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Four important developments in China

By Jan Dehn

There have been four important developments in China. Argentina's presidential election goes to a second round as vanquished third-placed candidate Sergio Massa assumes the role of king-maker. The Law and Justice Party takes overall majority in Poland and must now reconcile promises made in a populist campaign with macroeconomic reality. Ivory Coast looks set to return Ouattara to power following peaceful fair elections. We also cover developments in Brazil, Mexico, Malaysia, Costa Rica, Venezuela, South Africa, Turkey and Saudi Arabia before discussing the implications of the ECB's strong signal to further ease in December, particularly for the Fed.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	0.39%
MSCI EM Small Cap	12.2	–	0.09%
MSCI Frontier	8.8	–	0.35%
MSCI Asia	11.6	–	0.76%
Shanghai Composite	13.0	–	0.62%
Hong Kong Hang Seng	7.5	–	1.79%
MSCI EMEA	9.8	–	-1.11%
MSCI Latam	13.3	–	0.23%
GBI-EM-GD	6.77%	–	-1.52%
ELMI+	4.26%	–	-0.78%
EM FX spot	–	–	-1.54%
EMBI GD	5.94%	384 bps	-0.03%
EMBI GD IG	4.69%	251 bps	-0.24%
EMBI GD HY	8.02%	609 bps	0.25%
CEMBI BD	5.91%	406 bps	0.36%
CEMBI BD HG	4.46%	259 bps	0.29%
CEMBI BD HY	8.47%	662 bps	0.48%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	2.09%
1-3 year UST	0.64%	–	-0.07%
3-5 year UST	1.41%	–	-0.25%
7-10 year UST	2.07%	–	-0.44%
10+ years UST	2.88%	–	-0.40%
US HY	7.82%	651 bps	0.57%
European HY	5.16%	526 bps	0.56%
Barclays Ag	–	227 bps	0.19%
VIX Index*	14.46	–	-0.59%
DXY Index*	96.89	–	1.96%
EURUSD	1.1028	–	-2.64%
USDJPY	120.98	–	1.24%
CRY Index*	193.71	–	-5.73%
Brent	48.1	–	-1.03%
Gold spot	1167	–	-0.31%

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

Emerging Markets

- **China:** Four important developments have taken place in China. Firstly, China completed the full liberalisation of bank interest rates by completely eliminating the ceiling on deposit rates. This was a target for 2015 and has been achieved ahead of schedule. Commercial banks can now compete to attract deposits. China has cleverly timed interest rate liberalisation to take place in an environment of falling inflation, so that real rates have risen in the context of declining nominal yields (see chart below). As China's economy becomes more consumption-driven, interest rates will become the single most important tool of macroeconomic control. This is also why China is developing its bond market, notably via the municipal bond market. With freely determined bank rates and bond yields, the People's Bank of China (PBOC) will be able to transmit its interest rate changes to the broader economy along the entire term structure. By eliminating the ceiling on deposit rates, China has shown once again that it has no intention whatsoever of changing the pace or direction of reform.

Fig 1: **China is raising real rates while nominal rates are falling: 5-year nominal and implied real government bond yields**

Source: Ashmore, Bloomberg.

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Emerging Markets

The second important development in China was that the PBOC cut interest rates by 25bps and reserve requirements by 50bps. China's economy is slowing on the back of deep reform efforts designed to rotate the economy from export to consumption led. The reforms create transitory uncertainty resulting in postponement of investment and consumption decisions. China has plenty of means of easing policy in order to support growth during this transition. This is a good environment for bonds. Five year government bond yields have fallen from 4.5% in early 2014 to 2.9%, but real rates remain significantly positive given China's inflation rate of just 1.6%. In a positive sign, house prices in China rose 0.5% in September, a similar rise to that recorded in August, while the number of cities with declining home prices fell to 17 from 23 (out of 70).

The third important development was that Britain and China took the first steps to set up a stock-connect scheme that would link the Shanghai and London stock exchanges. This is an extremely important and positive development. The UK government – far more so than the US government – appears to have understood China's importance as it opens its economy and the Renminbi (RMB) becomes a global reserve currency. This may be because London is the world's main hub for global currency trading. In a world flooded with QE money, exchange rate trading will only become more and more important. China's RMB has most to gain in this environment, because it is destined to become the next major global reserve currency. Unlike most of the existing reserve currencies, China is not printing money ad nauseum and it is certainly not shying away from reform. This guarantees the rise of the RMB and much of this rise will happen in London. China is therefore 100% right in focusing so strongly on the relationship with Britain in general and London in particular.

Finally, unidentified Chinese officials said last week that the IMF is close to final approval of the RMB's inclusion in the Special Drawing Right (SDR) basket. The US government recently dropped its political objections, leaving only a small number of technical criteria to be satisfied. This should not surprise too much. The value to China of becoming a global reserve currency is difficult to overstate. The plenum to adopt the 13th Five-Year Plan is likely to adopt 2020 as the target data for full dismantling of capital controls. This is not a pre-requisite for SDR inclusion.

- Elections: On Sunday, there were important elections in Ivory Coast, Poland and Argentina as well as local elections in Ukraine.
  - In Argentina, early indications suggest that opposition candidate Maurico Macri, whose pro-business policies have endeared him to sections of the market, did far better than expected in the first round of Argentina's presidential election. Specifically, he prevented a first round victory for Daniel Scioli, a candidate closely aligned with President Cristina Kirchner. A second round will now be held on 22 November, which will pit Macri head to head with Scioli. This means that the key question is now how the roughly 20% of voters who cast their ballot for third-placed candidate Sergio Massa, a former Cabinet Chief in the outgoing Cristina Kirchner administration, will vote. Macri clearly has momentum and Massa's break from the 'Kirchnerismo' camp of Peronism some years back was a messy one, so it cannot be ruled out that Massa will support Macri. This would be a very positive outcome. On the other hand, Massa is a Peronist, like Scioli, unlike Macri. In the end, this affiliation with Peronism could be the decisive factor that pushes Massa towards Scioli. After all, Peronism has usually managed to unify at times like these, though to do so this time Daniel Scioli may have to move decisively towards the centre and in so doing jeopardise the support he needs from supporters of Cristina Kirchner (about 25% of the electorate).
  - In Poland, the Law and Justice Party (PiS) won an outright majority. During the campaign, the PiS made very generous promises to voters, raising scepticism about a PiS victory in the market. Hence, the focus now shifts to how PiS will balance delivery of its promises to voters with maintenance of overall macroeconomic stability. In addition to promising generous increases in pensions and child allowance, members of the PiS have also exerted a great deal of pressure on the central bank with promises to place more dovish members on the central bank's monetary policy committee. In other news, retail sales and industrial production were softer than expected.
  - Voting in Ivory Coast's presidential election ran smoothly. Incumbent President Alassane Ouattara is expected to be re-elected on the basis of his sound economic leadership since the brief civil war in 2010.
  - In Ukraine, a local election in Mariopol, a strategic coastal town in Eastern Ukraine, was cancelled after alleged irregularities. Pro-Ukranian and pro-Russian political groups pointed the finger of blame on each other. Voting in the rest of Ukraine went smoothly. The outcome will provide a local snapshot of the popularity of the government of President Poroshenko following tough reforms.

- Brazil: The economy continues to weaken. Some 95,000 jobs were lost in September versus 61,600 job losses expected. The unemployment rate, however, remained unchanged at 7.6% as the participation rate declined. Labour market weakness is now pushing down real wages sharply. Year-on-year, real wages are now down 6.1%. The IPCA-15 inflation index clocked up 0.66% inflation in the first 15 days of October versus 0.68% expected. The current account balance continued to show major improvement on a yoy basis. September's

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current account deficit was USD 3.07bn, a bit wider than expected, but massively stronger than September 2014 when the deficit reached USD 8.4bn. FDI flows were also good – USD 6.04bn versus USD 4.5bn expected. Another marginally positive development was that September's Federal tax revenues reached BRL 95.2bn versus a forecast of BRL 94.0bn. Even so, the government is widely expected to further revise down its primary surplus target for this year. The central bank left rates unchanged at 14.25%, but dropped the objective of bringing inflation within the target range by the end of 2016. This reflects a weaker economy, which in turn results in more fiscal slippage and a weaker currency all of which work against normalisation of inflation. Even so, we expect significant declines in inflation in 2016 and going forward.

- Costa Rica: The Central American nation became the latest Emerging Markets (EM) country to rack up a better than expected external balance number. The trade deficit narrowed to 8.2% of GDP in January to September compared to 9.1% of GDP in the same period last year. Unlike many other EM countries that have experienced major currency depreciation versus the USD, Costa Rica uses the US dollar. The decline in the trade deficit was mainly due to falling energy import prices.

- Malaysia: The government launched the 2016 Budget with a marginally wider than expected fiscal deficit of 3.1% of GDP due to higher levels of spending on infrastructure as well as tax incentives to spur investment. Taxes on the highest income brackets plus Goods & Services Tax (aka Value added tax) will increase to cover the higher spending, so the overall level of fiscal slippage is minimal, in spite of lower oil prices.

- Mexico: Unemployment in September was lower than expected at 4.5% of the labour force compared to 5.1% in September last year. At the same time, the CPI index for the first half of October reached a new historical low of just 2.47% yoy. Mexico is experiencing an unspectacular goldilocks period of slowly improving growth (mainly due to domestic demand – retail sales were up 6.4% yoy in August versus 4.8% yoy expected) and extremely benign inflation. President Enrique Peña Nieto has proposed to link Mexican fuel prices to global prices starting in January 2016 instead of 2018. This would be good for both consumption and inflation as prices are currently controlled at 38% above world prices.

- Venezuela: The US government has held out the prospect of investigating PDVSA, the national oil company of Venezuela, for alleged corruption. This is a clear signal from the US to the Maduro administration that the former wants to see a free and fair election in December. If the opposition is allowed to secure its fair share of the votes in the election nothing is likely to come of these threats. On the other hand, if the Maduro administration is deemed to fiddle excessively or cancel the election the US government may push ahead with charges. Major bond maturities are coming due this month. Reserves have recently declined sharply. We believe this is because the government has set aside money to make the debt service payments. The next major hump in debt service will be in Q1 2016.

- South Africa: The government passed a budget with a narrower fiscal deficit target for 2015/2016 of 3.8% of GDP than current fiscal year's target of 3.9% of GDP. The 2015/2016 fiscal deficit target will further decline to 3.3% of GDP. The market reacted negatively due to exaggerated expectations for the rate of improvement. We think the concerns are overblown.

- Turkey: CHP, a leading opposition party, increased its share of voting intentions by 5% to 30.4%, while the AKP received 40.9% of voting intentions, according to a new poll. This points to a possible coalition after Turkey's parliamentary election scheduled for 1 November. The central bank left rates unchanged, but the accompanying rhetoric was marginally more hawkish than expected.

- Saudi Arabia: The Chairman of the Capital Market Authority, Saudi Arabia's main regulator, has said that the country will be open to further relaxing its rules on foreign participation in the stock market.

Snippets:

- Colombia: The trade deficit was USD 1.4bn in August versus USD 1.3bn expected. Retail sales rose at a robust 5.4% yoy rate in August, more than twice the rate expected (2.6% yoy). Industrial production also rose more than expected.
- Hungary: The central bank left rates unchanged at 1.35%.
- Nigeria: Former central bank governor Lamido Sanusi has called on the central bank to devalue the Naira. Sanusi, one of the best policy makers in recent Nigerian history, is absolutely right. Nigeria has so far failed to make the necessary adjustments to lower oil prices.
- South Korea: Exports in the first 20 days of October surprised to the downside resulting in a narrower trade surplus.
- Taiwan: Export orders declined far less than expected in September (-4.5% yoy versus -11.4% yoy anticipated) due to stronger exports of consumer electronics, such as tablets and mobile phones.
- Thailand: In September, exports were stronger than expected, while imports dropped more than expected. As a result, the trade balance shot higher to USD 2.8bn from USD 0.7bn in August. The market had expected a trade surplus of just USD 1.1bn.

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Global backdrop

ECB gave a clear signal that it intends to 'extend and expand' the central bank's easing operations starting in December. The last time the ECB made a similar signal – H2 2014 – it did so as a pre-emptive move ahead of an expected Fed hike in Q1 2015 (which never materialised, instead the European economy picked up). The same motivation appears to be behind ECB easing call this time as the Fed continues to signal its intention to hike in December of this year. ECB President Mario Draghi did not rule out negative interest rates either. US stocks reacted positively, clawing themselves back to flat for the year, also aided by China cutting rates. But the Fed now faces the problem that its excuse for not hiking rates in September – global weakness – becomes less credible after these easing moves. Speculation about a not so distance hike could therefore soon begin to weigh on markets, with the immediate focus being this week's (October) FOMC meeting. A growing possibility of near-term rate hikes could bode poorly for US stocks, not least because hikes would push the US dollar higher and hurt growth. In our view, the real reason for the Fed's reluctance to hike was not empathy with the rest of the world, but concern that the strong US dollar is hurting American trade, particularly against the backdrop of fairly unexciting domestic growth.

As for the US economy, high frequency economic data was mixed to marginally positive. The Markit PMI rose to 54 in the flash October report from 53.1 in September and housing starts rose. Leading economic indicators, however, fell more than expected (-0.2% mom versus -0.1% mom anticipated). The US Treasury cancelled a two-year note auction for fear that a failure to raise the debt ceiling by 3 November could make impossible to service bonds. In Europe, Credit Suisse, an investment bank, announced that it will no longer act as primary dealer in Europe. This will reduce liquidity in the European bond market, which is clearly regressive, particularly at this point in the financial cycle, where bond are trading at or near the pinnacle of a 30 year rally in global fixed income.

In Portugal, Anibal Cavaco Silva, Portugal's constitutional president, refused to appoint a left-wing coalition government despite the coalition's absolute majority in the Portuguese parliament. It has been reported that this is because the coalition contains Eurosceptical parties. This is not the case. Democracy remains alive and well in Portugal. The country's Constitution requires the president to appoint a 'stable' majority. In this particular case, the left-wing majority in the parliament was formed by three parties that had such completely different ideas that they were unable to commit to an agreed set of policies. The President therefore had no choice but to appoint the biggest party to form the Executive, albeit as a minority administration. This is standard procedure in most parliamentary democracies.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	9.75%	-7.01%	-9.05%	-1.82%	-1.99%
MSCI EM Small Cap	7.54%	-2.84%	-6.12%	1.67%	-1.44%
MSCI Frontier	1.71%	-12.14%	-19.96%	6.70%	1.84%
MSCI Asia	10.40%	-3.24%	-2.37%	3.58%	2.04%
Shanghai Composite	11.80%	7.15%	50.55%	20.41%	5.32%
Hong Kong Hang Seng	14.21%	-7.61%	6.10%	3.85%	-0.97%
MSCI EMEA	8.78%	-4.84%	-13.06%	-5.75%	-4.28%
MSCI Latam	8.41%	-23.03%	-29.04%	-14.96%	-11.56%
GBI EM GD	4.91%	-10.73%	-17.02%	-7.37%	-2.90%
ELMI+	2.89%	-4.81%	-9.89%	-4.33%	-2.62%
EM FX Spot	2.81%	-13.97%	-20.38%	-11.60%	-8.81%
EMBI GD	2.96%	2.89%	1.08%	2.00%	5.04%
EMBI GD IG	3.08%	0.93%	0.57%	1.09%	4.25%
EMBI GD HY	2.79%	5.53%	1.12%	3.32%	6.22%
CEMBI BD	2.24%	3.10%	1.12%	2.97%	4.64%
CEMBI BD HG	1.55%	2.73%	2.01%	3.08%	4.87%
CEMBI BD HY	3.42%	3.66%	-0.95%	2.85%	4.28%

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Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	8.19%	2.47%	8.60%	16.08%	14.27%
1-3 year UST	0.00%	0.95%	0.80%	0.59%	0.71%
3-5 year UST	-0.18%	2.51%	2.34%	1.57%	1.65%
7-10 year UST	-0.33%	3.21%	4.24%	2.10%	4.13%
10+ years UST	-0.25%	0.21%	5.86%	3.17%	7.51%
US HY	2.64%	0.32%	-2.11%	4.21%	6.79%
European HY	2.37%	2.54%	3.36%	8.28%	9.74%
Barclays Ag	0.88%	0.58%	1.45%	3.00%	4.37%
VIX Index*	-40.98%	-24.69%	-10.24%	-18.81%	-28.49%
DXY Index*	0.56%	7.33%	13.01%	21.00%	24.68%
CRY Index*	-0.03%	-15.76%	-28.31%	-34.74%	-35.70%
EURUSD	-1.33%	-8.84%	-13.15%	-14.76%	-20.43%
USDJPY	0.92%	1.00%	12.21%	51.89%	48.57%
Brent	-0.54%	-16.08%	-44.14%	-56.08%	-42.49%
Gold spot	4.67%	-1.45%	-4.85%	-31.79%	-12.93%

*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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