Play it again, Sam!

By Jan Dehn

Emerging Markets (EM) inflation has fallen faster than nominal bonds yields in the past thirteen months, so real yields are higher today than in January 2017. This is good news for those who are already in EM local currency bonds. It is also an opportunity for those who have not yet entered to do so with a reasonable expectation of making good returns in the coming year. Meanwhile, the outlook for the US has deteriorated following the imposition of tariffs on steel and aluminium. While the specific tariffs do not materially change the US outlook, the fact that the US government is so inclined to intervene in free markets bodes poorly for the future. Latin America offers countless examples of what happens under populism and heterodox economic policies; investors ultimately end up paying.

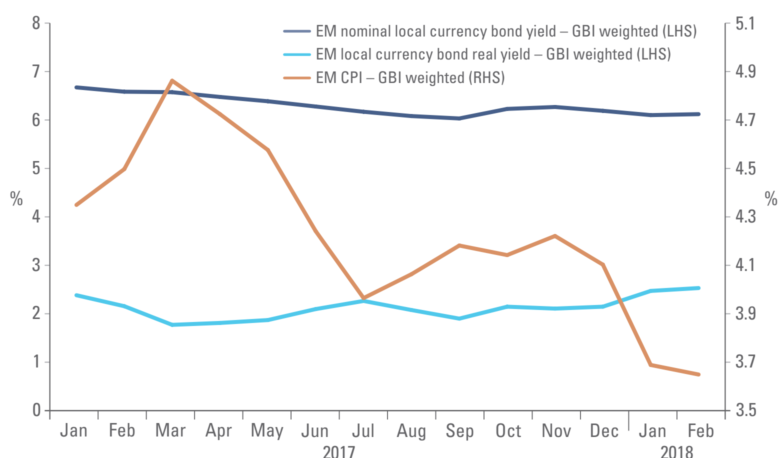
Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.4	–	-2.80%
MSCI EM Small Cap	11.5	–	-1.47%
MSCI Frontier	11.3	–	-0.51%
MSCI Asia	11.9	–	-2.12%
Shanghai Composite	11.0	–	-1.05%
Hong Kong Hang Seng	6.9	–	-4.17%
MSCI EMEA	10.0	–	-4.24%
MSCI Latam	12.6	–	-2.99%
GBI-EM-GD	6.09%	–	-1.04%
ELMI+	4.05%	–	-0.49%
EM FX spot	–	–	-0.94%
EMBI GD	5.75%	288 bps	0.00%
EMBI GD IG	4.53%	165 bps	0.02%
EMBI GD HY	7.03%	419 bps	-0.01%
CEMBI BD	5.44%	263 bps	0.05%
CEMBI BD IG	4.49%	168 bps	0.14%
CEMBI BD Non-IG	6.63%	382 bps	-0.08%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.6	–	-1.98%
1-3yr UST	2.22%	–	0.05%
3-5yr UST	2.58%	–	0.05%
7-10yr UST	2.82%	–	0.13%
10yr+ UST	3.10%	–	0.50%
10yr+ Germany	0.60%	–	0.32%
10yr+ Japan	0.04%	–	-0.14%
US HY	6.24%	348 bps	-0.20%
European HY	2.88%	364 bps	0.19%
Barclays Ag	–	249 bps	-0.08%
VIX Index*	19.59	–	3.10%
DXY Index*	90.16	–	0.31%
EURUSD	1.2283	–	-0.28%
USDJPY	105.39	–	-1.45%
CRY Index*	194.12	–	-1.88%
Brent	64.5	–	-4.46%
Gold spot	1326	–	-0.54%

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

Emerging Markets

Fig 1: **EM inflation, nominal bonds yields and real bond yields (GBI weighted)**



Source: Ashmore, Bloomberg, JP Morgan. Data as at 2 March 2018.

Inflation has been extremely benign in EM over the past thirteen months. CPI inflation, weighted by the JP Morgan GBI EM GD index of local currency bonds, has declined from a yoy rate of 4.35% in January 2017 to just 3.64% as of end of February 2018. This 71bps decline in inflation exceeds the 56bps decline in nominal bond yields over the same period. 2017 was a very good year for local bonds with returns from a duration of

Emerging Markets

9.52% and an FX gain of 5.69%, i.e. a total return in Dollar terms of 15.21%, but investors can now enter the EM local currency bond market at an even higher real yield than at the start of 2017. Play it again, Sam!

Investors should also be encouraged that EM local currency bonds continue to hold up extremely well in the face of the recent bout of volatility in developed markets. So far this year, EM bonds are up 3.15% in Dollar term and EM currencies have outperformed the USD by 1.78%. We attribute this resilience to a combination of attractive absolute valuations, improving fundamentals and very benign technicals following years of outright institutional selling of EM local currency induced by Quantitative Easing (QE) in developed markets.

EM bonds also look more attractive in a relative sense. Yields are much higher in both nominal and real terms, while policies in the US and some other developed economies appear to be getting worse (see the global backdrop section). Besides, in addition to overvalued financial markets, developed countries suffer from excessive reliance on monetary stimulus, poor fiscal policies, lack of reforms, protectionism, anti-immigration policies and deteriorating inflation and debt dynamics. These problems will get compounded by higher interest rates in the years ahead. Finally, the current political trends in the UK, the US and other developed countries do no offer encouragement that the right kind of solutions will be forthcoming. Death by a thousand cuts seems more likely in developed market bonds.

Snippets:

- Argentina: Economic activity expanded at a much higher than expected 0.6% mom sa rate in December, up from 0.1% mom sa in October and 0.3% mom sa in November. The central bank left the policy rate unchanged at 27.25%.
- Bahrain: S&P downgraded the sovereign credit rating to BB- (stable) from BB+ over fiscal concerns.
- Brazil: Real GDP growth was 1% in 2017, five times larger than in 2016. Growth is expected to reach somewhere around 3% in real terms in 2018. The trade surplus reached USD 4.9bn in February, up from USD 2.8bn in January and the fiscal surplus was also larger than expected in January (BRL 46.9bn vs BRL 34.9bn). Unemployment ticked higher, however.
- Chile: The economy appears already to be benefitting from the election of Sebastian Pinera as President as manufacturing activity increased at a rate of 5.7% yoy in January.
- China: Caixin's manufacturing PMI increased from 51.5 in January to 51.6 in February. Official PMI – which has greater representation from state-owned enterprises – was impacted by the Chinese New Year and declined to 50.3 from 51.3 over the same period. Services PMI also moderated. The government set a 6.5% growth target and term limits were lifted for the post of President. This is a two-edged sword. Provided Xi Jinping intends to realise China's potential to become the world's undisputed economic hegemon he now has the means to do so.
- Colombia: Ivan Duque, a right-wing protégé of former President Alvaro Uribe, has drawn level in an opinion poll (Guarumo published in El Tiempo) with Gustavo Petro, a socialist former rebel, ahead of the presidential election scheduled for 27 May 2017. Duque polled 23.6% versus 23.1% for Petro. The current account deficit narrowed to 3.3% of GDP in 2017 from 4.3% of GDP in 2016.
- Hong Kong: The 2017 fiscal outturn was a surplus of HKD 138bn versus HKD 111bn in the previous fiscal year. Retail sales were 4.1% higher in January on a yoy basis, while the PMI rose to 51.7 in February from 51.1 in January.
- Hungary: The central bank left the policy rate unchanged at 0.9%.
- India: Growth was stronger than expected in Q4 2017. Real GDP was up 7.2% yoy in the quarter versus 7.0% yoy expected. The good news looks set to continue, because PMI continued to expand in February 2018 (52.1), although services PMI weakened.
- Indonesia: Headline inflation was in line with expectations in February (3.2% yoy).
- Malaysia: CPI inflation in January declined to 2.7% yoy from 3.5% yoy in December and the trade surplus increased to MYR 9.7bn vs MYR 7.9bn expected. The improvement was driven by strong exports.
- Mexico: Business confidence edged higher in February, but manufacturing indices gave mixed messages. Remittances from overseas workers were 7.5% higher in January 2018 than the same month in 2017. Real credit to the private sector expanded at a rate of 5.8% yoy in December, up from 4.9% yoy in November. The trade deficit was USD 4.4bn in January versus USD 3.4bn expected and unemployment declined to 3.39% in January versus 3.59% in the same month of 2017, but retail sales softened in January.
- Peru: The rate of CPI inflation declined to just 1.18% in February from 1.25% in January.
- South Africa: A cabinet reshuffle saw two market-friendly political heavy-weights, Nhlanhla Nene and Pravin Gordhan, appointed to the key posts of Finance Minister and Public Enterprises Minister, respectively. This is very good news, in our view.

Continued overleaf

Global backdrop

- **South Korea:** The rate of growth of industrial production was 4.6% yoy in January, which was higher than expected (1.7% yoy). Exports were 4% higher in February on a yoy basis compared to a market expectation of just 0.5% yoy. The central bank left the policy rate unchanged at 1.5%. Lee Ju-yeol was re-appointed governor.
- **Sri Lanka:** February yoy inflation declined to 4.5% from 5.8% yoy in January.
- **Thailand:** The rate of CPI inflation was 0.4% yoy in February versus 0.6% yoy expected. The trade surplus was USD 32bn in 2017, marginally lower than the record surplus of USD 36.5bn in 2016.
- **Venezuela:** The electoral council postponed the presidential election to 20 May2018. The opposition remains divided over whether to participate.

Global backdrop

By slapping heavy tariffs on all steel and aluminium imports in the US, the Trump Administration issued a clear signal that US economic policy is becoming even more heterodox and populist than has hitherto been the case. This is very bad news for investors with positions in US dollar denominated assets, because protectionism causes real exchange rate overvaluation and slows growth. Latin America offers countless lessons about how populist and heterodox economic policies impact economies: basically they exert a destructive influence. At best, they are policies which provide a modest degree of comfort in the very short term while leaving you worse off in the longer term.

Populists shy away from taking tough decisions and reforming economies, even if such decisions are clearly in a country's long-term interest. Instead, they favour short-term palliative measures, which help them to preserve their popularity, but only by accumulating even bigger problems in the future. The costs of populist policies tend to rise in non-linear fashion as countries approach full employment. This is because the kind of measures typically favoured by populists, including fiscal stimulus, barriers to trade and measures against immigrant labour are exactly the types of interventions, which hurt more in the late stages in the business cycle.

The US economy is, of course, already at, or close to, full employment. The US economy also faces major challenges competing in export markets. Contrary to the rhetoric of the Trump Administration this lack of competitiveness is not due to some sudden surge in protectionist measures abroad. Rather, it is due to declining productivity at home and the over-valued US dollar. Unfortunately, protectionism will only make these problems worse. The tariffs on steel and aluminium may keep alive a small number of very unproductive producers, who really ought to be shut down rather than be protected, but the rest of the economy will suffer due to the resulting higher input costs. In net terms, this undermines the competitiveness of American companies in overseas markets by driving up the real effective exchange rate via higher domestic costs pressures. The US current account balance will worsen, not improve. In the end, American consumers pay too, of course.

The plunge into outright protectionism is disconcerting enough on its own, but the Trump Administration has also recently engaged in another classic example of late cycle populism, namely turning to fiscal stimulus as central banks begin to tighten policy. The recently approved Trump tax cut will cost 8% of GDP and it is entirely unfunded. Productivity is unlikely to be impacted at all. The dominant impact of the reform on the private sector will be a massive increase in issuance of US government bonds in the coming years, which will push up both interest rates as well as the overall debt stock, which has already nearly doubled since the 08/09 financial crisis. The combination of loosening fiscal and higher interest rate will also hurt investment by sucking up investable resources and pushing up the cost of capital (also known as 'crowding out'). The depressing impact on investment is the most worrisome, because lower investment will depress the US growth potential for a long time into the future and according to the perverse logic of populism the government will likely intervene more rather than less as the sluggishness of the private economy intensifies.

Investors cannot claim to not have been given fair warning. Economic history is littered with precedents. Ashmore published an *Emerging View* in April 2016, which was specifically dedicated to highlighting the likely heterodox direction of policies in developed markets beyond QE.[1] Ashmore also published an *Emerging View* on the risk of protectionism under Trump in January 2017.[2] Those publications are both worth re-reading at this point. It has been abundantly obvious to for some time – and our conviction is only getting stronger based on the most recent developments – that serious supply-side reform and fiscal retrenchment will not form any part of the Trump Administration's economic agenda. Rather, it seems bent on forging ahead along a track with the twin aims of stimulating demand-side with short term measures even when the economy is already at full capacity and identifying scape goats both at home and abroad to blame for the rising costs of its own inappropriate policies. This policy mix does not have a happy ending. The only escape from the growing debt and productivity problems will be inflation and currency debasement. And that means, of course, that holders of US assets will soon appear on the growing list of scape goats.

[1] See '*Beyond 'conventional unconventional policies'*', The Emerging View, April 2016.
[2] See '*Trump and EM*', The Emerging View, January 2017.

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Global backdrop

Meanwhile, three conflicting developments shaped sentiment in Europe. On the positive side, a German Grand Coalition was finally formed, which means that the German-French program for reform of the European Union can now move forward. Also, in the UK the Theresa May Administration was compelled to shift in the direction of a softer Brexit when a combination of forces conspired to this end. Specifically, opinion polls are beginning to show a majority against Brexit, Labour's Corbyn announced that he favours Customs Union membership for the UK and the EU launched a Brexit Roadmap in the absence of one from the UK. Also, former Prime Minister John Major issued a stinging attack on the Hard Brexit camp. On the negative side, the Italian election delivered a significant victory for populists, although none of the populist parties are able to form a viable government. Italy, it seems, is in for some uncertainty in the coming months, but this hardly news in Italy. On balance, we would characterise these three events as moderately positive.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.09%	2.18%	29.48%	9.08%	5.20%
MSCI EM Small Cap	-0.72%	0.73%	23.06%	7.61%	4.95%
MSCI Frontier	-0.67%	3.47%	28.03%	6.73%	8.36%
MSCI Asia	-1.02%	1.12%	30.84%	9.77%	8.18%
Shanghai Composite	-0.15%	-1.58%	2.85%	1.06%	9.22%
Hong Kong Hang Seng	-1.44%	4.22%	23.87%	3.77%	5.50%
MSCI EMEA	-1.98%	2.21%	23.73%	5.92%	1.00%
MSCI Latam	-0.03%	9.09%	22.25%	8.48%	-1.36%
GBI EM GD	-0.23%	3.15%	14.78%	4.14%	-0.96%
ELMI+	-0.09%	1.71%	10.13%	3.49%	-0.22%
EM FX Spot	-0.23%	1.78%	5.86%	-2.41%	-6.48%
EMBI GD	-0.21%	-2.23%	4.49%	5.67%	4.42%
EMBI GD IG	-0.08%	-2.75%	3.40%	3.23%	3.10%
EMBI GD HY	-0.32%	-1.77%	5.56%	8.59%	5.94%
CEMBI BD	0.00%	-0.94%	4.32%	5.24%	4.19%
CEMBI BD IG	0.11%	-1.22%	3.08%	3.33%	3.43%
CEMBI BD Non-IG	-0.14%	-0.57%	6.07%	8.26%	5.18%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.81%	1.00%	15.22%	10.59%	14.47%
1-3yr UST	0.05%	-0.30%	0.07%	0.44%	0.49%
3-5yr UST	0.13%	-1.11%	-0.10%	0.73%	0.74%
7-10yr UST	0.11%	-2.97%	-0.49%	0.35%	0.88%
10yr+ UST	-0.02%	-6.16%	1.61%	0.26%	2.48%
10yr+ Germany	0.31%	-1.15%	-1.83%	0.07%	4.93%
10yr+ Japan	-0.16%	0.39%	2.54%	4.33%	4.67%
US HY	-0.49%	-0.74%	3.43%	5.00%	5.22%
European HY	-0.08%	-0.46%	3.76%	4.29%	6.63%
Barclays Ag	-0.14%	-1.78%	3.04%	2.74%	3.40%
VIX Index*	-1.31%	77.45%	78.74%	39.53%	45.33%
DXY Index*	-0.50%	-2.13%	-11.20%	-6.45%	9.84%
CRY Index*	0.09%	0.13%	2.32%	-12.60%	-33.43%
EURUSD	0.73%	2.32%	16.06%	11.37%	-5.86%
USDJPY	-1.21%	-6.48%	-7.46%	-12.28%	12.97%
Brent	-1.96%	-3.56%	15.37%	6.63%	-42.22%
Gold spot	0.60%	1.78%	8.24%	10.68%	-15.82%

*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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