A nail in the coffin for the largest QE trade

By Jan Dehn

The rise in US company costs exposed by the latest round of results is by far the most important change in the global financial landscape in the past couple of weeks. The results show that rising costs are now directly eroding earnings in some sectors of the US economy. If sustained, cost pressures will become more pervasive and could threaten the single largest consensus trade since Quantitative Easing (QE) began in 2010, that is, to be long US equities.

Two other big 'QE trades', namely being long Dollars and being short everything in Emerging Markets (EM), already began to unwind in early 2016. While these two trades were interrupted in 2018 due to US fiscal and trade policy interventions designed to help Republicans win the upcoming midterm election, the interruptions are likely to prove temporary. After all, the US fiscal stimulus will fade and trade policies only impose more and more costs on US businesses.

Against this backdrop, we expect the Dollar to resume its decline in 2019 accompanied by stronger EM markets, but possibly now also accompanied by a worse performance for US stocks. Certainly, it will be difficult to reverse the new trend of rising costs facing US companies as long as the current policy mix is maintained. Given the heavy positioning in US stocks, asset allocators may well find themselves getting very busy soon.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.8	–	-3.27%
MSCI EM Small Cap	9.6	–	-3.99%
MSCI Frontier	10.2	–	-0.54%
MSCI Asia	10.2	–	-3.66%
Shanghai Composite	9.2	–	1.91%
Hong Kong Hang Seng	6.9	–	-1.58%
MSCI EMEA	8.1	–	-3.46%
MSCI Latam	11.4	–	-0.52%
GBI-EM-GD	6.70%	–	-0.83%
ELMI+	5.57%	–	-0.51%
EM FX spot	–	–	-0.96%
EMBI GD	6.74%	365 bps	-0.15%
EMBI GD IG	5.07%	197 bps	-0.01%
EMBI GD HY	8.67%	560 bps	-0.30%
CEMBI BD	6.29%	327 bps	0.02%
CEMBI BD IG	5.08%	206 bps	0.15%
CEMBI BD Non-IG	7.88%	485 bps	-0.15%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.0	–	-3.93%
1-3yr UST	2.83%	–	0.25%
3-5yr UST	2.94%	–	0.58%
7-10yr UST	3.11%	–	1.06%
10yr+ UST	3.34%	–	1.26%
10yr+ Germany	0.39%	–	1.32%
10yr+ Japan	0.11%	–	0.84%
US HY	6.87%	378 bps	-0.70%
European HY	4.06%	471 bps	-0.72%
Barclays Ag	2.18%	-93 bps	0.28%
VIX Index*	22.77	–	3.13%
DXY Index*	96.64	–	0.62%
EURUSD	1.1378	–	-0.75%
USDJPY	112.44	–	0.34%
CRY Index*	194.05	–	-3.20%
Brent	77.1	–	-3.39%
Gold spot	1230	–	0.68%

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

Emerging Markets

A turning point for US equities?

It has not escaped anyone's attention that of late US equity markets have displayed violent and, for the standards of the last 5-6 years, unusual levels of volatility. Neither the causes of this volatility nor the eventual consequences are likely to be trivial.

The cause of the sudden volatility is that, for the first time in the ongoing expansion, which is now into its eighth year, there is now evidence that higher costs are eroding company earnings in segments of the US economy. This is a serious issue, because cost-related problems are difficult to fix and the current US policy mix is, if anything, pushing costs up rather than down.

Rising US company costs could, if sustained, have major consequences for global asset allocators. After all, to be long US equities was by far the largest of four 'QE trades', which emerged as global consensus trades among institutional investors following the onset of Quantitative Easing (QE) eight years ago.

In addition to going long US equities, investors also went long Dollars, long core European government bonds and short everything in EM. However, by far the biggest and most visible of the four 'QE trades' was the US equity trade. How should EM investors respond if this trade is now beginning to unravel?

Continued overleaf

Emerging Markets

Why did everyone get so long?

Investors in the US and the rest of the world are extremely long US stocks. The triggers for decision to go long equities included the deep discounts on offer following the rout in 2008/2009 as well as extreme policy stimulus in the US, including zero interest rate policy, trillions of Dollars of QE and fiscal stimulus to the tune of 40% of GDP. It was also extremely important for the expectations of economic recovery that the US government intervened early and decisively to bring US banks back to health.[1]

The combination of stimulus and bank healing provided ideal conditions for the private sector to recover. Investors correctly anticipated stronger US growth and, with a lag, rising US rates, which make ideal conditions for going long stocks and the Dollar. However, the eventual scale of these trades was mind-boggling: US stocks rallied 300% and the Dollar has rallied 35% in broad terms (and 50% against EM currencies). QE also inspired eye-watering trades on European core bonds, including German long bonds, which delivered about 80% return over the same period. Of course, EM yields alone could not compete with such enormous capital gains, so institutional investors pulled about a third of their money out of EM between 2010-2015 in order to chase capital gains in the QE sponsored developed countries. This is how shorting EM became one of the four 'QE trades'.

The point of rehashing this little piece of financial history is that the QE trades remain largely in place to this day. The US equity trade was not only the largest of the four 'QE trades', but it has also proven to be the most resilient. Hence, if rising costs are now posing a threat to future returns in the US equity market then investors really need to sit up and pay attention.

Two other QE trades had already began to unwind in 2016 and 2017

If long positions in US stocks are about to be unwound, it would only be consistent with what has been happing in two other 'QE trades' over the past couple of years. Investors already began to unwind long Dollar and short EM trades starting in early 2016. The Dollar fell against EM currencies in both 2016 and 2017. EM local bonds made 25% and EM equities nearly 50% in USD terms over the same period. In 2017 alone, the Dollar was down 14% against EUR.

Granted, the unwinding of Dollar longs and EM shorts reversed course in 2018, but this will prove a temporary interruption. The Dollar has only been able to claw back territory this year due to an extraordinary fiscal stimulus and a protectionist onslaught designed to support Republicans in the upcoming mid-term election. As the fiscal stimulus fades and tariffs are priced in, the Dollar rally cannot be sustained, so we fully expect the EM rally and the Dollar decline to resume in 2019. The really intriguing prospect for 2019 is that the resumption of these trades may now be accompanied by the unwinding of the US equity 'QE trade'.

Rising costs

If US equities struggle to perform in 2019, it will most likely be due to rising cost pressures for US companies.[2]

Why are costs rising? Obviously, the attainment of full employment is part of the answer, but wage pressures are not what they used to be due to globalisation, which has enabled American companies to source cheaper inputs overseas, either by importing or by outsourcing.

This is why, at the margin, US government policies are now playing a leading role in the sudden emergence of cost pressures. Today, all aspects of US government policy contribute to pushing up costs for US companies, including trade policies, fiscal policies and monetary policies. We now explore the reasons why.

Policy culprit Number One

Trade policies obviously contribute to higher company costs. China's unit costs are far lower than those in the US, so the imposition of tariffs on imports of final and intermediate goods from China directly raises costs for US companies. The same is true for tariffs on steel and aluminium.

Additionally, tariffs impose two types of indirect costs on companies. First, they push up the Dollar, which hurts US exporters and secondly they make it uneconomical to outsource production, which hurts all companies, not just exporters. The reason why tariffs impede outsourcing is that re-imported intermediate goods are subject to taxes. Hence, tariffs force US companies to source inputs at home, which are not only more expensive in absolute terms, but also more expensive at this late stage due to lack of spare capacity. In other words, sourcing at home pushes up costs with no offsetting compensation in the form of higher productivity.

[1] Dual policy interventions at the height of the crisis by then Treasury Secretary Hank Paulson and then Federal Reserve Chairman Ben Bernanke to shore up US banks were critical to the subsequent bullish narrative for US stocks. Hank Paulson pushed a massive bank recapitalisation through Congress and Ben Bernanke lifted all the rotten mortgages off the balance sheets of US banks and placed them on the Fed's balance sheet

[2] Ashmore pointed to the risk of higher US costs in a recent publication. See *'From protectionism to inflation'*, Weekly investor research, 24 September 2018.

Continued overleaf

Emerging Markets

Policy culprit Number Two

Fiscal policy is also hurting US companies. Granted, the recently approved unfunded tax cut lowered the tax burden of companies and boosted consumer demand. However, from an economic perspective the timing of the tax cut was horrendous. Significantly boosting aggregate demand at a time when the economy is already at full capacity only leaves one lasting legacy: greater business cycle instability, not sustained higher growth. The Q3 2018 real GDP growth print of 3.5% qoq saar is already a step down from the growth rate of 4.2% qoq saar in Q2 2018 and the consensus is for the US economy to grow with a 2% handle in 2019 and a 1% handle in 2020.

Loose fiscal policy also hurts business in other ways. One is crowding out. The increase in supply of government bonds following the tax cut will soak up capital to the tune of several percentage points of GDP over the coming years. This implies a transfer of resources from the very productive US private sector to the very unproductive US public sector, which clearly undermines overall US productivity.

Finally, the debt burden is now rising very fast, which is well-known to be bad for companies' willingness to make long-term investments. The US government's total debt load has increased by more than 40% of GDP since 2008 and is currently north of 105% of GDP. The debt to GDP ratio is only likely to rise in the coming years, especially if the economy slows, which now seems consensus. The reason higher debt hurts investment is that it implies for companies one, or a combination of higher future taxes, default, higher future inflation and/or currency devaluation.

Policy culprit Number Three

US monetary policy is obviously contributing directly to higher rates via the policy interest rate, but also increasingly via higher term yields. The Fed is not only raising the Fed funds rate, but also reducing its stock of bonds, i.e. the Fed is tightening quantitatively. Between these two policies, the total tightening so far has amounted to about 400bps in rate-equivalent terms. The typical range for rates over the cycle in the last 50 years is about 500bps. Of course, the real Fed funds rate is still very low (negative in real terms, in fact) and the pace of quantitative tightening is only going to accelerate over the next few years. Hence, the really worrying thing about the current state of affairs is that US companies are already smarting at such low levels of absolute real rates. This testifies to deeper problems of low productivity, high levels of debt and the myriad of other cost burdens imposed on US businesses for the reasons mentioned in previous two sections.

Change is afoot for global asset allocators

Given the direction of policies, cost pressures on US companies are likely to increase further in the coming years. Barring a productivity miracle, the stock market could therefore find it increasingly difficult to match the impressive returns since the onset of QE. At issue here is obviously not the usual short-term knee-jerk reaction in markets to bad news. The far more serious implication of rising costs and disappointing earnings is that so much money is still parked in US stocks. Since the US equity 'QE trade' was emphatically a bull market trade, which was explicitly predicated on expectations of higher growth and rising rates, it follows that if stocks soften then growth may well slow and then rates will have to come down too. In other words, much of the capital parked in US stocks is predicated on strong growth and rising rates may now find itself in the wrong place and so could leave. So, there could be large and more protracted changes coming for global asset allocators.

EM a flow winner as the 'QE trades' unwind

Simply put, the unwinding of the US equity 'QE trade' is inevitable and part of a broader normalisation in global markets as the era of extra-ordinary stimulus comes to an end. Our base case is that unwinding of the 'QE trades' is likely to drive global asset allocation well into the medium term, with the occasional and inevitable interruptions along the way, such as we have seen this year.

Based on our estimates, EM will be the big winner as the 'QE trades' unwind. This is because EM was the only market to experience major outflows during the height of QE. Hence, as QE reverses, we expect developed markets to experience outflows and EM to experience inflows.

EM also offers better valuations

Needless to say, the distortions in global asset allocation triggered by QE also affected valuations. This means that allocating back to EM as the 'QE trades' unwind will also be profitable compared to keeping money in developed countries. Consider the current level of distortion in EM FX and bond markets. After declining by 50% during the QE period, EM currencies are now about 20% cheaper to the Dollar based on real exchange rates, productivity and expected relative growth rates. Hence, EM FX should be able to claw

Continued overleaf

Ashmore

Emerging Markets

back 20% over the next five years without in any way jeopardising real yields or macroeconomic balances. Similarly, EM bonds currently price in a terminal Fed funds rate of 520bps compared to about 350bps in the US Treasury market and just 70bps in the German bond market. This is clearly nonsensical and suggests solid returns for EM bonds in the coming years (and much pain in German bonds).

Taking both FX and yields into consideration, we expect EM local currency bonds to deliver an average of about 10% return in Dollars per year over the next five years, while sovereign and corporate Dollar bonds should deliver about 30% and 25% return over the five years, respectively. The difference in returns between local and hard currency boils down to FX.

Step away from the crowd

Clearly, most investors still regard EM as a peripheral investment destination, which means that the bulk of flows as the 'QE trades' unwind may take place between European and US assets. However, we do not see how European or US assets can compete with EM assets in terms of risk-adjusted returns over the coming years. Hence, the road less travelled – out of the QE-sponsored markets and into the non-QE markets, i.e. EM – may well turn out to be the road more richly rewarded.

- Brazil: As expected, Jair Bolsonaro won the second round of the presidential election. He will take office in January 2019. Attention will now shift to the composition of his administration, his policy preferences and prospects for forming a working coalition in the parliament. A close ally indicated last week that Bolsonaro would replace all heads of state-owned enterprises. This could be part of a broader program of increasing the role of the private sector in Brazil. However, the single most important issue from a market perspective is the pension reform. If, as we expect, the pension reform is passed early in Bolsonaro's presidency, this should pave the way for a sustained cyclical upswing in the Brazilian economy. In other news, the electricity sector regulatory agency (ANEEL) has lowered electricity prices with the result that the rate of inflation on a yoy basis may fall by about 30bps to just over 4% by year-end. Credit growth continued to expand in September, which is consistent with the cyclical upswing underway in Brazil. The current account surplus was USD 32m in September compared to USD 423m in the same month of last year. The trade surplus was USD 4.56bn compared to USD 4.92bn last September. The yoy rate of headline inflation increased to 4.53% in October from 4.28% in September.

- Mexico: The trade deficit was much smaller than expected in September (USD 194m versus USD 1.9bn expected). The better number was due to a combination of lower imports and stronger exports. Inflation in the first half of October was lower than expected at 0.4% mom, which is equivalent to a yoy rate of 4.94%, down from 5.17% in H2 September. Unemployment was unchanged at 3.6% in September. The monthly indicator of economic activity pointed to 1.7% yoy real GDP growth in August, down from 3.3% yoy growth in July. In political news, Mexicans voted in favour of cancelling a USD 13bn new airport project already under construction. The cancellation of the project will be costly for the government and the vote has been viewed by some market participants as an exercise in populism. However, the airport was a signature project for the last administration and we do not expect new government to support similar votes on its own projects.

- Argentina: The real economy contracted at a rate of 1.6% yoy in August. This was marginally better than expected. On a seasonally adjusted basis, output actually expanded 1.3% in the month. The trade balance swung back into surplus in September (USD 314m compared to a deficit of USD 698m in the same month of last year). The IMF Board formally approved a revised USD 56.3bn credit line for Argentina.

- South Africa: The medium term budget statement implies an increase in the fiscal deficit to 4.2% of GDP over the next three years from 4.0% of GDP this year. This increase was higher than expected, but is likely to be adjusted after next year, which is an election year. CPI inflation in September was 4.9% yoy, unchanged from August.

- China: Industrial profits and revenues declined in September compared to August. The government responded with a 1% of GDP tax cut starting in January 2019 and a strongly worded statement from President Xi Jinping that the government will be "unwavering" in its support for private business development.

- Sri Lanka: The Sri Lankan government has been plunged into a constitutional crisis after the President Maithripala Sirisena sacked his prime minister Ranil Wickremesinghe and appointed a former president, Mahinda Rajapaksa, as his replacement. It is unclear if the Sirisena has powers to replace his prime minister. Rajapaksa is associated with economic populism.

- Ukraine: The National Bank of Ukraine left the policy rate unchanged at 18%. IMF approved a new stand-by program with the government, which should see USD 3.9bn disbursed to Ukraine provided that the 2019 Budget is consistent with program requirements.

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Ashmore

Emerging Markets

Snippets:

- **Colombia:** The central bank kept the policy rate unchanged at 4.25%.
- **Indonesia:** Bank Indonesia kept the policy rate unchanged at 5.75%.
- **Malaysia:** Inflation was just 0.3% yoy in September versus 0.6% yoy expected.
- **Russia:** The central bank maintained the policy rate at 7.5%.
- **Singapore:** The rate of CPI inflation was unchanged at 0.7% yoy in September.
- **South Korea:** Real GDP growth was 0.6% qoq saar in Q3 2018, unchanged from Q2 2018.
- **Taiwan:** Industrial production rose 2.2% mom (1.5% yoy) in September (versus 1.1% yoy in August.
- **Turkey:** The central bank left the policy rate unchanged at 24.0%.

Global backdrop

The US Q3 2018 GDP growth rate was 3.5% qoq saar versus 3.3% qoq saar expected. However, the boost to consumption, which was the reason for the stronger than expected print, is unlikely to be sustained, because it was caused by a temporary tax cut. Worryingly, all segments of investment spending declined, which bodes poorly for future growth. The Beige Book highlighted rising labour costs. Taken together, the data is consistent with the current populistic policy mix in the US. Pending home sales recovered a bit (+0.5% mom) from the big drop (-1.9% mom) in August, but new home sales collapsed by 5.5% mom in September, while August sales were also revised down sharply (from +3.5% to -3.0%, both mom). Housing is a good leading indicator of the business cycle.

In Europe, the composite PMI declined 1.4 points in October to 52.7, which may be due to the testing of a new emissions scheme for German and French cars. Other data was more supportive, including higher consumer confidence and strong bank lending. The election in Hesse was a repeat of the recent Bavarian election in that it led to heavy losses for Merkel's Christian Democratic Union (CDU) and the Social Democrats, with the Greens emerging as the big winners.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-10.27%	-10.27%	-16.99%	-12.88%	5.52%	0.95%
MSCI EM Small Cap	-11.13%	-11.13%	-21.93%	-17.32%	0.96%	-0.27%
MSCI Frontier	-4.05%	-4.05%	-16.18%	-13.33%	2.90%	1.55%
MSCI Asia	-12.44%	-12.44%	-17.83%	-13.98%	5.12%	3.47%
Shanghai Composite	-7.88%	-7.88%	-19.51%	-21.88%	-6.83%	6.41%
Hong Kong Hang Seng	-8.69%	-8.69%	-10.58%	-8.53%	1.86%	3.69%
MSCI EMEA	-8.68%	-8.68%	-19.66%	-10.09%	1.01%	-4.71%
MSCI Latam	4.36%	4.36%	-2.61%	-2.95%	12.67%	-2.05%
GBI EM GD	-1.09%	-1.09%	-9.15%	-5.84%	3.09%	-2.78%
ELMI+	-0.66%	-0.66%	-5.11%	-2.73%	2.13%	-1.62%
EM FX Spot	-1.17%	-1.17%	-9.43%	-7.69%	-2.64%	-7.91%
EMBI GD	-1.68%	-1.68%	-4.67%	-3.38%	4.36%	4.40%
EMBI GD IG	-1.79%	-1.79%	-3.53%	-2.33%	3.29%	3.67%
EMBI GD HY	-1.56%	-1.56%	-5.92%	-4.56%	5.54%	5.11%
CEMBI BD	-0.33%	-0.33%	-1.93%	-1.47%	4.43%	4.26%
CEMBI BD IG	-0.36%	-0.36%	-1.34%	-0.97%	3.04%	3.68%
CEMBI BD Non-IG	-0.30%	-0.30%	-2.61%	-2.03%	6.69%	5.03%

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Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-8.67%	-8.67%	0.98%	5.84%	10.92%	10.84%
1-3yr UST	0.23%	0.23%	0.47%	0.32%	0.42%	0.59%
3-5yr UST	0.35%	0.35%	-0.56%	-0.77%	0.23%	0.94%
7-10yr UST	0.20%	0.20%	-2.55%	-2.03%	-0.20%	1.57%
10yr+ UST	-1.64%	-1.64%	-7.34%	-3.63%	-0.04%	3.64%
10yr+ Germany	1.69%	1.69%	4.52%	5.23%	2.73%	6.85%
10yr+ Japan	0.45%	0.45%	-0.24%	0.60%	3.31%	3.91%
US HY	-1.64%	-1.64%	0.89%	0.93%	6.55%	4.72%
European HY	-1.34%	-1.34%	-1.29%	-1.43%	4.27%	4.87%
Barclays Ag	-0.51%	-0.51%	-2.87%	-1.10%	1.66%	0.35%
VIX Index*	87.87%	87.87%	106.25%	132.35%	55.85%	69.80%
DXY Index*	1.58%	1.58%	4.90%	1.81%	-0.67%	21.39%
CRY Index*	-0.57%	-0.57%	0.10%	3.83%	-0.06%	-30.85%
EURUSD	-1.95%	-1.95%	-5.22%	-2.34%	3.65%	-17.22%
USDJPY	1.12%	1.12%	0.22%	0.66%	7.73%	-12.67%
Brent	-6.77%	-6.77%	15.33%	27.60%	58.03%	-29.25%
Gold spot	3.32%	3.32%	-5.55%	-3.59%	7.37%	-8.52%

*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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