OVERSEAS HOT SPOTS - ABENOMICS, BREXIT AND IMPUGNAÇÃO DE MANDATO

I was in Hawaii earlier this month, doing my best to implement the second part of the very well known (and highly debated) Wall Street adage - Sell in May and Go Away. I also (partially) tested another hotly discussed investment topic, particularly when it comes to the Japanese economy, the so-called "helicopter drop" monetary policy. Unfortunately, there was no money to drop from the helicopter but the views were worth the effort. I highly doubt that the bank will consider this a work-related experiment and agree to reimburse the expense report I submitted upon my return.

This brings me to Japan and one of the least anticipated developments so far this year, i.e. the significant appreciation of the Japanese Yen. On a trade weighted basis, the Yen has appreciated 16% since the lows at the end of 2014 (and 9% so far this year), pushing inflation expectations significantly lower and driving real bond yields higher. Japanese stocks have suffered from this development and entered bear market territory earlier in the year, having fallen more than 20% since the highs reached in 2015. The economy has also lost ground with year-on-year declines in trade, investment, retail sales and industrial production, while leading economic indicators are consistent with further weakness in the near term. These developments have unwound many of the benefits achieved in the early stages of the Abenomics program. Aggressive monetary easing and Yen weakness were, until recently, the most successful component (the so-called first "arrow") of Prime Minister Abe’s plan to end years of deflation in Japan. The other two arrows (fiscal stimulus and structural reforms) have yet to be implemented in any significant way. This is particularly the case on the fiscal front where the VAT hike implemented in 2014 pushed the economy back into recession. The second phase of this tax increase is scheduled for April 2017 (part of a long term plan to achieve a primary budget surplus by 2020). Given fierce public opposition and a struggling economy, the most likely scenario is that this measure will be delayed.
Yen strength has persisted and even intensified following the Bank of Japan's (BoJ) surprising decision to introduce a negative interest rate on a small portion of excess reserves this past January. Japanese bank stocks have suffered large declines since the announcement given the negative impact on interest rate margins. A similar trend has taken place in Europe after the ECB brought deposit rates even deeper in negative territory. This shows the limits of negative interest rates as a monetary policy tool. Over the past few weeks, expectations for further rate cuts in Japan have come down but, at the same time, the Fed made a significant dovish turn at the March FOMC meeting. The relative trends in expected interest rate differentials led to further Yen strength.

As evidenced by recent announcements from several Japanese companies (including Toyota), the stronger Yen is becoming more problematic for Japanese exporters. Based on a survey conducted by the Japanese Cabinet Office, the breakeven rate for Japanese exporters is around 100 Yen/$, dangerously close to where the currency was trading just a few days ago. Historically, this has often resulted in official intervention to weaken the Yen. An intervention could prove quite effective at this stage given that net speculative positioning as a percentage of open interest is now significantly long the Yen (i.e., positioned for a further appreciation), which also appears overbought from a technical perspective.

Several other factors point to renewed Yen weakness in the near term. In particular, capital outflows from Japan (both portfolio and direct investment) have intensified and are now larger than the current account surplus, resulting in a negative basic balance of close to 5% of GDP. This is not exactly an environment where one would expect a currency to appreciate (supported by long term capital inflows). It therefore suggests that much of the Yen appreciation results from the massive shift from net short to net long speculative positions.

As discussed last month, another factor which could reignite Yen weakness is our
view that the Fed has reached a point of maximum dovishness and markets have moved to price in a very glacial pace of rate hikes in the US. Any signs that the Fed is becoming marginally more hawkish (in light of ongoing wage growth, improving financial conditions and reduced tail risks in China) could pave the way for a resumption of the dollar uptrend. This would be good news for the BoJ.

Beyond relative trends in interest rates and the potential for official intervention (probably at levels closer to the exporters’ breakeven rate), there is a growing sense that Abenomics is failing and that Japan is stuck in a liquidity trap. Even when the Fed hikes interest rates (most likely) later this year, Yen weakness might only prove temporary if tighter US financial conditions act as a trigger for another wave of selling pressures across risk assets (the Fed Policy Feedback Loop described last month). This is because the Yen fundamentally remains a “risk-off” currency as Japan has a very large net international investment position and low nominal interest rates.

There is therefore a growing consensus that the BoJ will soon have to resort to more radical policy measures in order to lift inflation expectations in a more meaningful and sustainable fashion. These measures could include a shift from inflation to price level targeting, increased purchases of foreign financial assets (in order to weaken the currency), debt monetization (directly purchasing debt issued by the government) and helicopter drops (printing money and distributing it directly to the public in order to stimulate spending). Aggressive fiscal easing together with ongoing BoJ bond purchases (either directly from the government or in the secondary market) will most likely boost growth and inflation expectations (at least for a while). This will help reduce real interest rates and weaken the currency, while also boosting Japanese stocks. Delaying the next VAT increase and instead focusing on fiscal stimulus (Abenomics’ second arrow) should lead to a more durable depreciation of the Yen. In this environment, FX-hedged Japanese equities might be ripe for a rebound, particularly given recent underperformance and investors’ positioning.

**SHOULD I STAY OR SHOULD I GO?**
The upcoming UK referendum on continued EU membership (June 23rd) appears to be a knife’s edge contest. Although financial markets have already felt some impact, if the vote produces a “leave” result, global markets will likely face additional turbulence this summer. While the reality is that a vote to leave the EU will be mostly emotional rather than rational, proponents of Brexit advance three major arguments in order to sway voters:

1. **Trade:** EU membership hurts UK trade with non-EU countries
2. **Regulation:** massive regulations imposed by the EU act as a drag on productivity and competitiveness for UK companies
3. **Immigration:** free movement of EU nationals (under the Single European Labor Market) is a drain on public finances (through benefits) and a source of cheaper competition in the labor market.
The reality is that all of these arguments appear to be unfounded. Immigration, for example, has been a key source of economic growth in the UK (GDP growth being the combination of productivity gains and labor force growth), foreign-born workers claim far less benefits than native UK citizens and with an unemployment rate around 5%, there is no evidence that immigrants are taking jobs from the native population. As far as trade is concerned, several EU economies have shown that being part of the EU is not at all an impediment to global (ex-EU) trade. Germany and Sweden have both seen a sharp improvement in their trade balance with the rest of the World, despite EU membership. By leaving the EU (the UK’s major trading partner), UK exports will likely suffer until a new trade agreement with the EU is reached (a process which could last several months, thereby negatively impacting the UK economy in the near term). Switzerland (through bilateral agreements) and Norway (through its membership in the European Free Trade Association) have been able to gain access to the vast European common market (450 million consumers) but the terms of these deals have largely been decided by the EU and both countries have to pay for this access. While it is true that the EU is known for over-regulation in various areas of the economy, most of these regulations would still apply to the UK once they renegotiate trade deals similar to Switzerland and Norway. The argument of greater sovereignty gained by leaving the EU also appears flawed since the UK would have to transpose the bulk of EU legislation in order to access the EU common market (and will lose any influence in determining these rules).

Despite the lack of economic and rational basis to Brexit, the outcome of the referendum will mostly be decided by politics and emotions. In particular, recent developments in Continental Europe (the EU debt crisis, terrorist attacks in Paris and Brussels, the Syrian
migrants’ crisis, among others) might convince the UK population to cut ties with Europe now before even more integration takes place in the future. On the political front, the referendum could be seen as strategy to blame the EU for some of the public resentment with regards to globalization, the loss of manufacturing jobs and the influx of immigrants. This seems very similar to the general malaise among the blue-collar working class in the US, which has resulted in a sweeping wave of anti-globalization populism, as highlighted by the support gathered by Bernie Sanders and Donald Trump.

A vote to leave on June 23rd will most likely rattle the markets, at least in the near term, mainly due to the uncertainty of what comes next for the UK and the EU. In accordance with article 50 of the European Union Treaty, the UK and the EU will have up to two years to negotiate new trade and bilateral agreements. Prolonged and tumultuous negotiations could be fertile ground for market volatility. This long timeframe could also cause significant uncertainty and negatively impact employment, investment and productivity trends. The British pound is where we believe the bulk of the adjustment will take place. So far this year, the pound has already depreciated +/- 7% against the Euro. However, Brexit uncertainty was not the only factor negatively impacting the GBP in recent months as expectations for rate hikes by the Bank of England have also come down. We therefore believe that a Brexit outcome is not yet fully discounted and that there is significantly more downside for the pound if British voters were to decide in favor of leaving the EU. On the positive side, a weaker GBP should help offset some of the negative impact for exporters.

Financials will probably come under pressure due to the importance of the City as the financial hub for Europe.
Uncertainties with regards to issues such as the so-called European Passport for financial products traded in London could negatively impact the UK economy if these markets move back to the Continent. Other domestic sectors are likely to suffer from a potentially softer growth outlook for the UK economy.

While there could be some spill-over into other European markets, the European common market will remain one of the largest single consumer markets in the world, even without the UK. While some investors will question what this means for the future of the EU, we firmly believe that the European integration will continue to move forward, particularly since the UK was not exactly the main driver for further integration, having recently obtained the right to opt out from ever-closer integration. The economic ties between the UK and the EU will also remain very strong once new trade agreements have been signed, as evidenced by the relationship with Switzerland and Norway. Unfortunately, this process could take several months (and up to two years) and some uncertainties will linger for a while.

As in the case of Japan and the next likely move from the BoJ, the Brexit referendum will be closely watched in the US, and most specifically by the Fed. Given the uncertain outcome and the likely negative currency impact of a vote to leave, we believe the Fed will hold off from any rate hike at the June FOMC meeting as this could compound upward pressures on the dollar.

While we expect a pickup in volatility in the days leading up to the referendum, we remain constructive on European equities and would look at any knee jerk selling as an opportunity to add to our exposure in this area. As far as UK equities are concerned, we are less bullish but we also believe that Brexit could offer a buying opportunity, particularly if it results in a significant depreciation of the pound. Indeed, the UK equity market is much more sensitive to the global economy (and exporters should benefit from a weaker currency) and would not be overly sensitive to softer domestic growth.

**BUY THE RUMOR, SELL THE NEWS**

After several weeks of drama worthy of the best telenovelas, Brazilian President Dilma Rousseff was forced to step down temporarily and face trial by the Senate over alleged fiscal accounting irregularities. Impugnação de Mandato (Impeachment) is the most likely outcome of the trial. If Rousseff is removed from power, Vice President Michel Temer (already now acting as President) will remain in office until 2018.

The impeachment of Dilma Rousseff is obviously a very positive development for Brazil given how badly damaged the economy and public finances are after more than a decade of leftist policies. Annual economic output shrank by 3.8% last year and is expected to decline further this year. The Brazilian currency has depreciated by more than 50% since 2011, inflation has soared, the unemployment rate has nearly doubled, the fiscal deficit has ballooned to 10% of GDP, Brazil’s
sovereign credit rating has been downgraded to junk and an ever-increasing corruption scandal seems to have impacted the majority of politicians. Amid this gloom and doom, the most traumatic event took place in July 2014 when the Seleção Brasileira de Futebol lost 7-1 against Germany in the World Cup semi-finals. What else can possibly go wrong?

On the positive side, Temer will surround himself with highly skilled and respected individuals such as Henrique Meirelles, likely to become the finance minister. Temer himself has indicated that he has no ambition to run for office during the next election in 2018. This is a positive sign as he will need to implement very painful and unpopular reforms in coming months. We already know that the administration’s first goal will be to tackle the very dire fiscal situation through major fiscal reforms. The second objective will be to bring inflation down, in particular by ending the indexation of minimum wages and social security benefits. On paper, this looks very promising as these measures will help repair Brazil’s public finances. In practical terms though, this will be a monumental challenge for several reasons. First, any major change to public spending will require a two-thirds majority in Congress. Second, Michel Temer is not exactly starting a honeymoon with the Brazilian public as a majority of Brazilians want his impeachment as well. Third, reforms are always painful in the near term, before they start producing positive long-term benefits. Members of Congress looking for reelection might decide to distance themselves from Temer if fiscal austerity leads to widespread public discontent. And finally, the corruption scandal seems to engulf a growing swath of elected politicians, most likely limiting the extent of political change in the medium term.
While we believe that recent developments are paving the way for fiscal and structural reforms in Brazil, we expect the road to be bumpy, in particular since general elections are looming in 2018. In the medium term, reforms and fiscal austerity will also further depress economic growth and weigh on Brazilian assets. The Bovespa (Brazil stock exchange) is up more than 40% over the past four months and it seems that the impeachment rally has probably run its course. Now the tough part begins.

We have increased our allocation to emerging markets several times in recent months and recommend a neutral allocation at this stage. Brazil accounts for roughly 7.5% of the EM equity market and we do not recommend a specific allocation to this country given how far the market has recovered and the potential for disappointment with the pace of change in coming months.