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Ashmore

Fade irrational Trump exuberance

By Jan Dehn

The material moves in EM asset prices and currencies following the Trump election victory are a market over-reaction and misdirected at EM. Markets are likely to take some time to form a consensus about America's path under a Donald Trump presidency. We think the EM sell-off will soon abate and buyers will return, attracted by the sudden cheapness. We also see no fundamental reasons to be worried about EM at this juncture. EM investors should therefore exploit the opportunity created by irrational Trump exuberance to buy. Having said that, there is no room for complacency among developed market investors. If Trump follows through on his election promises we see good reasons to believe that the 35-year rally in developed market fixed income is over.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.4	–	-3.51%
MSCI EM Small Cap	11.5	–	-1.96%
MSCI Frontier	10.5	–	-0.42%
MSCI Asia	12.1	–	-2.15%
Shanghai Composite	13.3	–	2.27%
Hong Kong Hang Seng	7.6	–	-0.61%
MSCI EMEA	9.3	–	-2.92%
MSCI Latam	13.1	–	-10.36%
GBI-EM-GD	6.77%	–	-5.69%
ELMI+	4.28%	–	-1.95%
EM FX spot	–	–	-3.93%
EMBI GD	5.60%	347 bps	-2.10%
EMBI GD IG	4.31%	211 bps	-2.34%
EMBI GD HY	7.27%	523 bps	-1.82%
CEMBI BD	5.28%	332 bps	-0.95%
CEMBI BD IG	4.19%	223 bps	-1.11%
CEMBI BD Non-IG	7.01%	506 bps	-0.70%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	3.87%
1-3yr UST	0.98%	–	-0.30%
3-5yr UST	1.65%	–	-1.13%
7-10yr UST	2.23%	–	-2.85%
10yr+ UST	3.01%	–	-6.31%
10yr+ Germany	0.35%	–	-3.06%
10yr+ Japan	-0.01%	–	-0.75%
US HY	6.59%	483 bps	-0.19%
European HY	4.00%	442 bps	-0.06%
Barclays Ag	–	240 bps	-1.32%
VIX Index*	14.17	—	-8.34%
DXY Index*	99.48	–	1.70%
EURUSD	1.0792	–	-2.26%
USDJPY	107.60	–	3.00%
CRY Index*	180.74	–	-1.76%
Brent	44.9	–	-2.73%
Gold spot	1225	–	-4.45%

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

Emerging Markets

EM's reaction to Trump

Don't be fooled! The material moves in Emerging Markets (EM) asset prices and currencies following the Trump election victory are due to the market overreacting. Overreactions of this kind are, of course, common to the asset class – as we warned in a publication prior to Trump's election victory.[1] As in previous such episodes we believe investors are likely to be proven wrong if they sell and be rewarded handsomely if they put money to work at the better entry levels.

That is not to say that investors should be complacent. The market reaction to Trump's victory may be excessive and somewhat irrational in EM, but it should be viewed as a harbinger of much larger and serious problems that threaten fixed income in developed markets. Specifically, if Trump follows through on his election promises we see good reasons to believe that the 35-year rally in developed market fixed income is over.

The end of the fixed income rally in developed markets is obviously no trivial matter. After all, long bond yields, for example in the US fell from an intra-year high of more than 15% in 1981 to a low of just 2.1% by mid-2016, negative yields in real terms. Unfortunately, consumers did not save in the face of lower borrowing costs. Rather, they increased spending. Since 1981 the US has doubled its debt to GDP ratio from 161% to 331% of GDP (more than 600% of GDP if one includes unfunded pension liabilities and the present value of Medicare deficits for the next 20 years).[2] The rise in debt has also been accompanied by a sharp decline in productivity, which has contributed to a slowdown in the average growth rate across developed countries by more than 40% since 2008/2009. This means, of course, that prospects of growing out of the debt problem have deteriorated rather than improved over the period.

[1] See *"EM and the US election"*, Weekly Investor Research, 7 November 2016.
[2] We recent dubbed this year's rally in the long end of developed markets bonds *"The Last QE trade"*, Weekly Investor Research, 31 October 2016.

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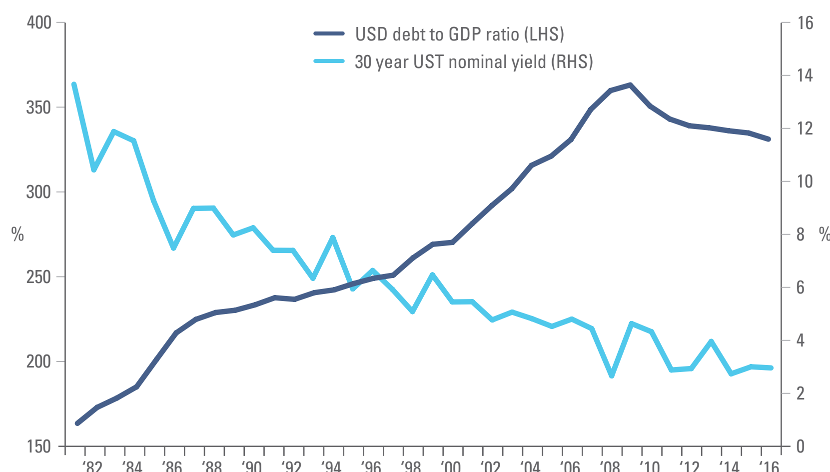
Fig 1: **US debt to GDP and nominal 30 year bond yields (annual averages)**



Source: Ashmore, Bloomberg, Federal Reserve.

Markets are likely to take some time to form a consensus about America's path under a Donald Trump presidency. Trump has not yet had time to be very specific about his policy priorities. Most of his team has not yet been appointed and his ability – or otherwise – to work with Congress remains to be determined. Pending more explicit policy prescriptions from President-elect Donald Trump we think the following broad features can be expected:

1. Focus shifts from social to economic issues

Trump's messages on social issues during the election campaign were divisive but effective. Now that he is in power he will have to deliver improvements in actual living standards for hard-working American families. This, of course, cannot be done by persecuting minorities, because they were not the root of the problem in the first place. The only way to improve the economy is to address the economy. Hence, expect the social rhetoric to be toned down and the focus to shift to economic issues.

2. Focus firmly on domestic rather than foreign issues

The hard reality facing most US presidents is that their political capital peaks in their first term, which is why they focus on domestic policy issues first. Foreign policy is almost always relegated to the second term, when there is no more political capital to push reforms through Congress. Trump will face the same constraints. Given that Trump is likely to have an extensive domestic policy agenda, we think his focus will very much be on domestic matters and not, as many think, imminent trade wars and other foreign policy related issues. Trump's domestic policy objectives include whole and partial repeals of financial regulation, climate change commitments and Obamacare in addition to corporate tax reform and infrastructure spending programmes. On the external front, we expect TPP not be ratified, which should not surprise anyone. Apart from that we expect protection to be afforded mainly to selected inefficient American industries with large labour forces, such as steel.

3. Bigger fiscal deficits

President Reagan's fiscal expansion is likely to be an inspiration for Trump, who has borrowed and built all his life. However, Trump will face three challenges when it comes to spending more. First, the US economy is already at full employment and inflation already exceeds the Fed's 2% target (core CPI is 2.2% yoy). Second, debt levels are twice as high as when Reagan began to spend. Reagan started his spending spree with a total US debt stock of 161% of GDP and eventually took the total debt stock to 262% of GDP by 1989. Trump starts with a debt stock of 331% of GDP. Hence, his room to stimulate fiscally may not be as big as many expect. Thirdly, Congress is full of fiscal hawks. One way around the Congressional hurdle is to roll out the fiscal stimulus at State level instead of Federal level. This would satisfy Tea Party Republicans, who famously dislike Federal Government spending (except on the military) and would like to see more power at local level.

4. Deregulation

A fiscally-induced boost to demand will only have a lasting effect on private sector demand if the private sector can borrow to invest alongside the government. This means that banks must be able to take more risk, so Trump is likely to execute a partial reversal of much of the bank regulation that was put in place after 2008/2009.

5. Rising inflation

Fiscal stimulus and greater private sector spending will push up inflation. Never before has the Fed allowed the US economy to reach full employment with the policy rate at just 25-50bps. The Fed cannot reach neutral for several years given the underlying fragility of financial markets, negative productivity growth and the overvalued Dollar. Indeed, San Francisco Fed's Williams' argument from earlier this year rings ever more true: the Fed ought to have raised the inflation target earlier this year, because then the Fed would look at if it was meeting its target rather than falling behind when prices rise.

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6. Financial repression
The problem with inflation is that long yields rise as markets price in an inflation risk premium. Trump may well be forced to give the long end of the US yield curve special attention to prevent serious bear steepening, which could blow up everything from the stock market through to housing. Japan looks ahead of the curve having already shifted to direct yield targeting at the long end of the curve.

7. Weaker USD
The rise of inflation in the context of negative real policy rates and repressed long bond yields should mean lower real rates, which in turn means a lower Dollar. A weaker Dollar would also help American producers versus overseas competitors and push up US GDP growth by stimulating net exports. The currency, rather than a trade war, may be the most effective way for Trump to favour American business interests over foreigners.

8. Stagnant trend growth
We do not see Trump tackling America's tougher supply-side problems, such as the enormous debt burden, unfunded healthcare plans and unfunded pension deficits. Deregulation may boost productivity temporarily, but it could just as easily result in more bubbles. More debt and selective protectionism will certainly worsen productivity. On balance, we do not see US trend growth rise materially.

9. Declining US global influence
As Trump's America retreats from the global stage to focus on domestic matters we see China continuing to advance in Asia, while Europe will be forced, whether it likes it or not, into closer ties with Russia on account of Europe's dependence on Russian energy. No wonder Putin strongly supported Trump during the campaign.

Against this menu of likely policy preferences, we think the EM sell-off will soon abate and buyers will return, attracted by the fortune of sudden cheapness.

We see no fundamental reasons at all to be worried about EM at this juncture. EM's growth premium is improving and technicals are good. EM has proven its resilience by successfully weathering major shocks in recent years, including the Taper Tantrum, a massive fall in commodity prices, a sizeable Dollar rally and the start of the Fed hiking cycle.

Moreover, EM yields are already close to levels last seen when US monetary policy was normal prior to the Developed Market Crisis of 2008/2009. Indeed, as of this morning the average index-weighted EM fixed income yield across corporate and sovereign bonds in local currency and Dollars is now 6.02%, which is just 50bps shy of the yield at the end of 2006, when the Fed funds rate was 5.375%. The duration of EM debt is also substantially shorter than the average duration of developed market debt.

Finally, we note that EM government debt levels have dropped by about half since the end of the Cold War and currently average less than 50% of GDP. Incorporating all private sector debt as well, including bonds and loans, we estimate that EM countries have issued a grand total of USD 48trn of liabilities, while developed countries have issued nearly four times as much (USD 135trn). To put these numbers in context EM countries now make up more than half (58%) of global GDP, so it does not take a great mathematical genius to work out who has a debt problem.

These are the reasons why we view the current volatility (a) as a reaction to the huge uncertainty created by Trump's election and (b) as an opportunity. Some USD 50bn in passive ETF money entered the EM asset class this year and is now in retreat, but EM bond markets alone are some USD 18.5trn, so this flow is actually very small. The outsized market reaction is not flow-related as much as a reflection of market-makers scaling back trading in EM assets during bouts of volatility as they always do, wherefore liquidity temporarily deteriorates, which, obviously, tends to punish those who sell during such periods by giving them very poor pricing on exit.

EM investors should ruthlessly exploit the opportunity created by irrational Trump exuberance to buy. Numerous previous episodes have shown that the best time to buy EM is always during bouts of risk-aversion and Q4 looks to be a perfect entry point as markets also engage in the usual year-end position squaring and the Italian referendum, the next ECB decision and the 14 December Fed hike loom large.

To those who are uneasy about the precise time of their EM allocations we suggest that they divide their allocations into several 'bullets' and spread them over Q4. The risk of using this strategy is that investors do not get to use all the bullets before the markets reverse course, but this is clearly preferable to missing the turning point and the whole opportunity. By contrast, selling right now would only crystalize completely unnecessary losses, i.e. turns volatility into permanent losses that are quite simply not justified by fundamentals.

When can investors expect to be rewarded for taking risk now? We expect solid EM performance in 2017. Next year is already shaping up to be very similar to 2016, in our view. As investors will recall 2016 also began with a bearish backdrop for EM (the Dec 2015 Fed hike) only to deliver excellent performance. The drivers of performance in 2017 will be much the same, including high yields and good technicals, but now also accompanied by an even stronger growth premium and the fruits of deep reforms undertaken in large parts of EM over the past couple of years.

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Emerging Markets

We believe Trump's policies will not be nearly as draconian as his election rhetoric would suggest and that many of his policies will actually be quite positive for EM. For example, financial deregulation will be good for liquidity, fiscal stimulus will be positive for growth and a rise in inflation against the backdrop of a Fed, which is far behind the curve could be very good for EM currencies. Commodity prices will rise if Trump's policies are taken at face value.

The outlook for markets from here depends not just on Trump, but also on the Fed's reaction to rising inflation. Currently, the Fed would have to hike eight or nine times just to bring the real Fed funds rate to positive territory. This seems extremely unlikely, because growth is simply too tepid to enable the Fed to hike enough to fight inflation without also killing the US economy. Faced with a choice between growth and inflation we think the Fed will opt to protect growth. It will also want to appear to act on rising inflation, however, so the most likely compromise is that the Fed raises rates more or less in line with inflation, which keeps real rates more or less constant. The problem with this approach, of course, is that inflation gradually rises and the long end sells off.

Hence, we believe that the central global macroeconomic questions for 2017 are: (a) how far can the US economy cope with bear steepening and (b) what will policy makers do once the tolerance threshold for bear steepening has been reached?

Our core view is that the economy cannot stomach bear steepening for very long. It is important to remember that the USD is already 20% overvalued, that stock markets are already very expensive, that bond yields are very low and the economy heavily indebted with low productivity. A supply-side driven growth miracle, which would free up room to increase spending without pushing up prices, looks unlikely. Hence, bear steepening would soon pose a serious risk to US growth as well as housing and financial markets. The pain is already evident. As of this morning the US 30-year Treasury bond has lost its entire return for the year, having been up 15% as recently as July.

Given these circumstances, it is quite likely that the US authorities may have to consider various policies to control the long end of the curve. The measures could include Helicopter Money, swapping maturing bonds on the Fed's balance sheet into longer-dated securities, direct yield curve targeting à la Japan and good old fashioned financial repression (forcing pension funds and others to extend maturity in government securities).

How will EM bonds fare under a volatile Treasury curve scenario? So far, EM local currency bonds have proven far more resilient than long US bonds in the face of steeper curves. The year to date return for EM local currency bonds is 8.5%, while EM FX is marginally positive versus the USD. One important reason for better EM performance is higher yield. At 4.78 years EM local bonds also have relatively short duration, while EM high yield bonds additionally have a decent spread cushion, which protects them better than developed market fixed income. Real effective exchange rates are back to levels last seen in 2003, just at the start of the largest EM local currency bond rally in history.

- India: The government is withdrawing large denomination bills from circulation, allegedly in a bid to curb financing of terrorism. We think terrorism is a relatively small part of the problem. Instead, the real objective may be to drive the informal economy into the formal sector, which will improve the tax base, expand the role of banks and increase savings in the banking sector. Money in circulation is the liability of the central bank, backed by FX reserves. If x% of the bills are counterfeit they will not be tendered to the central bank in exchange for new bills, thus in effect extinguishing x% of the central bank's liabilities. Or to put it in another way, this is supportive for the currency and tightens liquidity. The central bank may therefore offset the tightening effect by cutting rates. Overall this should therefore be good for bonds too. Similar proposals to remove large bills from circulation have been put forward in developed economies, also to combat terrorism financing. However, in developed economies the real purpose may be to eliminate the freedom of depositors to withdraw funds from the banking system. By keeping depositors' money in the banks the government can introduce negative rates without risking defunding of the banking system. Industrial production rose 0.7% yoy in September, which is faster than expected (0.5% yoy).

- Brazil: Brazil's main inflation index (IPCA) rose just 0.26% in October. This was below expectations (0.29% mom) and 0.82% mom in the same month last year. On a yoy basis, inflation declined to 7.87% from 8.48%. Core inflation dropped to 7.41% yoy from 7.71% yoy last month. A cut in fuel prices by Petrobras announced last week may reduce inflationary pressure further in the coming months. Retail sales declined 0.1% mom, better than expected (-0.5% mom).

- China: The recent economic indicators are consistent with a modest pick-up in economic activity. Inflation was 2.1% in October, in line with expectations, while core inflation was 1.8% yoy, up from 1.7% yoy in September. The trade surplus increased to USD 46bn in October from USD 42bn in September. Credit numbers improved moderately. Industrial production rose 6.1% yoy and fixed asset investment accelerated. Retail sales, however, slowed a bit mainly due to larger ticket items (car sales). The Shanghai Composite index formally entered bull market territory on Friday after rallying more than 20% since January, which is better than the rally in the S&P 500 index since it bottomed out in February. Chinese government bonds have also outperformed US bonds in the recent Trump sell-off. Chinese 30 year bond yields have gone up only about 1/3 of the rise in yields on US 30 year bonds since October.

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- **Colombia:** The government and FARC rebels have struck a new peace deal, which they say addresses the concerns that led voters to reject an earlier version of the peace accord a few months ago. The critical test of this new deal will be how former president Alvaro Uribe reacts – his views could easily swing a critical mass of voters for or against the deal.

- **Venezuela:** The government and opposition have met and agreed to make changes to the national Electoral Council, the body that regulates elections. The government has also agreed to allow foreign food and medicine donors to provide help to the country. The next meeting is scheduled for 6 December.

Snippets:

- **Argentina:** The central bank cut the 35-day Lebac policy rate by 50bps to 26.25%. Luis Caputo, finance secretary, said that the government is looking to develop its local savings and local bonds markets. Inflation was 2.4% mom in October versus 2.5% mom expected.
- **Chile:** The trade surplus reached USD 3.43bn in the first ten months of 2016, which is nearly 12% higher than the trade surplus in the same period last year. Inflation was lower in October than anticipated (0.17% mom versus 0.30% mom expected). The economy expanded by a modest 1.4% yoy in Q3, down from 1.5% yoy in Q2.
- **Costa Rica:** Inflation rose to a modest 0.6% yoy in October from 0.4% yoy in September.
- Hungary: Inflation picked up to 1.0% yoy in October from 0.6% yoy in September. The main reason for the increase was a change in administered prices (a rise in fuel tax).
- **Indonesia:** The current account deficit was lower in Q3 2016 than expected (USD 4.49bn versus USD 4.54bn expected). FDI flows rose sharply to USD 5.2bn from USD 1.8bn a year ago.
- **Malaysia:** Real GDP growth was 4.3% yoy in Q3, up from 4.0% yoy in Q2 and higher than anticipated (4.0% yoy).
- **Mexico:** Consumer confidence rose 0.9% mom in October, but remains down 6.9% on the year due to persistent pessimism arising from the fallout from Trump's ascent to the presidency. The government cancelled a 30 year bond auction last week, not wanting to validate current valuations.
- **Nicaragua:** Daniel Ortega won a third consecutive term as president with a landslide.
- **Panama:** The fiscal deficit declined to 1.7% of GDP in the first nine months of 2016, down from 1.9% of GDP in the same period last year.
- **Peru:** The trade deficit narrowed to just USD 0.3bn in the 12 months to September from USD 3.0bn at the same time last year. The central bank left rates unchanged at 4.25%.
- **Philippines:** The central bank left rates unchanged at 3%. The trade deficit narrowed to USD 1.89bn in September from USD 2.02bn in August.
- **South Korea:** Bank of Korea left rates unchanged at 1.25%.
- **Taiwan:** Core inflation was unchanged at 0.96% yoy in October despite a spike in headline inflation due to rising vegetable prices (1.7% yoy versus 0.33% yoy in September).
- **Thailand:** The central bank left rates unchanged at 1.5%.
- **Ukraine:** Fitch upgraded the sovereign credit rating in Ukraine to B- (stable).

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.16%	9.40%	4.66%	-2.47%	0.11%
MSCI EM Small Cap	-4.60%	2.66%	2.47%	-0.43%	2.25%
MSCI Frontier	-0.29%	1.52%	-3.08%	-1.30%	3.82%
MSCI Asia	-3.78%	6.82%	4.82%	1.36%	4.42%
Shanghai Composite	3.09%	-7.84%	-10.63%	17.50%	7.84%
Hong Kong Hang Seng	-1.31%	1.86%	-3.95%	-0.03%	1.92%
MSCI EMEA	-6.94%	9.96%	-1.41%	-8.80%	-3.98%
MSCI Latam	-15.45%	23.14%	11.65%	-9.48%	-7.91%
GBI EM GD	-6.51%	8.52%	4.79%	-4.70%	-2.25%
ELMI+	-2.00%	4.43%	3.02%	-3.56%	-1.54%
EM FX Spot	-4.64%	0.12%	-2.85%	-10.68%	-8.32%
EMBI GD	-2.29%	10.75%	9.64%	6.54%	5.98%
EMBI GD IG	-2.49%	8.46%	7.48%	5.61%	4.54%
EMBI GD HY	-2.07%	13.24%	11.97%	7.35%	7.93%
CEMBI BD	-1.07%	9.91%	8.21%	5.45%	5.85%
CEMBI BD IG	-1.12%	6.96%	6.18%	5.16%	5.25%
CEMBI BD Non-IG	-1.00%	14.97%	11.58%	5.59%	7.04%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.92%	7.90%	6.61%	9.16%	13.76%
1-3yr UST	-0.18%	1.27%	1.25%	0.65%	0.60%
3-5yr UST	-0.83%	2.28%	2.51%	1.85%	1.38%
7-10yr UST	-2.37%	3.05%	3.80%	4.08%	2.70%
10yr+ UST	-5.91%	3.45%	5.81%	8.76%	3.97%
10yr+ Germany	-2.38%	8.99%	9.25%	11.00%	7.67%
10yr+ Japan	-0.40%	10.64%	12.78%	7.13%	6.29%
US HY	-0.93%	14.48%	10.16%	4.32%	7.17%
European HY	-0.29%	8.12%	5.86%	5.76%	10.81%
Barclays Ag	-1.23%	6.34%	6.29%	4.62%	4.92%
VIX Index*	-16.94%	-22.19%	-7.33%	9.84%	-56.81%
DXY Index*	1.05%	0.86%	0.49%	22.78%	28.25%
CRY Index*	-2.97%	2.61%	-4.58%	-34.13%	-43.33%
EURUSD	-1.72%	-0.59%	0.99%	-19.82%	-20.84%
USDJPY	2.65%	-10.38%	-12.65%	7.59%	39.61%
Brent	-7.06%	20.41%	2.94%	-58.64%	-59.88%
Gold spot	-4.12%	15.38%	13.11%	-4.86%	-31.21%

*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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