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Ashmore

From protectionism to inflation

By Jan Dehn

Globalisation made inflation global. Protectionism now threatens to make it local again. This is a problem for countries, which are closer to full employment than the world economy, i.e. the US.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	2.28%
MSCI EM Small Cap	10.8	–	0.35%
MSCI Frontier	10.9	–	2.98%
MSCI Asia	11.5	–	1.83%
Shanghai Composite	9.8	–	4.37%
Hong Kong Hang Seng	7.3	–	4.28%
MSCI EMEA	9.3	–	3.52%
MSCI Latam	11.6	–	4.64%
GBI-EM-GD	6.63%	–	1.57%
ELMI+	4.73%	–	0.69%
EM FX spot	–	–	1.08%
EMBI GD	6.50%	343 bps	0.48%
EMBI GD IG	4.85%	177 bps	-0.05%
EMBI GD HY	8.42%	535 bps	1.04%
CEMBI BD	6.17%	314 bps	0.36%
CEMBI BD IG	4.97%	193 bps	-0.09%
CEMBI BD Non-IG	7.73%	469 bps	0.92%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	0.86%
1-3yr UST	2.81%	–	-0.01%
3-5yr UST	2.95%	–	-0.14%
7-10yr UST	3.07%	–	-0.53%
10yr+ UST	3.21%	–	-1.17%
10yr+ Germany	0.46%	–	-0.15%
10yr+ Japan	0.13%	–	-0.54%
US HY	6.26%	317 bps	0.07%
European HY	3.31%	400 bps	0.35%
Barclays Ag	2.13%	-94 bps	0.06%
VIX Index*	11.68	–	-0.39%
DXY Index*	94.35	–	-0.14%
EURUSD	1.1729	–	0.39%
USDJPY	112.49	–	0.57%
CRY Index*	193.98	–	3.49%
Brent	80.4	–	2.95%
Gold spot	1196	–	-0.48%

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

Emerging Markets

The end of the Cold War ushered in a new consensus about economic policies, which favoured free trade, liberalisation of markets, a more modest role for the state and reliance on a rules-based system for international conflict resolution and crisis management. As a result, the world integrated economically at an unprecedented pace. Lower geopolitical rivalry meant less uncertainty associated with cross-border transactions, so previously unconnected markets were able to link up to create massive efficiency gains from trade, outsourcing and increased specialisation. Improvements in information and communications technology also reduced risks associated with international trade and investment. Technology, much of it developed in the US, spread across the globe and in turn spurred new technology at local level. The single greatest advance was the integration of Europe's small and fractured markets into the largest free trade area in the world, the European Single Market. Throughout this period, the United States maintained a leadership role as sponsor-in-chief of global governance, which was rewarded with undisputed dominant global reserve currency status for the Dollar.

Emerging Markets (EM) played a crucial part in realising the gains from global economic integration. The end of the Cold War led directly to dramatic improvements in macroeconomic policies in EM countries, which paved the way for integration into global bond and equity markets. Access to capital in turn eased binding financing constraints, which meant that EM countries became the undisputed engines of global growth.[1] Importantly, better global transport and communications links also made it possible to move erstwhile expensive production processes in developed countries to much lower-cost EM destinations. This freed up workers in rich countries to move into higher value-added activities with higher remuneration, while EM countries experienced the largest drop in poverty ever recorded. As unprecedented numbers of people entered the middle classes, EM's young people became great consumers of high quality education from universities in developed economies. They brought their skills back home, which helped to increase EM productivity. The improvements were broad-based across EM, but China stood out for the sheer enormity of its advance. Over a period of some thirty years, China has evolved from a deeply introverted Maoist backwater to the most successful export-led economy the world has ever known.

The rapid global economic integration, which took place in the wake of the end of the Cold War, was particularly important from the perspective of inflation. Better macroeconomic policies in individual EM countries contributed significantly to lower global inflation, but so did the *de facto* globalisation of factor

[1] Even in 2015, which was the peak of the 2013-2015 bear market in EM, real GDP growth was still twice as high in EM as in developed countries.

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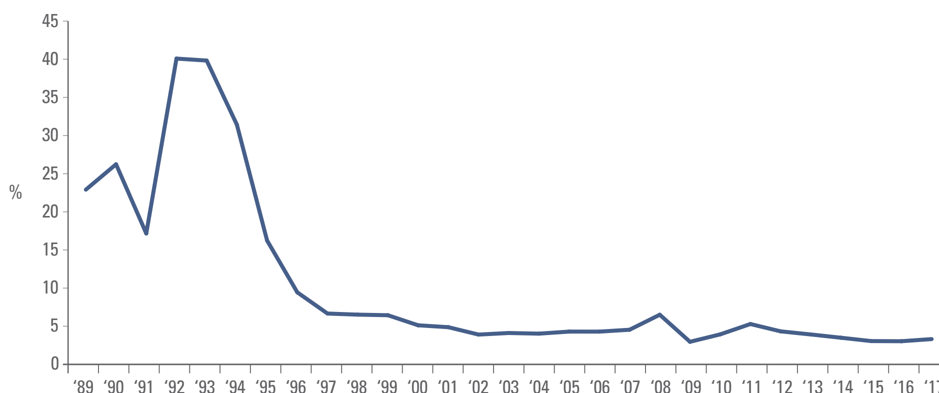
markets. Erstwhile *national* markets for capital, labour and technology became global markets due to the ability to outsource production. For example, a US machine shop in need of engineers found itself better served by outsourcing production to countries with excess supply of qualified engineers (with lower salaries) than poaching local talent at a premium to the going wage in the local market. On a macroeconomic level, this meant that inflation, as a whole became a function of global factor constraints rather than local or national factor constraints. The extremely diverse nature of the world economy with its myriad of countries at different stages of the business cycle meant that inflation episodes have become very rare indeed, because *local* inflation now requires global full employment (Figure 1).

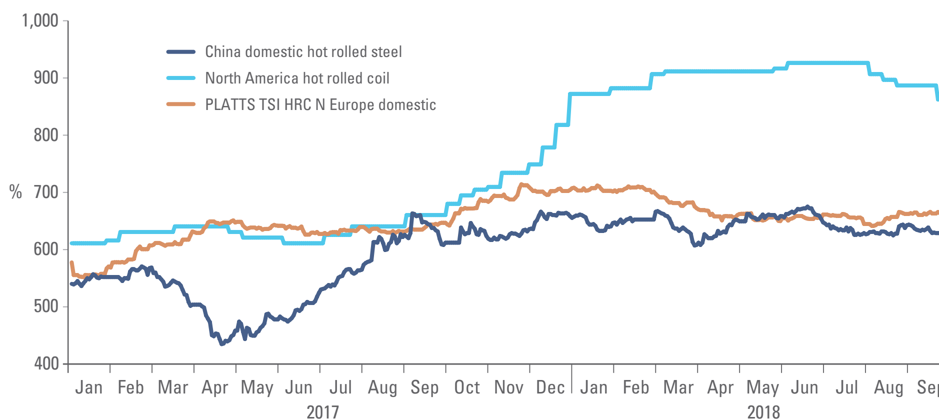
Fig 1: **Global CPI inflation (1989-2017)**



Source: Ashmore, IMF (2018-2023 are IMF forecasts).

Enter protectionism. In a stark break from America's traditional role as supporter of free trade, the Trump Administration has embarked on an aggressive programme of protectionism, which has seen tariffs imposed on solar panels, steel and aluminium. Whole countries have also been targeted, especially China, which remains one of America's most important suppliers of very low cost inputs and consumer goods. The economic negatives associated with protectionism are well known. They include rent-seeking, inefficiency, distorted prices and misallocation of capital. However, protectionism also poses an inflationary threat. Consider Figure 2, which shows how US steel prices have increased compared to Chinese and European steel prices since Trump's imposition of tariffs. This means that every single industry in the US, which uses steel, i.e. just about every manufacturing, industrial and construction-related industry in the country, now pays a massive premium on a key input. The US steel market is now clearly a local market due to the tariffs. Brexit is another example. When Britain leaves the world's largest free trade area on 29 March 2019, the UK market will shrink from USD 19trn to USD 2.6trn. UK supply will constrain production and economies of scale and other positive externalities, such as tapping into a Europe-wide pool of talent, will evaporate overnight.

Fig 2: **Chinese, European and US steel prices**



Source: Ashmore, Bloomberg.

In short, protectionism turns global markets into local ones. This can lead to an inflationary shock to the extent that the local markets are closer to full employment than the global market. This is certainly the case in the US. The inflationary impulse is partly due to the effect of taxes (tariffs), but also because trade barriers prevent local markets from benefitting from access to cheaper inputs. In the example above, the shortage of engineers locally becomes a binding constraint on the US machine shop, which is then forced to offer a higher salary in

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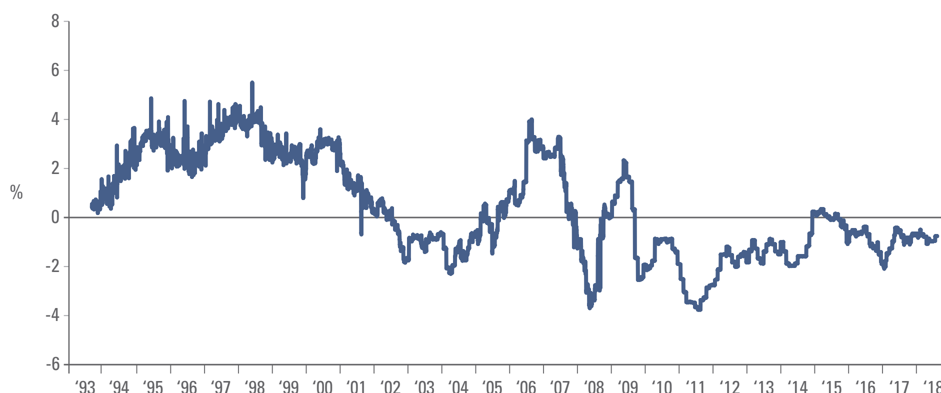
a bid to lure an engineer from a rival firm, despite the fact that the engineer's productivity will not increase. The other engineers will also demand higher salaries. The engineers obviously love the pay increases, but society as a whole suffers, because costs will rise across the board despite lower cost options being available elsewhere.

Do higher US costs matter? At this stage of the business cycle, absolutely. The US economy is at or close to full employment, yet the real Fed funds rate is still negative (Figure 3) and the Trump Administration is maintaining massive fiscal stimulus. Clearly, inflation risks are higher in the US than in the rest of the world, where there is still plenty of spare capacity. We note in passing that restrictions on immigration into the US will only worsen the inflation problem by placing further restrictions on supply of labour.

Fig 3: **Real US Fed funds rate**



Source: Ashmore, Bloomberg.

Also, should inflation risks materialise, the Federal Reserve would have to raise rates much more than expected. This would almost certainly push the US economy into recession, given the late stage of the business cycle. On the other hand, if the Fed holds back from hiking rates in order to avoid a recession, inflation will only rise further. There are no easy choices. The only thing that is clear is that bad macroeconomic management will be widely regarded as a default on the high standards expected of the global hegemon and the proprietor of the world's pre-eminent global reserve currency. The Dollar's reserve status will wane over time, but it could fall more precipitously too. Remember that cost-push inflation was a key ingredient of the inflationary episode of the 1970s, which saw the Dollar fall by 50% over the decade. Cost-push inflation is the worst kind of inflation, because it is structural in nature (caused by protectionism), and therefore immune to rising Fed funds rates. Rather than lower costs, higher Fed funds rates only sap demand to bring about much-dreaded stagflation, that is, anaemic growth going hand in hand with rising inflation.

Snippets:

- Argentina: Real GDP growth was -4.2% yoy in Q2 2018, in line with expectations. Argentina is in the middle of a massive macroeconomic adjustment following a longer period of unsustainable policies.
- Brazil: With two weeks to go before the first round of the presidential election, Jair Bolsonaro on the far right and Fernando Haddad of the left-wing PT party continue to lead in the polls with leftist Ciro Gomes in third. The attack on Bolsonaro during campaigning has reduced his rejection rate. The central bank left the policy rate unchanged at 6.5%. Real GDP growth was 2.6% yoy in July, which was higher than the consensus expectation.
- China: The People's Bank of China (PBOC) announced that foreign participants in the interbank bond market may now hedge bond positions using onshore forwards with entities other than local FX counterparty banks. This eases bond trading for foreign investors significantly, because it allows asset managers to face London banks for FX hedging purposes. SAFE, China's FX regulator, also indicated that there is no requirement to utilise onshore USD accounts under SAFE regulation. These operational improvements are taking place ahead of index inclusion for Chinese government bonds planned for Q2 2019.
- Croatia: Standard and Poor's raised the sovereign credit outlook to positive from stable. Croatia is rated BB+ by S&P.
- Ecuador: Government data shows the fiscal programme is on track and that the government needs another USD 1.2bn in financing this year. Half will likely come from the domestic market, the other half from international banks.
- Hungary: The National Bank of Hungary left the policy rate unchanged at 0.9%.
- Malaysia: CPI inflation slowed to 0.2% yoy in August from 0.9% yoy in July.

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- **Mexico:** Real GDP growth was 2.6% yoy in Q2 2018, up from 1.4% yoy in Q1 2018.
- **Peru:** Congress has backed a referendum on anti-corruption measures supported by President Vizcarra. This is good news. Real GDP growth was 2.3% yoy in July, in line with expectations.
- **Russia:** Inflation was zero in the week of 17th September for the second consecutive week.
- **Singapore:** CPI inflation in August was in line with expectations at 0.7% on a yoy basis. The rate of core inflation was stable at 1.9% yoy.
- **South Africa:** The South African Reserve Bank kept the policy rate unchanged at 6.5%, but with a clear hawkish bias. CPI inflation slowed to 4.9% yoy in August from 5.1% yoy in July. The consensus was wrong, expecting 5.2% yoy.
- **South Korea:** Exports in the first twenty days of September were 21.4% higher than at the same point in time last year.
- **Thailand:** Exports were up 6.7% on a yoy basis in August compared to a consensus expectation of 4.5% yoy. The Bank of Thailand left the policy rate unchanged at 1.5%.
- **Turkey:** The government's new fiscal programme envisages a frontloaded fiscal adjustment of 1.8% over the next three years, which should result in a 0.8% of GDP primary surplus in 2019, up from 0.1% in 2018. The fiscal austerity follows a recent hike in interest rates, which have taken real interest rates into positive territory.

Global backdrop

A new study for the Bank of International Settlements (BIS) finds empirical evidence in support of one of our longstanding themes, namely that volatility in EM asset prices is far higher than the underlying volatility in EM fundamentals. The study by Ilhyock Shim and Kwanho Shin shows that increased levels of stress in countries, where global banks are located, i.e. developed economies, causes global banks to decrease their lending to EM, which then in turn acts as a major driver of capital outflows from EM. They find that financial stress in developed countries is a *more important driver* of flows than the local financial conditions and macroeconomic fundamentals of EM.[2] This happens partly because banks are incredibly myopic, but also because EM business is peripheral for the banks compared to their core businesses in developed countries. The implication is clear: do not pay too much attention to what banks are saying or doing when it comes to EM, unless, of course, you are strictly interested in trading short-term momentum.

The US imposed tariffs on another USD 200bn of Chinese imports and China retaliated by placing tariffs on USD 60bn of US imports as well as calling off further talks on trade. Markets had priced in these developments, because risk sentiment improved following the Chinese announcement last week. However, the issue of protectionism is neither dead nor even close to dying. The parallels between the US protectionist policies of today and those of the Smoot-Hawley era in the 1930s are depressing. Governments, it seems, are hell bent on repeating mistakes. Both episodes of protectionism followed in the wake of crises, both were terrible policies and, just like the Smoot-Hawley Act worsened the Great Depression, so today's protectionism á la Trump will end up having very serious negative consequences for US economic health.

The European Union rejected the UK government's Chequers proposal for exiting the EU. UK Prime Minister Theresa May will this week face a hostile Conservative Party with many members who wish to see her move in the opposite direction to where the EU needs UK to go in order to strike a deal. As such, we see clear and present political and economic dangers in the UK. If May falls, the hard Brexit camp of the Tory party will likely take over. This means that the UK will likely crash out of Europe and the British economy will tank further. One imagines there will be a need for scapegoats across the board. Not a great recipe for a stable and predictable investment environment.

US existing home sales were softer than expected. Most housing indicators peaked in late 2017 and now show clear declining trends. Permits and single-family starts are also moderating. A house is the single biggest investment most households ever make. As such, the slowing housing market has historically been a good late cycle indicator.

[2] See https://www.bis.org/publ/work745.pdf

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.25%	-7.23%	-2.56%	11.83%	3.53%
MSCI EM Small Cap	-2.29%	-11.22%	-5.32%	7.05%	3.05%
MSCI Frontier	1.56%	-11.24%	-5.89%	5.27%	3.17%
MSCI Asia	-0.73%	-5.50%	-0.02%	12.74%	6.57%
Shanghai Composite	2.78%	-13.37%	-14.67%	-1.82%	7.39%
Hong Kong Hang Seng	1.78%	-2.00%	2.50%	7.94%	4.42%
MSCI EMEA	0.81%	-12.93%	-4.09%	5.33%	-2.55%
MSCI Latam	3.46%	-7.79%	-11.73%	12.20%	-2.76%
GBI EM GD	1.59%	-9.04%	-9.25%	4.20%	-2.30%
ELMI+	0.88%	-4.67%	-3.46%	2.98%	-1.30%
EM FX Spot	1.16%	-8.79%	-9.66%	-1.99%	-7.64%
EMBI GD	0.78%	-3.74%	-2.58%	5.05%	5.06%
EMBI GD IG	-0.33%	-2.35%	-1.41%	4.16%	4.37%
EMBI GD HY	1.95%	-5.25%	-3.89%	6.01%	5.74%
CEMBI BD	0.46%	-2.08%	-1.28%	4.81%	4.64%
CEMBI BD IG	-0.42%	-1.32%	-0.93%	3.41%	4.12%
CEMBI BD Non-IG	1.59%	-2.97%	-1.62%	7.09%	5.31%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.08%	11.12%	19.43%	16.56%	13.67%
1-3yr UST	-0.20%	0.17%	-0.12%	0.40%	0.56%
3-5yr UST	-0.64%	-1.02%	-1.64%	0.25%	1.01%
7-10yr UST	-1.48%	-2.91%	-3.42%	0.08%	1.91%
10yr+ UST	-3.16%	-5.99%	-4.51%	1.47%	4.57%
10yr+ Germany	-1.82%	2.45%	2.96%	2.93%	6.88%
10yr+ Japan	-0.44%	-0.57%	-0.31%	3.31%	4.15%
US HY	0.39%	2.39%	3.17%	7.14%	5.41%
European HY	0.36%	0.55%	1.34%	5.15%	5.69%
Barclays Ag	-0.35%	-1.86%	-1.23%	2.19%	1.03%
VIX Index*	-9.18%	5.80%	21.79%	-50.23%	-17.05%
DXY Index*	-0.83%	2.42%	2.37%	-1.71%	17.12%
CRY Index*	0.53%	0.06%	5.67%	0.20%	-31.98%
EURUSD	1.09%	-2.30%	-1.01%	4.41%	-12.94%
USDJPY	1.32%	-0.18%	0.68%	-6.31%	13.91%
Brent	3.78%	20.16%	41.31%	66.81%	-26.04%
Gold spot	-0.47%	-8.24%	-8.78%	3.62%	-9.64%

*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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Ashmore

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

Tokyo
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