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WEEKLY INVESTOR RESEARCH

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Crime and punishment

By Jan Dehn

It is not a coincidence that Fed Chairman Powell and President Donald Trump both U-turned on key policy positions last week. They are responding to mounting evidence that the US economy is slowing. The slowdown is largely attributable to their own policy mistakes, which they are now belatedly trying to remedy. Crime and punishment. What do the U-turns mean for EM?

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	2.65%
MSCI EM Small Cap	10.4	–	2.53%
MSCI Frontier	10.3	–	1.09%
MSCI Asia	11.2	–	2.92%
Shanghai Composite	9.7	–	0.34%
Hong Kong Hang Seng	7.6	–	2.24%
MSCI EMEA	8.7	–	0.91%
MSCI Latam	11.4	–	1.69%
GBI-EM-GD	6.62%	–	0.21%
ELMI+	5.21%	–	0.30%
EM FX spot	–	–	-0.07%
EMBI GD	6.98%	396 bps	0.50%
EMBI GD IG	5.20%	216 bps	0.46%
EMBI GD HY	9.06%	606 bps	0.55%
CEMBI BD	6.42%	347 bps	0.01%
CEMBI BD IG	5.22%	227 bps	0.08%
CEMBI BD Non-IG	8.08%	513 bps	-0.09%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.5	–	4.91%
1-3yr UST	2.84%	–	0.06%
3-5yr UST	2.88%	–	0.14%
7-10yr UST	3.05%	–	0.41%
10yr+ UST	3.33%	–	0.09%
10yr+ Germany	0.34%	–	0.22%
10yr+ Japan	0.08%	–	0.25%
US HY	7.22%	418 bps	0.44%
European HY	4.69%	540 bps	-0.38%
Barclays Ag	2.19%	-86 bps	-0.02%
VIX Index*	18.07	–	-3.45%
DXY Index*	96.78	–	-0.29%
EURUSD	1.1373	–	0.40%
USDJPY	113.50	–	-0.08%
CRY Index*	181.74	–	2.14%
Brent	62.1	–	2.70%
Gold spot	1231	–	0.67%

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

Emerging Markets

Fed Chairman Jay Powell turned dovish and US President Donald Trump retreated from his threat of additional tariffs against China in the very same week. This is no coincidence. Both policy U-turns have the same underlying cause, namely that the US economy is weakening. The ongoing slowing of the US economy is due in large measure to Powell and Trump's policy mistakes, in our view. Crime and punishment. Having made mistakes, both men are now trying to patch things up before they get completely out of hand.

There is no doubt that the US economy is now experiencing late cycle blues. Housing is falling, costs are eating into company earnings and stocks are not doing very well. Worryingly, initial claims for unemployment benefit, which is widely regarded as one of the very best coincidental indictors of the business cycle, are now rising. The speed of the economy has halved in the last six months. Growth was a 4.2% handle in Q2, then assumed a 3% handle in Q3 and now tracks just a 2% handle in Q4. Perhaps too optimistic, market economists expect growth only to fall to a 1% handle by 2020.

The slowdown unfolding in the north American economy can be attributed to three serious policy errors committed over the last couple of years. The first policy mistake was the badly designed and poorly timed Trump tax cut of 2017. Ask yourself this question: where has all that supposed growth-enhancement from the tax cut gone? Is it too cynical to repeat that maybe the tax cut was never going to have much of an impact on growth, since it only grants relief for the wealthy with low propensities to consume and companies, which use the savings to buy back shares rather than to invest in the economy? As for timing, even a rudimentary training in economics is surely sufficient for anyone to understand that an election-related fiscal splurge – such as a major unfunded tax cut implemented at the point of full employment – is a recipe for macroeconomic instability rather than higher sustained growth.

The second, even greater, policy mistake was the very un-American decision to abandon free trade. Policy-makers dating back to David Ricardo in the 1700s have known that protectionism harms business. Tariffs, a euphemism for taxes, applied to stuff imported from particular destinations, directly increase costs for healthy companies, while keeping alive weak and inefficient businesses. In today's economy, where

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outsourcing is so widely used, tariffs also undermine efficiency and therefore competitiveness by forcing companies to abandon cost saving strategies. After all, outsourcing is just the modern day equivalent of Adam Smith's specialisation and division of labour.

The third policy mistake was the Fed's excessively hawkish statements about the economy for the past six months. The Fed should have known that the economy was in the middle of a sugar rush, not embarking on a higher trend growth path. In fairness, it is understandable that Powell wanted to exploit the temporary burst in US growth immediately after the Trump tax cut to sound hawkish, because he was new to the job and needed to establish his credibility and independence from President Donald Trump. However, to be hawkish in June only to turn dovish by December is not the steady policy-making expected of a credible central bank. Rather, this embarrassing U-turn smacks of opportunism, myopia, ineptitude, or all three. So far, Powell's Fed has contributed to instability.

Investors should be more positive about Emerging Markets (EM) after these two developments, especially easing of trade tensions.[1] Everyone is better off if the US reverts to engaging constructively with the rest of the world, moving away from its self-inflicted brink. EM investors will also relish the Fed's newly found dovishness, but mostly because it reduces the risk of major calamities in developed markets, for now at least. As for EM countries, EM bonds currently price in a terminal Fed funds rate in excess of 5%, which is about 2% higher than where the Fed is likely to stop hiking, and EM countries have been living with high real yields for years and yet have managed to grow much faster than developed economies. In short, we have not been particularly concerned about the economic impact of Fed hikes in EM for some time, but a more dovish Fed is still positive, because it reduces risks for developed countries.

Slower US growth, a more dovish Fed and a truce in Trump's trade war mean that all the factors, which pushed the Dollar higher in 2018, are now moving into reverse. After its eight-year rally predicated on a strong US recovery, the Dollar is now 20% over-valued versus EM currencies. We expect this misalignment to unwind over the next few years at a pace determined by the nature of the US economic slowdown. As far as EM currencies are concerned, this implies markets very similar to those, which prevailed over the 2003-2009 period, when EM currencies rallied 30% versus the Dollar. The single biggest difference from 2003-2009 is the backdrop of US growth. In the mid-2000s, US growth was on the up, but in the next few years US growth will likely slow. The poorer growth outlook for the US should make for a more ambiguous sentiment towards EM. On one hand, the prospect of solid returns will appeal to investors. On the other hand, their 'better prejudice' will urge them not to invest at a time of fear over growth in developed markets. The net effect of these conflicting emotions will be one of most reluctant EM rallies of all time.

Snippets:

- Argentina: The government reached agreement with the IMF on the second review of the standby agreement, meaning that the economic programme is on track. Wholesale prices inflation slowed to 3% mom, the lowest point since April. China expanded the PBOC credit line to Argentina from RMB 70bn to RMB 130bn.
- Brazil: The fiscal primary deficit contracted to 1.24% of GDP on a 12m trailing basis in October compared to 1.69% of GDP at the end of last year. Real GDP growth quadrupled in Q3 2018 to 0.8% qoq from 0.2% qoq in Q2 2018. The current account surplus was USD 329bn in October on the back of strong foreign direct investment of USD 10.4bn. Business sentiment improved.
- Chile: Manufacturing production surged at yoy rate of 9.1% in October versus 5.0% yoy expected. The rate of unemployment in October was unchanged at 7.1% in seasonally adjusted terms.
- China: The economic data mainly softened last week amidst the on-going trade dispute with the US and domestic deleveraging. Manufacturing PMI declined to 50 in November from 50.2 in October and industrial profits slowed to 3.6% yoy in October from 4.1% yoy in September. On the other hand, the Caixin manufacturing PMI increased to 50.2 in November from 50.1 in October. In other positive developments, PBOC announced that investors will be able to trade Chinese bonds via Bloomberg terminals, while the futures exchange reduced margin requirements and trading fees.
- Czech Republic: Q3 GDP growth was revised up to 0.6% from 0.4% qoq in a previous data release. PMI slowed to 51.8 in November versus 52 expected.
- India: Real GDP growth slowed to a still very strong pace of 7.1% yoy in Q3 2018 from a scintillating pace of 8.2% yoy in Q1 2018. PMI manufacturing increased to 54 in November from 53.1 in October.
- Indonesia: November's inflation rate was unchanged at 3.2% relative to October.
- Israel: Police indicated that there is sufficient evidence to charge Prime Minister Netanyahu with corruption. Bank of Israel hiked the policy rate by 15bps to 0.25%.

[1] A shift away from protectionism was always likely after the mid-term election for reasons explained here: '*The green light for EM local markets just got significantly greener*', Market Commentary, 7 November 2018.

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- **Malaysia:** As of October, the fiscal deficit ytd reached MYR 40.1bn compared to MYR 37.2bn over the same period in 2017.
- **Mexico:** The pace of real credit growth accelerated to 6.5% yoy in October from 5.9% yoy in September. The trade deficit widened to USD 12.8bn in October from USD 12.1bn in September. Retail sales were 4.1% higher in September from the same month last year.
- **Peru:** CPI inflation on yoy basis increased to 2.17% in November from 1.84% in October.
- **Poland:** The Polish economy expanded at a solid yoy rate of 5.1% in Q3 2018, while inflation slowed to 1.2% yoy (November) from 1.8% yoy (October). The fiscal deficit narrowed to 1.1% of GDP in October from 1.3% of GDP in September.
- **Russia:** The Russian central bank indicated that it intends to resume FX purchases in January, when seasonality typically favours Russia's balance of payments. The European Union is considering additional sanctions on Russia following the altercation with Ukraine in the Kerch Strait.
- **Slovenia:** Real GDP growth was 4.8% yoy in Q3 2018 on solid investment and export performance.
- **South Africa:** The PMI surprised strongly to the upside in November (49.5 versus 43.5 expected and 42.4 last).
- **South Korea:** Industrial production was 1% higher in October than in September, marginally less than expected (1.1% mom). Exports were up 4.5% yoy in November, which was slower than in the previous three months (average of 7.7% yoy). The central bank hiked the benchmark policy rate by 25bps to 1.75%.
- **Taiwan:** Nikkei manufacturing PMI declined to 48.4 in November from 48.7 in October.
- **Thailand:** Consumption was 1% higher in October compared to September. CPI inflation was 0.9% yoy in November, down from 1.0% yoy in October. The central bank's target range for inflation is 1%-4%.
- **Turkey:** Prices declined 1.44% in November versus -0.29% mom expected. This lower than expected monthly print took the yoy inflation rate from 25.24% in October to 21.62% in November.
- **Ukraine:** The government imposed martial law in ten of twenty-four regions of the country bordering the Black Sea and Russia following altercation with the Russian navy in the Kerch Strait. Martial law will be in effect for thirty days during which the presidency will have greater powers.
- **Uruguay:** The public finances will look better following new legislation, which allows workers to migrate their pensions from the private to the public pension system. Due to the age structure of the Uruguayan population, this change implies higher net contributions to the public pension system.

Global backdrop

The oil price caught a late bid as Saudi Arabia and Russia agreed to cut production and Canada joined in production cuts. Markets largely ignored Qatar's withdrawal from OPEC.

Italy plunged into negative growth in Q3 2018 following a sharp decline in domestic demand, which may be related to the uncertainty triggered by the assumption of power by a populist government. Populist governments, which are now in power in the UK and US as well, typically pursue incompetent economic policies, which, though popular at first, soon leave everyone worse off.

The Bank of England (BOE) and the UK Treasury published independent studies, which both showed that if Britain leaves the European Union without a deal the result could be a major economic disaster. The two institutions predicted a drop in real GDP of 8-10%, a 30% fall in house prices, nearly a 50% decline in the prices of commercial property and a 25% fall in the Great British Pound. They also predicted unemployment to rise to 7.5%, while inflation would accelerate to 6.5%. The latter would in turn force BOE to hike rates to 5.5%. They also noted that Britain's trend growth rate would decline as the UK morphed from a net immigration country to a net emigration country.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	4.13%	-4.93%	-12.02%	-8.77%	9.85%	2.28%
MSCI EM Small Cap	5.48%	-5.63%	-17.09%	-13.97%	4.49%	1.39%
MSCI Frontier	2.17%	-1.44%	-13.89%	-11.19%	5.16%	1.64%
MSCI Asia	5.31%	-6.11%	-11.85%	-9.38%	9.68%	4.65%
Shanghai Composite	-0.55%	-8.24%	-19.83%	-20.07%	-7.10%	5.47%
Hong Kong Hang Seng	4.77%	-3.58%	-5.58%	-3.66%	7.00%	2.41%
MSCI EMEA	4.53%	-2.51%	-14.24%	-8.22%	6.33%	-2.56%
MSCI Latam	-2.18%	1.21%	-5.55%	-1.28%	13.84%	-1.79%
GBI EM GD	2.81%	0.79%	-7.42%	-5.55%	4.66%	-1.32%
ELMI+	1.68%	0.52%	-3.98%	-3.11%	3.12%	-0.97%
EM FX Spot	1.07%	-0.84%	-9.13%	-8.33%	-1.64%	-7.22%
EMBI GD	-0.42%	-2.57%	-5.54%	-4.84%	4.19%	4.61%
EMBI GD IG	0.02%	-2.26%	-4.00%	-3.66%	3.44%	4.01%
EMBI GD HY	-0.88%	-2.89%	-7.19%	-6.18%	4.98%	5.14%
CEMBI BD	-0.16%	-0.75%	-2.35%	-2.04%	4.51%	4.24%
CEMBI BD IG	-0.05%	-0.75%	-1.73%	-1.54%	3.20%	3.69%
CEMBI BD Non-IG	-0.30%	-0.76%	-3.06%	-2.59%	6.67%	4.93%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	2.04%	-4.94%	5.10%	6.26%	12.14%	11.10%
1-3yr UST	0.36%	0.50%	0.75%	0.76%	0.65%	0.62%
3-5yr UST	0.69%	0.78%	-0.13%	-0.16%	0.63%	0.99%
7-10yr UST	1.36%	0.99%	-1.78%	-1.57%	0.41%	1.95%
10yr+ UST	1.89%	-1.21%	-6.93%	-5.34%	0.61%	4.33%
10yr+ Germany	0.80%	1.91%	4.74%	3.84%	3.01%	6.77%
10yr+ Japan	0.92%	1.15%	0.45%	0.75%	3.48%	3.94%
US HY	-0.86%	-2.45%	0.06%	0.36%	7.09%	4.39%
European HY	-2.10%	-3.24%	-3.19%	-3.18%	3.30%	4.14%
Barclays Ag	0.31%	-0.81%	-3.16%	-2.82%	2.20%	0.56%
VIX Index*	0.00%	49.09%	63.68%	58.09%	-0.22%	24.19%
DXY Index*	-0.50%	1.73%	5.06%	4.19%	-0.86%	20.09%
CRY Index*	0.00%	-6.88%	-6.26%	-4.69%	-0.85%	-34.23%
EURUSD	0.47%	-1.99%	-5.26%	-4.15%	3.96%	-16.31%
USDJPY	-0.04%	-0.18%	0.72%	0.97%	-7.43%	10.71%
Brent	5.79%	-24.92%	-7.12%	-2.54%	41.67%	-44.85%
Gold spot	0.66%	3.20%	-5.56%	-3.56%	15.86%	0.59%

*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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