Growth polarisation

By Jan Dehn

The latest IMF World Economic Outlook confirms that the difference in economic growth rates between Emerging Markets (EM) and developed markets (DM) will continue to widen over the next five years. According to the IMF, the differential is set to nearly double to 3.2% over the period. Investors should pay heed; stronger relative growth is associated with more investment opportunities, better investment performance, and stronger EM currencies. In country-specific news, Turkey announces vacuous economic policy changes, voting kicks off in the world's largest democracy, Lebanon reforms its electricity sector, Sudan unseats a strongman, exports and credit data stage a strong rebound in China, JP Morgan places Venezuela on index watch, and Indonesians prepare to vote in parliamentary and presidential elections.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	0.41%
MSCI EM Small Cap	10.3	–	0.22%
MSCI Frontier	9.1	–	0.40%
MSCI Asia	12.2	–	0.32%
Shanghai Composite	10.9	–	-1.77%
Hong Kong Hang Seng	8.2	–	-0.28%
MSCI EMEA	8.8	–	2.30%
MSCI Latam	11.1	–	-2.53%
GBI-EM-GD	6.16%	–	0.50%
ELMI+	5.67%	–	0.44%
EM FX spot	–	–	0.55%
EMBI GD	6.03%	345 bps	-0.33%
EMBI GD IG	4.36%	175 bps	-0.08%
EMBI GD HY	7.87%	531 bps	-0.57%
CEMBI BD	5.70%	321 bps	0.02%
CEMBI BD IG	4.47%	198 bps	0.06%
CEMBI BD Non-IG	7.39%	489 bps	-0.05%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	0.56%
1-3yr UST	2.39%	–	-0.04%
3-5yr UST	2.37%	–	-0.19%
7-10yr UST	2.55%	–	-0.41%
10yr+ UST	2.97%	–	-0.99%
10yr+ Germany	0.06%	–	-1.15%
10yr+ Japan	-0.03%	–	0.45%
US HY	6.11%	349 bps	0.57%
European HY	4.07%	415 bps	0.33%
Barclays Ag	1.85%	-70 bps	0.16%
VIX Index*	12.01	–	-0.81%
DXY Index*	96.88	–	-0.17%
EURUSD	1.1304	–	0.36%
USDJPY	111.92	–	0.39%
CRY Index*	188.36	–	0.68%
Brent	71.3	–	0.24%
Gold spot	1288	–	-0.75%

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

Emerging Markets

The IMF's new growth forecasts, released as part of the April 2019 World Economic Outlook (WEO), formalise what the organisation had hinted at back in February of this year, namely that global growth is slowing.[1] The main difference from the February statement was the publication of detailed country-specific forecasts out to the year 2024. The new forecasts reveal that the growth differential between EM countries on one hand and US and DM on the other will rise every single year from 2019 through 2024. By 2024, the difference between the average annual growth rate in EMs and DMs have nearly doubled to 3.2% (from 1.7% in 2018).

Figure 1 illustrates this sharp polarisation in growth projections between EMs and DMs. EM growth rates are expected to accelerate moderately through the forecast horizon from 4.5% in 2018 to 4.9% by 2024. By contrast, US growth is expected to almost halve from 2.9% in 2018 to 1.6% by 2024, while growth rates in developed economies as a whole are set to slow from 2.2% in 2018 to 1.6% by 2024. Based on these growth rates and EM's share of the global economy, EM countries will contribute no less than 84% of all growth on Planet Earth by 2024.

[1] Ashmore has written extensively about IMF's recent downwards revisions of global growth. Please see: *'EM versus DM growth (2019-2023): How global is 'global' growth really?'*, The Emerging View, 26 February 2019, and *'Pay heed to weaker developed market growth'*, Weekly investor research, 11 March 2019.

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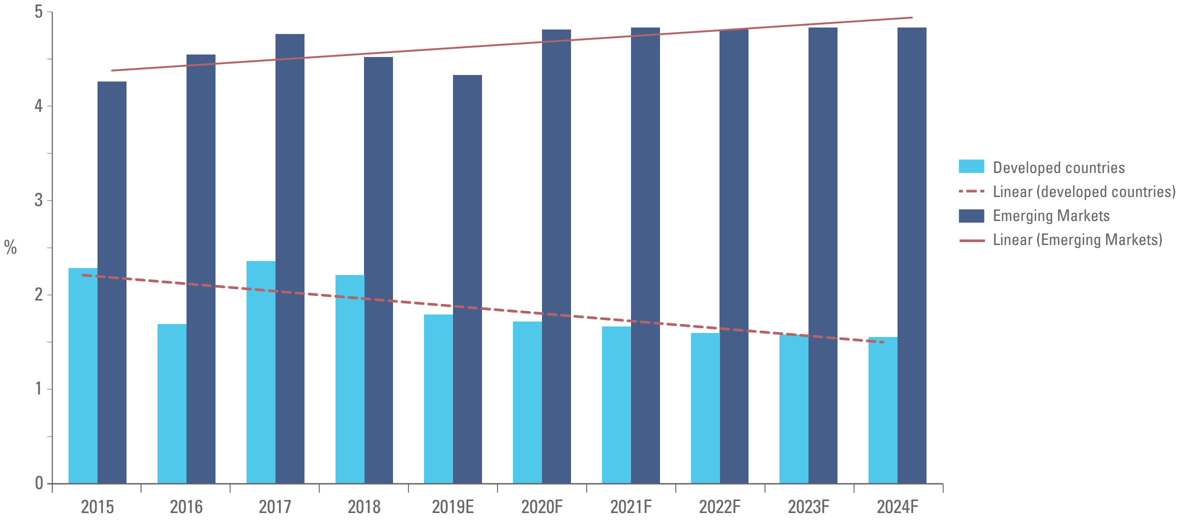
Emerging Markets

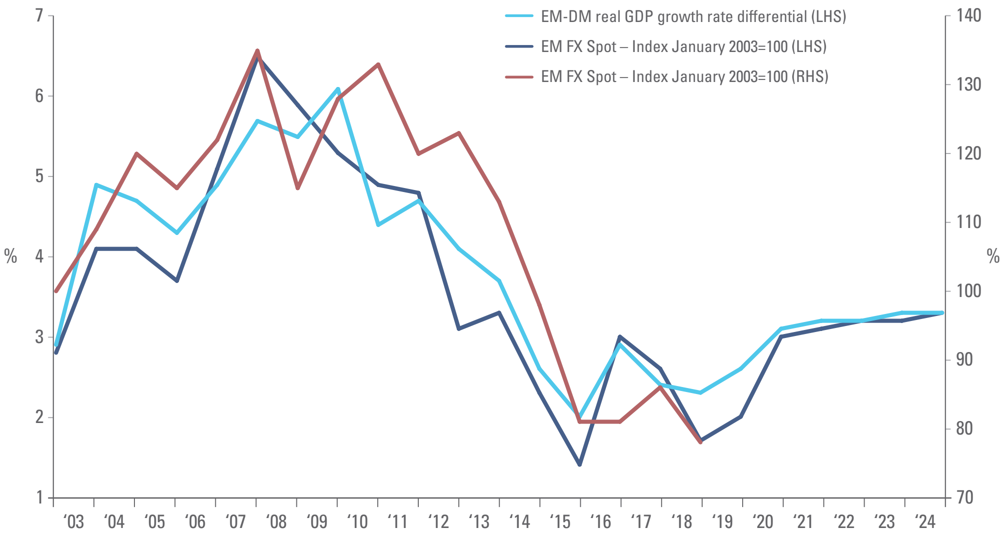
Fig 1: **Growth rates for EM versus developed countries**



Source: Ashmore, IMF ('E' denotes IMF estimate, 'F' denotes IMF forecast).

The implications of global growth polarisation are fairly obvious: first, the investment environment should continue to improve in EM countries, since countries with stable to marginally stronger growth rates tend to produce more and better investment opportunities. Second, the investment environment in developed markets may well deteriorate outright. This is not just due to the direct effect of slower growth. Slower growth also worsens the investment environment indirectly by inducing more populist policies, including larger fiscal deficits and protectionism. Both undermine productivity.[2] Third, the rise in the EM-DM growth differential may put the Dollar under pressure. There is a strong long-term relationship between the EM-DM growth differentials and EM currency performance as shown in Figure 2. Based on the past relationship between growth differentials and EM currencies, the potential upside for EM FX versus the Dollar over the next half a decade is about 20%.

Fig 2: **EM-DM growth differentials and EM FX**



Source: Ashmore, IMF, Bloomberg, JP Morgan.

Other factors point to EM FX upside versus the Dollar. Misalignment of real effective exchange rates and the excessive valuation of the Dollar relative to US productivity growth also suggest about a 20% upside for EM FX versus the Dollar.[3] Finally, we note that the current trend in the US twin deficit also suggests a lower Dollar as shown in Figure 3.[4]

[2] See *'Beware of Big Fiscal'*, The Emerging View, 3 April 2019.
[3] To see why, specifically examine Section 2 in the following: *'The 2019-2023 EM fixed income outlook'*, The Emerging View, 6 December 2018.
[4] 'Twin deficits' refer to the sum of the fiscal deficit and the current account deficit, expressed as a percentage of GDP.

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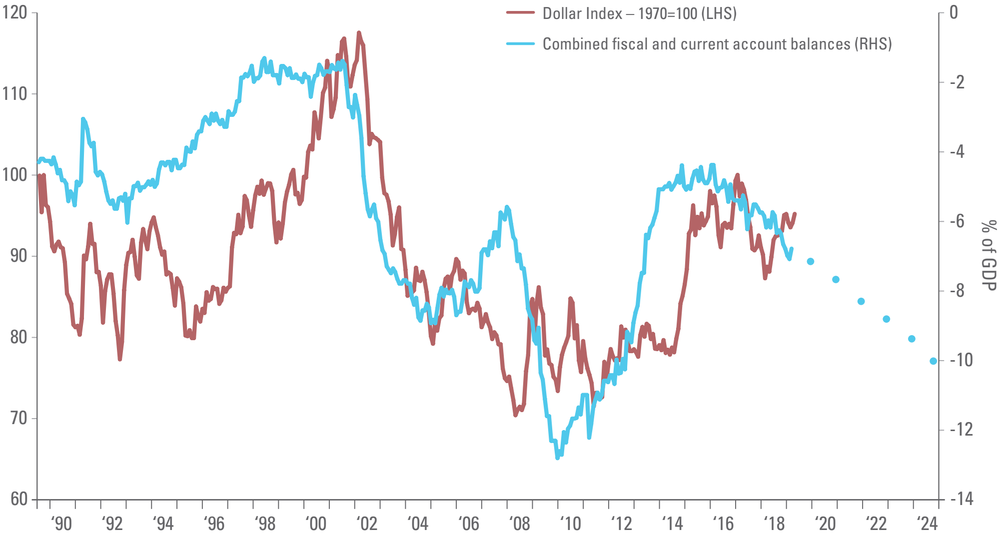
Emerging Markets

Fig 3: **The Broad Dollar and the US twin deficits**



Source: Ashmore, Bloomberg. Ashmore projections for the US twin deficits for the period 2019-2024.

- Turkey: Following his political setback in recent local elections, will Erdogan turn to reforms or double down on heterodox policies? The answer is likely to be more heterodoxy. Last week, Finance Minister Albayrak announced that the government will recapitalise Turkish state banks and take bad loans in the construction and energy sectors off the balance sheets of the banks. Such measures may be necessary as part of a broader package of reforms, but in isolation they amount to nothing other than sticking plaster on a cancer. The underlying ailment in Turkey is bad monetary policy and the credit problems in the banks are merely symptoms of the problem. As such, by merely spending government money without address the excess demand problem caused by over-easy monetary policy, there is no reason to expect the problem not to recur.
- India: The largest democracy in the world has started the process of electing new leaders. Voting began in the Indian general election last week. Ninety-one constituencies will elect 543 members of parliament. Voting ends on 23 May. The ruling BJP party of Prime Minister Modi faces a challenge from the India National Congress ('Congress'). The run-up to the election has been characterised by modest fiscal slippage, but Congress is promising far more populist measures if they come to power. We think markets will welcome Modi's return to office, which is our base case. In economic news, CPI inflation increased marginally to 2.9% yoy in March from 2.6% yoy in February, but core inflation slowed to 5.0% yoy from 5.3% yoy.
- Lebanon: The Lebanese government has approved an extremely important reform of the electricity sector, which currently costs the government about USD 2bn per annum. The reform should increase economic efficiency, deliver reliable power and improve the public finances, which in turn may help Lebanon obtain additional financing. Indeed, it is now likely that the government will come to market with a bond issue, in our view.
- Sudan: Following widespread popular unrest, the military has ousted Sudan's strongman Omar Al-Bashir. Al-Bashir failed to maintain stability and growth. The military says it will hand power to a civilian government. Popular protests also recently forced Algeria's authoritarian ruler Abdelaziz Bouteflika from power after he too failed to manage the economy properly. EM populations with no access to inflation hedges, unemployment benefits or social security tend to have very little tolerance for macroeconomic mismanagement. Most EM governments are acutely aware of this fact, which is why most of them pursue prudent fiscal and monetary policies.
- China: China delivered blowout net exports in March. Exports were up 14.2% yoy versus 6.5% yoy expected, while imports contracted at a 7.6% yoy pace. The trade surplus was USD 33bn versus USD 5.7bn expected. The larger than expected trade surplus will contribute positively to growth (since net exports add to GDP). As for lower imports, they are largely explained by China's ongoing reforms, which impart uncertainty and depress domestic demand. The latest reform effort was announced last week, when NDRC announced the abolition of the hukou system in all cities with less than three million inhabitants. Larger cities are also encouraged to move towards removing the hukou system. Hukou is a system, which places restrictions on rural-to-urban migration, thereby slowing the pace of economic development (since urban productivity tends to be higher than rural productivity). In other news, money supply and credit also picked up strongly in March, while a rise in pork prices pushed yoy CPI inflation to 2.3% in March from 1.5% in February. Core inflation remains moderate at 1.8% yoy (versus 1.7% in February).

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Emerging Markets

- **Venezuela:** Index-provider JP Morgan has announced that Venezuelan sovereign and PDVSA bonds are on index watch until 28th June. During this period, the bank will evaluate investors' ability to trade the bonds. On 28th June or shortly after, JP Morgan will then either maintain index weight or begin to phase Venezuela/ PDVSA out of the index at a yet-to-be determined pace, depending on the bank's assessment of the level of impairment of liquidity (i.e. ability to execute trades). Lower index weights would force passive investors to sell, but active investors would be able to pick up the securities at potentially attractive prices, in our view. The twenty Venezuelan and PDVSA bonds in the EMBI GD index currently have a combined weight of 0.97% in the EMBI GD index. The index contains sovereign and quasi-sovereign bonds denominated in Dollars. The index has 73 countries with an average rating of investment grade. Meanwhile, on the ground in Venezuela, the country was plunged into a third nation-wide electricity blackout last week.

- **Indonesia:** Indonesia is due to hold presidential and parliamentary elections on Wednesday this week. President Jokowi holds a commanding lead in the polls of 15-20% over his main opponent, Prabowo. We expect Jokowi to be re-elected. Markets are likely to focus on the balance of power in the new parliament, where Jokowi currently commands a majority. Meanwhile, the Indonesian trade surplus was USD 540m in March. Markets had expected a deficit of USD 177m. The trade balance was also in surplus in February (USD 330m).

Snippets:

- **Argentina:** In the government's recent local bond auction, the rollover rate was higher than expected at roughly 70%. The higher than anticipated rollover rate eases the governments financing needs later in the year.
- **Brazil:** Inflation was higher than expected in March (0.75% mom versus the consensus of 0.63% mom). This was mainly due to rising food prices. Core inflation was in line expectations. Retail sales were solid at +7.7% yoy in February.
- **Colombia:** CPI inflation increased to 3.21% yoy in March from 3.01% yoy in February.
- **Czech Republic:** The yoy rate of CPI inflation picked up to 3.0% in March from 2.7% yoy in February.
- **Ecuador:** The government expelled Julian Assange from the Ecuadorian Embassy in London, where the fugitive has been in exile since 2012. Relations between Ecuador and the US have improved sharply under President Lenin Moreno.
- **Egypt:** The annual rate of CPI inflation declined by 0.1% to 14.2% in March. The government is re-engaging with the IMF to offer reassurance for investors, according to officials.
- **Hungary:** CPI inflation increased to 3.7% yoy in March from 3.1% yoy in February.
- **Kazakhstan:** The presidential election will be held on 9 June.
- **Malaysia:** Industrial production slowed to a yoy pace of 1.7% in February from 3.2% yoy in January, mainly due to lower mining output.
- **Mexico:** Core inflation increased marginally to 3.6% yoy in March from 3.5% yoy in February. Industrial production was up 0.3% in February, which was more than the market had expected (0.2% mom).
- **Philippines:** The trade deficit narrowed to USD 2.79bn in February. This was far better than expected (USD 3.41bn). The lower than expected deficit was mainly due to lower capex imports, which in turn was due to a delay in the approval of the government's budget.
- **Romania:** March inflation was 4.02% yoy versus 3.83% yoy in February.
- **Russia:** The preliminary current account surplus in Q1 2019 was USD 32.8bn versus USD 31.0bn expected.
- **Singapore:** Sequential growth accelerated meaningfully to 2.0% qoq saar in Q1 2019 from 1.4% qoq saar in Q4 2018. The Monetary Authority of Singapore left the policy nominal effective exchange rate unchanged.
- **South Korea:** The rate of unemployment declined to 3.8% in March versus 3.9% expected.
- **Taiwan:** CPI inflation was in line with expectations (0.6% yoy).
- **Vietnam:** S&P raised Vietnam's sovereign credit rating to BB from BB- with stable outlook.

Global backdrop

The Federal Reserve and the European Central Bank both maintained broadly dovish stances at their April meetings. ECB highlighted still soft European growth, while the Fed emphasised lower than expected inflation. The US Senate looks set to reject Trump's Fed nominee Herman Cain on account of his inadequate qualifications for the job. Unfortunately, Stephen Moore, another inadequately qualified Trump Fed nominee may yet obtain Senate approval. Meanwhile, Trump continues to pile political pressure on the Fed with sharp verbal attacks in the media. Such interference does not usually end well; witness political interference with central banks in Argentina during the Cristina Kirchner era and in Brazil, when Guido Mantega was in charge of the Ministry of Finance.

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Global backdrop

On the US data front, core CPI inflation slowed to 2.0% yoy in March from 2.1% yoy the previous month. Job openings ('JOLTS), which happens to be former Fed Chairwoman Janet Yellen's favourite labour market indicator, declined sharply in February. On the other hand, initial claims dropped to a 50-year low. In short, considerable uncertainty surrounds the precise state of the US labour market.

Turning to fiscal and trade policy developments, the Italian government downgraded its growth forecast and announced a fiscal deterioration as a result. An old trade dispute between the US and Europe over airline subsidies re-erupted with the announcement of fresh US tariffs on European goods imports. EU is likely to respond in kind. In reality, both the US and Europe subsidise their airline industries. The US and China continued to move towards a resolution to the trade war, which was instigated by US President Donald Trump.

The biggest freak show in developed economies remains the UK, where Brexit continues to deliver rich material for speculators and other deviants. Following last week's EU Summit, all eyes are now on the upcoming EU election scheduled for 23-26 May 2019. EU has granted UK Prime Minister Theresa May an extension of the Brexit deadline until 31 October, which forces UK to participate in the EU election, barring approval of May's Withdrawal Agreement, which still seems unlikely.

EU hopes that UK participation in the EU election will break the Brexit deadlock. The EU election will be the first serious examination of the British electorate's opinion about EU since the Brexit referendum of June 2016. As a mid-term election revolving around the single issue of Brexit, the election will be a *de facto* second referendum on UK's EU membership, polarising the UK electorate into hard Brexit and Remainer camps and likely punishing severely the mainstream Conservative and Labour parties. In short, everyone will be a lot wiser about where ordinary Brits stand with respect to Europe after 26 May.

The shorter than expected extension of the Brexit deadline was a small victory for French President Emmanuel Macron. Macron, a centrist, needs renewed momentum behind his EU reform program, which can only get underway once the Brexit issue is out of the way.

UK had no influence over the Brexit deadline extension, which was decided exclusively by the other EU members. As such, the EU Summit last week illustrated just how much UK's influence has declined since the 2016 Brexit referendum. Larger powers now dictate Britain's choices. This is a foretaste of Britain's future outside the EU: a medium-sized economy with restricted influence and few powers to shape international events, forced to accept the decisions of bigger economic powers (US, China, EU27).

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	3.00%	3.00%	13.19%	-4.88%	12.47%	4.22%
MSCI EM Small Cap	2.05%	2.05%	9.98%	-11.44%	6.74%	2.08%
MSCI Frontier	1.33%	1.33%	8.33%	-13.28%	7.41%	-0.19%
MSCI Asia	2.75%	2.75%	14.45%	-3.45%	13.60%	6.70%
Shanghai Composite	3.18%	3.18%	27.88%	2.73%	4.02%	10.88%
Hong Kong Hang Seng	2.46%	2.46%	15.16%	-1.24%	14.19%	6.69%
MSCI EMEA	6.15%	6.15%	12.09%	-2.82%	8.13%	-0.10%
MSCI Latam	0.59%	0.59%	8.57%	-6.97%	11.28%	-0.59%
GBI EM GD	1.72%	1.72%	4.69%	-5.47%	3.69%	-0.68%
ELMI+	1.04%	1.04%	2.54%	-2.90%	2.78%	-0.54%
EM FX Spot	1.43%	1.43%	1.69%	-8.91%	-2.35%	-6.86%
EMBI GD	-0.08%	-0.08%	6.87%	4.02%	5.52%	5.19%
EMBI GD IG	-0.23%	-0.23%	5.73%	5.68%	4.25%	4.54%
EMBI GD HY	0.07%	0.07%	8.08%	2.33%	6.94%	5.65%
CEMBI BD	0.34%	0.34%	5.51%	4.90%	5.59%	4.75%
CEMBI BD IG	0.13%	0.13%	4.91%	5.77%	4.21%	4.17%
CEMBI BD Non-IG	0.62%	0.62%	6.30%	3.86%	7.83%	5.50%

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Ashmore

Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	2.66%	2.66%	16.67%	11.33%	14.43%	12.14%
1-3yr UST	-0.13%	-0.13%	0.86%	2.68%	0.93%	0.92%
3-5yr UST	-0.43%	-0.43%	1.15%	3.74%	0.79%	1.53%
7-10yr UST	-1.01%	-1.01%	1.83%	5.32%	0.49%	2.55%
10yr+ UST	-2.47%	-2.47%	2.09%	4.73%	0.47%	4.56%
10yr+ Germany	-2.09%	-2.09%	3.22%	8.87%	2.19%	6.83%
10yr+ Japan	-0.25%	-0.25%	3.04%	3.66%	0.57%	4.70%
US HY	1.07%	1.07%	8.40%	6.09%	8.58%	4.85%
European HY	1.04%	1.04%	6.73%	2.47%	5.15%	4.32%
Barclays Ag	-0.32%	-0.32%	1.88%	-0.55%	1.16%	0.76%
VIX Index*	-12.40%	-12.40%	-52.75%	-31.02%	-11.82%	-23.06%
DXY Index*	-0.42%	-0.42%	0.73%	7.88%	2.30%	21.40%
CRY Index*	2.51%	2.51%	10.93%	-5.68%	8.48%	-39.09%
EURUSD	0.78%	0.78%	-1.44%	-8.68%	0.19%	-18.18%
USDJPY	0.97%	0.97%	2.02%	4.48%	2.89%	9.82%
Brent	4.21%	4.21%	32.47%	-1.80%	65.36%	-34.46%
Gold spot	-0.35%	-0.35%	0.41%	-4.32%	4.34%	-1.14%

*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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