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Ashmore

Inflows to China support bonds

By Jan Dehn

Continuing inflows into China's domestic markets have supported CNY and helped to make Chinese bonds among the strongest performers over the past year. The rate of economic growth accelerated strongly in Chile and Thailand. In Venezuela, Nicholas Maduro secured another term in office, but there are serious questions about how long he can hold on to power given the dire economic situation and the threat of sanctions. IMF issued strong support for Argentina after the government announced fiscal measures. A NAFTA deadline came and went in Mexico. Brazil's central bank interrupted the cutting cycle. In Russia, President Putin's new cabinet suggests continued emphasis on orthodox economies policies. Malaysia cut GST from a position of fiscal strength. Turkey's Erdogan did his best to undermine confidence in the Lira. Sentiment towards Emerging Markets (EM) continued to deteriorate despite the lack of fundamental or valuation drivers; this suggests that a very powerful value proposition is currently in the making within EM local markets in particular, which bodes well for returns over the next couple of years.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	-2.25%
MSCI EM Small Cap	11.2	–	-1.32%
MSCI Frontier	10.7	–	-0.99%
MSCI Asia	11.8	–	-1.19%
Shanghai Composite	11.1	–	0.97%
Hong Kong Hang Seng	7.5	–	0.28%
MSCI EMEA	9.3	–	-4.63%
MSCI Latam	11.6	–	-5.87%
GBI-EM-GD	6.50%	–	-3.47%
ELMI+	4.34%	–	-1.53%
EM FX spot	–	–	-2.48%
EMBI GD	6.35%	328 bps	-0.88%
EMBI GD IG	4.94%	187 bps	-1.02%
EMBI GD HY	7.94%	488 bps	-0.74%
CEMBI BD	5.95%	292 bps	-0.35%
CEMBI BD IG	4.93%	191 bps	-0.31%
CEMBI BD Non-IG	7.20%	417 bps	-0.39%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.6	–	-0.47%
1-3yr UST	2.57%	–	0.02%
3-5yr UST	2.91%	–	-0.11%
7-10yr UST	3.07%	–	-0.62%
10yr+ UST	3.21%	–	-1.61%
10yr+ Germany	0.57%	–	-0.43%
10yr+ Japan	0.06%	–	-0.35%
US HY	6.35%	337 bps	-0.19%
European HY	3.05%	373 bps	-0.06%
Barclays Ag	2.05%	-102 bps	-1.09%
VIX Index*	13.42	–	0.77%
DXY Index*	93.89	–	1.30%
EURUSD	1.1741	–	-1.56%
USDJPY	111.35	–	1.55%
CRY Index*	203.69	–	0.13%
Brent	79.1	–	1.15%
Gold spot	1286	–	-2.12%

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

Emerging Markets

Fig 1: **Total return in USD-terms - trailing 12 months**

Source: Ashmore, Bloomberg.

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Emerging Markets

- **China:** Cross-border inflows to China's domestic markets hit a three-year high in the month of April. CNY remains 1.9% higher for the year versus the USD. These factors have helped the Chinese local currency government bond GBI index to significantly outperform other bond markets in USD terms over the past year (see Figure 1). EM local currency bond markets have been very volatile of late, but have still managed to outperform US 5-year bonds over the past twelve months to the tune of 3.3% in USD terms and now appear to offer a very interesting entry point. Chinese bonds are still not easy to access and have not yet been included in the JP Morgan GBI EM GD index. However, we believe that the Chinese authorities are working hard behind the scenes to fix the remaining obstacles against investing. Chinese stocks are due to be included in the MSCI EM stock market index next month, while Barclays-Bloomberg will include Chinese bonds into their Global Aggregate index starting in April next year. Other index providers may well follow suit or risk losing market share. A combination of higher yields, low volatility and low correlations with other fixed income markets make Chinese bonds extremely attractive both within EM and Developed Markets portfolios. Please consult Ashmore's *Emerging View* publications for the months of March and May to see how China's rapid integration into global financial markets is likely to impact these markets.[1] In other news, Chinese industrial production beat expectations in April by rising at a yoy rate of 7.0% versus 6.4% yoy expected. Retail sales and fixed asset investment were marginally softer than expected.

- **Growth:** The economic upswing accelerated further in Chile as the rate of real GDP growth hit 4.2% yoy in Q1 2018 compared to 3.3% yoy in Q4 2017 and 2.5% in Q1 of 2017. Investment spending in particular picked up sharply, which bodes well for future growth. Encouragingly, domestic demand more broadly is also picking up with consumption accounting for more than half of the growth recorded in Q1. Interestingly, Chile's current account deficit narrowed sharply to USD 269m in the same quarter from USD 1.3bn in Q1 2017 despite the acceleration in domestic demand. This appears to be due to Chile's cheap currency and rising commodity prices. Behind the recovery in economic activity lies the recent change in government in Chile, which has helped to usher in an improvement in business confidence. Meanwhile, Thailand also recorded stronger than expected growth in Q1 2018. The rate of real GDP growth reached 4.8% yoy in Q1 2018 versus a consensus expectation of 4.0% yoy. The economy expanded at a rate of 4.0% yoy in Q4 2017. Asia as a whole is growing strongly. Excluding India and China, whose economies expanded at rates of 6.6% and 6.8% respectively in Q1 2018, Asian economies grew at a speed of 3.9% qoq saar in Q1 2018 compared to 2.6% qoq saar in Q4 2017.

- **Venezuela:** President Nicholas Maduro secured another six-year term in office after winning a highly disputed election at the weekend. Serious questions remain about how long he can stay in power given the dire economic situation in the country and the threat of sanctions on the oil sector. The opposition largely boycotted the election over concerns about fairness. The US and Latin American economies also failed to recognise the election. Turnout was low at just 46%. Opposition candidate Henri Falcon claimed the election was not fair. Attention will now turn to the official response of other Latin American countries and the US to the election. US officials have indicated that sanctions against the Venezuelan oil industry are under 'active review'. Sanctions against the oil sector would further undermine the economy and possibly speed up regime change, in our view. In related news, the US government imposed personal sanctions on Diosdado Cavello, who is speaker of parliament and an ardent supporter of President Nicholas Maduro.

- **Argentina:** The IMF issued strong support for the government in Argentina, which is currently struggling with a currency under attack. The IMF particularly praised the government's focus on fiscal adjustment. We agree with the IMF on this point, because the failure to adjust fiscal policy in recent years has been the main reason for the failed attempt to bring about price stability. The good news today is that Argentina has already announced most of the measures, which the IMF is likely to propose as part of a stand-by agreement, including devaluation, fiscal adjustment, higher interest rates and reforms. As such, we think the IMF program may not extract as big a political price for the Macri Admininstration as markets currently seem to fear. On the other hand, the economy could slow, although the slowdown in growth can be ameliorated through greater investor confidence due to major improvements in the overall quality of economic policies. Annual headline inflation increased marginally to 25.5% in April from 25.4% in March. The government last week successfully rolled a USD 25bn position of short-term debt.

- **Mexico:** A 17th May deadline announced by US House of Representatives Speaker Paul Ryan for submitting a revised NAFTA proposal to Congress in order to have the treaty approved in the current Congress has come and gone. We do not think this is a big deal, though there are some risks. First, the next Congress may be more hostile to Trump and could thus obstruct legislation. Second, Mexico will be under a new government soon. Andres Manuel Lopez Obrador (AMLO), the likely winner in the upcoming presidential election, may want to impose his own stamp on the treaty. Having said that, the protectionists in the US government have found that US supply-chains are so closely integrated with those in Mexico and Canada that dissolving NAFTA would be extremely costly for US companies. Given that AMLO is also likely to support NAFTA we see the revised treaty eventually being approved. In other news, Mexico's central bank left the policy rate unchanged

[1] *'How Chinese bonds can enhance your portfolio'*, The Emerging View, March 2018 and *'Chinese bonds in Developed Markets bond portfolios'*, The Emerging View, May 2018.

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Global backdrop

at 7.50%, while Margarita Zavala, independent presidential candidate, dropped out of the election race with a poll rating in mid-single digits. Her supporters will now likely vote for either Anaya or Meade. The election is 1st July.

• Brazil: The central bank unexpectedly interrupted the cutting cycle early by holding rates at 6.5% in last week's monetary policy committee (COPOM) meeting. The surprise 'hold' led to unwinding of receiver positions in bonds. Economic activity declined 0.7% in the month of March, which was weaker than the consensus expectation of a drop of 0.1%.

• Russia: President Vladimir Putin last week proposed a list of officials for key positions in his new government. Dmitry Medvedev is to be re-appointed as Prime Minister (PM), while Finance Minister Anton Silaunov will become deputy PM with responsibility for the economy. Economy Minister Maxim Oreshkin and Energy Minister Alexander Novak are also expected to be reappointed. The composition of the new cabinet signals a continued commitment on the part of Putin to macroeconomic orthodoxy. Orthodox policies have seen the Russian economy successfully weather lower oil prices, sanctions, external conflicts and endless bouts of investor nervousness.

• Malaysia: The government has immediately cut the GST rate to zero from 6% in line with promises made during the recent election campaign. Depending on which taxes, if any, will replace GST, Malaysia should now face a period of lower inflation and a larger fiscal deficit. The current fiscal deficit is 2.2% of GDP, which is well within the government's target of 2.8% of GDP, so there is some room for lower GST revenues. Meanwhile, Q1 GDP growth was 5.4% yoy versus 5.6% yoy expected. The government also announced that it is launching a probe into the scandal surrounding 1MDB, a government investment fund.

• Turkey: President Erdogan helped to further undermine confidence in the Turkish Lira last week, when he appeared on an international financial television station to restate his strong conviction that higher interest rates cause higher inflation. While high interest rates do indeed often coincide with higher inflation, not least because high inflation often induces central banks to hike rates, conventional economic wisdom would suggest that that higher rates bring inflation rates lower over time, for example by driving up the cost of borrowing and reducing demand. It is not clear why Erdogan thinks the causality should run the other way. Nevertheless, Erdogan said that he intends to take greater control over monetary policy if he is re-elected in the upcoming election.

Snippets:

- Colombia: Real GDP growth was 2.2% yoy in Q1 2018 compared to 1.8% yoy in Q4 2017. The growth rates was in line with expectations.
- Ecuador: President Lenin Moreno quickly replaced Maria Elsa Viteri as finance minister after markets jitters. The new finance minister is Richard Martinez, who has headed the business chamber in Ecuador since 2015. We do think the market was right to be sceptical about Viteri, but Martinez is clearly a market friendly person.
- India: The trade deficit was stable at USD 13.7bn in April (same as the average for January to March 2018). The ruling BJP emerged as the largest party in the Karnataka election. The yoy rate of inflation ticked higher to 4.6% yoy in April from 4.3% yoy in March.
- Indonesia: The central bank hiked the policy rate by 25bps to 4.5%. Exports expanded at a solid 9.0% yoy pace in April compared to 6.2% yoy in March, while imports surged 34.7% yoy versus 8.9% yoy in March. The trade deficit was USD 1.6bn compared to a surplus of USD 1.1bn in March.
- Philippines: Remittances contracted at a yoy rate of 9.8% in March due in part to the Holy-Week bank holidays and repatriation of workers from Kuwait following a diplomatic spat.
- Poland: The central bank left the policy rate unchanged at 1.5% amidst dovish rhetoric.
- Russia: The real GDP growth rate accelerated to 1.3% yoy in Q1 2018 from 0.9% yoy in Q4 2017.
- Singapore: The trade surplus increased marginally from USD 4.5bn in March to USD 4.6bn in April.
- South Korea: The rate of unemployment declined to 3.8% in April from 3.9% in March.
- Thailand: The Bank of Thailand left the policy rate unchanged at 1.5%.
- Vietnam: Fitch raised the sovereign debt credit to BB from BB- (stable).

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Global backdrop

Sentiment towards EM remains negative amidst mounting uncertainties primarily emanating from the developed countries, prompting further squaring of positions, especially in local markets. The unease arises mainly from two sources. The first concern is rising yields in the US Treasury market. The US 10-year yield briefly pushed above 3.11% last week, at which point the US stock market struggled to perform (US stocks were down 0.47% last week). Returns in both stock and bond markets are low this year compared to previous years, which leads to overall nervousness. The second concern is Italy, where a newly formed populist coalition government put forward a programme of government based on rapid fiscal deterioration. Italian concerns helped to extend the move lower in EURUSD, which in turn precipitated sympathy kneejerk selling in EM currencies. The sell-off in EM continues to lack a foundation both in terms of valuations and fundamentals, however, so we see the current price action as mainly sentiment-driven, wherefore serious investors should take advantage. With nominal yields in the JP Morgan GBI EM GD index now 6.5%, the real yield has reached 330bps, which is extremely attractive, in our view (duration is just five years and the bonds are 85% investment grade). A very powerful value proposition is currently in the making, which bodes very well for returns over the next couple of years (along the lines of the returns achieved in 2012 and in 2016-2017).

On a more serious note, it is worrisome that Italy is turning to fiscal stimulus, when, in 2017, the general government's gross debt burden stood in excess of 131% of GDP, according to the IMF. The US government is similarly pushing the fiscal levers at a time when the government debt burden is 108% of GDP. In general, developed economies have been unable to return to the strong growth rates, which prevailed prior to the Developed Markets Crisis of 2008/2009, so they are now turning to fiscal stimulus instead after a long period of monetary stimulus. However, this is likely to significantly worsen their debt dynamics given declining productivity and the prospect of rising interest rates. EM countries are in a far healthier situation. They have much lower debt levels to begin with, are already funding at 'normal' interest rates and tend reform rather the borrow, since markets never give EM countries room to indulge in unsustainable fiscal policies.

Aside from rising debts and falling productivity the third threat to the global economy emanating from developed countries is protectionism. In this regard, the Trump Administration was forced to blink in the face of Chinese refusal to countenance US demand for a USD 200bn reduction in the Chinese trade surplus with the US. This demand was in any case economically nonsensical. However, China and the US did manage to issue a bland communique, which stated that both sides want to avoid a trade war. Meanwhile, we see the risk of protectionism rising in UK. The pro-Brexit government of Theresa May continues to struggle to come up with a post-Brexit framework for trade with Europe. If the UK crashes out of the EU Customs Union before completing new free-trade agreements with third parties, which seems extremely likely, then UK exporters will most likely begin to demand protection from the UK government to help them cope with loss of markets.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.18%	-1.22%	18.09%	5.86%	4.48%
MSCI EM Small Cap	-2.25%	-2.17%	15.85%	3.20%	3.59%
MSCI Frontier	-4.89%	-3.32%	13.56%	3.96%	5.39%
MSCI Asia	-0.64%	0.70%	20.66%	7.43%	7.83%
Shanghai Composite	3.67%	-3.34%	5.45%	-7.59%	9.53%
Hong Kong Hang Seng	0.40%	5.75%	25.30%	-0.20%	6.40%
MSCI EMEA	-3.94%	-6.99%	8.18%	0.20%	-0.95%
MSCI Latam	-9.37%	-3.25%	12.93%	2.73%	-3.41%
GBI EM GD	-5.42%	-4.14%	2.66%	1.30%	-2.73%
ELMI+	-2.43%	-1.85%	3.38%	1.02%	-0.99%
EM FX Spot	-3.65%	-4.46%	-2.22%	-4.73%	-7.50%
EMBI GD	-1.70%	-4.82%	-0.48%	4.20%	3.52%
EMBI GD IG	-1.14%	-4.77%	-0.90%	2.41%	2.39%
EMBI GD HY	-2.27%	-4.94%	-0.16%	6.26%	4.81%
CEMBI BD	-1.00%	-2.76%	0.57%	3.70%	3.55%
CEMBI BD IG	-0.74%	-2.83%	-0.50%	2.41%	2.88%
CEMBI BD Non-IG	-1.33%	-2.65%	2.12%	5.59%	4.41%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.63%	2.24%	16.93%	10.69%	12.51%
1-3yr UST	-0.01%	-0.34%	-0.43%	0.30%	0.46%
3-5yr UST	-0.23%	-1.59%	-1.96%	0.32%	0.65%
7-10yr UST	-0.85%	-3.91%	-4.03%	0.14%	0.70%
10yr+ UST	-1.83%	-6.91%	-2.99%	1.69%	2.52%
10yr+ Germany	-0.41%	-0.39%	-0.68%	1.75%	4.84%
10yr+ Japan	-0.17%	0.73%	1.48%	4.27%	4.81%
US HY	0.01%	-0.21%	3.01%	4.93%	4.65%
European HY	-0.12%	0.01%	2.97%	4.34%	5.91%
Barclays Ag	-1.57%	-1.83%	1.53%	1.82%	1.12%
VIX Index*	-15.76%	21.56%	11.46%	10.82%	0.37%
DXY Index*	2.23%	1.92%	-3.35%	-1.43%	11.96%
CRY Index*	0.85%	5.07%	10.06%	-10.76%	-29.26%
EURUSD	-2.78%	-2.20%	4.49%	5.66%	-9.03%
USDJPY	1.84%	-1.19%	0.04%	-8.01%	8.66%
Brent	5.27%	18.33%	47.60%	18.92%	-23.85%
Gold spot	-2.26%	-1.34%	1.98%	6.57%	-6.59%

*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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