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Clear thinking from Singapore

By Jan Dehn

Singapore Prime Minister Lee Hsien Loong has proposed that Emerging Markets (EM) countries form closer regional ties in bid to offset the fallout from the US trade war against China. The need for closer cooperation arises from the fact that the largest problems in the world are of the cross-border variety, such as immigration, the environment, economic and financial contagion and terrorism. Moreover, these types of problem will increase over time as the world inevitably integrates further on the back of rising living standards in EM countries and greater cross-border communications, trade, finance and travel. Cross-border solutions solve cross-border issues. Hence, the logic of forming closer ties between countries. The ideal solution would be cooperation at global level, but if the US does not want to lead then the second best solution is for smaller countries to form highly inclusive regional groups to promote free trade, cross-border capital flows and security.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	1.04%
MSCI EM Small Cap	10.0	–	0.72%
MSCI Frontier	9.2	–	0.84%
MSCI Asia	11.7	–	0.83%
Shanghai Composite	9.9	–	-2.44%
Hong Kong Hang Seng	7.6	–	-0.63%
MSCI EMEA	9.1	–	1.46%
MSCI Latam	11.4	–	2.45%
GBI-EM-GD	5.96%	–	1.60%
ELMI+	5.56%	–	0.95%
EM FX spot	–	–	0.99%
EMBI GD	5.79%	368 bps	1.46%
EMBI GD IG	4.04%	189 bps	1.19%
EMBI GD HY	7.85%	578 bps	1.73%
CEMBI BD	5.48%	348 bps	0.57%
CEMBI BD IG	4.16%	216 bps	0.48%
CEMBI BD Non-IG	7.39%	538 bps	0.69%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.5	–	4.46%
1-3yr UST	1.90%	–	0.21%
3-5yr UST	1.91%	–	0.35%
7-10yr UST	2.14%	–	0.51%
10yr+ UST	2.62%	–	0.36%
10yr+ Germany	-0.22%	–	1.63%
10yr+ Japan	-0.12%	–	0.62%
US HY	6.24%	407 bps	0.91%
European HY	4.29%	471 bps	0.38%
Barclays Ag	1.57%	-57 bps	1.20%
VIX Index*	16.12	–	-2.74%
DXY Index*	96.81	–	-0.33%
EURUSD	1.1308	–	0.60%
USDJPY	108.62	–	0.51%
CRY Index*	174.42	–	-0.95%
Brent	63.2	–	3.08%
Gold spot	1328	–	0.22%

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

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In a landmark speech at the Singapore Shangri-La Dialogue on 31 May, Singapore Prime Minister Lee Hsien Loong offered a clear vision for the way forward for the +200 countries of the world, which happen not to be direct protagonists in the ongoing US-China trade war.

In an intelligent and pragmatic speech, Lee argued that a trade war could easily be resolved if the issues were merely related to trade. He believes, however, that interest groups in the US are promoting the idea that China and the US are locked into a zero sum conflict from which there can only be one winner and one loser. There are also interest groups within China, which argue for a hard line response from China to what they view as naked aggression.

The characterisation of the US-China trade war as a zero sum game is fundamentally wrong, according to Lee. Unlike the situation that prevailed during the Cold War, China and the US do not subscribe to mutually exclusive systems. Both countries support the role of market forces and both are fundamentally in agreement about the need for a single system of multilateral governance. Since neither China nor the US operate economic systems, whose internal flaws guarantee eventual Soviet-style economic collapses, the conflict between China and the US could, in principle, go on forever. This is clearly not in the interest of the populations of the two countries. It is therefore up to the leaders in both countries to rise above populism. Indeed, Lee points out, if they manage their bilateral relations on a stable rather than a confrontational basis, they will both be in a far better position to address their respective domestic problems.

Despite the fact that reconciliation would be the rational outcome for both countries, Lee concedes that it is possible that the US, China, or, indeed, both countries could fail to exercise the leadership required to move beyond this costly and meaningless conflict.

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If so, it is imperative that other countries do not make the same mistake. Third parties must look for second best solutions.

Lee's proposal for a second-best solution is for third parties to form closer regional ties with a view to deepen trade relations, encourage cross-border capital flows and enhance security. But why the need to form groups in the first place? Closer regional ties have become genuinely necessary in today's global economy, because the largest problems facing all countries today are of the cross-border variety: immigration, the environment, terrorism, economic and financial contagion. As the world integrates further due to rising living standards in EM countries and technical progress, cross-border problems will only grow in importance. No individual country can shield itself from cross-border problems, only cross-border cooperation can solve cross-border problems.

Lee believes that cooperation would ideally take place at a global level, but as long as large countries, such as the United States, are unwilling or unable to exercise strong leadership, the second-best solution of joining regional groups is the right way forward for smaller countries. Regional groups are not immune to the fallout from the US-Chinese rivalry, but at least they enable third party countries to continue to benefit from working together even if the US and China do not.

In our view, Lee's logic is irrefutable. It is the same logic that lies behind the European Union, the newly formed African Continental Free Trade Agreement (ACFTA) and recent talk of a currency union among Mercosur countries in South America. Lee's logic also underpins the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the Regional Comprehensive Economic Partnership (RCEP) and ASEAN itself.

However, we would argue that third parties should take Lee's logic one step further. While regional arrangements, which are designed to maintain free trade, cross-border finance and political cooperation are extremely useful, they do not address an absolutely central vulnerability, which cuts right across all countries, regardless of their regional affiliations, namely reliance on the US financial system.

The near-universal reliance on the US financial system used to be efficient, because the US was a trusted partner. However, the Trump Administration has proven itself perfectly willing to exploit America's power as a financial hegemon in pursuit of narrow self-interest. The sudden announcement of tariffs on Mexico is a good example (see the Mexico section below for more details) and it is by no means the only example. Turkey, Mexico, Canada, Iran, Russia and other countries have also found themselves on the receiving end of Trumpian exploitation of American power.

The US, like other countries, has always pursued national interest, but, as we noted in a recent publication, the willingness of the current US Administration to use American financial, legal and economic power to instil fear in others, marks a clear break from 70 years of US policy. Countries that ignore this change err on the side of recklessness.

Given the ever-changing landscape of geopolitics, unless there is a clear reversal of US policies it is only a question of time before other countries fall prey to their overreliance on the US financial system, especially if they get into some kind of diplomatic spat with the Trump Administration. This risk is particularly pronounced in Asia, where China is the largest trading partner of almost all countries. At a minimum, countries should begin to hedge themselves against US fear tactics by gradually reducing exposure to New York Law, the US Dollar and the American banking system. Following US Treasury Secretary Steven Mnuchin's recent suggestion that countries with exposure to China's Belt and Road Initiative could receive less IMF funding, they should also work to develop new multilateral alliances. Indeed, it is time to rethink the entire global financial system. Just in case.

- Passive investing in EM bonds: Exchange traded and passive funds own just 3% of EM hard currency debt and 1% of EM local currency debt, according to the Institute of International Finance (IFF). The low level of participation of ETFs and passive money is a good thing, in our view. However, the low participation rate also presents challenges. Almost all media and investment bank coverage of flows into and out of the EM asset class is based on flows through ETFs and passive funds. Such information can be extremely misleading. Retail-like, ETF and passive funds often respond to headlines and other short-term events. By contrast, institutional investors with active mandates tend to invest over longer time horizons. Within this group, local institutional investors are by far the most important, because they own at least 90% of EM local currency debt. Foreign institutional investors own the vast majority of EM external debt. So why do banks and the media groups focus so much on ETF and passive flows? The most obvious reason is that it is the only data they have. Most institutional flow moves via segregated accounts, which are not picked up in the published weekly flow numbers. However, they also appear to have a collective blind spot when it comes to EM-based institutional investors. For example, when is the last time you saw Bloomberg TV or some other financial media outlet cover the holdings of Mbonos by the Mexican AFORES (Administradores de Fondos para el Retiro – regulated, specialised private pension funds managers responsible for managing employee's retirement accounts)? Finally, retail data is obviously more exciting, because it is so volatile. There is nothing wrong with reporting and paying attention to ETF and passive funds in EM, but just remember that they really do not reveal the full story of what is going on in the asset class.

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- Mexico: It is tough to be Mexican these days. Ratings agencies and US President Donald Trump both have the knives out for the country. Fitch downgraded Mexico's sovereign credit rating from BBB+ to BBB with negative outlook, while Moody's placed the sovereign credit rating on negative watch. Fitch twisted the knife by also downgrading Pemex, the national oil company to junk status (BB+) with a negative outlook. This means that Pemex is just a single rate cut away from no longer qualifying for inclusion in investment grade only funds, an event which could trigger forced selling to the tune of USD 9-13bn. The ratings agencies are citing Pemex, the national oil company, as a major fiscal liability for the sovereign. Pemex is a heavily indebted and extremely inefficient employment creation agency with a bit of oil business on the side. Fortunately, Trump appears to have staged a spectacular U-turn on his tariffs threat over the weekend, but as we argued in the lead story above, the threat from the US is not over until there is a decisive change in the current US Administration's willingness to exploit its financial hegemony to bully smaller countries, such as Mexico. Sadly, there are signs that the Mexican economy is already reeling from the onslaught. Gross fixed capital investment contracted at a yoy pace of 2.4% in March, which was far worse than expected (-1.7% yoy), while manufacturing PMI declined in May. Private consumption declined 1.5% mom sa in March. At least inflation also softened (3.77% yoy in May from 3.94% in H1 April), so there is more room for the central bank to ease.

- South Africa: South Africa is another country where things are getting a bit tough. South Africa's main challenge right now revolves around its badly managed public sector energy giant, ESKOM. Load shedding by ESKOM is now contributing to lower exports, which in turn is causing the current account deficit to widen to 2.2% of GDP in Q1 2019. Manufacturing PMI also declined to a six-month low of 45.4. However, the real shocker was GDP growth, which contracted at a much larger than expected rate of 3.2% qoq saar. Activity in both primary and secondary industries contracted meaningfully.

Hardly was this news out when voices within ANC began to call for a change in the mandate of the South African Reserve Bank (SARB), such that it takes account of employment in addition to inflation and growth, which are already included in the mandate specification. There were also calls for QE. The proposed changes to the SARB mandate emanate from anti-Ramaphosa factions within ANC, which are not actually in a position to effect change. Indeed, officials from the finance ministry soon confirmed that the government is satisfied with the existing mandate.

As for QE, this is an operational matter within the remit of SARB itself. Lesetja Kganyago, the SARB governor, was also quick to state that QE is not appropriate for the current conditions in South Africa. Lesetja is right. It would be a major mistake to change the SARB mandate and to engage in QE at this stage. SARB's mandate is well designed and SARB remains the single most credible government institution in South Africa.

South Africa's problems are unrelated to monetary policy. They are structural, rooted in labour market issues, deficits in the state-owned enterprises and lack of broader structural reforms. These problems are all outside the remit of SARB. If SARB's mandate were to change for what would be political reasons, it would undermine investor confidence in South Africa, resulting in even less investment and even worse economic conditions. President Cyril Ramaphosa knows this. That is why the whole story of changing the mandate is not a serious risk, in our view.

- India: Following the lower than expected growth rate of 5.2% in Q1 2019, services PMI softened to 50.2 in May from 51.0 in April and the Reserve Bank of India wasted no time in cutting the repo rate by 25bps to 5.75% adopting a dovish outlook. It is nice to have plenty of room to cut. The yield on the 10-year government bond is about 7.2% and the central bank only expects 3.3% yoy inflation for the 2019/2020 fiscal year. Good for bondholders.

- Ukraine: Barring a late ruling to the contrary by the Constitutional Court, Ukraine will hold parliamentary elections on 21 July instead of 27 October as originally scheduled. An early election favours President Zelensky, whose alliance stands to gain a significant number of seats in the Rada. Zelensky has appointed reform-friendly former Finance Minister Oleksandr Danylyuk to head the National Defence and Security Council, an influential government body, which often takes the lead in defining government policy on key issues, notably regarding corruption, constitutional matters and defence.

- Peru: The government's proposal to root out corruption in the political system survived a no confidence vote in parliament last week. The political reform improves the rules for campaign financing among other things. CPI inflation was 0.15% mom in May, which was 0.3% lower than expected.

- Argentina: A poll by Elypsis showed that President Mauricio Macri would win a second round run-off against the joint Peronist ticket of Alberto Fernandez and former President Cristina Kirchner by 5%. Meanwhile, manufacturing activity picked up in April (2.3% mom sa), which puts Argentina on track for a return to positive growth in Q2 2019, just in time for the presidential election, which is scheduled to be held on 27 October 2019.

In other news, officials from Argentina and Brazil are discussing the possibility of merging their currencies, according to press reports. Argentina's central bank denied the report. A currency union is obviously a good idea in principle, especially for Argentina, whose institutions have yet to discover the secret sauce behind price stability, but monetary union would also require fiscal union, which seems unlikely. Without fiscal union, one can easily imagine, ten years down the road, Argentina desperately trying to exit the currency union, while Brazil vehemently opposing 'Argxit'.

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- **Brazil:** The benign environment for bonds continues. The main IPCA consumer prices index declined to 4.66% yoy inflation in May, which was a meaningful drop from 4.94% yoy inflation in April. Industrial production was also lower than expected on weaker mining activity (+0.3% mom versus 0.7% mom expected). Sentiment towards Brazil has improved in recent weeks for two reasons. First, President Jair Bolsonaro has gone a bit quiet. Second, a popular trade to short BRL and go long MXN has gone into reverse.

Snippets:

- **Chile:** Economic activity continued to pick up in April, gaining 0.3% mom sa. Retail sales softened in April. In a surprise move, the central bank revised upwards the country's long-term potential GDP growth (to 3.75% from 3.25%), and cut the monetary policy rate by 50bps to 2.5%.
- **China:** Caixin services PMI eased to 52.7 in May from 54.5 in April.
- **Colombia:** CPI inflation increased marginally to 3.31% yoy in May from 3.25% yoy in April.
- **Czech Republic:** Retail sales in April delivered a solid beat versus expectations by racking up 4.8% yoy growth (3.4% yoy consensus). Industrial output was also well ahead of expectations (3.3% yoy versus 2.7% yoy consensus). Wage growth was solid in Q1 in both construction and services.
- **Hungary:** Industrial output growth was solid at 6.0% yoy in April. Retail sales growth was on fire at 7.1% yoy in April. CPI inflation was unchanged at 3.9% yoy in May.
- **Mozambique:** The government has reached agreement with bondholders about restructuring the 2023 bond.
- **Nigeria:** The current account swung from a surplus of USD 1.1bn in Q4 2018 to a deficit of USD 1.1bn in Q1 2019. FX reserves increased to USD 45.1bn in May due to net capital inflows.
- **Poland:** The National Bank of Poland left the policy rate unchanged at 1.5%. CPI inflation increased marginally to 2.3% yoy in May from 2.2% yoy in April.
- **Philippines:** CPI inflation increased to 3.2% yoy in May from 3.0% yoy in April.
- **Romania:** Real GDP growth was 5.0% yoy in Q1 2019.
- **Russia:** The rate of CPI inflation declined to 5.1% yoy in May from 5.2% yoy in April. Manufacturing PMI softened to 49.8 in May.
- **Serbia:** The National Bank of Serbia left the policy rate unchanged at 3.0%.
- **Slovakia:** Retail sales ramped sharply higher to 1.8% yoy in April from -1.9% yoy in March.
- **South Korea:** The government is planning to extend tax relief on car purchases for another six months in light of the fallout from Trump's trade war with China. CPI inflation was 0.7% yoy in May.
- **Taiwan:** CPI inflation increased to 0.9% yoy in May from 0.7% yoy in April.
- **Thailand:** Consumer prices inflation was 0.1% mom in May. This translated into 1.1% inflation in yoy terms versus 1.0% yoy expected.
- **Turkey:** CPI inflation eased to 18.7% yoy in May, which was much better than expected (19.25% yoy).
- **Uruguay:** CPI inflation moderated to 7.7% yoy in May from 8.2% in April.

Global backdrop

Euro area core CPI inflation declined to 0.8% yoy in May from 1.3% yoy in April, while economic activity generally picked up. German manufacturing orders beat expectations in April and car production also continued to recover, although industrial production continued to fall short of expectations. Euro area PMI was stronger than expected at 51.8 in May versus 51.4 in April and Euro area Q1 2019 GDP pointed to healthy growth in private consumption and fixed investment. Against this backdrop, the European Central Bank was dovish, but not quite as dovish as expected. The decision of the Governing Council was not to touch rates for another twelve months and to stand ready to engage in further quantitative easing should conditions require. The main risk from the ECB's perspective is lower than expected inflation rather than lower than expected growth. For example, if the Fed begins to cut rates and the Dollar falls, then the higher EUR will depress prices in Europe. Within the European Union, Italy remains a weak spot, but the EU is now punishing Italy for its fiscal sins by commencing the so-called Excessive Debt Procedure.

In the UK, manufacturing PMI came down with a bump in May, entering contraction territory (49.4 versus 53.1 in April). Economic activity has been strong over the past year as businesses hoarded inputs in anticipation of a Hard Brexit. Having hoarded, British business now appears to be content to sit back and wait for the pain to begin. In a notable by-election, Labour held Peterborough, where more than 60% of voters favoured leaving the European Union in 2016, but with a much-diminished majority. Tories were also hurt badly as the single-issue Brexit Party and the Liberal Democrats gained. In short, UK politics remains completely out of joint.

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Global backdrop

In the US, Senator Marco Rubio proposed a bill that, if approved, would delist Chinese companies from US exchanges. This is another example of America retreating into a shell from which it will only re-emerge as a diminished global power. Fed Chairman Jerome Powell noted mounting risks from protectionism, which markets correctly interpreted as dovish. The Fed can do nothing about protectionism, but it rightly views protectionism as a macroeconomic negative, which justifies a more cautious stand. The US economy is not doing well. Payrolls disappointed heavily, wage growth slowed, factory orders softened in March and April, and ISM manufacturing fell 0.7 points in May to 52.1. Imports also weakened in April, which points to lower domestic demand and unit labour costs declined, which will weaken demand further. ISM services delivered good news, but services generally tend to be more stable than manufacturing due to lower fixed costs. Still, new orders weakened. Productivity growth was also revised lower to 3.4% qoq saar from 3.6% qoq saar. Productivity growth is still higher than any previous quarter since 2014, but it remains to be seen whether this continues to be the case in Q2 2019, when real GDP growth is widely expected to slow, because Trump's Administration once again gave in to his protectionist urges. One wonders why he insists on doing things, which are so obviously bad for the economy.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	1.04%	-4.28%	5.24%	-9.83%	9.41%	2.03%
MSCI EM Small Cap	0.72%	-4.00%	3.46%	-14.25%	4.45%	0.32%
MSCI Frontier	0.84%	3.05%	10.17%	-3.84%	5.94%	-1.22%
MSCI Asia	0.83%	-5.99%	4.75%	-13.02%	9.68%	4.27%
Shanghai Composite	-2.26%	-8.04%	13.97%	-6.99%	1.03%	9.31%
Hong Kong Hang Seng	-0.18%	-7.98%	3.43%	-12.03%	9.96%	4.02%
MSCI EMEA	1.46%	2.86%	8.62%	-2.08%	6.64%	-1.90%
MSCI Latam	2.45%	0.87%	8.87%	16.17%	12.04%	-0.99%
GBI EM GD	0.95%	1.72%	4.02%	1.39%	3.74%	-1.23%
ELMI+	0.65%	0.36%	1.54%	-0.42%	2.74%	-0.88%
EM FX Spot	0.99%	-0.18%	0.07%	-4.79%	-2.50%	-7.18%
EMBI GD	1.46%	2.12%	9.22%	9.44%	5.43%	4.87%
EMBI GD IG	1.19%	3.10%	9.26%	11.33%	4.84%	4.51%
EMBI GD HY	1.73%	1.19%	9.29%	7.59%	6.12%	4.98%
CEMBI BD	0.49%	1.85%	7.01%	8.13%	5.34%	4.60%
CEMBI BD IG	0.48%	2.26%	7.14%	9.18%	4.44%	4.18%
CEMBI BD Non-IG	0.69%	1.28%	7.00%	7.03%	6.75%	5.10%

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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	4.46%	1.79%	15.68%	5.82%	13.07%	10.30%
1-3yr UST	0.21%	1.15%	2.16%	3.85%	1.32%	1.16%
3-5yr UST	0.35%	1.92%	3.54%	6.23%	1.53%	1.97%
7-10yr UST	0.51%	3.07%	6.03%	10.02%	1.63%	3.24%
10yr+ UST	0.36%	5.01%	9.92%	13.19%	2.45%	5.81%
10yr+ Germany	1.63%	3.87%	9.51%	15.16%	3.29%	7.67%
10yr+ Japan	0.62%	1.45%	4.80%	5.62%	0.64%	4.96%
US HY	0.91%	1.13%	8.47%	5.91%	7.09%	4.53%
European HY	0.38%	0.04%	5.68%	2.16%	4.07%	3.68%
Barclays Ag	1.20%	2.27%	4.52%	4.69%	1.64%	1.20%
VIX Index*	-13.84%	17.58%	-36.59%	32.35%	-5.34%	46.68%
DXY Index*	-0.96%	-0.48%	0.67%	3.51%	2.37%	19.79%
CRY Index*	-0.54%	-5.08%	2.72%	-12.81%	-9.58%	-42.91%
EURUSD	1.24%	0.80%	-1.39%	-4.04%	0.51%	-16.53%
USDJPY	0.30%	-2.02%	-0.98%	-1.28%	1.54%	6.13%
Brent	-2.05%	-7.63%	17.42%	-17.38%	24.99%	-42.32%
Gold spot	1.73%	2.77%	3.57%	2.13%	4.24%	5.42%

*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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