

How will Trump's Trade War with China impact EM FX and rates?

By Jan Dehn

US President Donald Trump continues to escalate his trade war with China. How will America's seemingly inexorable lurch towards autarchy impact the rest of the world, including EM FX and rates? Read all about it here!

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.8	–	-2.26%
MSCI EM Small Cap	10.7	–	-3.00%
MSCI Frontier	10.4	–	-0.72%
MSCI Asia	11.4	–	-2.88%
Shanghai Composite	10.0	–	-4.78%
Hong Kong Hang Seng	6.9	–	-5.02%
MSCI EMEA	9.1	–	-0.33%
MSCI Latam	10.9	–	0.53%
GBI-EM-GD	6.64%	–	0.38%
ELMI+	4.64%	–	-0.05%
EM FX spot	–	–	0.18%
EMBI GD	6.44%	353 bps	0.30%
EMBI GD IG	4.89%	198 bps	0.35%
EMBI GD HY	8.24%	534 bps	0.25%
CEMBI BD	6.05%	319 bps	-0.06%
CEMBI BD IG	4.92%	205 bps	0.02%
CEMBI BD Non-IG	7.46%	459 bps	-0.15%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	-0.87%
1-3yr UST	2.52%	–	0.07%
3-5yr UST	2.74%	–	0.16%
7-10yr UST	2.87%	–	0.27%
10yr+ UST	3.02%	–	0.15%
10yr+ Germany	0.31%	–	0.80%
10yr+ Japan	0.04%	–	0.11%
US HY	6.28%	339 bps	-0.04%
European HY	3.62%	424 bps	-0.29%
Barclays Ag	2.01%	-86 bps	0.11%
VIX Index*	13.77	–	1.46%
DXY Index*	94.64	–	-0.12%
EURUSD	1.1635	–	0.10%
USDJPY	109.45	–	-0.99%
CRY Index*	197.53	–	1.30%
Brent	74.2	–	-1.50%
Gold spot	1267	–	-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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Trump's trade war with China: impact on EM FX and rates

US President Donald Trump unilaterally started the trade war with China and he shows no signs of letting up. His policies on trade mark a major departure from America's long-standing commitment to free markets. The combination of protectionist measures and fiscal profligacy is likely to further increase the challenges faced by American companies in their quest to compete internationally by pushing up the real effective exchange rate. American companies will also face higher costs at a microeconomic level as a direct result of protectionism. Regardless, we would expect the economically inept trade team in the Trump Administration to view further headwinds in global competitiveness as justification for yet more protectionist policies. For this reason, it seems sensible to assume that American protectionism will continue, even escalate. As if to underline this point, the US Treasury Department announced at the weekend that it is drafting legislation, which would limit Chinese ownership of some US companies on national security concerns. Given this backdrop, how is America's seemingly inexorable lurch into protectionism going to impact the rest of the world, including EM FX and rates?

The first point to make is that EM FX and rates markets have already responded to rising trade tensions in the US. As in previous times, Emerging Markets (EM) have over-reacted to global risk factors, even before they have materialised in full. The last time EM markets over-reacted in this way was in the lead-up to the first Fed hike in December 2015. By the time the Fed finally got around to raising rates for the first time, EM local bonds were already trading at an average yield of 7.25%, which was a full 45bps higher than the yield, which prevailed in 2006 under pre-crisis monetary policy (Fed funds rate of 5.25%). Indeed, this was why EM local bonds and currencies did so well in 2016 and 2017. We expect a similar dynamic in response to the US protectionist threat; an over-reaction followed by a strong rally. We are already in buying territory, in our view.

Of course, EM local markets have pulled back in the past couple of months not solely due to fears of US protectionism, including profit-taking in EUR leading to a strong surge in USD, which in turn prompted profit-taking in EM FX. Markets also fretted over macroeconomic events in Turkey and Argentina plus elections in Mexico and Brazil, but these risks are either being addressed or will be entirely extinguished by October.

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Which leaves US protectionism as the main remaining 'live' risk. Given the starting point, how will US protectionism impact investments in EM going forward? We think the fear of US protectionism is over-stated as far as most EM countries are concerned, for the following reasons:

First, it is important to realise that there will be limits to how far the US can surround itself with tariffs without inflicting major pain upon American companies on account of the global nature of modern US manufacturing and services. For example, if, say, 25% of the value added of a car assembled in America is contributed within the US then barring imports of intermediate goods is clearly going to hurt the US car assembly plant. No one will buy a car, which is only a quarter built. The protectionists are obviously hoping that the entire production chain can be induced to move back to the US, but this plan founders fatally on the obvious fact that repatriation of production would dramatically increase the cost of the car and probably reduce its quality too. Blanket protectionism of whole industries is really only feasible in very simple value added businesses, where the entire value added takes place within the US, such as steel and aluminium.

The alternative to blanket industry-wide tariffs is to target individual countries. The US government could successfully impose import restrictions against a single country without too much domestic damage provided it maintains open trade ties with third countries, so that US businesses are able to replace essential imports from the target country with imports from third countries. Of course, this does not help the current account at all, because the US trade deficit merely shifts from the target country to one or more of the third countries, however this logic seems lost on Trump's protectionists. Indeed, the US seems hell bent on going down this route targeting China in particular. That China has become the target is no surprise: Mexico and Canada are already too integrated into the fabric of the American economy to dissolve NAFTA, tariffs on Germany would incur hefty EU counter-tariffs and Japan is rapidly becoming America's only ally in Asia.¹

The fact that the US protectionists are targeting just China and not any of the other eighty investable EM countries should offer EM investors some comfort were it not for the fact that many EM investors still cling to the out-dated notion that EM cannot survive without strong growth in China. The alleged chain of causality in this line of reasoning runs from US tariffs to lower Chinese exports to slower Chinese growth to lower commodity prices to weaker EM exports to wider EM current account deficits to softer EM growth to weaker EM currencies to higher inflation to EM central banks interest rate hikes to even lower EM growth. However, we do not agree with this line of argument for several reasons.

First, Chinese growth should hold up well. Estimates of the cost in GDP terms of the first USD 50bn of US tariffs are very small – about 0.2% of GDP for 2018. The Chinese current account will remain in surplus. The economic cost could rise if the US imposes more tariffs, of course, but then China's formidable capacity to defend its growth kick in. China has enormous potential to stimulate domestic demand in a bid to replace lost export demand, given its savings rate of about 47%.

Indeed, last week China gently began to pull the fiscal lever, when the government lowered the threshold for personal income tax from RMB 60,000 to RMB 42,000. This will give a spending boost to a whopping 340 million Chinese workers. There is also plenty of ammunition on the monetary policy side. PBOC, China's central bank, cut reserve ratios by 50bps for major banks at the weekend. The cut, announced prior to the latest round of US protectionist measures, should unleash RMB 700bn in fresh liquidity to banks to help them manage the liquidity challenges surrounding some RMB 600bn in upcoming dividend and quarterly tax payments. The funding has to be realised via debt to equity swaps, however, so the measure should trigger a fairly rapid reduction in outstanding debt at eligible banks.

In general, we think China is robust. China's economy continues to benefit from a sound macroeconomic framework with constant attention to supply-side issues. We do not see China abandoning its broader commitment to opening the economy either, even if China retaliates against US tariffs. The reason is that China knows that America's decision to abandon its role as global leader on economic matters presents a unique opportunity for China to gain credibility on the global stage with a view to eventually acquiring the mantle as global economic and financial hegemon. China will not engage in gratuitous manipulation of its exchange rate nor sell US Treasuries, because this could destabilise global markets and undermine China's growing reputation as a responsible global player.

Finally, we note that China is generally in a good position to move towards greater reliance on domestic demand as a basis for growth. China has grown mainly via exports for the last few decades, but has been putting in place reforms to wean itself off reliance on trade for some time. In other words, China is moving in the direction of relying on domestic demand anyway. The same cannot be said for the US, which has relied on consumption-led growth for decades and continues to do so. The US has built up copious amount of debt in the process, so if trade diminishes at this point in the cycle the US will find it challenging to rely even more on domestic demand. A rising interest environment and a widening current account deficit only compound this problem. In short, Chinese growth should not only hold up well in the near-term, but also do better than US growth over the medium term.

¹ For more details on why the US targets China see ["Trump and EM"](#) The Emerging View, 12 January 2017.

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Chinese growth may turn out to be resilient in the face of US protectionism, but EM is also not nearly as dependent on China as many think. China accounts for a large share of EM (38%) in GDP terms, but the economic linkages between China and the rest of EM are much smaller. China only accounts for 8% of EM trade (equivalent in value to 3% of EM GDP). This is because China trades more with developed countries than with other EM countries. Indeed, intra-EM trade has grown dramatically from about 20% of EM trade 25 years ago to about 40% on average across EM today. Since intra-EM trade is highly concentrated within regions, it follows that negative fallout from slower growth in China would be felt in Asia with comparatively few effects in other EM regions. The commodity linkage is also small. Some two thirds of EM GDP now comprises countries, which are not commodity dependent at all. This includes most of the countries in Eastern Europe and Asia, which are actually net commodity importers, wherefore they would benefit from lower commodity prices. The link from slower growth in China to the rest of EM via commodities would mainly impact Africa and Latin America, but by less than most people imagine.²

The previous discussion implies that the impact of US protectionism on EM local markets mainly operates via fear, which finds expression in volatility in EM FX markets. However, such volatility is unlikely to have a lasting impact on EM inflation and rates. Indeed, weakness in EM currencies is typically associated with lower, not higher, inflation.³ While pass-through from weaker currencies can lead to higher import prices in the short term, this effect tends to be strictly temporary and may be quite small. Indeed, most EM central banks have enough inflation fighting credibility to enable them to look through such short-term effects the exception being the small number of countries, where central banks do not have credibility. The reason why weaker EM FX in general tends to have a depressing impact on inflation is that weaker currencies lower prices for non-tradable goods and services, which make up a bigger part of CPI than tradable goods.

As of right now, we think EM FX is already very cheap, which should further limit the downside for EM currencies. EM real interest rates are also high at about 350bps for 5-year investment grade sovereign bonds, while the growth outlook for EM countries looks solid right now and well into the medium term. Look at the country stories and the Snippets section below to get a sense of the generally strong state of EM economies.

Obviously, the Dollar can rise if Trump continues to deliver nasty surprises on the protectionism front, but this would only provide a temporary and very bitter-sweet sugar high for the Greenback, in our view. This could easily be followed by a slump and possibly a protracted decline as the costs of the current set of trade and fiscal policies in the United States begin to take their toll. The damage is probably already happening: American companies are beginning to smart under a double-whammy of nominal and real effective exchange overvaluation and the microeconomic costs are going up too.

China's retaliation against American protectionism will inflict further pain. American agriculture is already putting the pressure on Republican heartlands with practically no blowback on the Chinese economy. The next wave of US tariffs against China will cover intermediate goods, which will inflict collateral damage on American and South East Asian businesses alike, since intermediate exports are partly produced outside of China, some even in America, and used as inputs by American companies.

Granted, there is a large imbalance in trade in goods between US and China, but China could also begin to target American services. US services exports to China make up USD 80bn per year. Apple sells USD 40bn of iPhones in China each year. GM sells more cars in China than in the US. China could make life very unpleasant for American businesses operating in China. This would also have long-term consequences, because American companies could miss out on Chinese consumption, which is likely to emerge as the single largest economic force in the world over the next few decades. In addition, China can make life more challenging in the political arena, for example by scuppering Trump's attempt to win a Nobel Peace Prize by easing pressure on North Korea.

Finally, investors should not lose sight of the very big picture. We see very little evidence that other major economies in the world share Trump's fondness for protectionism. So, supposing that that rest of the world reciprocates US protectionism, but continues to trade freely among each other, the result in aggregate will be to plunge the US into autarchy, while the rest of the world continues to enjoy the indisputable benefits of free markets and trade. This would be bad for the US, but leave everyone relatively unscathed. The Dollar should decline in this scenario.

- **Turkey:** President Erdogan won the Turkish presidential election on Sunday by a significant margin, obviating the need for a second round. Meanwhile, an alliance of Erdogan's own party (AKP) and the nationalist MHP jointly obtained a clear majority in parliament. This performance was stronger than expected. Erdogan assumes the presidency with enhanced powers to govern due to past constitutional changes, which now take effect. The only fly in the ointment, as far as Erdogan is concerned, is that the AKP-MHP coalition failed to secure the two-thirds majority (400 seats) required to change Turkey's constitution. Still, Turkey should now have political stability for the foreseeable future, though markets will mainly be interested in the question of economic stability. Erdogan may be the undisputed political giant of his time, but we believe he has displayed poor judgement in foreign policy matters and outright ineptitude in his handling of macroeconomic issues. Do leopards change their spots?

² See *"Intra-EM trade"*, The Emerging View, 6 September 2017.

³ See *"The Myth of EM FX pass-through"*, The Emerging View, 14 March 2017

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- **Argentina:** MSCI, an influential equity index provider, announced that Argentina's stock market will be included in its much followed EM equity benchmark index. This should result in some USD 3bn in new flows into the Argentinian stock market. Argentina will also drop out of the much smaller Frontier Markets index resulting in an outflow of about USD 300m. Hence, the net impact on flows should be massively positive. The Argentinian economy expanded at a yoy rate of 3.6% in Q1 2018 versus 3.5% yoy expected.
- **Mexico:** About a week before the presidential election, which should see Andres Manuel Lopez Obrador assume the country's top job, Mexican core CPI inflation remains well behaved despite recent currency weakness. Core CPI was 0.08% in the first half of June, which was lower than expected (0.16%). The yoy core inflation rate therefore declined to 3.59% from 3.69% in May. Meanwhile, real GDP growth was stronger than expected in Q1 2018 at 1.3% yoy. Due to big seasonal effects in Q1, when these effects are stripped out growth was closer to 2.3% yoy compared to 1.6% yoy sa in Q4 2018. The high frequency monthly GDP indicator also pointed to solid yoy growth in April of 4.54%. The Mexican central bank accordingly hiked the benchmark policy interest rate by 25bps to 7.75%.
- **Russia:** The Russian government announced that it intends to retaliate against US steel tariffs by applying a tax on imported American cars. Russia has not indicated that it intends to depart from free trade in any other areas or with other countries. The economy is doing well. Industrial production (IP) was revised materially higher following adoption of better statistical methods. The revisions to IP were 0.9% in 2016, 1.1% in 2017 and 1.4% in 2018 (January through April). Meanwhile, new data on retail sales, construction and unemployment were solid at 2.5% yoy, 5.6% yoy and 4.8% respectively.
- **Brazil:** IPCA-15 inflation was 1.11% mom in June, which was higher than expected (1.0% mom). However, the upward surprise was overwhelmingly due to food prices, which increased due to an eleven-day truckers strike during the sample period. We expect inflation to revert to normal levels in the coming months. The Brazilian central bank is credible; it left the policy rate unchanged at 6.5% reflecting the fact that inflation is below target and that USDBRL will have to rise well beyond 4 before the 4.25% 2019 inflation target is in jeopardy.
- **Malaysia:** CPI inflation was 1.8% yoy in May (1.3% yoy for core CPI). This inflation print was in line with expectations. Inflation is likely to fall sharply on a one-off basis in the coming months as the recently approved cut in GST enters the data. Nor Shamsiah, a former central bank and IMF official, assumed the role of governor of the Malaysian central bank.

Snippets:

- **Colombia:** The upswing in the Colombian business cycle continued with strong retail sales, which increased at a yoy rate of 6.3% in April. IP expanded at a rate of 10.5% yoy in the same month.
- **India:** Minutes of the Monetary Policy Committee's rate setting meeting showed strong support for the recent 25bps hike due to strong domestic growth and inflation risks from rising oil prices.
- **Indonesia:** In a sign of healthy economic activity, exports and imports both beat expectations in May. Imports rose at a yoy rate of 28%, while exports increased at a 12.5% yoy rate. The trade deficit was USD 1.52bn, a decline relative to April (USD 1.6bn).
- **Philippines:** The central bank hiked the main policy interest rate by 25bps to 3.5%.
- **Poland:** IP expanded at a yoy rate of 5.4% in May versus 4.3% yoy expected.
- **South Africa:** CPI inflation was 4.4% yoy in May, down from 4.5% yoy in April.
- **South Korea:** Exports in the first twenty days of June were down 4.8% yoy due to base effects and working day adjustments. The underlying rate of exports remains strong. Exports were 14.8% yoy in May and 8.3% yoy in April.
- **Taiwan:** Export orders surged at a rate of 11.7% yoy in May versus 8.6% yoy expected. The central bank left the policy rate unchanged at 1.375%.
- **Thailand:** The central bank left the policy rate unchanged at 1.5%. The growth outlook was revised higher to 4.4% in 2018 and 4.2% in 2019.

Global backdrop

On average, the US data released last week disappointed relative to expectations. While initial claims for unemployment declined marginally, PMI for June declined to 54.6 from 56.4 in May. Services PMI also declined and the Philadelphia Fed's manufacturing survey slumped. At the same time, the US current account deficit widened to 2.5% of GDP in Q1 2018 from 2.4% of GDP in Q4 2017. The current account deficit is likely to continue to widen due to fiscal stimulus and protectionism. The application of tariffs on steel will help a handful of unproductive steel workers, but raise the costs for everyone else in the US economy, including American exporters, thus undermining their competitiveness. A World Bank study showed that the US already has the highest weighted average tariff rate among the G7 countries (1.61% compared to 1.60% for the EU, 1.35% for Japan and 0.85% for Canada).

The European Union Summit scheduled for this week should result in further modest integration of the European Union with moves towards a common Eurozone budget, provided that Europe's tribalistic politicians do not fall out over immigration issues. Further progress in risk sharing in the Eurozone requires further compliance with the fiscal compact. To this end, there is some hope following the Italian Finance Minister's presentation of the government's economic plan, which was more fiscally orthodox than feared. Europe could also get distracted by Trump's trade war; Trump has hinted at tariffs on European car imports and European politicians may well find this topic of discussion more palatable than deeper issues of European integration. At least on the economic front there was some good news as composite PMIs for the Eurozone picked up in June to allay fears of a protracted downturn following weather-related weakness in Q1 2018.

Finally, we note that OPEC agreed to increase production by 600k barrels per day (roughly 0.6% of global daily output). WTI oil prices rose more than USD 2 per barrel after the news.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.72%	-5.22%	10.60%	6.14%	6.63%
MSCI EM Small Cap	-4.56%	-6.47%	8.50%	2.57%	5.20%
MSCI Frontier	-0.02%	-7.69%	5.84%	3.33%	4.72%
MSCI Asia	-2.67%	-2.64%	12.61%	7.64%	9.70%
Shanghai Composite	-6.04%	-11.74%	-5.97%	-11.73%	9.42%
Hong Kong Hang Seng	-4.79%	-1.84%	13.48%	-1.55%	7.92%
MSCI EMEA	-3.22%	-11.68%	5.94%	0.72%	1.01%
MSCI Latam	-4.57%	-12.41%	1.10%	0.99%	-1.36%
GBI EM GD	-2.44%	-6.04%	-1.41%	1.66%	-0.94%
ELMI+	-1.21%	-2.99%	1.61%	1.16%	-0.58%
EM FX Spot	-1.65%	-6.01%	-4.25%	-4.44%	-6.82%
EMBI GD	-0.81%	-4.86%	-1.42%	4.66%	5.40%
EMBI GD IG	-0.17%	-3.86%	-1.12%	3.26%	4.42%
EMBI GD HY	-1.47%	-5.95%	-1.88%	6.28%	6.57%
CEMBI BD	-0.37%	-2.83%	-0.11%	3.92%	4.76%
CEMBI BD IG	-0.15%	-2.35%	-0.68%	2.84%	4.16%
CEMBI BD Non-IG	-0.65%	-3.39%	0.80%	5.51%	5.53%

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.95%	4.00%	15.38%	11.35%	13.90%
1-3yr UST	-0.09%	-0.05%	-0.13%	0.41%	0.58%
3-5yr UST	-0.27%	-0.98%	-1.49%	0.60%	1.13%
7-10yr UST	-0.38%	-2.40%	-3.26%	0.95%	1.91%
10yr+ UST	-0.86%	-4.00%	-3.12%	3.30%	4.57%
10yr+ Germany	-1.05%	2.52%	0.66%	4.33%	6.19%
10yr+ Japan	0.12%	1.53%	1.86%	4.61%	5.19%
US HY	0.94%	0.69%	3.50%	5.44%	5.60%
European HY	0.43%	-0.66%	1.72%	4.49%	6.30%
Barclays Ag	-0.60%	-1.61%	1.08%	2.35%	1.37%
VIX Index*	-10.76%	24.73%	37.43%	-1.71%	-25.45%
DXY Index*	0.70%	2.73%	-2.70%	-0.58%	14.60%
CRY Index*	-2.62%	1.89%	17.76%	-11.95%	-28.95%
EURUSD	-0.50%	-3.08%	4.05%	3.86%	-11.03%
USDJPY	0.58%	-2.88%	-2.15%	-11.47%	11.89%
Brent	-4.36%	10.98%	62.96%	17.42%	-26.71%
Gold spot	-2.44%	-2.78%	1.77%	7.98%	-0.85%

*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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