional neutral, cash levels)		02-Nov-18	4.7	3.4	0	9	10x10	(21)	142
LOCAL RATES										
Directional	Buy IGBs Jan 2028		10-Dec-18	TBD	7.52	7.05	7.65	10	-	-
	Buy SAGB Feb 2048		25-Nov-18	9.83	10.05	9.60	10.10	10	(22)	(645)
	Pay 1y1y USD/TRY		25-Nov-18	16.92	17.70	22.50	15.50	10	77	775
	Receive Brazil DI Jan '24		25-Nov-18	9.35	9.48	8.50	10.15	10	(13)	(130)
	Buy INDOGBs May 2028		25-Nov-18	7.85	8.07	7.60	8.25	10	(22)	(245)
Curve RV	5s10s TIIE Steepener		15-Aug-18	23	24	50	10	10	1	(12)
CURRENCIES										
Directional	Short USD/BRL 3m NDF		06-Dec-18	3.91	3.93	3.62	4.04	10	-	(62)
	Short USD/ZAR		21-Nov-18	13.91	14.13	13.00	14.50	10	-	(121)
	Short USD/IDR 3m NDF		15-Nov-18	14755	14734	14300	15100	10	-	68
	Short USD/CLP 3m NDF		08-Nov-18	677	675	624	704	10	-	111
Closed Trades										
We closed Pay 10yr KRW NDIRS at publication. We hit target on Buy IGB Jan 2028 on 06-Dec-18. We closed Pay 1y INR NDOIS on 06-Dec-18 and closed Long USD/MYR 3m NDF at 4.13 on 04-Dec-18. We closed Pay 10yr PLN on 30-Nov-18. We hit target on Chile 1s5s10s CLPxCAM Butterfly on 29-Nov-2018. We closed Long BRL 3m NDF/ MXN 3M NDF at 5.25 on 27-Nov-18.										

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:** Falling inflation expectations for two consecutive months in Argentina gave BCRA the option to remove the 60% rate floor. Subsequently, the authorities announced the removal of the floor and the implementation of a new crawling band of 2% starting in 1Q19 (versus 3%). While this announcement triggered some weakness in ARS, we remain bullish on the peso, but think that it will likely trade range-bound in the near term, as the markets navigate the broader risk environment and adapt to the recent BCRA changes in parallel.	Overall, the support from the IMF has helped to reduce the risk premium in local assets, and we expect it to continue declining in 2019. With the focus on 0% nominal monetary base growth into 2019, real rates should remain elevated in 2019. We expect carry returns to outperform duration returns. The local bond curve inversion makes duration extension unattractive. Therefore, we prefer receiving short-duration yields as we expect the front end to outperform as the curve normalises in the medium-to-longer term.
BRL	**Like: Short USDBRL 3m NDF:** The BCB's FX credit line auctions have relieved some of the pressure on the real caused by a shortage of USD liquidity onshore, and we expect BRL to continue retracing losses. The new president assumes office on January 1, with significant popular support, as suggested by recent polls. We see a window of opportunity for BRL to outperform in the coming weeks as the new administration takes over, given its recent market-friendly cabinet appointments and more orthodox economic agenda.	**Like: Receive 5y DI:** Positive momentum in Brazilian assets continues as the perception of governability from the new administration, particularly relating to pension reform in 2019, remains upbeat. In the medium-to-longer term, we expect term premium to compress and the BCB to normalise monetary policy in the year ahead quite slowly. Therefore, we prefer to receive the longer end of the DI curve **(5y, targeting 8.50% with a stop at 10.15%).**
CLP	**Like: Short USDCLP 3m NDF:** The fundamental story in Chile remains attractive and supportive for CLP, with relatively strong economic growth and a more sustained increase in business sentiment helping to drive investment. With near-term trade risks in the price and a more positive outlook for copper, according to our commodities strategists, we expect CLP to gain some momentum in the weeks to come.	**Like:** We keep our bias for duration and further curve flattening in Chile as the latest BCCh IPOM shows continued inflation convergence and growth moderating through 2019 and 2020. The swaps rates curve has normalised in the belly as relative value reverted in the 5yr sector of the curve. Looking specifically at the front end, monetary policy market pricing relative to the BCCh forecast is in line 1yr ahead but lower than forecast 2yr ahead, suggesting more upside risk in 2yr rate levels over 1yr rate levels.
COP	**Dislike:** With risks for oil tilted to the downside, and inexpensive carry, COP looks vulnerable relative to its LatAm peers. Moreover, Colombia requires comprehensive fiscal reform to maintain its investment grade credit rating (more long term) and cover a COP 14 trillion gap in the 2019 budget (more immediate). However, the modified tax bill that is being introduced in Congress now excludes some of the initial proposals (e.g., expanding the VAT base to include basic foods). In our view, the proposed tax bill does not sufficiently address the broader fiscal concerns and we remain cautious on Colombian assets.	Our economists expect that BanRep will kick off the 125bp hiking cycle in January 2019, given inflationary pressures induced by the new tax reform proposal supporting a broader VAT taxable base, with risks of further hawkishness than projected. This is fairly consistent with the markets' pricing of a 150bp hiking cycle commencing in December 2018. While 2s10s in Colombia are flatter than suggested by our fair value model, we see limited room for steepening in the medium term as risks continue to be tilted towards an early start to the normalisation cycle.
MXN	**Dislike:** We think that investor confidence had already been affected going into the airport consultation, and risk premium in local assets should continue to increase. We see the 2019 budget (likely to be presented in the first days of December) as the potential catalyst for further weakness. In our view, even if a balanced budget is presented for 2019, potential concerns about assumptions on growth and/or savings from spending reengineering will likely tilt risks to the downside.	**Dislike: 5s10s TIIE steepener:** We remain concerned about potential fiscal slippage over the medium term. On the budget vote, even if a balanced budget is presented for 2019, potential concerns about assumptions on growth and/or savings from spending reengineering will likely tilt risks to the downside. We keep defensive positions in rates despite attractive valuations and recommend 5s10s steepeners as we do think that monetary policy is not as tight as initially assumed due to a structural shift higher in the neutral rate in the new higher-uncertainty regime.
PEN	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.	**Like:** Our economists expect the economy to grow at 3.4%Y in 2019 with inflation pressures well anchored as public investment should remain anchored due to polarisation between Congress and the Executive Branch. As a result, we expect the curve to flatten as the economic cycle continues to mature. In addition, Peru's strong external balance and fiscals keep rates well tied to developed market yield curves which, according to our global interest rate team, should see further yield curve flattening in 2019.

CEEMEA Local Markets		
	FX	**Local Rates**
CZK	**Like:** We expect 2019 to be the year when CZK rallies. Growth should accelerate in 2019, compared to the deceleration expected elsewhere in CEE, while the Czech National Bank will likely deliver another three rate hikes next year. Rate hikes have hardly helped CZK in 2018, but this is because of weakness in EUR and highly correlated EUR-linked currencies such as CEE. This should change in 2019.	**Dislike:** The CZK curve is not fulling pricing in our economist's monetary policy profile and so front-end rates will likely continue moving higher in 2019. This monetary policy outlook suggests curve flattening, but with the curve already flat and Bund yields likely to head higher, we see a parallel move as more likely, and underperformance versus high yielders. CZK yields typically move with a negative correlation to FX.
HUF	HUF will likely perform ok versus USD but we expect it to underperform versus other CEE currencies. Inflationary pressure is building in the economy and yet we expect Bubor to only rise gradually from the middle of the year onwards. With the ECB heading for tighter policy, in our view, this raises the risk of some HUF weakness.	**Dislike:** Valuations remain unattractive, in our view, with real yields very low and inflation rising. The recent change to the monetary policy mix has caused some confusion among investors since the NBH needs to use bank reserves, FX swaps and the depo rate to manage liquidity. The front end could anchor Bubor, but long-term investors are unlikely to buy HGBs, given opaque monetary policy
ILS	We think that ILS will rally against USD, but see little case for a strong move and expect underperformance versus others in CEEMEA and EM. Following the surprise hike recently our economist now expects rates to stay on hold next year with a modest growth slowdown. We doubt that political uncertainty will have much of an impact on the currency.	**UAH FX: Like** With the IMF SBA in place and the elections some time away, there is likely an opportunity for UAH to trade well in the near term. Moreover, the National Bank of Ukraine will likely keep real rates high with moderate rate cuts as inflation falls. Our economist expects USDUAH to end 2019 at 31 compared with forwards around 33.5 and so carry provides positive total returns.
PLN	**Like:** We expect the currency to perform well simply due to expected EUR strength. Versus EUR, we expect 4.20 by end-2019, a relatively moderate forecast for next year. While greater optimism about Europe should also help PLN versus EUR, one risk is the expected hands-off approach to monetary policy amid ECB tightening next year and a heavy electoral calendar.	**Dislike:** We were stopped out of our 10y PLN payer but we keep PLN rates as a dislike as they offer little value, in our view. Real yields are low versus history and other EMs. While currency strength should help, PLN has a relatively low correlation with 10y bond yields. Should the NBP remain dovish as the ECB hikes and Bund yields rise then we'd expect to see curve steepening and underperformance of Polish bonds.
RUB	**Like:** RUB remains a favoured currency for us. A rebound in oil prices following the recent OPEC+ supply cut could help, though oil-RUB correlations are low at present. There should be a temporary pick-up in inflation in early 2019 and we expect the central bank to hike. We are in line with consensus on CPI and more hawkish on policy rates. The biggest risk is sanctions and, although we think that this risk will reduce appetite for bonds, we think that the current account and USD trends will keep RUB on an appreciating path.	Valuations look attractive on Russian government bonds and FX strength will likely see OFZ yields track lower. However, we doubt that there will be significant foreign participation in local bond auctions next year, given the possibility of sanctions being imposed. Our base case is that sanctions on sovereign debt are not imposed but the risks will likely prevent significant participation from real money investors for the forseeable future.
TRY	We key TRY at neutral. The currency will probably deliver positive total returns by the end of 2019 but it will be driven entirely by carry, in our view. Given high inflation differentials, TRY could be one of a small group of currencies that actually buck the USD trend in 2019 and we expect a gradual move weaker in nominal terms, keeping the real exchange rate relatively stable after a strong rally seen in recent months.	**Dislike: Pay 1y1y USDTRY:** We see little value in Turkey long-end rates at current levels. Inflation would need to drop back to the low-teens in 2019 in order to justify current valuations, let along drive a further rally, while our economist's expectation is for inflation to average 15.9%Y next year and 15.7%Y in 2020, suggesting little value in bonds at current levels.
ZAR	**Like: Short USDZAR:** The South African rand is among the more sensitive currencies to USD weakness so is a natural candidate to outperform while the DXY weakens. We acknowledge risks around the 2019 budget, Eskom and associated ratings decision by Moody's and elections in 2Q. These will likely prompt volatility but it's not clear that it will be long-lived. Our economist is more hawkish than consensus on SARB rate hikes, more dovish on inflation and more bullish on growth. This should be good for the currency in the near term.	**Like: Buy SAGB Feb 2048:** SAGB yields are among the most sensitive in EM to currency movements. As such, should our FX view materialise then bonds should perform well. The recent budget was a clear negative but, with that news out of the way, risks are largely priced in and we see a chance of an upside surprise. The 2019 budget will be important to gauge. Morgan Stanley monetary policy and inflation forecasts should be good for the long end and, with real yield differentials with the US relatively high, we think that there is some value in local bonds.

AXJ Local Markets		
	FX	Rates
CNY	**Dislike:** CNY could strengthen against USD should DXY stay weak but CNY is likely to weaken in basket terms in 2019 as a weaker currency could support exports and growth. The currency is expensive from a capital account perspective as errors and omissions remain large. Rapid depreciation is unlikely, given the importance of capital inflows. In our 2019 Global FX Outlook: Top 10 FX Trades, we recommend long SGDCNH.	CNY could weaken in NEER terms but bond yields could move lower given the sealed capital account, in our view. Should the government decide to expand its fiscal deficit, the back end could be under pressure for a while, but we believe that the macro slowdown should ultimately drag bond yields lower. In order to support private sector funding, the PBOC is likely to keep government bond yields low and stable, in our view.
INR	**Like:** The RBI kept the policy rate unchanged at 6.5% and maintains its monetary policy stance of calibrated tightening. Inflation projections were revised lower and our economists expect CPI to stay benign. Easing inflation pressure continues to suggest a continuing INR recovery. Our economists expect strong growth in India compared to its regional peers and pencil in 50bp of hikes by the RBI in 2019. With rate differentials against the US remaining high and given our DXY weakness view, we are bullish on INR.	**Like: Long IGBs Jan 2028:** India should benefit the most from lower oil prices, which alleviate the concerns about a widening current account deficit. The market could price in no rate hike from the RBI, given the difficulties in the domestic banking sector, while inflation has played in favour of the RBI. Recovering foreign inflows into IGBs should help to flatten the yield curve. We re-enter long IGBs Jan 2028 after it hit the target of 7.4%. We were stopped out of the 1y payer in INR NDOIS.
IDR	**Like: Short USDIDR 3m NDF:** With BI's proactive policy hikes since May 2018 to increase real rates and to reduce IDR vulnerability, we're bullish on IDR, given the attractive carry. In addition, with our bearish view on DXY and with UST continuing to rally, funding pressure on the current account deficit can be released. The potential inflows to bonds and equity, on which our equity strategists are overweight, could support IDR.	**Like: Buy INDOGBs May 2028:** Indonesia's government and central bank are proactively reducing its macro vulnerability by cutting the current account deficit and hiking interest rates. The introduction of DNDF should help to reduce the hedging cost for foreigners and encourage more inflows into INDOGBs. High real rates also make INDOGBs attractive.
KRW	**Dislike:** The BoK raised its policy rate by 25bp at its November meeting to help ease financial imbalances derived from the household debt issue. However, the central bank reiterated that monetary policy is still accommodative as the inflation trajectory is likely to stay benign. The slowing global economy, Korea's dependence on exports and the absence of a more aggressive fiscal policy stimulus do not bode well for the Korean economic outlook.	**Dislike:** The BoK hiked 25bp in November, in line with consensus. 10y KRW rates has rallied to the lowest level since mid-2017. We used to pay 10y KRW to hedge against the spike in UST yields, which rallied strongly given the volatility in equity markets. We stay on the sidelines for now but would like to pay rates again should US or Korea data surprise on the upside.
MYR	**Dislike:** We estimate that USDMYR is one of the most sensitive AXJ FX pairs to an S&P sell-off. Our equity strategists see further S&P weakness towards end-2018, and we'd expect a higher USDMYR should the historical relationship hold. Moreover, Malaysia is one of the few oil exporters in Asia and, with crude prices below US$60 per barrel, this should add further downward pressure on MYR.	We are neutral on Malaysia rates. Inflation pressure remain muted, which allows BNM to keep rates on hold. We don't believe that issuance on the back of a wider fiscal deficit is a concern as locals have the ability to absorb the supply. The concern is about the liquidity in both bonds and FX. And foreigners might sell into the rally should EM perform well.
SGD	The MAS is likely to continue its current appreciation slope for S$NEER. Thus, as we see DXY weakness and a lower CNY NEER, SGD could outperform. In addition, our economists expect Singapore GDP to stay at a healthy level.	SGD rates could move higher should UST sell off again, but could rally should our stronger SGD FX view play out. SGD-USD spread widening should continue.
TWD	The G20 meeting outcomes and the November election results could suggest some temporary support for TWD as the KMT party won a majority at the local government elections. With our equity strategists' neutral stance on the Taiwanese stock market and the low-volatility characteristic of TWD, the currency is likely to stay relatively stable. However, widening interest rate differentials could pose some downward pressure on the currency.	We are neutral on TWD rates as the central bank is likely to stay dovish on the back of a domestic slowdown, trade tension and steady inflation.
THB	Thailand's 3Q GDP figures surprised significantly to the downside and may deter the BoT from hiking at the upcoming meeting in mid-December. For the time being, we remain neutral on THB as EM sentiment towards Asia's high-yielders such as INR and IDR is reviving. Moreover, the upward momentum in Thailand's inflation seems to have turned and may be an impedient to the BoT turning more hawkish.	Thailand rates should move lower when UST rallies or global EM sells off as Thailand is seen as a safe haven and could move higher if our weak USD view plays out.
PHP/ HKD	**PHP FX: Dislike:** The Philippines' economic overheating problem is likely to persist and the BSP would need more rate hikes to curb macro-instability. However, this would mean more downside risks for growth, weighing on PHP in the longer term.	**HKD rates:** With the Fed pressing ahead with its hiking cycle and Hong Kong banks hiking prime rates, we see tightening liquidity conditions and USDHKD heading back gradually to the ceiling at 7.85, pushing HKD rates higher.

Sovereign credit snapshots

Simon Waever, Jaiparan Khurana

Credit	Commentary and curve preference	Curve
Latin America		
Brazil	News regarding the governability of the new administration, and in particular the ability to pass social security reforms, is likely to be positive in the coming months. However, the problem is that this is largely already priced in, with 10y spreads trading 70bp inside of BBs. Positioning is also already OW, even if this is mostly via Petbra. Overall, this makes risk/reward neutral at best, meaning that a strategy should be one of buying on dips instead. That said, the 10s30s curve looks steep versus peers, with the low cash price 45 bond most attractive. The CDS-bond basis in Brazil no longer looks as extreme as previously, yet we maintain a preference for CDS in the front end.	Long end
Chile	**Like:** Chile looks attractive among the higher-rated and tighter-trading credits by nature of trading wide to Peru, Poland and Malaysia. Fundamentals are also still positive, with our economists expecting growth of 3.3%Y, yet with upside risks due to our bullish view on copper and the successful passing of the tax reform. This view is best played via the 10y sector due to a very flat 10s30s curve.	Belly
Colombia	**Like: Buy COLOM 2027 vs. MEX 2027:** While we remain concerned about longer-term fiscal sustainability in Colombia, this is unlikely to be the driver of spreads for now. 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 US$1 billion of redemptions. The 10s30s curve has flattened recently and we thus prefer the 10y sector of the curve instead, with a preference for the 2027 bond. We also like EUR bonds in the belly.	Belly
Mexico	**Dislike: Switch out of MEXCAT 2026 into MEXCAT 2046:** Despite trading at a discount to IG peers and pricing in two downgrades already, we think that it's too early to buy into the weakness. We see three important risks: First, we expect fiscal slippage, with increased spending unlikely to be covered by planned revenues. Second, the energy sector continues to be a focus, given the weak fundamentals and high financing needs of Pemex, particularly if the plan to build a new refinery goes ahead. Third, we don't expect negotiations between the government and Mexcat bond holders to go smoothly even if an agreement is eventually reached. Positioning by EM debt-dedicated funds across Mexico is not that heavy yet crossover investors still have significant positioning which leaves technicals challenged as well. This means that the spread over sovereign of both Pemex should widen, even though later in 2019 we expect government support to be forthcoming for Pemex, which may then see a recovery. In Mexico, we prefer the 10y sector of the curve, and USD over EUR bonds. In Pemex, we would also stick with USD low-dollar price bonds in the long end (such as 44 and 46) and avoid EUR bonds due to potential selling from EU IG accounts. In Mexcat, we recommend switching out of 2026 into 2046 as prices should converge.	Belly
Peru	Peru should perform in line with other tighter-trading credits yet lag Chile, which it has outperformed this year to trade tight to despite its lower rating. That said, the 10s30s curve in Peru is very steep and we see the 2050 bond as most attractive.	Long end
Argentina	**Like:** We expect Argentine spreads to outperform and maintain our like stance on Argentina. A more front-loaded IMF 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 negative net supply of US$3.3 billion until 2020 in addition to coupons of US$12.5 billion should help. Valuations are still cheap at 180bp wide to single Bs, with our target being 50bp wide in the near term. If spreads rally, we expect the curve to steepen.	Belly
Venezuela (see the end of the report for important note regarding economic sanctions)	Chances of seeing a structural change in how the country is managed have fallen in the past year as the current government is increasingly getting used to managing scarcity and with an opposition that is still not pulling in the same direction. That said, the challenges will likely intensify, with oil production expected to fall further, continued restrictions on new funding and the worsening humanitarian crisis in the country. We still think that bonds do hold value but, as time passes it's clearly being diluted, both as the probability of change diminishes but also as potential asset values are eroded and a more significant write-down would be needed in a potential restructuring. Incentives to accelerate bonds should also increase for these reasons. For now, bond prices below 20 make sense to hold onto, we think, which means that the low-coupon PDVSA bonds hold the most value across the complex. This is in part driven by our view that PDVSA and VENZ claims will eventually be collapsed and see the same recovery value. In VENZ, there is not as high a cash price difference between low- and high-coupon bonds, meaning that value is skewed towards the high-coupon bonds like 26 and 31.	PDVSA over VENZ

Credit	Commentary and curve preference	Curve
Europe		
Russia	While the growth outlook remains subdued, with our economist's estimate for 2019 at a low 1.6%Y, the upshot is that excess oil revenues are saved and leave the economy more resilient to the numerous external shocks that may still materialise (Morgan Stanley forecasts a budget surplus at 2.5% in 2019). Low foreign ownership from a historical standpoint also makes this point. We also remain of the view that the more severe sanctions such as targeting new sovereign debt issuance are unlikely, reinforced by a lack of headlines around the US mid-terms. However, the significantly negative impact of such a tail-risk scenario still impacts the risk/reward calculation. At 40bp versus BBBs, a neutral stance is warranted, We would look to levels of 70bp versus BBBs to add. The 10s30s curve has steepened recently and leaves the 2047 in particular looking attractive.	Long end
Turkey	**Buy TURKEY 23N versus SOAF 30 (DV01-unhedged):** While Turkey's credit fundamentals remain weak, the current account adjustment is well under way. The potential impact of the economic adjustment on corporate and banking sector balance sheets could take a few quarters to play out but, with our more sanguine view on EM credit for 2019, the challenge of rollover of short-term external debt could also ease. With the rally from the 2018 wides, most of the good news seems to be priced in, but foreign investor positioning has reversed to an underweight, which is a positive technical. We expect the TURKEY 10s30s curve to steepen.	Front end
Ukraine	**Like:** With the expected 2018 bond issuance behind us and confirmation of the IMF deal, two of our four concerns have been addressed. Heavy investor positioning is still an issue and politics also remains uncertain. However, with the presidential elections still four months away and polls stable, we think that near-term risks are skewed positively, given the possibility of new candidates rising in the polls. With now cheap valuations, given 10y spreads near year-to-date wides versus single B credits and yields at early 2016 levels, we think that Ukraine will outperform. Given a steeper curve, we like the long end of the curve, with our preference being the low-cash price 2027 bond as opposed to the new 2028.	Long end
Middle East and North Africa		
Qatar	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 recent months, leaving us neutral on valuations. We think that the bid from Qatari banks for Qatar sovereign paper could increase over the next 6-12 months.	Belly
Saudi Arabia	**Like:** 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 from the sovereign is likely to be higher than for UAE, Kuwait and Qatar, we may still see a decline on a year-on-year basis. That said, any geopolitical uncertainty needs to be monitored.	Long end
Oman	**Like:** Oman is trading wider than BBB sovereigns, but also significantly wider than BB sovereigns. This indicates that a downgrade to sub-IG is already factored in. As such, if Fitch reaffirmed Oman at IG at its upcoming December review, we should see some relief rally. Fiscal performance in 8M18 has been strong, with a 35%+ consolidation in the deficit if we exclude expenses under settlement. Our view is tactical going into Fitch's review as Oman could look to tap the global bond markets in January, leading to some volatility. Oman has narrowed the gap with EMBI oil exporters, which reduces the spread headroom should oil prices remain at current levels.	Long end
Bahrain	EMBI index inclusion, a larger-than-expected Gulf support package, approval of the VAT law in the lower house and declining supply expectations are all positive factors. Yet, we think that this is going to mainly impact the front end for now, where investors are yet to factor in significantly reduced rollover risk. For EM investors, we think that BHRAIN 30y offers better value than BHRAIN 10y as the 10s30s has steepened. Also, as Bahrain aims to reduce its interest cost significantly as per its fiscal balance programme, we think that going forward issuance in 30y would be unlikely given that it entails a higher coupon rate.	Front end
Egypt	Egypt's current account deficit narrowed in 2017, and the sovereign is done with the planned external debt issues to plug the financing gap for 2018. That said, we expect issuance in early 2019 as portfolio outflows from local bond markets have continued. Given that EGYPT is a large overweight and any issuance will take the outstanding debt stock above the EMBI Index country average, the issuance should lead to wider spreads. We prefer the long end of the curve as the EGYPT 10s30s curve is steep versus peers.	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. Fiscal performance for 1H18 has also been weak. In addition, inflation has picked up. A delay in forming a government would impact investor sentiment, especially given upcoming maturities.	Front end

Credit	Commentary and curve preference	Curve
Sub Saharan Africa		
South Africa	**Sell SOAF 30 versus TURKEY 23N (DV01-unhedged):** While South Africa spreads have widened, we see them performing in line with the broader index in the near term as significant alpha would be unlikely ahead of the February budget, ratings decision by Moody's and elections in 2Q. Positioning is still OW and we think that supply is also likely over the next 3-4 months. We think that this leaves the risk/reward balanced. In terms of curve preference, we like the long end of the curve – given the lower cash prices – over the front end.	Long end
Angola	The IMF EFF (funded) should provide credibility to the reform process. The IMF programme should also provide more transparency about bilateral borrowings. The 2019 budget aims for a fiscal surplus and the 2018 budget target has been revised to a surplus from a deficit earlier, a credit positive. Debt/GDP at 70% as per budget documents also allays market concerns that kwanza depreciation would lead to significantly higher leverage.	Belly
Ghana	**Dislike:** 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. The 2019 budget targets a wider fiscal deficit than 2018, breaking the trend of fiscal consolidation seen under the IMF programme. Moreover, the target GDP growth rates seem unrealistic, which increases downside risk to revenues and may lead to an even wider deficit. With the IMF programme ending in 1Q18, we think that risk remains to the downside.	Belly
Asia		
Indonesia	**Sell INDON 2028 (Treasury-hedged), sell INDON 5y CDS:** With Pertamina, PLN and Inalum having issued bonds recently, we don't expect further quasi-sovereign supply until after the elections. The sovereign has pre-financed part of its 2019 borrowings needs in December 2018 and the rest of the supply will likely be well diversified into EUR, JPY and sukuk markets. Nonetheless, with the recent large issuances, if concerns about the upcoming election arise, the credit curves could steepen. We prefer the sukuks over conventionals in the belly, and prefer the quasi-sovereign bonds in the long end.	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. While the sovereign will be revisiting the global bond markets in near term, we think that issuance will likely be longer-dated and net supply will be higher than in the past. 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	Malaysia's wide deficit targets for 2018 break the trend of fiscal consolidation seen since 2009. Furthermore, investors could also turn cautious on MALAYS on the back of the recent oil price moderation. We think that with the budget revisions the supply dynamics will change and we now expect the sovereign to tap the global bond markets in 2019. As such, we think that the MALAYS 10s30s credit curve should steepen and the 5y CDS-bond basis should narrow. Petronas' spreads should underperform the sovereign as its cash outlay would increase on back of the special dividend.	Front end
Sri Lanka	Political uncertainty remains high and some of our key credit concerns such as a widening current account deficit, high external debt rollover needs and fiscal slippages persist as well. That said, valuations have adjusted significantly. At current valuation levels, we think that supply would be extremely unlikely and investor positioning is likely to be underweight. As such, any positive news could lead to a significant tightening of spreads. This suggests a neutral stance and covering underweights via low cash price bonds.	Long 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 and the IMF programme seems to be back on track. 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. We prefer the quasi-sovereign over the sovereign.	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 made strong progress in tieing up a programme – sooner than our expectations – we still think that disbursements in the near term are unlikely, as the IMF would ask the authorities to undertake prior action items. We think that the fund may ask for an upfront fiscal adjustment, which could be tough. We would like to wait for progress on it before taking a more constructive stance.	Belly

Live trades: Rationale and risks

Exhibit 7: Trades

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Rates						
Buy IGBs Jan 2028	10-Dec-18	TBD	7.05	7.65	Lower oil and food prices should alleviate the concerns about a widening current account deficit in India. We expect the RBI to stay on hold until April 2019, given the difficulties in the domestic banking sector, while inflation has played in favour of the RBI. Recovering foreign inflows into IGBs should help to flatten the yield curve.	A surge in oil prices and more hawkish RBI hikes. Significant improvement in the banking sector.
Buy SAGB Feb 2048	25-Nov-18	9.83	9.6	10.1	Investors have cut back their positions and funds are flat. We forecast inflation for 2019 to be below consensus and think that the long end of the curve has value.	Worse fundamentals than expected, fiscal challenges and a ratings downgrade.
Pay 1y1y USD/TRY	25-Nov-18	16.92	22.50	15.50	We believe that the market has overpriced rate cuts over the next 12 months.	CBT becoming more dovish.
Buy INDOGBs May 2028	25-Nov-18	7.85	7.60	8.25	The government and central bank are proactively reducing Indonesia's macro vulnerability by cutting the current account deficit and hiking interest rates. The DNDF should help to reduce the hedging cost for foreigners and encourage more inflows into INDOGBs. High real rates also make INDOGBs attractive.	Global EMFX sell-off which could pose more funding pressure on IDR and cause foreign outflows.
Receive Brazil DI Jan '24	25-Nov-18	9.35	9.42	10.15	In the medium-to-longer term, we expect term premia to compress and the BCB to normalise monetary policy in the year ahead quite slowly. Therefore, we prefer to receive the longer end of the DI curve	BCB speeds up the pace on monetary policy normalisation, while domestic or external shocks push the neutral rate higher in Brazil
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. So, 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. Also, 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.
Trade	**Date**	**Entry Level**	**Target**	**Stop**	**Rationale**	**Risks**
Buy COLOM 2027 vs. MEX 2027	25-Nov-18	-15	-40	5	We expect Mexico to underperform due to increased pressure on fiscal accounts and the energy sector. Positioning in Colombia is lighter and fiscal issues should be slower to materialise.	Significant fall in the price of oil.
Buy TURKEY 23N versus SOAF 30 (DV01-unhedged)	25-Nov-18	84	-15	155	Turkey's funding needs are high but its current account deficit is set to narrow. On the other hand, South Africa spreads are unlikely to outperform EMBI ahead of the February budget.	Stronger dollar, sharp rise in global oil prices or geopolitical noise will impact Turkey more than South Africa.
Sell INDON 2028 (Treasury-hedged), Sell INDON 5y CDS	15-Oct-18	-2	-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.
Switch out of MEXCAT 2026 into MEXCAT 2046 (notional basis)	2-Nov-18	4.8	0	9	We expect bond prices to converge in a downside scenario while 5 points is still in line with the one-year average. Higher carry in the long end.	Different treatment in a potential restructuring.

Source: Morgan Stanley Research

Exhibit 8: Likes/dislikes

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Like South Africa Local Rates	25-Nov-18	NA	NA	NA	SAGB yields are among the most sensitive in EM to currency movements. As such, should our FX view materialise then bonds should perform well. The recent budget was a clear negative but with that news out of the way there are few near-term catalysts to spark additional concern. The 2019 budget will be important to gauge. Our monetary policy and inflation forecasts should be good for the long end and, with real yield differentials with the US relatively high, we see some value in local bonds.	Deterioration in broader sentiment towards EM.
Like India Local Rates	25-Nov-18	NA	NA	NA	India should benefit the most from lower oil prices, which alleviate the concerns about a widening current account deficit. The RBI is unlikely to hike rates, given the difficulties in the domestic banking sector, while inflation has played in favour of the RBI. Recovering foreign inflows into IGBs should help to flatten the yield curve.	More hawkish stance from the RBI due to increased inflation along with improved domestic banking sector conditions.
Like Indonesia Local Rates	25-Nov-18	NA	NA	NA	The government and central bank are proactively reducing Indonesia's macro vulnerability by cutting the current account deficit and hiking interest rates. The introduction of DNDF should help to reduce the hedging cost for foreigners and encourage more inflows into INDOGBs. High real rates also make INDOGBs attractive.	Global EMFX sell-off which could pose more funding pressure on IDR and cause foreign outflows.
Dislike Korea Local Rates	25-Nov-18	NA	NA	NA	The front end is pricing in a 25bp rate hike from the BoK. The BoK faces a challenge – a slower economy and high debt argue for low rates while booming property prices and widening rate differentials versus the US require higher rates. We pay the back end given the flat curve and as it provides protection should UST sell off.	Domestic economic conditions deteriorating further and high household debt lead to a more dovish BoK. Lower UST yields.
Dislike Czech Local Rates	25-Nov-18	NA	NA	NA	The CZK curve is not fulling pricing in our economist's monetary policy profile and so front-end rates will likely continue moving higher in 2019. This monetary policy outlook suggests curve flattening, but with the curve already flat and Bund yields likely to head higher, we see a parallel move as more likely, and underperformance versus high yielders. CZK yields typically move with a negative correlation to FX.	Less hawkish CNB than our forecasts and inflation softer than expected.
Dislike Hungary Local Rates	25-Nov-18	NA	NA	NA	Valuations remain unattractive, in our view, with real yields very low and inflation rising. The recent change to the monetary policy mix has caused some confusion among investors since the NBH needs to use bank reserves, FX swaps and the depo rate to manage liquidity. The front end could anchor Bubor, but long-term investors are unlikely to buy HGBs, given opaque monetary policy.	Bund yields going against our forecasts and inflation being softer than expected.
Dislike Poland Local Rates	29-Oct-18	NA	NA	NA	Polish rates have been in a tight range. With the yield approaching the lower end of the band, we believe it provides a good opportunity to pay rates again. The front end is well anchored given low inflation and a dovish NBP. We expect the long end to rebound should global core rates start to move higher on the back of higher wages.	Weaker global inflation.
Dislike Mexico Local Rates	29-Oct-18	NA	NA	NA	We remain concerned about potential fiscal slippage over the medium term. In addition, uncertainty relating to the airport consultation has raised concern among investors about policy in the future.	Investor sentiment improves as the next administration pursues an orthodox policy agenda.
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 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	Our economists expect the economy to grow at 3.4%Y in 2019 with inflation pressures well anchored as public investment should remain anchored due to polarisation between Congress and the Executive Branch. As a result, we expect the curve to flatten as the economic cycle continues to mature. In addition, Peru's strong external balance and fiscals keep rates well tied to developed market yield curves which in 2019 should see further yield curve flattening, according to our global interest rate team.	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	Relative to 2018 growth, 2019 growth in Chile is expected to moderate, after exhibiting a year of above trend growth. As a result local assets should see stable performance in 2019 and lower levels of term premium as the economic growth cycle matures, suggesting a strong bias to extend duration and continue the bias for curve flattening.	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	A significant sell-off in UST yields or large fall in copper prices.
Like Saudi Arabia Hard Currency Bonds	29-Oct-18	NA	NA	NA	The fiscal deficit is consolidating, which should lead to lower supply, and EMBI inclusion should lead to demand. With spreads still trading cheap on a ratings-adjusted basis, we think it offers an attractive risk/reward.	Pick-up in geopolitical uncertainty or fall in oil prices.
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.	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 reinstatement 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 Ukraine Hard Currency Bonds	29-Oct-18	NA	NA	NA	Outright valuations are attractive with yields around 9.5%, and with the recent bond issuance supply in the very near term is unlikely.	Pick-up in political uncertainty ahead of election or the final 2019 budget not being in line with IMF expectations.
Dislike Mexico Hard Currency Bonds	29-Oct-18	NA	NA	NA	We expect risk premium to remain high to account for the uncertainty around future policy-making and the risk of a deterioration in the fiscal balance.	Investor-friendly budget, and pragmatic policy actions around the quasis Pemex and Mexcat.
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 Ghana Hard Currency Bonds	25-Nov-18	NA	NA	NA	We think conclusion of the IMF programme and a wide 2019 budget deficit target could make investors cautious on Ghana. Overweight investor positioning also poses a risk.	Sharp increase in oil production or 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 9: History of recommendations for EM stances

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 Mexico Hard Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Dislike Mexico Hard Currency Bonds	09-Apr-18	24-Sep-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 Ukraine Hard Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Like Ukraine Hard Currency Bonds	9-Apr-18	2-Jul-18

History of recommendations for Hungary Local Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Dislike Hungary Local Currency Bonds	29-Jan-18	30-May-18

History of recommendations for Poland Local Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Dislike Poland Local Currency Bonds	29-Jan-18	15-Aug-18

History of recommendations for South Africa Local Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Like South Africa Local Currency Bonds	18-Dec-17	15-Aug-18
Dislike South Africa Local Currency Bonds	07-Sep-18	25-Nov-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

Source: Morgan Stanley Research

Exhibit 10: History of recommendations for EM trades

Sell INDON 28, Sell INDON 5y CDS AND Buy TURKEY 23N versus SOAF 30 (DV01-unhedged)												
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

Switch out of MEXCAT 2026 into MEXCAT 2046												
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**
MEXCAT 4.250 10/31/2026	31-Oct-26	Buy Mexcat 26 vs. Pemex Jan'26	25-Jun-18	-18bp	11-Jul-18	-68bp	-65bp	10bp	US$10m	USP6629MAA01	50bp	294k
PEMEX 4.500 01/23/2026	31-Oct-26	Buy Mexcat 26 vs. Pemex Jan'26	25-Jun-18	-18bp	11-Jul-18	-68bp	-65bp	10bp	US$10m	US71654QBW15	50bp	294k

Source: Morgan Stanley Research

Exhibit 11: History of recommendations for FX trades

Sell USD/CLP 3m NDF												
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**
USD/CLP	3m	Sell USD/CLP 3m NDF	13-Sep-18	680.00	09-Oct-18	685.00	651.00	685.00	$10m	CHN+3m Curncy		

Short USD/IDR 3m NDF												
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**
USD/IDR	3m	Short USD/IDR 3m NDF	13-May-18	14360.00	07-Jun-18	14126.00	13500.00	14560.00	10m	IHN+3M Curncy		
USD/IDR	3m	Buy USD/IDR 3m NDF versus sell USDIDR 6m NDF	1-Oct-18	225.00	05-Oct-18	280.00	100.00	280.00	10k	IHN+3M Curncy		
USD/IDR	6m	Buy USD/IDR 3m NDF versus sell USDIDR 6m NDF	1-Oct-18	225.00	05-Oct-18	280.00	100.00	280.00	10k	IHN+6M Curncy		

Source: Morgan Stanley Research

Definition of terms

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