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Europe's Choice

By Jan Dehn

The US-instigated trade war with the rest of the world kicked off last week with US tariffs on Chinese imports. China responded in kind, but also launched a charm offensive in Europe. Europe faces an important choice between looking backwards towards an American financial and economic hegemony in decline or forward towards a Chinese financial and economic hegemony in the ascendancy.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	-0.68%
MSCI EM Small Cap	10.5	–	-0.96%
MSCI Frontier	10.2	–	1.77%
MSCI Asia	11.1	–	-1.50%
Shanghai Composite	9.9	–	-3.43%
Hong Kong Hang Seng	6.8	–	-0.94%
MSCI EMEA	9.2	–	1.78%
MSCI Latam	11.4	–	1.93%
GBI-EM-GD	6.55%	–	0.92%
ELMI+	5.19%	–	0.35%
EM FX spot	–	–	0.59%
EMBI GD	6.35%	351 bps	1.36%
EMBI GD IG	4.79%	195 bps	0.82%
EMBI GD HY	8.13%	530 bps	1.91%
CEMBI BD	6.06%	325 bps	0.20%
CEMBI BD IG	4.87%	206 bps	0.28%
CEMBI BD Non-IG	7.55%	474 bps	0.11%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	1.64%
1-3yr UST	2.56%	–	0.01%
3-5yr UST	2.75%	–	0.03%
7-10yr UST	2.85%	–	0.20%
10yr+ UST	2.96%	–	0.69%
10yr+ Germany	0.31%	–	0.30%
10yr+ Japan	0.04%	–	0.45%
US HY	6.52%	365 bps	0.06%
European HY	3.78%	439 bps	0.71%
Barclays Ag	1.98%	-87 bps	0.48%
VIX Index*	13.19	–	-2.90%
DXY Index*	93.77	–	-0.70%
EURUSD	1.1776	–	1.18%
USDJPY	110.57	–	-0.30%
CRY Index*	198.40	–	-1.99%
Brent	77.8	–	0.63%
Gold spot	1263	–	1.70%

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

Emerging Markets

US tariffs against China took effect last week. China responded immediately by putting into effect tariffs against US imports of agricultural goods and other categories of US imports. However, China also responded in a more constructive manner by sending officials to Europe in a bid to deepen trade ties between China and Europe. China is arguing that US protectionism could get worse and may impact Europe too, while China is committed to continuing to open its own economy to international trade. So far, the US has threatened to impose as much as USD 1trn of tariffs on goods traded with China and other key trading partners, including Europe, Russia, Mexico and Canada. If the US protectionist threats are realised, all of these countries will be affected as will the US itself, but the rest of the world can insulate itself from US protectionism to a large extent if they continue to deepen trade ties among each other.

Sadly, Europe has so far displayed the usual dithering in the face of the mounting threat to global trade emanating from the US. This dithering is partly due to the complexity involved in reaching agreement on anything across the 27 independent nations making up the European Union, but there is also a strong element of 'raging against the dying of the light' in Europe's hesitation. Europe finds it difficult to face up to the profound changes unfolding in the global economic and political landscape, both in the US and within Emerging Markets (EM), notably in China. However, the fact that the process of shifting economic and political ties away from the US towards China is difficult does not make it wrong. Specifically, there are three strong reasons why it is in Europe's interest to begin to diversify economic relations away from the US and towards China (and other EM countries).

The first of these reasons is that Trump's political fortunes have picked up of late and may yet improve further. The US economy is growing strongly at the moment, which certainly helps Trump, even if the source of growth is unsustainable (a fiscal stimulus implemented at the top of the business cycle). Trump may too do well even if the economy falters, since Trump's entire political strategy is based on exploiting widespread discontent which is rooted in stagnating productivity and rising inequality. These conditions have given rise to broad mistrust of conventional mainstream politics, which Trump deftly exploits by deliberately opposing –

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Emerging Markets

attacking even – all the core policies, which sit at the very heart of Western establishment politics, including free trade. These policies (which also include the North Atlantic Treaty Organisation (NATO), the United Nations (UN), the Human Rights Council and the Paris Climate Agreement) have been put in place because they are critical to maintaining peace and prosperity. However, should US popular anger deepen further, say, if the US business cycle weakens in the coming year or two, Trump may well double down on disassociating himself with conventionality. The other reason for expecting Trump's policies to be around for some time is that the Democratic Party is sorely lacking in ideas and leadership, wherefore Trump currently looks like a shoe-in for a second term in office. In short, Trump and his policies are not going away and Europe needs to face up to this fact.

The second reason why Europe should begin to diversify its economic and financial ties away from the US towards China is that US consumption will not be the driver of global growth that it once was. The extraordinary environment of ever falling interest rates, which prevailed in the nearly four decades since the early 1980s, enabled US consumers to fuel global demand by borrowing heavily at ever lower cost. Many of the goods consumed and much of the financing to pay for the resulting deficits came from China, as well as from Europe, which is why both China and Europe run large trade surpluses with the US. China in particular has maintained high savings rates for many years, in effect suppressing domestic spending, in order to make the US consumer boom possible. However, this regime of high US spending financed by high Chinese savings effectively ended in 2008/2009. Since that crisis, the global economy has been able to sustain a twisted encore version of the pre-crisis regime only by means of extraordinarily low interest rates and Quantitative Easing (QE) policies. However, these policies are nearing their end and big changes are afoot. As the economic consequences of low productivity and high levels of debt reassert themselves with rising interest rates in the years ahead, US consumers will be able to spend far less and the US economy as a whole will need to rely more on exports in order to grow, if there is to be any growth at all. Export-led growth will not only require significant depreciation of the US real effective exchange rate, which can only come about via recession or currency debasement due to the steady structural decline in US productivity, but, importantly, it will also require a global environment receptive to free trade. This is why Trump's protectionism is so deeply inappropriate at this time. As far as Europe is concerned the message is clear: US demand cannot be expected to continue to sustain European exports.

The final reason why Europe should turn towards China is, of course, that China is likely to develop in exactly the opposite direction of the United States in the coming years, that is, Chinese consumption will increase and China will move forward with trade and capital account liberalisation. Why is China taking this path? To start with, China has a savings rate of almost 50%, which means that Chinese consumption has a lot of room to expand over the next few decades. China will actively promote domestic consumption, because, unlike Europe, China has understood the direction of change in the US; there is no future in exporting to the US. The rise in Chinese consumption in the coming decades will be nothing short of awe-inspiring. China's economy could overtake that of the US within just a few years, but with Chinese consumption rising at an even faster pace than growth, it follows that Chinese consumption could be the biggest economic force the world has ever known. Incidentally, Asian economies have been aware of this fact for some time, which is why erstwhile US allies such as South Korea and Philippines are already turning toward China. The good news for Europe is that it is going to become steadily easier to do business with China, because China is continuing to open its economy. Indeed, the entire thrust of China's current growth strategy is to turn the Chinese economy into something akin to the US economy in the post-World War II period, that is, an economy based on consumption with a current account deficit financed from overseas with Renminbi gradually becoming the dominant global reserve currency. The process of making this happen requires China to 'go the extra mile' in terms of overcoming deep-seated suspicions in the West about China's intentions. Since China can only overcome these suspicions by embracing the very policies, which Trump is currently rejecting, including free trade, environmental awareness, etc, Europe is actually taking a far smaller gamble in turning towards China than many perceive.

The world is in midst of profound changes, which are difficult grasp, let alone adjust to. New political and economic opportunities are becoming available, but politicians often choose to rely on experiences, which are rooted in the past rather than gleaned from their insights about the future. The post-World War II US hegemony is rapidly being undermined by the US itself. This means that the past no longer offers insights, which are relevant to the future. Until politicians embrace the new realities of the future, uncertainty inevitably ensues, which perversely often triggering a doubling down on obsolete practices. Reluctance or inability to adjust to change can even lead to crisis. Be that as it may. Crisis eventually forces politics to conform new economic realities and when this happens, a new dawn will begin. Europe's politicians must today face the choice of sticking with an increasingly protectionist US, which may already be past its peak, or beginning to deepen ties with an increasingly open China. We do not trust Europe's politicians to make the right choice yet, but institutional asset managers can do so, because it is within their powers to avoid the mistakes of the past, provided that they make forward-looking asset allocation decisions. This is precisely what investing is all about; at root investing is a forward-looking exercise. By allocating capital to reflect the future rather than the past, investors can prosper where politicians fail.

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Emerging Markets

- **Turkey:** President Erdogan was sworn in as President of Turkey yesterday. His biggest problem will be to bring aggregate demand into line with aggregate supply. If he fails in this task, he will experience a serious macroeconomic crisis under his watch. Ironically, Erdogan's macroeconomic problem is entirely self-inflicted as he has consistently applied pressure on the central bank to keep rates too low. Last week, Erdogan received a stark reminder of the size of the problem he faces, when the yoy rate of headline inflation surged to 15.4% in June from 12.2% yoy in May. An already sceptical consensus had expected 'only' 13.9% yoy inflation. We think Erdogan will struggle to get a grip on the economy, which he manages with the mindset of a mayor (Erdogan used to be Mayor of Istanbul). Mayors are good at implementing big construction projects, but less convincing at foreign policy matters and dealing with macroeconomic issues.

- **China:** USDCNY was volatile last week ahead of US tariffs. All else even, a US tariff increase will reduce imports from China, thus reducing flows of Dollars to China and pushing USDCNY higher. However, speculative flows often dominate the simple mechanical effects arising from tariffs. This was the case last week, which prompted the PBOC to intervene to limit volatility, but we do not think China is going to engage in currency war to match Trump's trade war. China is interested in developing acceptance of its currency as an alternative to the Dollar, wherefore the direction of travel, as far as the currency is concerned, is towards less rather than more intervention. However, central banks occasionally intervene because EM currencies, including CNY, often experience excess volatility due to investor behaviour. In other news, the Caixin services PMI rose to 53.9 in June from 52.9 in May. PBOC also announced that block trading will commence on Bond Connect starting in the middle of July. Repo and derivatives markets will also be opened for international investors. Finally, JP Morgan, a major provider of benchmark index services, has been approved as market-maker on Bond Connect.

- **Russia:** The Russian National Wellbeing Fund (FNB) increased sharply to USD 77.1bn in June as a surplus of USD 14.4bn from 2017 was added to the fund. The fund receives inflows when oil prices exceed the budget oil price, which is currently USD 40 per barrel plus global inflation (currently around 2.5%). The FNB is run along conservative lines, but once it exceeds 7% of GDP it will be allowed to invest in less liquid and lower rated securities. The FNB is part of Russia's FX reserves, which now exceed USD 450bn. On current oil prices, Russia's FX reserves may well exceed USD 500bn by the end of 2018. In other news, Russia manufacturing PMI softened to 49.5 in June from 49.8 in May, while the yoy rate of CPI inflation declined to 2.3% in June from 2.4% yoy in May. Russia applied 25%-40% tariffs on selected US imports in response to Trump's earlier tariffs on metal imports.

- **Venezuela:** President Trump inquired about the possibility of invading Venezuela and deposing President Nicholas Maduro, according to a senior administration official. US military intervention in Venezuela would obviously go down quite badly with President Maduro, but more importantly it would go down badly with other Latin American leaders too given the long history of US intervention and US sponsored military dictatorships in Latin America during the Cold War.

- **India:** Services PMI rose sharply to 52.6 in June from 49.6 in May. Last week manufacturing PMI also rose sharply. Combined, the June composite PMI increased to 53.3 from 50.4 in May. The government hiked minimum support prices for farm goods by 15.2%, up from 6.1% last year. This a clear political gesture, which raises inflation, the prospect of rate hikes and undermines the fiscal balance.

- **Global FX reserves:** IMF currency composition for Q1 2018 shows that holdings of CNY assets by central banks increased by 18% in the quarter, which is twice the rate implied by valuation adjustments. Central banks appear to be re-allocating to CNY from CAD and AUD. Global FX reserves stand at about USD 11.5trn of which EM central banks account for nearly 80%. EUR allocations remain close to 20%, down from 28% in 2009. This shows that central banks have still not unwound their big USD longs accumulated during the QE years. CNY is still only 1.4% of global reserves but the share of CNY is rising steadily every quarter.

Snippets:

- **Argentina:** The central bank hiked the reserve ratio by 3% and issued local currency bonds in order to tighten domestic peso liquidity.
- **Brazil:** The rolling 12-month trade surplus was USD 60.9bn in June, down from USD 62.2bn in May. Industrial production declined sharply in May (-10.9% mom) due to a strike by truck drivers. The strike ended after two weeks, so industrial production should bounce back strongly in June.
- **Chile:** Retails sales softened to a yoy rate of 3.0% in May from a very strong yoy rate of 7.4% in April. Inflation in June was 0.1% mom versus 0.2% mom expected. Real GDP growth was 4.9% yoy in May versus 4.0% yoy expected.
- **Colombia:** Inflation in June was 0.15% mom versus 0.17% mom expected.
- **Dubai:** The PMI hit 57.1 in June from 56.5 in May.
- **Ecuador:** The economy expanded at a yoy rate of 1.9% in Q1 2018. The current account moved into surplus (USD 108m) in the quarter.
- **Hong Kong:** PMI edged lower to 47.7 in June from 47.8 in May.

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Emerging Markets

- **Hungary:** The yoy rate of retail sales was 7.8% in May, up from a strong 6.1% yoy rate in April.
- **Malaysia:** The trade surplus was USD 2.1bn in May, down from USD 3.4bn in April.
- **Mexico:** Chief of Staff of President-elect Andres Manuel Lopez Obrador confirmed that the new Mexican government will not reverse the energy reform approved in the last government. The reform gives a greater role for the private sector in the oil industry.
- **Pakistan:** An anti-corruption court has sentenced former president Nawaz Sharif to 10 years in jail for corruption. Impunity for politicians is being eliminated in numerous EM countries.
- **Romania:** The National Bank of Romania kept the policy rate unchanged at 2.5% in line with expectations.
- **Saudi Arabia:** The PMI surged to 55 in June from 53.2 in May.
- **Taiwan:** The yoy rate of inflation declined to 1.3% yoy in June from 1.6% yoy in May.
- **Uruguay:** The rate of CPI inflation increased to 8.1% yoy in June from 7.2% yoy in May.

Global backdrop

German Chancellor Angela Merkel overcame opposition from within her own coalition with respect to an immigration deal struck at EU level. However, Austria has now indicated that it will build holding centres and border checks on its southern border if Germany implements the deal struck by Merkel with Seehofer of the Christian Social Union, which involves transit centres on the German southern border. A similar dynamic played out in Denmark, when Sweden closed its border for refugees at the height of the Syrian refugee crisis. There is no greater indication of the relative impotence of European Union institutions relative to power vested with national states than the European Union's inability to strengthen its external borders and distribute refugees fairly within the Union.

The employment report for the United States made pleasant reading. The participation rate increased. While this also pushed the rate of unemployment higher, a higher participation rate indicates that more workers are being drawn into work. Wages were subdued, however, so the net effect of the employment report was positive for rates at the margin (more supply, lower wages). In its minutes from the June FOMC meeting, the Committee expressed a heightened sensitivity to downside risks to growth due to President Trump's protectionist trade policies.

In the UK, the prospect of 'hard Brexit' was reduced somewhat, when Prime Minister Theresa May was able to get Cabinet support for a softer line in negotiations with the EU. However, we believe that there is no chance that even this softer position adopted by May will pave the way for a deal with the EU. This means that the UK still faces a binary choice: hard Brexit, which implies economic disaster, or an arrangement with the EU, where the UK has far less influence than when it was a fully-fledged member of the EU.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.68%	-7.24%	8.04%	6.80%	5.74%
MSCI EM Small Cap	-0.96%	-9.29%	5.14%	3.78%	4.57%
MSCI Frontier	1.77%	-9.34%	3.29%	2.95%	4.61%
MSCI Asia	-1.50%	-6.19%	8.79%	7.76%	8.39%
Shanghai Composite	-3.43%	-15.89%	-12.32%	-8.19%	8.85%
Hong Kong Hang Seng	-2.79%	-6.55%	6.49%	-0.89%	6.82%
MSCI EMEA	1.78%	-9.18%	8.67%	2.95%	1.16%
MSCI Latam	1.93%	-9.29%	2.63%	3.70%	-0.90%
GBI EM GD	0.92%	-5.58%	-0.14%	2.52%	-0.95%
ELMI+	0.35%	-3.06%	1.55%	1.70%	-0.57%
EM FX Spot	0.59%	-5.88%	-3.80%	-3.64%	-6.76%
EMBI GD	1.36%	-3.94%	0.49%	5.02%	5.38%
EMBI GD IG	0.82%	-2.88%	0.90%	3.63%	4.53%
EMBI GD HY	1.91%	-5.11%	-0.10%	6.64%	6.33%
CEMBI BD	0.20%	-2.68%	0.29%	3.94%	4.78%
CEMBI BD IG	0.28%	-1.83%	0.23%	2.97%	4.25%
CEMBI BD Non-IG	0.11%	-3.70%	0.52%	5.42%	5.49%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.56%	4.25%	16.73%	12.37%	13.38%
1-3yr UST	0.02%	0.07%	0.06%	0.38%	0.61%
3-5yr UST	0.04%	-0.71%	-0.77%	0.51%	1.27%
7-10yr UST	0.19%	-1.78%	-1.11%	0.91%	2.34%
10yr+ UST	0.75%	-2.26%	1.69%	3.44%	5.35%
10yr+ Germany	0.30%	4.22%	7.11%	4.56%	6.57%
10yr+ Japan	0.45%	2.00%	3.46%	4.99%	5.22%
US HY	0.01%	0.17%	2.67%	5.52%	5.52%
European HY	0.71%	-0.80%	1.85%	4.55%	6.18%
Barclays Ag	0.48%	-0.99%	2.35%	2.83%	1.83%
VIX Index*	-18.02%	19.47%	17.87%	-33.95%	-8.08%
DXY Index*	-0.74%	1.79%	-2.33%	-2.93%	10.87%
CRY Index*	-0.99%	2.34%	14.97%	-8.82%	-30.04%
EURUSD	0.79%	-1.91%	3.31%	6.71%	-7.86%
USDJPY	-0.17%	-1.88%	-3.04%	-8.88%	9.31%
Brent	-2.08%	16.33%	66.54%	32.72%	-27.85%
Gold spot	0.84%	-3.05%	4.02%	8.94%	0.94%

*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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