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President Moon Jae-In's bold vision paves the way for peace in Koreas

By Jan Dehn

South Korean President Moon Jae-In deserves credit for the thaw in relations with North Korea. China has also been working towards the détente behind the scenes, while US President Donald Trump deserves credit for getting out of the way of a potential deal. The road ahead in the two Koreas is long and fraught with potential setbacks. In China, PBOC Governor Zhou Xiaochuan has indicated that big changes are afoot in China's regulatory arrangements. This should be good news for investors in the Chinese onshore fixed income market. Maria Elsa Viteri takes over the job as Finance Minister in Ecuador. Ecuador defaulted on its debt the last time Viteri was Finance Minister. Are appearances deceptive in Ecuador? The global backdrop improved last week on the back of goldilocks style labour market data even as Trump got down to business on protectionism and the European Central Bank changed its forward guidance on asset purchases.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.6	–	2.18%
MSCI EM Small Cap	11.5	–	0.43%
MSCI Frontier	11.5	–	1.27%
MSCI Asia	12.1	–	1.80%
Shanghai Composite	11.2	–	1.62%
Hong Kong Hang Seng	7.6	–	1.86%
MSCI EMEA	10.3	–	3.12%
MSCI Latam	12.8	–	2.10%
GBI-EM-GD	6.11%	–	0.57%
ELMI+	3.83%	–	0.56%
EM FX spot	–	–	0.52%
EMBI GD	5.75%	284 bps	0.14%
EMBI GD IG	4.55%	163 bps	-0.02%
EMBI GD HY	7.01%	413 bps	0.28%
CEMBI BD	5.46%	262 bps	0.01%
CEMBI BD IG	4.52%	168 bps	-0.08%
CEMBI BD Non-IG	6.64%	379 bps	0.14%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	3.59%
1-3yr UST	2.27%	–	-0.02%
3-5yr UST	2.66%	–	-0.08%
7-10yr UST	2.90%	–	-0.17%
10yr+ UST	3.15%	–	-0.40%
10yr+ Germany	0.63%	–	-0.15%
10yr+ Japan	0.05%	–	0.29%
US HY	6.14%	336 bps	0.35%
European HY	2.82%	357 bps	0.24%
Barclays Ag	–	248 bps	-0.11%
VIX Index*	15.52	–	-3.21%
DXY Index*	90.14	–	0.06%
EURUSD	1.2297	–	-0.32%
USDJPY	106.62	–	0.40%
CRY Index*	194.55	–	-2.12%
Brent	65.0	–	-0.88%
Gold spot	1317	–	-0.21%

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

Emerging Markets

- **South Korea:** The big headline grabber in the past week was the announcement that President Donald Trump has agreed to a face-to-face meeting with North Korean strongman Kim Jong Un. The prospect of a resolution to one of the last remaining Cold War conflicts therefore appears to have moved a step closer. The credit for this opportunity, however, rests squarely with South Korean President Moon Jae-in, whose successful presidential election campaign, which culminated with his rise to power in May 2017, was based on a pledge to improve relations with both China and North Korea.[1] China has worked tirelessly behind the scenes by putting pressure on the North Korean leader and building deeper ties with South Korea. In light hereof, Trump, although he grabbed all the headlines, is mainly contributing to the process by getting out of the way of a deal. Clearly peace between North and South Korea requires the US to relinquish one of its most important geopolitical footholds in Asia, something, which Japan will not look upon kindly, but may simply have to accept. The reality is that Trump has already been moving in this direction for some time, albeit for domestic political reasons. For example, he pulled out of TPP (a trade agreement involving nations around the Pacific Rim) soon after coming to office. We think China will be willing to give up support for Kim Jong Un if required. History shows that it has been difficult for despots, such as Kim Jong Un, to hold on to power once the process of liberalisation gets underway. China will be aware of this fact and will probably be willing to accept a unified Korea provided that the US pulls out of South Korea. Trump and Chinese President Xi Jinping may well be rewarded with Nobel Peace Prizes if they make these required concessions.[2]

[1] See '*South Korea's new path*', Weekly Research, 8 May 2017.
[2] See '*What if?*', Weekly Research, 15 January 2018.

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Emerging Markets

A détente and possible eventual reunification between North and South Korea have tantalising upside potential, but also major risks. Aside from tantrums from the two most volatile protagonists in this equation, namely Trump and Kim Jong Un, previous examples of re-unification, such as Germany, ended up costing a lot of money and creating deep social problems. Investors therefore need brush up on their favourite German trades from the decade after 1989. On the plus side, an independent and unified Korea will eventually become a large and powerful economy and the world will be much safer. Indeed, the birth of modern Emerging Markets (EM) owes everything to the end of the Cold War in 1989 prior to which most EM countries were vassal states answering to one or another Superpower with detrimental implications for political stability, economic prosperity and market development. EM became possible as an investment opportunity because the Superpowers left EM.

- China: PBoC Governor Zhou Xiaochuan confirmed last week that in the coming days, the government will announce detailed changes to China's regulatory framework. The announcement will likely involve a major increase in the role of the PBoC, which may emerge as China's lead regulator. This would be good news, and developments should be watched closely by investors with an interest in the onshore Chinese fixed income market. Hitherto, involvement in China's onshore fixed income markets has been hampered by a plethora of sometimes conflicting regulations from different regulators, so greater visibility under PBoC oversight would be welcome news. In other developments, total social financing and new loans moderated, which is consistent with the ongoing deleveraging policies of the Chinese government. The rate of CPI inflation picked up to 2.9% yoy in February from 1.5% yoy in January due to food prices, which may have been positively impacted by a holiday season replete with eating. The Chinese trade surplus increased to USD 33.7bn in February from USD 20.6bn in January on the back of a very strong surge in exports. Reserves dropped marginally to USD 3.14bn.

- Ecuador: Maria Elsa Viteri has been appointed as Ecuador's new finance minister. Viteri was finance minister during the last sovereign default in 2008, but we do not think this fact should be taken at face value. In 2008 President Rafael Correa defaulted for political reasons and all the decisions at the time were taken by Correa himself and his foreign relations minister, Ricardo Patino. We think the main reason why President Lenin Moreno appointed Viteri was that she is willing and able to do difficult jobs. In 2008 this meant default, today it means the opposite, namely pushing through austerity measures. An audit of debt is ongoing in Ecuador but, in our view, its purpose is to weaken Correa. We believe Moreno wishes to continue to service debt. He is advised by a panel of good private sector analysts and business people all of whom dislike Correa and do not want to default.

Snippets:

- Brazil: The Brazilian CPI index, known as IPCA, showed that the yoy rate of inflation declined from 2.9% in January to 2.8% in February. Yet, at the same time industrial production picked up at a brisk pace of 5.7% yoy.
- Colombia: The rate of CPI Inflation declined to 3.37% yoy in February from 3.68% yoy in January and 4.09% yoy in December.
- Czech Republic: The yoy rate of inflation declined to 1.8% in February from 2.2% in January.
- Hungary: The rate of CPI inflation decreased to 1.9% yoy in February from 2.1% yoy in January. The central bank's inflation target range is 3.0% +/- 1pp.
- Indonesia: FX reserves dropped by USD 3.9bn to USD 128.bn in February.
- Malaysia: Bank Negara left the policy rate unchanged at 3.25%.
- Mexico: The rate of core CPI inflation declined to 4.3% yoy in February from 4.6% yoy in January.
- Peru: The central bank cut the policy rate by 25bps in response to lower than expected inflation. The policy rate is now 2.75%. Opposition parties have renewed their attempts to impeach President Pedro Pablo Kuczynski over his alleged financial ties with Odebrecht, a Brazilian construction company.
- Philippines: The trade deficit in January declined to USD 3.3bn from USD 3.8bn in December. CPI inflation surprised on the upside at 4.5% yoy versus 4.2% yoy expected and 4% yoy in January, but the increase may be partly related to change in base-year for the index.
- Poland: The central bank left the policy rate unchanged at 1.5%.
- Russia: The rate of CPI inflation was unchanged at 2.2% yoy in February.
- South Africa: The pace of real GDP growth materially beat expectations in Q4 2017. The growth rate was 3.1% qoq saar compared to the consensus expectation of 1.8% qoq saar.
- South Korea: The rate of CPI inflation increased to 1.4% yoy in February from 1.0% yoy in January.

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Emerging Markets

- **Sri Lanka:** The government declared a 10-day, nation-wide state of emergency try to stop violence between Muslim and Buddhist communities.
- **Taiwan:** Exports declined at a rate of 1.2% yoy in February versus +3.7% yoy expected. The rate of inflation picked up to 2.2% yoy from 0.9% yoy, mainly due to holiday effects (similar to China – see above).
- **Turkey:** Moody's downgraded Turkey's long-term credit rating by one notch from Ba1 to Ba2 and changed the outlook to stable from negative. The policy rate was left unchanged at 12.75%.
- **Venezuela:** Henri Falcon, an opposition candidate, has announced that he will appoint Francisco Rodriguez to head his economic team. Rodriguez is a former investment banker popular with investors. The market reacted positively to the news.

Global backdrop

The US non-farm payroll data last Friday in effect undid most of the fears, which had caused the convulsion in the US market earlier this year. Job numbers were strong and, importantly, wage inflation was benign. Hence, the data restored the perceived goldilocks scenario of stable inflation and strong growth, which has been driving much of the performance in the US stocks market for several years. With risk sentiment improving, the backdrop for EM also improved and markets ended on a strong note.

President Donald Trump formally launched his tariffs on steel and aluminium imports to the US. In the process he lost his Chief National Economic Advisor, Gary Cohn, whose greater sophistication in economic matters compelled him to resign in response to Trump's plunge into protectionism. Trump has reversed the traditional US position that free trade is good unless there are compelling reasons to intervene, to one where protectionism is good unless there are compelling reasons to have free markets. The underlying rationale for turning the erstwhile free trading position on its head is a myth that the rest of the world is taking advantage of the US. Not only is this patently untrue, in our opinion, but protectionism is also not the best way to address the problem even if it was true. At root, the American problem is that productivity is too low, consumption is too high and the Dollar is too strong and protectionism will only make things worse.[3]

Finally, we note that the European Central Bank (ECB) dropped its forward guidance regarding additional asset purchases. All the major Quantitative Easing (QE) central banks are heading toward the exit regarding asset purchases. This introduces headwinds to the four major QE trades, namely long USD, long US stocks, long European bonds and short everything in EM.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.06%	4.40%	34.19%	10.95%	5.39%
MSCI EM Small Cap	-0.29%	1.17%	25.02%	8.38%	4.75%
MSCI Frontier	0.59%	4.79%	29.12%	7.17%	8.61%
MSCI Asia	0.76%	2.94%	34.34%	11.10%	8.47%
Shanghai Composite	1.47%	0.01%	4.93%	1.95%	9.95%
Hong Kong Hang Seng	0.40%	6.17%	28.06%	5.98%	5.63%
MSCI EMEA	1.08%	5.39%	31.86%	8.04%	1.30%
MSCI Latam	2.08%	11.39%	27.77%	12.14%	-1.55%
GBI EM GD	0.34%	3.74%	16.31%	5.59%	-0.88%
ELMI+	0.46%	2.28%	11.40%	4.08%	-0.16%
EM FX Spot	0.29%	2.31%	7.24%	-1.45%	-6.40%
EMBI GD	-0.07%	-2.10%	5.58%	6.04%	4.49%
EMBI GD IG	-0.10%	-2.76%	4.37%	3.72%	3.16%
EMBI GD HY	-0.04%	-1.49%	6.74%	8.71%	6.01%
CEMBI BD	0.01%	-0.93%	4.94%	5.30%	4.19%
CEMBI BD IG	0.02%	-1.30%	3.49%	3.45%	3.46%
CEMBI BD Non-IG	0.00%	-0.43%	6.98%	8.18%	5.11%

[3] See '*Play it again, Sam!*', Weekly Research, 15 January 2018.

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.75%	4.63%	20.17%	12.56%	14.77%
1-3yr UST	0.04%	-0.32%	0.17%	0.45%	0.49%
3-5yr UST	0.05%	-1.19%	0.17%	0.77%	0.81%
7-10yr UST	-0.06%	-3.13%	0.19%	0.54%	1.14%
10yr+ UST	-0.42%	-6.53%	3.10%	0.74%	3.03%
10yr+ Germany	0.16%	-1.30%	-0.43%	-0.57%	5.19%
10yr+ Japan	0.13%	0.68%	2.79%	4.72%	4.64%
US HY	-0.15%	-0.40%	5.20%	5.33%	5.20%
European HY	0.15%	-0.22%	4.37%	4.32%	6.49%
Barclays Ag	-0.25%	-1.88%	3.61%	2.84%	3.50%
VIX Index*	-21.81%	40.58%	33.10%	0.65%	26.49%
DXY Index*	-0.53%	-2.16%	-10.98%	-9.35%	9.15%
CRY Index*	0.31%	0.35%	6.52%	-9.37%	-34.21%
EURUSD	0.84%	2.43%	15.43%	15.63%	-5.65%
USDJPY	-0.06%	-5.39%	-7.19%	-12.10%	10.97%
Brent	-1.25%	-2.86%	26.46%	13.81%	-40.76%
Gold spot	-0.07%	1.12%	9.39%	14.18%	-17.29%

*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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