Fire and fury or geopolitical flatulence?

By Jan Dehn

The Global Backdrop section explains why the Trump-Kim Jong-un verbal slugfest is an opportunity to buy completely unrelated assets at a discount. The report also discusses the recent decline in Emerging Markets (EM) inflation, the Venezuelan situation, the Kenyan election, President Jacob Zuma's political survival in South Africa, the primaries in Argentina, weaker data in China and green shoots in Brazil.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.8	–	-2.24%
MSCI EM Small Cap	12.0	–	-2.79%
MSCI Frontier	11.0	–	1.02%
MSCI Asia	12.4	–	-2.61%
Shanghai Composite	12.8	–	-1.61%
Hong Kong Hang Seng	7.7	–	-3.91%
MSCI EMEA	10.0	–	-0.96%
MSCI Latam	13.3	–	-0.79%
GBI-EM-GD	6.10%	–	-0.22%
ELMI+	3.93%	–	-0.23%
EM FX spot	–	–	-0.24%
EMBI GD	5.31%	311 bps	-0.20%
EMBI GD IG	4.09%	185 bps	-0.10%
EMBI GD HY	6.68%	454 bps	-0.30%
CEMBI BD	5.04%	299 bps	-0.04%
CEMBI BD IG	4.07%	202 bps	0.01%
CEMBI BD Non-IG	6.44%	438 bps	-0.11%

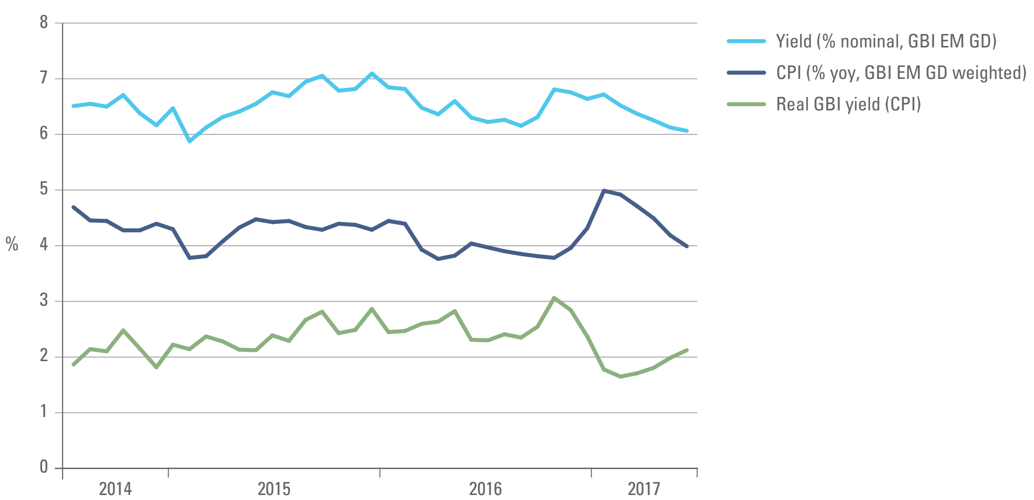
Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.8	–	-1.37%
1-3yr UST	1.31%	–	0.14%
3-5yr UST	1.76%	–	0.34%
7-10yr UST	2.21%	–	0.66%
10yr+ UST	2.81%	–	1.15%
10yr+ Germany	0.40%	–	1.42%
10yr+ Japan	0.05%	–	0.21%
US HY	5.76%	387 bps	-0.75%
European HY	2.95%	337 bps	-0.40%
Barclays Ag	–	250 bps	0.05%
VIX Index*	15.51	–	5.48%
DXY Index*	93.20	–	-0.24%
EURUSD	1.1825	–	0.25%
USDJPY	109.55	–	-1.07%
CRY Index*	179.61	–	-1.08%
Brent	52.0	–	-0.74%
Gold spot	1287	–	2.29%

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

Emerging Markets

- **Inflation:** Continuing downside inflation surprises in individual EM countries have now taken the GBI EM GD weighted CPI inflation rate below 4% for the first time since December 2016. The July index weighted inflation rate was 3.99% and just 3.74% if Argentina is excluded (on account of its atypically high levels of inflation). The decline in inflation makes EM local currency bonds more attractive as real yields are higher. Indeed, EM real yields are now +210bps for 4.5 year duration bonds. This is higher than at the height of the 2014 collapse in commodity prices (see chart).

Fig 1: **EM: GBI EM GD weighted inflation, nominal bond yields and real yields**



Source: Ashmore, JP Morgan, Bloomberg.

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Emerging Markets

• **Venezuela:** Comments from US President Donald Trump which refer to a military option being considered in response to recent developments in Venezuela have been met with strong opposition in the rest of Latin America. US Vice President Mike Pence said that the US is seeking a "peaceful path". Colombian President Juan Manuel Santos, a staunch US ally, said that military intervention "shouldn't even be considered". The strong opposition to US military intervention in Latin America has deep roots. It brings back bad memories of the Cold War era, when most countries in the region were under military dictatorships (which were, in the main, sponsored by the US, though a few such as Nicaragua and Cuba received support from other superpowers). Trump's comments will, in our view, give credence to Venezuelan President Nicholas Maduro's claims that Venezuela is the victim of a US-led conspiracy. Trump's comments may therefore end up strengthening Maduro rather than weakening him. Indeed, Maduro announced over the weekend that he is moving local elections forward to October of this year. This is a clear sign that he feels strengthened. The recent approval of a pro-government Constituent Assembly has also significantly increased Maduro's political standing at the expense of the opposition.

In other news, the investment bank Credit Suisse (CS) has stopped transacting in 2022 PDVSA bonds and 2036 Venezuelan bonds as well as any securities issued after 1 June 2017. Business with counterparties controlled by the Venezuelan government, private individuals and private companies involving Venezuela's underlying assets also have to be cleared by the bank's reputational risk office. However, the bank will continue to make markets in other PDVSA and Venezuelan bonds in the secondary market. CS is trying to protect itself from the reputational risk associated with extending new financing to Venezuela after opposition leader Julio Borges placed counterparties in recent deals involving the above-mentioned bonds on notice. This is a blow to the Maduro Administration, but by no means a fatal one. The main source of financing for Venezuela has been coming from joint venture partners, which provide the bulk of credit lines for PDVSA, Venezuela's national oil company. Joint venture partners include Russia's Rosneft, China, Chevron, ENI and Total. We do not think CS's announcement has a material impact on Venezuela's oil production and its capacity to service debt. As we have commented before, the Venezuelan government has strong incentives to continue to make debt payments, since debt service is critical to the willingness of Venezuela's joint venture partners to extend finance. PDVSA recently stated that it guarantees the legal security of all foreign energy companies operating as joint venture partners in the country. The joint venture partners benefit from their operations in Venezuela in three ways: they make money from providing financing, they get to book oil reserves and they run their core oil businesses.

• **Kenya:** Former US Secretary of State John Kerry said in his capacity as election observer for the Carter Center that last week's elections were not rigged despite "little aberrations here and there". This verdict gave credence to the Kenyan election commission's verdict that incumbent President Uhuru Kenyatta won the Kenyan election legitimately. Opposition leader Raila Odinga has refused to accept the result and called for a general strike, though tensions are already showing signs of easing. In our view, attention will gradually shift to economic policies once the political noise dies down.

• **South Africa:** President Jacob Zuma only barely defeated a no-confidence vote in parliament. His narrow political survival is testimony to his broader political weakness, though he may use what is likely to be a pyrrhic victory to consolidate his position somewhat. Showtime is not until December this year, when the African National Congress (ANC) picks a new chairman. Zuma will try to get the ANC to pick his chosen successor, but others will have different plans. Until then, nothing much will happen in South Africa. The ANC faces a far larger challenge than picking a new leader. The party is losing its way as a result of having been in power for far too long. The ANC may well be forced into a coalition after the next general election scheduled for 2019.

• **Argentina:** Extreme populist and former President Cristina Kirchner failed to deal a knock-out blow against President Mauricio Macri in this weekend's primaries for the mid-term elections scheduled for later this year. At the time of writing, Macri's candidate for the Senate seat for the Province of Buenos Aires, Esteban Bullrich, was leading with 34.31% of votes ahead of Kirchner's 33.98%. Polls conducted prior to the primary had shown Kirchner winning by a handsome margin. We view the stronger than expected showing for Bullrich as good news. The Senate seat for the Province of Buenos Aires is one of the most important electoral districts in Argentina. A strong showing for Kirchner would have paved the way for her political renaissance, which we consider would have been a disaster for the country. The primary is also an important indicator of the popularity of the government. The outcome of the mid-term election scheduled for 22 October 2017 may impact the government's ability to implement reforms in Argentina over the next couple of years. In other news, inflation surprised to the downside in July at 1.7% yoy rate versus 2.0% yoy expected.

• **China:** The latest data has been weaker than expected across the board. Chinese CPI inflation was 1.4% yoy in July versus 1.5% yoy expected, while producer prices inflation was also lower than anticipated (5.5% yoy versus 5.6% yoy consensus). China's trade surplus also increased to USD 46.7bn in July from USD 42.8bn in June on the back of weaker imports, while retail sales, industrial production and fixed asset investments fell short of expectations. The Trump Administration is widely expected to unveil an investigation into Chinese trade practices this week.

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Emerging Markets

- **Brazil:** The very slow but definite improvement in Brazil's economic indicators is continuing. Last week saw 36K new jobs created for the month of July, which was the highest rate of monthly jobs creation since 2013 and well above expectations (5.8K). The yoy inflation rate continued to decline, reaching 2.7% in July from 3.0% in June and 8.7% in July 2016.

Snippets:

- **Chile:** The trade surplus was USD 231m in July versus USD -69m expected. Real GDP growth was also better than expected in June (1.4% yoy versus a consensus expectation of 1.1% yoy).
- **Egypt:** The rate of CPI inflation spiked to 33% yoy in July the removal of important subsidies in electricity and fuel, which took effect 29 June 2017.
- **Hong Kong:** The economy expanded at a rate of 1.0% in real terms in Q2 2017 versus 0.6% qoq expected.
- **Malaysia:** Industrial production was 4% higher in June than in the same month of 2016. This was stronger than the market had expected (3.0% yoy).
- **Mexico:** The central bank left the policy rate unchanged at 7% in line with expectations. Banxico has hiked by 400bps since December 2015. Core inflation was in line with expectations in July (0.27% mom).
- **Nigeria:** In a boost for local bond markets, Nigeria announced that it would seek to tap external markets for USD 3bn to refinance maturing three year treasury bills.
- **Peru:** The central bank left the policy rate unchanged at 3.75% at the August monetary policy meeting.
- **Philippines:** The central bank left the policy rate unchanged at 3% and the trade deficit narrowed to USD 2.2bn in June from USD 2.7bn in May.
- **Romania:** Inflation was broadly in line with expectations (1.4% yoy versus 1.4% yoy expected).
- **Russia:** The real GDP growth rate was 2.5% yoy in Q2 2017 versus just 1.7% yoy expected.
- **Taiwan:** Core CPI inflation declined to a yoy rate of 0.9% in July from 1.0% yoy in June, while the rate of export growth was higher than anticipated (12.5% yoy versus 9.8% yoy expected).
- **Turkey:** The current account deficit narrowed to USD 3.8bn in June from USD 5.4bn in May. Industrial production declined 0.4% in July, which was materially weaker than expected (+0.4% mom).

Global backdrop

Tensions between the US and North Korea ramped higher last week for the second time this year. The verbal spat saw the rhetoric of flamboyant US President Donald Trump almost match the dazzlingly piquant oratory of his North Korean nemesis, Kim Jong-un. The market is left asking: are we in for genuine "fire and fury" or just another bout of geopolitical flatulence? The answer will determine if this is a time to sell or a buying opportunity.

Our view is that the current posturing of these two fearless leaders will amount to nothing other than a release of geopolitical gas made pungent by the stagnant air in the summer lull. We do not expect a nuclear conflagration to materialise. Repricing of global asset prices is therefore not justified. It is a good time to pick up assets at a discount. If we are wrong, of course, the repricing of global assets will be far greater. In other words, the current pullback offers no real protection anyway.

Why do we think US and North Korea will not go to war? First, a lot of people would suffer, mostly North Koreans. This has not prevented wars in the past, of course, but there would also be Western casualties and potentially many casualties in South Korea. A senior Korean presidential advisor, Moon Chung-in, publicly criticised Donald Trump's threats over the weekend as "very worrisome". Besides, appetite in the West for large scale casualties in foreign wars has been declining steadily in recent years on account of the many misadventures in the Middle East. Peaceniks would strongly object and we believe it would be very difficult to get broad political support for the boots on the ground which would be required to effect genuine regime change in North Korea.

Second, Kim Jong-un is notoriously unpredictable. To some he is a comical imp with a funny quiff and an inflated ego, but to others, he is also highly temperamental and quite ruthless. And he has dangerous toys. North Korean society is heavily militarised. He could try to invade South Korea, even seek to explode a dirty bomb in Seoul or maybe strike Japan.

Third, it is important never to forget that the stand-off on the Korean peninsula is a proxy conflict for a much larger and more important head-to-head between the US and China over influence in north-east Asia. While Kim Jong-un would run a big risk if he unilaterally launched an attack on, say, Guam or South Korea, since

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Global backdrop

China has stated clearly that it will remain neutral if Kim Jong-un is the aggressor, a US first strike would be a different matter altogether. If the US draws first blood it could force China's hand. Kim Jong-un would respond by launching, say, an attack on South Korea and China would enter on the side of North Korea in order to prevent a massive realignment of the balance of power on the Korean Peninsula. In short, the US could find itself in a direct confrontation with China.

Still, Trump's motivation for getting hot under the collar over North Korea may ultimately be domestically motivated. The US President is not doing very well in the polls and he recently suffered a stinging defeat over the non-repeal of Obamacare. The weekend's events in Charlotteville have not boosted his popularity. He will be aware that his approval ratings picked up, albeit briefly, after he MOABed Afghanistan and missiled Syria. Hence, the hawkish rhetoric against North Korea.

However, the truth is that this conflict can easily be de-escalated. All it takes is an almost imperceptible concession on one side or the other. This may already be taking place. Secretary of State Rex Tillerson stepped in last week to try to calm the waters. We also believe that China's statement about remaining neutral in the event of a North Korean-led strike is an invitation to de-escalate. We therefore like the Trump-Kim Jong-un dip. Ultimately, we believe the two fearless leaders in this conflict will not follow through.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.10%	23.10%	17.94%	2.14%	4.06%
MSCI EM Small Cap	-2.68%	17.03%	10.19%	1.22%	5.03%
MSCI Frontier	0.37%	18.38%	20.75%	-3.03%	8.63%
MSCI Asia	-2.44%	26.40%	20.59%	5.36%	7.86%
Shanghai Composite	-1.90%	5.37%	9.06%	15.17%	10.79%
Hong Kong Hang Seng	-2.35%	16.69%	16.57%	2.33%	5.36%
MSCI EMEA	-1.12%	10.28%	8.08%	-3.28%	-1.23%
MSCI Latam	0.20%	19.71%	12.85%	-4.56%	-2.92%
GBI EM GD	-0.25%	12.37%	4.80%	-1.78%	-0.92%
ELMI+	-0.25%	8.68%	4.33%	-1.51%	-0.46%
EM FX Spot	-0.41%	5.62%	-0.87%	-8.37%	-6.79%
EMBI GD	0.25%	7.35%	3.96%	5.87%	5.09%
EMBI GD IG	0.19%	6.93%	1.21%	4.78%	3.47%
EMBI GD HY	0.30%	7.87%	7.16%	6.61%	7.28%
CEMBI BD	0.10%	5.94%	5.28%	5.28%	5.13%
CEMBI BD IG	0.10%	5.15%	2.76%	4.35%	4.29%
CEMBI BD Non-IG	0.11%	7.15%	9.30%	6.48%	6.62%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.06%	10.40%	14.02%	10.31%	14.05%
1-3yr UST	0.15%	0.81%	0.44%	0.80%	0.68%
3-5yr UST	0.39%	1.99%	0.02%	1.85%	1.30%
7-10yr UST	0.86%	3.67%	-2.18%	2.96%	1.79%
10yr+ UST	2.11%	7.08%	-6.13%	5.42%	2.90%
10yr+ Germany	2.74%	-1.69%	-8.43%	5.84%	5.51%
10yr+ Japan	0.41%	-0.24%	-4.52%	5.35%	5.01%
US HY	-0.71%	5.34%	8.89%	4.99%	6.44%
European HY	0.04%	4.32%	6.79%	5.52%	8.55%
Barclays Ag	0.29%	4.20%	2.23%	4.00%	4.15%
VIX Index*	51.17%	10.47%	34.29%	24.88%	4.44%
DXY Index*	0.36%	-8.82%	-2.64%	14.23%	12.99%
CRY Index*	-1.66%	-6.70%	-1.68%	-37.81%	-40.20%
EURUSD	-0.14%	12.40%	5.73%	-11.52%	-4.03%
USDJPY	-0.64%	-6.37%	8.19%	6.93%	39.13%
Brent	-1.27%	-8.52%	10.67%	-49.04%	-54.42%
Gold spot	1.36%	11.66%	-3.94%	-2.05%	-19.54%

*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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