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Ashmore

The non-crisis of capitalism

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Leading economic thinkers are arguing that capitalism is in crisis. However, one can equally well argue that capitalism remains very successful, but that politics is in crisis for failing to address one of the best-known downsides of capitalism, namely the tendency for income inequality to rise in capitalist societies. The experiences of EM countries in the past three decades offer important insights into how rich countries can overcome the problems currently besetting their like. It is all about reform.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	2.67%
MSCI EM Small Cap	10.1	–	2.08%
MSCI Frontier	8.7	–	1.23%
MSCI Asia	11.8	–	2.42%
Shanghai Composite	10.3	–	1.75%
Hong Kong Hang Seng	8.1	–	3.15%
MSCI EMEA	8.5	–	1.74%
MSCI Latam	11.7	–	4.46%
GBI-EM-GD	6.22%	–	1.07%
ELMI+	5.35%	–	0.78%
EM FX spot	–	–	0.82%
EMBI GD	6.12%	351 bps	0.98%
EMBI GD IG	4.50%	186 bps	0.57%
EMBI GD HY	7.87%	529 bps	1.36%
CEMBI BD	5.80%	329 bps	0.54%
CEMBI BD IG	4.63%	212 bps	0.35%
CEMBI BD Non-IG	7.42%	490 bps	0.80%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.2	–	2.95%
1-3yr UST	2.44%	–	0.09%
3-5yr UST	2.40%	–	0.15%
7-10yr UST	2.60%	–	0.29%
10yr+ UST	3.02%	–	0.03%
10yr+ Germany	0.09%	–	-0.45%
10yr+ Japan	-0.04%	–	0.11%
US HY	6.54%	388 bps	0.73%
European HY	4.43%	450 bps	0.76%
Barclays Ag	1.89%	-71 bps	0.43%
VIX Index*	13.13	–	-1.20%
DXY Index*	96.47	–	-0.74%
EURUSD	1.1344	–	0.88%
USDJPY	111.53	–	0.29%
CRY Index*	183.87	–	3.19%
Brent	67.2	–	0.93%
Gold spot	1304	–	0.80%

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

Emerging Markets

Pointing to the rise in populism and income inequality in rich countries, several leading economic thinkers are now arguing that capitalism is in crisis. However, it is equally plausible to argue that capitalism is in rude health, while the crisis is a political one. Politicians in developed countries have failed to address one of the best-known negative externalities of capitalism, namely the tendency for capitalism to increase income inequality. The experiences of EM countries in the last few decades offer important insights into how to overcome the sense of marginalisation, which currently fuels the sense of a crisis of capitalism in rich countries. The key is not to attack capitalism. Rather it is to reform. To root out the old with a view to find relevance in the new.

There is no doubt that one of the greatest risks facing investors today is the rising tide of populism in developed countries. Examples are legion: Yellow Vests in France, protectionism and fiscal profligacy in the US, Brexit in the UK, Hungarian nationalism, anti-establishment sentiment in Italy. Common to all populist movements is a desire to appeal to the emotions of the electorate, while diverting attention away from the real underlying problems. Almost invariably, populism relies on myopia and scapegoating, populism sows division and conflict and ends up making everyone worse off. That is why populism poses such a big risk to investors.

Some of the world's finest economic thinkers are now waking up to the dangers posed by the recent surge in populism. They characterise the problem as crisis of capitalism. Conveniently, to the uninitiated, Nobel Prize winning economist Angus Deaton recently reviewed two of the most important books on the topic of the perilous state of capitalism. One by Raghuram Rajan of the Chicago Booth School of Business, the other by Paul Collier of Oxford University. Both men are formidable economists.[1]

Rajan and Collier make very similar points. They argue that societies consist of three broad sets of institutions, namely governments, globalised markets and local communities. During the last few decades, local communities in rich countries have fallen far behind others in society due to a combination of internal and external forces. Internally, class barriers have given way to meritocracy, which has enabled the brightest and most talented young people to leave in pursuit of better opportunities in highly competitive global markets and government.

[1] See https://www.project-syndicate.org/commentary/crisis-of-capitalism-rajan-collier-by-angus-deaton-2019-03

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Both happen to be located mainly in cities. Externally, local communities have faced a new source of competition for lower-end jobs from driven and talented immigrants from poorer countries, who have been able to move due to globalisation.

The dual onslaught of meritocracy and globalisation on local communities has resulted in sharp divisions in living standards and opportunities between cities and local communities in rich countries. Cities, by virtue of their extreme dynamism, richness in global talent, multi-ethnicity and tolerance, have become hyper-competitive incubators of wealth for people with talent and drive. By contrast, local communities have fallen behind due to brain drain, intolerance, fear and their own unwillingness to change. Many people in local communities now struggle to compete with even the poorest immigrants, such as Mexican fruit pickers in the US and Eastern European and African manual labour in Europe. As far as they can tell, their detriment is due to immigration. This explains why local communities are among the most vocal supporters of populism, including the Brexit movement in the UK and Trump in the United States.

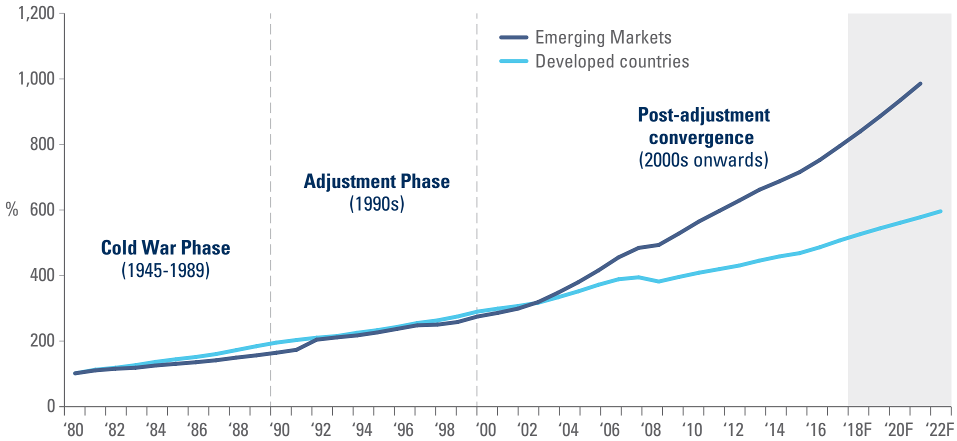
Does this crisis in local communities in rich countries constitute a crisis of capitalism? In our view, it does not. By allocating resources more efficiently than other systems, capitalism has a universal and enduring relevance. Besides, there are established remedies for dealing with capitalism's well-known imperfections, such as negative externalities (e.g. environmental degradation and species depletion) and imperfect competition (e.g. monopolies). Governments can address such problems within the capitalist systems by ensuring that these market failures are internalised within the price mechanism.

However, the most difficult aspect of capitalism is arguably its tendency to deepen income inequalities over time, particularly after major crises. Governments often fail to compensate those who lose out in free trade agreements and tend to reward the rich with tax cuts in booming markets. At some point, inequality becomes so pervasive that voters begin to demand change. In the aftermath of the Great Depression in the 1930s, voters rejected free societies in favour of left- and right-wing authoritarian governments due to a widespread feeling of marginalisation across large swathes of society. Then, like today, people in these marginalised groups sought refuge in the false comforts peddled by populists.

Rajan and Collier both argue that strengthening local communities can remedy populism. Perhaps. However, the devil is in the detail. Change is normal and healthy. It is important not to stop progress. In his review, Deaton makes the important point that "the genie of meritocracy cannot be put back in the bottle". He is right. The same is true of globalisation. In economic terms, it is deeply desirable that talent can pursue the best available opportunities, wherever they are. It is similarly desirable that highly motivated Africans or Eastern Europeans can move to Europe to better their lives. They are not the problem. The problem is among the incumbents who cannot compete. The real question is what to do with them, and how.

The experience of many Emerging Markets (EM) countries in the post-Cold War period offers some constructive insight, which can help to answer these difficult questions. After all, only recently EM countries found themselves marginalised in a similar way to local communities in rich countries today. To see this, consider Figure 1, which shows per capita GDP in EM countries compared to developed economies (indexed to 1980=100). The 'EM development experience' involves three distinct phases: During the first phase, the Cold War era, which lasted up to 1989, EM countries got poorer relative to rich countries. In the 1990s, Phase 2, GDP per capita in both EM and developed economies grew roughly at the same speed. Finally, in Phase 3, roughly since the early 2000s, EM per capita GDP has improved much faster than in rich countries. Clearly, EM underwent a dramatic turn-around from laggard to leader, from secular decliner to secular converger. This is exactly what is now required in local communities in rich countries.

Fig 1: **Three phases of EM development versus developed countries**



Source: Ashmore, IMF.

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Emerging Markets

How did EM improve its lot? The simple answer is reform. When the Superpowers finally relinquished their iron grip on EM economies after 1989, EM governments were able to respond to the demands of EM populations for greater stability and growth. They did so by adopting dramatically better economic policies, including inflation targeting, more responsible fiscal policies and by accumulating FX reserves. The improvement in macroeconomic conditions in turn encouraged saving, which facilitated both the establishment of pension systems and strengthened local investment.

In the same way that EM countries transformed themselves in the post-Cold War period, so local communities in rich countries now need to take a critical look at themselves to discover new ways of regaining relevance, attracting talent and generating opportunities.

It is clear that radical change is required. It is also clear that it is not easy for outsiders to offer help, because, to be sustainable, solutions have to be 'home grown'. The following may give some impression of the changes required. Consider farming communities in Europe or the US. Farmers currently sit on one of the most valuable assets in the world: land with the potential to become nature parks. Under threat all over the world, such spaces are becoming scarcer and it is likely that they will appreciate in value over time. Rich people in cities already pay for high quality environmental goods and services and are likely to do so even more in the future. Against this backdrop, it seems likely that serious investment in nature parks and other environmental services – as well as improvements in the infrastructure to enable city dwellers to access such services – should offer rich pickings. But are large numbers of European and American farmers ready to abandon conventional agricultural life styles? Are Western governments willing to abandon the subsidy policies, which keep alive these life-styles? Western agriculture has for a long time been negative for the environment and loss-making. Agriculture is better suited for regions with natural comparative advantages in the shape of abundant land and low population density, such as parts of Africa.

In conclusion, capitalism is not dead. The forces of meritocracy and globalisation – both expressions of capitalism – are massively positive for the global economy. Yet, meritocracy and globalisation have also been massive shocks to local communities in rich countries. Many have been left behind. The experiences of EM countries in the aftermath of the Cold War show that marginalised societies can find new relevance, new purpose. The same is true for local communities in rich countries. Government policies can and should assist to this end, but carefully and selectively, as enablers, however the main motivation has to come from within local communities themselves. Capitalism roots out that which cannot thrive, freeing up resources for that which can. The main role of government is to ensure that the transformation happens in a humane and efficient manner. If government cannot do this, we face a crisis of politics, not a crisis of capitalism.

- China: In sharp contrast with current US immigration policies, the Chinese government unveiled measures to attract overseas talent to the Guangdong-Hong Kong-Macau Greater Bay Area. Industrial production growth slowed, retail sales were unchanged and fixed asset investment picked up in February compared to January. The 70-city NBS housing price survey showed that property prices rose 0.7% in February, which is the same as in January.

- Brazil: President Jair Bolsonaro will visit US President Donald Trump in Washington this week. Topics for discussion include defence cooperation, space launches and the situation in Venezuela. Services activity was up 2.1% yoy in January versus 1.8% yoy expected, while retail sales were stronger than expected at 1.0% mom (0.2% mom expected). However, industrial production disappointed with a 0.8% mom decline in January. Core inflation was unchanged at 3.6% yoy in February.

- India: The trade deficit surprised to the low side in February at just USD 9.6bn versus USD 14.7bn in January and USD 13.7bn expected. The government introduced a long-term liquidity management tool in the form of a long-term repo. Inflation was 2.6% yoy in February, which was marginally higher than expected (2.4% yoy).

- Slovakia: Pro-European anti-corruption lawyer Zuzana Caputova won the first round of the presidential election with nearly 41% of the total vote. A second round run-off is scheduled to take place in two weeks' time. The Slovakian economy expanded 4.1% in real terms in 2018.

- Thailand: Voting has begun early ahead of the general election scheduled for 24 March 2019. The National Assembly has 750 members, which are split into 500 seats in the House of Representatives and 250 seats in the Senate. Under the current rules, Thailand's military appoint all the members of the Senate, which means that Thailand is unlikely to return to democratic populism immediately.

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Snippets:

- **Argentina:** Inflation accelerated to 3.8% mom in February, triggering additional tightening measures from the central bank. Regulated prices were up 54.5% yoy, accounting for the bulk of the price increases.
- **Colombia:** Economic activity was strong in January. Both retail sales and industrial production were up 3.0% yoy.
- **Czech Republic:** The real pace of retail sales was 1.5% yoy in January, which was far stronger than in December (0.1% yoy).
- **Ecuador:** In a likely first, an Ecuadorian company has issued a corporate bond, which will feature in the JP Morgan corporate bond index (CEMBI). Quito Airport raised USD 400m at 12% yield. IMF's board formally approved the USD 4.2bn Extended Financing Facility.
- **Indonesia:** The trade balance was in outright surplus of USD 0.3bn in February. This was a sharp turnaround from the deficit of USD 1.1bn in January.
- **Malaysia:** Industrial production was 3.2% higher yoy in January versus 2.3% yoy expected.
- **Mexico:** Industrial production beat expectations in January, rising at a mom pace of 0.6% versus 0.1% mom expected.
- **Peru:** Real GDP expanded at a yoy rate of 1.6% in January, down from 4.7% yoy in December. The central banks bought Dollars to slow the appreciation of the currency versus the Dollar.
- **Philippines:** The trade deficit was USD 3.8bn in January versus USD 3.6bn expected. Central Bank governor Diokno indicated an easing of banks' reserve requirements in coming months.
- **Poland:** Inflation picked up from 0.7% yoy in January to 1.2% yoy in February.
- **Romania:** Industrial production slowed to near zero in January, while at 3.8% yoy February inflation beat expectations.
- **Russia:** The fiscal surplus was unchanged at 2.8% of GDP in February compared to January. Foreign holdings of local government bonds (OFZs) increased to 25.5% in February from 24.4% in January.
- **Singapore:** Unemployment was stable at 3.1% in January, while non-oil domestic exports surprised strongly to the upside in February (4.9% yoy versus -1.6% yoy expected).
- **South Korea:** The rate of unemployment declined sharply to 3.7% in February from 4.4% in January.
- **Venezuela:** The US government is considering banning credit card companies from processing payments in Venezuela.

Global backdrop

The economic data continues, on balance, to be negative in the US. The Atlanta Fed's GDPNow model now estimates that growth in Q1 2019 is running at just 0.4% (qoq saar). This follows US industrial production and the Empire manufacturing survey, which were both weaker than expected. Initial claims for unemployment benefit increased. New home sales were lower than expected after dropping 6.9% in January. Core PPI was soft and core CPI inflation undershot expectations at the margin (2.1% yoy in February versus 2.2% yoy expected). Business inventories increased against the backdrop of a major downwards revision in retail sales in Q4 2018. On the other hand, capital goods orders picked up in January. The general weakening of the economy, much of which is down to President Donald Trump's trade policies, is now hurting the president's ability to influence policy. In the latest evidence of his lame-duck status after Democrats took the House of Representatives in the mid-term election in November last year, the Republican-controlled Senate last week blocked Trump's declaration of emergency over funding of the border wall with Mexico. There is still no sign that Mexico is going to fund the wall.

In the UK, parliament rejected hard Brexit and approved a motion that the government should request an extension of the 29 March 2019 deadline for UK to leave the European Union (EU). Theresa May's government is now likely to try to gain approval for its Brexit deal for the third time.

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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	0.68%	9.74%	9.74%	-10.59%	13.24%	5.29%
MSCI EM Small Cap	1.49%	8.34%	8.34%	-13.49%	7.92%	2.51%
MSCI Frontier	1.23%	6.90%	6.90%	-14.59%	7.52%	1.53%
MSCI Asia	0.76%	10.36%	10.36%	-9.65%	13.44%	7.26%
Shanghai Composite	2.75%	21.17%	21.17%	-5.94%	4.03%	11.04%
Hong Kong Hang Seng	1.24%	13.67%	13.67%	-5.82%	14.72%	8.46%
MSCI EMEA	-1.09%	5.83%	5.83%	-13.25%	9.24%	0.42%
MSCI Latam	1.10%	11.93%	11.93%	-3.33%	16.33%	3.21%
GBI EM GD	-0.39%	3.90%	3.90%	-5.73%	5.33%	0.04%
ELMI+	-0.09%	2.12%	2.12%	-3.41%	3.77%	-0.27%
EM FX Spot	-0.81%	1.38%	1.38%	-9.52%	-1.27%	-6.47%
EMBI GD	0.43%	5.91%	5.91%	3.45%	6.13%	5.58%
EMBI GD IG	0.71%	4.20%	4.20%	4.35%	4.64%	4.69%
EMBI GD HY	0.18%	7.67%	7.67%	2.47%	7.76%	6.41%
CEMBI BD	0.57%	4.42%	4.42%	3.63%	5.93%	4.89%
CEMBI BD IG	0.65%	3.62%	3.62%	4.27%	4.41%	4.23%
CEMBI BD Non-IG	0.46%	5.49%	5.49%	2.88%	8.40%	5.77%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	1.46%	13.11%	13.11%	4.80%	14.16%	11.16%
1-3yr UST	0.23%	0.59%	0.59%	2.46%	1.00%	0.88%
3-5yr UST	0.49%	0.83%	0.83%	3.41%	1.11%	1.47%
7-10yr UST	1.03%	1.39%	1.39%	5.05%	0.98%	2.53%
10yr+ UST	1.54%	0.98%	0.98%	4.24%	0.95%	4.74%
10yr+ Germany	1.12%	2.50%	2.50%	9.18%	2.92%	6.90%
10yr+ Japan	0.44%	2.11%	2.11%	3.34%	1.35%	4.58%
US HY	0.31%	6.59%	6.59%	4.99%	8.60%	4.67%
European HY	0.59%	5.13%	5.13%	1.22%	4.85%	4.26%
Barclays Ag	0.43%	1.37%	1.37%	-0.83%	1.90%	0.78%
VIX Index*	-11.16%	-48.35%	-48.35%	-16.90%	-6.35%	-9.57%
DXY Index*	0.33%	0.31%	0.31%	6.91%	1.46%	21.48%
CRY Index*	0.61%	8.28%	8.28%	-5.45%	4.26%	-39.27%
EURUSD	-0.24%	-1.09%	-1.09%	-8.03%	0.66%	-18.58%
USDJPY	0.13%	1.67%	1.67%	5.12%	-0.02%	9.94%
Brent	1.77%	24.91%	24.91%	1.50%	63.11%	-37.07%
Gold spot	-0.73%	1.66%	1.66%	-0.99%	3.86%	-3.83%

*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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