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Trump blinks first at the G20

By Jan Dehn

The G20 Summit delivered a significant de-escalation of trade tensions between China and the US, which will probably help to sustain the positive momentum in Emerging Markets. In other news, Argentina's economy appears to be returning to growth, South Africa announces ESKOM restructuring, Mexican inflation returns to the central bank's target range, Brazil's economy continues to improve slowly, and China racks up a healthy current account surplus in Q1 2019, in spite of Trump's trade war.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	0.34%
MSCI EM Small Cap	10.3	–	0.32%
MSCI Frontier	9.3	–	-0.17%
MSCI Asia	12.3	–	0.70%
Shanghai Composite	10.4	–	0.44%
Hong Kong Hang Seng	7.9	–	0.44%
MSCI EMEA	9.4	–	-0.86%
MSCI Latam	11.7	–	-0.40%
GBI-EM-GD	5.67%	–	0.28%
ELMI+	5.09%	–	0.36%
EM FX spot	–	–	0.22%
EMBI GD	5.58%	355 bps	-0.39%
EMBI GD IG	3.90%	183 bps	-0.32%
EMBI GD HY	7.56%	556 bps	-0.46%
CEMBI BD	5.26%	334 bps	0.18%
CEMBI BD IG	3.98%	206 bps	0.09%
CEMBI BD Non-IG	7.09%	516 bps	0.30%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.9	–	-0.97%
1-3yr UST	1.76%	–	-0.03%
3-5yr UST	1.78%	–	-0.04%
7-10yr UST	2.03%	–	-0.03%
10yr+ UST	2.54%	–	0.11%
10yr+ Germany	-0.31%	–	-0.13%
10yr+ Japan	-0.16%	–	-1.19%
US HY	5.92%	381 bps	-0.16%
European HY	3.93%	425 bps	-0.08%
Barclays Ag	1.49%	-54 bps	0.10%
VIX Index*	15.82	–	1.07%
DXY Index*	96.14	–	-0.08%
EURUSD	1.1382	–	0.11%
USDJPY	107.70	–	0.38%
CRY Index*	182.48	–	3.85%
Brent	66.1	–	1.44%
Gold spot	1412	–	0.91%

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

Emerging Markets

- **G20:** US President Donald Trump was bluffing, as we suggested in a recent publication *'Trade war infinity or end-game skirmish?'*, Weekly investor research, 28 May 2019. At the G20 Summit in Japan at the weekend, Trump made major concessions to China, including re-opening trade talks, suspending a planned increase in tariffs and lifting the ban on American companies supplying Chinese technology giant, Huawei. The US climb down follows weaker US economic data (see global backdrop section). The de-escalation of tensions between the US and China should aid further the benign environment for Emerging Markets (EM) assets, but may not halt the slowdown in the US economy, which has many causes in addition to protectionism.
- **Argentina:** The economy is turning up just in time for the presidential election scheduled for 27 October. Economic activity picked up 0.8% in the month of April after contracting by 1.4% in the previous month. The trade surplus also increased to USD 1.4bn in May from USD 1.1bn in April and the Di Tella consumer confidence index rose for the third month in a row in June, hitting 42.9 after bottoming out last year at 31.1. Argentina's outlook is binary. If President Mauricio Macri remains in power, the economic reform programme will remain on track and Argentina will have a chance to recover economically. If the Peronist opposition assumes power, the reform programme will be ditched and the economy will head for ruin, in our view.
- **South Africa:** The government announced two years of financial support for ESKOM, the loss making government-owned energy monopoly. The two-year period will be used to restructure the firm. The government is appointing a Chief Restructuring Officer, who will produce a restructuring plan for the company within 18 months. This is positive news, in our view. A formal restructuring, which places the company on a commercially sustainable footing, is the only truly sustainable solution.
- **Mexico:** Mid-month inflation finally returned to the central bank's target range in June, declining to 4.0% yoy from 4.1% yoy in the previous month. This enabled the central bank to keep the policy rate unchanged at 8.25% with a slight hint that rate cuts may be coming. Meanwhile, the trade surplus was USD 1.3bn in May, which was far better than expected (a deficit of USD 1.0bn) due to stronger than expected export momentum. The rate of unemployment was 3.5% in May, unchanged from April. Retail sales expanded at a faster than expected rate

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Emerging Markets

(1.6% yoy versus 1.4% yoy consensus), but the latest supply-side economic activity indicator, IGAE, was softer than expected at 0.12% mom sa versus 0.4% mom sa expected. Consumer credit growth also slowed to 4.8% yoy in May from 5.8% yoy in April. Considerable uncertainty continues to surround the Mexican economic outlook. Many Mexicans in the business sector do not trust President Andres Manuel Lopez Obrador. Also, US President Donald Trump has attacked Mexico multiple times since he assumed power.

- Brazil: Economic data is slowly improving as markets continue to focus almost exclusively on the ongoing pension reform, which is making its way through parliament. Bank lending increased at a yoy rate of 5.5% in May versus 5.4% yoy in April and mid-month CPI inflation declined sharply to 3.84% on a yoy basis in June from 4.93% yoy the previous month. The current account surplus increased to USD 662m in May from a deficit of USD 62m in April. This was mainly driven by a greater trade surplus of USD 1.74bn than in May (USD 1.22bn). FDI inflows also picked up at the margin to USD 7.1bn in May from USD 7.0bn in April. The very slow economic recovery is helping the fiscal balance at the margin; the primary deficit has declined to 1.4% of GDP as of May from 1.6% of GDP in December 2018. However, there is still significant spare capacity in the economy; unemployment remains elevated at 12.3% of the labour force.

- China: Despite US tariffs, the Chinese current account surplus increased to USD 49bn in Q1 2019 compared to USD 34bn in the same quarter of last year. Industrial profit recovered strongly in May (up 1.1% yoy compared to -3.7% yoy in April). On the domestic policy front, the government lifted restrictions on intra-family transfers of property, which could result in significant additional demand for property.

Snippets:

- Croatia: After 56 months of improvement, Croatian retail sales finally took a breather, declining at a rate of 2.0% yoy in June, albeit after a strong print of 4.8% yoy in May. Industrial production also slowed to +0.2% yoy in May from +3.0% yoy in April.
- Czech Republic: The Czech National Bank left the policy rate unchanged at 2.0%.
- Hungary: The National Bank of Hungary left the policy rate unchanged at 0.95%, but tightened liquidity.
- India: The current account deficit narrowed sharply from USD 17.7bn in Q4 2018 to USD 4.6bn in Q1 2019.
- Kuwait: MSCI confirmed that Kuwait will be upgraded to 'Emerging Market' status joining the MSCI EM equity index in May 2020 with an initial weight of 0.5%.
- Malaysia: CPI inflation was 0.2% yoy in May, which was lower than expected (0.3% yoy). Core CPI inflation also declined to 0.4% yoy from 0.5% yoy.
- Poland: CPI inflation on a yoy basis increased to 2.6% in June from 2.4% in May. Inflation is now above the central bank's inflation target of 2.5%.
- Qatar: FX reserves hit USD 37bn in May, up 50% on a yoy basis.
- Russia: The Russian current account surplus was USD 33.7bn in Q1 2019 compared to USD 30.0bn in the same quarter of last year.
- Serbia: Industrial output improved marginally from -0.8% yoy in April to -0.6% yoy in May. Retail sales increased 5.9% yoy in May.
- Singapore: Industrial production declined at a rate of 2.4% yoy in May versus -1.8% yoy expected.
- Slovakia: CPI inflation increased to 1.8% yoy in June from 1.4% yoy in May.
- South Korea: Industrial production declined at a slower than expected pace in May (-0.2% yoy versus -1.0% yoy expected). Industrial production for April was also revised higher to +0.2% yoy from -0.1% yoy previously.
- Taiwan: Industrial production was 0.7% lower in May than in April, but industrial production improved marginally on a quarter on quarter basis.
- Thailand: Bank of Thailand left the policy rate unchanged at 1.75%. The trade balance swung into a USD 1.4bn surplus in May from a deficit of USD 94m in April.
- Vietnam: The real economy expanded at a rate of 6.7% yoy in Q2, beating the expectation of 6.6% yoy growth. Inflation slowed to 2.2% yoy in June from 2.9% yoy in May.

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Global backdrop

The global backdrop remains favourable for EM assets. EM has performed well despite US stock market volatility, slower developed market growth and trade wars. The strong performance is due, in large part, to sound technicals, attractive valuations and fundamentals, which are obviously better than in developed countries. Investors are realising these advantages and beginning to allocate back to EM in greater volumes. The positive news from the G20 should further strengthen the case for EM, in our view.

The evidence that the US economy is entering late cycle slowdown continues to mount. It is not just that the Fed has already signalled the start of the rate cutting cycle, the data is now clearly getting softer. June was a particularly bad month. Other than pending home sales and the University of Michigan consumer confidence index, both of which improved marginally, there was sogginess across the board. Personal spending slowed sharply to 0.4% mom in May from 0.6% mom in April, new homes sales declined 7.8% in May, house price appreciation slowed to 2.5% yoy from a peak of 6.8% yoy in early 2018, initial claims rose to a seven week high, durables orders declined 1.3% in May, Chicago PMI plunged below 50 and wholesale inventories are rising, which bodes poorly for future growth. What is doubly concerning is that, despite evidently weakening domestic demand, the trade deficit still widened to USD 74.5bn in May from USD 70.9bn in April and core PCE inflation was stronger than expected (1.6% yoy versus 1.5% yoy consensus). The combination of rising external deficits and higher than expected inflation in spite of slower domestic demand is prima facie evidence of low productivity growth and real exchange rate overvaluation. These problems can only be cured with devaluation, deflation or significant productivity gains, all of which involve pain (outflows, recession and reform, respectively).

Why does the weakening US economy matter for EM investors? Answer: it is all about flows. Ask yourself why investors went to long US equities and Dollars over the past decade? They did so, because they were bullish on the US economy. Hence, if the US economy is now slowing much of this bull market money is in the wrong place. Investors are currently in a transition period, where they are beginning to worry about the investment proposition in the US, but not yet quite ready to abandon the false comfort of the Dollar zone outright. This phase will ultimately give way to larger and sustained outflows from US markets. The problem is that there is too much money slushing around in the US, particularly if the economy is weakening. For now, this money washes back and forth between stocks and bonds rather than leaving the US, but in so doing volatility will gradually increase in both markets. This in turn means that the risk-adjusted return slowly begins to decline until, at some point, investors finally make the decision to abscond altogether.

What is the big risk for EM as far as US is concerned? Answer: a very strong US economy. A strong US is like a magnet for global capital. Strong growth increases earnings and pushes up US stocks. Everyone in the rest of the world buys Dollars to participate. In that sense, the big question facing investors today, as far as their allocations to EM are concerned, is simple: Do you believe the US economy is entering a late-cycle slowdown, or sitting on the cusp of a productivity miracle?

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	6.27%	0.68%	10.69%	3.29%	12.98%	2.97%
MSCI EM Small Cap	3.80%	-1.06%	6.62%	-4.56%	7.08%	0.85%
MSCI Frontier	1.79%	4.01%	11.20%	3.70%	8.80%	-0.79%
MSCI Asia	6.79%	-0.44%	10.95%	1.17%	13.30%	5.29%
Shanghai Composite	4.21%	-1.96%	21.52%	9.23%	3.47%	10.38%
Hong Kong Hang Seng	6.36%	-1.95%	10.21%	5.23%	12.88%	5.05%
MSCI EMEA	5.71%	7.18%	13.18%	10.78%	11.56%	-0.83%
MSCI Latam	5.55%	3.92%	12.16%	21.35%	14.17%	-0.57%
GBI EM GD	5.10%	5.23%	8.30%	8.74%	5.42%	-0.52%
ELMI+	2.51%	1.92%	3.42%	3.64%	3.65%	-0.61%
EM FX Spot	2.46%	1.26%	1.52%	-1.34%	-1.36%	-6.85%
EMBI GD	3.26%	3.93%	11.16%	12.30%	5.97%	5.25%
EMBI GD IG	2.59%	4.53%	10.77%	12.40%	5.19%	4.86%
EMBI GD HY	3.93%	3.37%	11.65%	12.28%	6.87%	5.37%
CEMBI BD	2.10%	3.39%	8.72%	10.05%	5.73%	4.82%
CEMBI BD IG	1.77%	3.58%	8.52%	10.25%	4.67%	4.38%
CEMBI BD Non-IG	2.55%	3.15%	8.97%	9.79%	7.47%	5.32%

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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	6.43%	3.70%	17.85%	10.56%	15.81%	10.56%
1-3yr UST	0.49%	1.43%	2.44%	3.96%	1.27%	1.21%
3-5yr UST	0.83%	2.42%	4.04%	6.30%	1.33%	2.04%
7-10yr UST	1.28%	3.86%	6.83%	9.79%	1.12%	3.28%
10yr+ UST	1.37%	6.07%	11.02%	12.07%	1.14%	5.78%
10yr+ Germany	2.77%	5.03%	10.73%	14.10%	2.13%	7.57%
10yr+ Japan	0.84%	1.68%	5.04%	5.62%	-0.16%	4.86%
US HY	2.15%	2.37%	9.80%	7.09%	7.81%	4.67%
European HY	2.04%	1.70%	7.43%	4.57%	5.41%	3.97%
Barclays Ag	2.05%	3.12%	5.39%	5.90%	1.76%	1.21%
VIX Index*	-15.45%	15.39%	-37.77%	-6.11%	-15.63%	40.50%
DXY Index*	-1.65%	-1.17%	-0.03%	0.87%	-0.11%	20.12%
CRY Index*	4.06%	-0.69%	7.46%	-8.25%	-4.73%	-41.29%
EURUSD	1.90%	1.47%	-0.76%	-1.62%	2.86%	-16.61%
USDJPY	-0.54%	-2.84%	-1.82%	-2.53%	4.81%	6.22%
Brent	2.56%	-3.29%	22.94%	-15.04%	36.15%	-41.62%
Gold spot	8.19%	9.29%	10.13%	13.15%	7.67%	7.31%

*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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