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WEEKLY INVESTOR RESEARCH

Ashmore

EM inflation hits a new cycle low

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Emerging Markets (EM) inflation continues to decline even as EM growth rates look set to pick up relative to growth rates in developed economies. This constellation of modest inflation and improving growth prospects is called 'goldilocks' and tends to be bullish for asset prices. The good folks of Turkey, Colombia, Mexico, Malaysia and Brazil are going to the polls this year; we provide updates on the latest political developments in these countries.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	-0.13%
MSCI EM Small Cap	11.4	–	-0.53%
MSCI Frontier	10.8	–	-1.17%
MSCI Asia	11.7	–	-0.56%
Shanghai Composite	10.5	–	-2.77%
Hong Kong Hang Seng	7.1	–	-1.69%
MSCI EMEA	9.7	–	2.26%
MSCI Latam	12.6	–	0.24%
GBI-EM-GD	6.05%	–	-0.53%
ELMI+	4.02%	–	-0.43%
EM FX spot	–	–	-0.61%
EMBI GD	5.91%	295 bps	-0.76%
EMBI GD IG	4.67%	171 bps	-0.79%
EMBI GD HY	7.29%	435 bps	-0.73%
CEMBI BD	5.61%	269 bps	-0.31%
CEMBI BD IG	4.68%	176 bps	-0.36%
CEMBI BD Non-IG	6.75%	383 bps	-0.25%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.5	–	0.54%
1-3yr UST	2.47%	–	-0.12%
3-5yr UST	2.81%	–	-0.38%
7-10yr UST	2.97%	–	-0.86%
10yr+ UST	3.16%	–	-1.76%
10yr+ Germany	0.62%	–	-1.24%
10yr+ Japan	0.06%	–	-0.43%
US HY	6.11%	321 bps	-0.06%
European HY	2.90%	363 bps	-0.06%
Barclays Ag	–	248 bps	-0.60%
VIX Index*	16.88	–	-0.53%
DXY Index*	90.37	–	0.94%
EURUSD	1.2276	–	-0.83%
USDJPY	107.86	–	0.69%
CRY Index*	201.92	–	2.22%
Brent	74.0	–	3.64%
Gold spot	1334	–	-0.90%

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

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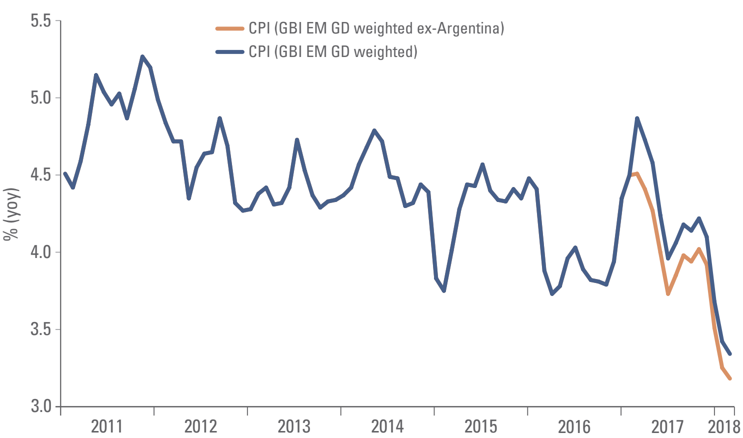
- **EM inflation:** EM inflation just hit a new cycle low in March following downside surprises to inflation rates in a number of prominent countries, including South Africa, Brazil, Malaysia, Colombia, Chile, Poland, Uruguay, etc. EM CPI inflation, weighted by the JP Morgan GBI EM GD, a commonly used benchmark index for EM fixed income investors, dropped to just 3.34% yoy in March from 3.42% yoy in February. Inflation was 4.87% yoy a year ago and 5.27% in November 2011, the cycle high. Argentina, a high inflation outlier, has an outsized effect on the index. Argentina's March inflation print was 23.2% yoy compared to an average inflation rate for the other index names of 3.3% yoy. Excluding Argentina, the index-weighted EM CPI print falls to just 3.18% yoy (Figure 1).

Fig 1: **GBI EM GD weighted CPI inflation (with and without Argentina)**



Source: Ashmore, JP Morgan, Bloomberg.

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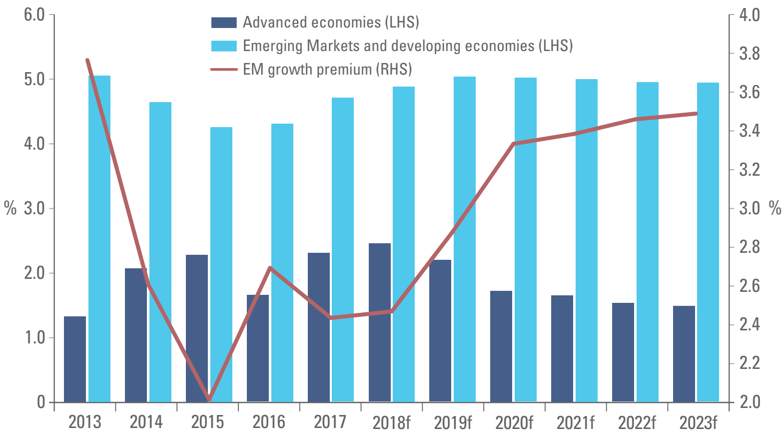
EM inflation has only been this low on five occasions since December 2012. Low inflation is not just a GBI phenomenon; a number of countries outside of the index, such as India, China, Taiwan and several African countries have also experienced strong disinflationary momentum recently. The significance of disinflation is that it boosts the return potential in both EM local rates and EM currencies. For EM rates, lower inflation translates into higher real rates. The nominal GBI yield is currently 6.06% (end of March), so the real yield is 272bps (investment-grade government bonds with less than 5 years of duration). The average real yield over the last decade was 277bps and the real yield was nearly 100bps lower at this time last year (174bps). The high real yields has ensured resilience against rising US Treasury yields; EM nominal bond yields have remained rock solid this year. Lower EM inflation also increases the scope for additional nominal currency appreciation before real exchange rates become overvalued.

- **EM growth premium:** EM growth rates are on track to outpace growth rates in developed economies at least until 2023, according the latest growth forecasts from IMF's World Economic Outlook (April 2018). IMF's new forecast predicts that the EM growth premium – that is, the difference between EM and developed markets' growth rates – will increase steadily from 2.4% in 2017 to 3.5% by 2023. This pick-up is mainly due to two specific moving parts: (a) Accelerating growth in Latin America, the Middle East and Sub-Saharan Africa, and; (b) decelerating growth rates in developed economies (Figure 2). Based on IMF's projections, EM economies will increase their share of global GDP from 40% in 2017 to 44% by 2023 in current USD and from 59% to 63% in PPP-adjusted terms. Note that EM economies currently command about 20% of global fixed income. The discrepancy between EM's share of global GDP and its share of global finance underlines the fundamental state of underfinancing in EM and its corollary, the state of over-financing in developed economies.

Fig 2: **EM growth premium (2013-2023)**



Source: Ashmore, IMF.

- **Politics, politics, politics:** The good peoples of Turkey, Colombia, Mexico, Malaysia, Venezuela and Brazil are electing new leaders this year. Here is a short summary of the latest political developments in these countries:

1. **Turkey:** President Erdogan called a snap general election for 24th June, close to the two-year anniversary of the failed coup against him in 2016. Elections in Turkey have typically been positive events for the market for two reasons. First, Erdogan typically manages to replenish his political capital leading to an expectation of greater stability. Second, greater stability in turn gives rise to hope for economic and institutional reforms, though these have not actually materialised. Erdogan will be re-elected as President in the first round if he garners 50 per cent of the cast votes plus one vote. Otherwise, the two leading candidates will face off in a second round on 8th July. Erdogan remains the towering figure in Turkish politics in the last decade and looks likely to be re-elected, in our view.
2. **Colombia:** Centre-right presidential candidate Ivan Duque's lead in the polls ahead of Colombia's presidential election on 27 May has been cut to 8%, according to a new poll conducted by CNC, a local polling company. Duque's support is 37% compared to 29% for the left-wing former mayor of Bogota, Gustavo Petro. We expect Duque to win in the two-round election.
3. **Mexico:** Andres Manuel Lopez Obrador (aka AMLO) increased his poll lead over his main competitors to 22%, according to a survey conducted by Reforma, a leading Mexican daily. AMLO's share of voting intentions reached 48% compared to 26% Ricardo Anaya of PAN and 18% for the PRI's Jose Antonio Meade. The Mexican election is a one-round contest, so Anaya and Meade are currently splitting the centre-right vote. AMLO's support is now so strong that he would win even if PAN and PRI combined their

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votes. We expect AMLO to win. AMLO has signalled that he will maintain orthodox macroeconomic policies, but he will likely favour other groups in Mexican society on a microeconomic level. Carlos Urzua, AMLO's pick for finance minister, is a respected economist. He pledged support for NAFTA in comments to the press last week.

4. Malaysia: Malaysia's general election is scheduled for 9th May. Prime Minister Najib Razak is in a strong position to retain his majority in parliament, with an outside chance of reaching a two-thirds majority, according to local political experts. Economic policies are unlikely to change if Najib wins. He has overseen a successful adjustment to lower oil prices and his policies prioritise infrastructure investment.

5. Venezuela: The election scheduled for 20 May pits Henri Falcon, erstwhile supporter of former President Hugo Chavez, against incumbent President Nicholas Maduro. Falcon is leading by more than 10% in most polls, but Maduro controls the authority overseeing the election. A Falcon victory would trigger a major market rally, in our view. Regardless of who wins, however, the state of the Venezuelan economy is so precarious that regime change could happen even if Maduro wins, albeit with a more uncertain timeline. Only last week Maduro had to make significant concessions to members of the military in a bid to hold on to power, including further control over PDVSA, the national oil company.

6. Brazil: Official registration of candidates for the Brazilian election scheduled for October 2018 does not start until July, but the election is already moving markets. Former President Lula has been sent to jail, thus removing a significant negative tail risk from the Brazilian outlook, but also creating considerable uncertainty about the outcome. The sixteen hopeful 'precandidates' count among them some very colourful personalities. The less exciting mainstream candidates can expect to benefit from support from large, established political parties, but they can no longer count on massive financial support. The so-called 'carwash' election financing scandal, which unseated former President Dilma Rousseff and numerous members of parliament, resulted in a change in campaign financing rules, which has resulted in a more level playing field. Jair Bolsonaro, a right-wing populist, and Marina Silva, a left-wing environmentalist, lead the polls. Former Supreme Court Judge Joaquim Barbosa is in third place and trailing far behind are the market-friendly candidates Jose Alckmin of PSDB and former Finance Minister Henrique Meirelles. As always, the centrist PMDB party, which is so far not fielding a heavyweight candidate, may end up playing an important part in the outcome.

- China: China's central bank, the PBOC, cut the reserve ratios for Chinese banks by 1% (reserve ratios range from 15% to 17%, depending on the type of bank). The change in reserve ratios should release about RMB 1.3trn in liquidity. There are mainly technical reasons behind the RRR cut: Chinese banks are facing imminent repayments of RMB 900bn of outstanding loans under PBOC's medium-term lending facility as well as tax payments, which also fall due this month. As for the economic backdrop, China's economy expanded at a solid pace of 6.8% yoy in Q1 2018, while inflation dropped sharply to 2.1% yoy in March from 2.9% yoy in February. The better than expected inflation number caused 5-year government bond yield in China to drop from 3.57% to 3.17%. Meanwhile, the government is undertaking major domestic reforms, including deleveraging. The external environment has deteriorated due to US President Donald Trump's decision to start a trade war with China. However, we do not think these factors played a major part in PBOC's decision to ease liquidity conditions. In other news, industrial production expanded at a 6% yoy pace, retail sales at a 10.1% yoy pace and fixed asset investment at a 7.5% yoy pace in March. The over-riding economic trend in China is that investment and exports are slowly giving way to higher consumption. These latest high frequency data points are consistent with this trend.

- Russia: Moody's indicated confidence in Russia's sovereign resilience in the face of US sanctions on account of the country's high ratio of reserves to external debt. Rusal, a Russian aluminium producer, which has become a target of sanctions, is reportedly turning to China and other EM countries for new markets for its products. Meanwhile, Russian industrial production slowed to 1% yoy in March from 1.5% yoy in February. The Central Bank of Russia is setting interest rates this week. FX reserves increased by USD 3.5bn to USD 462.4bn last week.

Snippets:

- Angola: The government is due to tap global markets for USD 2bn in Eurobonds next month.
- Brazil: Mid-April data pointed to continuing moderate inflation as the IPCA-15 inflation index showed a 0.21% mom increase in prices, which is less than expected (0.25% mom). In yoy terms, inflation is running at 2.8%.
- Colombia: Retail sales expanded at a solid yoy rate of 5.0% in February, which is marginally slower than January (5.2% yoy).
- Indonesia: Bank Indonesia kept the policy rate unchanged at 4.25%.

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- **Kazakhstan:** The National Bank of Kazakhstan cut the policy rate by 25bps to 9.25%.
- **Malaysia:** CPI inflation declined to 1.3% in yoy terms in March from 1.4% yoy in February.
- **Paraguay:** Mario Abdo Benitez of the ruling Colorado Party won yesterday's presidential election, according to preliminary results based on 98% of voting stations counted.
- **Peru:** Real GDP declined 0.2% mom in February.
- **Poland:** The core CPI inflation rate declined to 0.7% yoy in March from 0.8% yoy in February.
- **Singapore:** The trade surplus increased to USD 4.4bn in March from USD 3.3bn in February. The yoy rate of core CPI inflation declined to 1.5% in March from 1.7% in February.
- **South Africa:** The rate of CPI inflation declined to 3.8% in March from 4.0% in February.
- **South Korea:** Exports in the first twenty days of April were 7.7% higher than in the same period of 2017. The trade balance rose to USD 0.6bn from – USD 0.5bn last month.
- **Sri Lanka:** The government has reached staff-level agreement with the IMF on the review of the Extended Fund Facility.
- **Thailand:** Exports expanded at a yoy rate of 7.1% in March compared to 6.0% yoy expected. The trade surplus in March was USD 1.3bn.
- **Turkey:** The central bank has a policy meeting this week.

Global backdrop

Oil prices continue to rise. The Brent first future is trading just below USD 74 per barrel, up from USD 62 per barrel in early February. At the margin, the rise in oil prices is contributing to higher yields on the 10-year US Treasury Bond. EM sovereign bonds of the same duration are outperforming 10-year US Treasury bonds as spreads absorb some of the rise in yields, but the stronger Dollar is weighing on local markets. In the short term, we suspect fast money to focus on whether momentum carries the 10-year yield through 3.0%, while value investors should be looking to add duration and EM FX into this move, in our view. In other news, European data is weakening at the margin ahead of an ECB meeting on Wednesday, which is weighing on EURUSD. In political news, US Treasury Secretary Steven Mnuchin indicated that he might visit China to discuss trade as the US shrinks from an earlier more aggressive stance against China over trade.

In other political news, a senior US official met with North Korean strongman Kim Jong Un to pave the way for meeting between Kim and President Trump, although Trump indicated in comments over the weekend that he wants to see North Korea take concrete steps to disarm before further progress is possible. Kim indicated that he would accept inspection of North Korea's nuclear test site. In our view, it is eminently possible to end the Korean Conflict, which has looked like a legacy dispute for many years. After all, China has changed beyond all recognition over the last few decades and the Cold War ended nearly 30 years ago. The two Koreas could unify if China leans on Kim and if Trump relinquishes the heavy US military presence in South Korea. A unified and de-militarised Korea would benefit China and Asia more generally in economic and security terms, while the world would benefit from one less geo-political flashpoint. Japan would become more isolated and would presumably require concessions of various kinds in order to support a deal. As the primary driver of the peace process, South Korean President Moon Jae-In should be in line for the Nobel Peace Prize if a deal materialises. He would probably have to share the prize with President Xi Jinping of China and President Donald Trump of the United States of America.[1]

[1] We first draw attention to the prospect of a peace deal in the Koreas in May 2017 – see *'South Korea's new path'*, Weekly Research, 8 May 2017.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.13%	1.25%	25.01%	7.03%	5.78%
MSCI EM Small Cap	0.87%	1.04%	19.92%	5.43%	5.03%
MSCI Frontier	-2.14%	2.89%	24.04%	6.14%	7.92%
MSCI Asia	0.29%	0.88%	26.79%	7.45%	8.78%
Shanghai Composite	-3.06%	-7.10%	-1.19%	-8.31%	9.04%
Hong Kong Hang Seng	0.47%	2.95%	24.67%	-1.51%	6.70%
MSCI EMEA	-0.60%	-1.45%	17.45%	3.55%	1.37%
MSCI Latam	0.09%	8.21%	19.76%	8.15%	-1.08%
GBI EM GD	-1.19%	3.20%	10.52%	4.40%	-1.41%
ELMI+	-0.87%	1.62%	7.54%	2.90%	-0.45%
EM FX Spot	-1.26%	0.79%	2.98%	-2.40%	-6.75%
EMBI GD	-0.61%	-2.35%	2.62%	5.05%	4.11%
EMBI GD IG	-0.71%	-3.12%	1.27%	2.67%	2.62%
EMBI GD HY	-0.52%	-1.63%	3.92%	7.87%	5.84%
CEMBI BD	-0.21%	-1.33%	2.64%	4.42%	3.97%
CEMBI BD IG	-0.41%	-1.74%	1.27%	2.71%	3.15%
CEMBI BD Non-IG	0.04%	-0.79%	4.55%	7.02%	5.05%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.21%	0.44%	15.58%	10.60%	13.74%
1-3yr UST	-0.22%	-0.37%	-0.45%	0.28%	0.46%
3-5yr UST	-0.71%	-1.44%	-1.71%	0.20%	0.63%
7-10yr UST	-1.41%	-3.24%	-3.10%	-0.40%	0.58%
10yr+ UST	-2.74%	-5.94%	-1.97%	-0.48%	1.93%
10yr+ Germany	-1.55%	-0.46%	-3.39%	-2.20%	4.67%
10yr+ Japan	0.00%	1.01%	1.40%	3.88%	4.19%
US HY	1.03%	0.16%	4.39%	5.11%	5.07%
European HY	0.72%	0.17%	4.41%	4.43%	6.31%
Barclays Ag	-0.59%	-2.00%	1.48%	2.32%	3.08%
VIX Index*	-15.47%	52.90%	15.38%	35.26%	25.22%
DXY Index*	0.24%	-1.91%	-9.61%	-7.11%	8.81%
CRY Index*	3.35%	4.15%	11.02%	-9.73%	-28.14%
EURUSD	-0.39%	2.26%	12.97%	13.41%	-5.55%
USDJPY	1.49%	-4.29%	-1.73%	-9.80%	8.43%
Brent	5.34%	10.69%	42.46%	14.14%	-26.21%
Gold spot	0.67%	2.37%	4.52%	11.71%	-5.60%

*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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