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WEEKLY INVESTOR RESEARCH

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IMF's EM growth forecast too timid

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The IMF increased its forecast for EM real GDP growth to 4.6% in 2017 and 4.9% in 2018. We think this is far too timid. The IMF is still not adequately factoring in a likely rise in domestic demand as capital flows back to EM's finance constrained economies.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.0	–	2.08%
MSCI EM Small Cap	13.0	–	1.54%
MSCI Frontier	11.7	–	0.18%
MSCI Asia	12.4	–	1.85%
Shanghai Composite	13.1	–	1.24%
Hong Kong Hang Seng	8.1	–	0.53%
MSCI EMEA	10.5	–	3.90%
MSCI Latam	14.5	–	0.40%
GBI-EM-GD	6.05%	–	0.93%
ELMI+	3.79%	–	0.83%
EM FX spot	–	–	0.77%
EMBI GD	5.17%	287 bps	0.36%
EMBI GD IG	4.04%	171 bps	0.31%
EMBI GD HY	6.40%	416 bps	0.40%
CEMBI BD	4.96%	278 bps	0.25%
CEMBI BD IG	4.04%	188 bps	0.25%
CEMBI BD Non-IG	6.24%	405 bps	0.25%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.5	–	0.17%
1-3yr UST	1.52%	–	0.02%
3-5yr UST	1.93%	–	0.15%
7-10yr UST	2.30%	–	0.56%
10yr+ UST	2.82%	–	1.49%
10yr+ Germany	0.39%	–	0.64%
10yr+ Japan	0.06%	–	-0.01%
US HY	5.46%	348 bps	0.02%
European HY	2.69%	312 bps	0.29%
Barclays Ag	–	251 bps	0.49%
VIX Index*	9.96	–	0.31%
DXY Index*	93.20	–	-0.48%
EURUSD	1.1799	–	0.50%
USDJPY	111.86	–	-0.73%
CRY Index*	185.43	–	4.48%
Brent	58.2	–	4.36%
Gold spot	1305	–	1.61%

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

Emerging Markets

The IMF revised its forecast for Emerging Markets (EM) real GDP growth up to 4.6% in 2017 and 4.9% in 2018. We think this forecast is far too timid. The IMF has still not adequately factored into its forecasts the likely boost to EM growth from rising domestic demand in response to rising capital flows in the coming few years. So far the EM growth recovery has 'only' relied on rising net exports on the back of cheaper currencies, but trade is a small part of GDP. Domestic demand is far more important and is likely to pick up sharply in the coming years. Flows to EM are key to unlocking domestic demand and should pick up as Quantitative Easing (QE) finally winds down. QE was a massive distortion against EM markets, because it caused investors the world over to withdraw investments from EM in order to invest more in the QE sponsored markets in Europe and the US.

EM markets have already started to outperform developed markets quite strongly both in terms of growth and in terms of returns. There is far more to come due to the enormous difference in valuations of assets and currencies in EM and developed markets. Investors are still heavily underinvested in EM. Institutional investors typically react to major turning points in the market with a 2 year lag, so we think that 2018 will be a very strong flow year for EM. Inflows matter a great deal, because EM economies are so finance constrained.

Figure 1 (overleaf) shows the IMF's estimate of EM's share of global GDP (in PPP adjusted terms). The IMF currently expects EM's share of global GDP to reach 62% by 2022. However, EM is still only 20% of global fixed income. We expect the return of domestic demand to push EM's share of global GDP well beyond what the IMF is currently forecasting. In light of this investors should, at a minimum, have between 20% (EM's share of global fixed income) and 62% (EM's share of global GDP) of their total AUM in EM. However, given the superior prospects for returns in EM over the next few years we believe investors should be overweight relative to these market cap and GDP implied allocations at this point in time.

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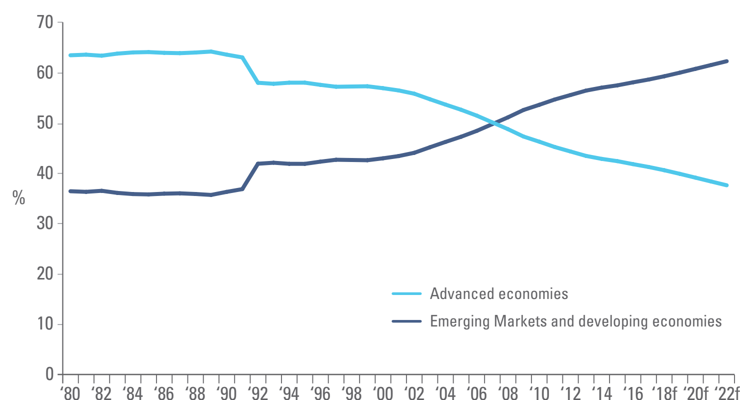
Emerging Markets

Fig 1: **EM and DM shares of PPP-adjusted global GDP**



Source: IMF's World Economic Outlook as of October 2017, Ashmore.

- China: The 19th Communist Party Congress kicks off this week. We expect the conference to strengthen President Xi Jinping and thus enable him to continue along the path of reforms he set out in his first five-year term. In addition, we expect President Xi Jinping to begin to tackle the toughest challenge of all, namely reform of state-owned enterprises (SOEs). SOEs are difficult to reform because they are debt-laden, inefficient and over-staffed. Reforming them therefore exposes weaknesses in the credit system, will create unemployment and will be met with opposition from those who are currently free-riding on society. However, measures will be put in place to soften the impact; in fact, some have already been put in place: China has already started the process of deleveraging and a recent cut in reserve ratios for bank-lending to small and medium sized enterprises is specifically designed to help this sector. The small enterprise sector will be the backbone of China's future economy and the idea is that this sector will absorb labour from the shrinking SOE sector. The economic backdrop for continuing reforms looks bright: inflation is under control as CPI inflation declines to 1.6% yoy in September from 1.8% yoy in August and credit and monetary data issued last week for the month of September was stronger than expected with broad money, new loans and total social financing all stronger than expected. Trade numbers also point to brisk economic activity with imports rising at a rate of 18.7% yoy, much stronger than consensus expectations, while the rate of growth of exports also picked up to a solid 8.1% yoy. Finally, we note that FX reserves increased by USD 17bn in September to reach USD 3,109bn. The Bloomberg consensus was for a rise of USD 8bn and reserves increased by USD 11bn in August.

- South Korea: China and South Korea put aside their differences over North Korea and renewed a three-year currency swap arrangement. Clearly, this is sensible policy on both their parts. It is difficult to say what will happen in North Korea, but China's rise as an economic powerhouse with growing influence in Asia, especially at the expense of US influence, is a very high probability event. South Korea is therefore wise to look through short-term tensions over North Korea and the noise caused by the decline in US influence in the region, especially when making economic policy decisions pertaining to China.

- India: In a very positive development India's trade deficit narrowed sharply in September to just USD 8.9bn compared to USD 11.6bn in August. This was a significant surprise relative to market expectations. Exports rose at a strong pace of 25.7% yoy, while imports were 18.1% higher than in September of 2016. Gold imports fell sharply, which is usually a good sign, since Indians tend to buy more gold when they worry about macroeconomic policy. Such concerns appeared earlier this year, when many analysts worried about the effects of GST implementation on inflation, fiscal policy and growth. Such fears now appear to be fading. On current trends India looks likely to rack up a current account deficit well below 1% of GDP this year, which is very comfortable. Historically, only current account deficits in excess of 3% of GDP have been associated with macroeconomic stress. Moreover, headline CPI inflation also surprised to the downside at 3.3% yoy in September versus 3.6% yoy expected and industrial production actually picked up to a much stronger than expected 4.3% yoy in August (versus 2.6% yoy expected).

- Ecuador: The government has announced fiscal measures, which will raise USD 1.7bn next year, including raising the corporate tax rate to 25% from 22%. Prevention of smuggling and tax evasion measures should additionally raise USD 1bn.

- Venezuela: The government won 17 of 23 gubernatorial contests in the election at the weekend. The opposition claims the election was rigged and is requesting a "full audit" of the results, but has failed to appoint any major factor in spite of representatives in poll stations across the country. The election outcome will have no major impact on the daily running of the central government. In other news, PDVSA, the national oil company, failed to pay a coupon due on 12 October. This is a bank holiday in Venezuela, so not a paying day according to the prospectus. PDVSA has been using the grace periods more often recently due to complexities involved in processing payments in correspondent banks' following the imposition of US sanctions.

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Emerging Markets

- **Brazil:** Retail sales were softer than expected in August. Specifically, retail sales were only 7.6% stronger than in the same month of 2016, whereas the market had expected a yoy rate of growth of 8.5%. Still, within the broad number there was a notable pickup in bulkier durable consumer items, which points to a greater propensity to spend overall. We expect the ongoing decline in inflation and interest rates in Brazil to continue to stimulate consumption going forward.

Snippets:

- **Argentina:** The central bank left the policy rate unchanged at 26.25%.
- **Egypt:** The rate of CPI inflation declined to 1.0% yoy in September from 1.1% yoy in August, which suggests that the spike in inflation from subsidy cuts last year is now fading.
- **Hungary:** September CPI inflation was lower than expected (2.5% yoy versus 2.7% yoy expected).
- **Indonesia:** Exports increased at a rate of 15.6% yoy in September and imports rose strongly too (13.1% yoy).
- **Malaysia:** Industrial production surged in August, expanding at a rate of 6.8% yoy compared to 5.8% yoy expected and 6.1% yoy in July. Both manufacturing and mining contributed to the strong number.
- **Mexico:** Industrial production in August was soft but marginally stronger than expected (-0.5% yoy versus -0.8% according to the Bloomberg survey). CPI inflation was 0.31% in September, which was below the median market expectation of 0.43% mom. In yoy terms inflation declined to 6.4% from 6.7% in August.
- **Peru:** The central bank left the policy interest rate unchanged at 3.5%.
- **Romania:** Q2 GDP growth was revised higher to 6.1% yoy from a preliminary estimate of 5.9% yoy.
- **Russia:** The rate of inflation declined to 2.9% yoy in the week to 9 October from 3.0% yoy in the previous week.
- **Singapore:** Q3 GDP growth was much stronger than expected at 4.6% yoy (versus a consensus expectation of 3.7% yoy). Growth also accelerated sharply from Q2's growth rate of 2.9% yoy. Retail sales for August were stronger than expected at 3.5% yoy. The Monetary Authority of Singapore kept the policy exchange rate unchanged.
- **South Africa:** Industrial production volumes rose 2.1% in the month of August. This was better than expected.
- **Taiwan:** Strong exports in September. Exports rose at a rate of 28.1% yoy from 12.7% in August. Import growth also accelerated to 22.2% yoy from 6.9% yoy.
- **Turkey:** The current account deficit was lower than expected in August. At USD 1.2bn the deficit was favourable compared to the consensus expectation of USD 1.4bn, but the current account deficit year to date of USD 27.2bn is still worse than same time last year (USD 22.9bn).

Global backdrop

For all their sophistication, financial markets tend to like to dumb things right down. Hence, in the last few months the near-sole focus has been the US business cycle, particularly prospects for tax reform and Fed hikes. Despite very modest expectations for both tax reform and interest rate hikes the markets have let themselves be completely steered by headlines related to issues. Tax reform, so the hyped up narrative goes, will stimulate growth and the Fed will then hike rates, because stronger growth will push up inflation. The US economy is already near or at full employment. The only 'problem' with this story is that inflation is not really going up. The main US data release last week was September's consumer price index. Once again it was lower than expected. Specifically, the yoy rate of headline CPI inflation was 2.2% yoy versus 2.3% yoy expected and core CPI inflation was 1.7% yoy versus 1.8% yoy expected. Markets will now try to gauge how this might impact the PCE measure of inflation favoured by the Fed.

The stubbornly low rate of inflation in the US is a two-edged sword for the Fed. On the one hand, low inflation makes it difficult for the Fed to get some hikes under the belt as insurance against a future recession. On the other hand, the persistently low rate of inflation gives the Fed a chance to scale back Quantitative Easing (QE) before having to hike rates. By first deflating the stock market bubble before hiking rates the Fed hopes to be able to de-risk the overall macroeconomic environment.

Of course, Europe faces similar bubble problems to the US, albeit in reverse. Europe's big bubble is in bonds rather than stocks and the currency. The unwinding of QE will therefore pose the greatest challenge for holders of European bonds, while European stocks and the EUR should actually benefit. Higher stock prices in Europe should stimulate consumer and business confidence, while a stronger EUR will be deflationary at the margin. The ECB has so far chosen to be even more dovish than the Fed in the face of these conflicting circumstances.

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Global backdrop

Debt is without question one of the largest problems facing developed countries as they try to begin to normalise monetary policies. Most economists will privately admit to concerns about the debt stock, but they are rarely willing to express their worries in public for an obvious reason: it is so difficult to predict when the day of reckoning will arrive and meanwhile crying wolf at the wrong time carries the risk of loss of credibility. Meanwhile, regulators ensure continued demand for developed market bonds by classifying them as risk free and politicians in developed economies continue to shy away from the debt issue in the hope that some future politician will face the music instead of them. All the while the Great Public languishes in blissful ignorance about the scale of the problem and it is precisely their ignorance, which makes it possible for the debt deception to go on and on. Until, of course, it no longer does.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.12%	33.36%	29.71%	7.16%	5.29%
MSCI EM Small Cap	3.06%	26.45%	20.83%	5.35%	5.54%
MSCI Frontier	1.99%	27.31%	28.66%	0.19%	8.93%
MSCI Asia	4.17%	36.63%	30.48%	10.34%	8.79%
Shanghai Composite	1.24%	11.49%	13.04%	14.88%	12.65%
Hong Kong Hang Seng	5.59%	27.53%	26.17%	7.80%	6.23%
MSCI EMEA	4.50%	17.03%	24.23%	1.44%	-0.22%
MSCI Latam	1.71%	29.17%	23.43%	-0.59%	-1.46%
GBI EM GD	-0.11%	14.15%	8.80%	-0.29%	-0.99%
ELMI+	0.33%	9.72%	6.97%	-0.32%	-0.72%
EM FX Spot	-0.04%	5.75%	1.97%	-6.95%	-6.89%
EMBI GD	0.41%	9.44%	5.83%	6.43%	4.73%
EMBI GD IG	0.15%	8.28%	3.34%	4.78%	3.21%
EMBI GD HY	0.65%	10.65%	8.58%	8.03%	6.65%
CEMBI BD	0.34%	7.59%	6.31%	5.53%	4.87%
CEMBI BD IG	0.21%	6.16%	3.78%	4.27%	3.98%
CEMBI BD Non-IG	0.51%	9.72%	10.20%	7.29%	6.33%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.42%	15.86%	22.20%	13.18%	14.69%
1-3yr UST	0.00%	0.69%	0.38%	0.66%	0.65%
3-5yr UST	0.09%	1.67%	-0.02%	1.51%	1.17%
7-10yr UST	0.44%	3.30%	-1.61%	2.31%	1.61%
10yr+ UST	0.93%	7.12%	-2.90%	3.97%	3.00%
10yr+ Germany	0.62%	-2.65%	-6.55%	4.63%	5.37%
10yr+ Japan	0.00%	-0.41%	-3.21%	4.97%	4.96%
US HY	0.19%	7.20%	8.64%	5.96%	6.26%
European HY	0.52%	5.84%	7.76%	5.93%	8.06%
Barclays Ag	0.50%	4.99%	3.19%	3.89%	3.86%
VIX Index*	4.73%	-29.06%	-38.21%	-60.48%	-34.56%
DXY Index*	0.13%	-8.82%	-4.92%	9.70%	17.37%
CRY Index*	1.28%	-3.68%	-2.13%	-32.00%	-39.44%
EURUSD	-0.13%	12.19%	7.26%	-7.89%	-9.61%
USDJPY	-0.58%	-4.36%	7.67%	5.20%	41.79%
Brent	1.18%	2.46%	12.07%	-31.08%	-49.40%
Gold spot	1.95%	13.70%	3.89%	5.32%	-25.34%

*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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