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Ashmore

EM mercantile trade volumes hit all-time high

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EM mercantile trade volumes hit an all-time high in January 2017. Both import and export volumes are rising faster in EM in than in developed countries. PDVSA, the Venezuelan national oil company, met its payment obligations in April. Erdogan claims victory in the referendum granting sweeping powers to the president as opposition contests the results. Argentina's central bank hiked rates 150bps. Russia and China both rack up large trade surpluses. Rates were cut by 100bps in Brazil. Political tensions rise in Zambia. In the global backdrop section we discuss Trump's comments on the Dollar and recent geopolitical tensions.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	0.53%
MSCI EM Small Cap	11.7	–	0.27%
MSCI Frontier	9.9	–	-0.76%
MSCI Asia	11.8	–	-0.06%
Shanghai Composite	12.1	–	-1.44%
Hong Kong Hang Seng	7.4	–	-0.70%
MSCI EMEA	9.4	–	3.33%
MSCI Latam	12.5	–	0.37%
GBI-EM-GD	6.52%	–	1.52%
ELMI+	3.68%	–	0.85%
EM FX spot	–	–	1.15%
EMBI GD	5.38%	312 bps	0.53%
EMBI GD IG	4.22%	192 bps	0.51%
EMBI GD HY	6.84%	468 bps	0.55%
CEMBI BD	5.14%	302 bps	0.29%
CEMBI BD IG	4.23%	211 bps	0.37%
CEMBI BD Non-IG	6.57%	446 bps	0.16%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.2	–	-0.26%
1-3yr UST	1.20%	–	0.27%
3-5yr UST	1.76%	–	0.56%
7-10yr UST	2.23%	–	0.97%
10yr+ UST	2.89%	–	1.44%
10yr+ Germany	0.18%	–	0.71%
10yr+ Japan	0.01%	–	1.33%
US HY	5.83%	392 bps	0.05%
European HY	3.47%	401 bps	-0.01%
Barclays Ag	–	245 bps	0.48%
VIX Index*	14.74	–	0.69%
DXY Index*	100.24	–	-0.78%
EURUSD	1.0650	–	0.42%
USDJPY	108.89	–	0.67%
CRY Index*	187.39	–	0.29%
Brent	55.1	–	-1.59%
Gold spot	1285	–	0.79%

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

Emerging Markets

Emerging Markets (EM) mercantile trade volumes reached an all-time high in January 2017 (see table overleaf). In the past twelve months alone EM trade volumes have increased by 5% versus 2% in developed economies. If we break trade volumes into their export and import components we find that EM export volumes have risen 4% in the past twelve months to January 2017, while EM import volumes rose by 6% over the same period. Both are rising faster than in developed economies. The fact that EM import volumes are rising faster than export volumes may suggest that EM domestic demand is recovering after the severe financial tightening of recent years, while demand in developed economies is weak. Indeed, export volumes in developed economies rose 3% over the twelve months to January 2017 compared to just 2% for import volumes. In addition to higher volumes, prices of mercantile traded goods also picked up over the course of the past year, so the value of EM mercantile trade rose by 11% over the period to USD 6.8trn. The total value of mercantile trade is USD 8.4trn in developed economies, so EM's share in global mercantile trade now stands at 45%, up from 29% in 2000. Since 2000 the value of EM trade has increased by a massive 295%, or USD 5.1trn compared to 96% (UDS 4.1trn) for developed economies. Within EM, mercantile trade increased the most in Central and Eastern Europe (343%) followed by Asia (318%), Middle East & Africa (290%) and Latin America (197%), although the largest absolute increase was Asia due to its larger size.

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Emerging Markets

Fig 1: **Trade patterns: Emerging Markets (EM) versus Developed Markets (DM)**

Value of trade (USD trn)	Jan-00	Jan-16	Jan-17	% yoy
EM	1.7	6.1	6.8	11%
% of global trade	*29%*	*43%*	*45%*	–
DM	4.3	8.0	8.4	5%
Volume of trade (constant 2010 USD trn)				
EM	2.8	6.9	7.3	5%
% of global trade vol.	*31%*	*43%*	*44%*	–
DM	6.3	9.0	9.2	2%
Export volumes (constant 2010 USD trn)				
EM export volume	3.1	7.3	7.6	4%
EM share of global exports	*34%*	*46%*	*46%*	–
DM export volumes	5.9	8.6	8.9	3%
Import volumes (constant 2010 USD trn)				
EM import volume	2.5	6.5	6.9	6%
EM share of global imports	*27%*	*41%*	*42%*	–
DM import volume	6.7	9.4	9.6	2%

Source: CPB Netherlands Bureau for Economic Policy Analysis, Ashmore.

- Venezuela: PDVSA paid. On Wednesday last week the national oil company of Venezuela paid USD 2.2bn toward final redemption of the 2017 bond plus coupon payments on the Nov-2017 and 2037 bonds. As usual, the market had assigned a very high probability of default and the bonds rallied strongly after news that payment had been made.

There is no doubt that the situation in Venezuela is dire. Reserves are low and there are high levels of discontent among the Venezuelan population on account of the severe economic crisis. This does not necessarily mean that PDVSA will not service its debt. On the contrary, PDVSA found the cash without a material drawdown in reserves by drawing on funds elsewhere in the public sector. But why does the Maduro government prioritise debt servicing so highly? There are two basic reasons. First, servicing debt is critical to keeping oil production going. PDVSA relies on credit lines from banks and a default would cut off the credit lines which would stall oil production very quickly. As a consequence, President Maduro would soon find himself dangling from a lamppost, literally or metaphorically. Secondly, experience has shown that the government can get away with prioritising debt service: the Venezuelan population and opposition politicians in particular appear to find it extremely difficult to unite around a single objective. It is almost as if Venezuelans suffer from extreme myopia and completely lack social initiative. The inability of the opposition and population to work together actively towards a better state is what allows Maduro to cling on to power. As long as he can continue to make this trade-off he will do so.

- Turkey: Erdogan claims victory in the referendum granting broader powers to the presidential office. The "Yes" side won a tight majority of 51.4% according to official results. Both Ankara and Istanbul had a majority of "No" voters, further illustrating a deep division in society which is in line with the pattern in recent elections. The opposition has contested the results based on last minute changes in the criteria of validation of the ballot. The Organization for Security and Cooperation in Europe has also pointed to these irregularities adding the *"one-sided media coverage and limitations to fundamental freedoms have created unlevel playing field on the referendum"*. President Erdogan immediately announced the intention to discuss the implementation of capital punishment, which would increase its distance from Europe and the "no" camp. Erdogan extended the state of emergency for another three months allowing the government to rule the country via decrees. The protests are unlikely to have any impact on results over the short term with Erdogan radicalising further to tighten his grip on power. An increased injection of liquidity via state owned banks and negative real interest rates may stabilise unemployment in the short term at the cost of higher and more protracted inflation. Good liquidity conditions for EM also help Erdogan to "get away" with poor policy making. But the medium term scenario has deteriorated further. The economy is likely to slow down further even with increased liquidity as inflation picks up. Debt is also likely to increase, particularly off-balance sheet debt via state owned companies. Increased ruptures in society and the economy will eventually lead to a more serious destabilisation when liquidity conditions tighten again.

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Emerging Markets

- Argentina: The central bank hiked the 7-day repo policy rate by 150bps to 26.5% in the light of stubbornly high core inflation and inflation expectations, which continue to diverge from the target ranges for inflation of 12-17% for 2017 and 8- 12% for 2018. March CPI inflation was 2.40% mom versus 2.00% mom expected and 2.50% mom in February. Inflation is just not coming down fast enough. The problem the central bank faces is similar to the predicament facing most central banks in developed economies, namely that Argentina's economy needs a lot of structural reform and central banks simply cannot help with such issues. Argentina needs to liberalise the current account and moderate fiscal spending, but neither seem likely ahead of the upcoming mid-term election later this year. In the meanwhile, high levels of bond issuance crowds out investment. The decision to hike is therefore welcome news as the rate hike should anchor inflation expectations and support the currency. The cost will be felt in terms of meeting the government's growth target as higher real rates discourage private sector investment.

- Russia: The current account surplus rose to USD 23bn (2.5% of GDP) in Q1 2017. The trade surplus rose to 7.4% of GDP. Russia's FX reserves now stand at USD 398bn. The strength of the external accounts is testament to decisive demand and currency management in the aftermath of the 2014 drop in oil prices. Russia's experience stands in marked contrast to the experience of Nigeria, which refused to let the currency go and maintained unsustainable levels of spending despite lower national income. In other words, treating all oil countries the same could prove very costly from an investment perspective.

- El Salvador: Ratings agencies S&P and Fitch downgraded El Salvador's sovereign credit rating to CCC- and CCC from B- and B, respectively. This was in response to a failure on the part of the government to make payments on its obligations to a local pension fund. In our view this is a very rash reaction. El Salvador does not have a strong credit due to weak growth, high levels of debt and a widening fiscal deficit, but this particular failure to pay has nothing to do with El Salvador's external debt obligation. Quite the contrary, El Salvador has both the ability and willingness to service external debt. The government was unable to pay the pension fund, because Parliament failed to approve a supplementary budget for this purpose. This failure reflects a deep division between the two main parties in the country.

- China: China's trade balance improved sharply in March. The balance surged from a deficit of USD 9.15bn in February to a surplus of USD 23.93bn in March. Imports rose 20.3% yoy versus 15.5% yoy expected, while exports rose at a rate of 16.4% yoy versus just 4.3% yoy expected. The improvement in the trade balance will enter directly – and positively – into the GDP growth calculation for Q1 2017. Inflation remains moderate as CPI was 0.9% yoy versus 1.0% yoy expected in March, while core inflation ticked higher to 2.0% yoy from 1.8% yoy in February. The Chinese real 5yr government bond yield of 1.1% compares favourably to real yields in all other SDR countries. Meanwhile, growth surprised on the upside with Q1 GDP expanding 6.9% (vs. 6.8% consensus). Industrial production, fixed asset investment and retail sales have also exceeded expectations with a strong housing market also supporting activity.

- Brazil: The central bank increased the pace of rate cuts to 100bps per meeting, taking the SELIC policy rate to 11.25%. IPCA inflation is currently 4.57% and still falling albeit at a marginally slower pace. Still, that makes for a attractive real policy rate of nearly 6.7%. The leaders of the main congressional parties in Brazil last week gave their backing to a crucial pension reform. The chairman of the lower house's special committee analysing the reform said he now expects 350 votes in favour of the reform. A total of 308 votes are required for passage. The reform is critical for the fiscal outlook in Brazil. By increasing the retirement age significantly the reform reduces statutory commitments to pensions, which in turn provides room to spend on other things as Brazil implements a 20-year spending cap The General Prosecutor Janot has published the list of names of more than one-hundred politicians to be investigated for involvement on the Odebrecht bribe schemes. This increases anti-establishment feelings and favours Joao Doria – the recently elected Mayor of Sao Paulo for the 2018 election. Doria is a competent businessman who has been quickly gaining national visibility by confronting former president Lula publically. The release of the list doesn't have a negative impact on the approval of the pension plan reform. If anything, politicians involved should be keener to take actions that will lead to a sentiment and growth rebound ahead of the Oct-18 parliamentary and presidential elections. Meanwhile, retail sales beat expectations (-3.2% yoy vs -7% yoy expected) with a big positive revision in January, when retail sales were revised to 5.5% mom after an originally reported drop to 0.7% mom.

- Zambia: Opposition politician Hakainde Hichilema has been charged with treason. President Edgar Lungu is clamping down on Hichilema, who has refused to accept his presidency due to alleged election rigging. Hichilema decided to block the presidential motorcade and Lungu is now using this error as a pretext to put him away. How costly will this be for Zambia? In African countries the persecution of politicians often brings protests from donors, including bilateral agencies, the World Bank, EU, etc. This pressure will likely increase, though it could take a long time before it becomes a really seriously binding constraint for the government. Besides, China is an important source of financing in Zambia and China famously stays out of domestic politics.

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Emerging Markets

Snippets:

- **Bahrain:** Having dropped by 70% since 2014 Bahrain's FX reserves now cover just one month of imports.
- **Costa Rica:** The monthly GDP growth indicator was 3.9% higher in February than in the same month last year.
- **Hungary:** The rate of inflation slowed to 2.7% in March from 2.9% in February.
- **India:** The yoy CPI inflation rate was 3.81% in March versus 3.94% yoy expected. Industrial production was 1.2% lower in February compared to February 2016 and lower than expected (+1.3% yoy). India will launch GST, a national sales tax, on 1 July 2017 as planned, according to government officials.
- **Indonesia:** Government budget revenues were 19% higher in Q1 than in the same quarter last year due to revenues related to primary commodities, such as gas, value-added and other taxes.
- **Malaysia:** Industrial output was 4.7% higher in February than in the same month of 2016. The market expectation was 6.1% yoy.
- **Mexico:** Industrial production rose 0.1% mom sa in February versus -0.1% mom expected. Even so, industrial production was 1.7% lower in February than in the same month of 2016.
- **Peru:** The trade surplus hit a four-year high of USD 3.6bn in February. This is equivalent to 1.7% of GDP.
- **Philippines:** Exports were 11% higher yoy in February. Export to ASEAN, China and Hong Kong were 19%, 25% and 67% higher than in February last year, while exports to the US, Japan and EU were 0.3% yoy, -22.5% yoy and 7.9% yoy, respectively.
- **Poland:** CPI inflation declined to 2% in March from 2.2% in February.
- **Singapore:** The Monetary Authority of Singapore left the exchange rate policy unchanged with dovish forward guidance.
- **South Africa:** Manufacturing dropped sharply in February (-3.6% yoy). A sharp recent deterioration in the political environment may now usher in a recession in South Africa.
- **South Korea:** The South Korean unemployment rate declined to 3.7% in March from 4.0% in February. The market had expected unemployment at 3.8%. The Bank of Korea left the policy rate unchanged at 1.25% in the April meeting.
- **Taiwan:** Exports expanded at a rate of 13.2% yoy in March. The trade surplus was USD 3.9bn versus USD 3.4bn in February.
- **Uganda:** The central bank cut the policy rate to 11% from 11.5%

Global backdrop

The divergence between hard and soft data remains with Nowcast GDP trackers showing below 1% expansion of Q1 GDP in spite of record high levels of confidence in the economy. CPI posted a large downside surprise of -0.3% mom in March vs. 0% expected, taking yoy inflation from 2.7% to 2.4%. Core CPI also declined from 2.2% to 2.0%. The non-farm payroll and CPI downside surprises led the market to reprice the odds of a further two-hikes signalled by the FOMC to below 40%, pushing the US Dollar weaker across the board.

US President Donald Trump explicitly talked down the Dollar last week. He also said that he strongly favours low interest rates. These statements fly in the face of consensus opinion, but they make sense. The overvaluation of the Dollar is creating major problems for US companies to compete and other growth drivers are missing (productivity), fading (monetary stimulus) or being delayed/reduced (fiscal stimulus). Hence, a lower Dollar is now the least onerous way to support US companies and growth – for details see *"It's the currency, stupid"*, Weekly Investor Research, 27 March 2017. Low interest rates serve the same purpose.

How can the US influence the Dollar? One way is verbal intervention. Verbal intervention sends a signal to central banks the world over that the US wants to see the Dollar go lower. Implicit behind this objective is a thinly veiled threat that the government will pursue policies that achieve this outcome, such as low interest rates and/or fiscal profligacy. Famously, John Connally, US Treasury Secretary, said in 1971 that "The Dollar is our currency, but it is your problem". This verbal intervention triggered a sharp decade-long Dollar collapse precisely because foreign central banks decided to off-load their large Dollar positions. The other way is simply to let markets take their course. Asset prices in the US are very high and the currency has become very expensive. The returns on offer for global investors are no longer as compelling as they were before the 40% move in the Dollar and the massive rally in US stocks and bonds. Other parts of the world, including EM, now offer better prospects.

A lower Dollar is not an immediate home-run for the US economy. It will take time before the weaker Dollar helps American exporters, since resources will first have to move from the non-tradable sector to the tradable sector. Meanwhile, capital outflow will have a depressing effect on US stocks at the margin, since so much foreign money is invested in stocks. This capital account effect is likely to occur far quicker than the impact on exports. In other words, a lower Dollar may well turn out to be a risk-off event to some extent.

The US Treasury report on FX policies did not name any country a "Currency Manipulator", although it has relaxed the criteria for inclusion in the monitoring list which includes Germany, Japan, Switzerland, China, Taiwan and Korea. It also added hawkish language against competitive-seeking FX devaluations.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.54%	12.05%	16.78%	1.15%	1.64%
MSCI EM Small Cap	0.09%	13.13%	13.06%	1.33%	3.45%
MSCI Frontier	0.93%	9.80%	12.59%	-3.10%	6.25%
MSCI Asia	0.13%	13.51%	16.58%	4.13%	5.31%
Shanghai Composite	0.00%	3.85%	6.85%	18.03%	9.34%
Hong Kong Hang Seng	-0.67%	8.62%	15.78%	3.78%	2.55%
MSCI EMEA	2.20%	5.09%	10.57%	-3.75%	-2.07%
MSCI Latam	1.64%	13.96%	22.47%	-4.19%	-5.04%
GBI EM GD	0.96%	7.53%	5.67%	-2.63%	-1.41%
ELMI+	0.38%	5.58%	3.96%	-2.33%	-1.25%
EM FX Spot	0.53%	3.71%	-1.03%	-9.29%	-7.67%
EMBI GD	0.87%	4.77%	8.39%	6.19%	5.84%
EMBI GD IG	0.60%	4.29%	4.18%	4.97%	4.21%
EMBI GD HY	1.16%	5.29%	13.33%	7.15%	8.02%
CEMBI BD	0.61%	3.60%	8.23%	5.30%	5.57%
CEMBI BD IG	0.63%	3.04%	4.80%	4.49%	4.83%
CEMBI BD Non-IG	0.58%	4.48%	13.92%	6.28%	6.85%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.50%	5.54%	15.30%	10.28%	13.44%
1-3yr UST	0.25%	0.65%	0.58%	0.74%	0.65%
3-5yr UST	0.70%	1.38%	0.15%	2.07%	1.39%
7-10yr UST	1.19%	2.34%	-1.49%	3.77%	2.38%
10yr+ UST	1.92%	3.84%	-4.14%	6.59%	3.93%
10yr+ Germany	2.72%	0.98%	-0.13%	9.55%	7.23%
10yr+ Japan	1.50%	0.39%	-3.41%	6.11%	5.61%
US HY	0.38%	3.09%	14.54%	4.58%	6.90%
European HY	0.18%	1.61%	7.96%	4.89%	9.37%
Barclays Ag	0.88%	2.10%	4.19%	4.11%	4.53%
VIX Index*	19.16%	4.99%	10.41%	10.33%	-20.92%
DXY Index*	-0.11%	-1.93%	6.09%	25.57%	26.03%
CRY Index*	0.81%	-2.66%	7.63%	-39.83%	-37.36%
EURUSD	-0.02%	1.26%	-5.86%	-22.90%	-18.84%
USDJPY	2.30%	7.41%	-0.06%	-5.93%	-25.37%
Brent	4.28%	-3.04%	28.38%	-49.70%	-53.30%
Gold spot	2.86%	11.98%	4.26%	-0.72%	-21.76%

*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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