EM and the US election

By Jan Dehn and Gustavo Medeiros

Regardless of who wins the US presidential election, EM looks poised for continued outperformance due to improving absolute and relative fundamentals, higher yields and sound technicals. The short-term market dynamics may be different depending on who becomes the next US president, but we expect the winner to be inevitably and severely constrained both politically and economically. In Argentina, government policy shifts decisively from targeting economics to targeting politics as the 2017 mid-term election draws nearer. In Egypt, the government belatedly decides to swallow the IMF medicine. In addition to the snippets, the Weekly discusses former US Treasury Secretary Larry Summers' proposal to end Fed independence.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.7	–	-2.57%
MSCI EM Small Cap	11.8	–	-2.85%
MSCI Frontier	10.4	–	-0.45%
MSCI Asia	12.4	–	-1.82%
Shanghai Composite	13.0	–	0.68%
Hong Kong Hang Seng	7.8	–	-0.24%
MSCI EMEA	9.4	–	-2.93%
MSCI Latam	14.2	–	-5.17%
GBI-EM-GD	6.38%	–	-0.46%
ELMI+	3.76%	–	0.00%
EM FX spot	–	–	-0.46%
EMBI GD	5.29%	349 bps	-0.26%
EMBI GD IG	4.00%	215 bps	-0.19%
EMBI GD HY	6.95%	526 bps	-0.34%
CEMBI BD	5.06%	345 bps	-0.16%
CEMBI BD IG	3.97%	236 bps	-0.02%
CEMBI BD Non-IG	6.81%	520 bps	-0.38%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	-1.89%
1-3yr UST	0.83%	–	0.15%
3-5yr UST	1.29%	–	0.40%
7-10yr UST	1.82%	–	0.65%
10yr+ UST	2.60%	–	1.08%
10yr+ Germany	0.17%	–	0.86%
10yr+ Japan	-0.05%	–	0.48%
US HY	6.54%	505 bps	-1.10%
European HY	4.17%	455 bps	-0.36%
Barclays Ag	–	243 bps	0.17%
VIX Index*	22.51	–	6.32%
DXY Index*	97.60	–	-0.85%
EURUSD	1.1062	–	0.74%
USDJPY	104.43	–	-0.37%
CRY Index*	182.50	–	-6.70%
Brent	46.3	–	-4.20%
Gold spot	1289	–	0.91%

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

Emerging Markets

The US election has become a major media event, but so far it has failed to move Emerging Markets (EM) asset prices very much with the sole exception of the Mexican Peso, which has become a favourite vehicle of many investors to express their views about the election outcome. EM fundamentals have been even less impacted. Still, given the uncertainty about the outcome of the election it is prudent to consider each of the two most likely scenarios. In no particular order:

- **Donald Trump wins:** Risk aversion rises temporarily and EM may underperform in the initial market reaction. Investors should fade the sell-off immediately after the election and add EM and global HY.
- **Hillary Clinton wins:** Solid broad-based relief rally with possible significant EM outperformance. Investors should fade the rally in the most expensive markets, that is the QE-buoyed markets, but remain long EM, which remains the better place to be invested in what is likely to be a status quo environment.

We expect that Donald Trump would have the support of the House of Representatives.[1] He would seek to cut taxes for corporates and aim to develop more infrastructure investment. Forget the wall with Mexico and other anti-immigration rhetoric. We think the actual policy changes will be slow and less extreme than expected. Hence, you could consider buying into bouts of risk aversion, especially EM.

If Hillary Clinton wins, we expect her presidency to born under a cloud of controversy due to the email scandal, which is likely to rear its head again despite a late reprieve from the FBI. She will start her presidency as one of the least trusted presidents in history. Without the support of the House of Representatives she faces the prospect of being a lame duck from day one. She will seek to raise taxes for the rich but since she may not be able to achieve much domestically she is likely to focus on foreign policy. Investors should therefore fade the rally in heavily inflated QE-supported markets and continue to rotate into EM markets, which have much more upside potential.

[1] The Trump-Ryan Show – see *"The Coming Trump Pitch"*, Weekly Investor Research, 16 May 2016.

Continued overleaf

Emerging Markets

The EM fundamental and technical backdrop remains solid. The political dynamics are sharply contrasting between EM and developing countries. In the latter, rising inequality and slowing growth is fuelling populism, which in turn is feeding into even worse economic policies. By contrast, the EM growth premium is now rising, which, by easing political constraints, is generally positive for reforms and the quality of economic policies in general. EM have undertaken significant external adjustment since 2013, so most countries are now also much less vulnerable to external shocks.

EM assets continue to show remarkable resilience in the face of shocks. The US presidential election is the fourth major source of risk in 2016 which, under other circumstances, could conceivably have led to a material sell-off in EM assets, but has not (the other three examples being the market pricing in three Fed hikes back in April, the Brexit shock and the Turkish coup attempt). EM asset prices are proving resilient in the face of uncertainty due to a combination of high yields (in both absolute and relative terms) and very good technicals. Many investors who normally buy and sell EM assets solely in response to headlines – retail, cross-over, hedge funds and banks included – are either lightly positioned or entirely out of the market. This is why there is little selling in response to risk-off events in developed economies. The remaining investors – real money – tend to buy on dips, which tends to limit the downside risks. The strong technicals also imply that should risk appetite return, there is plenty of room for upside. Returns should be far better in EM than in developed markets.

- Argentina: The government last week introduced its first political reform to parliament. The reform will, if passed, require political parties to list all their candidates individually instead of just political party lists. The reform is intended to end the tendency for block voting in favour of the Peronists, Argentina's largest party. The submission of the political reform to parliament signals a pause in economic reforms in Argentina as the government's focus now shifts decisively to mid-term elections next year. President Mauricio Macri's approval rating rose to 51.4% in a poll published last week, up from 46.7% in July. Economic reforms aside, we expect the current economic strategy of combining monetary tightening with fiscal easing and measures to attract capital from abroad to continue. The 2017 Budget was approved last week with a target fiscal deficit of 4.2% of GDP, which is only marginally tighter than this year's expected deficit of 4.7% of GDP, while the central bank left interest rates at 26.75%. The tax amnesty designed to encourage Argentinians to bring money back to the country has so far resulted in some USD 4.6bn in declared overseas deposits, which puts the government on track to achieve about USD 50bn of declared overseas capital. The government is in position to pursue easy fiscal policy, because debt levels are low.

- Egypt: After extensive prevarication, the Egyptian government finally decided to swallow the prescribed IMF medication required to restore macroeconomic equilibrium. The currency will be floated and the central bank has hiked interest rates materially. This is the classic response to an external demand shock and should materially improve Egypt's medium-term macroeconomic outlook, although, in the near-term there will be significant pain. A small number of commodity dependent EM countries sought to delay adjustment following the decline in commodity prices in mid-2014, including Nigeria. They have since been forced to take action and all of them now face bigger challenges than if they had acted promptly. In general, EM countries are usually not given much time to mismanage their macroeconomic policies, since there is very little tolerance for macroeconomic instability among voters, who tend to be poor, without inflation hedges, unemployment benefits or other types of social security. The fact that EM countries are forced to address imbalances early is one of the structural advantages that make EM countries safer places to invest than developed economies, especially over the long-term.

Snippets:

- Brazil: The trade surplus reached USD 2.3bn in October, thus taking the year to date trade surplus to USD 38.5bn and the twelve-month trade surplus to USD 46bn (the highest reading since records began in 1992). Industrial production rose 0.5% mom sa in September.
- China: Both the official and Caixin services PMIs rose in October. Caixin services PMI rose to 52.4 from 52 in September, while the official services PMI rose to 54 from 53.7. The official manufacturing PMI also rose to 51.2 from 50.4.
- Colombia: October CPI inflation was -0.06%mom, which was substantially below expectations (+0.11% mom). Inflation is running at a rate of 6.46% yoy, but declining fast.
- Ghana: The government has announced its intention to issue a maiden 10 year local currency bond.
- Hong Kong: The government raised residential property stamp duty substantially from a tier of rates ranging from 1.5% to 8.5% to a unified rate of 15%. The decision shows that authorities are keen to stamp out potential bubbles before they become destabilising. Hong Kong's PMI index declined to 48.2 in October from 49.3 in September.
- Hungary: Moody's raises Hungary's sovereign debt rating to investment grade.
- India: Federal and state ministers have agreed the tax rates that will be applied in the new GST regime.

Continued overleaf

Ashmore

Emerging Markets

The tax rates will now be subject to a vote in parliament in the coming winter session. Approval looks likely. So far, the GST reform has cost Prime Minister Modi less political capital than many expected. The PMI index rose to 54.5 in October from 52 in September.

- Indonesia: Inflation was 3.3% yoy in September, in line with expectations. Real GDP expanded at a rate of 5.02% yoy in Q3 2016, which was marginally slower than Q2 2016 (5.18% yoy).
- Ivory Coast: The Constitutional Court upheld the results of a referendum that lifted age limits and certain nationality restrictions pertaining to eligibility to run for the office of president. The referendum also approves the creation of a position of Vice-president and a Senate (bicameral system). Finally, the new constitution allows for constitutional changes to be approved with 2/3 majority in parliament rather than a referendum as was previously the case. This is a victory for President Ouattara. The new constitution was approved with 93% backing and 42% turnout.
- Malaysia: The trade surplus narrowed to MYR 7.6bn in September from MYR 8.5bn in August. Prime Minister Najib visited China and looks set to form closer ties with the country, possibly at the expense of the country's ties with the United States. The US Department of Justice has filed charges of money laundering against Najib.
- Mexico: Gross fixed investment rose at a pace of 1.3% yoy, which was better than anticipated (0.9% yoy). PMIs weakened, however. Remittances of Dollars back to Mexico from migrant Mexican workers based in the US hit a record high of USD 2.4bn in September. The rise in remittances probably reflects fears among many Mexican migrant workers that they will be barred from sending money home in the event of a Trump victory. A ban on remittances would inflict untold suffering on countless of the poorest families in Mexico.
- Peru: CPI inflation was 0.41% mom in October versus 0.16% mom expected, mainly due to higher than expected food prices.
- Philippines: Headline inflation was stable at 2.3% yoy in October (unchanged from September). The Manufacturing PMI was strong at 56.5 in October.
- Russia: Inflation continues to decline. In October, the rate of CPI inflation declined to 6.1% yoy from 6.4% yoy in September. The central bank remains hawkish and has promised not to resume rate cuts until next year. Even so, manufacturing managed to surge with manufacturing PMI rising to 52.4 in October from 51.1 in September.
- South Korea: President Park Geun-hye remains under considerable political pressure following revelations of influence peddling. Two aides have been arrested and public protesters are calling for Park's resignation. Two public apologies by the president have not appeased her opponents. Exports were down 3.2% yoy in September versus -3.1% yoy expected. A change in electricity tariffs pushed inflation in October to 1.3% versus 1.1% yoy expected.
- Sri Lanka: The government hiked VAT from 11% to 15%, thus keeping IMF on side. Sri Lanka's perennial problem is fiscal profligacy. The VAT hike therefore addresses a key Sri Lankan ailment from a bond investor's point of view.
- Taiwan: The PMI index rose to 52.7 in October from 52.2 in September.
- Thailand: October CPI inflation moderated to 0.3% yoy versus 0.4% yoy expected.
- Turkey: S&P raised the outlook for Turkish sovereign debt to stable from negative.

Global backdrop

Influential former US Treasury Secretary Larry Summers has called for the independence of the US Federal Reserve to be abolished. It would not be the first time that the Fed's independence was infringed; indeed, at various points in the past the Fed has been entirely abolished. It is important to remember that the Fed is perhaps the most fragile institution in the United States. Summers' call for removal of Fed independence is based on his view that fiscal and monetary authorities need to coordinate policies much more closely than they have been doing so far, a euphemistic way of saying that the fiscal authorities need to increase debt issuance dramatically and that the Fed should buy the bonds. This is indeed the likely direction policy will take in the US and other developed economies in the years ahead. While much attention is being paid to who will win the US presidential election, we think either candidate would be severely constrained politically and economically in terms of what they can achieve.

Markets are likely to be far more impacted by other developments in 2017, notably the shift from monetary to fiscal stimulus (to which Summers is alluding) and the resumption of inflation in the US. Both these changes will pose major risks for the long end of yield curves in developed economies following strong rallies in 2016. This shift from fiscal to monetary stimulus will change the US government into an issuer of debt rather than a buyer of debt, turning the technical dynamic in the bond market entirely on its head. The return of inflation – clearly already evident in above-target core CPI inflation and rising wage inflation in last week's payroll report – will put pressure on yields to rise at the long end of the curve. Never before in US history (as far as we know)

Continued overleaf

Ashmore

Global backdrop

has the US economy hit full employment with the Fed funds rate at just 25-50bps (we expect another rate hike in December as the Fed seeks to maintain the current pace of hikes of 25bps per year). It would take the Fed nearly ten rate hikes just to get back to neutral, something we, as well as the market, think is quite unlikely to happen. After all, the Dollar is already overvalued, financial markets are well into bubble territory and the economy is growing far too slowly to handle material increases in real interest rates due to very low productivity growth; newly released data last week showed that US productivity is now negative on a yoy basis for the second consecutive quarter.

As far as EM is concerned, if, as we suspect, the increase in long yields in developed markets next year will be accompanied by higher inflation then real rates should remain contained. This should broadly inoculate EM from bear steepening, as has been the case in the two bouts of bear steepening so far this year.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.74%	13.38%	4.15%	-2.40%	0.45%
MSCI EM Small Cap	-2.69%	4.71%	0.83%	-0.86%	2.20%
MSCI Frontier	0.12%	1.95%	-2.55%	-1.08%	4.01%
MSCI Asia	-1.66%	9.17%	2.83%	1.39%	4.14%
Shanghai Composite	0.80%	-9.88%	-7.79%	15.90%	6.96%
Hong Kong Hang Seng	-0.70%	2.48%	-6.25%	-0.15%	1.51%
MSCI EMEA	-4.14%	13.28%	-3.14%	-9.10%	-3.40%
MSCI Latam	-5.67%	37.37%	22.17%	-7.97%	-5.71%
GBI EM GD	-0.87%	15.07%	9.59%	-3.67%	-1.15%
ELMI+	-0.11%	6.45%	3.52%	-3.28%	-1.46%
EM FX Spot	-0.74%	4.21%	-0.10%	-9.97%	-7.62%
EMBI GD	-0.22%	13.10%	10.79%	6.87%	6.36%
EMBI GD IG	-0.11%	11.11%	8.88%	6.02%	4.99%
EMBI GD HY	-0.34%	15.24%	12.84%	7.60%	8.24%
CEMBI BD	-0.19%	10.89%	8.55%	5.66%	5.97%
CEMBI BD IG	-0.06%	8.11%	6.74%	5.41%	5.43%
CEMBI BD Non-IG	-0.41%	15.67%	11.57%	5.76%	7.06%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.87%	3.88%	1.38%	7.90%	13.11%
1-3yr UST	0.11%	1.57%	1.43%	0.75%	0.66%
3-5yr UST	0.30%	3.45%	3.33%	2.16%	1.60%
7-10yr UST	0.50%	6.08%	5.97%	4.77%	3.31%
10yr+ UST	0.42%	10.41%	10.53%	10.19%	5.30%
10yr+ Germany	0.71%	12.44%	11.38%	11.70%	8.50%
10yr+ Japan	0.36%	11.48%	13.62%	7.58%	6.53%
US HY	-0.84%	14.59%	8.87%	4.25%	7.02%
European HY	-0.31%	8.10%	5.72%	5.83%	10.61%
Barclays Ag	0.09%	7.76%	7.41%	4.88%	5.07%
VIX Index*	31.95%	23.61%	57.08%	61.83%	-24.59%
DXY Index*	-0.86%	-1.05%	-1.58%	20.72%	26.81%
CRY Index*	-2.02%	3.61%	-4.47%	-33.19%	-43.19%
EURUSD	0.74%	1.90%	2.88%	-17.56%	-19.70%
USDJPY	-0.37%	-13.02%	-15.22%	6.45%	33.80%
Brent	-4.20%	24.11%	-2.43%	-55.28%	-59.61%
Gold spot	0.91%	21.43%	18.00%	-1.43%	-28.20%

*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.

Continued overleaf

Ashmore

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 347 0649

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

Other locations
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper