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WEEKLY INVESTOR RESEARCH

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China in the news again: some perspectives

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China is back in the news. As usual, the coverage is tilted to the negative side. Will the G20 lead to an escalation in the US-China trade war? How badly is China's economy hurting from US trade aggression? Can China cope in policy terms? What is going to happen to the CNY? Will the recent tensions in Hong Kong further undermine China? We provide some perspective and, hopefully, balance. The Weekly also covers good political news in Argentina, progress on the pension reform in Brazil, declining oil production in Venezuela and fiscal conservatism in Colombia.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	0.90%
MSCI EM Small Cap	10.1	–	0.51%
MSCI Frontier	9.3	–	0.34%
MSCI Asia	11.8	–	0.86%
Shanghai Composite	10.0	–	2.11%
Hong Kong Hang Seng	7.6	–	1.06%
MSCI EMEA	9.3	–	1.38%
MSCI Latam	11.4	–	0.33%
GBI-EM-GD	5.82%	–	0.94%
ELMI+	5.65%	–	0.01%
EM FX spot	–	–	-0.01%
EMBI GD	5.77%	365 bps	0.25%
EMBI GD IG	4.02%	187 bps	0.20%
EMBI GD HY	7.82%	574 bps	0.30%
CEMBI BD	5.41%	341 bps	0.51%
CEMBI BD IG	4.10%	211 bps	0.42%
CEMBI BD Non-IG	7.29%	529 bps	0.64%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.6	–	0.53%
1-3yr UST	1.87%	–	0.05%
3-5yr UST	1.86%	–	0.06%
7-10yr UST	2.11%	–	0.06%
10yr+ UST	2.61%	–	-0.30%
10yr+ Germany	-0.25%	–	0.12%
10yr+ Japan	-0.12%	–	0.29%
US HY	6.13%	395 bps	0.36%
European HY	4.18%	458 bps	0.46%
Barclays Ag	1.57%	-54 bps	-0.34%
VIX Index*	15.28	–	-0.66%
DXY Index*	97.54	–	0.78%
EURUSD	1.1216	–	-0.85%
USDJPY	108.59	–	0.13%
CRY Index*	174.81	–	0.39%
Brent	61.9	–	-0.59%
Gold spot	1334	–	0.48%

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

Emerging Markets

- **China:** Investors are once again focusing on China ahead of the upcoming G20 Summit on 28/29 June, where the focus will be concentrated on the trade war with the US. The market's base case is that a deal will not be struck on this occasion, but we believe there will be some progress towards a deal. After all, China does not want a trade war, because it hurts economically (see below) and because a trade war is economic nonsense directly contrary to the general direction that China wishes to travel. As for the US government's intentions, they are less clear due to the strong ideological and populist bent of the Trump Administration. However, it is clear that the US economy will continue to weaken if the trade war carries on and particularly if it intensifies. A weaker US economy in turn undermines both President Trump's and the Republicans' re-election chances in November 2020. Both sides therefore have incentives to strike a deal and these incentives will strengthen daily, although there may be advantages in the very short run for one or both sides to ignore them. For example, the recent upsurge in hostilities between the two countries may well turn out to be late-stage positioning ahead of a trade deal, which may therefore be closer than many think. For more details on this particular interpretation of recent events, see '*Trade war infinity or end-game skirmish?*' Weekly investor research, 28 May 2019.

Regardless of where relations between China and the US are heading in the near-term, China's policy response has so far been reassuring. China has exercised restraint in its counter-measures against US trade aggression as well as liberalised trade outright with third parties. For example, a new report from the Peterson Institute for International Economics highlights that China has been cutting tariffs on imports from third parties, including Europe and Japan.[1] China's restraint with respect to the US and ongoing liberalisation of trade with third parties obviously makes sense from a narrow economic perspective, since protectionism undermines productivity and free trade improves productivity. However, it also makes sense from a broader strategic perspective. China's long-term economic strategy is to move towards global hegemony in finance and trade. This objective is clearly advanced most rapidly precisely at times, such as these, when China can build trust and deepen ties

[1] See: https://piie.com/blogs/trade-investment-policy-watch/trump-has-gotten-china-lower-its-tariffs-just-toward-everyone

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Emerging Markets

demonstrating maturity and rationality, while the US chips away at its standing in the eyes of the world by breaking with one of America's longest standing commitments, namely that of support for free trade. As an aside, European and Japanese exporters obviously enjoy improved access to the enormous Chinese consumer market under lower tariffs, while American companies get penalised outright.

Much attention is currently being directed at China's exchange rate. Bank analysts and the media are fuelling a speculative frenzy that the so-called 'psychologically important' level of 7 for USDCNY may be breached around the G20. The speculation rests on a possible negative outcome of the G20 Summit as well as recent tension in Hong Kong and some softer Chinese economic data. In Hong Kong, protestors are objecting to a new ruling, which allows prisoners in Hong Kong to be extradited to China. Some fear that the US may use the protests as a pretext to escalate the trade war. As for the recent data, it has been mixed rather than outright negative. On the positive side, total social financing (TSF) increased marginally to RMB 1.4trn from RMB 1.36trn in April, meaning that credit grew at a solid of 10.5% yoy, which is actually marginally better than in April (10.4% yoy). Also, at 8.6% yoy, retail sales in May beat expectations significantly (8.1% yoy), while CPI inflation was entirely normal in May with the headline index increasing to 2.7% yoy compared to 2.5% in April and core CPI inflation softening marginally to 1.6% yoy from 1.7% yoy. On the negative side, fixed asset investment and industrial production both undershot expectations, which probably reflects that businesses are generally more sensitive to the recent upsurge in trade tensions with the US than, say, consumers.

A speculative attack on CNY around the G20 is nevertheless a possibility, but if USDCNY should temporarily push through 7, we believe this would be a short-term move. In our view investors should buy CNY for three reasons: Firstly, we think the bullish Dollar environment from last year is fading. The Dollar clearly benefitted from three specific short-term drivers: last year, namely the US fiscal stimulus, a hawkish Fed and the start of Trump's trade war. However, prior to 2018 the Dollar had already weakened significantly in 2016-2017 and may now resume weakness as the 2018 drivers fade. Understanding positioning here is key: Investors from all over the globe piled into US stocks over the past decade based on a very bullish view of the US economy and a hawkish view of the Fed. Now, as the US growth outlook is becoming less compelling, the basis for remaining very long the Dollar is slowly crumbling. We estimate that the broad Dollar is about 20% overvalued.

Second, global capital is likely to continue to flow into China. Some USD 16bn flowed into the Chinese bond market in net terms in May, which is the largest inflow so far this year. The Chinese bond market is 15.6% larger than a year ago, but foreigners still only own 3.1% of outstanding Chinese government bonds (compared to ten times that much in US bonds). A total of USD 0.5 trillion will likely flow into China's bonds over the next five years or so due to bond index inclusion. MSCI is also steadily increasing the weight of China equities in its benchmark index for stocks. However, index inclusion is only the beginning of the flow story. On realistic trends for economic growth, financial deepening and broadening and population growth, China's markets will be 2-3 times larger than those in the US by 2050. As Chinese markets grow larger than US markets, they also grow more liquid and inevitably replace US markets as the world's preferred benchmarks for FX, bonds and stocks. Investors need to get their heads around the fact that they will have to consider having 30% in China, not just 3%.

Third, China is once again turning to infrastructure investment. On 10th June, the State Council approved special bond issues to fund new infrastructure investments in China. The investments will target key bottlenecks in the economy including railways, highways, water, electricity and gas supply. The private sector will be incentivised to co-finance many of the projects. As a result, investment growth will likely quadruple in the rest of 2019 relative to 2018. Many investors habitually question the wisdom of yet more investment in Chinese infrastructure, but such concerns fail to take account of the fact that sustaining China's real GDP growth rate of more than 6% per year requires that China invests in infrastructure all the time. Otherwise, the economy will soon crash into important supply-side constraints, which in turn would impede China's ability to rely more on domestic demand-led growth going forward. There is therefore nothing wrong with the main thrust of economic policy in China, which, in a nutshell, boils down to relying on the private sector to produce, while the government provides all the major infrastructure investment to enable the private sector to expand. In fact, this is a winning strategy, in our view.

- Argentina: Markets reacted positively to improving poll ratings for President Mauricio Macri ahead of the presidential election on 27 October. Macri is now running neck and neck with Alberto Fernandez. Markets also loved the news that Macri has appointed a senior Peronist, Senator Miguel Angel Pichetto as his vice-presidential running mate. Pichetto's inclusion on the Macri ticket promises to split the Peronists and should broaden the support for Macri, thus increasing his chances of winning a second term. A second term means continuity for the ongoing IMF sponsored reform programme. Elsewhere in the political spectrum, former Cabinet Chief Sergio Massa joined the Alberto Fernandez/Cristina Kirchner team, while Roberto Lavagna launched his own bid with Urtebey. On the economic front, monthly inflation is now clearly coming down. In May, the inflation rate was 3.1% mom, which is significantly lower than April, March and February (3.8%, 4.7% and 3.8% mom, respectively). Under the IMF programme, Argentina is no longer printing money to finance the fiscal deficit, so prices have to decline as economic activity gradually increases.

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Emerging Markets

- **Brazil:** The government's pension reform has now cleared both the constitutional and special committee stages in parliament. The reform now heads for discussion and eventually a vote on the floor of the Lower House. In its present form, the reform looks set to deliver larger than expected fiscal savings of BRL 1.13trn over 10 years, or nearly USD 300bn. Further changes to the pension reform should not be discounted as the bill makes its way through the Lower House, but so far dilution has been far less than feared. This means that, in its current shape, the reform should: (a) bring the public finances onto a sustainable path; (b) give room for the central bank to cut rates; and (c) trigger a pick-up in business confidence, investment and growth. In other news, Justice Minister Sergio Moro was accused of misconduct in the prosecution of former President Lula, but the noise around this revelation gradually subsided as the news flow slowed. In economic developments, services activity picked up in May after three months in the red (0.3% mom), while retail sales were stable in April. Economic activity generally remains weak. CADE, the Brazilian agency responsible for anti-trust matters, approved Petrobras' plan to sell its refineries. A sale of Petrobras' refineries would bring revenues from the sale, reduce quasi-fiscal deficits and improve economic efficiency.

- **Venezuela:** In Venezuela's ongoing tale of misery, the country now only produces a measly 741,000 barrels of oil per day. In a country, which once produced five million barrels per day, this is truly astonishing. The reason for the decline in oil production is sheer government incompetence. Venezuela has the largest proven oil reserves in the world. Most of this oil is easily accessible in shallow onshore fields. Despite gross ineptitude on the part of the government, the main opposition movement has managed to lose momentum in recent months, so at present the most likely way for President Nicholas Maduro to be replaced is if oil production declines to a point where Maduro is removed by members of the military and other interest groups, whose welfare ultimately rests on oil-related income.

- **Colombia:** The government's latest fiscal plan implies fiscal deficits that are narrower than maximum deficits permitted under the Fiscal Rule. Specifically, the Fiscal Rule specifies a maximum fiscal deficit of 2.7% of GDP for 2019, but the government programme only envisages a deficit of 2.4% of GDP. The government's deficit projection for 2020 is also 0.1% of GDP lower than the maximum deficit permitted under the Fiscal Rule. Meanwhile, Colombian consumers are a happy bunch judging by retail spending in April, which was up 4% yoy.

Snippets:

- **Croatia:** CPI inflation was broadly stable at 0.9% yoy in May.
- **Czech Republic:** The yoy rate of CPI inflation picked up 0.1% in the month of April to reach 2.9% yoy. The current account surplus narrowed to CZK 62bn in April from CZK 80bn in the same month last year.
- **India:** Industrial production was 3.4% higher in April than in the same month of 2018. This was far stronger than expected (0.6% yoy). Meanwhile, May's CPI inflation rate came in line with expectations at 3.05% yoy. The trade balance was broadly unchanged in May with imports and exports rising roughly by the same amount. Wholesale prices inflation in May was much lower than expected (2.5% versus 3.0%, respectively). India retaliated against US trade tariffs.
- **Mexico:** Industrial production surprised to the upside by rising 1.5% in the month of April. The market had expected a contraction of 0.3% in the month.
- **Pakistan:** The government's 2020 fiscal year budget projects revenues to rise by a third. Spending is also set to rise meaningfully. The net effect will be to increase the government's share in the economy.
- **Peru:** The central bank left the policy rate unchanged at 2.75%.
- **Philippines:** The trade deficit widened to USD 3.5bn in April from USD 3.1bn in March. Both imports and exports declined.
- **Poland:** Inflation was revised up to 2.4% yoy in May from 2.3% yoy in a preliminary release. Core inflation was unchanged from April at 1.7% yoy.
- **Romania:** Headline CPI inflation was 4.1% yoy in May, unchanged from April.
- **Russia:** The central bank cut the policy rate by 25bps to 7.5% and signalled further rate cuts to come.
- **Serbia:** CPI inflation slowed marginally to 2.2% yoy in May.
- **South Korea:** Jobs have grown 258K in the year to May. The strong jobs number reverses the job losses recorded in the previous two months. Private sector job growth was particularly strong.
- **Taiwan:** Exports picked up modestly in May (+0.3% mom) following a steep decline in April (-1.8% mom). The improvement was due to stronger sales of electronic components.
- **Turkey:** The central bank left the policy rate unchanged at 24% and appeared dovish in the accompanying commentary. The current account deficit was USD 1.33bn in April, which was narrower than expected (USD 1.5bn). In other news, Moody's downgraded the rating on Turkey's long-term foreign currency debt to B1 from Ba3 and maintained its negative outlook.

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Global backdrop

What would a temporary spike in USDCNY above 7 do for Emerging Markets (EM) sentiment? We expect very little direct impact, because, remarkably, JP Morgan has still not included China in its GBI EM GD local currency bond index, so investors have very small positions. As for the potential indirect impact, after an extremely strong month so far for EM local markets, it is certainly possible that we see some profit-taking. But that too is likely to be very short-lived. We estimate that EM bonds currently pay about 200bps too much yield, relative to EM inflation and where the Fed funds rate is sitting. With EM FX 20% cheaper to the Dollar based on growth trajectories and real effective exchange rates, there is simply too much value in EM to justify sustained selling. EM technicals are also good. While flows have been returning to EM in the past two years, so far only one third of the money, which left EM during the Taper Tantrum has returned. Institutional investors are still structurally very underinvested (they have about 2% in EM fixed income versus EM's share of global fixed income of about 22%). We expect more inflows, which in turn support fundamentals that are, in any case, better than in developed economies. Indeed, the latest IMF projections for global growth imply that EM economies will contribute no less than 84% of all global growth by the year 2024.

Tonkin Incident? Oil prices increased on news that two oil tankers had been attacked in the Straits of Hormuz. The US claims that Iran was to blame, but trust in the US is low. Many have observed that one of the tankers was Japanese, and that Japanese Prime Minister Abe was in talks with Iran precisely at the same time to try and improve relations. The US withdrew from the Iran Nuclear deal despite the fact that Iran was in compliance with the terms of the deal. The US recently sent significant naval power to the Gulf as part of a broader offensive against Iran. Yemen is currently playing host to a proxy war between Iran and the US, which is pitting Shia Houthi rebels supported by Iran against Yemeni security forces, Saudi military and various mercenary forces.

US data was mixed last week. Retail sales and industrial production improve, but import prices declined 0.3% mom or 1.4% yoy, while core CPI inflation declined to 2.0% yoy in May from 2.1% yoy in April. Initial claims for unemployment benefit also increased for the third month in a row.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	1.95%	-3.42%	6.18%	-7.13%	11.18%	2.11%
MSCI EM Small Cap	1.23%	-3.51%	3.99%	-12.87%	5.63%	0.32%
MSCI Frontier	1.18%	3.39%	10.54%	-0.89%	6.57%	-1.16%
MSCI Asia	1.69%	-5.19%	5.65%	-10.13%	11.19%	4.33%
Shanghai Composite	-0.20%	-6.10%	16.38%	-2.99%	2.79%	9.32%
Hong Kong Hang Seng	0.87%	-7.00%	4.52%	-8.97%	11.46%	3.74%
MSCI EMEA	2.85%	4.28%	10.11%	2.64%	9.56%	-1.50%
MSCI Latam	2.79%	1.20%	9.23%	15.12%	13.89%	-1.22%
GBI EM GD	2.56%	2.68%	5.68%	4.89%	4.68%	-0.89%
ELMI+	0.96%	0.37%	1.85%	0.74%	3.02%	-0.83%
EM FX Spot	0.98%	-0.19%	0.06%	-3.90%	-1.97%	-7.05%
EMBI GD	1.71%	2.38%	9.50%	10.38%	5.74%	5.03%
EMBI GD IG	1.39%	3.31%	9.48%	11.65%	5.10%	4.68%
EMBI GD HY	2.04%	1.49%	9.62%	9.16%	6.49%	5.11%
CEMBI BD	1.08%	2.37%	7.64%	8.86%	5.53%	4.69%
CEMBI BD IG	0.90%	2.69%	7.59%	9.62%	4.54%	4.29%
CEMBI BD Non-IG	1.34%	1.92%	7.68%	7.89%	7.18%	5.14%

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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	5.01%	2.32%	16.29%	5.87%	13.91%	10.55%
1-3yr UST	0.26%	1.21%	2.21%	3.98%	1.29%	1.19%
3-5yr UST	0.41%	1.99%	3.61%	6.43%	1.42%	2.02%
7-10yr UST	0.57%	3.13%	6.09%	10.15%	1.38%	3.27%
10yr+ UST	0.07%	4.70%	9.59%	12.59%	1.65%	5.68%
10yr+ Germany	1.76%	4.00%	9.64%	14.67%	2.65%	7.72%
10yr+ Japan	0.91%	1.75%	5.11%	5.83%	0.42%	5.01%
US HY	1.28%	1.50%	8.86%	5.84%	7.36%	4.56%
European HY	0.84%	0.50%	6.16%	2.45%	4.55%	3.73%
Barclays Ag	0.86%	1.92%	4.16%	4.64%	1.51%	1.15%
VIX Index*	-17.00%	13.27%	-38.91%	29.63%	-19.99%	28.77%
DXY Index*	-0.37%	0.11%	1.26%	2.74%	3.38%	20.79%
CRY Index*	-0.31%	-4.86%	2.95%	-10.92%	-9.13%	-43.43%
EURUSD	0.64%	0.21%	-1.97%	-3.29%	-0.32%	-17.02%
USDJPY	0.26%	-2.07%	-1.02%	-1.79%	4.23%	6.28%
Brent	-4.16%	-9.62%	14.89%	-15.84%	25.71%	-45.52%
Gold spot	2.68%	3.73%	4.53%	4.87%	3.23%	5.51%

*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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