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King Canute and the tide

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King Canute tried to keep out the tide. He failed. Will Trump's Wall be his fall? Tax amnesties in EM. China (kind of) breaks into Bloomberg's fixed income indices. Colombia's central bank remains vigilant. Brazil's consumers are coming back. Turkey's central bank's efforts fall short of what is needed. Growth reappears in Argentina. Russia intervenes to put a lid on RUB appreciation. China is busy making babies. Did Mnuchin just signal a weaker Dollar policy?

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	2.54%
MSCI EM Small Cap	10.1	–	1.73%
MSCI Frontier	9.9	–	1.89%
MSCI Asia	11.7	–	2.39%
Shanghai Composite	12.0	–	1.87%
Hong Kong Hang Seng	7.4	–	0.91%
MSCI EMEA	9.5	–	1.87%
MSCI Latam	12.3	–	3.83%
GBI-EM-GD	6.70%	–	0.68%
ELMI+	3.87%	–	0.67%
EM FX spot	–	–	0.58%
EMBI GD	5.65%	317 bps	0.19%
EMBI GD IG	4.45%	192 bps	0.11%
EMBI GD HY	7.19%	479 bps	0.27%
CEMBI BD	5.32%	298 bps	0.23%
CEMBI BD IG	4.43%	209 bps	0.13%
CEMBI BD Non-IG	6.76%	443 bps	0.39%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	1.04%
1-3yr UST	1.21%	–	0.04%
3-5yr UST	1.93%	–	0.04%
7-10yr UST	2.48%	–	-0.05%
10yr+ UST	3.08%	–	-0.20%
10yr+ Germany	0.45%	–	-0.10%
10yr+ Japan	0.09%	–	-0.33%
US HY	5.82%	382 bps	0.41%
European HY	3.41%	384 bps	0.14%
Barclays Ag	–	240 bps	0.04%
VIX Index*	11.97	–	0.20%
DXY Index*	100.74	–	0.58%
EURUSD	1.0661	–	-0.97%
USDJPY	114.14	–	-1.25%
CRY Index*	191.63	–	-2.82%
Brent	55.1	–	-0.22%
Gold spot	1196	–	-1.86%

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

Emerging Markets

King Canute and the tide[1]: The Danish King Canute, protagonist of the apocryphal anecdote, who ruled over Denmark, Norway and England in the eleventh century so believed in his own powers that he thought he could command the tide. One morning Canute led his entire entourage down to the beach at high tide to prove this point. The tide promptly fell. Buoyed by his early success, however, Canute then proceeded to claim that he would also prevent the tide from returning. In this enterprise, sadly, Canute was less successful. The futility of his vainglorious effort to stop the tide has seen Canute go down in history as a ridiculous figure, a latter day example of what today we would label someone suffering from narcissistic personality disorder. It remains to be seen if Trump's Mexican Wall will also be Trump's fall, that is, the new US president's King Canute moment. Certainly, it was Mexico, which emerged a winner of sorts after last week's diplomatic skirmishes as Trump was forced to agree not to discuss in public the funding of his proposed 3,000 mile wall along the Mexican border. Trump's climb-down was the eventual outcome of a mini diplomatic storm, which had been kicked off by Trump himself, when, to great fanfare, he signed an executive order to commence work on the wall. Mexican President Enrique Peña Nieto responded by cancelling a planned visit to the US. This then prompted Sean Spicer, Trump's spokesperson, to announce a 20% tariff on Mexican exports to the US. Soon, however, it transpired that many Mexican exports have no obvious substitutes in the US, wherefore most of the tariff would probably be passed to US consumers in the form of higher prices. Spicer was soon forced to retract his tariff threat and Trump had to concede to Peña Nieto's proposal to stop talking about funding of the wall in public. Meanwhile, Paul Ryan announced that he would find money in the Budget to pay for the wall, which means that US tax payers will pay for it. Peña Nieto received widespread support from Mexicans for his stance, thus aiding his own position at home where, prior to the incident, his approval rating had fallen to just 12%. Peña Nieto also received public support from other Latin American governments, including Peru and Colombia. The big remaining question to us is this: will China publicly support Mexico? China may have many good reasons for doing so. For example, if the rift between Mexico and Trump's America can be turned into a

[1] The portrayal of King Canute as an arrogant ruler is historically incorrect; to his contemporaries he was a model of modesty and piety. Unfortunately history has twisted his story and made him into a cautionary tale which is what we are referencing here.

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Emerging Markets

major headache for the Trump administration then the latter may have second thoughts about engaging in a similar spat with China. China could, for example, offer Mexico a very large swap line in CNY. Mexico already has about 25% of GDP in FX reserves, including a USD 85bn Flexible Credit Line from the IMF.

In other Mexican news, Mexico's non-oil trade balance swung into a historic surplus in Q4 2016 and the 12m rolling overall trade deficit narrowed from USD 18.6bn in April to just USD 13.1bn in December. Much of the improvement is due to MXN, which last week weakened to levels last seen during the Tesobono Crisis of the mid-1990s. Mexico, on the other hand, is a far stronger, more diversified and financially self-sufficient economy than two decades ago. Retail sales were also strong, rising 11.2% yoy in November, a marked acceleration versus October and a stronger than expected number. Inflation was also higher than expected, which should keep the central bank vigilant. Finally, we note that Mexico launched a tax amnesty – see next item.

- Tax amnesty: A number of countries across the EM universe have launched tax amnesty schemes. What is prompting them to do so and how successful have they been? There is a growing realisation in a number of EM countries that enormous quantities of wealth reside outside the countries much of which has never been declared for tax purposes. Governments are implementing tax amnesties in order to encourage this money to be declared for tax purposes. This helps to widen the tax base and therefore increase tax revenues permanently going forward, despite the upfront amnesty. In Latin America, Argentina and Brazil have both implemented successful tax amnesties and on 18 January Mexico became the latest country to introduce such a scheme. Indonesia has also successfully implemented a tax amnesty for overseas wealth. The fact that such amnesties are proving successful fundamentally reflects that the quality of governance in EM is improving, because otherwise no one would agree to declare their overseas wealth. The big stashes of overseas wealth is a legacy of much worse times in EM's distant past, when truly no one trusted local banking institutions and where there were no decent investment opportunities and no credible financial assets to invest in within EM countries. These conditions were particularly pronounced during the Cold War period, but things have changed sharply in the last couple of decades. Most EM economies, including most Latin American countries now have deep domestic bond markets and equity markets, while macroeconomic conditions are far more stable. Many EM economies are now fully integrated into major fixed income and equity benchmark indices. This is why the time has come to get the rump of high net worth assets to go home. The amnesty schemes are generally good news from a bond holder's perspective. The government's tax base widens, so public finances become healthier. Also, the inflows associated with the amnesty tend to support currencies. Finally, some of the declared wealth will go into local bond and equity markets.

- Index news: Our view remains that China's government bonds are destined eventually to replace US Treasuries as the preferred benchmark for global fixed income. The main obstacle to this is that index providers have been reluctant to include Chinese securities in their benchmarks. However, cracks are already appearing. Thus, while RMB-denominated securities are still not formally eligible for inclusion in the Bloomberg (formerly Barclays) Global Aggregate Index and Bloomberg's local currency indices, Bloomberg is launching two new sister-indices, which do include Chinese fixed income securities. These indices will be launched on 1 March 2017 and Chinese securities will be capped at 10% weight on account of the enormity of the Chinese domestic market.

- Colombia: The central bank surprised markets by not cutting rates in a move which can only be described as prudent in light of upcoming inflationary pressure from a recent hike in VAT rates. The central bank left rates unchanged at 7.5%. Colombia closed 2016 with a 12m rolling trade deficit of USD 12.7bn, which was well down from USD 15.9bn in 2015.

- Brazil: The Brazilian consumer is slowly showing signs of life. Consumer credit increased in December and consumer confidence improved in January. This follows a largely self-inflicted recession of extreme length and depth. This year, however, we expect Brazil to return to positive growth, but there is still so much slack in the Brazilian economy that it will take some time before inflationary pressures return. Indeed, we expect inflation to continue to fall sharply. These goldilocks conditions will be complemented by rate cuts and currency appreciation, while the Temer Administration will pass reform of the Brazilian pension system. We expect the market-friendly PSDB party to win the 2018 election, thus creating a 6-year positive investment horizon in Brazil.

- Turkey: Turkey's central bank attempted to place a lid on TRY weakness by increasing the uncertainty of funding for those shorting the currency. The central bank did this by raising the upper band for lending rates. However, the central bank failed to raise the 7-day repo rate, its main policy instrument, so the underlying economic problems of excessively lose monetary policy and excess growth in domestic demand were not adequately addressed. In another negative development, all three of the big Western ratings agencies have now lowered their sovereign ratings for Turkey to sub-investment grade. S&P went one step further by assigning a negative outlook to Turkey's sovereign credit rating. Turkey's economic and political fundamentals have steadily been deteriorating for several years with no sign of any meaningful change to the trajectory. The culprit is bad macroeconomic management, though we think the risk of sovereign default in Turkey is still extremely small.

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Emerging Markets

- **Argentina:** In an encouraging sign that economic activity is finally beginning to improve, the monthly economic activity index (called EMEA) rose for the second consecutive month. November's EMEA index was up 1.4% mom following an expansion of 0.5% mom in October. We expect the government to stimulate the economy by fiscal means in H1 2017 ahead of mid-term elections later this year, but the associated political uncertainty plus the fact that adjustment still has a lot of work to do on the monetary side suggests that the recovery in activity will be very gentle. The biggest risk to the economic recovery is that the combination of lose fiscal policy and tight monetary policy has historically crowded out domestic private sector activity. On the other hand, conditions are improving for exporters. The trade balance swung into surplus in 2016 to the tune of USD 2.1bn compared to a trade deficit USD 2.7bn in 2015. Argentina thus joins a growing number of EM countries that have shown dramatic improvements in their external balances in recent years. Better external balances translate into rising FX reserves and better GDP growth.

- **Russia:** The Finance Ministry has begun to intervene in the Russian currency market in a bid to prevent the RUB from appreciating too fast. The intervention is relatively modest at this point, but deemed necessary since oil prices are now well above the budgeted USD 40 per barrel. Intervention will slow the pace of appreciation and therefore also the pace of disinflation, which means that the Russian central bank can maintain high real rates for a little bit longer. The other upside risk to RUB comes from the possibility of an easing of Western sanctions against Russia. Russia experienced some USD 80bn of outflows as a result of sanctions.

- **China:** China is making babies. Following the relaxation of the one-child policy a year ago China's, the number of new-borns has increased by 1.31 million compared with 2015 a whopping 7.9% year on year change according to the National Health and Family Planning Commission (NHFPC). More than 45% of the babies had elder siblings. Based on this birth rate the NHFPC estimates that China's work force will be larger by some 30 million by 2050 (more than 3% of the current workforce). In other news, the PBOC tightened liquidity conditions by hiking interest rates on the medium-term liquidity facility, thus reducing financial risks in the economy. The economy has recently shown signs of strength and China is simply ensuring that bubbles do not emerge.

- **AIIB:** The Asian Infrastructure Investment Bank (AIIB) is set to add an additional 25 members to its existing membership of 57 members. The rise of AIIB is a natural consequence of the reluctance of Western incumbents to grant proportionate power to rising EM countries within the Bretton Woods institutions, such as the IMF and the World Bank.

Snippets:

- **Hungary:** The central bank left the policy rate unchanged at 0.90%.
- **Nigeria:** The Central Bank of Nigeria left the policy rate unchanged at 14%.
- **Philippines:** Real GDP growth accelerated sequentially in Q4 2016 to 1.7% qoq sa from 1.5% qoq sa in Q3 2016. Investment spending was the main driver of the acceleration.
- **Singapore:** Industrial production significantly beat expectations in December by rising 21.3% yoy versus 10.4% yoy expected.
- **South Korea:** The real economy expanded by 2.7% in 2016, which was 0.1% faster than in 2015.
- **Taiwan:** Taiwan racked up a fifth consecutive quarter of positive growth in Q4 2016 (2.6% yoy compared to 2.0% yoy in Q3 2016)
- **Venezuela:** President Nicholas Maduro appointed Ricardo Sanguino as governor of the Venezuelan central bank, replacing Nelson Merentes. This will not change the overall direction of macroeconomic policy in the country, in our view.

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Global backdrop

The US economy only grew 1.6% in 2016 following a Q4 2017 GDP print of only 1.9% qoq annualised versus 2.2% expected. Taking into account that US productivity growth is close to zero and that population growth accounts for roughly two thirds of the expansion it is hard to escape the conclusion that something is really amiss when it comes to US growth.

Why, exactly, is the US growing so slowly? After all, never in US history has the economy been supported by so many tail winds, including negative real interest rates across almost the entire yield curve, huge volumes of outstanding QE liquidity, a cumulative stimulus of 30% of GDP from fiscal spending since 2008/2009 and, most importantly of all, almost endless availability of financing from the rest of the world (the biggest single consensus view in global financing market is that of a strong Dollar). We think there are both structural and cyclical reasons for America's sluggish growth rate. Excessive debt and declining productivity – both consequences of decades of excessive reliance on stimulus over reforms – are the main culprits on the structural side, while excessive capital inflows now present the single biggest challenges on the cyclical side. Not only does the US economy display all the symptoms of an investment constrained economy, meaning that too much money is chasing too few opportunities in the real economy, but inflows have also pushed the Dollar so high in real terms that American companies are struggling to compete. This was particularly evident in the Q4 GDP data, where the big miss was in net exports.

The diagnosis of the US economy as a reform-starved and over-financed country suggests that the economic plan currently under discussion – bigger fiscal deficits and import tariffs – is exactly the wrong medicine right now. It would further appreciate the US real exchange rate and thus push the economy further away from equilibrium. Absent deep structural reforms and aggressive deleveraging, which would be the right remedy, the second best strategy for getting growth back now would be to inflate the debt away and restore external competitiveness by weakening rather than strengthening the Dollar. We note that US Treasury Secretary Steven Mnuchin last week joined a chorus of other influential people including his boss Donald Trump, the IMF and the Fed in suggesting that maybe the strong Dollar is hurting the US economy.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	6.25%	6.25%	31.27%	2.16%	0.70%
MSCI EM Small Cap	4.80%	4.80%	18.98%	1.56%	2.80%
MSCI Frontier	7.05%	7.05%	20.67%	-0.62%	6.34%
MSCI Asia	6.63%	6.63%	25.33%	4.58%	4.31%
Shanghai Composite	1.79%	1.79%	17.78%	18.57%	9.33%
Hong Kong Hang Seng	4.36%	4.36%	24.09%	3.83%	1.07%
MSCI EMEA	3.34%	3.34%	38.26%	-2.45%	-2.23%
MSCI Latam	8.98%	8.98%	58.97%	-1.40%	-6.08%
GBI EM GD	1.57%	1.57%	13.79%	-2.38%	-2.35%
ELMI+	1.40%	1.40%	7.37%	-2.70%	-1.90%
EM FX Spot	0.57%	0.57%	3.91%	-9.12%	-8.31%
EMBI GD	1.43%	1.43%	12.63%	6.77%	5.91%
EMBI GD IG	1.18%	1.18%	7.97%	5.42%	4.32%
EMBI GD HY	1.70%	1.70%	18.15%	8.05%	7.99%
CEMBI BD	1.15%	1.15%	11.83%	5.49%	5.70%
CEMBI BD IG	0.69%	0.69%	6.92%	4.75%	4.90%
CEMBI BD Non-IG	1.85%	1.85%	20.33%	6.33%	7.15%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.60%	2.60%	24.55%	11.11%	14.15%
1-3yr UST	0.07%	0.07%	0.52%	0.58%	0.52%
3-5yr UST	0.14%	0.14%	0.08%	1.63%	1.11%
7-10yr UST	-0.06%	-0.06%	-1.49%	3.18%	1.89%
10yr+ UST	0.41%	0.41%	-2.74%	6.59%	3.11%
10yr+ Germany	-3.27%	-3.27%	1.38%	9.15%	6.84%
10yr+ Japan	-1.33%	-1.33%	5.06%	5.64%	5.43%
US HY	1.52%	1.52%	21.59%	4.95%	7.04%
European HY	0.80%	0.80%	12.00%	5.83%	10.10%
Barclays Ag	0.03%	0.03%	6.19%	4.07%	4.45%
VIX Index*	-14.74%	-14.74%	-40.74%	-30.77%	-38.30%
DXY Index*	-1.44%	-1.44%	1.14%	24.24%	27.25%
CRY Index*	-0.46%	-0.46%	14.92%	-32.42%	-38.96%
EURUSD	1.37%	1.37%	-2.08%	-21.35%	-18.89%
USDJPY	2.47%	2.47%	6.00%	-10.01%	-33.11%
Brent	-3.01%	-3.01%	58.64%	-48.95%	-50.24%
Gold spot	4.19%	4.19%	5.95%	-3.88%	-30.89%

*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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