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Free trade flourishes without US and China

By Jan Dehn

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) trade deal is expected to launch on 30 December, which shows that other countries around the Pacific Rim believe in free trade even as protectionism flourishes elsewhere. In other news, Sergio Moro becomes Justice Minister in Brazil, Xi re-emphasises the importance of the private sector in China, and PDVSA pays the 2020 bond. Colombia puts forward tax reform, Turkey's external balances improve, Goods & Services Tax collections hit INR 1trn in India, South Africa shifts focus to state-owned enterprise reform, Russia moves ahead of Switzerland, Netherlands and France in the World Bank 'Doing Business' rankings.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	6.09%
MSCI EM Small Cap	10.1	–	4.69%
MSCI Frontier	10.6	–	2.62%
MSCI Asia	11.1	–	6.71%
Shanghai Composite	9.7	–	2.99%
Hong Kong Hang Seng	7.3	–	6.25%
MSCI EMEA	8.7	–	6.30%
MSCI Latam	11.6	–	1.41%
GBI-EM-GD	6.69%	–	0.66%
ELMI+	5.07%	–	0.65%
EM FX spot	–	–	0.36%
EMBI GD	6.78%	355 bps	-0.14%
EMBI GD IG	5.13%	189 bps	-0.44%
EMBI GD HY	8.66%	545 bps	0.17%
CEMBI BD	6.33%	317 bps	-0.13%
CEMBI BD IG	5.17%	201 bps	-0.38%
CEMBI BD Non-IG	7.90%	474 bps	0.21%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.2	–	2.45%
1-3yr UST	2.90%	–	-0.14%
3-5yr UST	3.03%	–	-0.43%
7-10yr UST	3.21%	–	-0.96%
10yr+ UST	3.45%	–	-2.25%
10yr+ Germany	0.44%	–	-1.35%
10yr+ Japan	0.13%	–	-0.31%
US HY	6.83%	363 bps	0.22%
European HY	3.88%	455 bps	0.52%
Barclays Ag	2.25%	-96 bps	-0.57%
VIX Index*	19.51	–	-4.65%
DXY Index*	96.46	–	-0.12%
EURUSD	1.1393	–	0.18%
USDJPY	113.29	–	0.81%
CRY Index*	192.30	–	-3.20%
Brent	72.7	–	-6.00%
Gold spot	1232	–	0.18%

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

Emerging Markets

- **Trade:** The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) trade deal takes effect on 30 December. The trade pact slashes 95% of existing tariffs between participating countries, which include Canada, Japan, Mexico, New Zealand and Singapore with Brunei, Chile, Malaysia, Peru and Vietnam joining at later stages. Together, these countries account for 13% of global trade and nearly 500m consumers. China and United States are not part of this trade agreement and along with South Korea, Taiwan and Thailand could experience some trade diversion as the CPTPP takes effect. The launch of CPTPP illustrates that while US and China remain locked in their own trade war, most other countries around the Pacific Rim continue to believe in the obvious merits of free trade.
- **Brazil:** Judge Sergio Moro has accepted the job of Justice Minister in the new government of President-elect Jair Bolsonaro. This is extremely positive news. Moro led the intelligent anti-corruption campaign known as 'carwash', which culminated with the imprisonment of former President Lula. Moro's appointment is reassuring for two reasons. First, anti-corruption efforts now look likely to continue. Second, Moro will insist on the application of the rule of law, which will reassure those who have concerns about Bolsonaro's commitment to democratic principles. Bolsonaro gave an interview last week, where he said that his focus is Brazil's fiscal problems and that he would like to see the pension reform approved this year. There was already good fiscal news in September, when the 12-months running primary fiscal deficit declined to BRL 88bn versus BRL 159bn expected. Industrial production expanded at yoy rate of 2.3% after business day adjustment. Business confidence inched higher to 59.8 in October from 59.3 in September and gross debt levels declined marginally. The unemployment rate was unchanged in September at 11.9%. The central bank left the policy rate unchanged at 6.5%.

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Emerging Markets

- China: In speeches delivered to two separate audiences, President Xi Jinping announced a six-point program to support the private sector in China and reiterated China's commitment to freeing up international trade. The six-point program for private sector development includes tax cuts, easing access to finance, less red tape, equal treatment of companies with respect to deleveraging, property rights protection and better communications between government and business. Our view is that the Chinese economy is already, to all intents and purposes, private sector-led and that Xi's comments show that there the private sector's importance will only increase going forward. In his second speech at the China International Import Expo, Xi reminded everyone that Chinese consumption is on track to become the single largest growth engine in the world over the coming decades. Xi said that China expects to import about USD 30trn of goods and USD 10trn of service imports over the next 15 years, i.e. more than twice the current US GDP. In other news, the PBOC started to issue treasury bills in the Hong Kong market. This enables the central bank to manage liquidity in Hong Kong without using FX reserves. The Caixin Manufacturing gauge improved slightly to 50.1 in October from 50.0 in September, while official PMI moderated to 50.2 from 50.8. Caixin services PMI dropped to 50.8 in October from 53.1 in September.
- Venezuela: The government paid both coupon and principal amortisation in full on the PDVSA 2020 bonds. The value of the collateral backing the bonds now exceeds the value of the bonds outstanding. The bond prices has rallied from around 80 in early September to 94 as of Friday last week. In other news, the US government announced new sanctions against individuals in the gold sector, who are engaged in corrupt practices. The US government has so far shied away from targeting the oil sector for fear that sanctions will hurt US interests. We believe that sanctions will be ineffective unless they target the oil sector.
- Colombia: The government has submitted to Congress a reform, which proposes a rise in VAT from 17% to 19%, while also broadening the base for the tax. The reform should raise about 1.3% of GDP in new revenues next year.
- India: Collection of taxes from the recently introduced Goods & Services Tax exceeded INR 1trn for the first time. Over the next few weeks, there will be elections in the states of Chattisgah, Rajastan and Madhya Pradesh. These will be an important test of the level of support for the Modi Administration ahead of next year's general election. Manufacturing PMI increased to 53.1 in October from 52.2 in September and services PMI rose to 52.2 from 50.9 over the same period.
- South Africa: Investor sentiment improved last week as President Cyril Ramaphosa fired the Head of the Government Tax Agency, and Finance Minister Tito Mboweni hinted at serious reform in state-owned enterprises, including South African Airways and ESKOM, the national electricity generator. The trade deficit was larger than expected in September due to higher oil prices. Unemployment increased to 27.5% in Q3 2018 from 27.2% in Q2 2018. The fiscal balance swung to a surplus of ZAR 3.4bn in September from a deficit of ZAR 7.9bn in August.
- Russia: Russia now ranks 31st in the World Bank's Doing Business rankings, up four places over the last 12 months. Russia is moving up the rankings due to reductions in red tape for cross-border trade.[1] New Zealand, Singapore and Denmark rank top three, US ranks number nine, UK number ten. Notable countries with worse business rankings than Russia include France (32), Czech Republic (35), Netherlands (36), Switzerland (38), Japan (39) and Chile (56). Meanwhile, the manufacturing PMI increased to 51.3 in October from 50 in September. The consensus expectation was that PMI would only rise to 50.3. Russia sanctioned 322 Ukrainian individuals and 68 businesses.
- Turkey: Turkey's external balances are rapidly responding to monetary tightening and Lira depreciation. Preliminary data shows that the trade deficit in October was just USD 529m, down from USD 1.87bn in September following a 13% yoy increase in exports and a 23.5% yoy collapse in imports. Core inflation was 24.1% yoy in October, which shows that Turkey still faces challenges in bringing about macroeconomic stability, which in turn means that growth will likely slow further. In a bid to soften the economic blow, the government cut VAT on houses, white goods, cars and furniture. In a good piece of news, the US removed two ministers from the sanctions list.
- Mexico: Ratings agencies Moody's and Fitch joined the ranks of speculators by issuing negative reports on the outlook for Mexico on the back of the government's decision to stop a much delayed and over-budget airport project. This is an over-reaction, in our view. The airport project became heavily politicised during the election campaign. President Andres Manuel Lopez Obrador (AMLO) immediately attempted to wash his hands of the issue by holding a referendum and made sure he did not take sides. In our opinion, it is an economically unwise decision to halt the project at this stage due to the sunk cost, but it is equally wrong to draw interference to broader macroeconomic policies under AMLO based on this one observation. Our view is that AMLO knows that he cannot begin his administration with an economic crisis. The real risk, in our view, is that corruption will gradually begin to infest his administration as it has done in many other left-wing

[1] The World Bank's criteria for ranking business friendliness include: Starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency.

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Emerging Markets

governments in Latin America. Manufacturing PMI was unchanged at 51.6 in October, while remittances from Mexicans working overseas were roughly stable at USD 2.7bn. Real credit growth slowed to a yoy rate of 5.9% in September from 7.8% yoy in June. Real GDP growth was 0.9% qoq saar in Q3 2018 versus 0.5% qoq saar expected.

- Malaysia: The government's own fiscal deficit projection for 2018 has been revised up to 3.7% of GDP this year and 3.4% of GDP next year before declining to 2.8% of GDP by 2021. This is due to two changes. First, the government has brought a great deal of off-budget spending into the official budget numbers. Second, the government has cancelled GST, a sales tax. In other news, the trade balance was much stronger than expected (MYR 15.3bn versus MYR 6.7bn expected).

Snippets:

- Argentina: Multilateral donors granted loans totalling USD 1.85bn to Argentina in the wake of IMF's approval of the new standby program.
- Bahrain: FX reserves declined 24% in the month of September to USD 1.45bn due to government borrowing.
- Chile: The rate of unemployment declined to 7.1% in Q3 2018 from 7.3% yoy in Q2 2018. Industrial production contracted at a yoy rate of 0.8% in September.
- Czech Republic: The Czech National Bank increased the policy rate by 25bps to 1.75%.
- Ecuador: The 2019 Budget was presented to parliament; the budget keeps Ecuador on track for fiscal consolidation.
- Indonesia: Inflation remained well within the ceiling of the central bank's target range of 4.00%. October's yoy inflation rate was 3.16% yoy, while the rate of core inflation was 2.94% yoy. The economy expanded at a solid 5.2% yoy rate in Q3 2018.
- Kazakhstan: The rate of headline CPI declined from 6.1% yoy in September to 5.3% yoy in October.
- Peru: At 1.84% yoy, the rate of CPI inflation in October remained comfortable below the central bank's target of 2.00%.
- Philippines: The government has eased restrictions on foreign ownership of equities in construction and communications.
- Poland: The rate of CPI inflation declined to 1.7% yoy in October from 1.9% yoy in September.
- Saudi Arabia: The Q2 2018 budget deficit shrank sharply to SAR 7bn in Q3 2018 from SAR 49bn from Q3 2017.
- South Korea: Exports surged at a high yoy rate of 22.7% in October, well ahead of expectations (18.%% yoy), but industrial production was weaker than expected (-8.4% yoy versus -5.1% yoy expected).
- Sri Lanka: Parliament will convene today to reveal if President Maithripala Sirisena has support in favour of his decision to sack his prime minister.
- Taiwan: Q3 2018 real GDP growth was 2.3% yoy, down from 3.3% yoy growth in Q2 2018.
- Thailand: The rate of CPI inflation declined to 1.23% yoy in October from 1.33% yoy in September. Consumption growth was 4.4% yoy in September.

Global backdrop

The US Federal Reserve has approved looser lending rules for mid-sized to large banks in the US. Banks with assets from USD 100bn to USD 250bn and regional banks will no longer have to adhere to liquidity coverage ratios (i.e. hold liquid assets). Looser financial sector regulations can extend cycles, but often at a cost when it happens late in economic expansions.

The US mid-term election tomorrow will be the focus of global markets in the early part of this week. The US government has issued conflicting messages regarding its intentions with respect to trade with China. The key change after the mid-term election is that the political focus shifts to the 2020 election. Given the mature stage of the US business cycle expansion (see next paragraph), the main challenge may be how to keep growth alive for another two years. This consideration ought to result in better economic policies, especially on trade, which is already hurting American companies by pushing up costs.

A slew of data releases point to the fact that the US business cycle expansion is becoming mature: US productivity growth slowed to 2.2% qoq saar in Q3 2018 from 3.0% qoq saar in Q2 2018, while the

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Global backdrop

employment cost index hit a new cycle high of 2.8% yoy. Hence, last year's tax cut does not appear to have had a lasting impact on productivity. Morgan Stanley's indicator of capital spending plans by US companies also declined in October in a continuation of a downwards trend, which has been in place all year. The US trade deficit widened and ISM manufacturing activity was a disappointment (57.7 vs 59.0 expected), while IMS prices paid increased sharply (71.6 versus 66.9 last). Durable goods spending also slowed relative to expectations and while payrolls recovered from hurricanes and the unemployment rate remained very low at 3.7% (it is a known fact that labour market indicators are lagging indicators). Construction spending was flat in September, down from +0.8% in August and the moderation of house prices continued in August (5.49% yoy from a peak of 6.76% in March). The slowdown in house price appreciation shows that slower new home sales are not due to supply constraints, rather the slowdown is caused by weaker demand (otherwise prices would have accelerated).

Finally, new US sanctions against Iran take effect today. Iran will still be able to export oil due to special arrangements for large importers, including China, Turkey and others. Europe is opposed to the US withdrawal from the Iran nuclear accord, which it rightly sees as politically motivated. The current US Administration has withdrawn from numerous international agreements and applied sanctions to or entered into diplomatic quarrels with holders of 42% of the world's FX reserves, i.e. countries, which finance the US twin deficits. While Iran is not in this list (Iran does not transact in Dollars), US unilateralism gradually undermines the reserve currency status of the Dollar, but it is unclear if the current US Administration fully grasps the consequences.

Euro area GDP growth slowed to 0.6% qoq saar. The slowdown in growth contrasts with strong business and consumer sentiment as well as improving labour market indicators. The likely reason for the low print is a temporary hit to German car production associated with the introduction of a new emissions testing regime. German Chancellor Angela Merkel announced her intention to step down in 2021. Merkel has been an anchor of stability in the European Union since 2005.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	4.27%	-4.80%	-11.90%	-9.13%	8.35%	2.13%
MSCI EM Small Cap	4.00%	-6.96%	-18.26%	-14.15%	3.15%	0.86%
MSCI Frontier	2.07%	-1.54%	-13.98%	-10.15%	3.54%	1.98%
MSCI Asia	4.80%	-6.57%	-12.28%	-10.03%	8.31%	4.61%
Shanghai Composite	2.83%	-5.12%	-17.10%	-18.97%	-4.94%	6.87%
Hong Kong Hang Seng	5.42%	-2.98%	-4.99%	-4.08%	5.63%	3.96%
MSCI EMEA	4.08%	-2.93%	-14.60%	-6.39%	3.47%	-3.11%
MSCI Latam	2.29%	5.83%	-1.24%	0.54%	13.92%	-1.55%
GBI EM GD	1.55%	-0.44%	-8.55%	-5.35%	3.38%	-2.04%
ELMI+	1.14%	-0.02%	-4.50%	-2.27%	2.45%	-1.27%
EM FX Spot	1.10%	-0.81%	-9.11%	-7.27%	-2.47%	-7.46%
EMBI GD	0.35%	-1.81%	-4.80%	-4.37%	4.40%	4.50%
EMBI GD IG	0.06%	-2.22%	-3.96%	-3.34%	3.31%	3.73%
EMBI GD HY	0.65%	-1.39%	-5.75%	-5.50%	5.57%	5.23%
CEMBI BD	0.14%	-0.46%	-2.06%	-1.78%	4.42%	4.25%
CEMBI BD IG	-0.04%	-0.74%	-1.72%	-1.54%	2.99%	3.64%
CEMBI BD Non-IG	0.37%	-0.09%	-2.40%	-2.01%	6.73%	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	0.43%	-6.44%	3.45%	7.59%	11.22%	11.35%
1-3yr UST	-0.05%	0.09%	0.34%	0.14%	0.44%	0.56%
3-5yr UST	-0.17%	-0.08%	-0.99%	-1.45%	0.26%	0.87%
7-10yr UST	-0.40%	-0.76%	-3.48%	-3.76%	-0.24%	1.53%
10yr+ UST	-0.84%	-3.86%	-9.43%	-7.95%	-0.41%	3.45%
10yr+ Germany	-0.78%	0.32%	3.11%	2.70%	2.49%	6.46%
10yr+ Japan	-0.09%	0.14%	-0.55%	0.05%	3.18%	3.81%
US HY	0.18%	-1.42%	1.11%	1.17%	6.60%	4.71%
European HY	0.34%	-0.83%	-0.78%	-1.43%	4.32%	4.85%
Barclays Ag	0.04%	-1.08%	-3.42%	-2.11%	1.59%	0.45%
VIX Index*	-8.10%	60.97%	76.72%	113.46%	29.63%	47.02%
DXY Index*	-0.69%	1.39%	4.71%	1.60%	-1.51%	19.52%
CRY Index*	0.70%	-1.46%	-0.81%	1.54%	-0.07%	-29.57%
EURUSD	0.72%	-1.82%	-5.10%	-1.87%	4.68%	-15.44%
USDJPY	0.31%	-0.36%	0.53%	-0.37%	-6.95%	15.02%
Brent	-3.67%	-12.11%	8.72%	17.13%	51.52%	-30.98%
Gold spot	1.39%	3.28%	-5.48%	-3.94%	11.57%	-6.12%

*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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