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Changing of the guard

By Jan Dehn

The significance of Chinese President Xi Jinping's and US President Donald Trump's sharply contrasting visions of economic policy cannot be overstated. It marked the moment when China formally took over the mantle from America as the world's undisputed leader on economic issues.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.8	–	-0.30%
MSCI EM Small Cap	10.7	–	0.02%
MSCI Frontier	9.8	–	1.14%
MSCI Asia	11.5	–	-0.30%
Shanghai Composite	11.9	–	0.33%
Hong Kong Hang Seng	7.3	–	-0.73%
MSCI EMEA	8.8	–	-1.17%
MSCI Latam	12.2	–	1.28%
GBI-EM-GD	6.70%	–	0.18%
ELMI+	3.97%	–	0.24%
EM FX spot	–	–	0.05%
EMBI GD	5.66%	319 bps	-0.42%
EMBI GD IG	4.45%	194 bps	-0.63%
EMBI GD HY	7.21%	482 bps	-0.20%
CEMBI BD	5.34%	302 bps	-0.05%
CEMBI BD IG	4.43%	211 bps	-0.24%
CEMBI BD Non-IG	6.81%	449 bps	0.23%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.6	–	0.06%
1-3yr UST	1.17%	–	0.02%
3-5yr UST	1.91%	–	-0.09%
7-10yr UST	2.44%	–	-0.47%
10yr+ UST	3.03%	–	-0.99%
10yr+ Germany	0.39%	–	-1.40%
10yr+ Japan	0.06%	–	-0.78%
US HY	5.87%	387 bps	0.00%
European HY	3.43%	389 bps	0.07%
Barclays Ag	–	239 bps	-0.34%
VIX Index*	12.07	–	0.84%
DXY Index*	100.40	–	-0.78%
EURUSD	1.0732	–	1.24%
USDJPY	113.36	–	0.74%
CRY Index*	193.57	–	-0.97%
Brent	54.9	–	-1.81%
Gold spot	1215	–	1.01%

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

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It has been in the cards since 2008/2009. China has been preparing for it for years with aggressive reforms, even at the expense of slower growth. The United States and other developed economies have been drifting inexorably towards it on a wave of myopia, neglect of reforms, debt issuance and, lately, a lurch towards economic nationalism. And so we have finally arrived at the inevitable turning point, when China formally took over the mantle from America as the world's undisputed leader on economic issues.

Revealing a shocking degree of economic illiteracy, US President Donald Trump claimed in his inaugural speech that *"protection will lead to great strength and prosperity"*. His bleak, defensive and atypically American vision of pessimism and defeatism was a de facto abdication of America's erstwhile role as undisputed global leader on economic issues. By contrast, Chinese President Xi Jinping's message at Davos spelled out a positive and ambitious agenda of openness and support for globalisation with the words *"protection is like locking yourself in a dark room"*. The King is dead! Long live the King!

The irony of the contrasting positions adopted by Xi and Trump was not lost on the press: here was the leader of Communist China standing up for free markets, while the 'leader of the free world' proposes to turn his country's businesses into the equivalent of protected French farmers. In reality, however, China has been liberalising its economy for decades.

The hand-over of global economic leadership will severely challenge the finance industry, which is usually desperate to be seen to be on the side of power. The US economy is still bigger than China's and global financial markets are far more invested in the US than in China. The finance industry now finds itself in the uncomfortable position of having to justify the usual bullish stance on the US despite the fact that even half-educated economists can tell you that the policies under consideration by the Trump administration will have a negative impact on the economy. We think it is a fool's game to try to suck up to policy-makers if their policies are bad. Far more businesses will lose than gain.

Protectionism is supreme folly and history is littered with examples to prove it. In the 1970s, the US tried in vain to protect a car industry that produced enormous gas guzzling vehicles against imports of smaller, more fuel-efficient and ultimately more sophisticated Japanese vehicles. "Eat your Japanese car", said the bumper

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stickers, yet today we all drive smaller, better, more economical cars. In retrospect, it is clear that Japan was not to blame. The Japanese cars were just better. Imports were not the problem either. After all, they just provided consumers with the goods they really wanted. Protecting dying industries can save jobs in the short-term, but protectionism becomes ridiculous in the longer term. For example, suppose the good people of the Stone Age had insisted on defending the flint-axe industry as the Bronze Age beckoned. It is obvious that no amount of protection would have saved the flint-axe industry as times and technology moved on. It is the same situation today: American industry today needs to man up or shut down, not be kept alive by artificial means at a huge cost to the rest of the economy.

Clearly, China and the US are setting out on paths that will accelerate China's economic hegemony, while the US is now directly undermining its own economic future. China's path is one of relentless reform, while America's is one of relentless stimulus. China is opening up as America is closing. Investors and the rest of the world should take notice of these contrasting developments.

Leadership is not free. Leadership requires bravery. Leadership demands the strength to hold firm to principles that are known to be right, even in the face of populism. China has displayed precisely these characteristics in recent years, when, to the puzzlement of many, China has insisted on reforming even at the expense of a slowdown in growth. Perhaps now China's path will begin to make sense to the China-detractors. The truth is that China astutely recognised that 2008/2009 was a debt crisis in the Western world and that the widely adopted policy response – yet more fiscal spending and money printing rather than tackling the underlying problems of excess debt and declining productivity – would ultimately lead to a more hostile environment for Chinese exports.

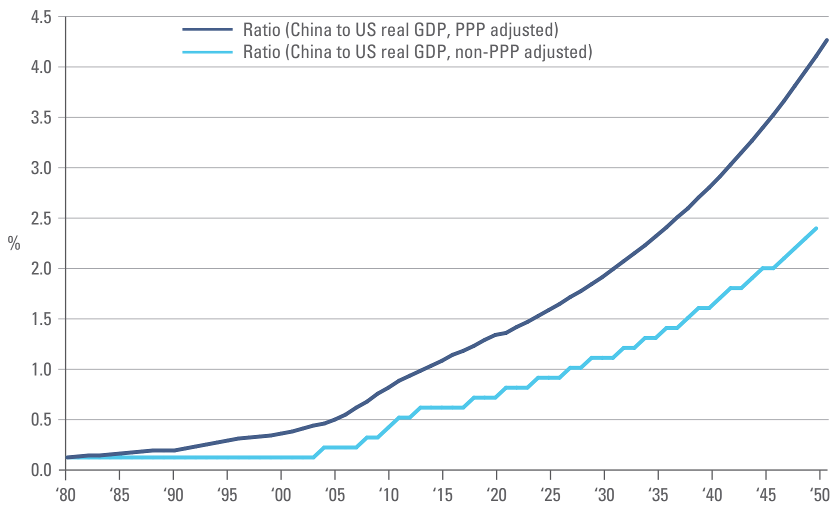
Indeed, regardless of whether the hostility was due to diminishing demand in the West, weaker currencies due to Quantitative Easing and inflation or protectionism à la Trump, China's critical insight was that American policy would ultimately seek to pass the cost of its own policy mistakes onto foreigners.[1]

This insight prompted China to commence an enormous reform effort to try to rotate its economy's growth drivers away from exports towards consumption, even if this required extremely tough reforms. China has therefore pushed ahead relentlessly with interest rate liberalisation, price liberalisation, painful productivity-enhancing reforms and capital account liberalisation. And the reforms will continue.

This is an opportunity for China detractors to stop and reflect anew: China was early and absolutely right in expecting hostility from the West and China was prudent to start to prepare early. Unlike Mexico, which continued to cling onto the flawed notion that the US would always be a force for economic good – and is now paying a heavy price for its naiveté – China read the economic tea leaves exactly right and is far better prepared as a result.

There is no doubt that global economic leadership will now gravitate to the East. In addition to exercising leadership of key economic issues, China is well underway to becoming a true economic giant. Based on the IMF's forecasts for Chinese and US medium-term real GDP growth rates of 6% and 2% respectively we estimate that China's economy will overtake the US economy within ten years (by 2027). Using PPP-adjusted per capita GDP and scaling up by the ratio of the Chinese population to the US population, we estimate that China's economy will be 4.1 times larger than the US economy by 2050 and even without PPP-adjustment China's economy will still be 2.4 times larger than that of the US by 2050.

Fig 1: **Ratio of Chinese to US real GDP**



Source: Ashmore, World Economic Outlook from IMF.

[1] Similarly, future generations will also end up paying the heavy price of these policies.

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The rise of China will have many profound implications. The world's currency and bond markets like to benchmark themselves against the largest markets. One obvious implication is therefore that CNY and the Chinese government bond market will replace the Dollar and the US Treasury market as the world's main benchmarks for FX and fixed income. This will be a de facto modern-day equivalent of the Great British Pound and the UK's gilt market's surrender of supremacy to the Dollar and the Treasury market in the interwar years.

While China's rise to unassailable economic and financial supremacy will be impressive in their own right, we think it is the rise of China as a consumer nation that will really take the biscuit. China's savings rate is likely to decline from 49% today towards single digits by the middle of the century. This means that China will experience the largest consumption boom the world has ever seen as consumption rises even faster than GDP. If America turns in on itself in some forlorn effort to cling on to former glories the once legendary US consumer will be far less impressive in the future.

All this matters so much because global trade relationships are strategic in nature. It takes years of building trust to create truly deep and lasting trading relationships. From the very highest level of executive power, the pathways for these two nations have now been laid bare for all to see. China is going to win and is inviting the rest of the world to ride along.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.61%	3.61%	32.14%	-0.12%	0.60%
MSCI EM Small Cap	3.02%	3.02%	18.69%	-0.18%	2.91%
MSCI Frontier	5.07%	5.07%	20.78%	-1.44%	6.12%
MSCI Asia	4.15%	4.15%	24.70%	2.43%	4.22%
Shanghai Composite	0.63%	0.63%	7.08%	18.87%	8.80%
Hong Kong Hang Seng	3.42%	3.42%	26.44%	2.74%	1.16%
MSCI EMEA	1.45%	1.45%	46.55%	-4.56%	-1.81%
MSCI Latam	4.95%	4.95%	59.51%	-4.27%	-6.52%
GBI EM GD	0.88%	0.88%	15.42%	-3.42%	-1.92%
ELMI+	0.73%	0.73%	8.00%	-3.33%	-1.64%
EM FX Spot	0.00%	0.00%	4.83%	-9.80%	-8.03%
EMBI GD	1.24%	1.24%	13.97%	6.28%	6.08%
EMBI GD IG	1.08%	1.08%	9.48%	5.10%	4.49%
EMBI GD HY	1.43%	1.43%	19.25%	7.26%	8.18%
CEMBI BD	0.91%	0.91%	11.99%	5.24%	5.83%
CEMBI BD IG	0.56%	0.56%	6.97%	4.61%	5.03%
CEMBI BD Non-IG	1.46%	1.46%	20.72%	5.86%	7.32%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.54%	1.54%	24.85%	9.55%	13.93%
1-3yr UST	0.03%	0.03%	0.53%	0.57%	0.54%
3-5yr UST	0.10%	0.10%	0.09%	1.71%	1.16%
7-10yr UST	-0.01%	-0.01%	-1.47%	3.38%	2.13%
10yr+ UST	0.61%	0.61%	-3.18%	7.20%	3.33%
10yr+ Germany	-3.17%	-3.17%	2.15%	9.61%	6.90%
10yr+ Japan	-1.01%	-1.01%	6.00%	6.04%	5.56%
US HY	1.10%	1.10%	23.54%	4.67%	7.21%
European HY	0.65%	0.65%	13.14%	5.58%	10.42%
Barclays Ag	-0.02%	-0.02%	6.09%	4.07%	4.68%
VIX Index*	-14.03%	-14.03%	-45.97%	-12.35%	-35.35%
DXY Index*	-1.77%	-1.77%	0.83%	24.82%	25.84%
CRY Index*	0.55%	0.55%	18.17%	-31.19%	-38.27%
EURUSD	2.04%	2.04%	-1.08%	-21.64%	-17.53%
USDJPY	3.18%	3.18%	4.36%	-8.91%	-32.06%
Brent	-3.47%	-3.47%	70.45%	-49.01%	-50.40%
Gold spot	5.88%	5.88%	9.66%	-3.89%	-27.55%

*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.

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

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

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