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WEEKLY INVESTOR RESEARCH

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South African voters deliver a clear mandate to Ramaphosa

By Jan Dehn

With the general election out of the way, President Cyril Ramaphosa finally has a clear mandate to re-inject momentum into the reform process in South Africa. The political situation has also cleared up in Thailand, while the latest economic data suggests that China is well-placed to handle last week's escalation in the Trump-instigated trade war. Growth slowed in the Philippines, but this is likely to be temporary due to delayed government spending. In Argentina, Cristina Kircher's support appears to be waning, while Maduro now looks more secure in Venezuela. Pakistan finally submitted a formal request for an IMF program. In the global backdrop section, we highlight the growing economic risks to the US outlook arising from last week's hike in trade taxes.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	-4.51%
MSCI EM Small Cap	9.9	–	-3.60%
MSCI Frontier	8.8	–	0.15%
MSCI Asia	11.8	–	-4.87%
Shanghai Composite	10.1	–	-4.48%
Hong Kong Hang Seng	7.8	–	-5.56%
MSCI EMEA	8.6	–	-3.91%
MSCI Latam	11.1	–	-2.78%
GBI-EM-GD	6.23%	–	-0.14%
ELMI+	6.43%	–	-0.41%
EM FX spot	–	–	-0.22%
EMBI GD	6.04%	356 bps	-0.25%
EMBI GD IG	4.29%	178 bps	0.06%
EMBI GD HY	8.02%	557 bps	-0.55%
CEMBI BD	5.63%	325 bps	0.08%
CEMBI BD IG	4.36%	198 bps	0.23%
CEMBI BD Non-IG	7.40%	501 bps	-0.12%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.6	–	-2.10%
1-3yr UST	2.21%	–	0.20%
3-5yr UST	2.21%	–	0.37%
7-10yr UST	2.42%	–	0.66%
10yr+ UST	2.85%	–	1.07%
10yr+ Germany	-0.06%	–	1.03%
10yr+ Japan	-0.05%	–	0.29%
US HY	6.33%	382 bps	-0.51%
European HY	4.21%	442 bps	-0.68%
Barclays Ag	1.79%	-63 bps	0.53%
VIX Index*	19.09	–	3.65%
DXY Index*	97.29	–	-0.22%
EURUSD	1.1250	–	0.46%
USDJPY	109.21	–	1.42%
CRY Index*	178.98	–	-1.70%
Brent	71.7	–	0.58%
Gold spot	1287	–	0.48%

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

Emerging Markets

- **South Africa:** The result of the General Election in South Africa was positive. ANC performed slightly better than many had feared. The uncertainty associated with the election itself is now out of the way. The long lame-duck period since former President Jacob Zuma's departure is now over and the government of Ramaphosa has a clear mandate. The Ramaphosa Administration is likely to put forward concrete policy proposals, which, we believe, will be market-friendly. South Africa should therefore now be able to experience some forward momentum in a positive direction. At the time of writing, some 90% of the votes had been counted and the ANC held a comfortable lead of about 58%, with DA holding just under 21% and the EFF's share of the vote just over 10%. In the populous Gauteng Province, the counting was not yet complete at the time of writing, but ANC was in a clear lead with a 53% vote share after 97% of votes in the province had been counted.

- **Thailand:** The Pheu Thai party of former Prime Minister Thaksin Shinawatra secured 245 seats in the 500 seat House of Representatives. This leaves the door open for parliamentarians supporting the military to form a majority coalition. Shinawatra is a populist, whose time in power was associated with rising corruption and political instability. Hence, the outcome of the election is good news. The Bank of Thailand left the policy rate unchanged at 1.75%.

- **China:** China will likely retaliate against higher US trade taxes for political reasons. Taxing one's own population just because another country does the same is economic lunacy, but politically expedient. Chinese trade tax retaliation will therefore be negative for the Chinese economy, but the government will seek to offset the cost of the taxes by easing policy in specific areas with a view to further encouraging private sector growth. The latest round of US trade aggression coincides with stronger economic data in China. Domestic demand is now

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Emerging Markets

humming along nicely and the government has recently felt confident enough about the economic outlook to scale back stimulus. Specifically, imports picked up at a yoy pace of 4% in April, which was far better than expected (-2.1% yoy). The government responded by reducing the pace of broad money growth to 8.5% in April from 8.6% in March, while total social financing also slowed to RMB 1,360bn in April compared to RMB 2,859bn in March. Stimulus remain significantly higher than in February, however, so the government is clearly fine tuning policy rather than using the big stick, which is another sign of quiet confidence on the part of policy makers. CPI inflation came in line with expectations in April at 2.5% yoy, up from 2.3% yoy in March, with core inflation very stable at 1.7% yoy, slightly down from 1.8% yoy in March. The one area of clear weakness is exports (-2.7% yoy), but softer exports tells you more about foreign demand, particularly in developed countries than it does about conditions within China. Besides, part of the export weakness was due to heavy front-loading of exports in March ahead of a cut in export VAT rebates, which took effect on April 1, so some bounce-back in exports can be expected in future months. In conclusion, as far as China macroeconomics is concerned, the news is broadly positive, which, on balance, is a good thing as trade war tensions re-appear.

In a notable development relating to the domestic Chinese capital market, a new report from HSBC points out that there are now RBM 4.9trn of outstanding corporate bonds from 271 individual issuers denominated in CNY with international credit ratings (i.e., Moody's, S&P or Fitch).[1] To place the size of this rated universe of bonds into some context, it is roughly equivalent to nearly half of the total Emerging Markets (EM) local currency corporate debt universe and some four times larger than the capped JP Morgan index of sovereign local currency government bonds (GBI EM GD). Demand for Chinese bonds increased at the fastest pace of the year in April, which was the month when Bloomberg included Chinese bonds in its Aggregate bond index. Foreigners now own USD 230bn of Chinese local currency government bonds.

- Philippines: The real economy expanded at a yoy pace of 5.6% in Q1, which was below expectations (6.0% yoy). The underperformance was due to slower gross capital formation, which in turn is attributable to delays in the approval of the government's budget. Budget approval has now taken place, however. Hence, capital spending – and therefore economic growth – should pick up in coming quarters, in our view. Capital goods imports pushed the trade deficit to USD 3.3bn in March from USD 2.7bn in February. The central bank cut the policy interest rate by 25bps to 4.5% in line with expectations following a lower than expected inflation print of 3.0% yoy in April (down from 3.3% yoy in March).

- Argentina: Voter support for Cristina Kirchner is waning, according to polls. Kirchner's lead is now down to about 2% from 6% previously. The decline in support for Kirchner has happened despite softer economic data, including significant manufacturing and construction sector weakness in March. One potential explanation is that President Mauricio Macri appears to have regained the political initiative ahead of the presidential election scheduled for Q3 2019 by sending a ten-point policy program to all opposition parties and members of civil society.[2] The ten-point program, which is designed to ensure stability, covers elements, which would be present in any responsible policy program and seems to have been well-received by voters. Macri must maintain momentum. Argentina's economic fortunes depend on the election outcome. Kirchner's time in office was characterised by an extreme version of populism, government intervention, confrontational politics and excess demand stimulus. Indeed, the reason why Argentina's economy is currently so weak is because Macri is trying to restore equilibrium after Kirchner's disastrous policies. Her return to power would mean a return to unsustainable policies and likely lead to economic disaster, in our view.

- Venezuela: President Nicholas Maduro suddenly looks far more secure in his job after Trump chickened out over military intervention in Venezuela. Trump's sudden wilt undermines his hawkish national security advisor, John Bolton, who favoured aggressive measures to effect regime change. The real implication of Trump's apprehension with respect to Venezuela is that the credibility of his administration's efforts with respect to Iran must now surely also be called into question. After all, in our view it will be infinitely easier to effect regime change in deeply dysfunctional Venezuela than in far better organised Iran. No doubt Teheran has taken note of the Trump Administration's U-turn with respect to Venezuela.

- Pakistan: The government submitted a formal application for an IMF program last week, concluding months of negotiations, which have also seen both the central bank governor and the finance minister replaced with former IMF officials. An IMF program will provide a strong anchor for policy stability, which is required to attract investment, in our view.

[1] HSBC Global Research, China Onshore Insights: *A new way to look at China's corporate bonds*, 8 May 2019.

[2] The 10 points are: 1. Maintain fiscal balance both in Nation and in the Provinces; 2. Ensure the independence of the Central Bank in handling monetary policy and FX stability; 3. Intelligent integration with the world; 4. Respect for the law, judicial system security; 5. Creation of formal employment through the updating of the Labor Law; 6. Reduction of the tax burden; 7. Consolidation of a sustainable and equitable Pension System; 8. Consolidation of a transparent Federal System that ensures transfers to the provinces without discriminating per party; 9. Ensure and consolidate a system of statistics and professional data that is reliable and independent; 10. Fulfil financial obligations with creditors.

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Emerging Markets

Snippets:

- **Brazil:** The central bank left the policy rate unchanged at 6.5% in line with expectations. Retail sales disappointed (0.3% mom versus 0.9% mom expected). CPI inflation was 0.57% in March, which was significantly lower than expected (0.67% mom).
- **Chile:** The yoy rate of core inflation moderated to 2.4% in April from 2.6% in March. Headline inflation was 2.0% yoy. The central bank target range is 3.0% +/- 1%.
- **Hungary:** The Serbian central bank left the policy rate unchanged at 3%, in line with expectations. Inflation drifted marginally higher to 3.9% yoy in April.
- **Indonesia:** The Q1 2019 current account deficit narrowed to USD 7.0bn from USD 9.1bn in Q4 2018. The goods trade balance hit a USD 1.1bn surplus, which was a market turnaround from the USD 2.6bn deficit in Q4 2018.
- **Malaysia:** The central bank cut the policy rate by 25bps to 3.0%.
- **Mexico:** Gross fixed investment contracted at a yoy pace of 1.9% in February, which was better than expected (-2.5% yoy). Inflation in the second half of April was 3.87% yoy. Industrial production beat expectations (-0.1% yoy in March versus a consensus expectation of -0.3% yoy). The government received no acceptable bids for the Dos Bocas refinery construction project.
- **Nigeria:** Central Bank Governor Godwin Emefiele has received the government's nomination for another five year term.
- **Peru:** The central bank left the policy rate unchanged at 2.75% with neutral forward guidance.
- **Saudi Arabia:** The government fiscal balance has returned to surplus for the first time, since the drop in oil prices in 2014. The budget surplus was SAR 28bn compared to a deficit of SAR 34bn in the same month last year.
- **Taiwan:** CPI inflation on a yoy basis was 0.7% in April. Core inflation was 0.6% yoy.
- **Vietnam:** The Trump Administration is considering adding Vietnam to its list of alleged currency manipulators, while dropping India and South Korea. The large US current account deficit is caused as much by excess US demand manipulation as by currency manipulation by other countries, in our view.

Global backdrop

Europe and the United States have a lot in common. Both regions have high living standards, reasonably well functioning institutions, rule of law, democracy and a free press as well as rising levels of populism, xenophobia, mounting debt, addiction to demand stimulus and low proclivity to undertake economic reforms of any kind. One of the main differences between the two regions is the banking system. The United States recapitalised its failing banks shortly after the Subprime Crisis, while Europe never did so. This single difference explains the contrasting economic fortunes of the US and Europe since the Financial Crisis. Due to its healthy banks, the US economy has been able to bounce back, which in turn has enabled the Fed to hike rates. US stocks markets have delivered better returns and the Dollar has been stronger than the Euro. It is quite astonishing to observe that the Fed is now at or near the end of its hiking cycle, while, in sharp contrast, ten years after the Financial Crisis, the European Central Bank has not even begun to hike rates yet. Never recapitalised, Europe's banks have not been able to support the European economic recovery, which has resulted in weaker overall growth, permanently low inflation and far lower interest rates. It has still been possible to make money in Europe, but in bonds rather than stocks. After all, bonds is what you buy when there is no growth, no inflation and no prospect of rate hikes.

How will the US and Europe compare going forward? Consider Europe first. There are no signs of major imminent reforms to the European banking sector, so the broader economic trends seem unlikely to change significantly. Macron's proposed economic reforms for the Eurozone have been placed on ice for now due to Brexit and change of leadership in Germany. European banking regulators recently swept the enormous money laundering scandal at Danske Bank under the carpet, reflecting the reality that there is no appetite among policy makers in Europe to tackle the deeper problems in the banking system. Why this reluctance, when the economic consequences are so serious? The answer is that fixing the European banking system requires fiscal policy coordination, which is non-existent in Europe. This in turn is because the individual nations of the European Union (EU) are still far too 'tribalistic' to be able to agree on Europe-wide tax and spend policies with asymmetric implications across countries within the EU. Hence, it is a relatively safe bet that growth, inflation and interest rates will continue to be low in Europe. The most realistic expectation is that the region will continue to have cyclical ups and downs against a broad trend of sluggish growth, low inflation and low rates. In light hereof, the most recent European news is actually marginally positive in that German industrial production, a cyclical indicator, rose 0.5% in the month of March in complete contradiction to expectations of a decline of 0.5%. German exports were also strong in March.

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Global backdrop

The news in the US is less encouraging. President Donald Trump's decision last week to hike taxes on imports from China is likely to be very bad for the US economy. Trade taxes hurt American consumers, push up prices in the US, cause real effective exchange rate overvaluation and encourage misallocation of resources by distorting relative prices. Add to this the likely damage to US exporters when the Chinese retaliate. Remember that the US economy slowed sharply after Trump's first round of trade taxes in May last year. The same will happen this time, only it will be worse than last time. Trade taxes cause disproportionately more domestic economic damage each time they are hiked, since they act as a wedge between the world price of a good and the domestic price paid by consumers. The larger the wedge the larger the so-called 'deadweight losses', i.e. the area of lost consumer surplus under the aggregate demand curve, which expands proportionately more than the trade tax rate itself.

The broader economic context here is also important. The US stock market corrected sharply in H2 2018, because costs began to eat into US company earnings. Higher trade taxes will now further increase costs for US companies, thus undermining earnings prospects further. The US stock market is therefore now a more risky place to invest. Recession risk is clearly higher too. As for Trump's frequent claim that trade taxes are good, because they raise revenue for the US Treasury, it is important to remember that Americans, not the Chinese, pay the trade taxes. If the Treasury wants to raise more money, there are far more efficient ways to do so than to interfere with international trade.

All of this is, of course, basic economics. The trade war is 99% bad news, but mainly for America. The only silver lining is that the two sides are still talking. In fact, our view remains that a deal on trade will be struck between the US and China. China is not interested in a trade war and Trump risks triggering the next US recession just ahead of the next US presidential election if he continues down the path of escalating protectionism. A failure to get re-elected means that Trump will go down in history alongside Jimmy Carter as a 'loser president', that is, a president, who is rejected by voters after just one term in office. Somehow, we do not think Trump fancies hanging out with Carter for eternity in the One Term Presidential After Life.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.18%	-2.14%	7.59%	-8.12%	11.60%	3.30%
MSCI EM Small Cap	-3.33%	-3.12%	4.41%	-13.49%	5.76%	1.20%
MSCI Frontier	1.75%	1.71%	8.74%	-7.48%	6.07%	-0.46%
MSCI Asia	-4.24%	-2.42%	8.74%	-7.67%	12.81%	6.03%
Shanghai Composite	-4.48%	-4.84%	17.95%	-5.14%	3.46%	10.36%
Hong Kong Hang Seng	-5.30%	-3.92%	7.99%	-7.00%	13.30%	6.49%
MSCI EMEA	-3.42%	1.62%	7.31%	-5.63%	7.94%	-1.23%
MSCI Latam	-3.17%	-2.73%	4.99%	-4.74%	9.56%	-1.59%
GBI EM GD	-0.20%	-0.38%	2.53%	-2.82%	3.37%	-1.30%
ELMI+	-0.39%	-0.31%	1.16%	-1.66%	2.65%	-0.90%
EM FX Spot	-0.32%	-0.54%	-0.28%	-7.24%	-2.49%	-7.23%
EMBI GD	-0.02%	0.22%	7.19%	7.21%	5.32%	4.92%
EMBI GD IG	0.11%	0.69%	6.70%	8.55%	4.40%	4.36%
EMBI GD HY	-0.15%	-0.22%	7.77%	5.89%	6.37%	5.35%
CEMBI BD	0.22%	1.00%	6.20%	7.12%	5.39%	4.74%
CEMBI BD IG	0.29%	1.01%	5.83%	7.97%	4.22%	4.19%
CEMBI BD Non-IG	0.13%	0.99%	6.69%	6.07%	7.30%	5.46%

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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	-2.09%	1.87%	15.77%	7.97%	13.68%	11.17%
1-3yr UST	0.09%	0.30%	1.29%	3.24%	1.03%	1.00%
3-5yr UST	0.16%	0.25%	1.84%	4.91%	0.97%	1.66%
7-10yr UST	0.46%	0.03%	2.90%	7.38%	0.75%	2.69%
10yr+ UST	1.25%	-0.57%	4.08%	8.08%	1.07%	4.79%
10yr+ Germany	0.88%	-0.46%	4.94%	11.32%	2.50%	7.06%
10yr+ Japan	0.30%	-0.35%	2.94%	3.89%	0.29%	4.65%
US HY	-0.49%	0.92%	8.25%	6.06%	7.77%	4.66%
European HY	-0.93%	0.42%	6.08%	1.82%	4.69%	3.96%
Barclays Ag	0.48%	0.18%	2.39%	2.18%	1.22%	0.81%
VIX Index*	45.50%	39.24%	-24.90%	50.91%	26.93%	57.38%
DXY Index*	-0.19%	0.01%	1.16%	5.14%	2.84%	21.40%
CRY Index*	-2.86%	-2.60%	5.40%	-12.08%	-1.96%	-41.66%
EURUSD	0.31%	0.29%	-1.89%	-5.68%	-0.52%	-17.91%
USDJPY	2.02%	1.51%	0.44%	0.41%	-0.53%	-6.36%
Brent	-1.58%	4.77%	33.18%	-7.09%	49.80%	-34.41%
Gold spot	0.29%	-0.40%	0.37%	-2.00%	1.08%	-0.49%

*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.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

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