EM growth is strong with more to come

By Jan Dehn

EM is growing faster than expected. This outperformance coincides with more positive sentiment towards the asset class among foreign investors. This may well be a causal relationship: finance constrained EM economies have considerable room to grow if financial conditions continue to ease on the back of inflows. S&P takes the long view in Brazil. The upcoming midterm elections in Argentina have taken on greater significance as the government considers a provincial fiscal responsibility law as part of the 2018 budget bill. Kenya's opposition agrees to go to court rather than to the streets to challenge the recent election result. Venezuela's Constituent Assembly takes over the powers of the National Assembly. China formalises rules governing FDI. ETF-related risks in EM remain very small. The global backdrop discusses inflation.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	1.64%
MSCI EM Small Cap	12.2	–	1.57%
MSCI Frontier	11.0	–	1.49%
MSCI Asia	12.5	–	1.37%
Shanghai Composite	12.9	–	1.90%
Hong Kong Hang Seng	7.7	–	1.14%
MSCI EMEA	10.1	–	1.41%
MSCI Latam	13.5	–	1.66%
GBI-EM-GD	6.07%	–	0.50%
ELMI+	3.84%	–	0.16%
EM FX spot	–	–	0.19%
EMBI GD	5.26%	305 bps	0.49%
EMBI GD IG	4.05%	181 bps	0.36%
EMBI GD HY	6.60%	445 bps	0.61%
CEMBI BD	5.01%	295 bps	0.26%
CEMBI BD IG	4.05%	199 bps	0.19%
CEMBI BD Non-IG	6.40%	433 bps	0.36%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.7	–	-0.58%
1-3yr UST	1.31%	–	-0.01%
3-5yr UST	1.76%	–	-0.06%
7-10yr UST	2.20%	–	-0.03%
10yr+ UST	2.78%	–	0.22%
10yr+ Germany	0.41%	–	-0.24%
10yr+ Japan	0.03%	–	0.07%
US HY	5.79%	389 bps	0.02%
European HY	2.91%	333 bps	0.16%
Barclays Ag	–	250 bps	0.12%
VIX Index*	14.26	–	-1.25%
DXY Index*	93.43	–	0.37%
EURUSD	1.1760	–	-0.52%
USDJPY	109.19	–	0.00%
CRY Index*	177.50	–	-2.11%
Brent	52.7	–	1.19%
Gold spot	1284	–	-0.42%

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

Emerging Markets

- **EM growth stronger than expected:** Real GDP growth rates surprised to the upside relative to expectations in a number of EM countries last week – see bullet points below. While the Hungarian growth rate was lower than expected, the strong growth in performance in so many other EM countries is consistent with the view that financial easing will further strengthen EM's growth outperformance both relative to expectations and to developed economies. Stronger growth also bodes well for EM currencies, which continued to rally versus the US dollar last week despite risk aversion on account of political noise in the US. Most EM countries are quite severely finance constrained (EM may account for 60% of global GDP, but EM countries only account for about 20% of global fixed income, for example). During the peak period of QE (2010-2015) huge amounts of capital left EM as investors chased returns in Europe and the US. These outflows resulted in much tighter financial conditions and slower growth rates across most of EM. This negative shock is now moving into reverse as investors cautiously allocate back to the EM asset class following strong performance for more than a year. The inflow of capital unleashes growth, because most EM countries have strong pent up investment and consumption demand, which awaits the return of finance.
  - **Philippines:** The rate of real GDP growth was 6.5% yoy in Q2 2017 versus 6.4% yoy expected. This means that growth gently accelerated in the course of H1 2017.
  - **Malaysia:** The economy grew at a rate of 5.8% yoy in Q2 2017 compared to 5.6% yoy in Q1 2017.
  - **Peru:** Economic activity growth was up 3.64% yoy in June versus market expectations of 3.5% yoy.
  - **Czech Republic:** The economy was 4.5% bigger in Q2 2017 than in the same quarter of last year. This was also faster than expected and faster than last quarter (3.0% yoy).
  - **Romania:** Real GDP growth beat expectations coming in at 5.9% yoy and was stronger than last quarter (5.7% yoy).

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Emerging Markets

- **Poland:** Growth beat expectations as the economy expanded at a rate of 4.4% yoy seasonally adjusted versus 4.2% yoy in Q1 2017.
- **Colombia:** Real GDP rose at a rate of 0.7% qoq (sa) in Q2 2017, which was higher than the median consensus expectation of 0.5% qoq. In yoy terms, growth was 1.3% versus 1.2% yoy expected.
- **Thailand:** Thailand's real economy expanded at a rate of 3.7% yoy in Q2 2017, which was faster than expected (3.2% yoy)

- **Brazil:** Standard & Poor's adopted a longer-term perspective in its assessment of the public finances in Brazil when, last week, the ratings agency removed Brazil from credit watch negative, while maintaining the current sovereign credit rating of BB with negative outlook. The decision followed an announcement by the government that the fiscal deficit will increase by a total of 2.6% of GDP for the period 2017-2020. Standard & Poor's decision seems sensible to us. Brazil's public finances are deteriorating for two reasons: One is purely cyclical due to the long and deep recession, which has undermined fiscal revenues and pushed spending higher than would otherwise be the case. However, there are now clear signs of green shoots in the Brazilian economy, so the fiscal numbers should gradually begin to improve. The second reason for the weak state of the public finances is structural, particularly the irresponsible commitments to pensions made by the Lula and Dilma administrations. However, the current Temer Administration is committed to reforming the public finances and has already made great strides. It is clear, however, that the Temer Administration does not have sufficient political capital to pass a pension reform, which would solve the fiscal problems. There is good reason to expect the next administration, which takes office after the 2018 election, to pick up the baton of reform. We think a partial pension reform under Temer followed by a second pension reform under a future PSDB-led government would be sufficient to avoid a downgrade. By then the cyclical upswing in Brazil will be much stronger, so ratings upgrades rather than downgrades could be quite conceivable.
- **Argentina:** Argentina is preparing to pass a fiscal responsibility law governing the finances of provincial governments. Under the proposal, the current spending of provinces would not be allowed to rise faster than inflation and government employment would not be allowed to rise faster than the pace of population growth. The proposal is due to be submitted as part of the 2018 budget proposal, but will not be voted on until after the midterm legislative election scheduled for October 22nd. If passed, this would be a big deal. Argentina is one of the world's great defaulters, not because of character flaws or cultural peculiarities, but because the Constitution grants provinces excessive powers compared to the central government. This flaw in the constitution has enabled provinces to borrow too much money time and time again in the knowledge that they will eventually be bailed out by the central government, which eventually defaults under this arrangement. In short, the upcoming midterm elections have suddenly gained a great deal more importance from an investor perspective.
- **Kenya:** A tense few days followed the recent election until the main opposition movement in Kenya, led by Raila Odinga, agreed to refer its claim of election rigging to the courts instead of taking to the streets to protest. Odinga's decision to rely on the courts is very good news, because it increases the odds that Kenya can avoid the bloodshed, which has often accompanied elections in the past.
- **Venezuela:** President Maduro now controls all branches of the government following a decision by the newly elected Constituent Assembly (CA) to take over all the functions of the National Assembly (NA) which is Venezuela's parliament. There are three major risks to investors in Venezuelan bonds: oil prices, Venezuela's relationship status with Joint Venture partners in the oil sector and Maduro's political standing. The fact that the pro-Maduro CA has now vanquished the anti-Maduro NA should therefore be seen as a positive development for bonds.
- **China:** China has now formalised rules governing foreign direct investment (FDI). All FDI will forthwith be categorised with regulations governing each category. The formalisation of rules increases transparency, but also increases the scope for the Chinese government to use FDI for policy purposes. For example, if the US goes ahead with plans to scupper Chinese exports to the US then China can scale back FDI into the US using the new framework. Capital inflows, including those from China, finance a big part of America's current account deficit. If less financing comes to America from abroad then either the Dollar will fall or Americans will have to tighten their belts (or both) in order to spend less on imports. That is how the current and capital account balances are linked and why the whole notion that somehow America can 'punish' China's exporters without inflicting a big cost onto Americas consumers and businesses is idiotic.
- **ETFs:** Several media outlets have recently paid attention to the growth in the market for EM exchange traded funds (ETFs) accompanied by concerns about the potentially destabilising effects due to the passive nature of such investments. We wholeheartedly concur that passive investing in EM is risky, but we do not agree that ETFs present a major risk. The level of ETF investment remains far too small to destabilise the market. For example, ETFs only account for 1% of total assets in local currency, 5% in external debt and 4% in EM equities. Of these holdings we estimate that up to a quarter is held by institutional long-term dedicated money.

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Emerging Markets

Snippets:

- **Brazil:** Retail sales expanded 2.5% mom (sa) in July after growing 1.4% mom in June. This means that retail sales are now up 7% since bottoming out in January last year.
- **Chile:** The central bank left the policy rate unchanged at 2.5%
- **Hungary:** The economy expanded at a rate of 3.2% yoy in Q2 2017 versus 3.6% yoy expected.
- **India:** The trade deficit narrowed to USD 11.5bn in July from USD13.0bn in June.
- **Indonesia:** Exports and imports surprised to the upside in July. Exports increased at a yoy rate of 41.1% versus 35.7% yoy expected, while imports surged at a rate of 54% yoy compared to 32.2% yoy expected.
- **Russia:** The pace of growth of industrial production slowed somewhat in July, but wage growth improved along with construction activity.
- **Singapore:** Tech (electronics) exports accelerated at a qoq saar rate of 16.2% in July compared to 4.8% in June.

Global backdrop

The July FOMC minutes showed that America's monetary policy authorities were still divided about balance sheet reduction and rate hikes and uncertainty about the future evolution of inflation. Will this change by the time Yellen and Draghi speak at the upcoming Jackson Hole symposium? Probably not, in which case, the market will continue to view the main developed market central banks as fundamentally dovish with considerable work to do before making significant changes in policy.

For EM countries, the Fed's path forward is obviously more important than the ECB's, because most EM currencies trade against the Dollar and most EM external debt trade has spread over the US treasury curve. How, then, will the Fed ultimately tighten policies? Deputy Fed Chairman William Dudley gave a clue last week when he said that the Fed is concerned about asset price valuations. This suggests that the Fed will place greater emphasis on balance sheet reduction rather than on rate hikes, since rate hikes would impact the entire economy, whereas balance sheet reduction would disproportionally impact financial markets.

This does not bode well for the US stock market, the Dollar and for European core bond markets, which have been the three main beneficiaries of unconventional monetary policies. Each of these markets attracted huge inflows from 2010 through 2016 as investors en masse adopted bullish views of the US economy and bearish views about Europe as pretexts for jumping on the QE central bank bandwagons.[1] However, we expect the pace of balance sheet normalisation to be very slow, because too much balance sheet reduction too fast would hurt the real economy. It could trigger a crash in financial markets, which would then lead to a recession, which central banks would struggle to cure.

Many investors bemoan the loss of US leadership in the world as Trump's presidency descends to new lows, but the reality is that US leadership was questionable to begin with and maybe such investors are just too long US assets and blind to the associated risks.

The main concern of the QE central banks remains low inflation. Cyclically, there are good reasons to expect inflation to go up. After all, barring recession, the US is close to full employment, the Fed's policy rate is still deep in negative territory in real terms and Congress is desperate to stimulate further by cutting taxes. In fact, we already have a lot of inflation in capital markets. The abundance of financial market bubbles are a clear manifestation of capital market inflation. The QE central banks have deliberately been fuelling capital market inflation for many years.

The softness of labour market inflation is a bit more mysterious although there is no shortage of hypotheses why labour markets are delivering so little wage inflation, including greater labour market flexibility, immigration, outsourcing, free trade, automation and increasingly artificial intelligence (AI).

AI offers some interesting perspectives. AI is a brand new vintage of technology, which distinguishes itself from conventional technical progress in one important aspect, namely that it removes the need to accumulate ever more human capital within individual workers. To see how this feature may be contributing adversely to wage inflation, imagine three simple economies, one with zero technical progress, one with conventional technical progress and one with AI:

- **Economy with zero technical progress:** In a simple economy with little or no technical progress the reward for labour and capital depends on their respective supply and demand. To eke out a bit of supernormal profit, employers must obtain monopoly power for their products and monopsony[2] power over their labour inputs. Workers fight back by organising themselves and seeking political representation. The strongest end up with supernormal profits at the expense of the other.

[1] See '*What's down with the Dollar?*', Market Commentary, 16 August 2017.
[2] A market situation in which there is only one buyer.

Global backdrop

- **Economy with conventional technical progress:** Conventional technical progress manifests itself in new vintages of machinery each of which results in more output per unit of input. Since complex machines require better trained workers conventional technical progress has typically also required investment in workers, who have become more productive as a result. Human capital is embedded within the worker, so the worker has been able to secure a higher wage even if the demand for his or her raw menial work has goes down. As long as labour 'skills up' in line with technical progress, the reward to the worker rises more or less in line with the reward to capital. This environment generally leads to balanced income distribution and fewer confrontations between workers and employers.
- **AI:** AI displaces the brainy bits of production, where conventional technical progress replaced menial bits of production. Programmers create and own AI, which competes directly with education produced in schools. Output is increasingly made more cheaply without any human capital input in the production process: a robot builds your car and the skilled autoworker is obsolete. An online retailer displaces the knowledgeable and service-minded shop assistant. By removing the need to invest in workers, AI leaves behind only the husks of yesteryear's skilled labourers, while the new jobs in the AI world are, for now, minimum wage jobs, such as driving delivery trucks. Eventually they too are made obsolete by a computer programme, which operates a self-driving delivery vehicle.

The transition towards AI implies stubbornly low wage inflation despite full employment as work becomes ever more commoditised. Meanwhile, rents to technology skyrocket, which results in a sharp and structural rise in income inequality. This soon translates into greater populism as large numbers of people are 'left behind'. Workers become less productive as technical progress shifts from within humans to increasingly existing outside of machines and humans altogether, almost like an independent factor of production. The future belongs to those who can make AI programmes, although as AI gains the ability to programme itself maybe humanity's last true edges over the machines may be a sense of creativity and, perhaps, irrationality.

Needless to say, there is a strong hint of Marxism in this narrative. Luddites made similarly gloomy and ultimately flawed predictions about the future when mass production took off in the early years of the industrial revolution. They could not imagine just how many news jobs would be created in the new economy and how much our living standards would rise. Maybe the new professions – in the creative industries, in programming, in services – will easily absorb all the workers released from conventional jobs and as well as the billions entering the labour markets as the world's population rises. Time will tell. Until then, the key question is how to minimise the damage inflicted by populists in the transition. President Donald Trump only last week accused Amazon of hurting "towns, cities and states throughout the US". Taxing tech is tempting but would discourage innovation and ultimately reduce the overall size of the pie, making us more equal, but poorer. Encouraging broader ownership of tech stock would enable ordinary people to supplement their declining wage incomes with rent from tech businesses, although achieving this without coercion will prove difficult. Ultimately, the right solution is to make the economy as efficient and flexible as possible and to intervene intelligently wherever markets clearly fail to operate properly, including in a distributional sense and intertemporally.[3] Part of this requires that inflation, whether in labour or capital, is managed well too.

[3] Intertemporal: A term describing how an individual's current decisions affect the options which become available in the future.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.50%	25.12%	18.65%	2.17%	4.57%
MSCI EM Small Cap	-1.15%	18.86%	11.29%	1.34%	5.33%
MSCI Frontier	1.86%	20.13%	23.10%	-2.48%	8.76%
MSCI Asia	-1.10%	28.13%	20.90%	5.37%	8.24%
Shanghai Composite	-0.04%	7.36%	7.47%	15.63%	11.76%
Hong Kong Hang Seng	-1.24%	18.03%	15.08%	2.63%	5.76%
MSCI EMEA	0.28%	11.83%	8.69%	-3.24%	-0.64%
MSCI Latam	1.86%	21.70%	15.31%	-4.64%	-2.47%
GBI EM GD	0.26%	12.94%	4.85%	-1.85%	-0.59%
ELMI+	-0.09%	8.85%	4.25%	-1.61%	-0.36%
EM FX Spot	-0.22%	5.82%	-0.90%	-8.40%	-6.61%
EMBI GD	0.74%	7.88%	3.73%	5.72%	5.30%
EMBI GD IG	0.56%	7.31%	0.95%	4.54%	3.75%
EMBI GD HY	0.92%	8.53%	6.94%	6.58%	7.34%
CEMBI BD	0.36%	6.22%	5.05%	5.11%	5.24%
CEMBI BD IG	0.29%	5.35%	2.57%	4.18%	4.43%
CEMBI BD Non-IG	0.46%	7.54%	8.98%	6.28%	6.64%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.64%	9.76%	13.22%	9.42%	13.70%
1-3yr UST	0.14%	0.80%	0.34%	0.78%	0.69%
3-5yr UST	0.33%	1.93%	-0.21%	1.77%	1.34%
7-10yr UST	0.84%	3.64%	-2.44%	2.82%	2.00%
10yr+ UST	2.34%	7.32%	-6.17%	5.19%	3.50%
10yr+ Germany	2.49%	-1.93%	-8.64%	5.51%	5.69%
10yr+ Japan	0.48%	-0.17%	-4.40%	5.25%	5.11%
US HY	-0.69%	5.36%	8.29%	4.68%	6.46%
European HY	0.19%	4.48%	6.62%	5.27%	8.55%
Barclays Ag	0.41%	4.32%	2.05%	3.93%	4.29%
VIX Index*	38.99%	1.57%	25.75%	21.26%	-5.06%
DXY Index*	0.61%	-8.59%	-0.77%	14.54%	13.12%
CRY Index*	-2.82%	-7.80%	-5.98%	-38.59%	-42.30%
EURUSD	-0.69%	11.79%	3.58%	-12.00%	-4.65%
USDJPY	-0.97%	-6.68%	9.31%	6.45%	37.24%
Brent	0.13%	-7.22%	3.60%	-48.11%	-53.64%
Gold spot	1.14%	11.43%	-5.05%	-1.12%	-20.55%

*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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