Keep calm and carry on in China

By Jan Dehn

China signalled continuity at the National People's Congress, including stable growth and inflation and a sustained commitment to reform. This should keep China on track to take over as the world's undisputed economic leader over the next couple of decades. South Korea has become a mini-battleground between China and the US following the deployment of an anti-missile defence system to the country. Brazil racks up another enormous trade surplus, but we show that Brazil is by no means the only EM country to exhibit strong improvements in external balances in the last few years. MXN rallied strongly late last week on benign comments about US-Mexican relations from US Commerce Secretary Wilbur Ross. Turkey racked up double-digit inflation as the economy slows and India's economy delivers far better growth than expected following demonetisation. In the global backdrop we note that the Fed has all but announced a March hike, which is now 96% priced in.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	-1.28%
MSCI EM Small Cap	11.6	–	-1.12%
MSCI Frontier	10.1	–	0.14%
MSCI Asia	11.8	–	-1.27%
Shanghai Composite	12.0	–	-1.08%
Hong Kong Hang Seng	7.6	–	-2.63%
MSCI EMEA	9.3	–	-1.11%
MSCI Latam	12.3	–	-0.37%
GBI-EM-GD	6.75%	–	-0.93%
ELMI+	3.99%	–	-0.62%
EM FX spot	–	–	-0.85%
EMBI GD	5.49%	300 bps	-0.15%
EMBI GD IG	4.31%	178 bps	-0.35%
EMBI GD HY	6.97%	456 bps	0.06%
CEMBI BD	5.23%	287 bps	-0.19%
CEMBI BD IG	4.35%	198 bps	-0.31%
CEMBI BD Non-IG	6.63%	427 bps	0.01%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.5	–	0.71%
1-3yr UST	1.30%	–	-0.36%
3-5yr UST	2.00%	–	-0.69%
7-10yr UST	2.47%	–	-1.28%
10yr+ UST	3.07%	–	-1.95%
10yr+ Germany	0.34%	–	-2.87%
10yr+ Japan	0.07%	–	0.05%
US HY	5.55%	349 bps	0.33%
European HY	3.28%	379 bps	0.16%
Barclays Ag	–	241 bps	-0.63%
VIX Index*	10.96	–	-0.51%
DXY Index*	101.42	–	0.29%
EURUSD	1.0602	–	0.14%
USDJPY	113.76	–	0.93%
CRY Index*	189.72	–	-1.22%
Brent	55.5	–	-0.80%
Gold spot	1232	–	-1.65%

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

Emerging Markets

- **China:** Prime Minister Li Keqiang has set out the government's economic targets at the National People's Congress. The growth target for this year is 6.5% with inflation around 3%. Monetary policy will be tightened marginally relative to last year and the fiscal deficit target is 3.0% of GDP. The objective is to achieve a rate of unemployment at 4.5%, which implies the creation of more than 10m new jobs in the coming 12 months (not dissimilar to recent years). Regarding reforms, markets will continue to be given a larger role in resource allocation, including in FX markets, where liberalisation will also continue. For example, China SAFE (State Administration of Foreign Exchange) announced last week that foreign institutional investors will be allowed to hedge FX positions onshore for the first time, thus bringing China yet another step closer to index inclusion, in our view. The broader reform objective is unchanged: China is to transform itself from an investment and export-led economy to one that relies far more on domestic demand. It is intelligent to take this path for two reasons: First, economic policies in the West are becoming more hostile towards China, so less reliance on exports is sensible. Second, China has a bright future ahead as a consumption-led economy on account of its very high (49%) savings rate. We continue to place great faith in China's ability to transform its economy without experiencing a hard landing. China's economic performance has been – and continues to be – characterised by stability underpinned by a focus on long-term policy objectives.

  In contrast, China's markets have been more volatile. While this is of course also true in all other countries, many foreign investors habitually regard the volatility as indicative of imminent very bad news, such as a hard landing. It is tempting to juxtapose market volatility with China's gentle economic slowdown, especially in the context of China debt stock, which is larger than in most other Emerging Markets (EM) countries, though far less debt than most developed economies. However, in our view such juxtaposition is lazy analysis intended

Continued overleaf

Emerging Markets

to appeal to deep-seated prejudices about China. We do not regard market volatility, the slowdown in growth and China's debt situation to be causally linked. Let us consider each in turn:

a) Market volatility: The occasional bouts of volatility in China's markets primarily reflect the fact that large pools of savings exist alongside a relatively limited set of financial instruments accessible to retail investors. Fixed income and foreign assets are particularly constrained from a retail investor point of view. This is why the continuing development of China's financial markets is a good thing: deeper broader markets will help to reduce the annoying volatility and channel investable capital to new and productive uses.

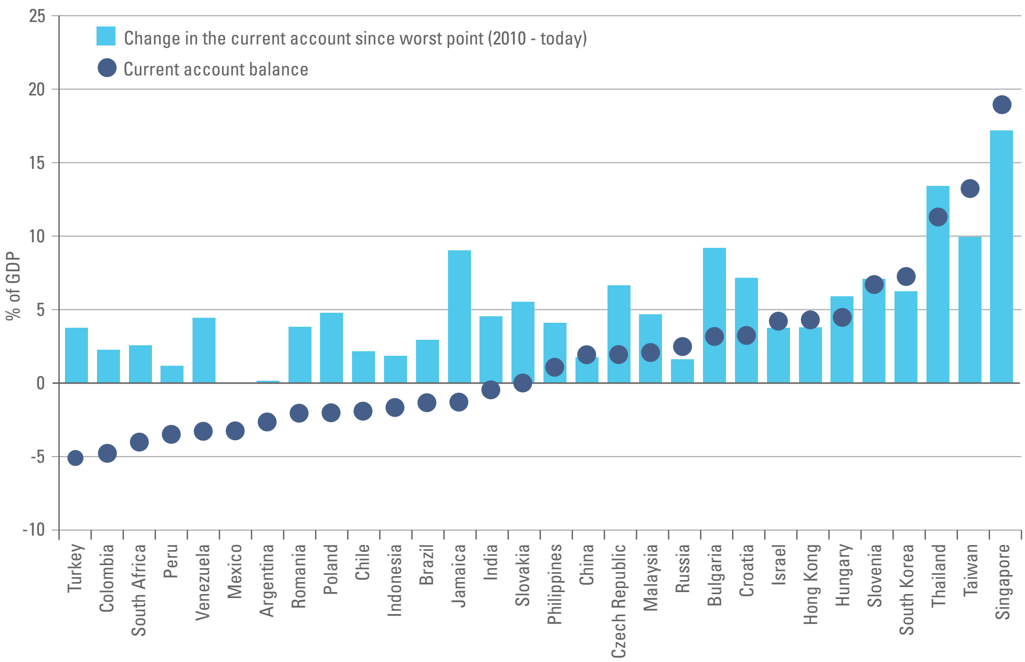
b) Slowdown: The slowdown in China's growth rate in recent years is mainly due to aggressive, but sensible reforms, such as price and interest rate liberalisation. Such policies create considerable short term uncertainty, which inevitably results in the postponement of investment and consumption decisions. However, the very fact that these reforms are taking place is grounds for optimism about the future.

c) Debt: China's debt stock is large relative to other countries, but this mainly reflects the country's very high saving rate. The banking system is not nearly as leveraged as Western banks and China has committed far more financing to productive investment, such as infrastructure rather than, say, consumption.

- South Korea: China and the US are engaging in a little proxy conflict with each other in South Korea. The latest tensions were triggered by the deployment of a US-supported anti-missile system in the country. China responded to the deployment by imposing a ban on all tourism related travel by Chinese citizens to South Korea. Various estimates put the potential economic cost to South Korea of the travel ban at 0.3-0.5% of GDP if the ban is maintained for a full year. Fortunately, the South Korean economy had the momentum going into this spat, which means it will likely withstand some pain. Industrial production and equipment investment both picked up in January and exports performed strongly in the first 20 days of February (up 20.2% yoy). The domestic political backdrop is important: the strongly pro-US Park Administration is extremely weak and hopes that tension with China can help it gain much-needed political support at home, given that the South Korean political opposition is not as hostile to China as the Park Administration. China is also happy to use the dispute over the anti-missile system as a warning to the US that they will not hold back in any conflict, military or trade-related, with the US. Meanwhile, to add flavour to an already rich broth, North Korea is taking advantage of heightened US-China tensions by firing a few missiles at Japan. Flare-ups like these are common-place and usually prove temporary.

- Brazil: Brazil racked up a whopping USD 4.6bn trade surplus in February. The surplus was well in excess of market expectations of USD 3.3bn and implies that Brazil's trade balance is now 84% stronger than at the same time last year. The chart below places the improvement in Brazil's external balances within the broader EM context. The chart shows that Brazil is clearly not the only EM country that has achieved strong improvements in recent years. In fact, the improvement in the current account balances of the thirty most traded EM countries has been (on average) 5.1% of GDP since their lowest point in the period. All but one country, namely Mexico, have seen their current account balances improve.

Fig 1: **Level and change in current account balances (% of GDP)**



Source: Ashmore, Bloomberg.

Continued overleaf

Ashmore

Emerging Markets

As in Brazil's case, the main source of improvement in current account balances is the trade balance. EM is winning trade share due to declining inflation and much more competitive currencies, which jointly have pushed real effective exchange rates in EM to their most competitive level since 2003, the year of the last major EM local currency government bond rally. Incidentally, the opposite is true in the United States, where rising inflation and the overvalued Dollar is hurting export competitiveness and growth. In other Brazilian news, minutes from the February 22 monetary policy committee meeting were dovish. This keeps the possibility alive that the central bank will increase the pace of rate cuts from 75bps per meeting to 100bps per meeting. The Brazilian pension reform has now reached the committee stage of the Lower House. The pension reform is accompanied by a bill to assist economic recovery at state level by enabling states to suspend debt repayments to the Federal Government temporarily. This fiscal trade-off between temporary debt relief for states in exchange for large permanent improvements in the overall public finances makes a great deal of sense, provided, that the pension reform is eventually passed, which is our base case.

- Mexico: US Commerce Secretary Wilbur Ross confirmed last week that trade discussions between the US and Mexico will take place within the sensible and rational framework of a NAFTA renegotiation. The MXN rallied strongly in response. Meanwhile, the Mexican 12 month rolling public sector borrowing requirement dropped to MXN 545bn in January, which was materially lower than in the same month last year. The improvement was mainly due to a sharp pickup in oil revenues aided in part by higher oil prices and in part by the weaker Peso compared to last year. Despite its outperformance this year MXN is still down over the past year due to the hostile attitude towards Mexico adopted by US President Donald Trump. Finally, gross fixed investment accelerated in Q4 2016 to 1.0% yoy from -1.2% yoy in Q3 2016.

- Turkey: Despite recent weaker economic activity the rate of inflation in Turkey continues to rise. In February inflation thus returned to double-digit territory (10.1% yoy). The central bank is managing monetary policy badly due to pressure from President Erdogan, whose is focused on winning electoral support in favour of concentrating more power into his own hands. In our view Turkey will ultimately pay a heavy economic price for Erdogan's political ambitions.

- India: Manufacturing and services PMIs both returned to positive territory in February in a clear sign that the downturn in economic activity associated with the recent demonetisation exercise was temporary in nature. Q4 2016 real GDP growth came at 7.0% yoy versus 6.1% yoy expected. The solid growth numbers validate the Reserve Bank of India's reluctance to countenance major rate cuts in recent months. In the coming week attention will shift to the results of five state elections in India. Results are due on 11 March. These elections have the potential to shift the balance of power in India's Senate, where the ruling BJP does not command a majority.

Snippets:

- Argentina: The central bank cut the reserve requirements for banks by 2% in a bid to deepen financial markets.
- Chile: The rate of unemployment rose to 6.2% in January, in line with expectations.
- Colombia: Jose Antonio Ocampo has been appointed to the central bank's board of directors. Ocampo is a left-leaning economist, who is likely to be strongly dovish.
- Hong Kong: The Nikkei PMI declined to 49.6 in February from 49.9 in January. On the other hand, the demand-side of the economy picked up with better than expected retail sales (-1.4% yoy in January versus -2.9% yoy in December).
- Hungary: The central bank left policy rates unchanged.
- Indonesia: Inflation picked up in February to 3.8% yoy from 3.5% yoy in January, though this was less than expected (3.9% yoy). Core inflation was in line with expectations (3.4% yoy).
- Malaysia: Malaysia's trade surplus increased at a rate of 1.1% yoy in January, which was a slowdown relative to the rate of growth in December (2.0% yoy). Exports rose at a fast rate of 10.6% yoy, but imports rose even faster at 13.0% yoy. The fact that capital imports rose strongly bodes well for growth going forward.
- Russia: Inflation was zero in the week of February 20-27, which took yoy inflation to just 0.8% ytd. Pass-through from the exchange rate was negative in Q4 2016.
- Saudi Arabia: Retail sales picked up strongly (+7.0% yoy) in January.
- Thailand: CPI inflation was 1.4% yoy in February versus 1.6% yoy expected, while core inflation declined to 0.6% yoy from 0.7% yoy last month. Tourism and other exports rebounded strongly in January.

Continued overleaf

Global backdrop

The Fed made it very clear last week that it aims to hike at the March meeting. The market has now all but priced the event (96% priced in). The Dollar sold off heavily on Friday following hawkish comments by Janet Yellen. With the Fed move effectively out of the way EM markets now look set for another upturn if the usual pattern is repeated. Meanwhile, US President Donald Trump received a warm reception for his first speech to Congress, but made no specific announcements. Soon afterwards, however, the Trump Administration was once again embroiled in various self-inflicted problems. FBI sources have denied allegations that the Obama Administration bugged Trump Towers and US Attorney General Jefferson Sessions was alleged to have had ties with Russia during the election campaign and had to recuse himself from involvement in any investigation of such matters. This is all irrelevant to EM investors except for the fact that Trump's declining political capital has implications for the odds of reform. The commitment by Trump to repeal and replace Obamacare is already delaying tax reform considerably and the odds that House Speaker Paul Ryan's controversial border adjustment tax will be implemented also decline as Trump becomes less popular (since border adjustment has a great deal of opposition both within the Republican Party and among many lobby groups). The tax reform matters to EM because it impacts the size of a likely US fiscal stimulus and the outlook for the Dollar. Meanwhile, both inflation and economic activity in Europe ex-UK were both much stronger than expected, so EURUSD remained within recent ranges despite the transitory uncertainties arising from upcoming elections in Holland, France and Germany.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.54%	8.11%	22.57%	2.07%	-0.16%
MSCI EM Small Cap	-1.00%	9.02%	17.05%	1.55%	1.59%
MSCI Frontier	0.70%	7.02%	12.07%	-0.88%	5.72%
MSCI Asia	-0.88%	8.81%	19.93%	4.17%	3.60%
Shanghai Composite	-0.72%	3.70%	14.85%	18.42%	8.17%
Hong Kong Hang Seng	-1.49%	7.98%	26.08%	5.24%	0.99%
MSCI EMEA	1.14%	3.38%	21.40%	-1.80%	-3.66%
MSCI Latam	0.32%	11.84%	36.45%	-0.82%	-6.83%
GBI EM GD	-0.43%	3.65%	9.53%	-2.41%	-2.41%
ELMI+	-0.62%	2.89%	5.62%	-2.54%	-1.92%
EM FX Spot	-0.50%	1.73%	1.24%	-9.14%	-8.41%
EMBI GD	-0.25%	3.22%	10.85%	6.69%	5.61%
EMBI GD IG	-0.37%	2.76%	6.34%	5.14%	4.10%
EMBI GD HY	-0.11%	3.73%	16.15%	8.32%	7.57%
CEMBI BD	-0.20%	2.44%	10.76%	5.43%	5.39%
CEMBI BD IG	-0.33%	1.78%	6.38%	4.52%	4.69%
CEMBI BD Non-IG	0.00%	3.46%	18.17%	6.61%	6.57%

Continued overleaf

Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.85%	6.85%	22.13%	11.20%	14.11%
1-3yr UST	-0.14%	0.00%	0.25%	0.54%	0.53%
3-5yr UST	-0.27%	0.10%	-0.26%	1.33%	1.15%
7-10yr UST	-0.62%	0.12%	-2.53%	2.70%	1.96%
10yr+ UST	-1.24%	0.47%	-5.63%	5.79%	3.20%
10yr+ Germany	-2.24%	-2.30%	-1.37%	8.57%	6.69%
10yr+ Japan	-0.48%	-1.29%	-1.06%	5.41%	5.44%
US HY	0.14%	3.07%	19.79%	4.78%	6.83%
European HY	0.11%	1.66%	12.01%	5.47%	9.29%
Barclays Ag	-0.57%	0.76%	5.87%	3.83%	4.23%
VIX Index*	-15.17%	-21.94%	-34.99%	-22.87%	-47.48%
DXY Index*	0.30%	-0.77%	4.19%	27.31%	26.99%
CRY Index*	-0.48%	-1.45%	12.56%	-38.32%	-39.67%
EURUSD	0.25%	0.78%	-3.73%	-23.51%	-19.14%
USDJPY	0.88%	-2.77%	0.26%	10.37%	40.64%
Brent	-0.20%	-2.36%	43.29%	-48.68%	-54.52%
Gold spot	-1.30%	6.93%	-2.78%	-8.79%	-26.41%

*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

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

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