Trade war infinity or end-game skirmish?

By Jan Dehn

The trade war has recently escalated, but this may be a sign that an end is nearer rather than the prospect of a never-ending conflict. Both sides have incentives to make last minute gains before a final truce locks in the gains and losses forever. The Weekly also covers the Indian election, Vietnam's alleged currency manipulation, political shenanigans in Brazil, PEMEX news in Mexico, the power struggle in South Africa, political noise in Argentina, capital controls in Turkey, a bond index fund in China and Ukrainian politics. The global backdrop discusses weak US data, May's tearful resignation in the UK and the European parliamentary election.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	-0.34%
MSCI EM Small Cap	9.8	–	0.67%
MSCI Frontier	8.8	–	1.36%
MSCI Asia	11.4	–	-0.70%
Shanghai Composite	10.0	–	0.86%
Hong Kong Hang Seng	7.5	–	-1.48%
MSCI EMEA	8.0	–	-0.65%
MSCI Latam	11.0	–	2.58%
GBI-EM-GD	6.17%	–	0.66%
ELMI+	5.60%	–	0.44%
EM FX spot	–	–	0.26%
EMBI GD	6.04%	369 bps	0.21%
EMBI GD IG	4.24%	187 bps	0.33%
EMBI GD HY	8.07%	576 bps	0.08%
CEMBI BD	5.63%	339 bps	0.06%
CEMBI BD IG	4.32%	208 bps	0.14%
CEMBI BD Non-IG	7.47%	522 bps	-0.06%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.3	–	-1.14%
1-3yr UST	2.15%	–	0.09%
3-5yr UST	2.09%	–	0.22%
7-10yr UST	2.28%	–	0.49%
10yr+ UST	2.71%	–	1.17%
10yr+ Germany	-0.15%	–	0.02%
10yr+ Japan	-0.07%	–	0.51%
US HY	6.36%	393 bps	-0.10%
European HY	4.30%	462 bps	-0.12%
Barclays Ag	1.73%	-55 bps	0.47%
VIX Index*	16.51	–	0.20%
DXY Index*	97.78	–	-0.28%
EURUSD	1.1188	–	0.24%
USDJPY	109.33	–	-1.06%
CRY Index*	178.63	–	-2.36%
Brent	69.9	–	-3.10%
Gold spot	1283	–	0.67%

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

Emerging Markets

Some commentators have suggested that the recent escalation in trade-related tensions between the US and China and particularly the recent attack by the Trump Administration on Huawei, a Chinese company, shows that Trump's trade war against China is turning into a permanent conflict. While one cannot rule out an infinite trade war, it is also entirely possible, plausible even, that the trade war is in fact drawing closer to conclusion.

How can the view that the trade war may be entering its final stages be reconciled with the observation that tensions have recently escalated? As military strategists know, hostilities often break out just before a truce. This happens because a truce locks in gains and losses forever. The prospect of an end to the game gives strong incentive to try to increase their bargaining position at the last minute with a view to securing the best possible deal, especially if one side is worried that it is getting the worse end of the bargain.

It is possible, indeed plausible, that the recent US attack on Huawei is a last gasp escalation designed to improve the US position in a final deal with China. Certainly, the latest developments in the conflict suggest this interpretation. First, China is steadfastly refusing to change any of the core elements of the overall trade deal. China appears happy with the terms of the overall deal, which may imply that US is not, i.e. is on the losing side of the deal as it currently stands. Second, the US only launched its attack on Huawei at a very late stage in the game, when most parties believed that a final agreement was imminent. Third, last week Trump offered to include Huawei in the final trade deal with China.

A sober assessment of these three developments implies that: a trade deal may be close; that China is happy with the deal; that the US feels that it is not getting as good a deal as China; that Trump wants to improve on the deal; and, Trump thinks his attack on Huawei can improve the deal from a US perspective.

In this interpretation, it suits both sides that Huawei is getting all the headlines. On the US side, nasty headlines about Huawei makes Trump look powerful vis-à-vis China. As for China, her focus is on the larger deal, whose scope encompasses the entire trading and investment regime between the two countries. Hence, US attention on the narrow topic of Huawei is actually a very convenient distraction.

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Emerging Markets

Indeed, one might even speculate that China's optimal strategy is to play up the Huawei issue in order to give the impression to the Americans that Huawei is super important. This will detract US attention from the rest of the deal, which is far more important and favours China.

What if China's diversionary tactic based on Huawei fails? Then China does have several credible counter-measures. One includes the restriction of exports of rare earth elements to US companies. Rare earth elements are key ingredients in most modern technology. The other is time. The longer the trade tensions last the more the American economy and the US stock market will hurt – see the Global Backdrop section below. This works against the US as the country moves inexorably towards the presidential election in November 2020.

The correct interpretation of the Huawei issue has implications beyond the trade war itself. Some of Huawei's suppliers, who have broken off ties in recent weeks, may regret their decisions. If Huawei is merely a last gasp skirmish, then these suppliers will have made a serious mistake by revealing themselves as 'fair weather friends'. They may find it difficult to do business in the future not just with Huawei but also with other Chinese companies.

In another development related to the US trade war against China, US Treasury Secretary Steven Mnuchin hinted last week that US may interfere with IMF lending policies. Specifically, Mnuchin said that the IMF would not approve lending for countries with liabilities under China's Belt and Road Initiative unless there is "full transparency of payments". The IMF is a highly technocratic institution, which, as standard practice, always establishes a clear and full picture of its clients' finances before lending money. Mnuchin's threat implies that the US may interfere with the operations of the institutions. This would undermine the credibility of the IMF, which, in the main, bases all lending decisions on objective criteria, not political preferences. The effect of US interference at operational level would be to push more and more countries into seeking financing from alternative sources, such the New Development Bank (formerly known as the BRICS Bank).

In the near-term, however, some EM countries could be affected, including Pakistan, Sri Lanka and a number of African countries. These countries receive considerable funding from China, but also depend heavily on multilateral aid, which is conditional upon IMF approval. The broader implication is that it is clearly dangerous to rely too heavily on systems rooted in the US legal and financial system in the current political climate.

- India: Prime Minister Modi increased his majority in the general election. His National Democratic Alliance took 353 of the 545 seats in the Lower House, an improvement relative to 2014. Attention now shifts to appointments to the Cabinet (June) and the Budget (July), but the real question is how Modi will use his now larger stock of political capital to reform India. The economy is broadly balanced, albeit slowing, while policy credibility is high. If, as he did in his first term, Modi focuses on reforms early in his new term to remove supply-side obstacles to India's expansion, then demand can rise without creating major imbalances. Modi may, in our view, focus on furthering India's integration into the global economy. A country of India's size and sophistication ought to be a major player on the global stage, but it is not. Instead, India remains a relatively insulated economy punching far below its weight. It is only possible to open the economy if the government addresses the solvency problems in the public sector banks. Education, infrastructure and deregulation are other areas, where India can make major progress.

- Vietnam: The US has decided that Vietnam does not manipulate its currency. The United States unilaterally sets criteria, whereby it judges if other countries manipulate their currencies. Dressed up as a technocratic measure, the process of determining if other countries are currency manipulators is in fact a purely political instrument, which the US employs to further its own national self-interest.

- Brazil: President Jair Bolsonaro's disapproval rating increased to 36% from 31% last month, according to the latest Ipespe poll. The economy is slowing and parliament is only making slow progress on the pension reform. Meanwhile, the government is forced to cut spending in other parts of the public sector in order to pay pensions (due to the existence of a fiscal rule, which limits overall spending). In an interesting new development, however, Brazil witnessed demonstrations in favour of Bolsonaro's reform program over the weekend. Also, despite Bolsonaro's declining popularity, Brazil's Senate approved a reform that allows up to 100% foreign ownership in Brazilian airlines. In macroeconomic news, mid-month IPCA inflation was just 0.35% mom in May, which was well below expectations (0.41% mom). For comparison, the inflation print in April was 0.72% mom. The 12-months current account deficit was stable at USD 13.7bn in April. FDI was USD 7.0bn in April, which was well ahead of expectations (USD 5.9bn).

- Mexico: The government will announce a change in the tax regime for PEMEX, the state-owned oil company, according to a report from Bloomberg. The new PEMEX tax regime should improve the financial position of the company. In other news, CPI inflation was stable at 4.4% yoy in the first fortnight of May, while the economy expanded at a yoy rate of 0.1% in Q1 2019. This was well down from the 1.6% yoy rate recorded in Q4 2019. Retail sales and services activity also softened in Q1 2019, but the Mexican trade surplus was higher than expected in April at USD 1.4bn (versus an expected USD 0.2bn deficit).

- South Africa: Following his recent election victory, President Cyril Ramaphosa is engaged in a power struggle with supporters of former President Jacob Zuma within his Cabinet. The main focus is on the position of David Mabuza, the corrupt Deputy President of South Africa and the ruling ANC. It is critical that South Africa's government eradicates corruption if it hopes to deliver public services and improve the climate for

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Emerging Markets

investment. This process has to start at the top. In other news, CPI inflation declined to 4.4% yoy in April from 4.5% yoy in March as the South African Reserve Bank (SARB) kept the policy rate unchanged at 6.75%. SARB revised its inflation forecast lower leading to expectations of rate cuts going forward.

- Argentina: MSCI, an index provider, has upgraded Argentina from 'frontier' to 'Emerging Markets' status effective today. MSCI says Argentina's index weight will be 0.3%. This may result in some USD 600m in passive flows into Argentinian stocks. In political news, leading moderate Peronists have indicated that they would not affiliate themselves with the joint ticket of Alberto Fernandez and former President Cristina Kichner. The two formed the alliance in a bid to unify the many disparate strands of Peronism. Meanwhile, Union Civica Radical has confirmed support for President Mauricio Macri's Cambiemos coalition. In economic news, the trade surplus reached USD 1.1bn in April, which is significantly higher than in the same month of 2018 (USD 890m). The improvement in the trade is due to spending restraint as well as the seasonal rise in exports of soybeans. Economic activity declined 1.2% in the month of March, but 1-year ahead inflation expectations also declined to 36.6% from 40.6% last month.

- Turkey: Last week, the government took another tentative step down the slippery slope of economic heterodoxy by imposing a soft version of capital controls. Specifically, the government imposed a small tax on FX sales and introduced forced delays on large purchases of Dollars. The government also raised reserve requirements for FX deposits. These measures will hurt companies in the commercial sector, which rely on ready access to Dollars in order to trade and produce.

- China: In an important development, China is launching an exchange-traded bond index mutual fund. This should enable more retail investors to access fixed income products. China's stock markets exhibit excessive volatility, because many retail investors do not have access to bonds. Hence, they tend to short stocks in downturns rather than buy bonds. Bond index mutual funds should gradually help to reduce stock market volatility as they gain wider acceptance. In other news, industrial profits declined at a yoy rate of 3.7% in April, which was partly payback following very high profits in March (13.7% yoy).

- Ukraine: Parliament has objected to a call by newly elected President Volodymyr Zelensky to hold early parliamentary elections. The final decision on the timing of the election will be down to the Constitutional Court. Meanwhile, oligarch Ihor Kolomoiski, an ally of Zelensky, has called upon the government to abandon relations with the IMF in favour of defaulting on the country's sovereign debt obligations.

Snippets:

- Chile: The real economy expanded at a yoy rate of 1.6% in Q1 2019 versus 1.8% yoy expected.
- Colombia: Moody's upgrade the sovereign credit outlook to stable, while Fitch downgraded the sovereign credit outlook to negative. Make of that what you want.
- Malaysia: Headline CPI inflation was 0.2% yoy in April versus 0.4% yoy expected.
- Nigeria: The central bank left the policy rate unchanged at 13.5%.
- Pakistan: The central bank hiked the policy rate by 150bps to 12.25%.
- Peru: Real GDP growth decelerated to 2.3% yoy in Q1 2019, according to INEGI, the national statistics bureau. The economy expanded at a very strong rate of 4.8% yoy in Q4 2018.
- Philippines: The government recorded a fiscal surplus of PHP 87bn in April following a deficit of PHP 58bn in March. The April surplus, which is the largest on record, was due to moderation in spending.
- Poland: Industrial production growth was very strong at 9.2% yoy in April. Wages rose at a high rate of 7.1% yoy in April.
- Russia: Industrial production was strong in April at 4.6% yoy. The strong print suggests that the weakness in Q1 2019 GDP is temporary.
- Singapore: Industrial production rose 2.4% mom sa in April, which was well ahead of expectations. Core CPI inflation was in line with expectations at 1.3% yoy. Q1 2019 GDP growth was 3.8% qoq saar.
- South Korea: Exports in the first twenty days of May were soft at -11.5% yoy compared to -10.1% yoy in April.
- Taiwan: Industrial production surprised significantly to the upside with a 5.5% surge in the month of April. This translated into a 1.1% yoy gain versus -5.0% yoy expected.
- Thailand: Exports declined at a yoy rate of 2.6% in April. This was slightly worse than expected (-2.0% yoy). Real GDP growth was 2.8% yoy in Q1 2019, in line with expectations.
- Venezuela: *De jure* leader Juan Guaido has allegedly hired Lee Buchheit, a well-known sovereign debt restructuring lawyer, to advise on a future restructuring of Venezuela's defaulted bonds.
- Zambia: ZESCO, the national electricity company, is to restrict electricity supply. The immediate reason is drought, but the deeper reason is lack of long-term planning by the government.

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Global backdrop

The Trump Administration's latest re-engagement in naked trade aggression against China is already taking a toll on the US economy. The same happened last year during Trump's first foray into protectionism. At -2.1% mom, durables goods orders were very weak in April, but flash PMI surveys for May also soured and new home sales crashed 6.9% mom in April. This follows weak retail sales and soft industrial production, so real GDP growth in Q2 2019 is now looking very soft. The Atlanta Fed's GDPNow forecast is currently placing Q2 2019 growth was 1.3% qoq saar.

German GDP growth was stronger than that at 1.7% qoq saar in Q1 2019. Investment, consumption and trade all contributed, while inventories declined, which could signal an even larger ramping up of output going forward to restock inventories.

The European parliamentary election saw mainstream centre-left and centre-right groups weakened and fractured, but the overall shift to populism was less pronounced than many had feared. Mainstream political forces in the European Parliament continue to control more than two thirds of the seats, but they will certainly be challenged to work more closely together. Their problems, however, pale in comparison with the situation in the UK, where the ruling Conservative Party was nearly wiped out by Nigel Farage's Brexit Party, a nationalistic protest movement with no manifesto and shady financing. The UK Labour Party, led by Jeremy Corbyn, a far-left Eurosceptical populist, also did badly, ceding seats to pro-EU parties, such as the Liberal Democrats, the Green Party and Change UK, an opportunistic pro-Remain entity.

It is against this chaotic backdrop that UK finds itself looking for a new Prime Minister after Theresa May's tearful resignation last week. Her successor will almost certainly be even more pro-Brexit, which means that a hard landing for the UK economy is now considerably more likely. Boris Johnson, the arch-populist former mayor of London, leads in the polls to succeed May.

The rise of populism across developed economies is already translating in worse policy decisions, slower growth, rising discontentment and a tendency for politicians to blame domestic problems on foreigners, either at home or abroad rather than facing up to the underlying issues.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-8.11%	-6.16%	3.17%	-10.46%	9.96%	1.89%
MSCI EM Small Cap	-5.76%	-5.55%	1.79%	-15.15%	4.97%	0.23%
MSCI Frontier	1.35%	1.31%	8.30%	-3.24%	5.58%	-0.88%
MSCI Asia	-8.43%	-6.68%	3.99%	-11.54%	10.60%	4.33%
Shanghai Composite	-5.88%	-6.23%	16.22%	-5.76%	3.06%	9.75%
Hong Kong Hang Seng	-9.21%	-7.89%	3.53%	-10.01%	11.22%	4.67%
MSCI EMEA	-6.04%	-1.14%	4.40%	-5.35%	6.86%	-2.36%
MSCI Latam	-4.76%	-4.33%	3.26%	1.72%	11.54%	-1.71%
GBI EM GD	-0.19%	-0.37%	2.55%	-0.20%	4.14%	-1.39%
ELMI+	-0.48%	-0.40%	1.07%	-0.61%	2.96%	-0.98%
EM FX Spot	-0.91%	-1.12%	-0.87%	-5.90%	-2.02%	-7.34%
EMBI GD	0.24%	0.48%	7.47%	6.98%	5.50%	4.83%
EMBI GD IG	0.68%	1.26%	7.31%	8.98%	4.84%	4.34%
EMBI GD HY	-0.19%	-0.27%	7.72%	5.00%	6.27%	5.17%
CEMBI BD	0.34%	1.12%	6.33%	7.27%	5.41%	4.60%
CEMBI BD IG	0.63%	1.36%	6.19%	8.29%	4.38%	4.12%
CEMBI BD Non-IG	-0.05%	0.80%	6.50%	5.99%	7.11%	5.21%

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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	-3.87%	0.02%	13.67%	5.71%	13.09%	10.49%
1-3yr UST	0.32%	0.53%	1.52%	3.30%	1.21%	1.02%
3-5yr UST	0.68%	0.77%	2.37%	5.24%	1.38%	1.68%
7-10yr UST	1.47%	1.04%	3.94%	8.37%	1.40%	2.74%
10yr+ UST	3.33%	1.48%	6.22%	10.47%	1.99%	4.97%
10yr+ Germany	1.97%	0.61%	6.07%	11.37%	3.18%	7.00%
10yr+ Japan	0.78%	0.13%	3.43%	4.33%	0.31%	4.71%
US HY	-0.66%	0.76%	8.07%	6.01%	7.43%	4.57%
European HY	-1.04%	0.30%	5.95%	2.22%	4.53%	3.94%
Barclays Ag	0.77%	0.47%	2.68%	2.91%	1.60%	0.85%
VIX Index*	25.84%	20.42%	-35.05%	24.89%	25.84%	43.44%
DXY Index*	0.31%	0.51%	1.67%	3.75%	2.37%	21.36%
CRY Index*	-3.05%	-2.79%	5.20%	-12.15%	-4.03%	-41.74%
EURUSD	-0.25%	-0.26%	-2.45%	-3.76%	0.65%	-17.68%
USDJPY	-1.88%	-1.37%	-0.34%	-0.08%	-0.91%	7.34%
Brent	-3.93%	2.27%	30.00%	-7.12%	41.81%	-36.31%
Gold spot	-0.02%	-0.70%	0.06%	-1.14%	5.80%	2.00%

*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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