Issued: 23 October 2017
WEEKLY INVESTOR RESEARCH

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Big political shift in Argentina

By Jan Dehn

Odds of deeper market-friendly reform were given a major boost at the weekend after sweeping victories by the Cambiemos alliance across the whole of Argentina. The big take-away from President Xi Jinping's address to the Chinese Communist Party's National Congress is that China under his leadership will clearly continue to prioritise economic development over other policies. The relentless focus on the economy keeps China on track to achieve the status of absolute global economic hegemon within just a couple of decades. More corruption charges against President Michel Temer are defeated, opening a possible window for pension reform before year-end. President Zuma reshuffles his cabinet in a further bid to take the day at the approaching ANC party conference and Babis takes power in the Czech Republic. Global markets continue to focus mainly on the short-term momentum created by improving prospects of a US tax cut and the question of who becomes the next Fed Chairperson.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	-0.54%
MSCI EM Small Cap	12.9	–	-0.15%
MSCI Frontier	11.7	–	-0.82%
MSCI Asia	12.4	–	-0.11%
Shanghai Composite	13.1	–	-0.35%
Hong Kong Hang Seng	8.1	–	0.33%
MSCI EMEA	10.2	–	-1.98%
MSCI Latam	14.3	–	-1.21%
GBI-EM-GD	6.10%	–	-0.80%
ELMI+	3.90%	–	-0.39%
EM FX spot	–	–	-0.64%
EMBI GD	5.19%	280 bps	-0.04%
EMBI GD IG	4.05%	163 bps	-0.04%
EMBI GD HY	6.43%	409 bps	-0.05%
CEMBI BD	4.98%	270 bps	0.07%
CEMBI BD IG	4.07%	180 bps	-0.06%
CEMBI BD Non-IG	6.23%	394 bps	0.26%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.6	–	0.88%
1-3yr UST	1.58%	–	-0.11%
3-5yr UST	2.02%	–	-0.34%
7-10yr UST	2.38%	–	-0.75%
10yr+ UST	2.89%	–	-1.40%
10yr+ Germany	0.43%	–	-0.66%
10yr+ Japan	0.07%	–	-0.24%
US HY	5.34%	330 bps	0.31%
European HY	2.60%	301 bps	0.26%
Barclays Ag	–	251 bps	-0.23%
VIX Index*	9.97	–	0.36%
DXY Index*	93.79	–	0.48%
EURUSD	1.1754	–	-0.36%
USDJPY	113.77	–	1.41%
CRY Index*	184.12	–	-0.71%
Brent	57.8	–	0.00%
Gold spot	1275	–	-1.53%

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

Emerging Markets

- **Argentina:** The mid-term election in Argentina delivered the best possible news. President Mauricio Macri extended his political base, when his Cambiemos coalition made sweeping gains against former President Cristina Kirchner. Macri's candidates won all five major electoral districts in Argentina, including the Buenos Aires province. Macri's victory increases the odds of further supply-side reforms in the next couple of years. As such, the election outcome is extremely positive news. So far, in a bid to preserve political capital ahead of the mid-term election, the government has been slow to implement supply-side reforms and has maintained a high level of fiscal stimulus, while tightening monetary policies. This policy mix has encouraged hot money inflows to Argentina, but it has not been ideal for private sector investment, which tends to get crowded out by a strong currency and tightening financial conditions on the back of heavy government bond issuance. A greater focus on supply-side reforms should now help to generate more balanced growth and thereby increase incentives for investors to commit to longer-term investment in the country. There is a widespread expectation that Macri's Administration will now submit several bills to Congress to begin to reform the country's fiscal system and the labour code.
- **China:** The big take-away from the Chinese Communist Party's Congress is that China under President Xi's leadership will continue to prioritise economic development over other policies. China's relentless emphasis on economic reform should keep the country on track to achieve the status of absolute global economic hegemon within just a couple of decades, especially as Western influence diminishes due to a combination of myopic economic policies and deepening political populism. President Xi Jinping outlined his broad policy objectives for the next five years, which can be summarised in four words: consumption, technology, SOEs and BRI:
  - **Consumption:** President Xi will seek to accelerate the transformation of the economy from a narrow export-led growth model to broad-based and therefore far more inclusive consumption-led growth model. One element within this program was revealed last week, when the rural land reform was launched. The

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Emerging Markets

reform will unlock rural land wealth to the tune of USD 20trn (more than the US GDP) by making more land available for private development and trade.

- Technology: China will seek to traverse the middle-income trap by investing heavily in innovation and technology.
- State-owned enterprises (SOEs): President Xi will also use his stronger mandate to tackle reform of China's thousands of SOEs, which will be consolidated into fewer larger and more efficient entities. The central bank has already prepared monetary policy measures to help small and medium-sized enterprises to hire workers laid off from the SOE sector.
- Belt and Road Initiative (BRI): The Belt and Road Initiative (BRI) will continue to be the main avenue of Chinese influence in the global economy with major investments aimed at deepening economic integration with countries along China's most important trading routes.

In other news from China, Real GDP growth was 6.8% yoy in Q3 2017, which was in line with expectations. The economy has now grown at a rate of 6.9% in the first three quarters, so the government's full year growth target of 6.5% looks set to be exceeded. Hence, 2017 will be yet another year of the hard landing crowd eating humble pie, although when it comes to China it is seemingly possible to play the hard landing card over and over without loss of face and credibility. The continuing discrepancy between sentiment towards China and the country's reality of stable growth and inflation as well as continuing reforms probably owes a great deal to the low levels of exposure to China among global investors, profound ignorance about the country and a chunky dose of plain old prejudice.

- Brazil: Last week the Justice Committee of the parliament rejected a second accusation of corruption against President Michel Temer with a similar majority to the last time it rejected similar accusations against Temer. This means that the Lower House plenary vote on the matter will likely result in a full dismissal of the accusations against Temer in the course of this week. The reason why this matters is that there is a window in the legislative agenda for parliament to focus on the pension reform, which is still pending. The reform is ready to be voted upon, but a vote has been delayed due to various political issues, including the charges against Temer. In economic news, Brazil had yet another low inflation print. Mid-month IPCA-15 inflation was 0.34% mom in the month to mid-October compared to a consensus expectation of 0.35% mom. Other activity indicators were mixed. Job creation and services activity slowed, but a broader indicator of economic activity increased at a rate of 1.6% yoy in August from 1.3% yoy in July and real tax revenues increased at a rate of 8.7% yoy in September. The credit rating of Petrobras, the national oil company, was revised higher to Ba3 with stable outlook.

- South Africa: President Zuma reshuffled his Cabinet in a bid to improve his chances of securing a friendly person to take over the job as head of ANC. The main ANC party conference is in December. Markets will react very negatively to a Zuma-friendly ANC president, because this will enable Zuma and those close to him to continue to abuse power at the expense of the public finances and the health of the wider economy. Despite the bad political news, retail sales grew more strongly than expected (5.5% yoy in August versus 2.7% yoy expected), but inflation was also higher than expected (5.1%yoy versus a consensus expectation of 5.0% yoy).

- Czech Republic: Andrej Babis, a populist Eurosceptic billionaire accused of fraud linked to European Union subsidies, won the largest number of seats in the parliamentary elections and will now be asked to form a government. The parliament has been left fractured by the rise of numerous smaller, populist right-wing parties. It remains to be seen if Babis can form a stable government.

- South Korea: Exports continued to grow strongly in the first 20 days of October. Despite 4.5 fewer working days due to holidays over this short time span exports increased at a rate of 6.9% yoy and now look set to rise nearly 20% yoy for the month as a whole. Semi-conductors and shipbuilding were particularly strong and exports to Europe, China and Vietnam rose most strongly, while exports to the US and Japan contracted. The Bank of Korea left the policy rate unchanged at 1.25%, but growth and inflation projections were revised higher and a single member of policy committee dissented in favour of a hike. Asia will be the first part of Emerging Markets (EM) to materially raise rates as domestic demand picks up on the back of returning flows.

Snippets:

- Chile: The central bank left the policy rate unchanged at 2.5%.
- Indonesia: The central bank left the policy rate unchanged at 4.25% and issued a positive assessment of the economic outlook
- Malaysia: CPI inflation was 4.3% yoy in September in line with expectations.
- Mexico: Unemployment was low at 3.6% in September compared to 4.14% in September 2016. NAFTA talks with the US and Canada were extended into Q1 2018.
- Russia: Retail sales expanded strongly at a rate of 3.1% yoy in September compared to 2.1% yoy expected. Industrial production was slower than expected in September (0.9% yoy versus 1.5% yoy expected).
- Taiwan: The yoy rate of export growth moderated 6.9% in September from 7.5% in August.
- Thailand: Thailand racked up a strong trade surplus in September due to very strong exports and moderating imports. Exports were up 12.2% on yoy basis, while imports were 9.7% higher yoy. The trade surplus increased to USD 3.4bn.

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Global backdrop

Lacking anything more substantive to fret about, global markets continued to focus on near-term – and ultimately quite minor – themes, such as the US tax reform and the choice of the next Fed chairperson. The strong showing of Prime Minister Shinzo Abe in the Japanese election and still unresolved issues pertaining to Catalonia, where the Spanish government has now imposed direct rule, have given a boost to the broad Dollar and helped to push US Treasury yields higher.

Prospects for a tax cut in the US were given a boost last week when the US Senate passed a blueprint for the budget. Budget approval is a prerequisite for passing an unfunded tax cut. The Trump Administration claims that the tax cut will boost growth strongly, wherefore there is no need to fund the tax cut through fiscal savings elsewhere in the budget. Still, unless the tax cut introduces genuine efficiency improving measures it will likely increase the level of US government debt, which will result in further transfers of funds from the more productive US private sector to the less productive US government sector, thereby lowering the productivity of the economy as a whole. Lower productivity in turn reduces the Fed's long-term policy interest rate target. Hence, after an initial market reaction a debt funded corporate tax cut could ultimately prove dovish, not hawkish.

The question of who becomes the next Fed Chairperson is also punching above its weight in terms of near-term market impact. Regardless of who becomes the Fed Chairperson we think the economic reality does not change materially. Since the turn of the century the US government debt stock has nearly doubled to more than 100% of GDP, while productivity has fallen sevenfold and the Dollar has become overvalued. Because they too are expensive, the US stock markets are delivering smaller increments of performance and are already materially underperforming, say, EM stock markets. US bond yields are also precariously low, which means that the Fed is still very far from reaching the 5% level for the Fed funds rate typically required in order to have enough room to ease policy in the event of a recession. In light of these many constraints on Fed policy, what is in a Chairperson's name? Probably much less than the market currently believes. We think the Fed, regardless of who is at the helm and barring a major policy mistake, will continue to keep interest rates lower than usual for this stage of the business cycle. As long as a recession could prove unfixable due to inadequate room to cut rates and as long as the stock market is materially overvalued, there is a lot of risk involved in hiking too fast, especially as inflation remains contained. The Fed is therefore likely to continue to hike strictly on an opportunistic basis, i.e. when the market has almost fully priced the hike. In the meantime, the Fed's real focus will be to scale back QE in order to bring stock prices to more reasonable valuation levels. If this objective can be achieved in a calm manner, then, when inflation does show up, the Fed will be in a much stronger position to hike rates without causing outsized fundamental damage than it is today.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.55%	32.63%	25.79%	7.31%	4.96%
MSCI EM Small Cap	2.91%	26.26%	18.69%	5.55%	5.44%
MSCI Frontier	1.16%	26.27%	26.95%	0.49%	8.75%
MSCI Asia	4.06%	36.48%	27.94%	10.20%	8.55%
Shanghai Composite	0.89%	11.10%	11.80%	14.89%	12.33%
Hong Kong Hang Seng	5.94%	27.95%	24.12%	7.88%	5.62%
MSCI EMEA	2.43%	14.71%	18.17%	1.04%	-0.81%
MSCI Latam	0.48%	27.61%	16.19%	0.86%	-1.92%
GBI EM GD	-0.92%	13.23%	6.81%	-0.60%	-1.32%
ELMI+	-0.06%	9.29%	5.88%	-0.43%	-0.83%
EM FX Spot	-0.67%	5.08%	0.54%	-7.06%	-6.98%
EMBI GD	0.37%	9.39%	5.47%	6.26%	4.63%
EMBI GD IG	0.12%	8.24%	3.02%	4.45%	3.16%
EMBI GD HY	0.61%	10.60%	8.17%	8.16%	6.45%
CEMBI BD	0.41%	7.66%	6.14%	5.52%	4.80%
CEMBI BD IG	0.15%	6.09%	3.55%	4.16%	3.90%
CEMBI BD Non-IG	0.77%	10.00%	10.10%	7.47%	6.25%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.31%	16.88%	22.74%	12.93%	14.81%
1-3yr UST	-0.11%	0.58%	0.21%	0.58%	0.64%
3-5yr UST	-0.25%	1.32%	-0.44%	1.23%	1.16%
7-10yr UST	-0.32%	2.52%	-2.32%	1.79%	1.62%
10yr+ UST	-0.48%	5.61%	-3.90%	3.18%	3.05%
10yr+ Germany	-0.05%	-3.29%	-7.77%	4.02%	5.65%
10yr+ Japan	-0.24%	-0.65%	-3.42%	4.83%	4.96%
US HY	0.50%	7.53%	8.22%	5.90%	6.19%
European HY	0.79%	6.12%	7.33%	6.31%	7.88%
Barclays Ag	0.27%	4.74%	2.72%	3.72%	3.78%
VIX Index*	4.84%	-28.99%	-25.26%	-39.69%	-47.05%
DXY Index*	0.77%	-8.24%	-4.97%	9.26%	17.27%
CRY Index*	0.56%	-4.36%	-2.79%	-32.42%	-38.60%
EURUSD	-0.51%	11.73%	8.02%	-7.05%	-9.49%
USDJPY	1.10%	-2.76%	9.21%	5.08%	42.48%
Brent	0.49%	1.76%	11.66%	-33.41%	-46.59%
Gold spot	-0.38%	10.68%	0.85%	3.52%	-25.32%

*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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