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WEEKLY INVESTOR RESEARCH

Ashmore

Thank you, Mr President

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More reforms in Brazil. NAFTA volatility in Mexico. Hikes in Turkey. OAS withdrawal in Venezuela. Accelerating growth in South Korea. Court goes nuclear in South Africa. FX reserves hit USD 400bn in Russia. China focuses on financial stability. We thank Trump for the good times and speculate about the upcoming UK-EU divorce settlement.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.2	–	0.89%
MSCI EM Small Cap	11.7	–	0.78%
MSCI Frontier	9.1	–	0.20%
MSCI Asia	11.9	–	1.51%
Shanghai Composite	12.0	–	-0.57%
Hong Kong Hang Seng	7.5	–	1.69%
MSCI EMEA	9.7	–	0.14%
MSCI Latam	12.6	–	-0.69%
GBI-EM-GD	6.40%	–	-0.36%
ELMI+	3.91%	–	-0.50%
EM FX spot	–	–	-0.53%
EMBI GD	5.31%	299 bps	0.23%
EMBI GD IG	4.18%	181 bps	-0.03%
EMBI GD HY	6.60%	436 bps	0.51%
CEMBI BD	5.09%	290 bps	0.22%
CEMBI BD IG	4.20%	202 bps	0.11%
CEMBI BD Non-IG	6.45%	426 bps	0.39%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	0.61%
1-3yr UST	1.29%	–	-0.05%
3-5yr UST	1.86%	–	-0.07%
7-10yr UST	2.34%	–	-0.30%
10yr+ UST	3.02%	–	-1.02%
10yr+ Germany	0.34%	–	-0.31%
10yr+ Japan	0.02%	–	0.00%
US HY	5.62%	369 bps	0.48%
European HY	3.29%	375 bps	0.32%
Barclays Ag	–	244 bps	0.01%
VIX Index*	10.04	–	-0.72%
DXY Index*	99.04	–	0.25%
EURUSD	1.0913	–	-0.12%
USDJPY	112.30	–	-1.08%
CRY Index*	181.59	–	0.66%
Brent	51.9	–	-0.35%
Gold spot	1255	–	-0.70%

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

Emerging Markets

- **Brazil:** More reforms! Brazil last week approved a reform of the labour code, which significantly increases flexibility in areas of vacation, working hours, types of labour contracts, part time work, union contributions, termination of contracts, time limits for labour related lawsuits and others. Brazil's labour code has not been reformed since the 1950s, so this is a major step forward, which should help the labour market to clear more quickly. The government passed the legislation with 296 in favour and 177 against. Only a simple majority of 257 votes was required. Brazil's unions did not like the labour reform one bit, especially the bit about reducing union contributions, so they called a general strike, but this did not change anything. In other news, Brazil posted a USD 1.4bn current account surplus in March. This surplus far exceeded market expectations (USD 0.4bn). The result was mainly driven by a large USD 6.9bn trade surplus. Brazil also attracted USD 7.1bn in FDI inflow. Lending by private banks has now turned positive in Brazil. Private bank lending in March was up 4.4% relative to the same period last year. Public sector banks are still reducing lending, but this switch from directed credit by state banks towards market determined lending by private banks is a healthy development, in our view. Lending rates have started to moderate.

- **Mexico:** Conflicting communications with respect to NAFTA from within the Trump Administration contributed to significant USD/MXN volatility last week. Strong anti-trade elements within the Administration issued a statement that the US would unilaterally withdraw from NAFTA, which was then followed by a clarification from Trump himself that NAFTA would be subject to negotiation, not unilateral US withdrawal. This is yet another example of how much of the volatility in Emerging Markets (EM) currencies is generated by events in developed markets rather than within EM itself. Needless to say, the outlook for NAFTA is important for Mexico. Our view is that NAFTA will indeed be renegotiated. Meanwhile, Moody's affirmed Mexico's A3 rating with outlook negative and GDP surprised to the upside in Q1 2017 with an expansion of 0.6% qoq sa versus 0.5% qoq sa expected.

- **Turkey:** Turkey's central bank defied expectations by hiking the rate in the late liquidity window by 50bps to 12.25%. The statement was hawkish. This is very good news, though the outlook remains challenging for Turkey. Following years of excessively easy monetary policy it is clearly positive that the central bank is taking

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Emerging Markets

action, especially given that the central bank now sees year-end inflation at 8.5% instead of 8.0%. Yet, in spite of this a senior government advisor close to President Erdogan stated shortly after the decision to hike that the rate increase was not necessary. In other words, the political pressure on the central bank to keep rates low continues. Raising rates at this late stage in the cycle is obviously dangerous. The economy is already so imbalanced and credit growth has been so expansive in the last few years that any attempt to correct the monetary imbalances will likely cause significant pain in shape of much weaker growth for a protracted period. Yet, delaying adjustment only increases the eventual costs even further. The best-case scenario may be that Turkey simply stagnates with ever slower growth and a continuously weakening currency.

- Venezuela: The government says it will withdraw from the Organisation of American States (OAS). This follows pressure from within OAS on the government to undertake elections. The decision to leave, if implemented, speaks volumes about the determination of the Maduro Administration to hold on to power, come what may. President Nicolas Maduro signed a decree calling for the creation of a 'citizens' assembly' to rewrite the constitution as a way out of the country's political stalemate. According to Associated Press, National Assembly President Julio Borges calls the move a "giant fraud" and "trap" by Maduro and his allies to remain in power at any cost, denying Venezuelans the right to express their views at the ballot box. He is urging Venezuela's armed forces to step in to prevent the "coup" by Maduro from taking place. President Maduro also announced a 60 percent increase in the minimum wage in the face of continued protests going into their fourth week.

- South Korea: The economy is accelerating. Real GDP in Q1 2017 was 0.9% qoq saar compared to 0.5% qoq saar in Q4 2016. Industrial production in Q1 2017 was 3.6% higher than a year ago compared to 2.8% yoy in Q4 2016. Exports, investment and construction showed strong growth, while consumption was only marginally higher than in the previous quarter. In yoy terms, South Korea's economy was 2.7% higher in Q1 2017 compared to 2.4% yoy in Q4 2016. The latest poll ahead of the 9 May presidential election shows that Moon Jae-in from the main opposition liberal party leading with 39.8% to 41% of voting intentions versus 29.4% to 30% in favour of Ahn Cheol-soo from the minor opposition centrist party. The candidate for the ruling conservative party of recently impeached president Park Geun-hye is far behind. Moon's policies are more conciliatory towards both China and North Korea compared to Park's. Also, exports are on a tear - sequentially, exports rose 39% qoq saar in April versus 30% qoq saar in March.

- South Africa: The South African High Court ruled against the procurement process behind the government's push to introduce nuclear power in South Africa. This is good news. The push for nuclear power would have had major fiscal ramification and questionable economic benefits for the country as a whole.

- Russia: FX reserves are now back to USD 400bn after falling to a low of USD 350bn in early 2015. The recovery in Russian FX reserves has taken place despite still low oil prices, which is testimony to the success of Russia's adjustment to lower oil prices. Last week the Russian central bank cut the main policy rate by 50bps from 9.75% to 9.25%. Meanwhile, Russians appear to approve of the sensible economic management, regardless of the associated upfront pain, because 82% of Russians are happy with President Vladimir Putin's performance, according to the monthly popularity poll from independent pollster, the Levada Center.

- China: Chinese President Xi Jinping called for further measures to ensure financial stability in China, arguing that "accurate judgement of financial risks serves as a precondition for maintaining financial security". Xi's comments are currently reflected in the real world in that the central bank is tightening liquidity. Longer-term, two developments both of which are already underway will contribute significantly to reducing domestic financial volatility, namely granting Chinese greater access to foreign assets and developing a domestic retail fixed income market. Both these measures will help to absorb the excess liquidity, which currently flips between stocks and property in search for a home. On that note, speculation is mounting ahead of MSCI's June meeting that the index provider may admit some 169 of the most liquid Chinese CNY denominated A-share stocks into its indices (weeding out mid-cap and illiquid stocks). Further information is likely to emerge around June time. In addition, manufacturing continued to expand in April albeit at a more moderate pace than in March. The official NBS manufacturing PMI was 51.2 in April compared to 51.8 in March. A number above 50 signals expansion.

Snippets:

- Argentina: The 12-months rolling surplus on the trade balance was USD 1.4bn in March following a surplus of USD 2.0bn in February and USD 2.2bn in January. The central bank left the policy rate unchanged at 26.25% following a 150 bps emergency hike earlier in the month, and retains a hawkish bias. The monthly economic growth indicator EMEA was up 6.7% on a qoq saar basis in February.
- Chile: Manufacturing surprised to upside at 1.9% yoy in March. Markets expected a 1.5% yoy contraction.
- Colombia: The central bank is now in full-blown rate cutting mode, reducing the policy rate by 50bps on Friday and likely to make several further cuts in the course of 2017.

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Emerging Markets

- **Mexico:** The pace of retail sales growth increased to 7.6% yoy on a seasonally adjusted basis in February from 5.3% yoy sa in January.
- **Saudi Arabia:** The government reversed a number of austerity measures, notably cutbacks in employee benefits and will now have to find savings elsewhere in order to meet its fiscal target. Capital spending may be cut, or the government may live with a wider deficit and a higher debt load as a result.
- **Singapore:** Industrial production increased 5.0% mom in March versus 0.5% mom expected, but unemployment rose marginally in Q1 2017 to 2.3% from 2.2% in the previous quarter.
- **South Africa:** Massive beat on the trade surplus, which came in at ZAR 11.bn versus ZAR 6.2bn expected.
- **Suriname:** S&P cut the sovereign's credit rating to B from B+ with negative outlook due to higher government debt.
- **Taiwan:** The yoy rate of real GDP growth was 2.6% in Q1 2017 versus 2.4% yoy expected with a strong pickup in sequential growth (2.9% qoq saar versus 1.8% qoq saar in Q4 2016).
- **Thailand:** Year on year CPI declined significantly to 0.38% in April versus 0.76% yoy in March. This was significantly below market expectations (0.72% yoy).
- **Trinidad & Tobago:** Moody's downgraded the sovereign to Ba1 from Baa3 with stable outlook.

Global backdrop

British Conservatives are fond of describing the opposition Labour Party as 'unprepared to govern'. This phrase is used to refer to politicians, who talk a big game in opposition only to reveal themselves to be ineffective once in government. Having achieved practically nothing in his first 100 days in office we think US President Donald Trump's Administration is now in serious danger of falling into the 'unprepared to govern' class of governments. The repeated failure to repeal Obamacare, last week's rushed presentation of a half-baked tax cut proposal, the bungled handling of funding for the Mexican Wall monstrosity and, most recently, the U-turn on NAFTA are not, in our view, clever tactics designed to outwit and confuse the opposition. Rather, they are symptomatic of deep internal divisions, extremely poor preparation and lack of leadership on the part of the Trump Administration. Let us put it this way: if an EM government had displayed the same level of ineptitude investors would have a sold a long time ago.

The fact that investors continue to buy US assets reveals a degree of complacency with respect to the US outlook. Trump's tax plan – to the extent that a single sheet of paper can be called a plan – has all the hallmarks of a last-minute roll-out designed to give the impression that something has been achieved in Trump's first 100 days. Yet, many serious challenges remain before any tax changes will appear on the statute books. Firstly, the Trump Administration still needs to find a way through the Obamacare morass. Second, the tax proposal does not appear to satisfy important sections of the Democratic Party, because it does not include sweeteners, such as infrastructure. Thirdly, the plan also does not appear to be funded. Indeed, the Committee for a Responsible Federal Budget, a non-partisan think tank, estimates that Trump's proposal would increase government debt to 111% of GDP and that "no amount of growth would be able finance it". This means that the Freedom Caucus is unlikely to condone the reform. Hence, tax cuts, to the extent that they happen will be much smaller than the market is currently hoping for. Investors should discount the tax plan heavily, in our view.

Debt remains the main unspoken concern for the long-term outlook for the US economy, but the slow rate of growth is a far more immediate concern. Real GDP expanded only 0.7% in Q1 2017. The US reports growth in annualised terms, so the economy only expanded by 0.18% in real terms in the quarter itself. Moreover, looking forward the growth outlook is highly uncertain, because the Fed is now tightening policy at the margin as inflation gradually picks up. Monetary tightening threatens to remove the single most important source of fuel for the recovery so far. The frightening truth is that the US economy is still not able to 'walk without crutches', that is, grow of its own volition despite years of recuperation and incredible levels of stimulus. Why? One reason is that debt levels are excessive. Another is that productivity growth is dismal, not least because central bank asset purchases have made it far more profitable to invest in financial assets than to plough money into the real economy. The US dollar is also overvalued, which is strangling competitiveness. Rising employment costs do not improve matters at all (the employment cost index jumped from 0.5% last quarter to 0.8% in Q1 2017). And successive administrations have been unable or unwilling to tackle any of the underlying structural problems for fear of the political consequences. The tax package will help short-term growth, but if it ends up smaller and more delayed than expected the US growth picture does not look set to improve materially in 2017 and beyond, especially if the Fed continues to tighten. On balance, this should keep the Fed on the dovish side and Yellen's replacement is likely to be a dove rather than a hawk, in our view.

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As far as EM is concerned, this US backdrop should be broadly positive. For one, it should keep the Dollar in check. It is also positive that Trump's tax proposal appears not to assign a big role for the Border Adjustment Tax (BAT), which would have created headwinds for EM FX – for more details see 'Trump and EM', The Emerging View, January 2017. Mexico will delight in the US government avoiding a shut-down, because this was achieved by President Trump abandoning his demand for funding for his Mexican Wall project in the face of Democrat opposition.

On the other hand, it is concerning that the Trump Administration is beginning to make good on its promise to restrict international trade. The Administration announced last week that the US lumber and steel industries will be protected against competition from Canada and China, respectively.

Protectionism is unambiguously bad for everyone with the sole exception of the unproductive US lumber and steel companies, whose lobbying efforts will now be rewarded at the expense of the wider public interest. The decision to protect these companies also sends a clear signal that the Trump Administration is open to rent-seekers. Protectionism will not boost US growth at all. The only consolation is that the scale of protectionism is small enough not to pose a major macroeconomic risk. So far.

Finally, the Trump Administration is bluffing big on North Korea. This is easy to understand in light of the problems facing Trump's domestic policy agenda (no Mexican Wall, failure of Obamacare Repeal II, pie in the sky tax reform, etc.). It is a time-honoured tactic for governments facing problems at home to pick fights abroad to distract attention away from the domestic malaise. Our view is that there will be no nuclear conflagration with North Korea and that further sanctions on North Korea, should they materialise, are not of concern to anyone other than those heavily exposed to North Korean assets (we have none). As for the potential fall-out of North Korean tension for South Korean assets we think investors should buy any dip on the view that the conflict is a Trump bluff that will soon blow over.

And thus ends Trump's first 100 days in office. So far EM bonds, stocks and currencies have performed well under Trump, outperforming developed markets, including the US dollar. Since Trump has been the best thing to happen to EM for a long time, may this continue for a while!

Finally, a quick thought on Brexit and relations between the UK and Europe. Brexit is a divorce and many divorces end with an ugly battle over assets. In the relationship between the EU and the UK there are only two assets worth fighting over, namely financial services in the City of London and the UK market for EU exports (given that the UK imports more from the EU than it exports to the EU). A clear trade-off exists here, were Europe to usurp the financial services industry in the City of London the UK economy would likely suffer heavily, which in turn would hurt EU exports to the UK. Now, whether this trade-off is still worth making obviously depends on the relative cost and benefits. Since, within the EU Germany's lead will be critical, let us examine the trade-off from a narrow German perspective. UK imports from Germany are worth USD 88bn or 2.8% of German GDP. But the UK also exports a bit to Germany, so Germany's trade surplus is 'only' USD 44bn, or 1.4% of German GDP. This, then, is the potential cost to Germany of 'usurping' the City. On other hand, the value of financial services in the City of London is 7.2% to UK GDP, or USD 187bn per year, i.e. more than twice as much as the entire value of German exports to the UK. In addition, the financial services sector in London contributes 3% of all jobs in the UK plus 12% of total UK tax revenues. Clearly, in economic terms denying passporting rights for European firms in London and thus moving their operations from London to, say, Frankfurt would be massively net positive for Germany even if German exports to the UK fell to zero. However, the case for usurping the City's financial services is not just a question of GDP, jobs and tax revenue; it is also a question of risk. The UK is likely to have to heavily deregulate the City in order to compete once it loses exports markets in Europe. This will naturally make the UK financial market even more 'cowboy' like, which in turn will impart risks upon everyone who trades here. The EU will have no means of controlling UK regulations, which are likely to differentiate sharply from more conservative EU regulations over time. Usurping London's financial services is therefore not just economically beneficial for the EU, but should also be seen as a risk reducer. The EU has long sought a world class financial centre of its own – surrendering the City may well be the price the UK ends up paying for Brexit.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.18%	14.15%	19.80%	2.18%	1.88%
MSCI EM Small Cap	0.08%	14.41%	14.41%	2.13%	3.75%
MSCI Frontier	0.17%	10.17%	10.99%	-3.19%	6.24%
MSCI Asia	0.07%	15.95%	21.55%	5.47%	5.50%
Shanghai Composite	-2.07%	1.70%	9.60%	18.62%	8.31%
Hong Kong Hang Seng	-0.52%	8.78%	19.22%	5.41%	2.31%
MSCI EMEA	0.25%	7.60%	10.59%	-2.86%	-1.92%
MSCI Latam	0.68%	12.95%	17.48%	-4.40%	-4.98%
GBI EM GD	0.32%	8.09%	4.36%	-2.54%	-1.53%
ELMI+	0.00%	5.53%	2.70%	-2.34%	-1.40%
EM FX Spot	0.32%	3.72%	-2.51%	-9.28%	-7.78%
EMBI GD	-0.02%	5.40%	8.60%	6.26%	5.77%
EMBI GD IG	-0.05%	4.54%	4.51%	4.87%	4.18%
EMBI GD HY	0.01%	6.32%	13.35%	7.42%	7.83%
CEMBI BD	0.00%	4.13%	8.04%	5.38%	5.54%
CEMBI BD IG	-0.01%	3.20%	4.68%	4.45%	4.76%
CEMBI BD Non-IG	0.01%	5.55%	13.51%	6.55%	6.88%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.17%	7.34%	18.12%	10.52%	13.57%
1-3yr UST	-0.02%	0.57%	0.56%	0.71%	0.62%
3-5yr UST	-0.05%	1.26%	0.27%	1.86%	1.34%
7-10yr UST	-0.29%	1.92%	-1.39%	3.32%	2.21%
10yr+ UST	-0.71%	2.60%	-3.55%	5.44%	3.66%
10yr+ Germany	0.02%	-1.46%	0.25%	8.39%	6.56%
10yr+ Japan	-0.06%	-0.06%	-4.05%	6.01%	5.37%
US HY	0.04%	3.93%	13.35%	4.74%	6.79%
European HY	0.02%	2.34%	8.07%	4.96%	9.16%
Barclays Ag	-0.16%	1.98%	3.72%	3.84%	4.43%
VIX Index*	-7.21%	-28.49%	-31.61%	-22.23%	-40.52%
DXY Index*	-0.01%	-3.10%	6.92%	24.55%	25.15%
CRY Index*	-0.07%	-5.67%	-0.51%	-40.88%	-40.28%
EURUSD	0.17%	3.77%	-5.38%	-21.31%	-17.06%
USDJPY	-0.72%	4.15%	-5.24%	-8.99%	-28.64%
Brent	0.37%	-8.62%	13.29%	-52.19%	-56.07%
Gold spot	-1.03%	9.39%	-2.81%	-3.42%	-24.08%

*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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