Global Markets Monitor

Monetary and Capital Markets Department
Global Markets Analysis Division

Tuesday, May 28, 2019

- **European elections result in fractured parliament (link)**
- **Italian yields surge on strong League performance in European elections (link)**
- **US Treasury yields hit year-to-date low (link)**
- **EM fund outflows continue but at a slower pace (link)**
- **China regulators take over a small bank due to severe credit risk (link)**
- **Turkey central bank increases reserve requirements on FX deposits (link)**

US | Europe | Other Mature | Emerging Markets | Market Tables

Politics take center stage

Political developments continued to drive market volatility across asset classes last week, and chief amongst investor concerns were US-China trade tensions. Risk assets remained under pressure, with global equities posting their third straight weekly decline and both developed and emerging market credit spreads continuing to widen. Conversely, rising uncertainty provided support for safe-haven assets, with 10Y Treasury yields and 10Y Bunds dropping to their lowest levels since 2017 and 2016, respectively. Moreover, several segments of the US yield curve inverted again last week, reflecting investor concerns about the US economic outlook. Emerging markets were not immune to global uncertainty as EM dedicated funds experienced outflows for a third straight week. In addItion to trade tensions, a number of global political events fueled market volatility, including the announcement of the UK Prime Minister's resignation and the results of the European parliamentary elections over the weekend. The latter reflected somewhat positively on European equity and credit markets over the past two days, with investors seemingly relieved that Eurosceptic and far-right parties made only modest gains, on the aggregate.

Key Global Financial Indicators

Last updated: 5/28/19 7:56 AM	Level		Change from Market Close				
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
Equities				%			%
S&P 500		2826	0.0	-1	-4	4	13
Eurostoxx 50		3342	-0.7	-1	-5	-4	11
Nikkei 225		21260	0.4	0	-4	-5	6
MSCI EM		40	0.5	-1	-9	-14	2
Yields and Spreads				bps			
US 10y Yield		2.28	0.0	-15	-22	-65	-40
Germany 10y Yield		-0.15	-0.7	-9	-13	-50	-39
EMBIG Sovereign Spread		368	2	15	20	42	-46
FX / Commodities / Volatility				%			
EM FX vs. USD, (+) = appreciation		61.4	-0.2	0	-2	-8	-1
Dollar index, (+) = $ appreciation		97.8	0.2	0	0	4	2
Brent Crude Oil ($/barrel)		70.4	0.4	-3	-2	-7	31
VIX Index (%, change in pp)		16.9	1.0	1	4	4	-9

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

The trade war is expected to take center stage again this week as markets remain hostage to the latest news headlines. The holiday shortened week has a fairly eventful data calendar in the US, with the latest estimate of Q1 GDP due on Thursday and the all-important PCE inflation estimate coming out on Friday. The latter is the Fed's favored measure of inflation and a deviation from the consensus forecasts could have a big impact on markets. The University of Michigan consumer sentiment survey is also due on Friday. The most important reports in the euro area this week are those on French GDP and German employment on Wednesday and Italian GDP on Friday. Japan reports CPI, retail sales and industrial production on Thursday, while China reports PMI data on the same day. Key central bank meetings include Canada on Wednesday and Colombia and Korea on Friday.

United States

back to top

Trade war headlines dominated the markets last week with several bouts of severe intra-day volatility, but Friday saw calmer conditions and the eventual weekly decline was fairly moderate at 1.1%. However, the most significant market development of the week was that key US Treasury benchmarks hit new intra-day lows for 2019. Several sectors of the curve are inverted, such as the two-year/five-year and the three-month/ten-year, suggesting that markets are worried about the prospects for the US economy. May's PMI data showing the slowest expansion in three years highlighted the economic concerns. More negative trade headlines could push the two-year yield below 2% and trigger a broader repricing across the curve that could destabilize global markets. Most analysts agree that equity markets to do not fully reflect the risks of an escalation in the trade war or a slowing global economy, with the S&P 500 still trading within 4% of the record set on April 30. Contacts are worried that last week's volatility could be the harbinger of more market turmoil in the weeks ahead.

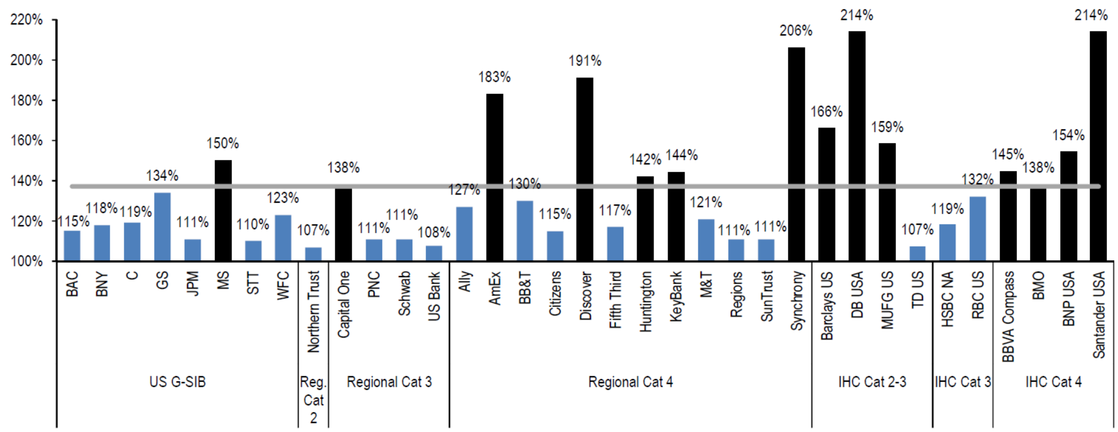
2019 Treasury Lows

Two-year	Five-year	Ten-year	30-year
2.12%	2.08%	2.29%	2.73%

Friday's durable goods report underlined the growing risk of an economic slowdown. Although the April report was slightly below forecasts, the March numbers were revised down significantly from 2.6% to 1.7% (headline) and the ex-transportation number from +0.3% to -0.5%. Capital expenditure was especially weak.

Large foreign banks had the strongest liquidity positions in the US market. International bank holding companies (IHCs) in the larger Category 2 and 3 classifications reported significantly higher liquidity coverage ratios (LCRs) than the US G-SIBs (global systemically important banks). Among the IHCs, seven out of ten banks had LCRs above the industry average while just 6 of 17 US regional banks and only one of the eight G-SIBs had above average LCRs. Overall, most banks had strong liquidity buffers with LCRs in the 107%-214% range compared to the 100% statutory minimum. In addition, the liquidity position of the US G-SIBs is believed to be stronger than the reported LCRs, as they likely hold additional high quality liquid assets (HQLAs) that are not eligible for inclusion in the LCR for miscellaneous regulatory reasons.

Exhibit 1: Bank liquidity coverage ratios by category* as of 1Q19 and average across all banks in sample (%)

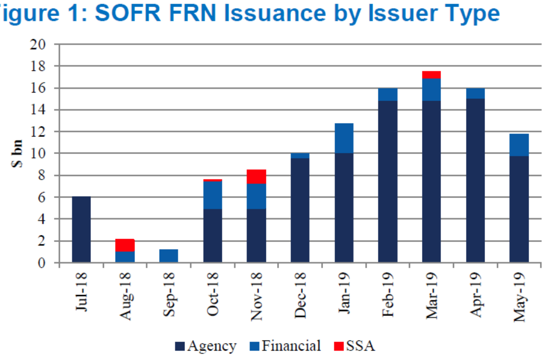


Source: Bank LCR disclosures, J.P. Morgan

* Categories based on the Fed's proposed modifications to enhanced prudential standards for domestic and foreign banks. Approximately speaking, Category 2 banks have assets ≥ \$700bn, Category 3 have assets between \$250bn and \$700bn, and Category 4 have assets between \$100bn and \$250bn.

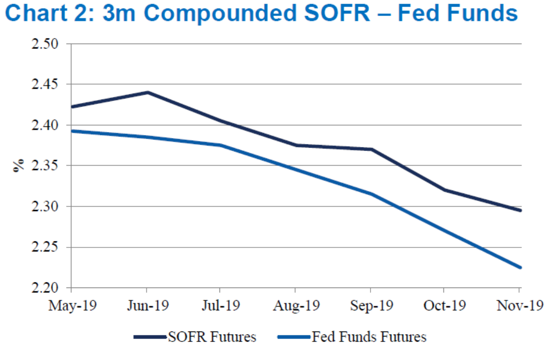
The issuance of floating rate notes (FRNs) based on the secured overnight funding rate (SOFR) is rising gradually, with \$13 bn in new deals brought to market so far this month. SOFR issuance is being closely monitored as it is the chosen substitute for Libor which is scheduled to be phased out worldwide by the end of 2021. The US authorities actively encourage greater use of SOFR by new issuers as well as the development of the SOFR futures markets run by CME and ICE. However, the adoption of SOFR is still in its early stages as the Libor transition continues to face headwinds. One issue is the continued volatility of SOFR compared to other key funding market benchmarks. The index has consistently traded above the Fed Funds rate and the futures market predicts that this will continue into at least November. The volatility of SOFR has been caused by the unusually high volatility in repo rates so far in 2019. Many analysts expect the Fed to address the repo volatility issue by introducing a new standing repo facility this year, but this remains speculation and there are open questions about the details and potential effectiveness.

Figure 1: SOFR FRN Issuance by Issuer Type



Source: BMO CM, Bloomberg

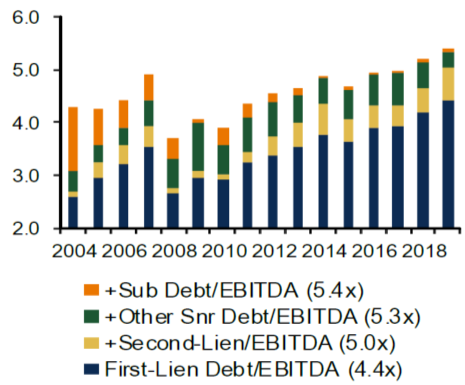
Chart 2: 3m Compounded SOFR – Fed Funds



Source: BMO CM, Bloomberg

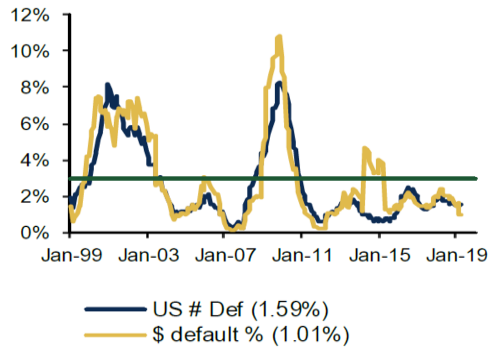
Despite the very high debt/EBITDA levels in the leveraged loan market, default rates remain very low. At the recent CLO investor conference in Las Vegas market participants remained optimistic about prospects for the market, citing the continuing unfolding of the very long credit cycle and the strength of the US economy. Bank of America reports that many investors think the lack of covenants has actually helped keep defaults low. They expressed the view that the strength of existing covenants is more important than the number of covenants governing a deal. However, it was widely agreed that recovery rates in the next downturn were likely to be lower than historical averages due to the higher leverage of deals and the reduced ability of lenders to control the behavior of borrowers in the current covenant-lite environment.

Chart 1: Average pro forma leverage ratios for new-issue loan transactions



Source: S&P LCD

Chart 2: Last-twelve-month default rates of the S&P/LSTA All Loan Index



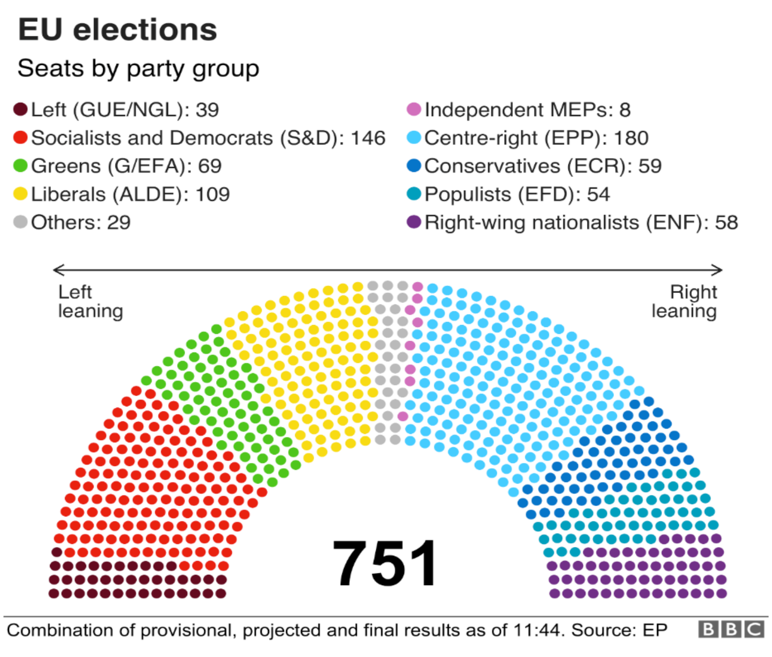
Source: S&P LCD

Europe

back to top

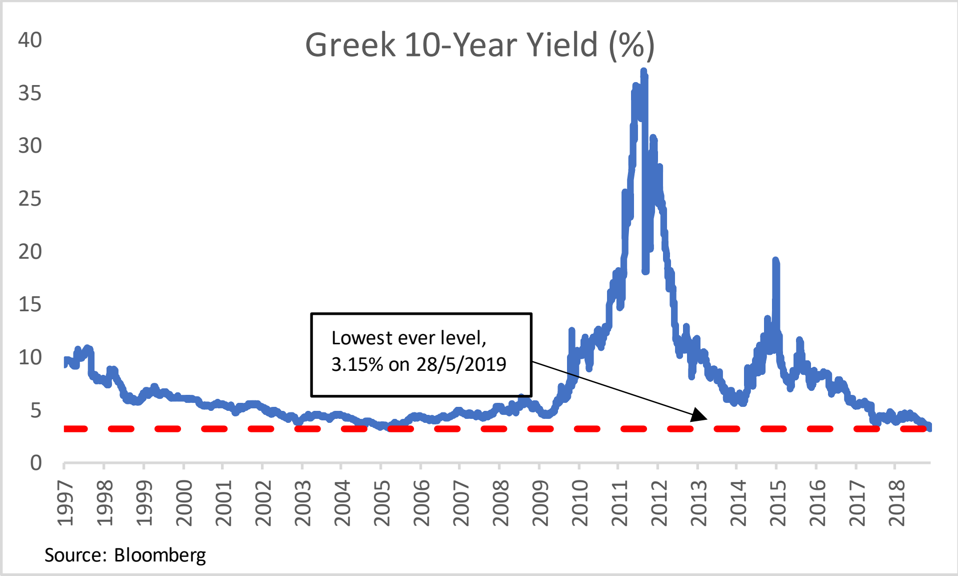
European Parliamentary Elections

Pro-EU groups retained their majority in the European parliament following the weekend elections. The vote share of nationalist and populists was lower than many had expected, with around 23% of seats shared between three Eurosceptic parties. However, the center-right EPP and center-left S&D lost seats and their majority. The coalition may now look to the Greens and the ALDE+R block to secure a new majority. Analysts have suggested that the results will lead to greater fragmentation within the parliament and could result in a less ambitious reform agenda. In aggregate, turnout was solid, increasing for the first time since 1979 to a 20-year high of 51%. Attention will now turn to the senior posts that need to be filled, including that of European Commission president and president of the ECB.



Sovereign yields were marginally lower in most European countries this morning, with the notable exception of Italy. Gilt yields saw the biggest fall with the 10-year falling 3 bps to 0.92%, the lowest level since 2016. Italian yields bucked the trend of lower yields and continued to climb. A mix of the European election results, domestic politics, and concerns over a renewed confrontation with the EU saw 10-year BTPs rise by 4 bps after a 12-bps jump yesterday. The League party's strong performance in the elections has raised fear of renewed tension within the coalition government, raising political risks. **Equities were slightly lower this morning,** with the Euro Stoxx 600 declining by about 0.3% and bank stocks dropping for a second day.

Greek bond yields fell sharply on yesterday's announcement of a snap general election. A poor performance in the European elections for the ruling Syriza party prompted PM Tsipras to call for the elections which could see his 4-year tenure end. New Democracy is expected to do well in the vote, which could come as early as June 30. Tsipras' decision saw a big fall in the country's borrowing costs, with the 10-year falling to the lowest level since Bloomberg began compiling data. Equities jumped on the news with the main index rising 6% on the day.



The Brexit party's success in the European elections has increased pressure on both the Conservative and Labour parties regarding their Brexit stance. The Brexit party's vote share of 31.6% was lower than some polls had suggested and was lower than the combined share of pro-Remain parties. However, the Conservative party's poor performance of 9.1% has led many of the leading contenders in the Conservative leader race to call for a more decisive Brexit stance which increases the likelihood of a no deal exit according to many analysts. For the Labour party, calls have been made for a clearer stance supporting a second referendum after the party's vote share almost halved to 14%. Apart from the Brexit party, the big winners were the pro-EU Liberal Democrats who came in second with 20% of total votes.

Austrian chancellor Kurz has lost a no-confidence vote in parliament, **triggering snap elections in September**. The no-confidence vote follows a corruption scandal that ended Kurz's coalition government with the far-right Freedom Party. Finance minister Loeger will serve as acting chancellor while Kurz has vowed to regain his position in September. He was bolstered by a strong performance by his party in the European elections where it saw record support despite the recent scandal.

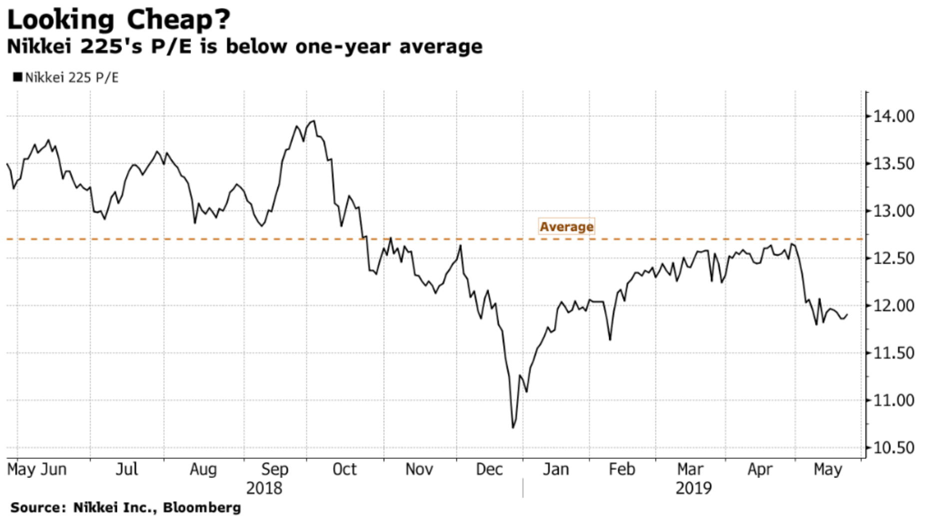
The German Financial Stability Committee has recommended activating the domestic countercyclical capital buffer. The committee, which consists of representatives from the supervisor, the finance ministry, and the central bank, suggested a buffer of 0.25%, to be activated in the third quarter of this year. Banks have twelve months to satisfy the requirement after the date of activation. The committee's rationale for the buffer was to prevent "cyclical systemic risks" from materializing amid the ongoing economic expansion which is the country's longest since reunification.

Other Mature Markets

back to top

Japan

Equities gained (Topix +0.3%, Nikkei +0.4%) for a third day buoyed by electronics and auto stocks. Meanwhile, President Trump's four-day state visit to Japan ended today without major agreements being reached. On trade, the President said that he is aiming to reach a deal with Japan by August, while Japanese officials said there was no such talk, according to Bloomberg. **The yen appreciated 0.2% and 10-year JGB yields fell 1 bps to -0.09%.**



Emerging Markets

back to top

Emerging-market stocks posted a third straight weekly loss last week (MSCI EM: -1%), the longest streak this year, as investors continue to reprice the odds and the timing of a trade deal between the U.S. and China. **Asian equities (+0.3%) rose slightly in a quiet trading session.** Rebalancing by MSCI likely provided support for Chinese equities at the end of the trading session (+0.6%). Regional currencies were little changed with the Thai baht leading gains (+0.2%), while the Chinese RMB depreciated (offshore -0.3%, onshore -0.2%). **In EMEA,** equity markets are mixed in narrow ranges, with the exception of Turkey rising 2.0% on headlines suggesting a delay by the Turkish government in purchasing the Russian defense system S-400. In FX markets, the South African rand is the only major mover, depreciating 1.1% against the dollar amid uncertainty about President Ramaphosa's cabinet. **In Latin America** asset prices were little changed on Monday in a quiet trading session given the US/UK holiday.

Key Emerging Market Financial Indicators

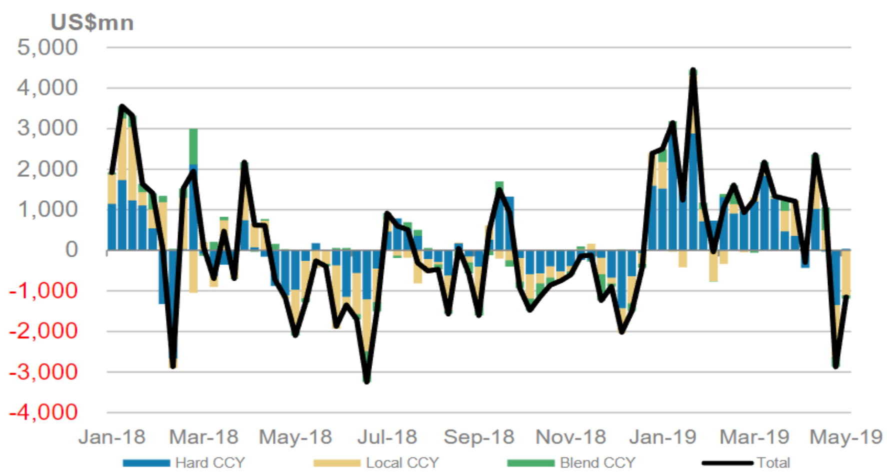
Last updated: 5/28/19 7:59 AM	Level: Last 12m	Level: index	Change: 1 Day	Change: 7 Days	Change: 30 Days	Change: 12 M	YTD
Major EM Benchmarks					%		%
MSCI EM Equities		39.95	0.5	-1	-9	-14	2
MSCI Frontier Equities		28.32	0.5	1	0	-7	8
EMBIG Sovereign Spread (in bps)		368	2	15	20	42	-46
EM FX vs. USD		61.44	-0.2	0	-2	-8	-1
Major EM FX vs. USD					%, (+) = EM currency appreciation		
China Renminbi		6.91	-0.2	0	-3	-7	0
Indonesian Rupiah		14377	0.0	1	-1	-3	0
Indian Rupee		69.67	-0.2	0	1	-3	0
Argentine Peso		44.82	0.1	1	-1	-45	-16
Brazil Real		4.04	-0.5	1	-2	-8	-4
Mexican Peso		19.11	-0.3	-1	-1	3	3
Russian Ruble		64.62	-0.3	0	0	-4	8
South African Rand		14.63	-1.3	-2	-2	-15	-2
Turkish Lira		6.05	0.2	0	-2	-24	-13
EM FX volatility		8.44	0.0	-0.5	0.3	-0.7	-1.3

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

EM Fund Flows

EM dedicated fund outflows continued for a third straight week during the week ending May 22, albeit at a slower pace, as trade tensions kept investor risk appetite at bay. Large outflows continued for **EM equity funds** (-$4.6 bn, from -$6.0 bn), split equally between ETFs and non-ETFs. **Local currency bonds** saw outflows of $1.1 bn, similar to the previous week, with flows at the 2nd percentile (from 1st percentile last week). **Hard currency bonds**, saw a small recovery with inflows of $39 million, moving up to the 46th percentile (from large outflows the previous week, which were in the 1st percentile). In addition to the relatively heavier positioning of investors in hard currency credit, analyst highlight that the ongoing rally in US treasuries is providing support for hard currency EM bonds compared to their local currency counterparts.

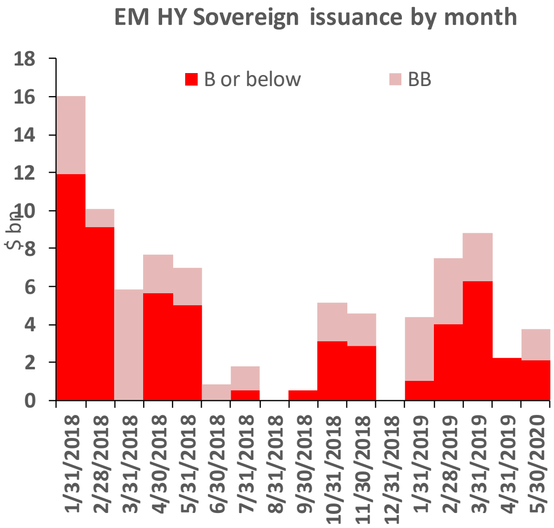
Exhibit 1: EM debt-dedicated local currency funds saw a second week of outflows at US$1.1 billion

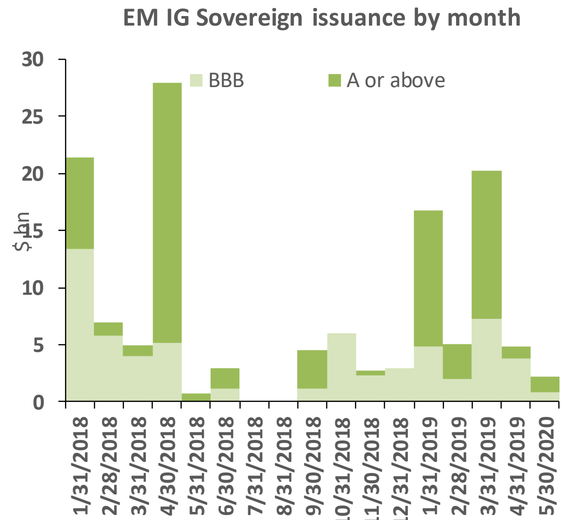


Source: EPFR, Morgan Stanley Research

EM Sovereign Issuance

EM hard currency sovereign issuance has slowed down since the near-record Q1 pace. Investment grade issuance has remained subdued following record issuances by GCC countries in Q1 while High-Yield issuance has picked up pace slightly over the last two weeks (including Guatemala's $1.2 bn issuance last week and Kenya's $2.1 bn issuance on May 15). Last week, Guatemala (Ba1/BB-/BB) returned to the markets after two years issuing a 2030 bond at a 5.1% yield and a 2050 bond at a yield of 6.25%.





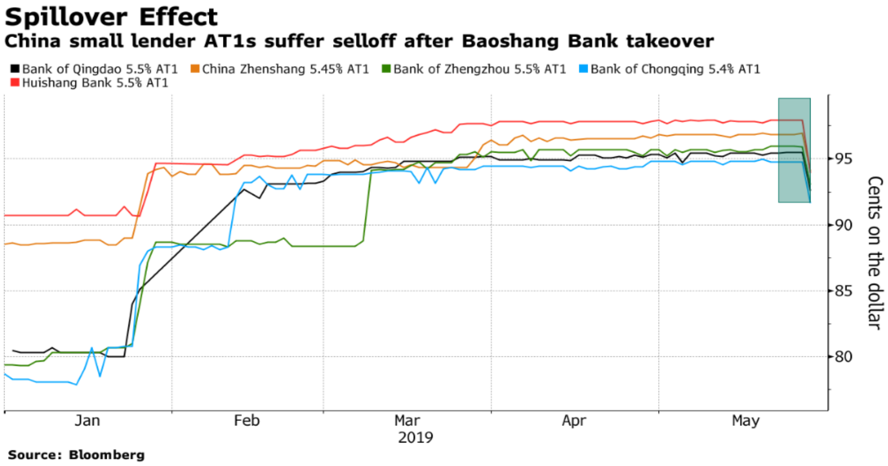
Source: Bondradar

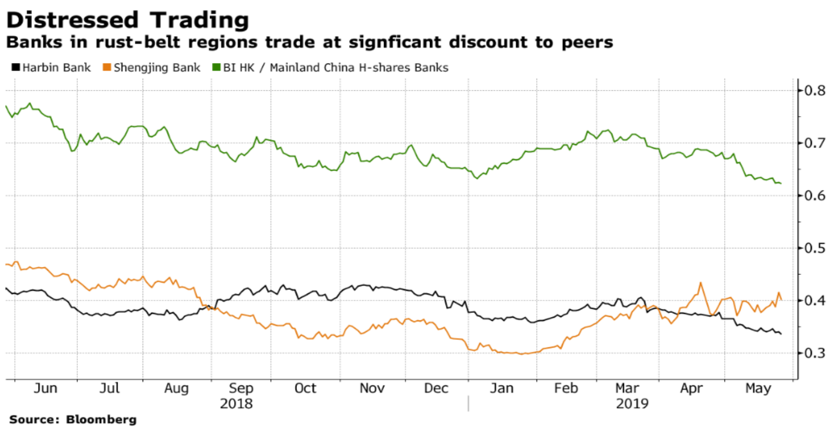
China

Equities gained (Shanghai +0.6%, Shenzhen +0.5%) on the day bouncing at the end of the trading session on MSCI rebalancing. Equities shrugged off comments by President Trump that the US was not ready to reach a trade deal with China and that tariffs on Chinese goods "could go up very, very substantially, very easily".

Chinese regulators on Friday took over a small regional lender. Baoshang Bank, citing severe credit risks. This takeover is the first such case since 1998. China Construction Bank, one of China's largest state-owned banks, has been entrusted with the day-to-day operations of Baoshang Bank to protect the interests of its depositors and customers. Regulators pledged to guarantee all deposits except for corporate deposits and interbank liabilities above RMB50 bn, the repayment of which will be negotiated between the takeover taskforce and creditors. **Interbank repo rates and yields on small bank loss-absorbing bonds (AT1s) jumped on the news**. Regional banks in China's northern rust-belt provinces such as Baoshang Bank are facing risks from a rapid expansion of shadow credit that peaked in 2018. These banks tend to trade at a discount to other Chinese lenders.

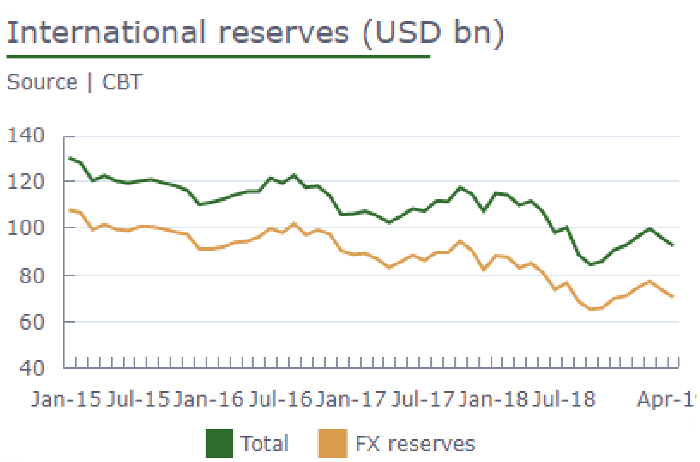
China's National Development and Reform Commission (NDRC) has tightened approvals for property companies and local government financing vehicles (LGFV) seeking quotas for offshore bond issuance since early April, according to Bloomberg. The rules were said to apply mainly to debut property issuers and lower-tier LGFVs. The greater scrutiny follows a rise in Chinese offshore bond issuance so far this year.





Turkey

The central bank increased the reserve requirement ratios on FX deposits by 200 bps for all maturities. The move will drain some $4.2 bn of foreign exchange liquidity from the market. The official statement justified the increase based on financial stability, but analysts thought it was another way to support the lira and strengthen the central bank's FX reserves. The latest official figures showed that gross FX reserve declined 4.3% mom in April to $70.7 bn. Net reserves (excluding short-term borrowing) stands at $13.9 bn, according to Bloomberg data. **Separately, the central bank restarted its 1-week repo auctions.** This means that banks can resume funding at the 24.0% rate instead of the overnight lending rate of 25.5%. The episode marked the second short bout of temporary tightening in the last two months, both lasted two weeks.



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Global Financial Indicators

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Equities					%		%
United States		2826	0.0	-1	-4	4	13
Europe		3342	-0.7	-1	-5	-4	11
Japan		21260	0.4	0	-4	-5	6
China		2910	0.6	0	-6	-7	17
Asia Ex Japan		65	0.1	-1	-9	-15	3
Emerging Markets		40	0.5	-1	-9	-14	2
Interest Rates					basis points		
US 10y Yield		2.28	0.0	-15	-22	-65	-40
Germany 10y Yield		-0.15	-0.7	-9	-13	-50	-39
Japan 10y Yield		-0.07	-0.3	-3	-3	-12	-8
UK 10y Yield		0.93	-2.6	-15	-21	-39	-35
Credit Spreads					basis points		
US Investment Grade		126	0.5	5	15	25	-21
US High Yield		445	0.0	12	48	97	-76
Europe IG		70	1.9	5	12	5	-17
Europe HY		300	4.9	21	52	2	-53
EMBIG Sovereign Spread		368	2.0	15	20	42	-46
Exchange Rates					%		
USD/Majors		97.80	0.2	0	0	4	2
EUR/USD		1.12	-0.1	0	0	-4	-2
USD/JPY		109.3	0.2	1	2	0	0
EM/USD		61.4	-0.2	0	-2	-8	-1
Commodities					%		
Brent Crude Oil ($/barrel)		70	0.4	-3	-2	-7	31
Industrials Metals (index)		113	0.1	0	-5	-17	3
Agriculture (index)		40	1.7	3	3	-20	-4
Implied Volatility					%		
VIX Index (%, change in pp)		16.9	1.0	0.6	4.2	3.7	-8.5
10y Treasury Volatility Index		4.2	-0.2	0.1	0.6	0.4	-0.4
Global FX Volatility		6.7	0.0	0.0	0.3	-1.0	-2.2
EA Sovereign Spreads					10-Year spread vs. Germany (bps)		
Greece		333	3.1	-12	1	-81	-82
Italy		287	4.6	16	26	53	37
Portugal		108	-2.2	-1	-7	-64	-40
Spain		96	-0.3	2	-9	-23	-22

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.

back to top

Emerging Market Financial Indicators

Last updated:	Exchange Rates							Local Currency Bond Yields (GBI EM)						
5/28/2019	Level		Change (in %)					Level		Change (in basis points)				
8:02 AM	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
		vs. USD	(+) = EM appreciation						% p.a.					
China		6.91	-0.2	-0.1	-3	-7	0		3.3	2.5	3	-5	-28	14
Indonesia		14377	0.0	0.7	-1	-3	0		8.1	-1.2	-14	20	36	-9
India		70	-0.3	0.1	0	-3	0		7.3	-4.4	-9	-26	-71	-17
Philippines		52	-0.2	0.4	0	0	1		5.1	0.0	-1	-14	-37	-122
Thailand		32	-0.1	0.2	0	0	2		2.6	1.3	-3	-6	-13	-8
Malaysia		4.19	0.0	-0.1	-1	-5	-1		3.8	-0.2	-2	-1	-48	-28
Argentina		45	0.1	0.9	-1	-45	-16		33.5	0.5	137	678	1422	1054
Brazil		4.05	-0.1	-0.2	-3	-8	-4		7.9	-5.0	-24	-26	-127	-21
Chile		699	-0.6	-0.3	-3	-11	-1		4.1	0.0	-1	0	-75	-39
Colombia		3359	0.0	-0.5	-3	-14	-3		6.3	-0.2	-2	-2	-5	-25
Mexico		19.10	-0.2	-0.4	0	3	3		8.1	1.5	-6	-6	44	-61
Peru		3.4	-0.2	-0.1	-1	-2	0		5.2	-0.1	-7	-16	-48	-52
Uruguay		35	0.2	0.7	-1	-11	-8		11.2	0.0	12	47		51
Hungary		292	-0.3	0.1	-1	-6	-4		2.0	0.1	-8	-8	0	-24
Poland		3.84	-0.1	0.6	0	-3	-3		2.3	-2.1	-7	-5	-28	1
Romania		4.3	0.0	0.3	0	-6	-5		4.3	0.0	1	6	0	7
Russia		64.6	-0.2	-0.3	0	-4	8		7.7	0.1	-8	-28	60	-70
South Africa		14.6	-1.2	-1.4	-2	-15	-2		9.3	4.6	-5	-3	31	-25
Turkey		6.03	0.6	0.4	-1	-24	-12		21.2	0.8	50	61	594	431
US (DXY; 5y UST)		97.8	0.1	-0.3	0	4	2		2.10	-2.0	-13	-19	-66	-41

	Equity Markets							Bond Spreads on USD Debt (EMBIG)						
	Level		Change (in %)					Level		Change (in basis points)				
	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD	Last 12m	Latest	1 Day	7 Days	30 Days	12 M	YTD
								basis points						
China		2910	0.6	0	-6	-7	17		179	0	2	5	-5	-15
Indonesia		6033	-1.1	1	-6	-1	-3		201	0	10	20	2	-35
India		39750	0.2	2	2	13	10		153	-5	-6	-2	-6	-43
Philippines		7761	0.5	1	-1	2	4		86	-1	5	2	-33	-35
Malaysia		1615	0.8	1	-1	-9	-4		128	0	1	3	-16	-34
Argentina		35448	1.0	6	18	24	17		907	1	21	-62	445	92
Brazil		94864	1.3	3	-1	26	8		261	2	11	15	-3	-12
Chile		4850	-0.6	-2	-7	-13	-5		137	0	5	11	-1	-29
Colombia		1480	-0.6	0	-7	-3	12		201	2	11	28	10	-27
Mexico		42491	-0.3	-2	-6	-5	2		317	2	11	27	52	-37
Peru		19669	-0.2	-1	-6	-6	2		143	2	10	17	-17	-25
Hungary		40416	0.5	2	-6	14	3		109	2	15	0	-14	-39
Poland		57169	0.7	1	-6	-2	-1		55	2	13	8	-15	-30
Romania		8370	1.5	3	-1	1	13		206	-1	12	7	57	-15
Russia		2636	0.1	1	3	14	11		210	-1	12	7	3	-42
South Africa		54532	0.1	-2	-7	-4	3		309	-1	3	0	46	-56
Turkey		87349	2.1	2	-8	-18	-4		557	2	42	44	175	128
Ukraine		574	0.0	0	2	28	3		664	16	37	13	201	-123
EM total		40	0.8	-1	-9	-14	2		366	0	13	18	40	-48

Colors denote tightening/easing financial conditions for observations greater than ±1.5 standard deviations. Data source: Bloomberg.