Pay heed to weaker developed market growth

By Jan Dehn

The weaker economic prospects in developed economies were on display last week; we explain why investors need to pay heed. South Africa's current account balance improved. China announced a 2% of GDP tax cut. Mexican inflation declined. The US government decided to tax Americans who consume Indian goods. Results are in from the first of several provincial elections in Argentina. Turkey entered recession. Loss of power in Venezuela, literally. The global backdrop section of the Weekly discusses yet another important upcoming vote on Brexit in the UK parliament, marginal improvements in European data and the widening US trade deficit.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.7	–	-1.99%
MSCI EM Small Cap	9.8	–	-0.79%
MSCI Frontier	8.4	–	0.17%
MSCI Asia	11.5	–	-2.06%
Shanghai Composite	10.1	–	-0.80%
Hong Kong Hang Seng	7.6	–	-3.04%
MSCI EMEA	8.4	–	-2.04%
MSCI Latam	11.1	–	-1.66%
GBI-EM-GD	6.25%	–	-0.97%
ELMI+	5.59%	–	-0.66%
EM FX spot	–	–	-1.22%
EMBI GD	6.25%	361 bps	-0.30%
EMBI GD IG	4.56%	189 bps	0.31%
EMBI GD HY	8.08%	547 bps	-0.87%
CEMBI BD	5.88%	333 bps	0.10%
CEMBI BD IG	4.67%	213 bps	0.36%
CEMBI BD Non-IG	7.55%	501 bps	-0.27%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.8	–	-2.12%
1-3yr UST	2.48%	–	0.22%
3-5yr UST	2.44%	–	0.52%
7-10yr UST	2.64%	–	1.08%
10yr+ UST	3.02%	–	2.19%
10yr+ Germany	0.07%	–	1.81%
10yr+ Japan	-0.04%	–	0.59%
US HY	6.74%	404 bps	-0.46%
European HY	4.60%	475 bps	-0.27%
Barclays Ag	1.91%	-73 bps	0.25%
VIX Index*	16.05	–	2.48%
DXY Index*	97.39	–	0.70%
EURUSD	1.1239	–	-0.89%
USDJPY	111.16	–	-0.52%
CRY Index*	180.67	–	-0.82%
Brent	66.0	–	0.53%
Gold spot	1297	–	0.80%

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

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The unifying theme in the three most important market-moving events last week was mounting economic weakness in developed economies. First, US payrolls disappointed severely in February, rising only by 20K, the fewest since September 2017. The most likely reason is that the US business cycle expansion is nearing its natural conclusion. The US economy is already operating at full employment, costs are catching up with earnings and the stock market has started to splutter. This macroeconomic backdrop is not conducive to continuing strong job creation. Indeed, the Atlanta Fed's GDPNow forecast is currently pointing to just 0.5% qoq AR growth in Q1 2019.[1] Second, the ECB revised down European growth prospects, offered dovish forward guidance on rates and launched a new long-term lending facility for European banks in a bid to encourage more credit to the corporate sector. The continuing weakness in the European banking sector has already inflicted enormous costs in terms of forgone European growth. For example, the US economy has grown so much that it is now nearing the end of the Fed hiking cycle, while in Europe the hiking cycle has not even begun yet. The main difference between Europe and the US is that the US bailed out its banks in 2008, while Europe never bailed out its banks due to the inadequate integration of fiscal policy within the European Union. Third, Chinese exports fell sharply, reflecting softening demand in China's main exports markets, which are affecting developed countries.

Investors should not dismiss the signals about the waning economic health in developed countries, because once the economic slowdown catches hold it will prove difficult to get growth going again. Europe's room for fiscal expansion is limited for institutional reasons, while the recently established majority by the Democrats in the House of Representatives could make it challenging to pass additional fiscal stimulus in the US. Of course, even without additional fiscal stimulus the US debt trajectory is already worrying. In a report issued last week, the Congressional Budget Office noted that the fiscal deficit will reach 4.2% of GDP this year and

[1] Seasonally adjusted annual rate as of 8 March 2019, see https://www.frbatlanta.org/cqer/research/gdpnow.aspx.

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that the US government debt to GDP ratio is on track to hit 150% by 2049. By then, interest payments on the debt will be the highest ever in US history as a share of GDP.

As for the scope for additional monetary stimulus, the negative market reaction to ECB's third Targeted longer-term refinancing operation (TLTRO) illustrates starkly the growing impotence of central bankers. While the US Fed has more room to stimulate monetarily, the potential cut in rates of 250 bps in the event of recession is unlikely to be enough. A return to asset purchases – also known as Quantitative Easing (QE) – would therefore become necessary, but QE would not have nearly the same powerful effect as last time, because the US is already operating at full capacity, while asset prices are severely overvalued.

The main problem with additional demand stimulus at this point – whether fiscal or monetary – is that governments in developed countries have already relied too heavily on both since 2008/2009. Developed economies have expended more than USD 15trn in asset purchases, pushed interest rates to historically low levels in real terms and burned through literally trillions of Dollars of fiscal stimulus. They have also shifted the regulatory goalposts to favour strongly their own bond markets. At this point, leaning further on asset purchases, rate cuts, regulatory forbearance and fiscal policy amounts to little more than pushing on a string.

The real underlying problems facing developed economies are not going to be solved with additional stimulus. Mounting debts, stagnating productivity growth, and rising inequality will not go away with lower rates or larger deficits. In fact, such policies may make the underlying problems even worse.

Sadly, there is no sign that developed economies are taking their structural challenges seriously. Indeed, the opposite seems to be happening. The US has taken the lead in abandoning free trade and pursuing nationalistic policies known to be detrimental to the economy. Populism is on the rise across Europe as well, especially in the UK and Italy. Worryingly, efforts are now underway within academic circles to find theoretical justification for doubling down on fiscal stimulus instead of dealing with the underlying structural problems. The Right recently revamped discredited Laffer Curve arguments to justify the Trump Tax cut, while the most obvious recent example from the Left is so-called Modern Monetary Theory (MMT). MMT holds that inflation is a fiscal phenomenon, wherefore the absence of high inflation today amounts to evidence that government debt levels can be pushed to much higher levels. Even orthodox left-leaning economists, such as Lawrence Summers, are now proposing big increases in deficit spending.[2] These initiatives amount to economic hocus pocus, in our view. Indeed, we believe that one of the main reasons for low inflation today is that public sector debt levels are already so high that future tax liabilities or inflation or currency debasement present serious threats to future company profitability, which is why companies chose to buy backs shares instead of investing in the real economy.

None of this would matter much if investors were not so heavily exposed in developed markets and if asset prices in these markets were not already so overvalued. However, they are and that presents risks to all investors, including investors in Emerging Markets (EM). The amazing returns in the Quantitative Easing (QE) sponsored US stock market and European bonds are not going to be replicated going forward. The combination of overvalued asset prices and deteriorating fundamentals is not entirely comfortable and is only made worse by the knowledge that there is frighteningly little policymakers can do when the inevitable economic downturn finally sets in.

In a recent publication, we highlighted the reasons for slowing 'global' growth and proposed a way for investors to protect themselves.[3] A key conclusion from this report was that slower 'global' growth is in fact a euphemism for slower developed market growth, because growth in EM countries is likely to be broadly stable over the next five years. Moreover, growth rates are likely to remain high in a very large number of EM countries going forward, which means that diversification into and across the vast EM space is likely to offer genuine protection from slower developed market growth. We estimate that EM countries already contribute about three quarters of global growth, but that this will rise to a stunning 84% of global growth within the next five years, based on IMF's most recent growth forecasts. The rising growth differential in favour of EM is likely to translate into better investment returns due to the well-known positive relationship between economic growth and investment performance.

Armed with this insight, investors should keep a close eye on precisely the kind of negative economic surprises in developed markets, which we saw last week. Such events may trigger the usual knee-jerk liquidation of EM assets by weak hands, but such selling also creates excellent opportunities for more intelligent investors to enter the EM asset class at more attractive valuations.

- South Africa: The current account deficit narrowed sharply to 2.2% of GDP in Q4 2018 from 3.5% of GDP in Q3 2018, while real GDP growth was stronger than expected in the fourth quarter (1.4% qoq saar versus 1.2% qoq saar expected). An opinion poll from IRR shows that support for the ANC has slipped marginally from 56% in December to 55% as of end-February. The main opposition DA party commands support of 22%, while 12% of potential voters support the populist EFF party. South Africa's general election is scheduled for 8 May.

[2] See https://www.washingtonpost.com/opinions/2019/03/07/risk-our-economy-secular-stagnation/?noredirect=on&utm_term=.5ee5128ca92d
[3] See *"EM versus DM growth (2019-2023): How global is 'global' growth really?"*, The Emerging View, 26 February 2019.

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- **China:** Following the announcement of a 2% of GDP corporate tax cut, the Chinese government announced a target real GDP growth rate of 6.0% - 6.5% for 2019. We expect growth to end up within this range. Meanwhile, CPI inflation eased to 1.5% yoy in February from 1.7% yoy in January, which means that the PBOC has room to ease monetary policy further, if required. As noted in the opening article of this Weekly, Chinese exports plunged due in part to the effects of US tariffs and holiday distortions, but mainly due to weaker demand in developed economies. In other news, bank lending slowed, but as this follows a large increase in January there is no reason to interpret this as a sign of renewed weakness. China's FX reserves increased by USD 2.3bn to USD 3,090.2bn in February. The Caixin services PMI moderated in February due to calendar effects.

- **Mexico:** In line with similar trends in many other EM countries, Mexican headline inflation slowed sharply to 3.94% yoy in February from 4.37% yoy in January. Investment spending also slowed in December (-6.2% yoy). This latter reflects lingering mistrust by Mexican businesses of the economic policies of President Andres Manuel Lopez Obrador (AMLO). Despite the concerns in Mexico's business sector, however, Mexican consumers appears to be very fond of AMLO, because the seasonally adjusted consumer confidence index hit a high of 119.9 in February from 113.2 in January.

- **India:** The US government has decided to tax Americans more for their consumption of Indian goods. The decision to end preferential treatment of some US imports from India under the System of Generalised Preferences (GSP) is unlikely to have a discernible impact on the Indian economy, in our view. The goods in question make up only 0.37% of the total value of US imports from India, based on 2018 data. Services PMI was 52.5 in February compared to 52.2 in January. The government has announced the schedule for the upcoming general election. Voting starts on 7 April and the result will be made public on 23 May 2019.

- **Argentina:** The incumbent governor of Neuquen Province, Omar Gutierrez, was re-elected over the weekend. This is positive news, because polls had indicated a tighter race between Gutierrez and Peronist opposition candidate Ramon Rioseco, who is backed by former President Cristina Fernandez de Kirchner. A strong showing for Kirchner's candidate would have raised concerns that Kirchner could stage a serious challenge to President Mauricio Macri in the upcoming general election scheduled for 27 October. There will be more provincial elections in April, May and June.

- **Turkey:** Turkey enters recession. GDP growth slowed to -3.0% yoy in Q4 2018 from 1.8% yoy in Q3 2018. This is the second negative consecutive growth print in qoq terms, however, so Turkey is now formally in recession. Meanwhile, the current account deficit narrowed to USD 0.81bn in January from USD 1.52bn in December and the central bank left the policy rate unchanged at 24%.

- **Venezuela:** Loss of power. Literally. Venezuela has been without electrical power since Thursday last week due to a nationwide blackout. The cause of the blackout is subject to dispute with the Maduro government blaming foreign sabotage, while opposition leader Juan Guaido says the blackout has been caused by bush fires around a key dam. Regardless, blackouts are frequent and reflect the total ineptitude of the Venezuelan government. In other news, ICSID, an arbitration body, has awarded ConocoPhillips a settlement of USD 8.75bn in respect of expropriation of the company's assets in 2007.

Snippets:

- **Argentina:** Industrial production was 4.6% higher in the month of January, while construction was 4.4% higher mom.
- **Chile:** CPI inflation declined to just 1.7% yoy in February, which is below the central bank's target range of 2%-4%. The monthly GDP proxy pointed to a rate of real expansion of the economy of 2.4% in January.
- **Colombia:** The yoy rate of headline CPI inflation declined to 3.01% in February from 3.14% yoy in January. The current account ended with a wider deficit of 3.8% of GDP in 2018 compared to 3.3% of GDP in 2017.
- **Croatia:** Industrial production surged higher in January (+4.7% yoy from -6.6% yoy in December 2018).
- **Ghana:** The fiscal deficit in 2018 was 3.9% of GDP compared to a target deficit of 4.5% of GDP agreed with the IMF. Most of the better than expected fiscal out turn was due to stronger than expected GDP growth as opposed to the government's actual fiscal effort.
- **Hungary:** The rate of CPI inflation picked up to 3.1% yoy in February from 2.7% yoy in January, mainly explained by non-core factors, such as fuel and food prices. Industrial production expanded at a yoy rate of 5.0% in January versus 3.2% yoy expected.
- **Malaysia:** The central bank left the policy rate unchanged at 3.25% in its March meeting.
- **Oman:** Moody's downgraded the sovereign credit rating to Ba1 from Baa3 with a Negative outlook.
- **Panama:** Moody's upgraded Panama's sovereign credit rating from Baa2 to Baa1 with stable outlook.
- **Peru:** Prime Minister Cesar Villanueva stepped down ahead of an expected reshuffle of cabinet members by President Martin Vizcarra. Vizcarra's approval rating is about 56%, according to a recent poll. The central bank left the policy rate unchanged at 2.75%.

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- **Philippines:** CPI inflation eased sharply to 3.8% yoy in February from 4.4% yoy in January. The market consensus expected inflation of 4.0% yoy in February. Benjamin Diokno, erstwhile fiscal policy chief, was appointed governor of the central bank. Diokno has vast experience in public policy.
- **Poland:** The central bank left the policy rate unchanged at 1.5%.
- **Romania:** Retail sales were up 1.9% in January after declining 1.0% in December.
- **Russia:** Headline CPI Inflation hit 5.2% yoy in February after recording 5.0% yoy in January. The rise in the CPI index reflects a recent hike in VAT, but inflation should soon start to decelerate in the coming months and quarters, in our view.
- **Slovakia:** The economy expanded 3.6% yoy in real terms in Q4 2018. The December print took the 2018 real GDP growth rate to a solid 4.1%. Retail sales were up 4.5% yoy in January versus 3.9% yoy expected.
- **South Korea:** CPI inflation in February was 0.5% yoy compared to 0.8% yoy in January. This is the lowest inflation print since 2016.
- **Sri Lanka:** The government announced a very ambitious programme of fiscal consolidation, which involves a 0.9% reduction in the deficit in both 2019 and 2020. This is positive news, but the news should be discounted somewhat, because Sri Lanka has a strong established record of missing fiscal targets in the past.
- **Taiwan:** Inflation remained low at 0.2% yoy in February, unchanged from January and lower than expected (0.3% yoy).

Global backdrop

How do you think Mexico would have traded if the government announced that it was unilaterally withdrawing from NAFTA? One of the important differences between EM and developed markets is investors usually react to perceived risks in EM, while they often ignore them, at their peril, in developed markets. Until they materialise, of course (European Debt Crisis, Subprime, Banking Crisis of 2008/2009, Dotcom Bubble, Telecoms Bubble and Brexit, of course). This week the market will have to focus on the UK as Prime Minister Theresa May tries once again to convince sceptical parliamentarians that her deal for exiting the European Union is the best available option for the UK. If parliament rejects her deal, which seems likely, there are two options: either parliament approves an extension of the Article 50 deadline or the UK crashes out of the EU on 29 March 2019 without a deal. Even if parliament extends the Article 50 deadline, however, it is still extremely unclear where this leads: is an extension anything other than a temporary respite? The country as well as Britain's political parties remains deeply divided along pro- and anti-EU lines. The lingering uncertainty arising from Brexit and the political stalemate surrounding the issue is already weighing on investment and economic growth and will continue to do so as long as the risk of a no-deal Brexit hangs over the country like the Sword of Damocles.

European data improved at the margin, but the ECB does not believe that the improvement will last. German factory sales were strong in January, tracking 8% higher annualised than in Q4 2018. Italian industrial production increased at a stronger than expected mom rate of 1.7% and Italian real GDP growth was revised higher from -0.9% qoq ar to -0.4% qoq ar (in Q4 2018). Euro area services PMI also improved to 52.8 in February from 51.2 in January, while the composite PMI rose to 51.9 in February from 51.0 in January. Euro area GDP growth was revised higher to 0.9% qoq saar in Q4 2018 from 0.6% qoq saar in Q3 2018. Despite the improvements in data, ECB President Mario Draghi talked down Europe's economic prospects. He blamed protectionism and lack of fiscal reforms, but he may also have had Brexit in the back of his mind, although no journalist at the ECB press conference thought it relevant to ask him about the rather obvious and important potential downside risk for Europe posed by Brexit.

Meanwhile, across the pond the US trade deficit increased by USD 10bn to USD 60bn in December. This took the goods trade deficit in real terms to an all-time high of more than USD 90bn. The widening US trade deficit illustrates one of the basic truths of macroeconomics, namely that trade deficits are a function of imbalance between aggregate demand and aggregate supply. Tariffs on China have had no impact on the trade balance at all, nor will it impact the trade balance going forward. The reason why tariffs are ineffective in influencing the trade balance is that tariffs push up the value of the Dollar, which ends up hurting US exports until exports decline exactly to offset lower Chinese imports. This illustrates that the current US Administration, which publicly claims to use protectionism in a bid to reduce the US trade deficit, is either politically opportunistic or economically illiterate, or both.

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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	-1.93%	6.89%	6.89%	-11.37%	12.38%	4.11%
MSCI EM Small Cap	-0.58%	6.13%	6.13%	-13.72%	7.27%	1.78%
MSCI Frontier	0.00%	5.60%	5.60%	-15.29%	6.70%	1.04%
MSCI Asia	-1.62%	7.76%	7.76%	-9.45%	13.03%	6.12%
Shanghai Composite	0.99%	19.09%	19.09%	-7.48%	2.99%	10.07%
Hong Kong Hang Seng	-1.85%	10.20%	10.20%	-5.85%	13.99%	6.86%
MSCI EMEA	-2.78%	4.02%	4.02%	-15.62%	8.10%	-0.59%
MSCI Latam	-3.21%	7.15%	7.15%	-8.06%	14.09%	1.70%
GBI EM GD	-1.45%	2.80%	2.80%	-6.72%	5.12%	-0.26%
ELMI+	-0.87%	1.32%	1.32%	-4.05%	3.67%	-0.47%
EM FX Spot	-1.62%	0.56%	0.56%	-10.34%	-1.45%	-6.66%
EMBI GD	-0.54%	4.89%	4.89%	2.58%	5.86%	5.34%
EMBI GD IG	0.14%	3.61%	3.61%	3.90%	4.48%	4.52%
EMBI GD HY	-1.17%	6.23%	6.23%	1.21%	7.40%	6.09%
CEMBI BD	0.03%	3.86%	3.86%	3.06%	5.86%	4.73%
CEMBI BD IG	0.30%	3.26%	3.26%	3.94%	4.35%	4.13%
CEMBI BD Non-IG	-0.34%	4.65%	4.65%	1.99%	8.34%	5.51%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-1.44%	9.87%	9.87%	2.15%	13.78%	10.10%
1-3yr UST	0.14%	0.50%	0.50%	2.38%	0.92%	0.88%
3-5yr UST	0.34%	0.68%	0.68%	3.35%	0.90%	1.51%
7-10yr UST	0.75%	1.10%	1.10%	5.13%	0.54%	2.68%
10yr+ UST	1.51%	0.94%	0.94%	5.55%	0.38%	5.16%
10yr+ Germany	1.57%	2.97%	2.97%	10.55%	2.55%	7.20%
10yr+ Japan	0.32%	2.00%	2.00%	3.31%	0.48%	4.51%
US HY	-0.42%	5.82%	5.82%	4.11%	8.65%	4.48%
European HY	-0.17%	4.34%	4.34%	0.52%	5.18%	4.07%
Barclays Ag	0.00%	0.94%	0.94%	-1.03%	1.65%	0.85%
VIX Index*	8.59%	-36.86%	-36.86%	9.63%	-2.73%	8.45%
DXY Index*	1.28%	1.26%	1.26%	8.09%	1.26%	22.13%
CRY Index*	-1.13%	6.40%	6.40%	-7.42%	4.12%	-40.75%
EURUSD	-1.16%	-2.01%	-2.01%	-8.88%	0.79%	-18.91%
USDJPY	-0.21%	1.33%	1.33%	4.45%	-2.41%	7.90%
Brent	-0.02%	22.71%	22.71%	0.81%	63.46%	-39.18%
Gold spot	-1.24%	1.13%	1.13%	-1.97%	3.70%	-3.86%

*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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