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WEEKLY INVESTOR RESEARCH

Ashmore

Big Bang!

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China typically undertakes at least one set of reforms for every stimulus undertaken in a typical developed country. Following the recently concluded Party Congress there is no reason to expect this pattern to change as officials announced last week that foreign banks will now be allowed to take majority stakes in Chinese financial institutions. We outline the main implications of China's 'big bang'. PDVSA, the Venezuelan national oil company, completed principal repayments of the 2020 and 2017N bonds last week despite severe market doubts. This week, attention turns to a pending coupon payment on the 2027 PDVSA bond and a meeting between bond holders and the government in Caracas. We see three main risks in the global backdrop: the rapid weakening of the UK government as an important Brexit deadline approaches, further delays to the implementation of a tax cut in the US and rising tensions in the Middle East.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.0	–	0.22%
MSCI EM Small Cap	12.9	–	-0.28%
MSCI Frontier	11.7	–	-1.19%
MSCI Asia	12.5	–	0.44%
Shanghai Composite	13.2	–	1.81%
Hong Kong Hang Seng	8.2	–	1.24%
MSCI EMEA	10.5	–	0.53%
MSCI Latam	13.7	–	-0.57%
GBI-EM-GD	6.24%	–	0.46%
ELMI+	4.15%	–	0.24%
EM FX spot	–	–	0.48%
EMBI GD	5.39%	298 bps	-0.80%
EMBI GD IG	4.11%	167 bps	-0.46%
EMBI GD HY	6.78%	440 bps	-1.12%
CEMBI BD	5.11%	280 bps	-0.45%
CEMBI BD IG	4.18%	188 bps	-0.41%
CEMBI BD Non-IG	6.38%	406 bps	-0.50%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.6	–	-0.14%
1-3yr UST	1.66%	–	-0.04%
3-5yr UST	2.05%	–	-0.13%
7-10yr UST	2.39%	–	-0.46%
10yr+ UST	2.86%	–	-0.98%
10yr+ Germany	0.40%	–	-0.88%
10yr+ Japan	0.05%	–	0.34%
US HY	5.76%	360 bps	-0.77%
European HY	2.88%	330 bps	-0.75%
Barclays Ag	–	251 bps	-0.53%
VIX Index*	11.29	–	2.15%
DXY Index*	94.60	–	-0.16%
EURUSD	1.1640	–	0.26%
USDJPY	113.51	–	-0.18%
CRY Index*	191.65	–	2.27%
Brent	63.5	–	-1.23%
Gold spot	1276	–	-0.45%

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

Emerging Markets

- **China:** Any doubts that China would continue to reform its financial sector following the recently concluded Party Congress can now be put to bed. A senior Chinese official announced last week that China is scrapping rules, which have hitherto barred foreign banks from taking majority stakes in Chinese financial institutions. The reforms will enable foreign financial institutions to own up to 51% of individual companies in the securities, fund management and futures business sectors, removing a limit of 20% maximum foreign ownership in Chinese banks and enabling foreign ownership of up to 51% in Chinese insurance companies.

The liberalisation of rules governing foreign ownership underlines the pivotal importance assigned by the Chinese leadership to capital account liberalisation, because it is so integral to the broader policy objective of consumption and innovation-led growth. After all, greater reliance on consumption will eventually lead to current account deficits, which will have to be financed via the capital account. Greater foreign involvement in the Chinese financial sector will likely speed up the transformation of Chinese banks from large warehouses of non-tradable local government infrastructure loans into more nimble institutions offering asset management services as well as corporate and household lending. Such a transformation of the banks will support the consumer sector, but also stimulate the private corporate sector as the government embarks on more ambitious reforms of China's state-owned enterprises. We also expect the expertise brought to China by large foreign market-making banks will help to accelerate index inclusion and overcome the many operational constraints, which still handicap Chinese domestic markets relative to their more developed foreign cousins.

Greater foreign involvement should additionally help Chinese banks speed up their penetration of the global market for financial services. Lastly, the change in policy is obviously a very strong indication of China's absolute commitment to globalisation – a winning strategy shared by most countries in world except for a few increasingly uncompetitive developed nations, which are finding it more and more difficult to compete against more aggressive reform-oriented countries within Emerging Markets (EM). In other news, tensions between

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Emerging Markets

China and the US over trade may have lessened marginally following the signing of USD 253bn of trade deals between the two countries during US President Donald Trump's visit to China last week, though US policy commitments appear to be far less reliable these days than in the past. Exports increased a rate of 6.9% yoy and imports rose at a rate of 17.2% yoy in October to generate a trade surplus USD 38.2bn compared to USD 28.6bn in September. The yoy rate of Chinese CPI inflation rebounded to 1.9% in October from 1.6% in September and FX reserves increased to USD 3.109trn, up USD 0.7bn in the month.

- Venezuela: Last week PDVSA, the national oil company of Venezuela, paid in full the partial and full amortisations of the 2020 and 2017N bonds, respectively. Earlier in the week the market has priced the bonds to default following statements by President Nicholas Maduro that he would pay the bonds in full. Hence, Maduro was right and the market was wrong. PDVSA transferred the funds on time, but the payments arrived later than normal due to additional checks undertaken by financial intermediaries fearful of falling foul of a recently imposed US sanctions regime. Bonds rallied strongly on Friday as news arrived that all the money was on its way to bond holders. This week investors will focus on a pending coupon payment on the PDVSA 2027 bond and a meeting of bond holders in Caracas, which has been called by the government of Venezuela. Meanwhile, the US Treasury last week announced further sanctions against named officials, and issued a statement that investors could go to Caracas to attend the meeting with the government, provided they do not engage in transactions or negotiations involving sanctioned individuals. Not averse to playing politics, the US Treasury also said that Venezuela was free to issue new debt provided that the bond issue is approved by the opposition-controlled National Assembly. In other news, trustees last week claimed that Venezuela defaulted on a USD 650m Electricidad de Caracas (EDC) bond. However, President Nicholas Maduro said at the weekend that the government intends to pay this bond. The EDC bonds does not cross-default to PDVSA or sovereign bonds.

Snippets:

- Argentina: The central bank raised the policy rate by 100bps to 28.75%.
- Brazil: Consumer prices inflation was lower than expected in October. The IPCA inflation index increased 0.42% in the month versus 0.47% mom expected. This implies a yoy inflation rate of 2.7%.
- Egypt: S&P revises Egypt's sovereign credit rating (B-) outlook to positive from stable on rising reserves and better growth.
- Hong Kong: Q3 2017 GDP growth was 3.6% yoy versus 3.5% yoy expected.
- Hungary: Fitch revises the Hungarian sovereign credit outlook to positive from stable (BBB-)
- India: Industrial production increased at a rate of 3.8% yoy in September versus 4.1% yoy expected. The yoy rate was unchanged from August.
- Malaysia: Bank Negara left the overnight policy rate unchanged at 3.0%, but issued a clearly hawkish statement, which cited increasing external as well a domestic demand pressures. Industrial production was 4.7% higher in September than in the same month the year before.
- Mexico: Industrial production declined 0.4% mom sa in September in response to a series of natural disasters which hit the Mexican gulf. The market expectation was for industrial production to decline 0.6% mom sa. The central bank left the policy rate unchanged at 7% as core inflation came broadly in line with expectations (0.25% mom versus 0.24% mom expected). The yoy rate of gross fixed asset investment increased to 0.3% in August from -0.1% yoy in July.
- Nigeria: Moody's downgraded Nigeria's sovereign debt rating to B2 (stable) from B1 citing an unsuccessful policy response to lower oil prices. The government's 2018 Budget proposal is based on unrealistic growth, oil production and exchange rate assumptions.
- Oman: S&P downgraded Oman's sovereign credit rating to BB (stable) from BB+ on rising external debt levels.
- Peru: The central bank cut the policy rate by 25bps to 3.25% in anticipation of declining inflation in the coming months.
- Philippines: The central bank left the policy rate unchanged at 3.0%, but hinted at an imminent cut on the reserve ratio, which is currently 20%. The September trade deficit narrowed to USD 1.92bn versus USD 2.2bn expected, while October's core inflation declined to 3.2% yoy from 3.3% yoy.
- Poland: The monetary policy council left the policy rate unchanged at 1.5%.
- Romania: The CPI inflation rate was 2.6% yoy in October, up from 1.8% yoy in September. The inflation target of the central bank is 2.5%. Core inflation increased far less from 0.9% yoy in September to a still very modest 1.0% yoy in October.
- Taiwan: CPI inflation was -0.3% yoy in October versus +0.2% yoy expected. Export growth slowed sharply to 3.0% yoy in October from 28.1% yoy in September. The slowdown was entirely due to day count effects.
- Thailand: The Bank of Thailand left the policy rate unchanged at 1.5% despite strong growth as inflation remains significantly below target.
- Turkey: The current account deficit was USD 5.4bn in September. This was wider than expected (USD 4.1bn).

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Global backdrop

There are three important developments in the global backdrop worth highlighting as potential sources of wider market instability:

First, in the UK two government ministers resigned from Prime Minister Theresa May's Cabinet and 40 MPs are said to be ready to sign a letter of no confidence in May. These developments further weakened the government ahead of a crucial December 14-15 deadline for reaching agreement on the UK's exit bill for leaving the European Union (EU). Agreement on the exit bill is critical in order to progress to trade talks. Meanwhile, the question of how to reconcile an open border between Northern Ireland and mainland Ireland, as specified under the Good Friday peace agreement, with the need for a hard border between post-Brexit UK and the EU (Ireland is an EU member) remains unresolved. The Irish border issue has direct implications for the stability of the May Administration, since the government's majority at Westminster hinges critically on the votes of a handful of Northern Ireland MPs. With May's Conservative Party deeply divided, the opposition Labour Party is waiting in the wings with policy objectives, which include much greater public spending, major changes in tax legislation and nationalisation of utilities. These policies would have potentially severe consequences for Britain's public finances. These risks facing the UK are, as is commonly the case in developed markets, not adequately priced, in our view.

Second, while both the House and the Senate are moving towards full votes on Trump's tax cut proposal the two versions of the bill look so different that final passage of a reconciled bill now looks extremely unlikely this year. It cannot be ruled out that reconciliation will prove impossible or that it will require significant dilution of the bill. The failure to repeal Obamacare means that funding for the tax cut will have to be found by cutting spending elsewhere, which may prove very challenging due to different political priorities for Senate and House Republicans. Much, though not all, of the rally in US equities in the last quarter has been predicated on expectations of stimulus from the proposed USD 1.5trn tax cut. Republicans understand that additional fiscal stimulus may be essential to fending off a recession before the next presidential election as the Federal Reserve slowly tightens policy.

Finally, tensions are rising between Saudi Arabia and Iran, particularly in the conventional proxy conflict country of Lebanon, where Prime Minister Hariri stepped down last week. Hariri's resignation, allegedly the result of Saudi Arabian discontent over Hariri's relaxed attitude towards Hezbollah, has left Lebanon with a dangerous power vacuum. No country in the Middle East is more vulnerable to proxy conflicts than Lebanon, which houses conflicting armed groups, which draw support from all the major powers in the region, including Saudi Arabia, Iran, Syria, Israel and other powers in and outside the region. Oil prices have risen in recent weeks and last week German long bond yields rose sharply. Most long bonds in developed markets are so low that inflation surprises may cause major losses.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.86%	33.74%	32.25%	7.01%	5.44%
MSCI EM Small Cap	0.15%	27.20%	24.29%	5.68%	5.59%
MSCI Frontier	-1.44%	24.54%	25.70%	1.14%	8.56%
MSCI Asia	1.55%	39.51%	34.76%	9.99%	9.14%
Shanghai Composite	1.16%	12.88%	10.48%	13.65%	13.32%
Hong Kong Hang Seng	2.07%	30.03%	27.97%	7.36%	6.42%
MSCI EMEA	0.34%	13.51%	20.48%	-0.10%	-0.66%
MSCI Latam	-1.84%	20.19%	21.89%	-0.38%	-2.40%
GBI EM GD	-0.15%	10.90%	10.25%	-0.73%	-1.61%
ELMI+	0.09%	8.83%	7.91%	0.03%	-0.76%
EM FX Spot	0.02%	3.48%	2.65%	-6.86%	-7.06%
EMBI GD	-0.97%	8.33%	7.75%	5.88%	4.52%
EMBI GD IG	-0.29%	8.00%	6.53%	4.49%	3.13%
EMBI GD HY	-1.60%	8.76%	9.16%	7.21%	6.33%
CEMBI BD	-0.42%	7.14%	6.88%	5.22%	4.69%
CEMBI BD IG	-0.39%	5.65%	4.54%	3.98%	3.80%
CEMBI BD Non-IG	-0.46%	9.36%	10.47%	6.94%	6.15%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.37%	17.33%	21.56%	10.49%	15.74%
1-3yr UST	-0.07%	0.54%	0.32%	0.64%	0.61%
3-5yr UST	-0.13%	1.30%	0.41%	1.45%	1.07%
7-10yr UST	-0.20%	2.46%	0.45%	2.17%	1.31%
10yr+ UST	-0.06%	5.98%	3.49%	3.96%	2.44%
10yr+ Germany	-1.02%	-3.01%	-3.09%	4.04%	5.05%
10yr+ Japan	0.57%	0.16%	-2.40%	4.60%	4.98%
US HY	-0.78%	6.62%	9.08%	5.32%	6.10%
European HY	-0.46%	5.99%	7.62%	5.67%	7.79%
Barclays Ag	-0.37%	4.74%	4.56%	3.88%	3.69%
VIX Index*	10.90%	-19.59%	-23.41%	-18.13%	-32.19%
DXY Index*	0.05%	-7.44%	-4.50%	7.90%	16.67%
CRY Index*	2.18%	-0.45%	4.53%	-27.56%	-34.40%
EURUSD	-0.05%	10.65%	8.41%	-6.71%	-8.38%
USDJPY	-0.11%	-2.98%	4.70%	-1.95%	43.00%
Brent	3.44%	11.72%	41.85%	-18.53%	-41.36%
Gold spot	0.41%	10.76%	4.50%	9.79%	-26.01%

*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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