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# EM and the US mid-term election

By Jan Dehn

The US mid-term election is approaching. After a long and noisy campaign, what does the post-mid-term election period have in store for EM investors?

| Emerging Markets | Next year forward PE/Yield | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| MSCI EM | 10.1 | – | -0.88% |
| MSCI EM Small Cap | 9.5 | – | -0.06% |
| MSCI Frontier | 10.3 | – | -0.68% |
| MSCI Asia | 10.6 | – | -1.14% |
| Shanghai Composite | 9.6 | – | -2.17% |
| Hong Kong Hang Seng | 7.2 | – | 1.28% |
| MSCI EMEA | 8.4 | – | -0.93% |
| MSCI Latam | 11.6 | – | 1.61% |
| GBI-EM-GD | 6.71% | – | 0.76% |
| ELMI+ | 5.44% | – | 0.21% |
| EM FX spot | – | – | 0.29% |
| EMBI GD | 6.70% | 349 bps | -0.16% |
| EMBI GD IG | 5.05% | 184 bps | -0.42% |
| EMBI GD HY | 8.59% | 540 bps | 0.10% |
| CEMBI BD | 6.28% | 313 bps | 0.02% |
| CEMBI BD IG | 5.10% | 195 bps | -0.10% |
| CEMBI BD Non-IG | 7.83% | 467 bps | 0.17% |

| Global Backdrop | Next year forward PE/Yield/Price | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| S&P 500 | 15.4 | – | 0.04% |
| 1-3yr UST | 2.91% | – | -0.06% |
| 3-5yr UST | 3.05% | – | -0.17% |
| 7-10yr UST | 3.20% | – | -0.36% |
| 10yr+ UST | 3.37% | – | -1.06% |
| 10yr+ Germany | 0.46% | – | 0.99% |
| 10yr+ Japan | 0.15% | – | -0.09% |
| US HY | 6.63% | 343 bps | -0.05% |
| European HY | 3.75% | 441 bps | -0.39% |
| Barclays Ag | 2.25% | -95 bps | -0.33% |
| VIX Index* | 19.53 | – | -1.77% |
| DXY Index* | 95.60 | – | 0.54% |
| EURUSD | 1.1523 | – | -0.48% |
| USDJPY | 112.72 | – | 0.85% |
| CRY Index* | 197.18 | – | -0.77% |
| Brent | 80.2 | – | -0.68% |
| Gold spot | 1225 | – | -0.20% |

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

## Emerging Markets

- **EM and the US mid-term election:** Scheduled for Tuesday 6 November, the US mid-term election is now just over two weeks away. The associated political noise is rising sharply and should reach a final crescendo within the next fortnight. So far, the campaigning has had a consistent theme: putting America first. The Trump Administration kicked off campaigning in May with a sharp escalation in trade tensions against the European Union and China. The US soon U-turned on the threat of tariffs against Europe as the costs from retaliation became clearer, but the attacks on China continued unabated all summer. NAFTA negotiations were also caught up in the mid-term political maelstrom with positive consequence; the need to preserve American jobs in an election year forced the US government to agree a new NAFTA deal with virtually no material changes relative to its predecessor. Then, last week, the mid-term election again made itself felt, when the US government threatened to shut the border with Mexico over Guatemalan immigration. Finally, this weekend mid-term related noise reached a fresh high as Trump announced new tax cuts (despite already large and rising fiscal deficits) and a promise to withdraw the US from the Intermediate-range Nuclear Forces Treaty, a long-standing arms treaty with Russia.

Clearly, elevated levels of political noise are par for the course leading up to any election. In all likelihood, noise levels will decrease in a few weeks' time. Hence, the more important question facing EM investors is where US policies will be heading after the mid-term election, particularly with respect to trade. Remember that protectionism has been an important source of Dollar strength this year.

While the mid-term election is unlikely to change the overall tendency for the US to shrink from the world, we do see an increasing likelihood that domestic and economic interests will begin to constrain the Trump Administration's protectionist urges. The rationale for this is that the focus of members of Congress as well as Trump himself ought to shift to the 2020 presidential and congressional election as soon as the mid-term election is over. Success in 2020 requires that the US economy continues to deliver strong and sustained economic growth and that the stock market remains buoyant.

However, achieving sustained growth and continued strong performance in the stock market may prove challenging unless the direction of economic policy changes, particularly with respect to trade. The US business cycle expansion is in a very late stage. The economy is at or close to full employment, the Fed is

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raising rates, the Dollar is very expensive in both nominal and real terms, the twin deficits are large and growing, the stock market is running on fumes, the housing market is showing serious signs of late cycle blues and the yield curve has been flattening for most of the year. While policy is providing short-term stimulus, government debt to GDP is already well above 100% and set to rise sharply in the coming years. The clear abandonment of both fiscal policy prudence and free trade could easily begin to undermine business confidence.

However, the biggest threat to the expansion arising from protectionism may be that tariffs could, in the end, forcethe hand of the Fed. While protectionism has a number of known negative economic effects, such as real effective exchange rate overvaluation and undermining productivity, the most serious risk at this stage in the business cycle is inflation. Tariffs not only directly push up prices for the goods subject to tariffs, but they also make it more difficult to outsource production to other countries with lower costs.

The threat to US growth from protectionism is unlikely to have gone unnoticed by Congress Republicans, who tend to be highly responsive to US corporate interests (this is actually one of the factors, which makes America such as good place for business). For this reason, we expect Congress Republicans to apply more pressure on Trump not to get too draconian on trade policy in 2019 and 2020 in the run-up to 2020. There is no guarantee that Trump will be responsive to such pressure. Certainly, it seems naive to expect an outright dismantlement of tariffs. However, it seems likely that the pace of protectionism will slow, even come to a halt. China, being strongly opposed to tariffs in the first place, would certainly welcome a de-escalation of protectionism and would reciprocate in kind.

What would a stabilisation of the situation regarding trade mean for EM countries? The primary benefit would be to remove the last of the four factors, which have given the US dollar a lift this year. Markets have already taken profits after the 14% rally of EUR versus the Dollar last year, have already priced in a more aggressive Fed and have already priced in the stronger growth trajectory due to the tax cut. If protectionism stabilises the last remaining factor, which has supported the Dollar this year goes away.

Our view is that the Dollar is about 20% overvalued versus EM currencies. We base this view on real effective exchange rates, growth expectations for EM countries versus the US over the next few years and the clear discrepancy, which has emerged between the value of the Dollar and US productivity. We believe the current mispricing of the Dollar is directly due to extremely distorted positioning by global asset allocators in favour of US stocks, the Dollar and European bonds following the years of Quantitative Easing (QE) policies. Moreover, we believe these so-called QE trades already began to unwind in 2016 and 2017 and that they will continue to unwind in the coming years. As such, from an imaginary vantage point in the future, an investor would be able to look back on the price action in 2018 and conclude that this was merely a temporary interruption in a multi-year process of unwinding QE trades.

In conclusion, the real significance of the mid-term election from an EM perspective is that once the election is over, the focus in US politics should be to protect growth in the run-up to 2020. Given the late stage of the business cycle, this requires more cautious trade policies. If trade policies improve, the last of the four temporary pillars, which have supported the Dollar in 2018 should fade.

- China: Real GDP growth slowed to 6.5% yoy in Q3 2018 versus 6.6% yoy expected and 6.7% yoy in Q2 2018. Chinese stocks rallied on the news as markets asked, "Is that it?". After all, markets had been poised for very bad data. China has not only been hit by draconian US trade tariffs over the summer, but is also undertaking a country-wide, government-led deleveraging exercise. Finally, stock prices are down 30% this year. Markets were also impressed by the fact that retail sales and fixed asset investment were both stronger than expected and house prices appreciated at a yoy rate of 7.6% in September compared to 6.8% yoy in August. In short, this is no disaster at all. Moreover, since the stimulus measures, which were introduced in the last month or so, have yet to show up in the data, there is every reason to expect that China will avoid a hard landing. Core inflation was just 1.7% yoy in September, so China has plenty of room to offer more monetary stimulus.

Having said that, China continues to face important on-going growth challenges associated with a broader policy programme to convert the world's most successful export-led economy into a domestic demand-led economy. Structural reforms of the magnitude and quality currently being undertaken by China cannot avoid causing widespread disruption. The silver-lining is that China is managing the transition intelligently and should emerge on the other side in a good position to deliver strong and sustained growth for decades to come. Viewed from this perspective, the decline in stock prices this year smacks of opportunity.

Finally, total social financing in September was higher than expected (RMB 2.2trn versus 1.5trn expected. However, the number was distorted by a broadening of the statistical base as part of China's ongoing programme of improving its macroeconomic data. On a like-for-like basis, the September data was consistent with continuing gradual deleveraging

- Brazil: The latest polls show that Jair Bolsonaro has increased his lead over Fernando Haddad in the polls ahead of the second round of the presidential election on 28 October. Datafolha's poll showed voting intentions in favour of Bolsonaro rising to 59% from 58% in a previous poll. Bolsonaro's lead has increased despite accusations from the Left that he benefitted from illegal campaign funding. In other news, it has been

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announced that Central Bank President Ilan Goldfajn will retire at the end of the year. Brazil has a large stock of excellent economists, who can replace him, so the transition should not give grounds for concern. In economic news, the cyclical upswing in Brazil continues. The monthly real GDP indicator known as IBC-Br was up 0.47% mom in August. This followed 0.65% increase in July. In addition to pension reform, the business cycle is likely to be a key driver of investor sentiment towards Brazil under the next government.

- India: Minutes from the Reserve Bank of India's meeting on 5 October shows that members of the monetary policy committee are aware of potential inflationary pressures on the economy, despite deciding not to raise rates. This suggests that risks are skewed towards a hike in future meetings. Meanwhile, the trade deficit narrowed to USD 14bn in September, which was much lower than expected (USD 17.3bn).

Snippets:

- Chile: The central bank hiked the policy interest rate by 25bps to 2.75%.
- Colombia: Consumer and producer strength in August: retail sales were up 5.5% yoy versus 4.6% expected and 3.2% in July and manufacturing production was up 3.9% yoy versus 3.5% yoy in July.
- Costa Rica: The Supreme Court has ruled that a fiscal reform, which includes changes to the salaries of public employees in the Judiciary impacts judicial independence. As such, the bill must either be changed or go through a more protracted approval process requiring at least 2/3 majority.
- Indonesia: Year-to-date tax revenues are well ahead of target, putting the government on track to beat its fiscal deficit target of 2.12% of GDP, according to the finance ministry.
- Peru: The real economy expanded at a 2.3% yoy rate in August, unchanged from July.
- Poland: Calendar effects pushed the pace of industrial production growth down to 2.8% yoy in September from 5.0% in August. Construction growth also slowed to 16.4% yoy from 20% yoy. The rate of inflation declined to 1.9% yoy in September from 2.0% yoy in August.
- Romania: The current account deficit widened to EUR 1.1bn in August compared to EUR 0.2bn in the same month of 2017.
- Russia: Retail sales expanded at a yoy rate of 2.2% in September, down from 2.8% yoy in August. Industrial production also slowed to 2.1% yoy from 2.7% over the same period.
- South Africa: Retail sales were far stronger than expected in August. The market has expected retail sales to decline at a yoy pace of 0.1%, but the actual number was +2.5% yoy. Manufacturing production has also been picking up.
- South Korea: Bank of Korea left the policy rate unchanged at 1.5%.
- Turkey: Credit growth as of mid-October was down 7.5% in annualised terms.

## Global backdrop

In the US, sales of previously owned ('existing') homes fell outright by 3.4% in the month of September, taking the level of sales to the lowest point since 2015. Other housing indicators, such as housing starts (-5.3% mom) and permits (-0.6% mom) are also softening. Housing is the single largest purchase most households make, wherefore housing is often viewed as a good early indicator of the direction of the travel for the broader business cycle. Retail sales were soft, but industrial production was strong.

In Europe, Moody's cut Italy's sovereign credit rating to Baa3 with stable outlook. Baa3 is one rating above junk. The Spanish Supreme Court ruled that lenders, not borrowers, must pay stamp duty on mortgages. This will hurt Spain's banks, but be great for homeowners. UK retail sales disappointed as uncertainty associated with Brexit continues to weigh on the UK economy.

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## Benchmark performance

| Emerging Markets | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| MSCI EM | -7.24% | -14.19% | -10.64% | 6.71% | 1.33% |
| MSCI EM Small Cap | -7.44% | -18.69% | -13.35% | 2.38% | 0.57% |
| MSCI Frontier | -3.53% | -15.72% | -12.07% | 3.62% | 1.76% |
| MSCI Asia | -9.12% | -14.71% | -10.71% | 6.60% | 3.88% |
| Shanghai Composite | -9.60% | -21.02% | -22.49% | -7.02% | 5.41% |
| Hong Kong Hang Seng | -7.22% | -9.14% | -6.33% | 2.59% | 3.10% |
| MSCI EMEA | -5.40% | -16.78% | -9.91% | 1.72% | -4.14% |
| MSCI Latam | 4.90% | -2.10% | -5.29% | 13.07% | -2.12% |
| GBI EM GD | -0.27% | -8.39% | -7.41% | 3.15% | -2.48% |
| ELMI+ | -0.15% | -4.62% | -2.92% | 2.09% | -1.50% |
| EM FX Spot | -0.21% | -8.55% | -8.41% | -2.63% | -7.72% |
| EMBI GD | -1.52% | -4.52% | -3.99% | 4.48% | 4.52% |
| EMBI GD IG | -1.78% | -3.52% | -2.89% | 3.32% | 3.76% |
| EMBI GD HY | -1.26% | -5.63% | -5.19% | 5.74% | 5.27% |
| CEMBI BD | -0.35% | -1.95% | -1.76% | 4.58% | 4.36% |
| CEMBI BD IG | -0.51% | -1.49% | -1.44% | 3.11% | 3.75% |
| CEMBI BD Non-IG | -0.15% | -2.46% | -2.08% | 6.98% | 5.16% |

| Global Backdrop | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| S&P 500 | -4.93% | 5.11% | 10.12% | 13.10% | 11.93% |
| 1-3yr UST | -0.02% | 0.22% | 0.01% | 0.31% | 0.54% |
| 3-5yr UST | -0.22% | -1.13% | -1.60% | -0.03% | 0.86% |
| 7-10yr UST | -0.85% | -3.57% | -3.92% | -0.65% | 1.48% |
| 10yr+ UST | -2.87% | -8.50% | -6.96% | -0.43% | 3.53% |
| 10yr+ Germany | 0.37% | 3.15% | 2.88% | 2.66% | 6.80% |
| 10yr+ Japan | -0.39% | -1.08% | -0.14% | 3.03% | 3.69% |
| US HY | -0.94% | 1.60% | 1.64% | 6.97% | 4.98% |
| European HY | -0.62% | -0.57% | -0.66% | 4.74% | 5.08% |
| Barclays Ag | -0.79% | -3.14% | -2.37% | 1.32% | 0.41% |
| VIX Index* | 61.14% | 76.90% | 95.89% | 35.16% | 46.51% |
| DXY Index* | 0.50% | 3.78% | 2.03% | -0.80% | 20.67% |
| CRY Index* | 1.03% | 1.71% | 7.09% | 0.80% | -30.75% |
| EURUSD | -0.70% | -4.02% | -1.92% | 3.73% | -16.38% |
| USDJPY | -0.86% | 0.03% | -0.63% | -6.60% | 14.86% |
| Brent | -3.01% | 19.98% | 38.93% | 66.87% | -27.04% |
| Gold spot | 2.83% | -6.01% | -4.50% | 5.02% | -8.62% |

*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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