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WEEKLY INVESTOR RESEARCH

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What would US capital controls mean?

By Jan Dehn

There is growing speculation that the US government may impose controls on US portfolio investments into China. What would US capital controls mean for the US, China, EM and the global economy?

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	-1.89%
MSCI EM Small Cap	8.7	–	-1.30%
MSCI Frontier	9.1	–	1.47%
MSCI Asia	12.2	–	-2.20%
Shanghai Composite	10.4	–	-2.42%
Hong Kong Hang Seng	7.7	–	-2.18%
MSCI EMEA	9.0	–	-1.54%
MSCI Latam	12.3	–	-0.04%
GBI-EM-GD	5.21%	–	-0.30%
ELMI+	5.83%	–	-0.32%
EM FX spot	–	–	-0.58%
EMBI GD	5.27%	357 bps	-0.47%
EMBI GD IG	3.51%	178 bps	-0.22%
EMBI GD HY	7.59%	592 bps	-0.77%
CEMBI BD	5.13%	350 bps	0.04%
CEMBI BD IG	3.65%	202 bps	0.10%
CEMBI BD Non-IG	7.24%	561 bps	-0.06%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	-0.98%
1-3yr UST	1.63%	–	0.17%
3-5yr UST	1.56%	–	0.38%
7-10yr UST	1.68%	–	0.70%
10yr+ UST	2.13%	–	1.33%
10yr+ Germany	-0.57%	–	1.21%
10yr+ Japan	-0.22%	–	0.36%
US HY	5.68%	377 bps	-0.32%
European HY	3.75%	414 bps	-0.47%
Barclays Ag	1.30%	-38 bps	0.10%
VIX Index*	17.22	–	1.90%
DXY Index*	99.13	–	0.53%
EURUSD	1.0935	–	-0.53%
USDJPY	107.84	–	0.27%
CRY Index*	175.72	–	-1.62%
Brent	61.8	–	-4.59%
Gold spot	1491	–	-2.08%

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

Emerging Markets

- **US capital controls:** The US Treasury stated at the weekend that the US government has no plans to block the listing of Chinese companies on US stock exchanges "at this time". This announcement follows rumours dating back to early September that the White House may wish to limit US portfolio flows into China. The Treasury's lukewarm denial and the Trump Administration's consistent record of inconsistency on a number of policy issues mean that investors should take the threat seriously.

What, then, would US capital controls mean on portfolio flows to China mean for the US, China, the rest of Emerging Markets (EM) and the global economy?

1. Market impact

Consider first the impact on the US. As far as we know, the application of US capital controls on a member of the club of countries, which make up the system of global reserve currencies, or special drawing rights (SDR), has no precedent. As such, overseas, controls on US flows to China would further erode the US-sponsored global financial system and America's leadership role within it, particularly since capital controls do not seem to have any justification other than the pursuit of very narrow political interests within the US. Indeed, capital controls would probably also raise eyebrows domestically, since they clearly constitute direct government meddling in the private investment decisions of individual Americans and American institutional investors.

A ban on portfolio flows to China would also be a kind of financial repression. Unable to invest in China under capital controls, American investors would, all else kept even, may have to invest more at home than they would otherwise have done. What would this mean? First, any positive effect on US asset prices in the short term would be small, since US portfolio investments in China are tiny in relation to the size of the US domestic market. For example, China is only 3% of the MSCI All Country World Index compared to the weight of US stocks in the index of 54%. In bonds, US portfolio investments in Chinese fixed income are also tiny due to China's still very small presence in global bond indices. FTSE has not yet included China in its World Government Bond Index (WGBI), Bloomberg only recently began to include China in its Global Aggregate Index and JP Morgan is not scheduled to include China in the GBI-EM until February 2020. Second, the riskiness of

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Emerging Markets

US portfolios would clearly increase, because US investment portfolios would immediately be rendered less diversified. Moreover, the cost of not being able to access China would grow over time, since China is – and will continue to be – the world's single most important growth story.

How would Chinese markets be affected? Clearly, Chinese stocks would be adversely impacted, especially to the extent they are owned by US investors. Chinese ADRs have already taken a hit. Alibaba was down 5.2% on Friday, JD.Com fell about 6% and Baidu was down nearly 4%. The iShares China ETF was down 2.1%. However, Chinese equities are the most liquid within EM with world class daily trading volumes for some stocks, such as Alibaba, of about USD 2.5bn. The markets for Chinese stocks will therefore soon clear, regardless of the news.

What about the effect on other EM markets? Given the popularity of index investing in the US, in the extreme scenario where, let's say, China was removed from benchmark indices, the weights of all other EM countries would be 'grossed up'. Hence, stocks in the rest of EM would benefit, possibly quite a lot. China makes up 32% of the MSCI EM index. Korea, Taiwan, India, South Africa, Brazil and Mexico would all stand to receive inflows, all else being equal. These markets are not as liquid as Chinese stock markets, so the impact on their markets would be meaningful.

2. Macroeconomic consequences

Given the size of both the US and Chinese economies, investors need to also consider the longer-term global macroeconomic consequences of a US ban on capital flows to China. A US ban on capital financing to China would, all else even, mean that China has to run a larger trade surplus versus the US, or, equivalently, the US trade deficit with China must increase in size. This is directly contradictory to the stated policy objectives of the Trump Administration. The widening of trade imbalances would come about through an even stronger Dollar versus CNY. However, a stronger Dollar is hardly what the American economy needs right now. It would render US exporters even less competitive and weaken US growth further just as the late cycle slowdown appears to be taking hold. Of course, the opposite would be true for China, which would be able to export more, which boosts growth.

A ban on capital flows to China would also worsen existing global imbalances dangerously. The reason why capital flows into China should be encouraged rather than discouraged at this time is that foreign capital facilitates China's rotation from an export-led to a consumption-led growth model. Foreign financing, say for Chinese consumption, enables China to import more goods and services from Western economies precisely at a time, when the latter struggle with rising debt burdens and slowing growth. Weak US consumer spending in August is a perfect case in point; spending rose a mere 0.1% mom and July spending was revised lower. September consumer confidence also declined. Chinese demand for US exports would be welcome, but this demand requires financing.

3. Forward looking impact

Just as the curtailment of financing to China is undesirable, so the addition of yet more money into the US financial system is also unhealthy. It is not a good idea to further increase the exposure of the global financial system to US assets at this time, when the US business cycle is already very long in the tooth, US asset prices are very elevated, positioning in US assets is extremely heavy and the US government makes so many serious policy mistakes.

How would China respond if the US nevertheless went ahead with capital controls? Under US capital controls, China's reserves would soon begin to rise again. We believe that China would continue to open up its economy to third parties with very little or no retaliation against the US. At worst, China could speed up its efforts to diversify its FX reserves away from Dollars (as other central banks ought to be doing as well). This would result in less demand for US Treasuries at the margin, but with reserves rising overall and no outright selling of Treasuries the impact would be small and drawn out. China might have to tighten restrictions on private flows to the US for a time, but would continue to pursue capital account liberalisation with other countries. The key to understanding Chinese policy is to realise that China is playing a very long game with the aim of establishing itself as a central element in the global financial system. To this end, it is critical that China appears responsible on the global stage. China will therefore act sensibly, just as it has done in response to Trump's trade war. It is obvious to intelligent observers that policies of the current US administration in effect mortgage America's standing in the world, so responsible policies in China at this time go a long way to furthering China's aims.

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Emerging Markets

- Index news: FTSE, which runs both equity and bond indices, announced that Tanzanian equities will be upgraded to Frontier Market status with effect from September 2020, while Romanian stocks will be upgraded to Emerging Markets status at the same time. With respect to bonds, FTSE is keeping Malaysian debt in the WGBI, while Chinese bonds are on watch list for possible inclusion in the WGBI in March or September next year.
- Argentina: There is mounting evidence that a future Alberto Fernandez Administration would pursue moderate economic policies. Fernandez said last week that his government must assume the State's responsibilities, i.e. its debts. He also indicated that he would not haircut the debt. He called for a broad political agreement to increase future visibility for markets. These messages are not consistent with the current low prices for Argentina's debt, in our view. In economic news, growth surprised to the upside in July. The monthly index of economic activity was up 0.6% yoy versus an expectation of a decline of 1.6% yoy. This confirms that Argentina's economy was experiencing the beginning of cyclical upswing prior to the recent volatility triggered by a big shift in the political outlook after the primary election in August. We believe that the economic upswing may resume provided that the political and financial outlook improves. Meanwhile, relations with the International Monetary Fund (IMF) continue to be good. Deputy Managing Director David Lipton indicated that IMF's next disbursement of USD 5.4bn could take place after the election, whose first round is on 27 October.
- Mexico: The central bank cut the policy rate by 25bps to 7.75% as the country recorded a trade surplus of USD 0.6bn in August. This was far better than the market's expectation of a deficit of USD 1.0bn. Still, the uncertain outlook in the US has impacted the Mexican economy by slowing capital spending even as Mexico has gained market share in the US at the expense of China. Government spending declined in the first year of President Andres Manuel Lopez Obrador; this has been positive for credit worthiness, but negative for short-term growth.
- Brazil: Brazil's parliament has approved a constitutional amendment, which allows for the transfer of rights to explore Brazil's large oil fields to the private sector. An auction for the rights is expected on 6 November with signature bonuses, which are expected to be as large USD 26bn. If realised, these signature bonuses would be largest ever recorded by a Brazilian government. In other news, IPCA mid-month inflation was low in September at just 0.09% mom, or 3.2% yoy.

Snippets:

- China: Industrial profits were 2% lower in August than in the same month of 2018. Official PMI marginally beat expectations in September (49.8 versus the 49.6 Bloomberg consensus). Caixin PMI did even better (51.4 versus 50.2 expected). Services PMI was 53.7 in September.
- Czech Republic: The Czech National Bank left the policy rate unchanged at 2.0%.
- Egypt: Police began to clamp down on protesters in Cairo, who have been demonstrating against President Abdel Fattah al-Sisi. The Central Bank cut interest rates by 100bps to 13.25%.
- Hong Kong: Protests continue in the run-up to the 70th anniversary of Communist rule in China.
- Hungary: The National Bank of Hungary left the policy rate unchanged at 0.9%.
- Malaysia: CPI inflation was 1.5% yoy in August in line with expectations. Core inflation was unchanged at 2.0% yoy.
- Peru: President Vizcarra is leaning towards dissolving Congress after members of parliament took steps to replace Supreme Court judges, who have been in the forefront of the fight against corruption in political circles.
- Philippines: The central bank cut the policy rate by 25bps to 4.0% and the reserve requirements for banks by 100bps.
- Serbia: Fitch upgraded Serbia's sovereign credit rating by one notch to BB+ with stable outlook.
- Singapore: Industrial production was far weaker than expected in August (-7.5% mom versus -0.5% mom expected). Electronics were weak, but pharmaceuticals improved.
- Slovakia: Moody's confirmed Slovakia's A2 rating, but downgraded the outlook to stable from positive citing marginal fiscal deterioration.
- Slovenia: CPI inflation was 1.7% yoy in September compared to 2.3% yoy in August.
- South Korea: Industrial production contracted 1.4% in the month of August following positive growth in the previous two months.
- Thailand: The central bank left the policy rate unchanged at 1.5%.
- Ukraine: S&P Global upgraded Ukraine's sovereign credit rating to B from B- citing improvements in the economy and government finances.

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Global backdrop

It is now widely expected that the US Federal Reserve will intervene more meaningfully in the US primary dealer system in order to relieve ongoing liquidity pressures. The tightness of liquidity can be traced back to the enormous expansion of the US fiscal deficit in recent years and the gradual reversal of Quantitative Easing (QE) policies by the Fed. The US primary dealer system requires chosen banks to buy whatever the Treasury issues. Hence, as the US government's fiscal deficit widens (more supply of Treasuries) and the Fed scales back its balance sheet (less official sector demand for Treasuries) primary dealers find their balance sheets clogged up with government securities. The result has been a spike in repo rates and the worsening of liquidity conditions for US investors. The Fed is likely to intervene by buying some of the securities held by the primary dealers, thereby easing their liquidity problems. This is not QE in the conventional sense, because the Fed is not trying to drive yields along the curve. Rather, this intervention is designed to unclog a financial system, which is drowning in government bonds. As such, investors may dismiss the Fed's intervention as a mere technicality, but we would warn against such complacency: the problems facing primary dealers reflect a sharply worsening fiscal outlook for the US, which is only likely to get even worse in the future. Moreover, as the share of the government in the US economy becomes larger and larger, future taxes liabilities go up and productivity declines. We highlighted this risk in a recent publication titled *"The Blind Spot"*.[1]

In US political news, Democrats in the House of Representatives launched a formal impeachment investigation of President Donald Trump over alleged election meddling following a whisteblower report that Trump requested the Ukrainian government to investigate Democratic presidential candidate Joe Biden and his son in the run-up to the November 2020 US presidential election. Ukraine's former prosecutor stated at the weekend that there was no case against the Bidens whatsoever. Still, politics has become so partisan in the US that barring the unveiling of the new and very damning evidence, we do not expect the US Senate to support the impeachment of Trump. Of course, for Democrats this is not the point. Democrats hope to adversely affect Trump's re-election campaign. As far as EM is concerned, perhaps the most important implication is that with the House of Representatives and the White House now on a war path, we believe there is now close to zero chance of fiscal stimulus in case of a further slowing of the US economy.

In the UK, politics is equally fraught. The Supreme Court ruled against Prime Minister Boris Johnson's suspension of parliament. Parliament is now recalled and MPs are rather angry. In this environment, we see little chance that parliament approves any Boris Johnson-sponsored deal to exit the European Union. This leaves plenty of room for unexpected events, including a no-confidence vote against Boris Johnson. Alternatively, Boris Johnson could conceivably break the law again or maybe he will be forced into asking for an extension to 31 January 2020 for Britain's exit from the EU. If an extension is granted, it seems likely that a UK general election will be called.

In other global news, US-China trade talks are said to resume on 10 October, according to press reports citing US officials. European economic sentiment worsened by 1.4 points to 101.7 in September. The European Stability Mechanism announced that it is changing from English to Luxembourg law for all its bonds. This decision likely reflects Britain's intention to withdraw from the European Union. The European Central Bank's Sabine Lautenschlaeger resigned with effect from 31 October. A hawk, she was clearly not happy with the direction of ECB policy. The ECB recently expended most of its policy instruments bar helicopter money and currency intervention.

Finally, the IMF got its first ever chief executive from an EM country. Bulgaria's Kristalina Georgieva will assume the role of IMF Managing Director on 31 October after previously working as CEO of the International Bank for Reconstruction and Development and International Development Association at the World Bank. Despite this positive development, EM remains woefully underrepresented in global governance institutions.

[1] See: *'The blind spot'*, Weekly investor research, 27 August 2019.

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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	1.95%	-4.11%	6.19%	-1.93%	6.07%	2.35%
MSCI EM Small Cap	2.12%	-4.32%	2.18%	-5.40%	1.37%	-0.11%
MSCI Frontier	-1.66%	-0.77%	10.94%	5.38%	7.42%	-1.26%
MSCI Asia	1.40%	-4.67%	5.63%	-3.57%	6.14%	4.09%
Shanghai Composite	1.70%	-0.44%	20.43%	7.62%	1.56%	6.76%
Hong Kong Hang Seng	1.06%	-5.50%	4.02%	-3.70%	5.37%	2.98%
MSCI EMEA	2.05%	-5.88%	6.72%	1.78%	4.78%	-0.57%
MSCI Latam	3.37%	-4.89%	7.31%	7.25%	7.39%	-1.02%
GBI EM GD	1.18%	-0.58%	8.09%	10.35%	3.11%	0.43%
ELMI+	1.32%	-1.91%	1.59%	2.84%	1.87%	-0.28%
EM FX Spot	0.39%	-3.87%	-2.22%	-3.10%	-3.62%	-6.47%
EMBI GD	-0.41%	1.55%	13.04%	11.60%	4.70%	5.61%
EMBI GD IG	-1.18%	3.84%	15.24%	14.62%	5.21%	5.59%
EMBI GD HY	0.47%	-0.88%	10.76%	8.53%	4.17%	5.40%
CEMBI BD	0.58%	1.61%	10.59%	10.69%	5.05%	5.14%
CEMBI BD IG	-0.22%	2.61%	11.50%	12.11%	4.67%	4.79%
CEMBI BD Non-IG	1.73%	0.23%	9.31%	8.73%	5.72%	5.59%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	1.35%	1.18%	19.94%	3.72%	13.35%	10.59%
1-3yr UST	-0.13%	0.56%	3.05%	4.45%	1.50%	1.32%
3-5yr UST	-0.47%	1.03%	5.17%	7.78%	1.79%	2.30%
7-10yr UST	-1.10%	2.72%	9.84%	13.99%	2.26%	3.77%
10yr+ UST	-2.56%	7.84%	19.68%	24.47%	3.85%	6.75%
10yr+ Germany	-1.82%	6.03%	17.36%	22.28%	4.17%	7.64%
10yr+ Japan	-2.21%	1.10%	6.60%	9.34%	2.05%	4.87%
US HY	0.37%	1.34%	11.42%	6.46%	6.25%	5.40%
European HY	-0.26%	1.11%	8.77%	4.25%	4.25%	4.32%
Barclays Ag	-0.91%	0.82%	6.43%	7.52%	1.56%	1.97%
VIX Index*	-9.27%	14.19%	-32.26%	42.08%	29.57%	5.58%
DXY Index*	0.22%	3.12%	3.07%	4.20%	3.84%	15.35%
CRY Index*	3.15%	-2.94%	3.48%	-9.96%	-5.69%	-36.92%
EURUSD	-0.52%	-3.81%	-4.66%	-5.55%	-2.71%	-13.43%
USDJPY	1.47%	-0.05%	-1.70%	-5.35%	6.42%	-1.65%
Brent	2.27%	-7.14%	14.87%	-25.29%	25.97%	-34.72%
Gold spot	-1.96%	5.75%	16.23%	25.36%	13.28%	23.37%

*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.

Ashmore

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

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