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WEEKLY INVESTOR RESEARCH

Ashmore

Brazilian politics comes alive

By Jan Dehn

Political parties are selecting their candidates in Brazil. PSDB's Alckmin has secured the support of a centrist coalition of parties, which ensures he gets about 50% of TV time. With Alckmin rising in the polls, albeit from a low level, it is too early to write off a possible market friendly outcome in the election. In Venezuela, Maduro is attacked by drone as he relaxes FX policy. Turkey is sanctioned. Russia is sanctioned. Iran is sanctioned. China slows. Argentina and Ecuador lift administered prices. Mnangagwa faces internal power struggle after winning Zimbabwe presidency. South Africa eyes constitutional change over land. SBY aligns himself with Prabowo as Indonesia racks up strongest growth rate in nearly five years. Peace breaks out in South Sudan. The Global Backdrop sections discusses market price action this year and the likely path of the US-instigated trade war with China.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	-1.67%
MSCI EM Small Cap	10.8	–	-0.49%
MSCI Frontier	10.4	–	-0.36%
MSCI Asia	11.3	–	-2.43%
Shanghai Composite	9.5	–	-4.61%
Hong Kong Hang Seng	6.9	–	-3.20%
MSCI EMEA	9.3	–	-0.42%
MSCI Latam	12.0	–	0.92%
GBI-EM-GD	6.57%	–	-0.63%
ELMI+	4.64%	–	-0.42%
EM FX spot	–	–	-0.51%
EMBI GD	6.28%	332 bps	-0.47%
EMBI GD IG	4.78%	181 bps	-0.32%
EMBI GD HY	8.01%	506 bps	-0.63%
CEMBI BD	5.96%	305 bps	-0.13%
CEMBI BD IG	4.82%	191 bps	0.06%
CEMBI BD Non-IG	7.38%	447 bps	-0.35%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	0.80%
1-3yr UST	2.65%	–	0.10%
3-5yr UST	2.82%	–	0.18%
7-10yr UST	2.95%	–	0.16%
10yr+ UST	3.09%	–	-0.02%
10yr+ Germany	0.40%	–	0.10%
10yr+ Japan	0.11%	–	-0.46%
US HY	6.27%	334 bps	0.33%
European HY	3.42%	412 bps	0.10%
Barclays Ag	2.06%	-89 bps	-0.27%
VIX Index*	11.73	–	-2.53%
DXY Index*	95.46	–	1.11%
EURUSD	1.1536	–	-1.45%
USDJPY	111.46	–	0.38%
CRY Index*	193.23	–	-0.92%
Brent	74.0	–	-1.31%
Gold spot	1209	–	-1.01%

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

Emerging Markets

- **Brazil:** Brazilian politics is suddenly coming alive. The various political parties are forming groups with a view to backing specific presidential candidates. They have to choose their candidate of choice by 15 August. In an important development last week, a group of centrist political parties calling themselves Centrao came together in favour of Geraldo Alckmin of PSDB as their presidential candidate. Political parties are extremely important in Brazilian elections, where TV time is proportional to the number of parliamentary seats. With the backing of Centrao, Alckmin should secure about 50% of TV time compared to no more than 1% for Jair Bolsonaro and Marina Silva, the poll leader. Alckmin will now attack PMBD's Henrique Meirelles, Bolsonaro and other candidates on the right with a view to winning a second round face off with a candidate from the left, which is divided between Marina Silva and Ciro Gomez. Imprisoned former President Lula is also a candidate after he received his party's nomination at the weekend. Because of his conviction for corruption, Lula's name will not appear on the ballot under current laws, despite his popularity in some segments of the electorate. Ana Amelia Lemos will likely be Alckmin's vice-presidential candidate. As a female senator from the south of Brazil, Lemos will directly challenge Bolsonaro, who polls very badly with women voters. Despite Alckmin's current low poll ratings, we expect an eventual second round between PSDB and a left-wing party with PSDB currently emerging as the eventual winner. Regardless of who wins, Brazil's next government will have to pass a reform of the pension system, which currently adds 3% of GDP to the debt stock every year.
- **Venezuela:** If the mountain will not come to Muhammad, then Muhammad must go to the mountain. President Nicholas Maduro appears to have given up on blaming Venezuela's economic woes on evil foreigners. Instead, he now accepts that he and the governing PSUV party are to blame. This suggests that Maduro is facing significant pressures from the military to improve the business environment in the country. With many years until the next election, Maduro appears to have decided to change economic policy: his government last week put forward legislation to liberalise the FX market significantly. This is potentially a

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Emerging Markets

significant and positive development, though a more liberal FX regime will not be effective unless it is matched by changes in order policies as well. This is because devaluation is generally ineffective in correcting misaligned real exchange rates unless accompanied by correction of the deeper underlying imbalances in supply and demand. If, for example, the Venezuelan government continues to run a loose fiscal policy then aggregate demand will clearly continue to exceed aggregate supply. In that case, devaluation only buys time, i.e. temporary relief for exports, but inflation soon erodes the previous benefits of a cheaper currency. Indeed, devaluation without broader macroeconomic adjustment could even worsen real exchange rate misalignment by increasing inflation expectations. This is precisely why Venezuela is experiencing hyperinflation even as the real economy is collapsing (exactly like Germany in the 1930s). In short, FX adjustment alone is insufficient. Meanwhile, the political environment remains challenging too. There is widespread discontent within the broader populace as illustrated by a botched assassination attempt by drone against Maduro over the weekend. The attack illustrates the instability of the political situation.

- Turkey: The US is imposing sanctions against Turkey's ministers for Justice and Interior, because of the arrest of an American pastor with alleged links with PKK and Gulenists. The prospect of US sanctions is negative for Turkish markets, not so much because of the actual sanctions, but because Turkey has placed itself in a position of considerable vulnerability due to the government's mishandling of both foreign policy and particularly monetary policies. For example, the central bank was forced to revise the current year inflation target up by a full 5% to 13.4% just last week. Inflation was 15.8% yoy in July. President Erdogan, though successful politically, has ruled Turkey with the mind-set of a mayor – he used to be mayor of Istanbul. However, mayors do not deal well with macroeconomic and foreign policy issues. Thus, Erdogan has sustained pressure on the central bank to keep rates low despite evident overheating of the economy. He has also pressured banks to increase credit and he has squandered Turkey's erstwhile enviable and powerful role as arbiter in the Middle East region. Turkey's economic vulnerability is particularly worrisome. Even if US sanctions are not targeting the financial sector, markets can be relied upon to speculate that financial sanctions could be next. If so, it may become more difficult for Turkey to attract funding for the current account deficit, which is a major area of risk for the country. If funding becomes restricted, Turkey will very quickly find itself in a fully-fledged credit crunch with negative implications for the banking sector and the wider economy. Turkey's external financing requirement for the next twelve months is USD 238bn. The Trump Administration is throwing its weight around far more than previous US Administrations, but Turkey's vulnerability is 99% self-inflicted due to Erdogan's extremely poor understanding of economics and geopolitics. We believe that future historians may well look back upon the Erdogan era and conclude that rarely has so much opportunity been squandered so fast for so little.

- Russia: The US Senate last week introduced a bill to impose further sanctions against Russia for alleged interference in the 2016 election. The draft includes a ban on transactions in new sovereign debt. Holders of existing debt would not be affected. If passed into law, the sanctions would likely have two effects. First, bonds would become less liquid. Second, supply of new debt would dry up. In related news, over the weekend Russia imposed tariffs of 25%-40% on US imports in retaliation for US tariffs on steel and aluminium.

- Iran: The US is this week re-imposing sanctions on Iran despite European opposition on the grounds that there is no evidence that Iran has violated the terms of an agreement to curb its nuclear programme. The US is demanding that other countries refrain from importing Iranian oil. Iran relaxed its FX regime in response. Decades of sanctions have failed to produce regime change in Iran and Iran has always been able to sell its oil.

- China: There is now fairly consistent evidence that a modest cyclical slowdown is underway in China. The Caixin services PMI softened to 52.8 in July from 53.9 in June. Caixin Manufacturing PMI declined to 50.8 from 51.0. Official PMI softened to 51.2 in July from 51.5 in July. The government announced that fiscal easing will be used to stimulate demand in H2 2018, including tax cuts, infrastructure investment with deleveraging still proceeding in state-owned enterprises. This cocktail of policies will support growth, but at the same time further China's structural adjustment agenda.

- Argentina: The government will raise prices for gas, electricity, transport, fuel and medical services as part of the broader fiscal adjustment required after the recent bout of FX instability. The adjustment is already taking a toll on growth. Industrial production fell at a yoy pace of 8.1% in June and construction contracted at yoy pace of -0.1% in June (after rising 15% yoy over the January to April period). In other news, members of the former Kirchner Administration plus leaders of engineering and construction companies have been arrested in a deepening corruption scandal with strong similarities to the Brazilian Lava Jato corruption probe. This most recent example of the growing intolerance of impunity and corruption in Emerging Markets (EM) is extremely welcome news, in our view.

- Ecuador: The government is scheduled to reduce fuel subsidies starting this week. A reduction in fuel subsidies would be extremely positive for the public finances, but tricky politically. Ecuador is a poor country without social safety nets. Cheap cooking gas has traditionally been a de facto income subsidy (in kind) for sections of the population, who will resist its removal.

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Emerging Markets

- **Zimbabwe:** Incumbent President Mnangagwa has been re-elected with more than 50% of votes and his party has taken two-thirds of the seats in parliament. However, the opposition disputes the results and there are concerns about divisions within the government's own ranks, which pit Mnangagwa (who favours reform) against members of the armed forces (who prefer to maintain the current regime which confers great benefits upon them).

- **South Africa:** The ruling ANC party has decided to revise the Constitution to clarify lingering uncertainties surrounding land expropriation. This is an extremely tricky topic, which will likely unleash considerable trading activity going forward. Due to the legacy of apartheid, inequality between blacks and whites is so enormous that even with various government income subsidies and educational sponsorship programmes it would take decades to bring about a more balanced wealth distribution (and with it reduced political tensions). Land redistribution can either be severely mismanaged (as in Zimbabwe), unfair (as in Kenya after independence) or done well (as in Colombia). Markets are likely to closely follow developments on this front going forward. In a positive development, the trade surplus was ZAR 12bn in June versus ZAR 5bn expected.

- **Indonesia:** Former President Susilo Bambang Yudhoyono aka SBY has endorsed Prabowo Subianto, a business man, for next year's Presidential election. A coalition between the Gerindra Party (13% of parliament) and the Democrat Party (11% of parliament) has been formed, providing Prabowo with financing. President Jokowi is currently very popular. Prabowo is a two-time losing candidate. In other news, inflation increased marginally to 3.2% yoy in July from 3.1% yoy in June, while real GDP growth hit 5.3% in Q2 2018, which was well ahead of consensus expectations (5.1%). This is the highest growth rate for nearly five years.

- **South Sudan:** The government and the leader of the main opposition group in South Sudan have signed a final peace agreement, which may usher in greater stability in this new nation. The country obtained independence in 2011 and depends heavily on crude oil revenues.

Snippets:

- **Chile:** The positive economic news continues with retail sales rising at yoy rate of 6.3% in June versus 4.8% yoy expected.
- **Czech Republic:** The central bank hiked the policy rate to 1.25% (a 25bps increase).
- **India:** The composite PMI surged to the highest level in 20 months with particular strength in services. The Reserve Bank of India hiked the policy rate 25bps to 6.5% with a neutral bias.
- **Malaysia:** The yoy pace of exports accelerated from 12.7% in May to 15.1% in June. The pace of import growth also accelerated to 22.9% yoy from 9.2% yoy. The trade surplus declined to USD 1.5bn from USD 2.1bn. The government cut spending sharply in June.
- **Mexico:** The central bank left the policy rate unchanged at 7.75%. Overseas workers' remittances rose to USD 3.1bn in June, a 23.1% yoy increase. The index of consumer confidence surged to 105 (vs 90.4 expected) following the Mexican presidential election.
- **Pakistan:** The newly elected government of Imran Khan is working with the IMF to secure up to USD 12bn in financial support.
- **Peru:** The rate of CPI inflation reached 1.62% yoy in July from 1.43% yoy in June.
- **Poland:** CPI inflation was unchanged at 2.2% in July.
- **Qatar:** FX reserves reached USD 25.2bn in June, a 13-month high.
- **South Korea:** Inflation surprised to the downside in July (1.5% yoy versus 1.7% yoy expected). Exports were 6.2% higher in July than at the same time last year, which helped to push the trade surplus to USD 7.0bn from USD 6.2bn in June. Industrial production growth was 1.6% yoy in June compared to 1.1% yoy in May.
- **Taiwan:** Manufacturing PMI moderated to 53.1 in July from 54.5 in June.
- **Thailand:** The rate of CPI inflation was 1.5% yoy in July, unchanged from June.

Global backdrop

2018 began with profit taking in EURUSD, which soon gave way to profit taking in EM local markets after very strong performance in both 2016 and 2017 (+25% return in USD terms). By Q2, EM countries were entering into clear oversold territory in value terms – buying territory if you wish – but the sluggishness continued due to four fresh risks, which emerged on the global investment horizon and needed to be better understood before investors were willing to put money to work. Most of these new risks were non-EM risks.

The first was Jay Powell, the new Chairman of the FOMC, who revealed a proclivity towards greater than expected hawkishness, no doubt to establish his credibility early in his term. He could do so without immediate consequences for the US economy by taking advantage of the second new 'risk', namely the likely growth boost from the recently passed Trump Tax Cut. How much growth would this stimulus generate? Thirdly, Trump seriously escalated his trade war against China and began to threaten Europe with tariffs too.

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Benchmark performance

Finally, within EM itself a small number of prominent EM countries had elections, including Colombia, Mexico and Turkey. These factors helped to keep investors in EM on the side lines, despite the emergence of value.

Today, markets have gained a reasonable understanding of most of these risks or they have simply come and gone. The Fed stood pat at the August FOMC meeting as expected and the more hawkish trajectory of Fed hikes for the rest of 2018 and beyond is priced in, so the scope for hawkish surprises has diminished. The US economy delivered a strong annualised real GDP growth rate of 4.1% in Q2, but this may well turn out to be the peak growth rate the year as housing is showing signs of weakness. Buying a house is the single largest investment a typical household ever makes, so housing is often a good early indicator of cyclical weakness. In EM, the elections in Colombia, Turkey and Mexico panned out as expected and the main trades around these events are behind us. Hence, apart from the Brazilian election to come – see the Brazil section above for some interesting recent developments in the past week – the last remaining unresolved risk revolves around Trump's trade war (until some other issue emerges, of course).

Should sentiment towards EM as a whole be dictated by the ups and downs in a bilateral trade dispute between US and China? Obviously not. However, the practice of arbitrarily labelling all EM assets as 'risky' and therefore approaching the entire asset class with greater caution at any sign of global uncertainty is so deeply entrenched that it happens anyway, even if the uncertainty does not directly affect the majority of EM countries.

What is more interesting from an investment perspective is that EM assets performed so strongly in July, when President Trump retreated on his threats of tariffs against Europe. The strong positive response of EM performance shows that EM assets could surge once the remaining uncertainty pertaining to US-China trade relations is fully priced in. What is the prospect of this happening anytime soon?

At first sight, not great. After already imposing USD 34bn of tariffs on China with more in the pipeline, Trump last week added to the woes by instructing his capos in the Commerce Department to study the possibility of raising the tariff rate on some additional USD 200bn of Chinese imports from a planned 10% to 25%. China retaliated by announcing tariffs on USD 60bn of US imports, but China can also retaliate in other ways, though it has so far chosen not to do so.

Some commentators have argued that Chinese retaliation has already taken place in the form of weakening the Chinese currency (CNY), since the currency has declined steadily in line with the bad news on tariffs over the last few months. However, this would be a misreading of the facts. In fact, on Friday China did the very opposite, namely shored up CNY. In general, the link between tariffs and currencies is poorly understood, particularly the fact that currencies mechanically decline in response to tariffs. When the US imposes taxes on imports of goods from China then the price of goods imported from China in the US clearly goes up. This makes Americans want to buy fewer Chinese goods, which in turn means that fewer USD flow from the US to China. The resulting decline in the availability of USD within China will, all else even, drive up the price of USD vs CNY. In fact, the USD rises until the currency has completely offset the effect of the tariff. It is this, rather than policy action, which is driving CNY lower. As an aside, the appreciation of USD will of course act as an impediment to all US exports, which is why bilateral tariffs have no impact whatsoever on the overall trade balance (which incidentally widened by USD 3.2bn in June to USD 43bn). Rather, bilateral tariffs distort the operation of free markets, limit the choices available to US consumers, reduce American real incomes and introduce incentives for newly 'protected' businesses in the US to rent-seek to ensure that the tariffs never get taken down again.

Despite the alarm surrounding headlines about tariffs and the associated short term volatility in stock, currency and bond markets, we see only a very small probability that the trade war 'goes global'. European governments and most EM governments fervently support free trade due to its obvious benefits. Moreover, supply-chains in all but the simplest value-added industries in the US are already so globalised that imposition of broad tariffs would be self-defeating. As far as country-specific tariffs are concerned only China really fits the Trump bill for reasons we have explained on numerous occasions – see "Trump and EM"[1] and "The limits of protectionism"[2].

This has not prevented some market participants from speculating that things could get much worse. This means that there are at least three schools of thought when it comes to deciphering the real objective of Trump's trade policy towards China:

a) The 'dealmaker' school of thought says that Trump is merely putting pressure on China in order to strike a better deal. If so, a resolution may be close at hand, because further escalation of tariffs against China will rapidly become self-defeating due to the large volume of intermediate goods in China's US exports, including some emanating from the US itself.

b) The 'election ploy' school of thought believes that America's escalation of trade tension with China is all about gaining votes ahead of the upcoming mid-term election. Most American voters are poorly equipped to gauge the validity or otherwise of Trump's accusations against China and Trump can deftly exploit this

1 See *'Trump and EM'*, The Emerging View, 12 January 2017.
2 See *'The limits of protectionism'*, Market Commentary, April 2018.

Benchmark performance

ignorance to reinforce the message that he is standing up for America even though, in fact, his policies will cost Americans. In this view, the end to the trade conflict with China is also in sight, because the mid-term election is in November of this year.

c) The 'hegemon death match' school of thought believes that Trump is taking on China in a bid to postpone or even entirely derail the threat China poses to America's standing as global and financial hegemon. In this view, there is no immediate end to America's economic war against China. Only the eventual outcome is known: US recession, even greater marginalisation of US in Asia and a collapse in USDCNY. Between now and then, the extent of volatility will depend in large part on how China responds to US aggression.

We believe that the Trump Administration harbours supporters of all three schools of thought. In the end, however, economic pain rather than ideology may end up dictating policy. Negotiations with Canada and Mexico over NAFTA and Trump's recent U-turn on European tariffs illustrate the US has little stomach for a fight if actual economic pain is involved. Slower growth may therefore emerge as a key turning point in the drive for more tariffs on the US side.

What about China? China has much greater tolerance for pain than the US, but may not need to feel a great deal of it, because the central government debt stock is less than 40% of GDP, which means that China can easily offset any negative effects of the trade war on exports by stimulating fiscally. In fact, only last week China's government indicated that the fiscal spigots may open to support growth in the face of early signs of a moderation in growth. The weaker CNY will also begin to stimulate Chinese exports in other regions.

Just a gratuitous currency manipulation is not on the cards, so China will not ditch US Treasuries. We also do not believe China will escalate trade tensions beyond a 'proportional response' to US aggression. The reasons are outlined in "Chinese reforms and American populism"[3]. China's long-term approach to economic policy-making dictates that China acts responsibly, reasonably, rationally. China will support the established global institutional framework. This approach accelerates China's inevitable rise to status of global economic and financial hegemon even as the US works hard to undermine its own status as leader.

[3] See *'Chinese reforms and American populism'*, The Emerging View, November 2016.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.24%	-5.61%	3.61%	9.37%	5.21%
MSCI EM Small Cap	-0.14%	-7.35%	3.52%	6.38%	4.50%
MSCI Frontier	0.22%	-7.43%	4.13%	4.70%	4.06%
MSCI Asia	-1.86%	-5.63%	3.71%	9.67%	7.73%
Shanghai Composite	-4.71%	-15.35%	-14.32%	-6.92%	8.63%
Hong Kong Hang Seng	-3.00%	-5.41%	0.97%	3.03%	5.89%
MSCI EMEA	-1.70%	-8.02%	3.29%	4.65%	0.04%
MSCI Latam	1.97%	-0.87%	1.97%	9.75%	-0.20%
GBI EM GD	-0.54%	-5.18%	-3.33%	3.58%	-1.17%
ELMI+	-0.43%	-2.98%	-0.76%	2.58%	-0.74%
EM FX Spot	-0.48%	-5.56%	-5.95%	-2.53%	-6.91%
EMBI GD	-0.32%	-3.11%	-0.79%	5.26%	5.38%
EMBI GD IG	-0.15%	-2.42%	-0.55%	3.73%	4.49%
EMBI GD HY	-0.48%	-3.91%	-1.18%	7.04%	6.33%
CEMBI BD	-0.22%	-1.68%	0.08%	4.36%	4.84%
CEMBI BD IG	-0.05%	-1.14%	-0.18%	3.15%	4.25%
CEMBI BD Non-IG	-0.43%	-2.33%	0.54%	6.23%	5.62%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.88%	7.40%	17.12%	12.93%	12.98%
1-3yr UST	0.07%	0.11%	-0.18%	0.40%	0.55%
3-5yr UST	0.15%	-0.82%	-1.56%	0.41%	1.02%
7-10yr UST	0.13%	-2.40%	-3.06%	0.31%	1.90%
10yr+ UST	-0.15%	-4.56%	-2.75%	1.23%	4.66%
10yr+ Germany	0.48%	3.32%	3.62%	2.85%	6.21%
10yr+ Japan	-1.21%	-0.16%	0.82%	3.95%	4.67%
US HY	0.16%	1.42%	2.72%	6.20%	5.40%
European HY	0.07%	0.11%	1.42%	4.49%	5.93%
Barclays Ag	-0.27%	-1.89%	-1.32%	2.39%	1.16%
VIX Index*	-8.57%	6.25%	16.95%	-14.81%	-7.78%
DXY Index*	0.96%	3.62%	2.05%	-2.43%	16.98%
CRY Index*	-0.67%	-0.33%	6.95%	-2.67%	-31.32%
EURUSD	-1.33%	-3.91%	-2.20%	5.59%	-13.30%
USDJPY	-0.36%	-1.09%	0.64%	-10.65%	14.04%
Brent	-0.35%	10.65%	41.15%	49.41%	-31.60%
Gold spot	-1.23%	-7.19%	-3.88%	10.97%	-5.77%

*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.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

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