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Ashmore

Recoveries from crises require both stimulus and reforms

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Experience from EM countries shows that sustainable recoveries from crises require a careful rotation from stimulus towards reform as economies reach full employment. Recent developments in the US and UK suggest that governments are set on a course of further stimulus and protectionism. This does not bode well for the sustainability of their recoveries. We also discuss developments in Brazil, Russia, India, Costa Rica, Ecuador, Indonesia, Romania and China plus the usual snippets.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	0.33%
MSCI EM Small Cap	11.1	–	1.81%
MSCI Frontier	10.0	–	0.31%
MSCI Asia	11.6	–	0.08%
Shanghai Composite	12.0	–	0.55%
Hong Kong Hang Seng	7.4	–	-0.61%
MSCI EMEA	9.5	–	0.56%
MSCI Latam	12.3	–	0.68%
GBI-EM-GD	6.64%	–	1.97%
ELMI+	3.72%	–	1.35%
EM FX spot	–	–	1.64%
EMBI GD	5.58%	309 bps	0.63%
EMBI GD IG	4.37%	184 bps	0.71%
EMBI GD HY	7.13%	474 bps	0.53%
CEMBI BD	5.28%	295 bps	0.44%
CEMBI BD IG	4.40%	207 bps	0.34%
CEMBI BD Non-IG	6.70%	437 bps	0.58%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	0.16%
1-3yr UST	1.19%	–	0.06%
3-5yr UST	1.90%	–	0.19%
7-10yr UST	2.46%	–	0.26%
10yr+ UST	3.09%	–	-0.22%
10yr+ Germany	0.41%	–	0.40%
10yr+ Japan	0.11%	–	-0.53%
US HY	5.74%	376 bps	0.33%
European HY	3.46%	392 bps	0.03%
Barclays Ag	–	240 bps	0.02%
VIX Index*	10.97	–	0.39%
DXY Index*	99.89	–	-0.54%
EURUSD	1.0758	–	0.59%
USDJPY	112.69	–	-0.96%
CRY Index*	193.20	–	-0.23%
Brent	57.1	–	3.40%
Gold spot	1222	–	2.21%

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

Emerging Markets

- **Recoveries from crises – a few lessons from EM countries:** The recoveries of Western economies from their severe banking and housing crises in 2008/2009 have so far relied almost exclusively on heavy demand-side stimulus, including zero interest rate policies, massive fiscal support and Quantitative Easing (QE).

The experience from Emerging Markets (EM) countries, however, shows that sustainable recoveries do not rely on stimulus alone. Rather, a critical turning point is reached in every recovery, when the focus of economic policy must shift from demand-side stimulus to supply-side reform. This important turning point is usually reached when the economy approaches full employment.

Experience from EM also shows that failing to switch from stimulus to reform at the appropriate time undermines the recovery and might, in extreme cases, lead back to crisis as imbalances multiply over time and become ever more difficult to reverse. EM experience also shows that getting the timing right for changing the direction of policy can be difficult and that changing policy is very difficult politically.

The recent history of Argentina illustrates these points quite clearly. In 2001, Argentina defaulted on USD 120bn of sovereign debt in what was then the world's largest sovereign default. The economy fell into outright depression. Following a period of political chaos Nestor Kirchner, an authoritarian populist, secured the presidency. Nestor was quite clear about what needed to be done for the economy to recover. He turned on the fiscal and monetary spigots and before long aggregate demand began to respond. Argentina's economic depression was so deep however that Nestor was able to stimulate the economy at full tilt right up to 2004/2005, before aggregate demand finally caught up with aggregate supply.

At this critical point, however, Nestor made a major mistake. He ought to have recognised that once the economy had reached full employment further stimulus would become counter-productive. Rather than pushing up prices, widening the trade deficit and overvaluing the real exchange rate he should have been encouraging trend GDP growth. The correct policy at that point would have been to address the many

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Emerging Markets

constraints on the supply-side of the Argentinian economy and to allow aggregate demand to rise only in line with increments in aggregate supply, that is, the pace of productivity growth. Nestor's policies began to push Argentina away from equilibrium.

Obsessed with keeping the expansion going, Nestor continued to stimulate the demand side of the economy and his wife, Cristina Fernandez de Kirchner, continued along the same lines after Nestor passed away in 2010. The ramifications of this colossal mistake were serious and very sobering. Argentina soon began to experience the inevitable inflationary pressures. But instead of tightening monetary policy the Kirchners opted to manipulate the official inflation numbers in a bid to make the problem go away. This approach understandably freaked out the local pension funds, which began to sell their holdings of government bonds. The Kirchner responded by nationalising the private pension funds and forcing the state pension fund, ANSES, to buy government debt. This sent a clear message to savers: get your money out of the country. As capital flight became a major problem the government decided to apply capital controls. Almost immediately a parallel exchange rate system emerged, which soon precipitated massive over- and under-invoicing of trade flows. In a bid to stamp out such unpatriotic practices, the government orchestrated a clampdown on trade, led by the commerce ministry. Meanwhile, the exchange rate was becoming ever more overvalued, so exporters were increasingly being priced out of their markets. The government actually made the problem worse by directly intervening in trade via a plethora of trade taxes, tariffs and other instruments. The multitude of distortions resulting from all these policies eventually so undermined business conditions that honest hard work and above-the-board businesses became entirely unprofitable. Thus, in the final days of the Kirchner administration there were only two games left in town, namely rent-seeking and speculating against the currency in the parallel FX market.

Argentina's example is an extreme one, but it illustrates two key points about heterodox policies that are entirely universal, namely that (a) it is critically important to rotate from demand to supply-side policies when the economy reaches full employment in order to avoid macroeconomic imbalances; and (b) once macroeconomic imbalances have re-emerged due to protectionism and other heterodox policies the temptation to introduce yet more controls only increases. This dynamic is extremely dangerous; addressing the symptoms rather than the causes tends to set in motion dynamics that ultimately lead to economic ruin.

Given EM experiences, alarm bells ought to be going off in the minds of investors with money invested in the US and the UK. Both economies are at or close to full employment and inflation is rising. Both countries have reached their respective turning points, where they ought to shift from demand stimulus to productivity-enhancing structural reforms. The central banks in both countries are far behind the curve with real policy rates lingering deep within negative territory. Neither the US nor the UK appears inclined to engage in serious structural reforms. To the contrary, they both seem to be leaning towards yet more fiscal stimulus. Both countries are also dismantling rather than deepening important trade ties. US protectionism and UK's withdrawal from the European Union's single market will erode trend growth rates and appreciate real exchange rates. This is precisely the opposite of what the doctor ordered for this stage of the recovery from crisis.

- Brazil: Brazil's external balances continue to improve after the country racks up a significant trade surplus of USD 2.7bn in January, the highest monthly trade surplus for nearly ten years and well ahead of expectations (USD 2.1bn). The improvement in Brazil's trade balance was driven mainly by declining imports for some time, but exports are now contributing more to the trade balance than imports. This shows that the domestic economy is finding a floor, while the competitive exchange rate is helping Brazilian exporters to gain market share in global markets. The domestic economy is still operating far below capacity, so inflation is unlikely to pose a challenge to export competitiveness for a long time, in our opinion. In other news, the fiscal result for the government for 2016 was better than expected. While the consolidated public sector primary deficit of 2.5% of GDP was poor it was far less bad than expected and also better than the Temer Administration's own target (the deficit was BRL 156bn versus BRL 170bn planned). The public finances are quite closely linked to the business cycle, which means that the return to modest positive growth this year and beyond should have significant positive effects on the fiscal balances over time. Finally, we note that Rodrigo Maia was elected as House Speaker for the next two years, which is positive news for the prospect of reform especially regarding Pension. The presidency of the Senate has also gone to a reform-friendly deputy, namely Eunicio de Oliveira of PMDB (Temer's own party).

- Russia: Evidence that the Russian business cycle is turning positive continues to mount. According to the latest flash estimate of real GDP growth in 2016 the Russian economy contracted by a mere 0.2% last year. This was much better than expected (-0.5%) and implies that the Russian economy must have returned to significant positive growth in Q4 (given what we already know about GDP growth in the previous three quarters). Manufacturing PMI also accelerated to 54.7 in January from 53.7 in December. The better than expected economic data immediately prompted the perennially hawkish Central Bank of Russia (CBR) to say that prospects for rate cuts have diminished. Moreover, a recent decision by the CBR to rebuild reserves (printing RUB to buy FX) will also have tilted the central bank towards hawkishness. So far the economic recoveries in many EM countries have been almost entirely due to major adjustments in real exchange rates. This recovery is taking place despite the fact that investors are still pulling money out of the asset class and commodities have not rallied materially since their epic decline in 2014. If flows and commodity prices pick up, the recovery will only get stronger.

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- India: The government's budget was more prudent than expected. The government is targeting a fiscal deficit of 3.2% of GDP for the 2017/2018 fiscal year, which is 0.3% of GDP narrower than the deficit in the current fiscal year. The government is cutting recurrent spending, while keeping investment spending unchanged. Recent measures to increase the size of the formal economy, including the much discussed demonetisation programme, are expected to broaden the tax base and thus enable the government to maintain strong revenue growth, while cutting tax rates modestly at the same time. The tighter fiscal stance should increase the odds of rate cuts from the Reserve Bank of India, especially given the context of sharply declining CPI inflation. On the other hand, funding for recapitalisation of banks was less than expected, although Finance Minister Jaitley said in comments to the media that more money will be allocated if required. In other news, the manufacturing sector returned to expansion in January based on the PMI index, which rose to 50.4 from 49.6 in December.

- Argentina: The energy ministry announced a series of planned hikes totalling 113%, despite upcoming mid-term elections. This is very positive for bond holders. The previous Argentinian government used energy subsidies to prop up its own popularity with very negative implications for the public finances. The Macri administration is seeking to bring prices to market-determined levels. Despite the announced measures energy prices still only cover 47% of generation costs. This illustrates the extent of the legacy created by the previous government.

- Costa Rica: In recognition of its waning popularity, the government has submitted a much watered down fiscal reform proposal to Congress in a last ditch attempt to get something done on the fiscal side ahead of elections next year. However, the effort may prove too little too late. The next election is on 4 February 2018. Chances of passage of the reform, even in its watered down format, are low. The fiscal deficit is 5.2% of GDP.

- Mexico: Trump's overt attacks on Mexico are impacting the economy as the Manufacturing PMI index declined by 3.6 points to 42.8 in January. Consumer confidence also declined sharply in January to 68.5 from 84.4 in December according to the Instituto Nacional de Estadística y Geografía (INEGI). However, the Mexican economy appears to have entered the current period of uncertainty with considerable positive momentum. The economy expanded at a stronger rate of 2.2% yoy in Q4 2014 than in Q3 2016 (2.0% yoy) and gross fixed investment was also stronger than expected in November (2.8% vs 2.5% expected). In related news, Foreign Minister Luis Videgarai said last week that Mexico will seek to deepen ties with China. This makes a great deal of sense, in our view. China supports free trade and globalisation, while the US is closing its borders and 'turning medieval' on Mexico. Mexico faces a major challenge: the country has become far too dependent on the US and has assumed, wrongly, that the US would always remain committed to free trade. We think China should follow up on President Xi Jinping's public statement in support of free trade and globalisation by extending support to Mexico. China could do so directly or via the BRICS bank or the AIIB, for example by extending swap or credit lines to Mexico, thus spreading the use of RMB in the process.

- Ecuador: Ecuador is heading to the polls on 19 February this year. President Rafael Correa's term is ending and he will not be seeking re-election. His presidency has been characterised by far more stable government than under previous administrations, mainly due to Correa's partial dismantling of institutional checks and balances. Correa's presidency was also marred by his default on Ecuador's 2012 and 2030 bonds in 2008. Ecuador's recurring problem in recent decades has been that the Executive was weak relative to powerful vested interest groups in Quito and Guayaquil. Correa was able to neutralise these groups and thus to introduce some stability. It remains to be seen if the next president will be able to do the same. A recent poll by Cedatos, a credible pollster, shows that Correa's successor Lenin Moreno leads with 34.3% of voting intentions ahead of banker Guillermo Lasso (22.9%). However, a large percentage of undecided voters and a significant rejection rate for Moreno points to a run-off between Moreno and Lasso on 2 April. As thing stand today, Lasso would win the run-off and thus become Ecuador's next president. Lasso is an influential and conservative banker, who would likely pursue market friendly policies. His key challenge, as always, will be to maintain stability in a country used to weak presidents and with the second worst record of sovereign defaults in the world after Spain.

- Indonesia: Real GDP growth slowed marginally to 4.94% yoy in Q4 2016 from 5.02% yoy in Q3 2016. However, sequential growth rate accelerated to 1.4% qoq sa from 1.0% mom sa despite the lower yoy print. This hints at a pick-up in momentum. Indeed, the manufacturing PMI also returned to positive territory for the first time in four months in January (50.4 from 49 in December), while CPI inflation rose marginally 3.49% yoy in January from 3.02% yoy in December.

- Romania: Mass protests in Bucharest over the last few days have forced the government to reverse an attempt to water down anti-corruption legislation. The protests may yet pose a risk to the government as a whole. Romania, like Brazil, has had enough of corrupt officials. A combination of people power and efforts from within the Judiciary are now putting serious pressure on both the Executive and the Legislature to clean up their act. These are obviously positive developments despite the short-term noise.

- China: The 'hard landing' crowd are yet again pulling their hair out – not only has China once again failed to have a hard landing, but the Chinese Central Bank is now tightening monetary policy. The PBOC increased the rate on the medium-term lending facility in January and last week it did likewise for both the reverse repo (by 10bps) and the standing lending facilities for three tenors (overnight, 7-day and 1-month) by 35bps, 10bps and 10bps, respectively. The manufacturing PMI index was 51.3 in January, which means that it remained in expansion territory and beat expectations of 51.2.

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Snippets:

- **Chile:** Industrial production expanded at a rate of 0.3% yoy in December versus -0.7% yoy expected. Retail sales expanded at a solid rate of 4.1% yoy.
- **Colombia:** Inflation on a year on year basis declined from 5.75% in December to 5.47% in January.
- **Egypt:** Net FX reserves increased to USD 24.6bn in January from USD 24.3bn in December.
- **El Salvador:** Fitch cut El Salvador's sovereign credit rating to B from B+ and applied a negative outlook due to erosion of the public finances.
- **Hong Kong:** Stronger than expected retail sales (-2.9% yoy versus -5.4% yoy in November and -4.9% yoy expected).
- **Malaysia:** The government appears to have met its 2016 fiscal target of 3.1% of GDP after cutting spending significantly late in the year.
- **Middle East:** PMIs in Saudi Arabia, Egypt and UAE all improved in January compared to December.
- **Mozambique:** The government officially defaulted on its USD 727m 2023 notes after failing to make payment within the grace period, which ended on 2 February.
- **Peru:** CPI inflation was just 0.24% in January versus 0.30% mom expected.
- **Poland:** Manufacturing PMI accelerated to 54.8 in January from 54.3 in December. Real GDP growth slowed to 2.8% in 2016 from 3.9% in 2015 against the backdrop of greater populism in the government.
- **South Africa:** The trade balance in December was much stronger than in November as the surplus rose to ZAR 12bn from ZAR 1.7bn. The consensus expectation was that the trade surplus would be ZAR 6.3bn.
- **South Korea:** Industrial production rose sharply in December (4.3% yoy). Exports surged by 11.2% yoy in January, nearly twice the pace of December's exports (6.4% yoy). Consumption remains sluggish, however. The current account surplus narrowed to USD 7.7bn in December from USD 8.9bn in November.
- **Thailand:** Inflation rose to 1.55% yoy in January from 1.13% yoy in December. Core inflation was broadly unchanged at 0.75%, since headline was mainly affected by the volatile energy component. The government passed a supplementary budget of 1.3% of GDP to finance infrastructure spending.
- **Tunisia:** Fitch lowered Tunisia's sovereign debt rating to B+ from BB-.
- **Turkey:** Inflation was 9.2% yoy in January, up from 8.5% yoy in December. The central bank revised up its inflation expectation for 2017 to 8% from 6.5% previously, yet refused to hike policy rates ahead of a change in the constitution intended to grant President Erdogan greater powers. Manufacturing PMI rose to 48.7 in January from 47.7 in December.

Global backdrop

The FOMC did not signal a March hike in its January meeting. This seems to confirm that this Fed is very dovish. A hawkish Fed could, had it wanted to, easily have established a strong case for hiking rates meaningfully, in our view. For example, the US data has been improving lately, the economy is close to full employment and the newly elected US President Donald Trump has announced that he wants to beef up infrastructure spending, cut taxes and increase import tariffs all of which are seriously inflationary. A prudent Fed with a hawkish bent would therefore have taken the data and President Trump's promises at face value and hiked rates pre-emptively with reference to the balance of risks. The fact that this Fed did not do so testifies to a clear dovish bent, in our view. Maybe Chairwoman Janet Yellen is hoping to keep the ship afloat until her term expires a year from now? If so, she will have been pleased with the payroll numbers, which were benign. The rate of unemployment increased, but this was mainly due to increased labour market participation, which is a good thing. Meanwhile, hourly earnings were lower than expected. Result: Goldilocks. On the other hand, the continued focus on immigration by the Trump Administration must be a source of concern for the Fed. Nearly 40% of population growth in the US is due to immigration. Population growth currently contributes about two thirds of all US growth, so if immigration was halted altogether, the US would have to waive goodbye to about one quarter of its annual growth.

We note in passing that the latest UK PMI numbers fell well short of expectations. One to watch. The UK went into the Brexit vote with very strong growth momentum, but it remains to seen how resilient the economy will be in a downturn given the enormous Brexit-related uncertainties that cloud the future outlook.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.06%	6.59%	30.67%	2.45%	0.15%
MSCI EM Small Cap	1.92%	6.70%	20.19%	2.10%	2.17%
MSCI Frontier	0.67%	7.38%	17.64%	-0.22%	6.33%
MSCI Asia	0.50%	6.72%	25.70%	4.54%	3.90%
Shanghai Composite	-0.60%	1.18%	17.00%	18.19%	8.81%
Hong Kong Hang Seng	-1.23%	3.07%	28.54%	3.38%	0.28%
MSCI EMEA	1.78%	3.92%	35.64%	-1.48%	-2.97%
MSCI Latam	1.94%	9.72%	53.37%	-0.35%	-6.66%
GBI EM GD	1.29%	3.57%	13.40%	-1.42%	-2.33%
ELMI+	0.91%	2.76%	8.24%	-2.22%	-1.87%
EM FX Spot	1.08%	2.22%	4.29%	-8.46%	-8.24%
EMBI GD	0.62%	2.07%	12.96%	7.14%	5.85%
EMBI GD IG	0.59%	1.90%	8.42%	5.68%	4.32%
EMBI GD HY	0.65%	2.25%	18.32%	8.67%	7.88%
CEMBI BD	0.35%	1.59%	11.72%	5.64%	5.64%
CEMBI BD IG	0.25%	1.04%	6.81%	4.83%	4.86%
CEMBI BD Non-IG	0.49%	2.44%	20.20%	6.63%	7.03%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.85%	2.76%	22.76%	12.00%	13.69%
1-3yr UST	0.01%	0.13%	0.30%	0.59%	0.54%
3-5yr UST	0.02%	0.33%	-0.28%	1.46%	1.16%
7-10yr UST	-0.02%	0.20%	-2.20%	2.84%	1.96%
10yr+ UST	-0.30%	0.18%	-4.48%	5.69%	3.24%
10yr+ Germany	-0.10%	-2.88%	-0.89%	8.79%	6.97%
10yr+ Japan	-0.54%	-1.86%	2.66%	5.34%	5.27%
US HY	0.40%	1.86%	22.37%	5.06%	7.00%
European HY	0.17%	0.83%	12.02%	5.85%	9.75%
Barclays Ag	-0.08%	0.05%	5.86%	3.84%	4.41%
VIX Index*	-8.51%	-21.87%	-53.08%	-36.33%	-38.23%
DXY Index*	0.38%	-2.27%	2.95%	23.47%	26.34%
CRY Index*	0.61%	0.36%	19.31%	-32.73%	-38.51%
EURUSD	-0.36%	2.26%	-3.89%	-20.84%	-18.07%
USDJPY	-0.10%	-3.68%	-2.73%	10.36%	47.21%
Brent	2.53%	0.51%	67.67%	-46.72%	-50.74%
Gold spot	0.94%	6.05%	2.75%	-2.88%	-28.97%

*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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