Ashmore

India's Budget: Modi does the right thing

By Jan Dehn

The Indian bond market rejoiced last week as Prime Minister Modi's government unveiled an austere budget. On the other hand, Turkey is heading the Venezuelan way as Erdogan sacks the central bank governor. In Argentina, the economy continues to recover. Japan's trade dispute with South Korea is not motivated by protectionist instincts, but can still cause pain for both sides. In Hong Kong, the protests continue with no clear solution in sight.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	0.68%
MSCI EM Small Cap	10.2	–	1.05%
MSCI Frontier	10.9	–	1.21%
MSCI Asia	12.4	–	0.72%
Shanghai Composite	10.2	–	1.39%
Hong Kong Hang Seng	7.8	–	0.64%
MSCI EMEA	9.2	–	0.21%
MSCI Latam	12.1	–	2.39%
GBI-EM-GD	5.59%	–	0.32%
ELMI+	5.11%	–	-0.12%
EM FX spot	–	–	-0.34%
EMBI GD	5.47%	340 bps	0.65%
EMBI GD IG	3.82%	172 bps	0.46%
EMBI GD HY	7.45%	540 bps	0.85%
CEMBI BD	5.19%	323 bps	0.37%
CEMBI BD IG	3.93%	197 bps	0.30%
CEMBI BD Non-IG	6.97%	500 bps	0.47%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.2	–	2.28%
1-3yr UST	1.84%	–	-0.18%
3-5yr UST	1.81%	–	-0.31%
7-10yr UST	2.02%	–	-0.26%
10yr+ UST	2.52%	–	-0.38%
10yr+ Germany	-0.38%	–	0.29%
10yr+ Japan	-0.15%	–	0.57%
US HY	5.84%	366 bps	0.38%
European HY	3.77%	400 bps	0.64%
Barclays Ag	1.49%	-53 bps	-0.41%
VIX Index*	13.28	–	-2.54%
DXY Index*	97.23	–	1.10%
EURUSD	1.1223	–	-0.56%
USDJPY	108.34	–	-0.10%
CRY Index*	180.78	–	-1.70%
Brent	64.2	–	-1.26%
Gold spot	1403	–	1.38%

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

Emerging Markets

- India: The Modi Administration surprised markets last week by putting forward a Budget with a tighter than expected fiscal deficit target of 3.3% of GDP. The Modi Administration engaged in a fiscal splurge in the run-up to the recent general election, which is now being reversed. Loose fiscal policies have traditionally been the biggest risk to investors in India, so the austere budget is welcome news, in our view. The Indian economy is currently slowing – witness the softer services PMI of 49.6 last week – so tight fiscal policy at this stage should enable the Reserve Bank of India to cut rates. This is obviously positive for bondholders. In other news, Prime Minister Modi has also proposed further liberalisation of India's large markets for insurance and aviation.
- Turkey: Last week, President Erdogan sacked Central Bank Governor Murat Cetinkaya and replaced him with Deputy Governor Murat Uysal. In our view, Erdogan has no intention whatsoever to improve the quality of macroeconomic policies in Turkey despite his recent disastrous defeat in the Istanbul Mayoral election. Rather, he is likely to 'double down' on his misguided economic policies, which are likely eventually to lead the Turkish economy to ruin. In fact, things are likely to get even worse, in our view. The next logical policy steps would be to introduce capital controls, nationalisations, and other policies to prevent the private sector from protecting its property as the macroeconomic environment deteriorates further. It is also likely that Erdogan will become more authoritarian in order to enforce such policies. In short, Turkey is currently on a path very similar to that of Venezuela. The only positive news in Turkey last week was that inflation declined to 15.7% yoy in June from 18.7% yoy in May, but any respite on the inflation front is likely to be short-lived, given the direction of policy, in our view.
- Argentina: The economic news continues to improve. Industrial production expanded in June (0.6% mom sa). This is the second consecutive month of expansion of industrial production and takes industrial production to a level, which is more than six per cent higher than the trough in December last year. Construction activity also returned to positive territory in the month of May, up 2.3% mom. The central bank lowered the floor for the policy rate from 62.5% in June to 58% in July. IMF and the government also agreed to disburse the next USD 4.5bn tranche under the standby agreement.

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Emerging Markets

- **South Korea:** Japan tightened rules on exports of tech-related materials to South Korea. Japan's decision to restrict trade with South Korea is rooted in a historical dispute, not a policy preference of protectionism. The conflict is therefore likely to remain strictly bilateral and relatively limited in scope, although South Korea may well retaliate in the near-term. There could also be some minor spill-over effect to other countries due to the highly integrated nature of Asian supply chains. In other news, South Korean's CPI inflation was lower than expected in June (0.7% yoy versus 0.8% yoy expected).

- **Hong Kong:** Protests against the government continued last week. Protesters demand a formal elimination of a bill, which would, if approved, allow citizens of Hong Kong to be extradited to China. Carrie Lam, who leads Hong Kong's ruling Legislative Council, has so far refused to withdraw the bill permanently. In our view, the conflict in Hong Kong goes well beyond a single piece of legislation. It is therefore likely to re-manifest itself many times over in different guises in the coming years as China's control of Hong Kong gradually increases.

- **Brazil:** The rapporteur for the Lower House Committee, which handles the pension reform, has issued a supplement to his original report, which specifies additional fiscal savings. In other news, industrial production was 7.1% higher in May than during the same month of 2018.

- **Venezuela:** The economic team of opposition leader Juan Guaido has issued guidelines for a future restructuring of Venezuela's debt (most of which is in default). Guaido wants a rapid restructuring as soon as President Nicholas Maduro has left office and sanctions been lifted. This is the right approach, in our view. Speed is of the essence if the next government is to survive and maintain control of the oil sector. Also, Maduro must go, because his policies are to blame for the current economic malaise. Guaido's plan also calls for a comprehensive renegotiation of all debts with a view to bringing the debt burden down to a sustainable level, taking account of the capacity of the Venezuelan economy to service debt. We also agree with this approach. After all, the only true measure of success of any debt restructuring is that the government in question regains full access to capital markets. The one thing missing from Guaido's statement pertains to the oil sector: a reform of the oil law is critical to obtaining new investment and generating growth in Venezuela, in our view.

Snippets:

- **Chile:** Retail sales were strong in May (3.3% yoy versus 1.0% yoy expected). Business confidence also improved.
- **China:** The Caixin Services PMI for June was 52.0, down from 52.7 in May. FX reserves increased by USD 18bn to USD 3,119bn in the month of June, mainly due to a weaker Dollar.
- **Czech Republic:** Industrial production was solid at 3.2% yoy in May.
- **Ecuador:** President Lenin Moreno has announced that Ecuador will join the Pacific Alliance, a free trade alliance formed by Peru, Mexico, Colombia and Chile.
- **Hungary:** Industrial production was up strongly in May (+6.1% yoy). Retail sales were up 2.6% yoy in May.
- **Malaysia:** The MYR 9.1bn trade surplus in May was higher than expected (MYR 8.2bn).
- **Mexico:** Mexico's three manufacturing activity indices (Inegi, Markit and IMEF) delivered conflicting signals in June as one index increased and two declined. Consumer and business confidence both declined, however.
- **Pakistan:** IMF's Executive Board approved a USD 6.0bn extended fund facility in line with expectations.
- **Peru:** CPI inflation declined 0.09% mom in June.
- **Philippines:** CPI inflation declined to 2.7% yoy in June versus 2.8% yoy expected, taking inflation below the mid-point of the central bank's target range (3%) and increasing the odds of rate cuts.
- **Poland:** The central bank left the policy rate unchanged at 1.5%.
- **Romania:** The central bank left the policy rate unchanged at 2.5%. Retail sales were up 3.7% yoy in May.
- **Russia:** Composite PMI declined to 49.2 in June from 51.5 in May. Weakness was broad-based, involving both domestic and external demand.
- **Thailand:** CPI inflation was lower than expected in June (0.9% yoy versus 1.1% yoy expected).

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Global backdrop

The quality of policy-making in Europe and the US may decline in the future based on the low quality of nominations to key top jobs in both regions. In Europe, Christine Lagarde was put forward to replace Mario Draghi at the ECB, while Ursula von der Leyen, former German defence minister, was nominated to the post of President of the European Commission. Meanwhile, in the US, President Donald Trump nominated Christopher Waller, an extreme dove, as well as Judy Shelton, a known flip-flopper on policy, to the Fed. None of these four candidates are the best available for the jobs in question, in our view.

Iran has announced that uranium enrichment will now be increased to levels, which exceed the limits enshrined in the Joint Comprehensive Plan of Action (JCPA) of 2015. Iran's decision to enrich more than the permitted amount of uranium follows the US withdrawal from JCPA. The US withdrew in spite of full Iranian compliance with the terms of the accord. Iran therefore regards the US withdrawal from JCPA as a threat to which Iran is now reacting. Europe will probably take side with the US in this conflict, underlining Europe's inability to exercise independent leadership. Clearly, the collapse of JCPA is endangering the world with no imminent solution in sight. Bad news.

The US labour market rebounded in June based on a stronger than expected payroll print of 224K new jobs. However, other parts of the labour market, such as hourly earnings were soft and the establishment survey also suggests caution. The broader economic picture in the US is one of broadening weakness consistent with a late stage business cycle slowdown. For example, the services ISM print was weaker than expected in June as were factory orders for May. Worryingly, the trade deficit is still widening (USD 55.5bn in May), which is eroding the GDP growth rate for Q2 2019.

The US treasury market has displayed considerable volatility in recent months. For example, the yield on 10-year Treasuries has fallen from nearly 2.80% at the start of the year to a low of 1.95% last week before rebounding to 2.02% now. This volatility has two specific causes. First, there is simply too much money slushing around in the US markets, so when investors flip from stocks to bonds each market displays exaggerated volatility relative to the changes in underlying fundamentals. The excessive volatility will of course worsen Sharpe Ratios and eventually become a reason for reducing overall exposure to US markets. Second, the market is uncertain about the Fed's intentions, because Fed has shown itself to be extremely sensitive to very short-term changes in the data. This sensitivity to individual data points betrays a low conviction on the part of the Fed in its own forecasts, perhaps reflecting weaker intellectual leadership at the Fed. For example, in May last year the Fed signalled multiple rate hikes and quantitative tightening throughout 2018 and 2019 before U-turning dramatically, when the negative effects on the US economy of Trump's trade war became apparent. The market is now speculating that the Fed will turn hawkish again after Friday's relatively strong payroll print. Our view is that the US economy is slowing in accordance with classic late business cycle dynamics, but not yet in recession, so that the Fed is near the end of its hiking cycle and likely to start cutting rates. Slower growth and lower rates will in turn weigh on the Dollar over the medium term.

In Europe, a sharp decline in German manufacturing orders (-2.2% mom versus -0.1% mom expected) and softer industrial production (0.3% mom versus 0.4% mom expected) challenged the thesis of improvement in European economic indicators. On the other hand, German exports were stronger than expected (1.1% mom versus 0.9% mom expected) and Greece rejected the Euro-sceptical left-wing populism of Syriza in favour of the pro-European centrism under New Democracy. The weakness of the European banking system was on full display for all to see as Deutsche Bank announced enormous job losses. European banks were never recapitalised after the 2008/2009 crisis in developed markets, so Europe has not been able to grow nearly as fast as the US and the ECB has not been able to hike even one single time, whereas the Fed has now in all likelihood completed its entire hiking cycle.

Finally, UK continues on its headlong rush towards economic oblivion as the 31 October Brexit deadline looms. Both Conservative candidates for Prime Minister, Boris Johnson and Jeremy Hunt, continue to compete to out-Brexit each other. This almost guarantees a hard Brexit on 31 October, in our view. Both candidates are also promising plenty of fiscal profligacy. Nothing good will come from these policies, in our view.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	0.68%	0.68%	11.45%	3.50%	11.45%	2.74%
MSCI EM Small Cap	1.05%	1.05%	7.90%	-2.16%	5.90%	0.68%
MSCI Frontier	1.21%	1.21%	13.16%	4.55%	8.70%	-0.70%
MSCI Asia	0.72%	0.72%	11.55%	2.51%	11.94%	4.93%
Shanghai Composite	1.39%	1.39%	22.65%	13.24%	2.46%	10.24%
Hong Kong Hang Seng	0.76%	0.76%	10.91%	6.97%	12.15%	4.58%
MSCI EMEA	0.21%	0.21%	13.62%	5.92%	9.58%	-0.74%
MSCI Latam	2.39%	2.39%	15.53%	20.33%	12.70%	-0.25%
GBI EM GD	0.32%	0.32%	9.07%	8.92%	4.60%	-0.36%
ELMI+	-0.12%	-0.12%	3.45%	3.44%	3.14%	-0.60%
EM FX Spot	-0.34%	-0.34%	1.38%	-1.74%	-2.04%	-6.84%
EMBI GD	0.65%	0.65%	12.03%	12.23%	5.39%	5.45%
EMBI GD IG	0.46%	0.46%	11.49%	12.40%	4.48%	5.06%
EMBI GD HY	0.85%	0.85%	12.70%	12.15%	6.44%	5.55%
CEMBI BD	0.37%	0.37%	9.23%	10.50%	5.44%	4.92%
CEMBI BD IG	0.30%	0.30%	8.98%	10.50%	4.40%	4.50%
CEMBI BD Non-IG	0.47%	0.47%	9.56%	10.49%	7.16%	5.39%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	1.69%	1.69%	20.55%	11.50%	15.00%	10.77%
1-3yr UST	-0.22%	-0.22%	2.25%	3.82%	1.18%	1.20%
3-5yr UST	-0.36%	-0.36%	3.72%	6.09%	1.17%	2.05%
7-10yr UST	-0.35%	-0.35%	6.56%	9.57%	0.88%	3.37%
10yr+ UST	-0.35%	-0.35%	10.60%	11.30%	0.41%	6.03%
10yr+ Germany	0.29%	0.29%	11.01%	13.22%	1.98%	7.67%
10yr+ Japan	0.57%	0.57%	6.03%	6.10%	-0.12%	5.08%
US HY	0.26%	0.26%	10.23%	7.85%	7.41%	4.74%
European HY	0.64%	0.64%	8.27%	4.99%	5.11%	4.13%
Barclays Ag	-0.41%	-0.41%	5.14%	5.16%	1.27%	1.25%
VIX Index*	-11.94%	-11.94%	-47.76%	-0.67%	0.61%	10.85%
DXY Index*	1.14%	1.14%	1.10%	3.47%	0.96%	21.26%
CRY Index*	-0.14%	-0.14%	6.46%	-8.72%	-3.42%	-40.42%
EURUSD	-1.28%	-1.28%	-2.14%	-4.49%	1.57%	-17.55%
USDJPY	0.42%	0.42%	-1.24%	-2.27%	7.75%	6.65%
Brent	-3.47%	-3.47%	19.41%	-16.69%	37.38%	-41.03%
Gold spot	-0.44%	-0.44%	9.42%	11.58%	2.70%	6.37%

*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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