South Korea's new path

By Jan Dehn

The South Korean election tomorrow is likely to usher in more than a new face as president. President Duterte's fiscal reforms advance in the Philippines. A key Lower House committee approves pension reform in Brazil. India takes an important step towards resolving the non-performing asset problem in the public sector banks. China's reserves go up for the third month in a row as Chinese corporates increase their foreign liabilities. Panama's stronger numbers point to rising global trade volumes. Venezuela's opposition rejects President Maduro's proposal for a constituent assembly. In the global backdrop, France becomes the second European country this year to reject far-right racist populists and events in the US go some way to restore optimism about the future.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.2	–	0.08%
MSCI EM Small Cap	11.8	–	-0.24%
MSCI Frontier	10.1	–	0.84%
MSCI Asia	11.8	–	0.20%
Shanghai Composite	11.9	–	-1.55%
Hong Kong Hang Seng	7.3	–	-3.79%
MSCI EMEA	9.6	–	-0.99%
MSCI Latam	12.5	–	0.83%
GBI-EM-GD	6.40%	–	0.13%
ELMI+	4.01%	–	0.00%
EM FX spot	–	–	0.04%
EMBI GD	5.35%	299 bps	-0.15%
EMBI GD IG	4.20%	180 bps	-0.11%
EMBI GD HY	6.65%	439 bps	-0.18%
CEMBI BD	5.09%	287 bps	0.06%
CEMBI BD IG	4.21%	199 bps	-0.01%
CEMBI BD Non-IG	6.43%	421 bps	0.16%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.5	–	0.66%
1-3yr UST	1.31%	–	-0.10%
3-5yr UST	1.88%	–	-0.17%
7-10yr UST	2.35%	–	-0.53%
10yr+ UST	2.98%	–	-0.63%
10yr+ Germany	0.42%	–	-1.34%
10yr+ Japan	0.02%	–	-0.16%
US HY	5.69%	371 bps	-0.10%
European HY	3.15%	357 bps	0.38%
Barclays Ag	–	244 bps	-0.18%
VIX Index*	10.57	–	-0.25%
DXY Index*	98.65	–	-0.40%
EURUSD	1.0998	–	0.93%
USDJPY	112.71	–	1.05%
CRY Index*	177.92	–	-3.80%
Brent	49.1	–	-5.08%
Gold spot	1222	–	-3.68%

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

Emerging Markets

- **South Korea:** Tomorrow is likely to mark the opening of a brand new chapter in Korean politics as Liberal Party candidate Moon Jae-in looks set to win a decisive victory in the presidential election. A Moon Jae-in victory would not only mark the end of 10 years of nationalist government rule, which ended ignominiously with the impeachment of President Park over influence peddling, but also signal an important shift in policies towards North Korea, China and fiscal policy. Moon seeks warmer relations with both China and North Korea and favours fiscal stimulus to inject further momentum into the economy. A softer stance towards China is particularly important, in our view. With the US withdrawal from TPP and China's stated pro-globalisation stance South Korea's longer-term interest may be shifting towards China and away from the US, especially if the US becomes more protectionist. Philippines has already become more ambiguous towards the US, so if South Korea follows suit Japan will find itself increasingly isolated in the Pacific Rim. We estimate that China's economy will be 2-3 times larger than the US by 2050 and that China's consumption will rise faster than GDP growth, so arguably China will replace the US as the most important destination for consumer goods produced by Asia's producers of high-valued manufacturing and services.
- **Philippines:** While President Duterte commands many headlines on account of his unorthodox approach to dealing with drug addicts away from the limelight Duterte's fiscal reform is making steady progress through parliament. Last week the relevant committee in the House of Representatives thus approved Duterte's fiscal reform proposal with few amendments. This paves the way for the reform's onwards journey via the floor of the House towards the Senate and its final approval by Q4 this year. The tax reform proposes to cut income taxes, closes VAT loopholes and hikes taxes on fuel and automobiles. In other news, inflation was lower than expected in April at 3.4% yoy versus 3.5% yoy expected.

Continued overleaf

Emerging Markets

- **Brazil:** Last week a committee of the Lower House of the parliament approved the government's pension reform by 23 votes to 14. This clears the bill to be voted upon on the floor of the Lower House in May or June depending on when the government has assembled the required votes. The Temer Administration, which took over the government following Dilma Rousseff's impeachment, has two important objectives prior to the next election in 2018: to pass a constitutional amendment to bring fiscal policy in line (already done) and to pass a pension reform to ensure that statutory payments to retirees are in line with the fiscal situation. This is the reform currently making its way through the Lower House. Our expectation is that the reform passes, albeit in a somewhat diluted form. We also expect the market-friendly PSDB party to win the 2018 election, thus ushering in four more years of reformist government. In other news, industrial production stabilised in Q1 2017. Up 1.1% on a yoy basis, industrial production expanded 0.7% in the first quarter compared to a contraction of 0.9% in Q4 2016. The significant improvement in Q1 should ensure that industrial production contributes positively to GDP in Q1 2017.

- **India:** The government has conferred greater powers onto the Reserve Bank of India to resolve issues relating to non-performing assets (NPAs) in the Indian public sector banks. This is an important and very positive development, which follows a decisive victory for Prime Minister Modi in the recent Uttar Pradesh elections. The significance of this victory was precisely that it would confer on Modi the political capital to get to grips with the thorny issue of public sector bank recapitalisation, which, in our view, is a precursor for further liberalisation of the Indian fixed income market, including greater access for foreign investors. The government should have sufficient funds to fix the NPA stock problem, but the only sustainable solution involves a wholesale restructuring of the business model of these banks. This is turn will doubtlessly step on the toes of many vested interests, hence, it will be politically challenging. Meanwhile, the economy continues to do well. The composite PMI remained firmly in expansion territory in April (51.3), although it moderated somewhat from the stronger pace recorded in March (52.3).

- **China:** Chinese corporates have issued significant numbers of bonds denominated in Dollars this year with estimates as high as USD 80bn. This issuance has taken place in the context of a weakening Dollar. It makes sense for Chinese corporates to borrow in the US when the Dollar falls because their cost, in CNY terms, will be lower on final repayment. In other words, the risk of FX mismatches is falling. Also, US yields are lower than in China where local yields have recently backed up following efforts to tighten liquidity on the part of the monetary authorities. FX mismatches are now reducing since the dollar is weakening. Recall that the opposite situation existed in 2015, when the government sensibly decided let CNY weaken versus the surging Dollar. At that time, Chinese onshore corporates, notably property names, engaged in a flurry of repayments of their Dollar liabilities. Instead, they issued in local currency, thus in effect swapping from Dollar to CNY financing. These swaps were encouraged by the authorities as a way to reduce FX mismatches. The result at the time was that CNY weakened, FX reserves declined, outstanding Dollar bonds shrank and domestic yields pushed higher. This year's developments may be a sign that the dynamics of 2015 are now taking place in reverse. If so then Chinese corporates can be expected to sell their newly borrowed Dollars to the central bank in order to obtain the CNY required to put the money to work at home. If so, reserves in China should now be rising. This, indeed, is what is happening: China's FX reserves rose to USD 3.03bn in April, the third monthly rise. If this dynamic continues we would expect CNY to rise and local bond yields to begin to fall, particularly if corporates start to buy back their outstanding local debt. In other news, Caixin services PMI was 51.5 in April, down slightly from 52.2 in March.

- **Panama:** Irrespective of its many other charms Panama's primary importance in the context of global economic activity derives from its famous canal's conduit of goods from one ocean to another. When global trade picks up so does Panama. It is therefore noteworthy that the monthly IMAE economic activity index picked up strongly in February: up 5.2% yoy. This is the strongest reading of the IMAE index for more than two years. Panama Canal toll revenues jumped 16.6% in Q1 2017 to USD 565m from USD 485m in the same quarter last year.

- **Venezuela:** Opposition leaders have rejected President Nicholas Maduro's proposal to form a constituent assembly in a bid to resolve an ongoing political deadlock. The opposition controls the National Assembly, while the government uses its control of the Supreme Court to nullify all hostile pieces of legislation passed by the Legislature. Maduro's constituent assembly would rewrite the constitution, which would probably take longer than Maduro has left in office (his term expires in 2018). Hence, the proposal is probably designed as an attempt to defuse tension. The opposition rejects the idea on the grounds that Maduro's constituent assembly would be formed mainly by interest groups aligned with Maduro himself.

Snippets:

- **Argentina:** Argentina will publish a full national-wide CPI index again starting 11 July this year. The previous government of Cristina Kirchner dismantled the statistics service in order to conceal massive overheating, which the current Macri Administration is now trying to rectify.
- **Chile:** March real GDP expanded at a pace of 0.2% yoy versus -0.4% yoy expected, based on the central bank's Imacec activity indicator. March retail sales were also stronger than expected (4.9% yoy versus 4.2% yoy).

Continued overleaf

Emerging Markets

- **Indonesia:** Real GDP growth accelerated in Q1 2017 to 5.01% yoy from 4.94% yoy in 4Q 2016.
- **Romania:** The National Bank of Romania left the policy interest rate unchanged at 1.75% in May.
- **Russia:** The headline CPI inflation rate dropped to 4.1% yoy in April from 4.3% yoy in March. This puts inflation on track to drop below target (4%) in the coming months. The market had expected inflation of 4.2% yoy in April.
- **Sri Lanka:** IMF staff recommended that the IMF Board approve the staff's review of the ongoing adjustment programme based on fiscal improvements.
- **Taiwan:** CPI inflation was 0.12% yoy in April, down from 0.18% yoy in March and lower than expected (0.5% yoy).
- **Turkey:** CPI inflation in April reached the highest level in more than eight years. At 11.9% yoy, Turkey's high level of inflation is a direct consequence of President Erdogan's political pressure on the central bank, which keeps monetary policy too loose.

Global backdrop

France convincingly elected centrist candidate Emmanuel Macron as president and rejected his far-right opponent Marine Le Pen. Macron's victory was larger than predicted by most polls, despite a low turnout, which was said to favour Le Pen. Attention will now shift to parliamentary elections in June, which will determine to a large extent Macron's ability to effect change.

Macron's decisive victory makes France the second major European country this year to reject far-right populism in favour of more moderate politics (Holland being the first). We also expect Germany to vote in favour of moderate parties later this year. This is bullish for Europe, whose economy is also currently performing significantly better than the US economy. European voters, it seems, are opting for protest votes in the vacuum at the centre of European politics rather than veering for the wings.

It is tempting to speculate that maybe it is not a complete coincidence that US and the UK embraced far-right populism, while continental Europe stepped back from that particular brink. After all, European countries experienced the full force of occupation by far-right regimes in World War II, while the US and the UK were never occupied and hence, despite suffering too, escaped the worst excesses.

Market sentiment towards the US improved last week due to strong labour market data, the Fed's dismissal of weak Q1 growth and Congress' passage of legislation to repeal & replace Obamacare. However, as we have noted in a recent publication the US macroeconomic outlook is not altogether unchallenging.[1] The tighter labour market only brings stagflation closer. Unit labour costs increased at a rate of 3.0% (saar) in 1Q 2017 and hourly compensation is now running at 3.9% yoy, which is one of the fastest rates in the current cycle. The Fed is therefore going to be forced to tighten monetary policies, despite leaving the Fed funds rate unchanged in last week's meeting. Tighter money could clearly threaten returns in financial markets, which have so far been predicated more on easy money than on rising productivity. Indeed, non-farm productivity actually declined outright at a rate of 0.6% (saar) in Q1 2017. The US economy is unlikely to produce spectacular trend growth this year even Q2 2017 is little stronger than the low growth rate of 0.7% qoq annualised in Q1 2017, because the underlying drags from excessive debt, insufficient investment, neglect of reforms and the strong Dollar remain firmly in place. The dismantling of Obamacare still has to be passed in the Senate, which may yet prove a lengthy and difficult process. This means that tax relief for the wealthy may yet be some time away, perhaps not until 2018. Even so, the more optimistic sentiment about the US is a good thing for EM investors, because 'risk on' sentiment about the US has been positive for EM markets for more than a year now.

The big drop in oil prices is also positive for the vast majority of EM countries. More than two thirds of EM countries import oil, so costs and real incomes will improve as a result. On other hand, the oil producing nations within EM will suffer, but as long as prices stick to the USD 40 to USD 60 range for WTI then most of them should be ok.

[1] *'Where are the main macroeconomic risks?'*, The Emerging View, April 2017.

Continued overleaf

Emerging Markets

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.08%	14.03%	24.16%	1.96%	2.10%
MSCI EM Small Cap	-0.24%	14.05%	16.84%	1.75%	3.59%
MSCI Frontier	0.84%	10.91%	11.22%	-3.35%	6.20%
MSCI Asia	0.20%	16.10%	24.71%	5.43%	5.56%
Shanghai Composite	-1.63%	0.05%	5.67%	17.92%	7.46%
Hong Kong Hang Seng	-2.87%	5.66%	20.00%	4.51%	2.09%
MSCI EMEA	-0.99%	6.28%	16.85%	-3.18%	-1.53%
MSCI Latam	0.83%	13.11%	24.59%	-4.99%	-4.54%
GBI EM GD	0.13%	7.89%	7.23%	-2.67%	-1.51%
ELMI+	0.00%	5.53%	4.25%	-2.43%	-1.29%
EM FX Spot	0.04%	3.43%	-0.32%	-9.39%	-7.70%
EMBI GD	-0.15%	5.26%	8.95%	6.15%	5.63%
EMBI GD IG	-0.11%	4.48%	4.76%	4.76%	4.02%
EMBI GD HY	-0.18%	6.12%	13.84%	7.37%	7.75%
CEMBI BD	0.06%	4.19%	8.15%	5.36%	5.48%
CEMBI BD IG	-0.01%	3.21%	4.55%	4.40%	4.68%
CEMBI BD Non-IG	0.16%	5.71%	14.06%	6.58%	6.84%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.66%	7.86%	19.48%	10.68%	14.27%
1-3yr UST	-0.10%	0.48%	0.30%	0.68%	0.59%
3-5yr UST	-0.17%	1.13%	-0.26%	1.84%	1.30%
7-10yr UST	-0.53%	1.68%	-2.36%	3.22%	2.05%
10yr+ UST	-0.63%	2.68%	-4.89%	5.43%	3.39%
10yr+ Germany	-1.34%	-2.80%	-3.18%	7.86%	6.04%
10yr+ Japan	-0.16%	-0.17%	-5.18%	5.94%	5.36%
US HY	-0.10%	3.78%	13.88%	4.66%	6.70%
European HY	0.38%	2.71%	8.71%	5.06%	9.12%
Barclays Ag	-0.18%	1.97%	3.39%	3.82%	4.30%
VIX Index*	-2.31%	-24.72%	-28.19%	-21.30%	-44.51%
DXY Index*	-0.41%	-3.48%	5.19%	24.11%	24.09%
CRY Index*	-2.09%	-7.58%	-1.10%	-41.88%	-39.71%
EURUSD	0.93%	4.54%	-3.57%	-20.74%	-15.94%
USDJPY	1.05%	-3.67%	5.08%	10.35%	41.15%
Brent	-5.08%	-13.59%	9.09%	-54.42%	-56.62%
Gold spot	-3.68%	6.02%	-4.39%	-6.77%	-25.61%

*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.

Continued overleaf

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