Issued: 23 July 2018

WEEKLY INVESTOR RESEARCH

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Investors should discount noisy schizophrenic tweets until mid-term elections

By Gustavo Medeiros

The current seasonal period of low liquidity has been accompanied by schizophrenic tweets and comments which translated in high intraday volatility in asset prices, but without major medium or long-term consequences so far. The US dollar was strengthening through the week, but reversed course to close flat vs the EUR after Trump criticised the FED's interest rate policy, suggesting it would "hurt all we have done". He also said, "China, the EU and others have been manipulating their currency lower (sic) while the dollar gets stronger with each passing day".

This convoluted trading pattern based on tweeting noise, rather than economic signals, may remain with us until the dawn of mid-term elections. If you believe in the mantra: "never believe in anything until it gets officially denied", you have a strong hint from Trump last week. When asked about the possibility of a decline on the stock market if the United States imposes a large amount of duties (USD 500bn on Chinese goods), Trump said: "If it does, it does. Look, I'm not doing this for politics". Fade the political noise coming from DC.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.8	–	-0.45%
MSCI EM Small Cap	10.5	–	-1.30%
MSCI Frontier	10.4	–	0.84%
MSCI Asia	11.4	–	-0.67%
Shanghai Composite	10.1	–	0.16%
Hong Kong Hang Seng	6.9	–	-0.59%
MSCI EMEA	9.0	–	-1.08%
MSCI Latam	11.7	–	2.79%
GBI-EM-GD	6.60%	–	-0.20%
ELMI+	5.00%	–	-0.36%
EM FX spot	–	–	-0.28%
EMBI GD	6.28%	338 bps	-0.22%
EMBI GD IG	4.74%	183 bps	-0.29%
EMBI GD HY	8.04%	515 bps	-0.15%
CEMBI BD	5.98%	311 bps	0.29%
CEMBI BD IG	4.82%	196 bps	0.07%
CEMBI BD Non-IG	7.41%	454 bps	0.57%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	0.04%
1-3yr UST	2.61%	–	0.02%
3-5yr UST	2.80%	–	-0.08%
7-10yr UST	2.94%	–	-0.38%
10yr+ UST	3.08%	–	-1.56%
10yr+ Germany	0.40%	–	-0.48%
10yr+ Japan	0.09%	–	0.08%
US HY	6.39%	350 bps	0.09%
European HY	3.53%	426 bps	0.06%
Barclays Ag	2.00%	-94 bps	-0.02%
VIX Index*	13.47	–	0.64%
DXY Index*	94.55	–	0.04%
EURUSD	1.1711	–	0.00%
USDJPY	111.33	–	0.86%
CRY Index*	192.61	–	1.43%
Brent	73.5	–	2.30%
Gold spot	1225	–	-1.27%

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

Emerging Markets

Smart long-term investors are starting to follow the signal (value created in EM Debt) by the recent sell-off (caused by tweeting noises and threats). Proxy flows to hard currency bonds were positive for the second consecutive week, following an 11-week stream of outflows according to a report from Bank of America Merrill Lynch based on EPFR data. Flows to local currency bonds and equity were close to flat.

The meeting between Trump and Putin in Helsinki was far from uneventful. While President Trump seemed to be lenient on increased Russian influence in the geopolitical space, Congress members called for sanctions on the pipeline connecting Russia directly with Germany through the Baltic Sea – Nord Stream 2. There were also calls for sanctions targeting specific companies and sovereign bonds in case the special investigation conducted by the Director of National Intelligence determines there was interference in the US election. Russia has shown significant resilience in the face of sanctions given its solid macroeconomic policies and FX reserves. The importance of the Nord Stream 2 pipeline in terms of energy supply for Germany and geopolitics for Russia means the pipeline construction is likely to go ahead. Trump displayed no coherent strategy on this front. The US president initially accused Germany of being "captive" to Russia. Later he told the Russian president he understood why Germany was pursuing the pipeline. The president finally acknowledged the imperative construction of the Nord Stream 2 suggesting American companies would compete with the pipeline via LNG exports.

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Emerging Markets

- **China:** The Renminbi depreciated 1% against the USD last week to 6.77, the lowest level since June 2016. Muted reaction from the Chinese authorities alongside clean daily RMB fixings gives us two signals before we can analyse the data. Firstly, contrary to 2015, the depreciation was not caused by large capital outflows. Secondly, the PBoC seems to have been adopting a free market based approach to the currency, after removing counter cyclical adjustments to fixing errors. The currency depreciation seems to be justified by equity outflows from international investors, together with a reduced current account surplus, the result of the economic rebalancing and concerns over trade disputes. However, there are reasons to believe the depreciation trend may not last. Foreign investors outflows from equities have been diminishing at the same time that locals consider the opportunity to buy into cheap valuations. On the data front, Q2 GDP growth moderated to 6.7% in line with expectations. Retail sales surprised on the upside at 9% YoY while industrial production was softer than expected at 6% YoY.

- **Argentina:** Argentina continues to struggle with its economic rebalancing following the mini-currency crisis and IMF bailout. Local newspaper La Nacion reported that Macri was considering a delay on a 50-80% price increase on gas and electricity prices set to take effect in September and October. Inflation rose from 26.30% to 29.50% on account of the weaker Peso.

- **Brazil:** In Brazil, strategic political alliances start to shape up as the October general election approaches and with it the August deadline for parties to form coalitions. The local press reports that the market friendly candidate Geraldo Alckmin, from the PSDB, has received support from an important number of parties including the PP, PRB, DEM and SD. The MDB party of current president Michel Temer has still not decided whether to support Alckmin or to launch its own candidacy with current Finance Minister Meirelles. Importantly, in spite of the good numbers displayed in preliminary polls, far right candidate Bolsonaro and leftist leaning Ciro Gomes seem to be struggling to make progress in gainingsupport from other parties. Former President Lula's PT party is also isolated at this stage – this could change if Lula manages to get out of jail, a scenario that looks unlikely considering the resilience of the decisions by the court in Curitiba. The coalition building process is crucial for the current presidential race. The distribution of the federal campaign funds (BRL 2.6bn – approximately USD 0.7bn) and the daily 12:30 minutes free TV ads are determined by the number of parliamentary members on the coalition. Geraldo Alckmin looks set to receive the lion's share of both if the alliances above are confirmed. These resources will be particularly important in the current election, which is likely to be devoid of traditional, non-declared private funding as a result of the car wash investigation.

- **Ethiopia:** Last Tuesday was a historic day for the horn of Africa. A 787 Boeing Dreamliner from Ethiopian Airlines took off from Addis Ababa to Eritrea's capital Asmara after a peace agreement ended a 20-year-old conflict. At the same time, on the ground, Eritrean troops pulled back from its border with Ethiopia. This is another astonishing achievement from new Ethiopian Prime Minister, Abiy Ahmed. Since coming to power in April, he has reigned in sectarian divides in Ethiopia, restarted relationships with troubled neighbours, secured USD 3bn of funding from UAE partners and pledged to open up the fast growing Ethiopian economy via large-scale privatisations of the main state owned companies in aviation, electricity and logistics.

- **Egypt:** House of Representatives set up a sovereign wealth fund, which will concentrate unutilised assets for a disguised form of privatisation, which will involve bringing the private sector to manage state assets. New Finance Minister Madbouly announced five state companies to pilot a state privatisation plan.

- **Ghana:** Ghana's Finance Minister Hon. Ken Ofori-Atta delivered a mid-term budget to address a revenue shortfall in the first five months of the year with the goal of bringing the fiscal deficit to 4.5% GDP from 5.9% GDP in 2017 and 9.3% in 2016.

Snippets:

- **South Africa:** The Reserve Bank of South Africa kept interest rates unchanged at 6.5% as expected. Inflation rose by 4.6% yoy in June, lower than the 4.8% expectation.
- **Poland:** Industrial production rose by 6.8% in June, faster than the 6.3% consensus.
- **Pakistan:** A presidential election will take place this Wednesday in Pakistan, the results are expected to be close.

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Global backdrop

It is undeniable that a trade war is the main concern in the global macro space. Economists are busy trying to make forecasts of its impact on the global economy. It is likely to be a hopeless exercise, as most models will miss the second round effects, which are likely to be much larger than the direct initial impact of the disruptions caused by the escalation of trade tariffs.

It is also hard to differentiate threats from effective, implemented measures. In the first round of trade disputes consisting of 25% tariffs on USD 50bn worth of imported products from China, USD 34bn were implemented on the 6th July. The remaining USD 16bn are going through a review and public readings ahead of their likely implementation. This round has targeted products where China holds a low share of the market, an average of 8% and maximum of 15%, which makes it easy to find substitutes with minimal impact on the economy. Furthermore, the tax will not have a direct impact on inflation as very few consumer goods were targeted. More than 90% of the products are capital goods or intermediate goods, making it more likely that some of the cost increase resulting from tariffs is absorbed within the supply chain.

The additional USD 200bn list of products to suffer a 10% tariff by September is not ready, but it is likely to target some products where China has close to 50% market share and reach a large numbers of consumer goods. Last Friday, Trump threatened to impose tariffs on a USD 500bn list of products (almost all imports from China). In order to make this happen, the US will have to target products where China has close to 70% market share, making it very hard to implement in practical terms. We seem to be reaching the point when a bilateral trade war sounds more and more like political bravado that is likely to bump into practical implications. Trump has been pushing trade protectionism as its most important flagship "Make America Great Again" going into mid-term elections. The measures make little economic sense but could resonate within his core voter base.

At the same time, Bank of America Merrill Lynch sentiment gauge points out that fears of trade wars are similar to concerns over European disintegration in 2012. According to the survey, active managers and investors have been running high cash levels at a time where non-US equities and credit markets have already suffered a significant correction.

Overall, we believe an escalation of the current politically driven protectionist measures into a full-blown trade war is a risk, but one that is unlikely to materialise as economic realities lead to corporate lobbying and put pressure on Congress to act as a mitigating force. Therefore, long-term investors will be rewarded by asset prices which have already discounted a trade war scenario. Schizophrenic tweets and comments amidst a low liquidity environment in the summer are likely to provide opportunities.

However, trade is not the only subject discussed by the US president. Last Friday, Trump said he was "not happy" about the FED interest rates increases, at the same time that he said he was "letting them do what they feel is best" and that these were his views as a "citizen".

Again, it is extremely unlikely that the FED will react to such statements, in our view. FED governors are appointed for a fourteen-year term with the chairman serving four-year terms. Governors can be removed only "for cause". This makes it hard for Trump to change the committee if it doesn't bend to his will. The chairman of the Federal Open Markets Committee (FOMC) also has a responsibility to report semi-annually to Congress. Therefore, there is a case to be made that any call for lower rates by president Trump would be met with a more hawkish tone by Governor Powell and FOMC members, as the committee tries to preserve its independence.

Finally, last week the IMF released its latest Global Economic Outlook. The Fund kept both its 2018 and 2019 global growth forecast unchanged at 3.9%. US growth forecasts were unchanged at 2.9% and 2.7% in 2018 and 2019 respectively. However, Euro area growth was revised down by 0.2% to 2.2% in 2018 and by 0.1% to 1.9% in 2019. Japan and the UK were also revised down 0.2% this year to 1.0% and 1.4% respectively with forecasts for 2019 unchanged. No surprises for China (6.6% in 2018 and 6.4% in 2019). The changes largely reflect downside surprises from Q1-18 and are unlikely to change market expectations, in our view.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.56%	-6.08%	3.64%	7.47%	5.23%
MSCI EM Small Cap	-0.63%	-8.98%	1.90%	3.50%	4.03%
MSCI Frontier	2.80%	-8.42%	3.45%	3.50%	3.99%
MSCI Asia	-0.35%	-5.09%	5.28%	8.35%	8.10%
Shanghai Composite	0.27%	-12.68%	-10.76%	-8.92%	9.75%
Hong Kong Hang Seng	-1.75%	-5.55%	2.32%	0.73%	6.50%
MSCI EMEA	0.80%	-10.05%	0.50%	2.09%	-0.39%
MSCI Latam	7.08%	-4.71%	-0.39%	5.96%	-0.74%
GBI EM GD	0.92%	-5.58%	-3.51%	2.54%	-1.49%
ELMI+	0.05%	-3.36%	-0.87%	1.85%	-0.93%
EM FX Spot	0.54%	-5.93%	-6.32%	-3.40%	-7.14%
EMBI GD	2.07%	-3.26%	-0.29%	5.20%	5.03%
EMBI GD IG	1.39%	-2.33%	0.10%	3.84%	4.12%
EMBI GD HY	2.78%	-4.30%	-0.83%	6.75%	6.07%
CEMBI BD	0.93%	-1.97%	0.23%	4.14%	4.63%
CEMBI BD IG	0.74%	-1.38%	-0.03%	3.10%	4.02%
CEMBI BD Non-IG	1.17%	-2.67%	0.71%	5.70%	5.45%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	3.17%	5.90%	15.48%	11.88%	12.90%
1-3yr UST	0.03%	0.08%	-0.10%	0.44%	0.56%
3-5yr UST	0.00%	-0.74%	-1.29%	0.66%	1.04%
7-10yr UST	-0.15%	-2.11%	-2.40%	1.00%	1.82%
10yr+ UST	-0.63%	-3.60%	-1.07%	2.94%	4.50%
10yr+ Germany	-0.27%	3.63%	5.46%	3.76%	6.02%
10yr+ Japan	0.48%	2.03%	3.16%	4.82%	5.14%
US HY	0.59%	0.76%	2.33%	5.79%	5.10%
European HY	1.25%	-0.27%	1.88%	4.22%	6.00%
Barclays Ag	0.03%	-1.43%	0.33%	2.89%	1.33%
VIX Index*	-16.28%	22.01%	43.91%	6.57%	6.40%
DXY Index*	0.08%	2.63%	0.73%	-2.65%	15.38%
CRY Index*	-3.88%	-0.65%	9.03%	-6.94%	-33.73%
EURUSD	0.23%	-2.45%	0.59%	6.62%	-11.43%
USDJPY	-0.51%	1.22%	-0.21%	11.32%	-10.69%
Brent	-7.49%	9.90%	52.91%	32.97%	-32.22%
Gold spot	-2.19%	-5.95%	-2.40%	12.33%	-8.92%

*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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