Turkey's coup

By Jan Dehn

President Erdoğan is likely to maintain his economic and political course in Turkey following the failed coup attempt at the weekend. China starts a number of pilot projects for reform of state-owned enterprises amidst stronger economic data. Indonesia's trade surplus more than doubled in size from last month. Prospects for reforms in Brazil improve further with the appointment of the new Lower House President. Malaysia cuts rates and the currency rallies. Argentina's central bank pauses rate cuts. India's macroeconomic situation looks comfortable. Venezuela's President Nicholas Maduro cedes major powers to a pragmatic general. The global backdrop for EM remains positive.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.6	–	4.85%
MSCI EM Small Cap	11.8	–	2.85%
MSCI Frontier	9.3	–	1.15%
MSCI Asia	12.1	–	4.68%
Shanghai Composite	12.4	–	2.41%
Hong Kong Hang Seng	7.1	–	6.04%
MSCI EMEA	9.9	–	5.47%
MSCI Latam	13.2	–	4.30%
GBI-EM-GD	6.24%	–	1.10%
ELMI+	3.40%	–	0.90%
EM FX spot	–	–	0.84%
EMBI GD	5.11%	351 bps	0.47%
EMBI GD IG	3.85%	218 bps	-0.05%
EMBI GD HY	6.91%	540 bps	1.08%
CEMBI BD	5.10%	363 bps	0.39%
CEMBI BD IG	3.91%	245 bps	0.13%
CEMBI BD Non-IG	7.06%	558 bps	0.83%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.2	–	1.51%
1-3yr UST	0.69%	–	-0.15%
3-5yr UST	1.12%	–	-0.49%
7-10yr UST	1.58%	–	-1.42%
10yr+ UST	2.29%	–	-2.92%
10yr+ Germany	-0.02%	–	-2.58%
10yr+ Japan	-0.23%	–	-1.61%
US HY	6.59%	520 bps	1.37%
European HY	4.49%	496 bps	1.24%
Barclays Ag	–	242 bps	-0.40%
VIX Index*	13.00	–	-0.54%
DXY Index*	96.57	–	-0.01%
EURUSD	1.1055	–	-0.03%
USDJPY	105.65	–	2.76%
CRY Index*	188.86	–	1.68%
Brent	47.6	–	2.98%
Gold spot	1329	–	-1.96%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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- **Turkey:** The attempted coup in Turkey at the weekend is unlikely to alter President Erdoğan's plans for his country's future. On one hand, the failed coup is an important milestone for Democracy in Turkey as fundamentally undemocratic elements will now be marginalised, thus reducing the odds of future military-led coups. On the other hand, the mere fact that a coup attempt of this seriousness could happen illustrates the deep political divisions that exist within Turkey, with major fault lines between Gulenists, Deep State, Kurds, Nationalists as well as the old antagonists the Justice and Development Party (AK) and the Republican People's Party (CHP). President Erdoğan has been concentrating power around his person for some time, weakening Turkey's institutions in the process. This may well have been one of the factors motivating the coup organisers. Yet, Erdoğan is not likely to seek reconciliation. Instead, he is likely to use the failed coup as a pretext to further centralise power as he continues to implement his vision of an investment-led development model with himself as its leading prime mover.

The challenges to this very Erdoğan-centric model of development – in addition to the obvious political opposition – are mainly of economic character. Investment-led growth economies in Asia in particular were able to grow strongly on the back of high domestic savings rates and a very technocratic public administrations, which ensured that stable financing was available for investment and that investments were selected and implemented efficiently. Neither condition applies to Turkey, which sources much of its financing from fickle external portfolio flows and where the political elite exercises considerable discretion in project selection and implementation. Turkey's political elite also routinely intervenes in monetary policy decisions, which raises serious questions about the sustainability of Turkey's credit-fuelled development model, especially in the event of higher global interest rates.

In short, while the immediate survival of Democracy in Turkey should be celebrated there is no reason to believe that this event sets Turkey onto a more sustainable economic and political path going forward.

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Emerging Markets

Meanwhile, the failures of Western powers to condemn the coup quickly and to support Erdoğan will, all else even, lead Erdoğan to look eastwards for friends, to Russia, to China, etc. This is a problem for the West. Turkey remains an important NATO member and a pivotal power with enormous influence in all affairs near-Eastern. As such, the West has, through its failure quickly to declare support for the principle of Democracy in Turkey, taken yet another small step in the direction of undermining its own influence in global affairs.

- China: The government has now embarked on one of the most politically sensitive of reforms, namely that of state-owned enterprises (SOEs). SACAC, the agency responsible for oversight of SOEs, has launched seven pilot projects for SOE reform at national level in addition to 147 pilot schemes for reform at local government level. SOEs in China, as elsewhere, tend to be loss-making, inefficient, strong rent-seekers and major employers. Reforming them can therefore be both fiscally and politically challenging. China's overall reform programme is aimed at rotating growth from exports and investment towards consumption and has three elements – interest liberalisation, capital account liberalisation and enhancing productivity. SOE reform is part of the latter, which also includes price liberalisation and protection of property rights. According to China's National Bureau of Statistics, China currently has about 130,000 SOEs. This is roughly 1.5% of all Chinese enterprises. In 2015, they accounted for about 15% of the total employment in urban areas.

The latest crop of macroeconomic data releases was stronger than expected. The headline figure of 6.7% yoy real GDP growth in Q2 was better than expected (6.6% yoy) and shows yet again that the 'hard landing' crowd was wrong. One wonders how many times analysts can 'cry wolf' about a hard landing and still retain credibility. Chinese industrial production in June was also stronger than expected, at 6.2% yoy versus 5.9% yoy expected. Importantly, retail sales – a good proxy for consumption – were up 10.6% yoy in June versus 10% yoy in May and 9.9% yoy expected, while fixed asset investment slowed to 9.0% yoy in June from 9.6% yoy in May. This is exactly what investors should expect given the overall direction of reform. Money supply, particularly broader aggregates such as M1 and M2, were also higher than expected as was total financing to the economy. China's trade surplus was USD 48.1bn in June versus USD 45.7bn expected. The twelve month moving average is now USD 50bn per month, up from about USD 20bn per month in 2014.

China's bond market is now USD 8.65trn. It has grown sharply as local governments continue a massive programme of converting non-tradable loans into tradable municipal bonds. Some 60% of the conversion is now completed and the municipal bonds market in China has reached a size of USD 1.23trn, according to Linan Lui, a respected China strategist. Demand for Chinese fixed income continues to be dominated by commercial banks (bought 59% of the market supply year to date), while asset managers bought 31% of the new supply. Offshore institutional investors still own only about 1.55% of total outstanding as of June 2016. Most investors are waiting for index inclusion. We think investors should not be constrained by the internal decisions of investment banks regarding whether or not to include this market in their indices. The fact remains that China's government bonds have outperformed US government bonds since 2014, in Dollar terms.

The Permanent Court of Arbitration (PCA) in The Hague has ruled that China has no claim to islands in the South China Sea that have become a source of dispute with the Philippines and, by proxy, the United States. China rejected the verdict of the tribunal. We do not think there is much that anyone can do to change China's mind on the question. Indeed, China's response is 100% consistent with the response of other permanent members of the UN Security Council, none of which have ever complied with even a single ruling by the PCA on the Law of the Sea, according to experts on the matter.

- Indonesia: The trade surplus nearly tripled to USD 900m in June on the back of stronger than expected exports. Imports also performed better than expected. Like many other EM countries, Indonesia's external accounts have been improving sharply in recent years due to weaker currencies and low inflation, which has significantly increased competitiveness, especially versus the US. Indonesia's trade deficit reached a trough of USD 2.3bn in July 2013.

- Brazil: Rodrigo Maia has been elected to the post of interim president of the Lower House with the support of the all parties that were in opposition to President Dilma Rousseff. The president of the Lower House has an important role to play in reforms, because of the administrative powers vested in his office. Meanwhile, the economy remains soft amidst declining inflation rates, which supports the case for local fixed income.

- Malaysia: The central bank surprised the markets by cutting the policy rate by 25bps to 3.0% and lowered its inflation forecast from 2.5%-3.5% to 2.0%-3.0% for 2016. The currency rallied following the rate cut. MYR has rallied 8.2% versus the USD this year, while inflation has been under control. Malaysia's bond markets were under pressure last year due to political noise and concerns that Malaysia's economy would suffer due to low oil prices. Malaysia, however, has managed the shock well. The domestic bond market is now one of many Asian markets which have considerable room to cut rates. The local bond markets in Malaysia, alongside those of Indonesia, offers the best value in Asia, in our view. Industrial production rose 2.7% yoy in May versus 2.5% yoy expected.

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- **Argentina:** The central bank stopped cutting rates following higher than anticipated consumer prices inflation in June. The central bank maintained the 35-day Lebac rate at 30.25%, unchanged from last week. CPI inflation was 3.1% mom in June versus 2.8% expected. We also think demand for Dollar bonds from Argentina is suffering from a bit of indigestion following a rapid pace of supply, thus slowing the pace of Dollar inflows to Argentina. Even so, short-dated local yields around 30% make for an attractive carry, in our view.

- **India:** The macroeconomic situation in India remains benign. Inflation in June was unchanged at 5.8% yoy, while industrial production picked up smartly (1.2% yoy vs -0.3% yoy expected). Much attention has been given to Central Bank Governor Raghuram Rajan's departure. We think concerns are misplaced. The government has secured a narrow majority in favour of the GST reform, but there is not enough political capital to do both GST and recapitalisation of public banks, the latter being a key objective of Rajan. Hence, Rajan's departure is not a question of monetary policy management, in our view, and we do not think macroeconomic stability is under threat at all.

- **Venezuela:** President Nicholas Maduro has given sweeping political powers to a senior member of military. Defense Minister General Vladimir Padrino Lopez will oversee all government ministries, thus placing him a position to dictate policy. We think this represents a genuine shift in power away from Maduro towards Lopez, who, in our view, is far more pragmatic than Maduro. Hence, this is a positive development from the perspective of the likely direction of economic policy, in our view.

Snippets:

- **Chile:** The central bank left rates unchanged at 3.5% in line with expectations.
- **Costa Rica:** Inflation was negative in June. CPI dropped at a pace of 0.9% yoy.
- **Croatia:** The President has called early elections for 11 September, while S&P, the ratings agency, affirmed Croatia's rating at BB with negative outlook.
- **Ecuador:** The fourth quarter current account deficit narrowed to 1.3% of GDP in Q1 2016 from 2.1% in Q4 2015.
- **El Salvador:** Real GDP was 2.5% yoy in Q2 2016, up from 2.2% yoy in Q1 2016.
- **Iraq:** The World Bank extended USD 3bn in guaranteed loans to Iraq.
- **Kazakhstan:** National Bank of Kazakhstan cut the policy rate by 200bps to 13.00%.
- **Mexico:** Industrial production rose 0.4% yoy in May. This was weaker than expected (1.6% yoy)
- **Nigeria:** The rate of CPI inflation rose to 16.5% yoy in June from 15.6% yoy in May.
- **Peru:** The central bank left rates unchanged at 4.25%.
- **Philippines:** Remittances were up 1.9% yoy in May versus 4.8% yoy expected. The slowdown in remittances from USD 2.21bn to USD 2.18bn may be related to the recent election. Exports also declined at a pace of 3.8% yoy in May, which was a moderation from the -4.1% yoy pace in April.
- **Russia:** The trade surplus was USD 7.5bn in May versus USD 7.2bn expected. The current account surplus in Q2 was USD 3.4bn. Russia's FX reserves increased marginally and are now nearly back to USD 400bn. As of July 8, FX reserves reached USD 395bn after bottoming out at USD 350bn in March 2015.
- **Singapore:** The economy expanded at a rate of 2.2% in Q2 2016, up from 2.1% in Q1 2016. Retail sales for May were also stronger than expected at 3.0% yoy versus 1.9% yoy expected.
- **South Africa:** Retail sales surged 3.4% in May (in seasonally adjusted terms).
- **South Korea:** The Bank of Korea left rates unchanged at 1.25%. Unemployment declined to 3.6% in June from 3.7% in May and April.
- **Turkey:** Industrial output increased 1.6% mom in May versus a consensus expectation for a monthly rise of 1.0%. The current account deficit narrowed to USD 2.9bn in May from USD 3.0bn in April. The deficit was USD 4.3bn in May of 2015.

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Global backdrop

The global backdrop remains positive for EM. Fundamentals, valuations and technicals strongly favour EM after years of QE-induced distortions in financial markets. In addition, the data out of China and the US are both better, while Japan, Bank of England and the ECB may ease further. Expectations of a major shift towards greater fiscal stimulus across the developed world are increasing and uncertainties about the fallout from Brexit plus political uncertainty in the US will keep the Fed on the side lines.

The Bank of England decided to wait for evidence of an economic slowdown before cutting interest rates, but indicated that a rate cut is highly likely in August. The Brexit vote is still so recent that very little hard data has yet become available to evaluate the impact of the Brexit decision, but we expect a significant slowdown in the UK economy to materialise over the next twelve months due to uncertainties surrounding the relationship with Europe as well as political uncertainty within the UK. Moreover, the dramatic weakening of GBP will undermine real incomes as imported goods become more expensive, while a pick-up in exports may be delayed due to J-curve effects and the lingering uncertainty surrounding trade and other relations with Europe and the rest of the world. Prime Minister Theresa May's appointment of strong supporters of Brexit to all ministerial posts whose portfolios pertain to the rest of the world indicates a hawkish stance towards the rest of the world. In turn that means that the government will have to rely more on domestic demand as the main source of growth in the coming years, something that can only happen with yet more fiscal spending and higher levels of debt.

The trend towards more fiscal spending is also likely to be replicated in Japan and the United States as monetary stimuli become progressively less potent. There is now widespread speculation about Helicopter Money in Japan, and in the US, Hillary Clinton last week said she would expand health care subsidies, support free education for students and unleash the largest public investment programme since the Second World War. This raises the prospect of massive additional supply of developed market bonds, which makes for an unattractive investment proposition at current low bond yields.

We remain convinced that Brexit will not adversely impact EM, because the UK is just 2% of global GDP. In fact, the lingering uncertainty surrounding the economic consequences of Brexit on the UK and potentially on Europe may keep the Fed on the side lines. Fed officials have also begun to signal that the US election may become a bigger drag on the US economy. Dennis Lockhart, President of the Federal Reserve Bank of Atlanta, said last week that US election uncertainty may adversely influence investment decisions of US firms. This places the US election front and centre in US monetary policy decisions. Hence, even as the US data stabilises after a weak Q1 – evidenced by stronger retail sales, industrial production and, worryingly, inflation – the Fed may yet keep rates at very low levels.

Germany auctioned 10 year bonds with negative yields for the first time last week. We think Brexit should prompt investors to question whether they are being adequately compensated for the risks they are taking by investing in such negative yielding bonds. Brexit should lead to greater flows into EM, where bond yields are much higher and where the macroeconomic fundamentals are demonstrably stronger.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.28%	11.08%	-4.88%	-0.33%	-2.50%
MSCI EM Small Cap	3.03%	4.49%	-6.50%	0.75%	-1.51%
MSCI Frontier	1.42%	0.92%	-10.49%	0.18%	1.66%
MSCI Asia	4.11%	6.44%	-4.64%	3.09%	1.12%
Shanghai Composite	5.15%	-12.21%	-18.10%	16.78%	4.17%
Hong Kong Hang Seng	4.24%	-2.50%	-19.13%	2.48%	-2.12%
MSCI EMEA	4.87%	17.17%	-8.33%	-5.23%	-5.92%
MSCI Latam	3.87%	30.53%	-2.75%	-6.50%	-8.55%
GBI EM GD	0.90%	15.05%	3.01%	-3.38%	-2.01%
ELMI+	0.48%	6.32%	0.10%	-2.98%	-2.62%
EM FX Spot	0.16%	5.42%	-5.81%	-9.88%	-8.95%
EMBI GD	2.02%	12.54%	11.71%	7.60%	6.83%
EMBI GD IG	1.63%	12.01%	10.00%	6.92%	5.93%
EMBI GD HY	2.47%	12.97%	13.78%	8.41%	8.11%
CEMBI BD	1.32%	9.23%	6.46%	6.03%	5.50%
CEMBI BD IG	1.05%	7.48%	6.28%	6.02%	5.64%
CEMBI BD Non-IG	1.78%	12.25%	6.41%	5.79%	5.25%

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	3.08%	7.04%	4.86%	11.01%	12.82%
1-3yr UST	-0.19%	1.46%	1.28%	0.76%	0.69%
3-5yr UST	-0.39%	3.38%	3.64%	2.61%	1.89%
7-10yr UST	-0.64%	7.02%	8.85%	5.28%	5.11%
10yr+ UST	0.20%	15.85%	20.89%	11.63%	10.81%
10yr+ Germany	-2.07%	15.51%	18.35%	12.04%	11.50%
10yr+ Japan	-0.93%	15.65%	20.61%	10.31%	7.86%
US HY	2.77%	12.08%	4.21%	4.62%	6.26%
European HY	1.82%	5.62%	3.65%	6.98%	9.45%
Barclays Ag	0.83%	7.42%	7.91%	5.36%	5.37%
VIX Index*	-16.83%	-28.61%	8.79%	-5.59%	-37.95%
DXY Index*	0.44%	-2.09%	-1.32%	16.59%	27.93%
CRY Index*	-1.93%	7.22%	-11.97%	-34.99%	-45.07%
EURUSD	-0.43%	1.83%	2.12%	-15.68%	-21.67%
USDJPY	2.37%	-12.00%	-14.99%	5.19%	33.67%
Brent	-4.13%	27.76%	-16.58%	-56.18%	-58.96%
Gold spot	0.50%	25.20%	21.17%	3.47%	-17.20%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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